Representation on Notification in Official Gazette under section 90 in view of judgement of Hon'ble Supreme Court on Most Favoured Nation (MFN) clause

Background

Meaning of MFN Clause and litigation issues before the Hon'ble Supreme Court ('Hon'ble SC') in case of Nestle SA[1]

(i) Double Taxation Avoidance Agreements ('DTAAs') are generally supplemented with 'Protocols' which operate as an addendum to DTAA. The Protocols to India's DTAA with certain countries, which are members[2] of Organisation of Economic Cooperation and Development (OECD), have a Most Favoured Nation (MFN) clause which provides that if after the signature/entry into force of the tax treaty with the first State (original treaty), India enters into a DTAA on a later date with the third State, which is an OECD member, providing a beneficial rate of tax or restrictive scope for taxation of dividend, interest, royalty, Fees for Technical Services etc. the same benefit should be accorded to first State.

(ii) This issue has been a matter of litigation in India. Hon'ble Delhi High Court (HC) in case of Concentrix Services and Optum Global's case (W.P.(C) 9051/2020 and W.P.(C) 882/2021, CM Appl. 2302/2021 respectively) extended the benefit of lower withholding tax rate of 5 percent on dividend provided in the India-Slovenia DTAA by invoking the MFN clause under India-Netherlands DTAA.

(iii) This decision was subsequently followed by various courts in cases like

a) *M/S Nestle SA versus Assessing Officer Circle (International Taxation)-2(2)(2), New Delhi (W.P.(C) 3243/2021),*

b) *Deccan Holdings BV vs Income Tax Officer &ANR (W.P.(C) 14602/2021)*

c) *Cotecna Inspection SA Vs Income Tax Officer Ward International Tax (W.P.(C) 14602/2021)*

where courts allowed the benefit of lower withholding rate pursuant to MFN clause to taxpayers. Further, countries like Netherlands, France, Switzerland have issued clarifications suggesting that in their understanding MFN clause has automatically resulted in benefit basis operative favourable treaties including with members which attained OECD membership later to their signing of treaties with India.

(iv) Further, Hon'ble Delhi HC ruling in *Steria (India) Ltd. Vs Commissioner of Income Tax (W.P.(C) 4793/2014 & CM APPL. 9551/2014)* invoked the MFN Clause in the Protocol to India-France DTAA to grant the benefit of a restricted provision of Fee for Technical Services contained in India-UK DTAA by virtue of the 'make available clause'.

(v) Due to lack of guidance in Indian context, representations were made before Indian tax authorities seeking clarification on India's stand on application of MFN clause. Considering the same, the CBDT issued the Circular No. 3/2022, dated 3 February 2022 clarifying its position.

[1] Assessing Officer Circle (International Taxation) vs. M/s Nestle SA, 2023 INSC 928 [Civil Appeal No(s). 1420 of 2023]
[2] Illustratively, Netherlands, France, Switzerland, Sweden, Spain, Hungary

(vi) Vide the aforesaid circular, it has been clarified that the third State must be a member of OECD both at time of conclusion of the DTAA with India as well as at the time of applicability of the MFN clause. Further, a notification under the provisions of Income Tax Act, 1961 ('the Act') was required to implement the provisions of DTAA as also any amendments to DTAA. However, it is a well settled principle that the any circular or instruction issued by CBDT is binding on the tax authorities but not on courts who are discharging judicial functions and therefore the provisions of MFN clause continued to be the subject matter of debate.

Summary of the Judgement of SC in case of Nestle S.A.

(i) The issue of availability of beneficial provision of MFN clause has been settled by the Hon'ble SC in a batch of appeals with the lead case being of Assessing Officer Circle (International Taxation) vs. M/s Nestle SA, 2023 INSC 928 [Civil Appeal No(s). 1420 of 2023] wherein the Hon'ble SC adjudicated on two issues: a) whether MFN clause is to be given effect to automatically upon occurrence of a "trigger event" (namely, the date when India enters into DTAA with a third state granting a beneficial treatment) or through a notification issued by the Government; and b) whether there is any right to invoke MFN clause with respect to provisions of the third country with which India has entered into DTAA, which was not a member of the OECD at the time of entering the DTAA.

(ii) In this regard, the Hon'ble SC ruled that in order to give effect to a DTAA or any Protocol changing its terms or conditions, which has the effect of altering the existing provisions of the Act, notification under Section 90(1) of the Act is necessary and mandatory. Further, it has been held that the benefits arising from DTAA pursuant to the MFN clause contained therein are essentially inert and non-binding, unless officially notified by the government. Unlike other countries, mere signing or ratification of a treaty does not become enforceable in India, as exclusive power to legislate the treaties entered by India lies with the Parliament. Even with reference to MFN clause already agreed as part of existing treaty, the beneficial provisions entered into with third country cannot be made applicable unless a notification is issued.

(iii) On the aspect of the time period when a third country should be an OECD member in order to apply the beneficial treatment accorded to such country by invoking the MFN clause, the SC held that the expression 'is' in the sentence 'third state which is a member of OECD' of MFN clause, has a present significance and derives the meaning from the context. Therefore, if a party seeks to avail the beneficial treatment based on existence of DTAA between India and another third country which is an OECD member state, the relevant date for evaluating OECD membership is the initial date on which treaty containing MFN clause was signed, and not any subsequent date when that third country becomes an OECD member.

(iv) This is a significant ruling in the context of interpreting Indian tax treaties. The decision is likely to affect claims that non-resident taxpayers have made regarding restrictive source taxation of interest, royalties, fees for technical services (FTS), dividends, etc. by relying on the MFN provisions and its scope as understood by lower courts. As a binding SC decision, the ruling may potentially impact all pending assessments and related proceedings irrespective of the stage of the dispute.

Issues under consideration and our recommendations

We have bifurcated issues and our recommendations into 2 categories viz.

- Category A: Application of automatic MFN clause in DTAA with first state and
- Category B: Taxation of dividends on account of subsequent accession of third state to OECD

Category A: Application of automatic MFN clause

Issue:

(i) As stated above, the first issue before SC was whether MFN clause in the treaty with the first state is to be given effect to automatically or through a notification issued by the Government even where the duly notified treaty with the first state contains MFN clause which is automatic i.e. which grants same benefits as third country treaty which is a OECD member on the date of signing third country treaty, without the need for any further intimations or negotiations by competent authorities. (E.g., Netherlands, Sweden, Hungary, France, Spain, Belgium). For instance, MFN clause in protocol to India-France treaty states as follows:-

> *"7. In respect of articles 11 (Dividends), 12 (Interest) and 13 (Royalties, fees for technical services and payments for the use of equipment), if under any Convention, Agreement or Protocol signed after 1-9-1989, between India and a third State which is a member of the OECD, India limits its taxation at source on dividends, interest, royalties, fees for technical services or payments for the use of equipment to a rate lower or a scope more restricted than the rate of scope provided for in this Convention on the said items of income,* ***the same rate or scope as provided for in that Convention, Agreement or Protocol on the said items income shall also apply under this Convention, with effect from the date on which the present Convention or the relevant Indian Convention, Agreement or Protocol enters into force, whichever enters into force later****."*

(ii) As per SC ruling, for MFN clause to come in effect, a separate notification for the same under Section 90(1) of the Act needs to be issued by the Government. The above ruling states that no automatic treaty benefit is available to NR's/foreign companies, unless a notification in this regard has been issued in India.. This is applicable even for a treaty which contains automatic MFN clause as above.

(iii) This would have wide ranging ramifications on cases where MFN benefit under various tax treaties have been claimed in the past based on automatic MFN clause.

(iv) It is relevant to note that the first ruling on this issue was rendered in by Kolkata Tribunal in the case of DCIT vs. ITC Ltd. (2002) 82 ITD 239 (Cal) which held that no fresh notification is required to apply automatic MFN clause in the India-France DTAA. This ruling appears to have been accepted by the Tax Department since it was not agitated further before the Kolkata High Court (even though the tax effect involved was well above the monetary limits for not filing appeals). There was solitary AAR ruling in the case of Steria (India) Ltd. (2014) 364 ITR 381 (AAR) which held that a fresh notification is required to apply automatic MFN clause but this was reversed by Delhi HC in (2016) 386 ITR 390 (Del) which held that it is not necessary to notify the protocol to India-France DTAA and it is also not necessary to notify the

DTAA with the third state for MFN benefit to become effective. All other Tribunal and Delhi HC rulings favoured the taxpayer.

(v) The payers located in India, who have bona fide deducted and deposited withholding tax at lower rates by considering the MFN benefit supported by multiple favourable rulings, may face demands of tax and interest under Section 201 of the Act. Indian headquartered multinational corporations (as payers) are also adversely impacted by this ruling, specifically those that have international transactions with countries with whom India has DTAAs that contain the automatic MFN clause.

(vi) Additionally, the possibility of past assessment proceedings being re-opened as a result of this ruling could generate further uncertainty and potential liabilities.

(vii) This ruling, if applied in a retrospective manner by the tax administration, could negatively impact the investment environment in India. The additional burden on account of tax and interest could potentially discourage foreign companies from investing or continuing their operations in the country.

(viii) As you may appreciate, the judgment highlights the crucial role that the Government plays in international tax matters by notifying beneficial provisions of DTAAs with third states, and by ensuring timely notifications, we can delay or resolve potential legal challenges concerning the enforcement of MFN clauses in DTAAs. At Annexure A is a list of illustrative treaties containing automatic MFN clause which are impacted because no notification has been issued till date.

(ix) At the root of the controversy is absence of notification for clarifying the benefit of automatic MFN clause which was intended by the treaty negotiators to take effect from the date of "trigger event". Therefore, all the adverse implications for past years can be avoided if the Central Government notifies the effect of automatic MFN clause from date of trigger event from which they were intended to be applied by treaty negotiators of both countries. It will put the entire controversy to rest and avoid any adverse actions for past years.

Recommendations:

(i) To address the situation, it is, therefore recommended, to collate the list of tax treaties contain automatic MFN clause (Refer illustrative list at Annexure A) and notify the same in Official Gazette from date of trigger event (from which they were intended to be applied by treaty negotiators of both countries).

(ii) The Notifications may be on lines of those notified for, illustratively:

- Canada (where treaty benefit was granted retrospectively for any contract signed after 12 December 1988, vide a notification issued on 24 June 1992) and
- France (where treaty benefit was granted retrospectively from 1 April 1995 for interest, and from 1 April 1997 for dividends, vide a notification issued on 10 July 2000) and
- Netherlands (where treaty benefit was granted retrospectively from 1 April 1997 for dividends and interest, vide a notification issued on 30 August 1999).

More particularly, in context of France, the restrictive condition of “make available” for fees for technical services (FTS) may be notified on lines of India-US treaty signed on 12 September 1989 (when USA was a member of OECD) & entered into force on 18 December 1990 or India-UK treaty signed on 25 January 1993 (when UK was OECD member) & entered into force from 26 October 1993. Such notifications may clarify the retrospective dates (being the dates of trigger event) from which such restrictive condition applies. This will regularize the past positions adopted by the payers & payees and preempt any action by field authorities for past years either for recovery of shortfall of TDS and/or interest u/s. 201(1A) or 234B/C or s.220. It will also clear the ambiguity for future years. The CBDT can also issue a clarificatory Circular post issue of such Notification directing field authorities not to take any coercive action for past years.

While issuance of Notifications may take time, in the interests of taxpayer certainty, such intention of regularizing past transactions through a retrospective Notification may be communicated upfront with a view to clear the present uncertainty amongst taxpayers.

(iii) It would provide certainty and transparency for both Indian and foreign entities involved in cross-border transactions and adopting such measures would reflect the government's commitment to fostering an equitable tax environment.

(iv) The above would enable the taxpayer to mitigate the procedural issues with respect to imminent litigations and reduce consequential penalties.

Category B: Taxation of dividends on account of subsequent accession of third state to OECD

Issue:

(i) The second issue before SC was application of lower dividend withholding rates on dividends paid to residents of Netherlands, France and Switzerland based on MFN clause in those treaties and lower rates in treaties with Slovenia, Lithuania and Colombia which became OECD members subsequent to India signing treaties with them. The SC held that since Slovenia, Lithuania and Colombia were not members of OECD on date of signing treaties with India, the benefit of MFN clause linked to favourable treaty signed with OECD country cannot be granted. The SC reversed the Delhi HC rulings, illustratively, in the case of Concentrix Services Netherlands B.V. (2021) 434 ITR 516 (Del.) in this regard which were in favour of taxpayer.

(ii) Based on favourable Delhi HC rulings, many Indian companies had granted benefit of lower dividend withholding tax rate to shareholders of countries with MFN clause. The adverse SC ruling will make them liable for recovery of TDS shortfall and interest u/s. 201(1A).

(iii) Having regard to SC ruling, the Tax Department's right to recover the shortfall of tax from the payer or payee cannot be disputed. However, the issue of concern for the payers and payees is levy of interest u/s. 201(1A) and initiation of penalty proceedings.

(iv) In this regard, it is relevant to note that CBDT Circular No. 11/2017 dated 24 March 2017 provides for guidelines for waiver of interest u/s. 201(1A). Similarly, CBDT Order No. F No. 400/129/2002-IT(B) dated 26 June 2006 provides for guidelines for waiver of interest u/s. 234A/B/C. The hurdle in making applications for waiver of interest under these guidelines is that they provide relief only where the tax payment shortfall is attributable to favourable jurisdictional High Court ruling. Not all dividend paying companies may be covered by jurisdictional Delhi HC rulings which were in favour of the taxpayer.

However, there are decisions of Gujarat HC[3] wherein HC held that circumstances prescribed in CBDT order for interest waiver are illustrative and even in absence of jurisdictional HC ruling, the case is capable of being considered for waiver. For instance, in Devarsons (P.) Ltd. v. U.P. Singh [2006] 284 ITR 36 (Guj.), the position of non-taxability was taken in return of income on the basis of favourable ITAT decision in taxpayer's own case, which came to be overruled by a retrospective amendment, and HC granted waiver despite absence of favourable jurisdictional HC ruling in taxpayer's favour.

(v) Thus, the removal of condition of favourable jurisdictional HC ruling in the above referred guidelines for waiver of interest will remove any doubts in the minds of the field authorities to waive the interest for taxpayers outside the Delhi HC jurisdiction.

(vi) The current Government has been very sensitive to India's image as an attractive investment decision not getting impacted by any adverse tax policy. Specific legislative amendments were brought in the income tax law in 2021 to provide for closure of pending litigation on retrospective amendments on indirect transfer. The

[3] Refer, Devarsons (P.) Ltd. v. U.P. Singh [2006] 284 ITR 36 (GUJ.) and Bhanuben Panchal and Chandrikaben Panchal [2004] 269 ITR 27 (Guj.)

above referred measures do not require any legislative amendment and can be easily implemented through Notifications and Circulars to be issued by CBDT. But it will bring out similar boost to India's investment image as the amicable closure of retrospective indirect transfer related controversy.

Recommendations:

(i) CBDT Circular No. 11/2017 dated 24 March 2017 and CBDT Order No. F No. 400/129/2002-IT(B) dated 26 June 2006 may be modified to remove the condition of existence of favourable jurisdictional HC ruling to avail waiver of interest u/s. 201(1A) and s.234A/B/C.

(ii) To ensure seamless collection of tax demands, payers may be permitted to file a revised TDS return without payment of interest and penalties. Once right amount of TDS is paid as reflected in revised TDS return, payees may be absolved from further compliance or alternatively be permitted to file an updated return for all past AYs, without payment of additional taxes or interest and consequential immunity from penalty and prosecution. The payee may also be given an assurance that their assessments shall not be reopened on this account as long as the relevant taxes are deposited by the payers or by the payees themselves. For this purpose, a time limit up to 31st March 2025 may be provided to avail the benefit of automatic waiver of interest and penalty and immunity from initiation of reassessment proceedings.

Annexure A - List of benefits which can get impacted and DTAAs which can get impacted:

Nature of benefit for royalty/FTS	**DTAAs impacted**
Lower rate of 10% with respect to FTS/royalty income due to say India-Germany DTAA	Spain
Make available clause for FTS	France, Hungary, Sweden, Spain, Belgium
No equipment royalty pursuant to India-Sweden DTAA	Hungary, France, Spain

Interest related benefit	**DTAAs impacted**
Interest arising in India shall be exempt from tax if the same is paid by the Government or local authority of India virtue of India-Italy	Netherlands, France, Hungary, Sweden
India-Ireland/Denmark - restricts source country from taxing the interest on loan extended or **guaranteed or insured** by the Government, a political sub-division, a statutory body or a local authority	France, Hungary, Sweden