

Interpretation of most favoured nations clause - Impact on non-residents and action points

The Dbriefs Corporate Income Tax series

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Agenda

- Understanding the foundation of the Apex court's ruling.
- Unpacking the reversal of Lower court's stance.
- Assessing implications and practical challenges for foreign taxpayers.
- Exploring the path forward for foreign taxpayers.
- Questions and answers.

Background

Background

India has entered into a Double Taxation Avoidance Agreements ('DTAA') with several countries; Most Favoured Nation Clause ('MFN') included in protocol

As per MFN, if India, in a separate DTAA with a third country (which is an OECD member), agrees for a lower or limited scope of taxation, that beneficial tax treatment will apply to India's original treaty partner

Rationale for granting MFN treatment –

- Economic, i.e. own subjects not economically disadvantaged vs. third States
- Similar provisions under World Trade Organization (WTO) requirement

Scope of MFN

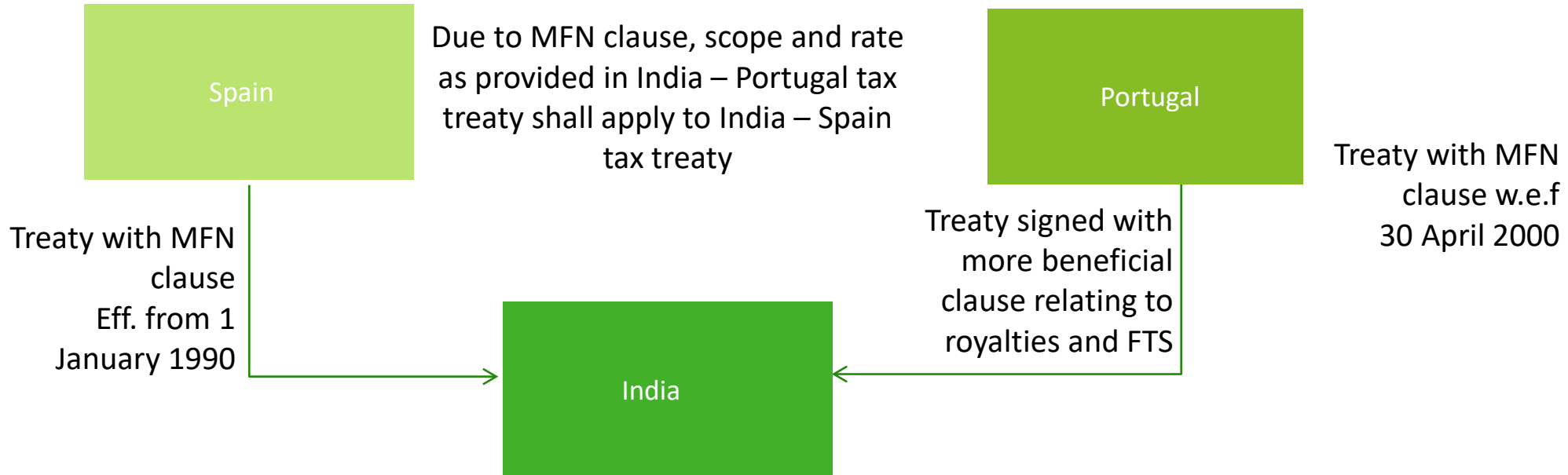
- Restricting rate of tax and / or scope of taxing royalties, fees for technical services, dividend, interest
- Restricting taxability of business profit (i.e., relaxing limitation on deductibility of executive and general administration)
- Restricting taxability of profits from air transport and shipping operations
- Favorable or effective arrangement of exchange of information

Indian DTAA with MFN clause [illustrative]

Belgium
Finland
France
Hungary
Netherlands
Spain
Sweden
Swiss Confederation
United Kingdom

Background

MFN tax treaty illustration –



Points to note –

- The date of applicability of the MFN clause i.e. date of agreement or date of entry into force or date of effective date or any other specified date
- Reference made to the third country convention, agreement, protocol i.e. OECD or non-OECD

Story so far

Story so far

Vis-à-vis fees for technical services (Steria India)

AAR (2011)

[Favour of revenue]

Protocol / MFN cannot be treated as forming part of the DTAA; notification by Indian Government [under Section 90 of the Income-tax law] mandatory to apply Protocol / MFN

High Court (2016)

[Favour of taxpayer]

Protocol / MFN considered as part of the DTAA itself and does not have to be separately notified for application of MFN clause

Vis-à-vis dividend income (Concentrix Services Netherlands BV, Optum Global Solutions International BV and Nestle SA)

Income-tax authorities (2020/2021)

[Favour of revenue]

Lower tax withholding application rejected by tax authorities; ruled tax rate applicable is 10% and not 5%

High Court (2021)

[Favour of taxpayer]

Protocol / MFN considered as part of the DTAA itself and does not have to be separately notified for application of MFN clause. Third country should be OECD member at the time of applying the MFN and not signing of the DTAA

***Authority for Advance Ruling (AAR)*

Indian Central Board of Direct Taxes via Circular no 3/2022 dated 3 February 2022, clarified following with regards to the MFN clause and its application in context of Indian tax treaties

- Third country which includes the lower tax rate / restricted scope, should be an OECD member country on the date of the signing of its tax treaty with India
- A notification under Section 90 of the Income-tax law is mandatory for Protocol / MFN to apply
- Unilateral decree/ bulletin/ publication do not represent understanding of the treaty partners on applicability of the MFN clause

Snapshot of Judgement

Snapshot of judgement

- On October 19, 2023, the Apex Court of India delivered a judgment that **significantly impacts the interpretation and application of the Most Favored Nation (MFN) clause within the context of Indian tax treaties.**
- The judgement primarily focuses on evaluating two streams of income, namely –

Case parties	Income subject to discussion
Steria India [India-France DTAA**]	Fees for Technical Services and applicability of MFN clause to limit the scope of taxing FTS. This limitation specifically pertains to the "make available" requirement in India's tax treaties with other countries pursuant to which the tax rate was reduced from 10% to 0%
Concentrix Services Netherlands BV Optum Global Solutions International BV [India-Netherlands DTAA**]	Applicability of a beneficial 5% tax withholding rate on dividend income pursuant to application of MFN clause in the respective tax treaties. This lower tax rate is derived from India's tax treaties with countries like Lithuania, Colombia, and Slovenia
Nestle SA [India-Switzerland DTAA**]	

**Double Taxation Avoidance Agreement (DTAA)

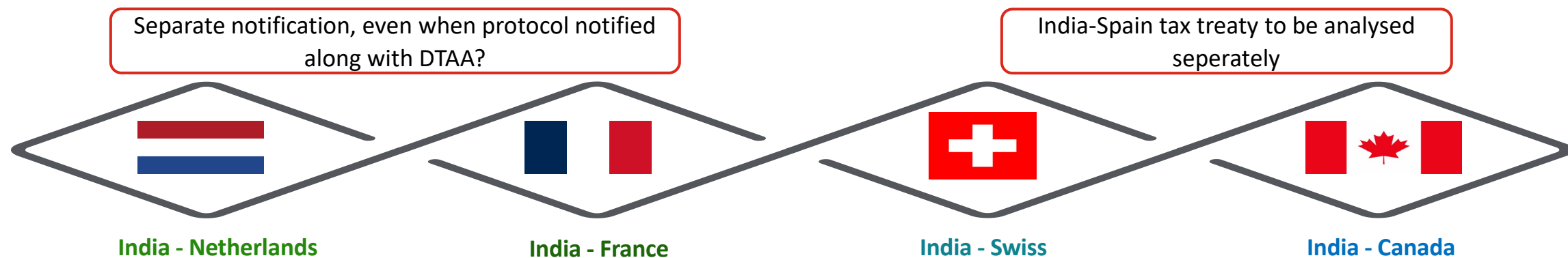
Snapshot of judgement

Held in **favour of revenue department**, as follows –

- Notification under Section 90(1) mandatory for a court, authority or tribunal to give effect to a DTAA / protocol (including MFN) which effects the provisions of Indian tax law
- “.....If after the signature of this convention under any Convention or Agreement between India and a third State which is a member of the **OECD**....”
- Interpretation of expression “is”; third-party country to be an OECD member at the time of entering the DTAA with India. The fact that the third-party country becomes an OECD member subsequently does not automatically result in application of MFN
- In such event, the terms of the earlier tax treaty require to be amended through a separate notification under section 90 of the ITA

Snapshot of judgement

India-Netherlands DTAA	<p>Other DTAA's subsequently signed with beneficial rates – India – Germany, India – Sweden, India-Switzerland, and India-USA</p> <p>Earlier dates of convention did not result in India automatic extension of benefit of Article IV of Protocol to India Netherlands</p>
India-France DTAA and Protocol	<p>Other DTAA's subsequently signed with beneficial rates – India-USA, India -Germany</p> <p>Omission of certain benefits (available to other members countries of OECD who entered DTAA's with India) in subsequent notification dated 10 July 2000, another indication 'trigger' event India granting favourable relief to country per se does not cover all benefits</p>
India-Switzerland DTAA	<p>Second Protocol required negotiations whereas third Protocol such requirement was only for restriction of scope but not for lower rate</p> <p>Requirement of notification of the Protocol and a separate amending Protocol is necessary</p>
India-Canada DTAA	<p>A separate notification was issued</p>



Practical challenges

Practical challenges

Vis-à-vis foreign taxpayers (Recipients)

Before Apex Court judgement

- MFN clause applied automatically
- FTS income not offered to tax by taking shelter from the 'make available' clause under MFN
- Dividend income offered at 5%
- Interest on income-tax refund claimed exempt
- No return of income filed in India where no tax payable in India pursuant to MFN



Post Apex Court judgement

- MFN cannot be applied automatically unless notified
- FTS / interest income on refund now taxable in India even though benefit available under protocol (until protocol and relevant MFN clause is notified)
- Dividend income to be offered without taking benefit of MFN

Vis-à-vis past

- Order to apply retrospective or prospective?
- Risk of re-opening past positions? Can this be a change in opinion?
- Should claim be withdrawn in open assessments?
- Interest and Penalty implications for past positions?
- Provision required to be in books for past taxes?

Vis-à-vis present and future

- Advocacy measure and MAP procedure?
- Position to be adopted in return of income? i.e., offer income to tax without MFN benefit or wait for advocacy measure
- File return of income absence MFN clause?
- Excess tax cost pursuant to withholding? Will it be borne by Indian payer or non-resident payee?
- Will home country give credit of entire tax paid in India or limit as per the MFN clause?

Practical challenges

Vis-à-vis Payers

Before Apex Court judgement

- MFN clause applied automatically
- Tax withholding as per MFN clause; for example, dividend income taxed at 5%, FTS income not subject to tax withholding taking shelter of 'make available' clause



Post Apex Court judgement

- MFN cannot be applied automatically unless notified
- Indian resident payers to now withhold taxes without providing the benefit of MFN (until notified)

Vis-à-vis past:

- Judgement to apply retrospective or prospective?
- Risk of re-opening past positions - disallowance of expenses for non-tax withholding? Can this be a change in opinion?
- Should claim be withdrawn in open assessments
- Penalty implications for past positions?
- Provision required to be in books for past taxes?

Vis-à-vis present and future:

- Advocacy measure?
- Should Indian payers begin withholding tax in the absence of MFN notification?
- Excess tax cost pursuant to withholding? Will it be borne by Indian payer or non-resident payee? Impact on grossed up contracts?

Polling question 1

Does this judgment impact you with increased compliances and / or taxation?

- Yes
- No
- Partly impacted

Practical challenges

Tax treaties impacted		
Country	Item of income under MFN	Impact of the judgement [Illustrative]
Belgium	Royalty/ FTS	FTS
France	Dividend, Interest, Royalty, FTS	Dividend, Interest, FTS
Netherlands	Dividend, Interest, Royalty, FTS	Dividend, Interest
Spain	Royalty/ FTS	FTS
Sweden	Dividend, Interest, Royalty, FTS	Dividend, Interest, FTS
Swiss Confederation	Dividend, Interest, Royalty, FTS	Dividend
Hungary	Dividend, Interest, Royalty, FTS	Dividend, Royalty

Way forward for dividend as well as other streams of income

- Review previous years positions
- Consider positions to be adopted going forward

Question and answers

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