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'MOST FAVORED NATION' CLAUSE IN TAX TREATIES, NOT AUTOMATICALLY FAVORABLE

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In a significant judgment that can have far-reaching ramifications concerning interpretation of Double Taxation Avoidance Agreements (DTAA), the Supreme Court of India, in a group of matters titled as *Assessing Officer Circle (International Taxation) vs. M/s Nestle SA,* 2023 INSC 928 *[Civil Appeal No(s). 1420 of 2023],* ruled that the benefits under the Most Favored Nation (MFN) clause under DTAAs can be availed only if the same has been separately notified by the Central Government.

Background

Under a DTAA, the contracting nations agree on allocation of taxation rights for specific categories of income. DTAAs are often accompanied by 'Protocols', which operate as an addendum to the DTAA. The Protocols to India's DTAAs with certain countries contain an MFN clause which, *inter-alia,* provides for lowering the tax rate on income streams like dividends, interest, royalties or fees for technical services (FTS), or restricting the scope of taxation of such income stream in the Relevant DTAA, similar to a subsequent concession given to another OECD member country. India's DTAAs with Netherlands, France and Switzerland (Relevant Countries) contain MFN clause (Relevant DTAAs).

Subsequent to signing the Relevant DTAAs, India entered into DTAAs with Slovenia, Lithuania, and Colombia (New OECD Countries) in 2005, 2012 and 2014 respectively which, amongst other things, provided for a lower rate of taxation for dividend income. Notably, these countries became members of OECD post signing their DTAAs with India (i.e., in 2010, 2018 and 2020 respectively). As these New OECD Countries were not OECD members on the date when the Relevant DTAAs were entered into, an ambiguity arose regarding the relevant date as on which the OECD membership status of the New OECD countries is to be tested in order to benefit from the MFN clause contained in the Relevant DTAAs - whether the date on which the DTAA with New OECD countries was signed; or whether the date on which the MFN clause contained in a Relevant DTAA is invoked, or both.

The Hon'ble Delhi High Court (please see our Ergo in the past had held that OECD membership is to be tested on the date when the MFN clause is being invoked. Further, it also held that no separate notification was required to give effect to the lower tax rate benefit (pursuant to application of the MFN clause), as the Protocol providing for such clause forms an 'integral part' of the Relevant DTAAs and hence applies automatically. Notably, thereafter, the Central Board of Direct Taxes (CBDT) issued a Circular No. 3 of 2022 (MFN Circular) in relation to the interpretation of MFN clauses in DTAAs (please see our Ergo).

Revenue authorities challenged these High Court rulings before the Supreme Court.

Contentions of the parties at Supreme Court

The Taxpayers sought to avail the lower tax rates under the Relevant DTAAs on the basis of the following main arguments:

a) The Relevant DTAAs and the Protocols (including the MFN clause) were already notified by the Government and consequently in force. Hence, a separate notification for a self-operative MFN clause contained in a Protocol was not required.

b) The language in the Relevant DTAAs does not mandate any fresh negotiations or notification for application of the MFN clause (unlike the MFN clause in India-Finland or India-Philippines DTAA, or Article 7(3) of the India-Netherlands DTAA.)

c) Since the taxpayer needs to be a tax resident of the Relevant Countries in the year in which a tax treaty benefit is availed; the phrase *'is a member of OECD'*, as it appears in the MFN clause of the Relevant DTAAs, should also mean that the New OECD Countries need to be OECD members when the MFN clause is invoked.

d) Executive decrees issued by Swiss, French, and Dutch authorities have clarified with respect to the automatic application of the MFN clause and the Indian Government is also required to extend the reciprocity to the taxpayers.

Conversely, the main arguments of the tax authorities were:

a) India follows a 'dualist approach' wherein a favorable tax regime is integrated into a DTAA through enabling legislation (such as a notification). Without such legislation, the advantageous tax rate would lack legal force, distinguishing it from 'monist' countries where provisions if international treaties are enforced like municipal laws.

b) A grammatical and literal interpretation indicates that the MFN clause in the Relevant DTAA would apply only if the New OECD Country was a member of the OECD as on the date of signing its DTAA with India (and not where it enters the OECD membership subsequent to signing).

c) Executive decrees issued by Swiss, French, and Dutch authorities declaring their interpretation of the MFN clause do not bind Indian Revenue authorities, who continue to be bound by Indian domestic law.

Supreme Court ruling

The Supreme Court ruled in favor of the tax authorities based on the premise that the terms of an international treaty do not *'per se'* acquire enforceability under domestic law until there is specific domestic legislative action for the same. In this regard, the Hon'ble Court noted that from conduct perspective also, there have been instances in the past wherein Indian Government has issued a separate notification for enabling the operation of MFN clauses in DTAAs.

The Apex Court held that the expression '*is a member*' (as it appears in the MFN clause of the Relevant DTAAs) has 'present signification', ie for the Relevant Country to claim parity and invoke the MFN clause, the New OECD Country should be an OECD member when it entered into a DTAA with India. Therefore, the relevant date to test OECD membership of the New OECD Country (for the purpose of MFN clause invocation) is the date on which it entered into a DTAA with India. After extensively engaging with the factual matrix of the Relevant DTAAs, including a sequence of amendments to the protocols, the Supreme Court noted that:

a) *With respect to DTAAs with Netherlands and France*: There is a clear precedent of India's conduct of giving effect of a subsequent beneficial arrangement with another OECD country to the Relevant DTAAs through an express notification.

b) *With respect to DTAA with Switzerland:* Article 16 of the DTAA specifically requires the concerned governments to notify each other as to the timing and manner of assimilation of the Protocol into the domestic legal system.

Comments

The Hon'ble Supreme Court has put to rest the interpretational ambiguities surrounding the import of tax benefits pursuant to an MFN clause. In this ruling, the Supreme Court has taken the same view as taken by CBDT in the MFN Circular. The ruling emphasizes that regardless of the language used in the Protocol, the benefits arising pursuant to the MFN clause therein are essentially inert and non-binding, *unless notified by the government*.

While the ruling pertained to the MFN clause involving the Relevant Countries, its implications are far-reaching and would affect India's other DTAAs that contain an MFN clause (for instance, India's DTAAs with Philippines, Finland, Sweden). This ruling would be relevant for cross-border structures and arrangements, wherein income streams like interest, royalty / fees for technical services, dividend (which generally enjoy the benefit of MFN clause in DTAAs) are common.

In cases where the taxpayers had taken the benefit of MFN clause in DTAAs, tax authorities may seek to recover the shortfall in tax (if any) pursuant to this Apex Court ruling. Going forward, ascertaining the benefit of the MFN clause with respect to such income streams will be far more nuanced and merit a detailed evaluation.

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