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INDIA-SPAIN TAX TREATY: PARTIAL RELIEF TO SPANISH RESIDENTS EARNING ROYALTY OR FEE FOR SERVICES FROM INDIA

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Introduction

On 19 March 2024, the Indian Government issued a notification (Notification No 33/2024) amending the India-Spain Tax Treaty (Spain Treaty) to reduce the erstwhile 20% tax rate on royalties and fees for technical services (FTS) to a 10% tax rate pursuant to the 'Most Favored Nation' (MFN) clause in the protocol to the Spain Treaty (MFN Notification). The benefit of the reduced rate is available from Financial Year 2023-24.

MFN Controversy: An overview

India's tax treaties with certain jurisdictions (such as France, Netherlands, Sweden, Spain, Hungary and Switzerland) have an MFN clause as part of the protocol to the relevant treaty. This clause is meant to grant the benefit of a lower tax rate or a more restricted scope of taxation with respect to certain income streams (i.e., dividends, interest, royalties or FTS) where such benefits form part of a tax treaty entered into subsequently with a third country that is a member of the Organization for Economic Co-operation and Development (OECD) (the third country being "New OECD Country").

There were two key issues with respect to interpretation and application of MFN clauses: (i) whether the MFN clause is self-operational or requires a separate notification by the Government to make the benefits effective; and (ii) whether the OECD membership of the New OECD Country (having more beneficial tax provisions) needs to be tested as of the date it enters into a tax treaty with India or as of the date the taxpayer intends to apply the MFN clause (where the OECD membership of the New OECD Country may be of a date later than the date it entered into a tax treaty with India). There are certain High Court decisions interpreting these issues liberally and in favour of the taxpayer.

The Central Board of Direct Taxes (CBDT) had issued Circular No 3/2022 on 3 February 2022 (CBDT Circular) clarifying, *inter-alia*, that: (i) the MFN benefit would not automatically apply in the absence of a specific notification by the government for enabling operation of the MFN clause; and (ii) 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 tax treaty with India (please see our [ERGO](#) on the same).

In a landmark development on the issue, the Supreme Court of India in the case of *Assessing Officer Circle (International Taxation) v M/s Nestle SA, 2023 INSC 928 [Civil Appeal No(s). 1420 of 2023]* (Nestle Ruling) overruled the favorable rulings and held that the date for testing whether the New OECD Country is a member of the OECD, is the date when it entered into a treaty with India. Further, the Supreme Court of India stated that, in the absence of a notification by the Government, tax benefits pursuant to the MFN clause would not be available automatically (please see our [ERGO](#) on the same). Notably, the Nestle Ruling did not cover the

Spain Treaty as the matter was de-tagged from the batch of appeals before the Supreme Court of India.

Notification pursuant to the MFN clause under the Spain Treaty

Currently, under the Spain Treaty, the tax rate is 10% for equipment royalty and 20% for other types of royalties and FTS. Notably, Germany was an OECD member at the time when it entered into a tax treaty with India (i.e., on 26 October 1996). The tax rate for royalty and FTS under the India-Germany Tax Treaty (Germany Treaty) is 10%.

A perusal of the CBDT Circular and the Nestle Ruling establishes that a specific legislative action by way of a notification by the Government is a pre-requisite to claim benefit under the MFN clause, even if the New OECD Country is a member of OECD as on the date of signing the tax treaty with India. According to this proposition, the MFN clause under the Spain Treaty cannot be invoked despite Germany being an OECD member on the date when it entered into the Germany Treaty with India.

In line with the CBDT Circular and the Nestle Ruling, the Government has exercised its powers to issue the MFN Notification, essentially restricting the tax rate for all types of royalties and FTS under the Spain Treaty to 10% (based on the favorable rate under the Germany Treaty).

Way forward

The MFN Notification grants the benefit of a lower tax rate for royalties and FTS under the Spain Treaty, based on the tax rates under the Germany Treaty. Consequently, the domestic tax rate on royalty and FTS of 20% (exclusive of surcharge and cess) will stand reduced to 10% under the Spain Treaty. It is pertinent to note that the India-Portugal tax treaty restricts the scope of FTS by way of a 'make available' condition. As per this restrictive scope, FTS would not be taxable in India unless the services are of such nature which enable a service recipient to independently apply the technical knowledge, know-how, skills, etc in future without any recourse to the service provider.

Notably, Portugal has been a member of the OECD since 4 August 1961, and the India-Portugal tax treaty entered into force on 30 April 2000. As the MFN Notification does not import the 'make available' condition into the Spain Treaty, such benefits would not be available.

Furthermore, even though the Germany Treaty entered into force on 26 October 1996, it is to be noted that the MFN Notification is effective from Financial 2023-24 onwards and does not retroactively confer MFN benefits. Pertinently, paragraph 5 of the CBDT Circular states that the MFN benefit would, subject to certain conditions, be available from the date as per the MFN clause of the concerned treaty. The protocol to the Spain Treaty unequivocally provides for such benefit to apply from the date of entry into force of either: (i) the Spain Treaty; or (ii) the treaty with the New OECD Country, whichever is later. The MFN Notification has, however, notified the benefit only with a prospective effect, contrary to the CBDT Circular, protocol to the Spain Treaty and the policy objectives.

It is important to note that the de-tagged appeal pertaining to the Spain Treaty as well as the review petition filed against the Nestle Ruling are pending for disposal. It remains to be seen whether policy objectives of honoring the spirit of international treaties and the limited and selective invocation of the MFN clause in the Spain Treaty (which departs from the express language of the MFN clause and the CBDT Circular), will be examined by the Supreme Court of India while hearing the appeal.

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