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SC rules on interpretation of tax treaty – notification mandatory for MFN clause to apply

The Supreme Court (**SC**) in the recent ruling in the matter of Nestle SA[1] examined the most favoured nation (**MFN**) clause contained in India's Double Tax Avoidance Agreements (DTAA) with Netherlands, France, and Switzerland.

The SC held that to give effect to a tax treaty or to its Protocol changing terms and conditions that alters existing provisions of the law, a notification is required to be issued under section 90(1) of the Income-tax Act, 1961 (**IT Act**). Further, it is also held that for invoking the MFN clause, the third country should be a member of the Organisation for Economic Co-operation and Development (**OECD**) when such DTAA is signed and obtaining OECD membership on a later date has no significance.

Background

Where a DTAA between India and any country contains an MFN clause and subsequently, India enters into a DTAA with another country which provides beneficial treatment, then it was interpreted that such beneficial treatment would automatically apply to the DTAA with the first mentioned country. Generally, the effect of an MFN clause is to reduce the rate of taxation at source on dividends, interest, royalties, or fees for technical services (**FTS**) as the case may be, or restriction of scope of royalty/FTS in the tax treaty, similar to concession given to another OECD country subsequently.

The application of MFN clause has been a subject matter of litigation in India over the past few years. The issues arising in the appeal before the SC in this matter were:

- Whether an MFN clause comes into effect automatically or it comes into effect only after a notification is issued by the India tax authorities under Section 90(1) of the IT Act.
- Whether an MFN clause can be invoked when a third country with which India has entered into a DTAA was not an OECD member at the time of entering into such DTAA.

SC's observations and ruling

Requirement of notification under section 90(1) of the IT Act

- The SC observed that as per Article 253 of the Constitution of India and the relative entries in the Union List, treaty making power vests exclusively with the Union. However, the treaty needs to be enacted by law or enabled through legislation for it to be binding on Indian nationals.
- In India, the treaty concerned must be legislatively embodied in law, either through a separate statute, or get assimilated through a legislative device, i.e., notification in the gazette; based upon some enacted law (some illustrations are the Extradition Act, 1962 and the Income Tax Act, 1961). In the absence of this step, treaties and protocols are per se unenforceable.
- The SC observed that India has a consistent practice to give effect to MFN clause under DTAA with original country pursuant to subsequent event of a more beneficial arrangement under DTAA with a third country, by issuing notification under section 90 of the IT Act. Such notification is generally preceded by an exchange of communication, negotiation, and acceptance of that position by India. The essential requirement of a notification under Section 90 of the IT Act cannot be disregarded.

[1] [TS-616-SC-2023]

- Considering the above, the SC held that an MFN clause in a DTAA does not automatically lead to extending the benefit covered in the DTAA of third county (which is a member of OECD), with which India entered into DTAA subsequently. A separate notification under section 90 of IT is required to amend the earlier terms of the DTAA.

Date when the third country should be an OECD member

- India has signed DTAA with countries like Slovenia, Colombia, Lithuania which provide for a lower rate of 5% tax for dividend taxation, subject to certain conditions. These countries were not OECD members when their respective DTAAs were entered into with India but became OECD members only at a later date.
- For instance, protocol to India-Netherlands DTAA has an MFN clause which provides that if India enters into a DTAA on a later date with a third country which "is" an OECD member, providing a beneficial rate of tax or restrictive scope for taxation of dividend, interest, royalty, etc. a similar benefit should be accorded to India-Netherlands DTAA as well.
- Therefore, an issue arose on whether an MFN clause can be invoked and a beneficial rate of 5% can be claimed based on India's DTAAs with Slovenia, Colombia, Lithuania.
- The SC clarified that the expression "is" in the sentence "third state which is a member of OECD" of the MFN clause, has deep significance. Therefore, the third country should be a member of OECD when entering into DTAA with India in order to claim favourable benefits. Obtaining an OECD membership by such countries on a later date has no significance.

ELP Comments

- *The SC has concluded that a notification is necessary and mandatory to give effect to a DTAA, or any protocol changing terms or conditions, which has the effect of altering the existing provisions of law. Further, in view of the SC ruling, the expression 'is' has a present signification. Therefore, for the MFN trigger, the third country has to be a member of OECD on the date of entering into its treaty with India rather than it being an OECD member when the MFN provision is applied.*
- *It may be noted that the SC's decision is in line with the CBDT's Circular of 2022 [2]wherein one of the conditions for availing DTAA benefits under the MFN route was that the notification should have been issued under section 90(1) of the IT Act importing benefits given to third country to the DTAA with the original country.*
- *The SC ruling is a significant development in the way tax treaties are interpreted and may have far-reaching consequences. It may impact all pending cases where benefits have been claimed based on an MFN clause and may also trigger reassessment proceedings by the Indian tax authorities.*
- *It may be noted that SC has listed the matter[3] involving interpretation of India-Spain DTAA separately.*

We trust you will find this an interesting read. For any queries or comments on this update, please feel free to contact us at insights@elp-in.com or write to our authors:

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[2] Circular No. 03/2022 dated 3 February 2022

[3] CA No. 1428/2023 in case of EPCOS Electronic Components S.A. v. Union of India