International Tax Updates
by Tirthesh Bagadia

Application of MFN clause under a tax treaty: Relevance of a third country being a member of OECD on the date of signing of tax treaty and whether a specific notification required to make MFN effective (Delhi High Court)

Under the context of tax treaties, an MFN clause is incorporated where one of the contracting countries decide to grant MFN status to the other contracting country in relation to specified income streams. The residents of the MFN country are given the same beneficial treatment that India has extended to a resident of a third country (OECD countries). The beneficial treatment is accorded in form of lower rate of tax or restricted scope. The MFN clause is intended to provide a level playing field to all the OECD members.

The MFN clause in a tax treaty entitles the eligible tax residents to adopt the beneficial treatment (by way of lower rate or restricted scope) accorded to a third country (OECD members).

Generally such MFN clause are provided as a protocol in the negotiated tax treaties. As per MFN clause in India-Netherlands tax treaty, if India enters into a tax treaty or Protocol with any other OECD member country after the date India-Netherlands signed the tax treaty, which restricts scope or provides for lesser rate of tax *inter alia* in relation to FTS, such restricted scope or lesser rate of tax would also apply to the India-Netherlands tax treaty.

As far as India is concern, surrounding the application of MFN there have been a few issues which requires/required certain jurisdictional interpretation/clarification.

Some of the are:

1. **Whether a specific notification would be required to give effect to a protocol containing MFN clause or being a protocol, it is an integral part of the tax treaty and no separate notification is required?**

2. **When the third country (with which India has signed a favorable agreement) should be a member of OECD-**
   on the date of their signing of tax agreement with India? Any time before applying MFN clause?

   The above issues were discussed by Delhi High Court in the case of *Concentrix Services Netherlands BV WP (C) 9051/2020 and Optum Global Solutions International BV WP (C) 882/2021*. *A summary of the the entire ruling is as under:*

BRIEF SUMMARY

Facts of the case:

Dividend received from an Indian company is taxable at 20% (plus applicable surcharge and cess) in the hands of the non-resident shareholders (and subject to withholding of applicable tax by the Indian company) subject to tax treaty benefit, if any. The Tax Treaty provides for a lower tax rate of 10% where the

recipient is the beneficial owner of dividend income. However, the Tax Treaty has an MFN clause which *inter alia* provides that, if India agrees to a more beneficial tax rate (or a restricted scope) in its tax treaty with a third country which is a member of the then such tax rate shall be applicable under the Tax Treaty as well.

Post signing of the Tax Treaty (1988), India entered into tax treaties with Slovenia (2005), Lithuania (2012) and Columbia (2014) agreeing to a tax rate of 5% on dividend income if the recipient company holds 10% or more of the share capital in the Indian company. However, these countries became OECD members post signing of their tax treaties with India, in the year 2010, 2018 and 2020 respectively.

In the instant case, the Taxpayer was a tax resident of Netherlands holding 99.99% of the share capital in the Indian company. Relying on the MFN clause read with India's tax treaties with Slovenia / Lithuania / Columbia, the Taxpayer had applied to the tax authorities to obtain a withholding tax certificate confirming the tax rate of 5%.

The tax authority however held that in the absence of any specific notification extending the benefit of the lower tax rate to the Tax

Treaty, the 5% tax rate could not be applied. Accordingly, the certificate was issued confirming 10% as the applicable rate of withholding tax. Aggrieved, the Taxpayer challenged the said position by way of a writ petition before the High Court.

High Court's observations:

- On a plain reading of the provisions of the Tax Treaty and relying on a previous decision on this issue (Steria (India) Ltd [2016] 386 ITR 390), the Court held that no separate notification is required to give effect to the lower tax rate under India's tax treaties with other OECD members, as the protocol providing for MFN clause forms an integral part of the Tax Treaty.
- The MFN clause, which forms part of the protocol, incorporates the principle of parity between the India-Netherlands tax treaty and the tax treaties executed with the third states thereafter by India in respect of the rate of withholding tax or the scope of the tax treaties in respect of items of income concerning dividends, interest and royalties. The principle of parity is applicable where the third state with whom India enters into a tax treaty should be a member of the OECD and the tax treaty executed with the third state limits the rate of withholding tax imposed by India at a rate lower or a scope more restricted, than the rate or scope provided in the subject tax treaty.
- Once the foregoing conditions are satisfied, the benefit of the lower withholding tax or the restricted scope of the tax treaty with the third state should be applicable to the India-Netherlands tax treaty from the date when the tax treaty with the third country comes into force.

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- The contention of the tax authority that the benefit of the MFN clause should be available only if the country with which India enters into a tax treaty was an OECD member at the time of execution of the subject tax treaty (i.e., India-Netherlands in the present case) is misconceived and contrary to the plain language of India-Netherlands tax treaty. Rather, there could be a gap between the dates on which the tax treaty is executed between India and the third state and the date when such third state becomes a member of OECD. The MFN clause can only apply when the third state fulfils the requirement of being a member of the OECD.
- To address the debate the Court considered the intent of the other treaty partner i.e. Netherlands as the best interpretative tool and referred to the decree issued by the Kingdom of Netherlands in the context of application of MFN clause. The decree *inter alia* referred to the fact that India has entered into a tax treaty with Slovenia on 17 February 2005 providing for a tax rate of 5% for dividend income (if recipient holds at least 10% of the share capital) and as Slovenia has become an OECD member on 21 July 2010, the said 5% tax rate would apply to the Tax Treaty with effect from 21 July 2010.
- The Court held that tax rate of 5% should be applicable from the date Slovenia became member of the OECD and emphasized that it's approach aligns with the accepted principle of "Common Interpretation" of tax treaties (subject to circumstances).

Our Comments

India has recently overhauled its dividend taxation regime. Effective 1 April 2020 tax is payable by the shareholder as against the distribution tax which was earlier payable by the distributing Indian companies with no further tax in the hands of a non-resident shareholder. Given these changes to tax law, this ruling is timely and may be beneficial not only for Netherland companies but also for companies from other jurisdictions having similar MFN clauses in their tax treaties with India such as France, Spain and Switzerland.

Hope you find the same an interesting read.

Should you have any clarifications please feel free to contact us.

Regards

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