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SC settles controversy regarding applicability of MFN clause in India's tax treaties

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Summary

The Hon'ble Supreme Court (SC)[1] has, in a batch of appeals, settled the controversy regarding the applicability of Most Favoured Nation (MFN) clause in the Indian tax treaties (Treaties). The MFN clause enables a taxpayer of a treaty country to import the beneficial provisions of India's treaty with another country (third country 'which is an OECD[2] member'), which is subsequently entered into if the scope in such treaty is restricted or rate is beneficial.

The SC held that the provisions of MFN clause will not get triggered automatically, and a separate notification is required to operationalise the same. Further, the SC held that for the purpose of importing the benefit of lower rate / restricted scope from treaty with a third country, it is imperative that such country is a member of the OECD at the time of entering into the treaty with India.

Facts of the cases

Brief facts of the cases before the SC were as follows:

A. Steria (India) Ltd[3]

- Steria, a public company registered in India, entered into a MSA[4] with Steria France (LLP incorporated in France) to provide management services.[5]

- Based on Clause 7 of the 'Protocol' to the India-France tax treaty (which contains MFN clause), Steria contended that the restrictive definition of fees for technical services (FTS) as per India-UK treaty, must be read as forming part of India-France treaty.

- The Authority for Advance Ruling (AAR) held that:

  - Protocol is not an integral part of the treaty.

  - Even if the conditions in MFN clause are satisfied, a separate notification is required to incorporate the restrictive definition of FTS as per the India-UK treaty into the India-France treaty.

- On appeal before Delhi High Court (HC), the HC reversed the AAR ruling and held that a Protocol is an integral part of the treaty and does not have to be separately notified to operationalise the MFN clause.

B. Concentrix Services Netherlands B.V. and Optum Global Solutions International B.V [6]

- Both the taxpayers mentioned above (residents of Netherlands) received

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[1] Nestle SA and others vide [CIVIL APPEAL NO(S). 1420 OF 2023]
[2] Organisation for Economic Co-operation and Development
[3] [2016] (72 taxmann.com 1) (Delhi HC)
[4] Master Service Agreement
[5] Services provided by Steria France include General Management Services included Corporate Communication Services, Group Marketing Services, Development Services, Information System and Services, Legal Services, Human Relation Services etc
[6] [2021] (127 taxmann.com 43) (Delhi HC)

dividend from their wholly-owned subsidiaries in India.

- The taxpayers filed an application for obtaining lower withholding tax certificate of 5% as per the India-Netherland treaty, read with MFN clause (importing beneficial provisions for India's treaties with Slovenia / Lithuania / Columbia).
- However, this benefit was not granted by the tax authorities which stipulated that the withholding tax rate should be 10% (as per the India-Netherlands treaty).
- On appeal before HC, it granted the benefit of 5% withholding tax by placing reliance on other judicial precedents on this issue.[7]
- HC also relied on the executive decree issued by Netherlands, pursuant to the Protocol, for arriving at its conclusion.
- HC held that:
  - Protocol forms an integral part of the treaty, and there is no requirement of issuing a separate notification in order to apply the provisions of the protocol.[8]
  - For interpreting the term 'is a member of OECD', the word 'is' describes a state of affairs that should exist when the taxpayer or deductee makes a request for issuance of a lower rate withholding tax certificate.

C. Nestle SA[9]

- This ruling followed the HC's decision in the case of Concentrix *(supra)*. Further, in this case, HC considered the provisions of the India-Switzerland treaty and its three protocols.
- Other judgements challenged before SC have similar facts and followed the decision of Steria *(supra)* and Concentrix *(supra)*.

SC's verdict

The SC observed that:

General

- Treaty making power vests exclusively with the Union, as per Article 253 of the Constitution, and the relative entries in the Union List[10]. Entering into a treaty is an attribute of sovereignty, and the power to do so vests solely in the Union executive.
- In India, unlike some other countries, the stipulations of a treaty duly ratified do not by virtue of such event (i.e., signing the treaty alone) have the force of law, and Article 253 of the Constitution of India recognises this position.
- Therefore, upon India entering into a treaty or Protocol *does not result in its*

[7] [Steria (India) Ltd [2016] (72 taxmann.com 1) (Delhi HC), Apollo Tyres Ltd. [2018] (92 Taxmann.com 166) (Karnataka HC), EPCOS Electronic Components S.A.(2019) (SCC OnLine Del 9113) (Delhi HC)]

[8] Reliance was placed on Steria (India) (72 taxmann.com 1) (Delhi HC)

[9] (2021) [W.P. (C) No. 3243 of 2021] (Delhi HC)

[10] List I, VIIth Schedule

automatic enforceability in courts and tribunals. The provisions of such treaties and Protocols do not confer rights upon parties till appropriate notifications are issued in terms of Section 90(1) of the Income tax Act, 1961 (the Act)

Interpretation of the term "is"

- As far as as the issue of whether 'is a member' means the present tense, i.e., whether the third country should be a member of OECD when it enters into a treaty with India. The SC observed that in all three cases, the 'third country': Lithuania, Colombia, and Slovenia, were initially not members of OECD when they entered into treaties and protocols with India. They became members later.

- It observed that the expression 'is' has a present signification and derives meaning from the context. Accordingly, when a third country enters into treaty with India, it should be a member of OECD for the earlier treaty country to claim parity.

Treaty practice (of India and some other countries) and interpretation of tax treaties

- The structure of the main treaty and its phraseology, based on negotiations with the countries concerned (i.e., Netherlands, France, and Switzerland), also plays a role in the kind of benefits that are assured through it. The structure and terms of other treaties might be different and the coverage and definition of certain terms (FTS, permanent establishment, etc.) might be dissimilar.

- Accordingly, the SC observed that the Revenue's argument that grant of automatic benefits based on the other country's entry into OECD is not feasible has merit.

- It observed that inbuilt in the entire eco-system of the treaties is the inarticulate premise that assimilation into the domestic legal system is not always within the control of the executive wing which enters into the convention or signs the Protocol and that compelling constitutional and legal requirements have to be satisfied before its benefits are integrated within the national legal regimes.

- On the plea that there needs to be reliance on decrees / decisions of each of the countries, SC observed that the context of these executive orders or decrees is to be understood in relation to each country's manner of assimilation of treaties in municipal or national law.

- In India, either the treaty concerned has to be legislatively embodied in law through a separate statute or get assimilated through a legislative device (i.e., notification in the gazette). If this step is absent, treaties and protocols are *per se,* unenforceable.

- There is no dispute that treaties constitute binding obligations upon their signatories. Yet, how the parties to any specific instrument view them, give effect to its provisions, and the manner of acceptance of such

conventions or compacts are in the domain of bilateral relations and diplomacy. It depends upon the relationship of the parties, the mutuality of their interests, and the extent of co-operation or accommodation they extend to each other. In this, a range of interests combine.

- The issue of treaty interpretation and treaty integration into domestic law is driven by constitutional and political factors subjective to each signatory. Accordingly, domestic courts cannot adopt the same approach to treaty interpretation in a black letter manner, as is required or expected of them, while construing enacted binding law.

- The role of practice is not bilateral or joint practice but practice by one, accepted generally by the international community as operating in that particular sphere, which is relevant and, at times, determinative.

- Treaty practice of Switzerland, Netherlands, and France is dictated by conditions peculiar to their constitutional and legal regimes.

- Similarly, the treaty practice in India points to a consistent pattern of behaviour, when the signatory to an existing treaty can avail benefit of India's treaty with third country (on account of MFN) only after a consequential amendment. This amendment would be preceded by exchange of communication, negotiation, and acceptance of that position by India. The essential requirement of a notification[11] cannot be undermined.

SC's conclusion

The SC concluded as follows:

- A notification under Section 90(1) of the Act is necessary and a mandatory condition for a court, authority, or tribunal to give effect to a treaty or any Protocol changing its terms or conditions, which has the effect of altering the existing provisions of law. This includes importing the benefits from another treaty on account of the MFN provisions.

- For a country to claim benefit of a 'same treatment' clause, based on entry of treaty between India and third country which is member of OECD, the third country has to be a member of OECD on the date of entering into treaty with India.

- Based on the above, the SC set aside the High Court's orders and ruled in favour of the Revenue.

[11] Under Section 90 of the Act

Our comments

While delivering this judgement though the SC has not discussed the CBDT[12] circular issued[13] earlier in this regard, the verdict is in line with the views laid down in that circular. Like the circular, the SC has treated tax treaties where language of the MFN clause suggests that a separate notification is required at par with those which suggest otherwise.

This decision significantly impacts the manner of interpreting this important aspect of India's tax treaties. It will have wide ramifications for taxpayers who have availed benefits under the MFN clause. This would be mainly in the case of royalty, FTS, dividend, or interest payments. Taxpayers would need to carry out an impact assessment basis the facts of the case.

It also remains to be seen to what extent this verdict will be retrospectively applied by the tax authorities.

[12] Central Board of Direct taxes

[13] Circular No. 3 of 2022 dated 3 February 2022

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