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Tax alert: Apex Court interprets MFN clause in certain tax treaties

20 October 2023

The Supreme Court of India (SC) examined the most favoured nation clause of the India-Netherlands, India-France, and India-Switzerland tax treaties, and held that a separate notification is required under section 90(1) of the Income-tax Act, 1961 to give effect to a tax treaty or to its Protocol changing terms and conditions that alters existing provisions of the law. Further, the relevant date for another state to be a member of OECD would be the date of entering into tax treaty with India, and not at a later date.

In a nutshell

A notification under section 90(1) of the ITA is necessary and a mandatory condition for a court, authority, or Tribunal to give effect to a tax treaty, or any Protocol changing its terms or conditions, which has the effect of altering the existing provisions of law.

A stipulation in a tax treaty or a Protocol with one nation, requiring same treatment in respect to a matter covered by its terms, subsequent to its being entered into when another nation (which is member of a multilateral organization such as OECD), is given better treatment, does not automatically lead to integration of such term extending the same benefit in regard to a matter covered in the tax treaty of the first nation, which was entered into with India. In such an event, the terms of the earlier tax treaty requires to be amended through a separate notification under section 90 of the ITA.

The interpretation of the expression 'is' has present signification. Therefore, for a party to claim benefit of a 'same treatment' clause , based on entry of tax treaty between India and another state which is member of OECD, the relevant date is the date of entering the treaty with India, and not at a later date, when, after entering into the tax treaty with India, such country becomes an OECD member, in terms of India's practice.

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Background:

- The case under consideration[1] before the Supreme Court (SC) involved interpretation of the Most Favoured Nation (MFN) clause contained in various Indian tax treaties with countries that are members of the OECD[2].
  - The MFN clause provides for lowering of 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 bilateral tax treaties under consideration in appeal before the SC were India-Netherlands, India-France, and India-Switzerland tax treaties and the issues arising in appeal were as follows:
  - Whether there is any right to invoke the MFN clause when the third country with which India has entered into a tax treaty was not an OECD member yet (at the time of entering into such tax treaty)?
  - Whether the MFN clause is to be given effect to, automatically, or if it is to only come into effect after a notification is issued?
- The Delhi High Court (HC) in earlier rulings[3] (against which appeal was filed by the Revenue before the SC) had observed / held that:
  - A Protocol is considered as part of the tax treaty itself and does not have to be separately notified for the purposes of application of the MFN clause.
  - The lower rate of tax or the scope more restricted contained in the tax treaty executed between India and the third State, could only apply when the third State fulfilled the attribute of being a member of the OECD.
  - An emphasis was laid on the word **'is'** that is mentioned in the context of the third State with which India has entered into the tax treaty after execution of the subject tax treaty.
  - The word 'is' described as a state of affairs that should exist not necessarily at the time when the subject tax treaty was executed, but when a request was made by the taxpayer or deductee for issuance of a lower withholding certificate under the Income-tax Act, 1961 (ITA).
  - When the request for parity is made by a party seeking aid of the tax treaty and the Protocol containing the term 'same treatment', the court has to consider whether at that time the third-party state is enjoying better benefits.

Relevant provisions in brief:

- **Extract of Section 90 of the ITA on 'Agreement with foreign countries or specified territories' is as below:**

  "90. (1) The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—

  (1) ………………

  may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement…"

Decision of the SC:

The SC noted/observed as follows:

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[1] [2023] Civil Appeal Nos. 1420 of 2023 along with batch of other appeals (SC)

[2] Organisation for Economic Cooperation and Development

[3] Steria (India) Ltd vs. Commissioner of Income-tax VI & ANR W.P.(C) 4793/2014 (Del-HC) ; W.P.(C) 9051/2020; W.P.(C) 882/2021; CM Appl. 2302; and W.P.(C) 3243/2021 2021

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General observations

- Treaty making power vests exclusively with the Union, per Article 253 of the Constitution of India, and the relative entries in the Union List (List I, VIIth Schedule).
- The SC in earlier rulings[4] had held that:
    i. The terms of a treaty ratified by the Union do not ipso facto acquire enforceability;
    ii. The Union has exclusive executive power to enter into international treaties and conventions under Article 73 [read with corresponding Entries - Nos. 10, 13 and 14 of List I of the VIIth Schedule to the Constitution of India] and Parliament, holds the exclusive power to legislate upon such conventions or treaties.
    iii. Parliament can refuse to perform or give effect to such treaties. In such event, though such treaties bind the Union, vis a vis the other contracting state(s), leaving the Union in default.
    iv. The application of such treaties is binding upon the Union. Yet, they "are not by their own force binding upon Indian nationals".
    v. Law making by Parliament in respect of such treaties is required if the treaty or agreement restricts or affects the rights of citizens or others or modifies the law of India. If citizens' rights or others' rights are not unaffected, or the laws of India are not modified, no legislative measure is necessary to give effect to treaties.
    vi. In the event of any ambiguity in the provision or law, which brings into force the treaty or obligation, the court is entitled to look into the international instrument, to clear the ambiguity or seek clarity.
- The legal position, therefore, was that upon India entering into a treaty or a Protocol, does not result in its automatic enforceability in courts and Tribunals; the provisions of such treaties and Protocols do not therefore, confer rights upon parties, till such time, as appropriate notifications are issued, in terms of Section 90(1) of the ITA.

The interpretation of the term 'is'

- Whether the expression - 'is a member' - means that the third party state should be a member of OECD in the present tense, when it enters into a tax treaty with India? This was relevant, because in all three cases[5], the three 'third party' nations - Lithuania, Colombia, and Slovenia - were initially not members of OECD when they entered into tax treaties and Protocols with India; they became members later.
- The expression 'is' has a current significance and derives meaning from the context. Given this interpretation, the conclusion was that when a third-party country enters into tax treaty with India, it should be a member of OECD, for the earlier treaty beneficiary to claim parity. Reliance in this regard was placed on earlier rulings[6].

Treaty practice of India, in relation to tax treaties and their Protocol, and practices of Netherlands, France and Switzerland

India-Netherlands tax treaty:

- The tax treaty between India and Kingdom of Netherlands was signed on 13 July 1988.
- The tax treaty between:

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[4] State of W.B. v. Jugal Kishore More 1969 (1) SCR 320 (SC); State of Gujarat v. Vora Fiddali Badruddin Mithibarwala 1964 (6) SCR 461 (SC); Maganbhai Ishwarbhai Patel & Ors. v. Union of India & Ors. 1970 (3) SCR 53; Gramaphone Co. of India Ltd. v. Birendra Bahadur Pandey & Ors

[5] India-Lithuania tax treaty, India-Columbia tax treaty and India-Slovenia tax treaty

[6] Jagir Kaur v. Jaswant Singh (1964) 2 SCR 73 (SC), P. Anand Gajapati Raju v. P.V.G Raju (2000) 4 SCC 539 (SC) and Vijay Kumar Prasad v. State of Bihar (2004) 5 SCC 196 (SC)

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- India and Germany entered into force on 26 October 1996;
- India and Sweden entered into force on 25 December 1997;
- India and the Swiss Confederation entered into force on 19 October 1994; and
- India and the United States of America (USA) entered into force on 18 December 1990.

These states were members of the OECD. The Union limited the taxation at source on dividends, interest, royalties, FTS, and payments for the use of equipment, to a rate lower or a scope more restricted than that provided in the India-Netherlands tax treaty on the said items of income.

- Consequently, the notification dated 30 August 1999[7] modifying the India-Netherlands tax treaty, provided certain benefits expressly on different dates, having regard to the fact that India entered into tax treaty with OECD members and gave them effect, subsequently. As per the said notification:
  - The date on which the relief of rate of taxation for interest and dividends was specified to be 1 April 1997; different dates (1 April 1995 and 1 April 1998) were applied as applicable to the definition of FTS and other details; the rates, too varied, depending on the period(s).
  - Such notification under section 90 of the ITA was issued on 30 August 1999.
  - The favourable or beneficial treatment was given to other OECD nations on 26 October 1996 (India-Germany); between India and Sweden entered into force on 25 December 1997, the India-Swiss Confederation tax treaty entered into force on 19 October 1994 itself. These earlier dates did not result in India automatically extending benefits of Article IV of the Protocol to the India-Netherlands tax treaty.
- Therefore, under the India-Netherlands tax treaty, there was precedent, of behavior, in relation to treaty practise and interpretation.

India-France tax treaty:

- The India-France tax treaty and Protocol came into force on 1 August 1994, after the notification by the contracting states to each other of the completion of the procedures required under their laws to bring them into force.
- The tax treaty between:
  - India and the USA entered into force on 18 December 1990;
  - India and Germany entered into on 26 October 1996.

  These tax treaties gave benefits or more favourable treatment to the USA and Germany, in respect of income on dividends, interest, royalties, definition of royalties and FTS.
- In light of these, India notified changes in the applicable provisions to the India-France tax treaty and Protocols through a notification in July, 2000[8]. The amending notification followed the same pattern, as in the case of the India-Netherlands tax treaty, of defining the rate and nature of relief on interest, and dividends and the rates applicable, and different definition for different dates for 'royalties and FTS'.
  - This notification reinforced India's practice and conduct of giving effect of the subsequent event of a more beneficial arrangement with a third country, to the country which had entered into a tax treaty previously, on the basis of a treaty provision, through an express action i.e., a notification under section 90 of the ITA.
  - It did not extend the expanded definition, and instead confined the benefits to definition and treatment of income from dividends, interest, and royalties. The "make available" condition, in other tax treaties was consciously omitted from the notification.

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[7] Notification No. SO 693(E), dated 30 August 1999

[8] Notification No. S.O. 650(E), dated 10 July 2000

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- The omission of certain benefits (available to other member countries of OECD who had entered into tax treaties with India) in the subsequent notification, dated 10 July 2000[9], was another indication that a 'trigger' event such as India granting favourable relief to a country per se did not cover all the benefits granted through the later instrument. Therefore, the benefit which India granted France, was within the framework of its treaty originally negotiated.

India-Switzerland tax treaty:

- There were three different dates when India-Switzerland tax treaty and the two later Protocols were entered into. They were given effect to by three separate notifications[10].
- The second Protocol[11] dated 7 February 2001:
  - — Contained a condition[12], which constituted the 'trigger' event. It obliged parties to enter into negotiations to ensure that benefits extended to state parties which later entered into OECD membership, were given to Switzerland.
- The language of the third Protocol[13] of 2010 notified on 27 December 2011, through the second paragraph of the amended Protocol states that in such event (of entry by third party state into OECD) "the same rate as provided for in that Convention, Agreement or Protocol on the said items of income shall also apply between both Contracting States under this Agreement as from the date on which such Convention, Agreement or Protocol enters into force."
- The second Protocol[14], by Article 16, had provided that:

  "ARTICLE 16

  The Governments of the Contracting States shall notify each other through diplomatic channels

  1.that all legal requirements and procedures for giving effect to this Protocol have been satisfied. [..]"
- It could plausibly be argued that this condition is not substantive, but only diplomatic. However, what it requires is that the concerned governments have to notify how and when the Protocol is assimilated into the domestic legal system. The provision does not assign any time frame within which the Protocol has to be made effective.
- Therefore, inbuilt in the entire eco-system of the tax treaties was the inarticulate premise that assimilation into the domestic legal system was 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 were integrated within the national legal regimes.
- This consideration, or premise, equally applied in the case of the India-Switzerland tax treaty and its amending Protocol; the requirement of notification of the protocol and a separate amending Protocol, (like in the case of

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[9] Notification No. S.O. 650(E), dated 10 July 2000

[10] No. GSR 357(E), dated 21 April 1995; as amended by Notification No. GSR 74(E), dated 7 February 2001 and Notification No. S.O. 2903(E), dated 27 December 2011

[11] Notification No. GSR 74(E), dated 7 February 2001

[12] "D. With reference to Articles 10, 11 and 12

If after the signature of the Protocol of 16th February, 2000 under any Convention, Agreement or Protocol between India and a third State which is a member of the OECD India should limit its taxation at source on dividends, interest, royalties or fees for technical services to a rate lower or a scope more restricted than the rate or scope provided for in this Agreement on the said items of income, then, Switzerland and India shall enter into negotiations without undue delay in order to provide the same treatment to Switzerland as that provided to the third State."

[13] Notification No. S.O. 2903(E), dated 27 December 2011

[14] Notification No. GSR 74(E), dated 7 February 2001

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France and Netherlands) is necessary, by reason of section 90 of the ITA. Switzerland could not claim an exception, based only on the language of the third Protocol.

India-Canada tax treaty:

- India had entered into a tax treaty with Canada on 30 October 1985 which was notified on 25 September 1986 under section 90 of the ITA.
- As per the Protocol of 1985[15] to the India-Canada tax treaty,

  "in the event that pursuant to an Agreement or a Convention concluded with a State which is a member of the Organisation for Economic Co-operation and Development after the date of signature of this Agreement, India would accept a rate lower than 30% for the taxation of royalties or fees for technical services paid by a resident of India to a resident of that State, it is understood that <u>such lower rate will automatically be applied</u> for the taxation of royalties and FTS paid by a resident of India to a resident of Canada where the royalties or FTS are paid in respect of a right or property".
- The India-Sweden tax treaty was signed on 12 December 1988, which extended more favourable benefits, than what was given to Canada; Sweden was an OECD member when the tax treaty was signed with India. This constituted the "trigger" event, impelling Canada to seek parity. The amendment to the India-Canada tax treaty was on 24 June 1992 which was notified under section 90 of the ITA on 28 October 1992.
- The Protocol[16], to the original India-Canada tax treaty required that the trigger event would lead to 'such lower rate will automatically be applied for the taxation of royalties and FTS paid by a resident of India to a resident of Canada where the royalties or FTS are paid in respect of a right or property'. In such an instance, of language, in the protocol, being as emphatic as the third Protocol to the India-Switzerland tax treaty, the treaty practice of India was consistent; a separate notification was later issued.

Decrees / decisions of the countries (i.e. Netherlands, France, and Switzerland) relied upon by the taxpayer:

- The status of treaties and conventions and the manner of their assimilation was radically different from what the Constitution of India mandates.
- In each of the said three countries (i.e. Netherlands, France, and Switzerland), every treaty entered into the executive government needs ratification. In Switzerland, some treaties have to be ratified or approved through a referendum. These mean that after intercession of the Parliamentary or legislative process/procedure, the treaty is assimilated into the body of domestic law, enforceable in courts.
- However, 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, based upon some enacted law (some instances are the Extradition Act, 1962 and the ITA). Absent this step, treaties and protocols are per se unenforceable.

International perspectives and practices:

The material provided from the ILC Draft Conclusions[17] and International Court of Justice (ICJ) rulings, though not binding, but certainly offered valuable insight into tax treaty interpretation.

- Whilst considering tax treaty interpretation, it is vital to take into account practice of the parties. Tax treaties constitute binding obligations upon their signatories. Yet, like all compacts, how the parties to any specific

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[15] GSR 1108(E), dated 25 September 1986

[16] GSR 1108(E), dated 25 September 1986

[17] International Law Commission (ILC) Draft Conclusions on Subsequent Agreements and Subsequent Practice in relation to the Interpretation of Treaties

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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.

- Much 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 tax treaty interpretation and treaty integration into domestic law is driven by constitutional and political factors subjective to each signatory. Therefore, domestic courts cannot adopt the same approach to tax treaty interpretation in a black letter manner, as is required or expected of them, while construing enacted binding law.
- The role of practice, which is not bilateral or joint practice, but practice by one, accepted generally by the international community as operating in that particular sphere, which was relevant, and at times determinative.
- The treaty practice of Switzerland, Netherlands and France is dictated by conditions peculiar to their constitutional and legal regimes.
- Likewise, the tax treaty practice in India points to a consistent pattern of behavior when the signatory to an existing tax treaty, points to the event of a third state entering into OECD membership, and a resultant trigger event, the beneficial effect given to the later third-party state had to be notified in the earlier tax treaty, as a consequential amendment, preceded by exchange of communication (and perhaps, negotiation) and acceptance of that position by India. The essential requirement of a notification under section 90 of the ITA of consequences of the trigger (or causative) event could not be undermined.

Conclusions

- In the view of the above, the SC held that:
  - (a) A notification under section 90(1) of the ITA is necessary and a mandatory condition for a court, authority, or tribunal to give effect to a tax treaty, or any protocol changing its terms or conditions, which has the effect of altering the existing provisions of law.
  - (b) The fact that a stipulation in a tax treaty or a Protocol with one nation, requires same treatment in respect to a matter covered by its terms, subsequent to its being entered into when another nation (which is member of a multilateral organization such as OECD), is given better treatment, does not automatically lead to integration of such term extending the same benefit in regard to a matter covered in the tax treaty of the first nation, which entered into tax treaty with India. In such event, the terms of the earlier tax treaty require to be amended through a separate notification under section 90 of the ITA.
  - (c) The interpretation of the expression 'is' has present signification. Therefore, for a party to claim benefit of a 'same treatment' clause, based on entry of tax treaty between India and another state which is member of OECD, the relevant date is entering into treaty with India, and not a later date, when, after entering into tax treaty with India, such country becomes an OECD member, in terms of India's practice.

Comments:

The manner of applicability of MFN clause in a tax treaty with a particular country pursuant to a subsequent beneficial provision entered into with another country has been a subject of litigation.

The SC in this ruling, in the context of MFN clause under the India-Netherlands, India-France and India-Switzerland tax treaties has held that:

- A notification under section 90(1) of the ITA is necessary and a mandatory condition for a court, authority, or tribunal to give effect to a tax treaty, or any protocol changing its terms or conditions, which has the effect of altering the existing provisions of law.

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- A stipulation in a tax treaty or a Protocol with one nation, requiring same treatment in respect to a matter covered by its terms, subsequent to its being entered into when another nation (which is member of a multilateral organization such as OECD), is given better treatment, does not automatically lead to integration of such term extending the same benefit in regard to a matter covered in the tax treaty of the first nation, which entered into with India. In such event, the terms of the earlier tax treaty require to be amended through a separate notification under section 90 of the ITA.
- The interpretation of the expression 'is' has present signification. Therefore, for a party to claim benefit of a 'same treatment' clause , based on entry of tax treaty between India and another state which is member of OECD, the relevant date is entering into treaty with India, and not a later date, when, after entering into tax treaty with India, such country becomes an OECD member, in terms of India's practice.

It is pertinent to note that, with respect to the interpretation of the India-Spain tax treaty in another case[18], the SC has not considered the same in this ruling and has instructed for its listing before the appropriate bench.

It is pertinent to note that the Central Board of Direct Taxes (CBDT) had issued a Circular No. 3/2022 which provided certain conditions to be met for the applicability of MFN clause in a particular tax treaty. Please refer to our below alert:

https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert/in-tax-gbt-alert-clarification-regardingg-mostt-favouredd-nation-mfn-clause-with-certain-countries-noexp.pdf

Further, the Pune bench of the Income-tax Appellate Tribunal (ITAT) had pronounced its ruling after considering the aforesaid circular and its applicability being prospective in nature. Please refer to our alert on the ITAT ruling:

https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert/in-tax-gbt-alert-protocol-an-integral-part-of-india-spain-tax-treaty-no-separate-notification-required-for-its-application-noexp.pdf

The link to the tax alert with respect to the earlier ruling[19] of the Delhi HC is also provided below:

https://intaxkm.deloitte.com/DTAlerts%20and%20Publications/Deloitte%20Tax%20Alert%20-%20Withholding%20tax%20on%20dividend%20applicable%20at%205%20percent%20for%20Netherlands%20tax%20resident.pdf

Taxpayers may evaluate the impact of this ruling to the facts of their cases.

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

[19] Concentrix Services Netherlands B.V. and Optum Global Solutions International BV [TS-286-HC-2021 (Delhi High Court)

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