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EY Tax Alert

Supreme Court rules notification to be mandatory to invoke most favored nations clause

Executive summary

This tax alert summarizes a recent Supreme Court (SC) decision in a batch of appeals [1] (Taxpayers), wherein the SC set aside the underlying favorable Delhi High Court (HC) decisions[2] and examined the following two issues:

- Whether the most favored nations (MFN) clause is to be given effect to automatically or it comes into effect only after a notification is issued; and
- Whether there is any right to invoke the MFN clause with respect to provisions of the third country with which India has entered into a Double Tax Avoidance Agreement (DTAA or treaty), which was not an Organisation for Economic Co-operation and Development (OECD) member at the time of entering into such DTAA.

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[1] Lead case being that of Civil Appeal No(s). 1420 of 2023, Decision dated 19 October 2023
[2] TS-286-HC-2021(DEL) - refer EY alert titled "Delhi HC applies 5% withholding tax under India-Netherlands DTAA on dividend income pursuant to Most-Favored-Nation clause"; TS-446-HC-2021(DEL) ; TS-416-HC-2016 (DEL)

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The SC ruled that in order to give effect to a DTAA or any Protocol changing its terms or conditions, which has the effect of altering the existing provisions of law, notification under Section 90(1) of the Indian Tax Laws (ITL) is necessary and mandatory. Unlike other countries, mere signing or ratification of a treaty does not become enforceable in India, as exclusive power to legislate the treaties entered into by India lies with the Parliament. Accordingly, the legislation is required to give effect to the treaty if it affects the rights of citizens or modifies the Indian law. Even with reference to MFN clause already agreed as part of an existing treaty, the beneficial provisions entered into with third country cannot be made applicable automatically unless a notification is issued. The treaty practice of India in relation to DTAAs and their Protocols suggests that any subsequent beneficial provision signed with other OECD member state is extended to earlier treaty beneficiaries only by way of a notification.

On the aspect of the time period when a third country should be an OECD member in order to apply the beneficial treatment accorded to such country by invoking MFN clause, the SC held that the expression "is" in the sentence "*third state which is a member of OECD*" of MFN clause, has a present significance and derives the meaning from the context. Therefore, if a party seeks to avail the benefits of a "same treatment" clause based on the existence of a DTAA between India and another third country which is an OECD member state, the relevant date is the initial treaty signing date with India and not any subsequent date when that third country becomes an OECD member.

Background

- Indian constitution permits the Union of India to enter into international tax treaties. However, it requires Parliamentary nod to legislate such treaties, which can be achieved through delegated executive function through a separate statute or through a legislative device like notifications. Treaties become effective once it is notified in the Official Gazette.
- India's DTAAs with certain OECD countries[3] have an MFN clause which provides that if after signature/entry into force[4] of the tax treaty with the first country (original treaty), 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 the first country.
- The application of MFN clause can be explained with the help of an illustration:
    - India-Netherlands (India-NL) DTAA was entered in 1989. The dividend article of India-NL DTAA provides that dividend paid by Indian entities to residents of Netherlands, who are beneficial owners of such dividend, are liable to tax at a rate not exceeding 10%[5]. However, Protocol to India-NL 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-NL DTAA as well.
    - DTAAs signed subsequently by India with countries like Slovenia, Colombia, Lithuania (third countries) provide for lower rate of 5% tax for dividend taxation, subject to certain conditions. Accordingly, if MFN clause were to be applicable, the rate under India-NL DTAA may be claimed to be reduced to 5%. However, in the present context, these third countries were not OECD members when their respective DTAAs were entered into with India. Instead, these countries became OECD members only at a later date[6].
    - Accordingly, issue arose whether the beneficial tax rate agreed under DTAAs with third countries could be applied to original tax treaties, say NL in our example, with the MFN clause.
    - In addition thereto, another issue which has also been subject matter of interpretation is whether a notification by the Government of India (GoI) is required to confer the benefit of MFN clause or the provisions operate on an automatic basis if any favorable treatment has been accorded to third State, subject to conditions stated therein.
- **Litigation before Delhi High Court:**

  The above issues have been a subject matter of litigation in India.
    - Delhi HC[7] observed that the MFN clause of the India-France DTAA is self-operational and there was no requirement to issue a notification to cover the benefit of lower rate of tax as well as the restricted scope of taxation under more than one DTAAs. Further, the Protocol containing MFN is an integral part of the DTAA. Accordingly, once the DTAA has itself been notified (which contains the Protocol including MFN clause thereof), there is no need for the Protocol to be separately notified or for the beneficial provisions of third State to be separately notified.
    - The Delhi HC in undernoted case[8] extended the benefit of lower withholding rate of 5% on dividend income as available in India's DTAAs with Slovenia/Lithuania/Columbia, though

[3] Illustratively, Netherlands, France, Switzerland, Sweden, Spain, Hungary
[4] Depending on language of the MFN clause
[5] Notification No. S.O. 693(E) dated 30 August 1999 issued by India has reduced tax rate from 15% to 10%
[6] For example, India signed DTAA with Slovenia in Feb 2005, however Slovenia became OECD member in July 2010
[7] W.P.(C) 4793/2014
[8] in the case of W.P.(C) 9051/2020

these countries subsequently became OECD members on the premise that:

- The use of the word "is" in the sentence "which is a member of the OECD" in MFN clause requires countries to be OECD members when source taxation is triggered in India and not at the time when the original DTAA (India-NL DTAA) was executed.
- Clarification issued by Netherlands authorities confirms the benefit of 5% basis MFN trigger.
- The Protocol of a DTAA forms an integral part of the DTAA and there is no requirement of issuing a separate notification in order to apply the provisions of the Protocol.
- Further, the above decision of the Delhi HC was subsequently followed by courts in various cases[9] where courts allowed the benefit of lower withholding rate pursuant to MFN clause.

- **Appeal before the SC**

  In a batch of appeals arising from the favorable Delhi HC decisions in various cases[10] on interpretation of the MFN clause contained in various Indian DTAAs (viz. Netherlands, Switzerland and France respectively), the revenue has appealed before the Supreme Court. The issue before the SC was two-fold:

  - Whether there is any right to invoke the MFN clause when the third country with which India has entered into a DTAA was not an OECD member at the time of entering into such DTAA.
  - Whether MFN clause is to be given effect to automatically or it is to only come into effect after a notification is issued in this regard.

Supreme Court ruling

The SC ruled that in order to invoke the beneficial provisions of a DTAA pursuant to MFN clause, India is required to specifically issue a notification to this effect. In absence of specific notification reflecting consequential amendment, MFN provisions cannot be invoked. The SC broadly concluded the controversy by laying down following three principles:

1. To give effect to a DTAA or any Protocol changing its terms or conditions, which has the effect of altering the existing provisions of law, notification under Section 90(1) of the ITL is necessary and mandatory.
2. 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. In such an event, the terms of the earlier DTAA require to be amended through a separate notification under Section 90 of the ITL.
3. On the aspect of the time period when a third country should be an OECD member in order to apply the beneficial treatment accorded to such country by invoking MFN clause, the SC clarified that the relevant date is the initial treaty signing date with India and not any subsequent date when that third country becomes an OECD member.

Brief reasoning provided by the SC has been discussed below:

- **Requirement of legislation to enforce treaty provisions:**
  - Having regard to the Indian Constitutional provisions (Article 253 and entries in the Union List) India has the sovereign right to enter into international treaties and conventions. However, for it to be binding on Indian nationals, treaty needs to be enacted by law or enabled through legislation. The terms of a treaty ratified by the Union do not *ipso facto* acquire enforceability.
  - Exclusive power to legislate the treaties entered into by the Union lies with the Parliament. If Parliament refuses to give effect to treaties, even though treaties bind the Union vis a vis other Contracting State, it is not binding upon Indian Nationals.
  - Unlike other countries[11], merely signing of a treaty does not result in it coming into force in India. A legislation is required to give effect to the treaty if it restricts or affects the rights of citizens or others or modifies the law of India. If such rights are not affected, no legislation is necessary. It is only in the event of any ambiguity in the law, that court is required to look at international instruments to get clarity.

- **Treaty practice of India in relation to DTAAs and their Protocol –**
  - It has been the practice of India to give effect to MFN clause of the original country pursuant to subsequent event of a more beneficial arrangement with a third country under a treaty, through an express action of issuing notification under Section 90 of the ITL. Various notifications reflect consistent practice followed by India providing the benefit of MFN clause in different scenarios[12].

[9] TS-446-HC-2021(DEL); TS-1008-HC-2021(DEL); TS-1132-HC-2021(DEL)
[10] TS-286-HC-2021(DEL); TS-446-HC-2021(DEL); TS-416-HC-2016 (DEL)
[11] State of Gujarat v. Vora Fiddali Badruddin Mithibarwala [1964 (6) SCR 461]
[12] With reference to certain DTAAs like India-Netherlands DTAA, India-France DTAA, India-Switzerland DTAA etc., wherein Notification under section 90 has been issued giving effect to beneficial treatment of DTAAs entered into by India with US, UK, Germany etc.

- In the context of controversy in the case of one of the taxpayers[13], the SC noted that the taxpayer wanted to claim the benefit of the restrictive definition of fees for technical services (FTS) (i.e., make available condition) given in the India-Portugal DTAA or India-UK DTAA by relying on the MFN Clause in India-France DTAA.

  However, the notification[14] issued by India for providing benefit of subsequent favorable DTAAs to India-France DTAA consciously omitted the "make available" condition.

- This conscious omission suggests that presence of MFN Clause in India-France DTAA does not entitle India to grant all the benefits or favorable treatments which are granted to other countries. In the case of other country with favorable DTAA provisions, a different trajectory of negotiations might have led to different kind of benefits to the third country (UK and Portugal, in the case of France). The structure of the DTAA, and its phraseology, based on negotiations with the countries with MFN clause also plays a role in the kind of benefits that are assured through it. The structure and terms of DTAAs might be different, the coverage and definition of certain terms (FTS, permanent establishment, etc.) might be dissimilar and, hence, grant of automatic benefits based on the other country's entry into OECD may not be correct.

- The third Protocol[15] of extant India-Switzerland DTAA, *inter-alia*, provides application of beneficial rate of tax to Switzerland based on third State beneficial DTAAs, while the second Protocol[16] of India-Switzerland DTAA required the governments of both contracting states to notify each other through diplomatic channels that all legal requirements and procedures, for giving effect to the Protocol so as to extend the MFN benefit, have been satisfied. The Taxpayers, based on the language of India-Switzerland DTAA, argued before the SC that the legislature has consciously used different terminology in its protocols suggesting that MFN clause as it stands today (after amendment vide third Protocol) is made auto-executory. The SC observed that the condition in third Protocol is more of a diplomatic formality rather than a substantial requirement, however, it does mandate the governments to notify each other about the assimilation of the Protocol into their respective domestic legal systems. Though, the provision does not give a specific timeline for this assimilation process, Switzerland cannot claim an exception from notification requirement solely based on the language of the third Protocol.

- **Unilateral decrees/clarifications of other countries**

  Reliance placed by the Taxpayers on the unilateral decrees/clarifications issued by governments of other countries (viz. Netherlands, France, Switzerland) to contend that India should extend reciprocity and extend similar benefit to them, following the principle of common interpretation, is not valid. Executive orders or decrees need to be understood in relation to each country's manner of assimilation of treaties in their law.

  The manner of assimilation in other countries is radically different from India and in India either the treaty has to be legislatively embodied in law through a separate statute, or get assimilated through a legislative device (i.e., notification in the gazette) under an already enacted domestic law. Until such a step is followed, treaties and its protocols are not enforceable.

- **International perspectives and practices on treaty applicability and interpretation**

  - The SC referred to Vienna Convention on Law of Treaties (VCLT), International Law Commission (ILC) Draft Conclusions and International Court of Justice (ICJ) decisions for treaty interpretation and noted that it is important to consider the practice of the parties involved in interpreting treaties. The interpretation and integration of treaties into domestic law are influenced by constitutional and political factors specific to each signatory. Domestic courts cannot approach treaty interpretation in the black letter manner as is done for enacting binding law. The role of practice, especially the practice of one party, accepted generally by the international community, is relevant and sometimes determinative.

  - The treaty practice of Switzerland, Netherlands, France and India exemplify the influence of their unique constitutional and legal regimes on treaty implementation. Particularly, from India perspective, the treaty practice reveals a consistent behavioral pattern wherein notification has been issued granting the benefit of MFN clause and such practice cannot be undermined.

- **The interpretation of the term "is" –**

  - The SC noted that Lithuania, Colombia and Slovenia were not OECD members when these countries entered into a DTAA with India, and they have become OECD members only on a later date.

  - The SC noted Delhi HC interpretation which ruled that use of word 'is', describes a state of

[13] W.P.(C) 4793/2014
[14] Notification No. S.O. 650(E), dated 10 July 2000
[15] Notification No. S.O. 2903(E), dated 27 December 2011
[16] Notification No. GSR 74(E), dated 7 February 2001

affairs that should exist not necessarily at the time of India entering into DTAA with third party countries, but when a request for parity or similar treatment is made under the MFN clause by the Taxpayers.

- The SC clarified that the expression "is" in the sentence *"third state which **is** a member of OECD"* of MFN clause, has a present signification and derives the meaning from the context and, therefore, the third State should be a member of OECD when entering into DTAA with India in order to claim the favorable benefits and obtaining membership on a later date has no significance.

Comments

The SC ruling, being the law of land and binding on all, is an important development in terms of interpretation of DTAAs and is a significant advancement in the way DTAA provisions may be interpreted in India. The SC has concluded that notification is necessary and a mandatory condition for a court, authority or tribunal to give effect to a DTAA, or any protocol changing terms or conditions, which has the effect of altering the existing provisions of law. In absence of notification, one may not be able to claim any benefit which MFN clause may provide. In view of the SC ruling, by relying on MFN clauses, Indian practice supports a consistent pattern of issuing a notification even for a consequential amendment of an agreed protocol. Further, in view of the SC ruling, the expression 'is' has a present signification and for MFN trigger, the third country had to be a member of OECD as at the relevant date of entering into its treaty with India rather than it being OECD member when MFN provision is applied.

The SC decision is likely to impact the claims which the taxpayers have made in respect of restrictive source taxation of interest, royalty, fees for technical services, dividend etc. by relying on MFN provisions and its scope as understood by lower courts.

Being a binding SC decision, the ruling may impact all pending assessments and related proceedings irrespective of stage of its pendency. It may be necessary to assess the potential effects of the SC decision on previous tax positions taken by taxpayers and withholding agents - particularly, considering the favorable decisions of lower courts. This impact analysis will need to take into account, *inter alia*, potential risks of reassessment and applicable time limits, associated interest cost, penal consequences as also consequences of short deduction of tax at source. The impacted taxpayers may need to explore if its case is fit for waiver of interest liability in terms of administrative circular[16].

[16] CBDT Circular No.3/2022 dated 3 February 2022

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