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International Tax-Circulars

International Tax

CBDT issues clarification on applicability of MFN clause in certain tax treaties [Source; Circular No. 3/2022 by Central Board of Direct Taxes dated 3 February 2022]

Facts/Background:

India has Tax Treaties with countries, namely Slovenia, Colombia and Lithuania that provide for lower rate of source taxation with respect to certain items of income. The Tax Treaties with Slovenia, Colombia and Lithuania restricts India's right to tax dividend at the rate of 5%.

India has entered into various Tax Treaties, especially with European countries and OECD members, namely, The Netherlands, France, the Swiss Confederation, Sweden, Spain and Hungary that has the Most Favoured Nation ('MFN') clause in the Tax Treaty. Where a Tax Treaty entered by India with a particular country has an MFN clause, any subsequent Tax Treaty with another OECD member country, wherein India lowers the tax rate or restricts the scope of income, such lower tax rate/ restricted scope of income as per the Tax Treaty with another OECD Member State, would also apply to the Tax Treaty with first country.

The Netherlands, France and Swiss Confederation passed the unilateral decree/ bulletin/ publication that the tax rate on dividends stands modified in view of MFN clause, whereby lower tax rate of 5% on dividend would be applicable to Tax Treaties entered by them based on lower tax rate as per Tax Treaties with Slovenia, Colombia and Lithuania. Slovenia became an OECD member on 21 July 2010, whereas Lithuania and Colombia became members of the OECD on 5 July 2018 and 28 April 2020. respectively.

The CBDT had received representations seeking clarity on the applicability of MFN clause available in the Protocol to the Tax Treaties with OECD countries, particularly on TDS on dividend income. The CBDT, in the current Circular has issued clarification on various issues raised on the applicability of MFN clause as under:

- **Requirement of Notification under section 90 of the Act**

  The CBDT has expressed the view that the applicability of the MFN clause and benefit of lower rate or restricted scope of source taxation rights, in relation to certain items of income provided in India's Tax Treaties with the third States will be available to the first (OECD) State, only when all the following conditions are met:

i. India subsequently enters into a Tax Treaty with third state.
ii. Subsequent Tax Treaty is entered into between India and a state which is a member of OCED at the time of signing the Tax Treaty;
iii. Subsequent Tax Treaty provide for lower rate of tax or restricted scope of taxation, and
iv. <u>India has issued a notification permitting invocation of MFN clause on account of beneficial treatment accorded in the subsequent Tax Treaty.</u>

The Tax Treaty or any amendment to it, could be implemented only after its notification in the Official Gazette in India. India has not issued any notification importing the benefit of treaties with Slovenia, Lithuania, and Colombia to treaties with the Netherlands, France, or Switzerland. Accordingly, the MFN clause cannot be invoked on income sourced from India unless the Indian government issues a specific notification.

- **The third state should be a member of the OECD on the date of the conclusion of the Tax Treaty**
  The MFN clauses in India's tax treaties requires the third state to be an OECD member, both, at the time of conclusion of the Treaty with India as well as at the time of applicability of the MFN clause. Where a particular country was not an OECD member at the time of entering into the Tax Treaty, a lower rate specified in such Tax Treaty cannot be imported into other Tax Treaties with MFN clause.

- **No selective import of concessional rates under MFN clause**
  India's treaties with Slovenia and Lithuania consist of a split rate of tax for dividends. Article 10(2) of the India Lithuania Tax Treaty provides for a 5% tax on dividend, if the company receiving the dividends holds directly at least 10% of the capital of the company, paying the dividends. Other dividends are to be taxed @ 15%.

  The Netherlands, France and Switzerland have taken into account the rate of 5% on holding of 10% of shareholding through the MFN clause, without switching to 15% tax rate in other cases. India has expressed its concerns on this position.

<u>CNK Comments:</u>

The Delhi High Court in the case of Concentrix Services Netherlands B.V. v. ITO had also referred to the Decree issued by the Netherlands authorities which stated lower tax rate for dividend income under the India Slovenia Tax Treaty would apply to India Netherlands Tax Treaty. India cannot have an understanding contrary to that of Netherlands basis the principles of interpretation and understanding of Tax Treaties. The CBDT Circular has given position which is not in consonance with the decision of Delhi High Court.

KEY TAKE AWAY

The Circular clarifies CBDT's stance on interpretation of MFN clauses in Tax Treaties which diverges significantly from the decision of various Courts, which has given a view that where the Tax Treaty has MFN Clause it amends the Tax Treaty automatically whereas the CBDT has clarified that it requires separate notification to apply.

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