ANALYSIS

Supreme Court ruling on the Most Favoured Nation clause likely to *withhold* benefits for taxpayers

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This analysis covers:

The Supreme Court of India (**Supreme Court**) recently delivered its much-awaited judgment in the case of *Assessing Officer v Nestle* (**MFN Judgment**).[1] The Supreme Court ruled in favour of the tax authority, denying benefits to non-residents claiming a lower rate or a narrower scope of taxation on dividends, interest, royalty or fee for technical services (**FTS**) basis the MFN clauses present in India's double taxation avoidance agreements (**DTAA**). While the judgment was in the context of India's DTAA with France, Netherlands, and Switzerland, it lays down the law for interpreting and applying MFN clauses in all of India's DTAAs.

Moreover, the Supreme Court's observations with regard to notification requirements for enforcing an MFN clause are likely to cause a ripple effect that can go far beyond the interpretation of MFN clauses and may fundamentally impact non-resident taxation in India.

> The Supreme Court recently delivered a judgment denying lower rates and narrower scope of taxation to non-residents claiming benefits under Most Favoured Nation clauses if the third state was not an OECD member when India signed the DTAA with it. The judgment lays down the law in India on interpretation and application of DTAAs and is likely to have far-reaching consequences for non-resident taxation in India.

1 The Dispute and the Ruling

India's DTAAs with a number of jurisdictions contain MFN clauses that require India to restrict its taxing rights with regard to dividends, interest, royalty and FTS to the extent restricted in its DTAAs with other OECD member states (**Third State**).[2] However, there has been a long-standing dispute between the taxpayers and the tax authority with regard to the point at which the Third State's membership to OECD is to be tested. The tax authority maintained that the Third State needs to be an OECD member at the time it enters into the DTAA with India, whereas, the taxpayers have insisted that the Third State needs to be a member of the OECD only when the taxpayer claims the benefit under the MFN clause.

In this regard, the Supreme Court addressed the following issues: (1) Whether the MFN clause may be invoked when the Third State with which India entered into a DTAA was not an OECD member at the time of entering into the DTAA but is an OECD member when the taxpayer is claiming the benefits under the MFN clause; and (2) Whether the benefit under an MFN clause can be claimed automatically upon the happening of the trigger event or whether a separate notification is required for such benefit to apply.

The Supreme Court has set aside lower court judgments that ruled in favour of taxpayers[3] and has held that (i) taxpayers resident in MFN jurisdiction can claim benefit of the MFN clause only if the Third State was a member of the OECD when it entered into the DTAA with India, and (ii) even upon satisfaction of the requirements of the MFN clause, it does not apply automatically, since a separate notification by Indian tax authority specifically extending the benefits of the MFN clause upon happening of the trigger event is required for taxpayers to avail the benefits of the MFN clause.

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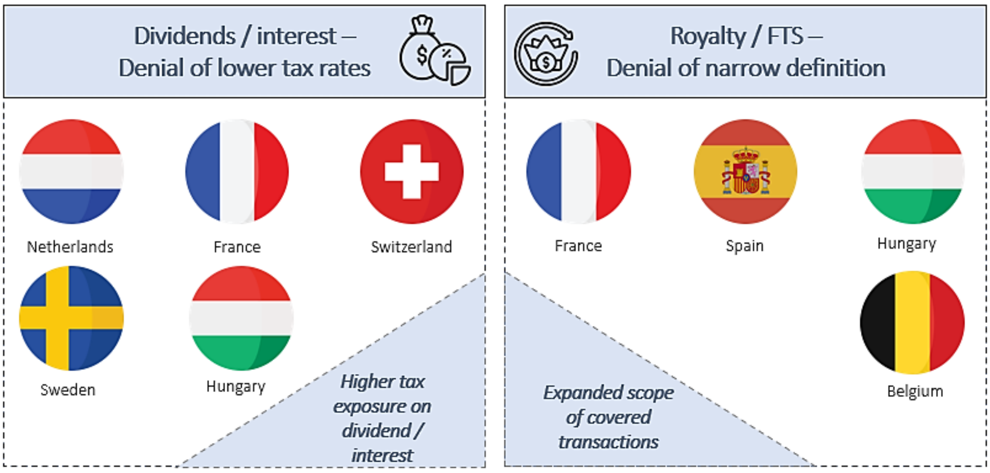
1 *Assessing Officer v Nestle SA*, Civil Appeal no. 1420 of 2023.

2 India has such MFN clauses in its DTAAs with Belgium, France, Hungary, Netherlands, Switzerland, Sweden, Spain.

3 *Steria (India) Ltd. v CIT*, [2016] 386 ITR 390 (Delhi); *Concentrix Services Netherlands v Income tax officer*, W.P.(Civil) No. 9051 of 2020; *Nestle SA v Assessing Officer*, W.P. (Civil) No. 3243 of 2021.

The diagram below represents the potential tax impact of the Supreme Court's judgment on various streams of income of non-residents based in key European jurisdictions:



* *List above is indicative only and not exhaustive*

2 Analysis and Observations

2.1 Issue 1: The time at which the Third State needs to be an OECD member

The Supreme Court arrived at its conclusion with regard to the first issue based on a technical interpretation of the expression '*is*' used in the relevant MFN clauses. The Supreme Court noted that the expression '*is*' "*has a present signification and it derives meaning from the context*". However, without explaining any further the Supreme Court drew the conclusion that for the MFN clause to be applicable, the Third State needs to be a member of the OECD when it enters into a treaty with India. In the context of interpretation of DTAAs, the Supreme Court in *Azadi Bachao Andolan v Union of India*[4] (**Azadi Bachao**) while noting that the rules of treaty interpretation are not the same as rules adopted in interpreting statutory legislation, quoted with approval leading academic texts which observed that "*the drafting of treaties is notoriously sloppy*" and that "*to get agreement, politic uncertainty is called for*."

While interpreting specific provisions of a treaty, the Vienna Convention on the Law of Treaties (**VCLT**) needs to be considered. While India is not a signatory to the VCLT, the Supreme Court has, in numerous judgments, including in the MFN Judgment, held that VCLT reflects the customary international law and is relevant for interpreting India's treaties.[5] Under the VCLT, the general rule of interpretation requires a treaty to be interpreted in accordance with its ordinary meaning, which, in turn, requires the interpreter to examine the text of the treaty in good faith together with its context as well as the object and purpose behind the treaty.[6] Such a textual approach accords primacy to the intention of the contracting parties, which is presumed to appear from the ordinary meaning of the terms used by them in the treaty.[7] However, as in the present case, such intention of the parties ascertained from the ordinary meaning of the text of the treaty may itself leave room for differing views from the perspective of the respective contracting states.

4 *Azadi Bachao Andolan v Union of India* (2004) 10 SCC 1.

5 *Ram Jethmalani v Union of India*, (2011) 339 ITR 107 (SC).

6 Vienna Convention on Law of Treaties, Article 31.

7 United Nations, *Draft Articles on the Law of Treaties with Commentaries* (1966), at commentary on article 27 (current article 31), paragraph 12.

With respect to the intention of the contracting states, from the perspective of France, the Netherlands, and Switzerland, it may be argued that, while negotiating these MFN clauses with India, they intended to ensure that they are treated at par with other OECD nations (irrespective of whether such group comprises primarily other similar affluent capital exporting nations or even other capital importing nations and less developed economies). For instance, while the OECD is generally considered to be a group of affluent capital exporting nations, it included less developed economies (such as Mexico) at the time of negotiation of some of these MFN clauses. Thus, the time at which any country becomes an OECD member should arguably be irrelevant when interpreting these MFN clauses in light of the intention of the parties from the perspective of these nations.

However, it may also be equally argued that adopting such an interpretation may result in outcomes that India could not have envisaged while negotiating these MFN clauses or while agreeing to lower rates of taxation. For instance, as noted by academics and civil society, at the time the DTAAs with France, the Netherlands and Switzerland were negotiated, the OECD was a largely static group and, accordingly, India may not have envisaged countries such as Slovenia, Lithuania and Colombia becoming members of the OECD. Further, since India typically agrees to favorable tax rates under DTAAs with the objective of encouraging investments and trade into such countries (for instance, as in the case of Mauritius), it may be argued that India specifically agreed to lower tax rates with Slovenia, Lithuania and Colombia with such objectives in mind. Thus, India while negotiating the DTAAs with states such as Colombia, may not have contemplated that these DTAAs may also alter its taxing rights under its DTAAs with countries such as France, the Netherlands and Switzerland (since investments are typically made into India from such countries). It may be argued that such an interpretation of the MFN clauses effectively deprives India of control over its taxing rights as a sovereign nation under international tax law.

While both of these arguments may have merit from the perspective of the respective contracting states, they do not seem to have been taken into account by the Supreme Court in arriving at its decision. The Supreme Court has also not considered the underlying purpose of the MFN clauses or the VCLT and instead delivered its judgment on the basis of a technical reading of a particular word.

2.2 Issue 2: Notification requirement for implementing MFN clauses

With regard to the second issue highlighted above, both the Supreme Court's decision and its reasoning are problematic and likely to open a pandora's box for taxpayers. The court's decision that a separate notification after the happening of the trigger event is required to enable taxpayers to claim benefits under an MFN clause even if the protocol containing the MFN clause is notified under Section 90 of the Income Tax Act (**ITA**), ignores the very scheme of Section 90 and the intention behind inserting it in the ITA. Further, the Supreme Court's decision is likely to give ammunition to tax authorities looking to unilaterally deny tax benefits under India's tax treaties, despite valid incorporation of such treaties into Indian law in accordance with Section 90 of the ITA.

2.2.1 Specific notification requirement is incompatible with Section 90

Under the Constitution of India, the executive has the power to enter into treaties with other countries and bind India under international law. However, under Article 253 of the Constitution, the Parliament has the exclusive power to enact legislation to enforce such treaties in India. Thus, under the Constitution of India, treaties entered into by the Union are enforceable in India only upon enactment of a legislation by the parliament to that effect.[8]

With regard to tax treaties, Section 90 of the ITA is a unique provision in that it does away with the general requirement of enacting parliamentary legislation to enforce tax treaties. Thus, Section 90 of the ITA allows the Central Government to implement a DTAA by issuing a notification in the official gazette. Once a DTAA has been notified by the government under Section 90 it is applicable in India alongside the ITA. The Supreme Court in *Azadi Bachao*, noted that a DTAA ordinarily "*would have to be translated into an Act of Parliament, which would be time-consuming and cumbersome*". The Supreme Court noted that Parliament enacted Section 90 as a special procedure for implementing tax treaties, to overcome these difficulties. Thus, under the scheme of Section 90 read with Article 253 of the Constitution, a treaty once notified has the effect of being incorporated under the domestic law.[9]

Upon notification of a DTAA or protocol containing an MFN clause under Section 90 of the ITA, such MFN clause also gets incorporated under the domestic law of India. Thus, unless the clause itself requires any further notification, its applicability should not be subject to any further notification from the executive. The MFN clauses in India's tax treaties with Netherlands, France and Switzerland do not contemplate any further action upon happening of the trigger event. Thus, the Supreme Court's reading of such requirement for application of these MFN clause is contrary to Section 90 of the ITA. Once a treaty has been incorporated into domestic law and has the force of law, implementation of such provisions should not then be subject to further notifications or actions by the executive.

2.2.2 India cannot unilaterally deny treaty benefits that are available under the MFN clause

The Supreme Court, in the context of the India-France treaty, noted that upon happening of the trigger event for the MFN clause in India-France treaty (India entering into a treaty with the USA), the Indian tax authorities issued a notification giving the benefit of the lower tax rate to French residents but not the narrower scope of taxation in the India-USA treaty. The Supreme Court, in this regard, held that even upon happening of the trigger event for an MFN clause, Indian tax authorities can choose to grant only certain specific tax benefits under the MFN clause, while denying other tax benefits. Thus, the Supreme Court noted that the tax authorities were within their powers in granting only the benefit of lower rate of tax basis the MFN clause in the India-France treaty, but deny the benefit of the narrower scope of definition of FTS despite the MFN clause being applicable to both rate and scope of taxation.

However, such a lop-sided interpretation of the MFN clause is contrary not only to the established principles of treaty interpretation but also to Section 90 of the ITA. As discussed above, upon notification of a protocol containing the MFN clause, the MFN clause gets incorporated in the domestic law of India. In this regard, Section 90 requires the tax authorities to grant the taxpayer more beneficial tax treatment under the ITA or the DTAA. Thus, allowing the tax authorities to unilaterally deny certain benefits even if such benefits are available under an applicable MFN clause is a violation of the express mandate of Section 90. The premise that the text of an existing treaty or notification issued to implement a treaty under Section 90 has to be amended to give effect to a subsequent rate change or restricted scope for instance is incorrect as the notification under domestic law is clear with regard to its automatic effect by directly referring to other notifications which form part of domestic law. An additional notification is only needed where new text has to be incorporated into an existing section 90 notification. Where the language under the existing Section 90 notification clearly states

[8] Id.
[9] Id.

that a differential rate or restricted scope will apply on certain conditions being met, no further notification should be required for the differential rate or restricted scope to apply.

2.2.3 Subsequent practice cannot be unilateral

The Supreme Court heavily relied on India's '*practice*' of issuing specific notifications for providing the benefit of MFN clauses upon happening of the trigger event. The Supreme Court in this regard noted that India has over the years issued specific notifications to implement MFN clauses in the India-France treaty, and India-Canada treaty. The Supreme Court, while relying on the VCLT concluded that India's subsequent practice is determinative of its treaty obligations.

The Supreme Court in the MFN Judgment is right that the VCLT does allow for resorting to subsequent practice for interpreting a treaty. However, under the VCLT only subsequent practice "*which establishes the agreement of the parties*" is relevant.[10] Thus, unilateral practice of one contracting state is generally not regarded as a binding aid to the interpretation of a bilateral DTAA since it reflects the views of only one contracting state and not the agreement between both the states.[11]

The reliance placed by the Supreme Court on India's unilateral practice to interpret India's tax treaties is particularly surprising and contradictory considering that the Supreme Court rejected the unilateral decrees issued by the Netherlands, France and Switzerland. Given that the decrees issued by these nations were opposite to the '*practice*' in India, it cannot even be said that these nations acquiesced to India's practice. Thus, even if a practice of issuing specific notifications to implement MFN clauses exists in India and the same is not in violation of Section 90 of the ITA, the practice cannot be considered to be a subsequent practice for interpreting India's tax treaties.

The Supreme Court has in effect conflated two issues namely how the treaty in question may be interpreted in light of '*subsequent practice*' (which is an international DTAA interpretation issue) and a purely domestic law issue as to whether a notification is required under Section 90 to implement the treaty under Indian law. It has incorrectly applied rules of interpretation for international tax treaties, such as '*subsequent practice*', under VCLT to arrive at a conclusion that a domestic law notification is required under Section 90 of the ITA. Being a domestic law issue, the question of whether a subsequent notification is required under Section 90 has to be interpreted according to rules of statutory interpretation in light of the Constitutional provisions, and to that extent this ruling is fundamentally flawed.

2.2.4 Unilaterally distorting the balance of tax treaties

Tax treaties are an agreement between two contracting jurisdictions that create obligations under international law. In this regard, tax treaties represent a compromise between contracting jurisdictions with the objectives of providing tax certainty and encouraging cross-border trade between the two jurisdictions. However, the MFN Judgment effectively allows India to unilaterally alter the compromise it agreed to with its treaty partner, even after it has incorporated the treaty in its domestic law. The Supreme Court's act of granting such a power to India's executive is contrary to the customary international law principle reflected in Article 26 of the VCLT, which binds the contracting states to the treaty and requires them to perform it in good faith. Further, it also detracts from the above objectives behind entering into tax treaties in the first place.

The Supreme Court's judgment has set a discouraging precedent for the investors in India as it undermines tax certainty and confidence in obtaining treaty benefits.

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10 Article 31(3)(b) of the Vienna Convention on Law of Treaties.

11 Phillip Baker, Double Taxation Conventions, Sweet & Maxwell, 3rd Ed., paras E.30-31

3 Conclusion

The present controversy has been continuing for a number of years, but the tax authority failed to offer any clarity to taxpayers. It is likely that benefits have been given to many taxpayers and that India's own '*subsequent practice*' is mixed at best and not been consistent. Considering India's goal of enhancing the ease of doing business and providing tax certainty, the government should have proactively clarified its stance.

Considering the MFN Judgment is now the law of the land, it is crucial that the Indian tax authority do not use this judgment as ammunition against settled past transactions. The positions taken by the taxpayers over the years were supported by India's treaty partners and by various judicial forum across India, including the Delhi High Court. Thus, to prevent undue hardship to bonafide cross-border transactions and to prevent a repeat of the Vodafone controversy, the MFN Judgment should be made applicable prospectively. The Indian tax authority should issue a circular reassuring non-resident investors that historical transactions will not be reopened by the tax authority.