

EY Tax Alert

Delhi HC applies 5% withholding tax under India-Netherlands DTAA on dividend income pursuant to Most-Favored-Nation clause

Tax Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

Executive summary

This Tax Alert summarizes a decision of the Delhi High Court (HC), dated 22 April 2021, in the case of Concentrix Services Netherlands B.V. and Optum Global Solutions International B.V. (collectively called as Taxpayers) on the issue of rate of withholding tax applicable on the dividend income received from Indian subsidiaries as per India-Netherlands (I-NL) Double Taxation Avoidance Agreement (DTAA). The Taxpayers, Netherlands residents, applied for lower withholding certificate under the Indian Tax Law (ITL) seeking a 5% withholding tax rate on dividends payable by their Indian subsidiaries by virtue of Most-Favored-Nation (MFN) clause read with DTAA entered into by India with Slovenia, Lithuania and Columbia which provide for a beneficial withholding rate of 5%. The tax authority issued withholding certificate at the rate of 10% on the basis that I-NL DTAA provide for 10% source-taxation and MFN clause is not triggered as Slovenia, Lithuania, and Columbia were not Organisation for Economic Co-operation and Development (OECD) member countries when I-NL DTAA was executed whilst these countries became members of OECD only on a later date.

By applying the principles of parity, the HC granted the benefit of 5% withholding tax rate on dividend income by virtue of MFN clause of I-NL DTAA and directed that the withholding certificates providing for 10% rate should be quashed and a fresh certificate indicating lower rate of 5% should be issued. The HC observed that MFN clause which is a part of the protocol to I-NL DTAA is an integral part of I-NL DTAA and no separate notification is required to apply MFN provisions of I-NL DTAA. Further, 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 subject DTAA (I-NL DTAA) was executed. The HC also noted that clarification issued by Netherlands provides benefit of 5% rate pursuant to India-Slovenia DTAA. For efficient and fair application of I-NL DTAA, the HC held that common interpretation should be applied to ensure consistency and equal allocation of tax claims between the contracting states as the rules of interpretation that apply to domestic or municipal law need not be applied, as DTAA's are negotiated by diplomats and not necessarily by men instructed in the law.

Background

- ▶ I-NL DTAA was entered in 1989 and was subsequently amended by way of Notification¹ dated 30 August 1999.
- ▶ As per I-NL DTAA, dividend paid by Indian entities to residents of Netherlands, who are beneficial owners of such dividend, is liable to withholding tax at a rate not exceeding 10%.
- ▶ Further, protocol to I-NL DTAA has an MFN clause which states 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 I-NL DTAA as well. The relevant extract of the MFN clause is as below:

*"If after the signature of this convention under any Convention or Agreement between India and a third State **which is a member of the OECD**, India should limit its taxation at source on dividends, interests, to a rate lower or a scope more restricted than the rate or scope provided for in this Convention on the said items of income, then as from the date on which the relevant Indian Convention or Agreement enters into force the same rate or scope as provided for in that Convention or Agreement on the said items of income shall also apply under this Convention."*

- ▶ It may be noted that some of Indian DTAA's with countries like Slovenia, Lithuania and Columbia (which are OECD member countries) provide for a lower withholding rate of 5% for dividend taxation subject to conditions. These countries were not OECD members when DTAA was entered into by India, but became OECD members only at a later date, post 2010.

Facts:

- ▶ The Taxpayers, being resident of Netherlands, were contemplating to receive dividend income from its wholly-owned Indian subsidiaries.
- ▶ The Taxpayers made an application with the tax authority to grant a lower rate withholding certificate under the ITL, wherein the request was to permit remittance of dividend by Indian companies after withholding taxes at lower rate of 5% as per I-NL DTAA read with MFN clause and India's DTAA's with Slovenia/ Lithuania/ Columbia.
- ▶ The tax authority issued a withholding tax certificate stating that the taxes will be required to be withheld at the rate of 10% as per I-NL DTAA when dividend income is remitted.
- ▶ The Taxpayers contended that the benefit of MFN clause was automatic and triggered the moment India entered into a beneficial DTAA with a member of OECD and there was no requirement to issue any specific notification to accord the beneficial rate of 5%. Aggrieved by the same, the Taxpayers filed writ petitions before the Delhi HC.

Tax authority's contention:

- ▶ Slovenia, Lithuania, and Columbia were not OECD members on the date when India executed DTAA's with these countries. Accordingly, the MFN benefit given to these countries is in their own right and was not due to the fact that they were OECD members.
- ▶ Further, the benefit of MFN clause would be available only if the country with which India enters into a DTAA was an OECD member at the time of execution of the subject DTAA (i.e. I-NL in the present case). However, Slovenia, Lithuania and Columbia were not OECD members on the date of execution of I-NL DTAA and became members only on a later date. Thus, MFN clause of I-NL DTAA have no applicability.

¹ Notification No. S.O. 693(E)

- ▶ Further, no notification has been issued in order to give effect to the MFN clause of I-NL DTAA.

HC ruling:

The HC granted the benefit of 5% withholding tax rate on dividend income by virtue of MFN clause of I-NL DTAA and based on the below reasonings ruled that the 10% withholding certificates should be quashed and a fresh certificate indicating lower rate of 5% should be issued by the tax authority:

- ▶ 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. Reliance was placed on the Delhi HC decision in the case of Steria (India) Ltd. v. CIT [[2016] 386 ITR 390].
- ▶ The MFN clause, which forms part of the protocol, incorporates the principle of parity between I-NL DTAA and the DTAA's executed with the third states thereafter by India qua the rate of withholding tax or the scope of the DTAA in respect of items of income concerning dividends, interest, royalties, etc.
- ▶ As per the MFN clause, the principle of parity is applicable if the following conditions are satisfied:
 - ▶ The third state with whom India enters into a DTAA should be a member of the OECD.
 - ▶ The DTAA executed with the third state limits the rate of withholding tax imposed by India at a rate lower or a scope more restricted, than the rate or scope provided in the subject DTAA, i.e., I-NL in the present case.
- ▶ On satisfaction of the above conditions, the benefit of lower withholding tax or the restricted scope of DTAA with the third state should be applicable to I-NL DTAA from the date when the DTAA with the third country comes into force.
- ▶ Further, the contention of the tax authority that the benefit of MFN clause would be available only if the country with which India enters into a DTAA was an OECD member at the time of execution of the subject DTAA (i.e. I-NL in the present case) is misconceived and contrary to the plain language of I-NL DTAA. Rather, there could be a hiatus between the dates on which the DTAA is executed between India and the third state and the date when such third state becomes a member of OECD. The MFN clause can only apply when the third state fulfils the attribute of being a member of the OECD.

- ▶ On the contention of the tax authority that MFN clause of I-NL DTAA can be made applicable only in cases where the third state "is" a member of OECD on the date when the DTAA has been entered into with India, whereas the DTAA's with Slovenia/Lithuania/Columbia were entered into with India when these countries were not OECD members and became OECD members only on a later date, the HC has observed as below:

- ▶ The word "is" describes a state of affairs that should exist not necessarily at the time when I-NL DTAA was executed but when a request is made by the payer or deductee for issuance of a lower rate withholding tax certificate under the ITL.
- ▶ Assuming the DTAA language is susceptible to two readings, to glean the intent of the India and Netherlands in framing MFN clause reliance can be placed on the decree issued by Netherlands, wherein Netherlands has provided the benefit of 5% withholding tax with reference to participation dividend paid by companies resident in Netherlands to a body resident in India from the date when Slovenia became a member of OECD.
- ▶ As per "common interpretation" rule, in order to allocate tax claims equally between the two contracting states, the courts of the contracting states are required to ensure that DTAA's are applied efficiently and fairly so that there is consistency in the interpretation of the provisions by the tax authority and courts of the concerned states. However, the common interpretation rule should be applied with care and caution having regard to the fact that the view expressed could be unique and/or personal to the tax authority or a court. Hence, an attempt should be made to choose a view that finds general acceptance with courts and authorities.
- ▶ In the present case, Netherlands has interpreted the MFN clause in a particular way and, therefore, the principle of common interpretation should apply on all fours to ensure consistency and equal allocation of tax claims between the contracting states.
- ▶ While interpreting international treaties including DTAA's the rules of interpretation that apply to domestic or municipal law need not be applied, as international treaties, conventions and DTAA's are negotiated by diplomats and not necessarily by men instructed in the law.

- ▶ Therefore, interpretation of DTAA is liberated from the technical rules which govern the interpretation of domestic/municipal law. The core function of a DTAA should be seen to aid commercial relations and equitable distribution of tax revenues in respect of income which falls for taxation in both the contracting States.

Comments

The HC decision provides guidance well in time as the issue of lower withholding pursuant to MFN clause has been a topic of debate especially due to switch over to classical system of dividend taxation in India from tax year 2020-21 and onwards. The HC reiterates that MFN clause has automatic application and there is no requirement of any notification in order to trigger MFN clause^[2]. Further, by applying the principles of parity, the HC has granted the benefit of lower rate pursuant to MFN clause as agreed by India in other relevant DTAA entered into after I-NL DTAA was executed.

The ruling is of significance as many DTAA entered into by India with countries such as France, Spain, Switzerland and Hungary have comparable MFN clauses. Furthermore, MFN clauses do also extend to income in the nature of interest, royalties and fees for technical services and hence multi-national companies from such countries may wish to evaluate the impact of this favorable ruling in respect of dividend and other streams of income.

^[2] India-Switzerland and India-Finland DTAA may stand on a different footing due to peculiar language

Our offices

Ahmedabad

22nd Floor, B Wing, Privilon,
Ambli BRT Road, Behind Iskcon Temple,
Off SG Highway,
Ahmedabad - 380 015
Tel: +91 79 6608 3800

Bengaluru

6th, 12th & 13th floor
"UB City", Canberra Block
No.24 Vittal Mallya Road
Bengaluru - 560 001
Tel: +91 80 6727 5000

Ground Floor, 'A' wing
Divyasree Chambers
11, O'Shaughnessy Road
Langford Gardens
Bengaluru - 560 025
Tel: +91 80 6727 5000

Chandigarh

Elante offices, Unit No. B-613 & 614
6th Floor, Plot No- 178-178A,
Industrial & Business Park, Phase-I,
Chandigarh - 160002
Tel: +91 172 671 7800

Chennai

Tidel Park, 6th & 7th Floor
A Block, No.4, Rajiv Gandhi Salai
Taramani, Chennai - 600 113
Tel: +91 44 6654 8100

Delhi NCR

Golf View Corporate Tower B
Sector 42, Sector Road
Gurgaon - 122 002
Tel: +91 124 443 4000

3rd & 6th Floor, Worldmark-1
IGI Airport Hospitality District
Aerocity, New Delhi - 110 037
Tel: +91 11 4731 8000

4th & 5th Floor, Plot No 2B
Tower 2, Sector 126
NOIDA - 201 304
Gautam Budh Nagar, U.P.
Tel: +91 120 671 7000

Hyderabad

THE SKYVIEW 10
18th Floor, "Zone A"
Survey No 83/1, Raidurgam
Hyderabad - 500032
Tel: +91 40 6736 2000

Jamshedpur

1st Floor, Shantiniketan Building
Holding No. 1, SB Shop Area
Bistupur, Jamshedpur - 831 001
Tel: +91 657 663 1000

Kochi

9th Floor, ABAD Nucleus
NH-49, Maradu PO
Kochi - 682 304
Tel: +91 484 433 4000

Kolkata

22 Camac Street
3rd Floor, Block 'C'
Kolkata - 700 016
Tel: +91 33 6615 3400

Mumbai

14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (W), Mumbai - 400 028
Tel: +91 22 6192 0000

5th Floor, Block B-2
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: +91 22 6192 0000

Pune

C-401, 4th floor
Panchshil Tech Park
Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: +91 20 4912 6000

Ernst & Young LLP

EY | Assurance | Tax | Strategy and Transactions | Consulting

About EY

EY is a global leader in assurance, tax, strategy, transaction and consulting services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. For more information about our organization, please visit ey.com.

Ernst & Young LLP is one of the Indian client serving member firms of EYGM Limited. For more information about our organization, please visit www.ey.com/en_in.

Ernst & Young LLP is a Limited Liability Partnership, registered under the Limited Liability Partnership Act, 2008 in India, having its registered office at 22 Camac Street, 3rd Floor, Block C, Kolkata - 700016

© 2021 Ernst & Young LLP. Published in India.

All Rights Reserved.

ED None

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.



Download the EY India Tax
Insights App

ey.com/en_in

[@EY_India](https://twitter.com/EY_India)

[in](https://www.linkedin.com/company/ey) EY

[You Tube](https://www.youtube.com/channel/UCYU838U2R9611111111111111) EY India

[f](https://www.facebook.com/EYCareersIndia) EY Careers India

[ig](https://www.instagram.com/ey_indiacareers) @ey_indiacareers