This Tax Alert summarizes a recent Central Board of Direct Taxes (CBDT) Circular No. 3/2022 dated 3 February 2022 (Circular), clarifying the applicability of MFN clause of Indian Double Taxation Avoidance Agreements (DTAAs or treaties) with OECD member states (or countries). The CBDT has issued the Circular in light of several representations received, seeking clarity on the applicability of the MFN clause.

The Circular provides that benefit of lower rate and restricted scope under MFN clause will be extended only when all the below conditions are satisfied cumulatively:

► India’s DTAA with the country which has beneficial lower rate or restricted scope (referred as the third State) is entered into after the signature/entry into force (depending upon language of MFN Clause) of India’s DTAA.

► The third State has to be an OECD member at the time of signing its treaty with India.

► India limits its taxing rights in relation to the rate or scope of taxation in its treaty with the third State.

► India issues a separate notification under the Income Tax Laws (ITL) for importing the favorable benefits of third State treaty into the original treaty.

Further, the above Circular will not be applicable in case of taxpayers who have received a favorable decision by any court on the applicability of MFN clause.
Background

India’s DTAAs with certain OECD countries² have an MFN clause which provides that if after signature/ entry into force³ of the tax treaty with first State (original treaty), India enters into a DTA 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 first State.

The application of MFN clause is explained with the help of an illustration. The dividend article of India- Netherlands (NL) DTA 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 15%⁴. However, DTAAs signed subsequently by India with countries like Slovenia, Colombia, Lithuania (third countries) provides 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 DTA 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 date⁵. 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.

This issue has been a matter of litigation in India. The Delhi High Court (HC) in case of Concentri⁶ extended the benefit of lower withholding rate of 5% on dividend provided in the DTAAs with third countries by invoking MFN Clause under India-NL DTA. Some of the key observations made by Delhi HC are:

► 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 DTA (India-NL DTA) was executed.

► Clarification issued by Netherlands provides benefit of 5% rate pursuant to India-Slovenia DTA.

► For efficient and fair application of India-NL DTA, a common interpretation should be applied to ensure consistency and equal allocation of tax claims between the contracting states as DTAAs are negotiated by diplomats and not necessarily by men instructed in the law.

This decision was subsequently followed by various courts in cases like Nestle⁷, Deccan Holdings⁸, Cotecna Inspection⁹ where courts allowed benefit of lower withholding rate pursuant to MFN clause to taxpayers.

Further, countries like Netherlands, France, Switzerland have issued unilateral clarifications for application of MFN clause:

► Netherlands and France published a decree¹⁰/ a notification¹¹ wherein it has been categorically provided that the treaty benefit of 5% rate as available in Slovenia treaty shall be made applicable to Netherlands/France DTA as well due to Slovenia becoming an OECD member, even though at a later date. It has been further stated in the decree/notification that the lower rate will be applicable retrospectively from the date Slovenia became member of the OECD.

► The Swiss competent authorities also released a similar statement¹² on 13 August 2021 wherein applicability of MFN clause was made conditional upon India’s acceptance.

Due to lack of guidance in the Indian context, representations were filed before Indian tax authorities seeking clarification on India’s stand on application of MFN clause. In light of the same, the CBDT issued the Circular clarifying its position.

Clarification provided in the Circular

On 3 February 2022, CBDT issued the Circular, clarifying India’s position on interpretation of MFN clause present in the Protocol to India’s DTAAs with certain OECD member countries. Briefly, the Circular states as below:

1. Plain reading of MFN clause clearly provides that the third State has to be a member of OECD both at the time of conclusion of the DTA with India as well as at the time of applicability of MFN clause.

2. Unilateral decree/notifications/clarifications given by other treaty partner does not represent shared understanding on applicability of the MFN clause.

► The unilateral instruments issued by Netherlands and France have no binding effect as the same has been issued without any consultation with India. These instruments represent only the views of the respective governments and does not

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² Netherlands, France, Switzerland, Sweden, Spain, Hungary
³ Depending on language of the MFN clause
⁴ Notification No. S.O. 693(E) dated 30 August 1999 issued by India has reduced tax rate from 15% to 10%
⁵ For example, India signed DTA with Slovenia in Feb 2005, however Slovenia became OECD member in July 2010
⁶ TS-286-HC-2021(DEL), Refer EY alert titled “Delhi HC applies 5% withholding tax under India-Netherlands DTA on dividend income pursuant to Most-Favored-Nation clause” dated 23 April 2021
⁷ TS-446-HC-2021(DEL)
⁸ TS-1008-HC-2021(DEL)
⁹ TS-1132-HC-2021(DEL)
¹⁰ Decree No IFZ 2012/54M, dated 28 February 2012
¹¹ dated 4 November 2016
have any effect on curtailing the tax liability that is payable to the Government of India (GoI).

► Extending MFN benefit based on Slovenia being OECD member state at the time of applicability of the MFN clause defeats the object and purpose of the MFN clause when Slovenia was not an OECD member when India entered into DTAA.

► As it appears from the Circular, India’s position on interpretation of MFN clause has been communicated to Netherlands/France and no reply has been received from these countries.

► Further, India has also communicated its position to Switzerland that the benefit cannot be imported as third State was not a member of OECD at the time of signing the DTAA.

3. Concessional rate or restricted scope to apply from the date of entry into force of the DTAA with the third State and not from the date on which such third State becomes an OECD member.

► Where wording of the MFN clause mandates the application of lower rate from the date of entry into force of the Indian DTAA with the third State, its application from the date of third State becoming OECD member by the unilateral instruments of Netherlands, France and Switzerland is not in accordance with the provision of MFN clause.

► One should not ignore the clear wording of the MFN clause which mandates application of lower rate from the date of entry into force of the Indian DTAA with third State.

4. Requirement of notification for implementation of tax treaty provisions under the ITL:

► As per the Supreme Court ruling in the case of Azadi Bachao Andolan\(^\text{13}\), a notification under the provisions of the ITL is required to implement the provisions of a DTAA.

► India has not issued any notification importing the beneficial provisions from DTAA with Lithuania to the DTAA with France, Netherlands or Switzerland.

5. Selective invocation and application of MFN clause as reflected in unilateral instruments of NL/France/Switzerland is not permitted as per the rules of interpretation of international treaties.

► India-Lithuania DTAA provides for the beneficial rate of 5% on dividend income only if the company, receiving the dividends, hold directly at least 10% of the capital of the dividend paying company. However, in all other cases, the rate prescribed is 15%.

► Import of only concessional rate of 5% and not the 15% for other cases by invoking MFN clause is not justified.

6. Further, it is provided that benefit of lower rate and restricted scope under MFN clause will be provided only when all the below conditions are satisfied cumulatively:

► Treaty with third State is entered into after the signature/entry into force (depending on language of MFN clause) of India’s DTAA.

► Third State has to be an OECD member at the time of signing its treaty with India.

► India limits its taxing rights in relation to rate or scope of taxation in its treaty with the third State.

► India issues a separate notification under the ITL for importing the favorable benefits of third State treaty into the original treaty.

7. It is also clarified that the Circular will not be applicable to those taxpayers in whose case there is a favorable decision by any court on this issue.

\(^{13}\) 2004, 10SCC
The present CBDT Circular provides guidance on application of MFN clause, especially with reference to the DTAs entered into with the OECD countries. The Circular provides that MFN clause with OECD countries can be made applicable only in circumstances where the beneficial treaty with the third State is entered subsequent to the original treaty and when the third State is already an OECD member. Further, the Circular concludes that benefit of MFN clause in Indian DTAs can be made applicable only when a notification in this regard has been issued by the Govt.

The above aspects clarified in the Circular appear to be at divergence compared to legal positions upheld by the courts. To illustrate:

- **The Delhi HC in the case of Concentrix**\(^{13}\) extended the benefit of MFN basis the treaty with third countries, wherein the third countries became OECD members at a date later than the date when DTA was entered into by India. Basis the language of MFN provision, the Delhi HC held that one needs to test the conditions as on the date of transaction and treaty applicability rather than the date when third State DTA was entered into. Further, the Delhi HC also noted that the clarification issued by Netherlands provides benefit of 5% rate pursuant to India-Slovenia DTA.

- **Further, it’s a generally accepted principle that Protocol is an integral part of the DTA and in that sense, there may be no need for a separate action for giving effect to the self-operational MFN clause provided in the DTAs, once the DTA (which contains the Protocol including MFN clause thereof) has itself been notified.** This is also supported by Delhi HC in case of Steria\(^{14}\) which is presently pending before the Supreme Court\(^{15}\).

Further the Circular seems to proceed on the basis that unilateral clarifications provided by other contracting states have adopted inconsistent pick and choose approach to apply only concessional rate and to an overall article. This could also be a subject matter of debate as MFN provision in terms of its clear language applies to confer only the benefit.

It is well accepted principle of interpretation that the Circular binds taxpayers only if it is favorable to taxpayers and not in cases where it was to be inconsistent with correct legal position.

Taxpayers intending to take the benefit of MFN in Indian context might need to evaluate the impact of the Circular taking into account applicable legal position and considering risk and consequences of failure of short tax deduction or short payment of tax.

\(^{13}\)TS-286-HC-2021(DEL), Refer EY alert titled “Delhi HC applies 5% withholding tax under India-Netherlands DTA on dividend income pursuant to Most-Favored-Nation clause” dated 23 April 2021

\(^{14}\)TS-416-HC-2016 (DEL), Refer EY Alert titled “Delhi High Court rules on application of MFN Clause, holds managerial services not taxable in India” dated 2 August 2016

\(^{15}\)Diary No. 4444/2017 filed on 8 February 2017
Our offices

Ahmedabad
22nd Floor, B Wing, Privilon
Ambil BRT Road, Behind Iskcon Temple, Off SG Highway
Ahmedabad - 380 059
Tel: + 91 79 6608 3800

Bengaluru
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 - 160 002
Tel: + 91 172 6717800

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
Gurugram - 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
Gautam Budh Nagar, U.P.
Noida - 201 304
Tel: + 91 120 671 7000

Hyderabad
THE SKYVIEW 10
18th Floor, “SOUTH LOBBY”
Survey No 83/1, Raidurgam
Hyderabad - 500 032
Tel: + 91 40 6736 2000

Jammu
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: + 91 133 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

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