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# Indian Ministry of Finance issues Circular on MFN clauses in Indian DTAAs

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**This blog is an update to our previous blogs titled "Reduction of Dividend WHT (to 5%) under India-Netherlands DTAA as India abolishes DDT (from 1 April 2020)" and "Delhi High Court confirms 5% dividend WHT rate under India-Netherlands DTAA". These blogs affirm that the effective WHT rate on dividends distributed by Indian subsidiaries to their parent companies in the Netherlands could be reduced from 15% (as stipulated in the India-Netherlands DTAA) to 5% (by operation of the MFN-clause in the DTAA) based on a Decree of the Dutch Ministry of Finance[1] and a recent Delhi High Court ruling[2]. On 3 February 2022, the Indian Central Board of Direct Taxes ("CBDT") issued a Circular stating their interpretation on the MFN clauses in India's DTAAs with European/OECD member countries, including the Netherlands. The Circular states that the effective WHT rate on dividends under the India-Netherlands DTAA should be 10% (and not 5% as stated in the Dutch Decree and the Delhi High Court ruling). In this blog, we summarize the main contentions of the CBDT with regard to the effective rate of dividend WHT under the India-Netherlands DTAA and also touch upon some considerations for Dutch companies receiving dividends from their Indian subsidiaries.**

## Background

India's Double Tax Avoidance Agreements ("DTAAs") with 12 countries (namely, the Netherlands (1988), Philippines (1990), France (1992), Belgium (1993), Spain (1993), Switzerland (1993), U.K. (1993), Sweden (1997), Hungary (2003), Saudi Arabia (2006), Finland (2010) and Nepal (2011)) contain Most Favoured Nation ("MFN") clauses. While the MFN clause in the DTAA with Philippines deals with income from air transport and those in the DTAAs with Saudi Arabia and U.K. deal with deduction of expenses in relation to permanent establishments, the MFN clauses in the other 9 DTAAs deal with WHT on dividends, interest, royalties and fees for technical services. Though the 9 MFN clauses are formulated differently, the underlying purpose of these clauses is that India is obliged to provide "favourable treatment" (as in, lower WHT rate or more restricted scope of application) to the residents of the DTAA-partner country (in relation to the item of income specified – dividends and/or interest and/or royalties) if such treatment is provided to the residents of certain other DTAA-partner countries via DTAAs concluded after the DTAA that contains the MFN clause.

MFN clauses are particularly difficult to interpret as they allow for specific "favourable treatment" provided for under certain other DTAAs to be imported into the DTAAs with the MFN clauses. Hence, there is some ambiguity as to the effective WHT rate on dividends paid by Indian companies to shareholders in the Netherlands. The ambiguity/room for alternate interpretations regarding the effective rate of WHT on dividends under the India-Netherlands DTAA arises from the wording of the MFN clause in the India-Netherlands DTAA, which can be found in Clause (IV)(2) of the Protocol to the DTAA.

## Operation of the MFN clause in the India-Netherlands DTAA

The India–Netherlands DTAA provides for a 15% WHT rate on dividends. However, Clause (IV)(2) of the Protocol guarantees the Netherlands favourable treatment with regard to WHT rates on dividends, interest, royalties and fees for technical services or for the use of equipment. This MFN clause reads as follows: *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, interest, royalties, fees for technical services or payments for the use of equipment 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 India 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.*

[1] Decree No. IFZ 2012/54M, dated 28th February 2012 issued by the Directorate General for Fiscal Affairs of the Netherlands.

[2] Delhi High Court judgement in the (joint) cases of Concentrix Services Netherlands B.V. vs Income Tax Officer (TDS), W.P. (C) 9051/2020 and Optum Global Solutions International B.V. vs Deputy Commissioner of Income Tax, W.P. (C) 882/2021, dated 22 April 2021.

Accordingly, with regard to dividends paid by Indian companies to their Dutch shareholders, India is obliged to apply a WHT rate lower than 15% if such lower rate has been awarded to shareholders in another treaty-partner-country (which is a member of the OECD) via a DTAA signed after the India-Netherlands DTAA. The lower dividend-WHT rate should be applied (under the India–Netherlands DTAA) from the date on which the other DTAA comes into force. India's DTAA with Germany (which entered into force in 1997, 9 years after the India-Netherlands DTAA was signed) provides for a 10% WHT rate on dividends. Germany was a member of the OECD (since 1961) when its DTAA with India was signed/came into force (in 1997) as well as when the India-Netherlands DTAA was signed (in 1989). The Indian tax authorities (at all levels) agree that the 10% WHT rate prescribed in respect of dividends in the India-Germany DTAA can be imported into the India-Netherlands DTAA (via the MFN clause in this DTAA) from the date on which the India-Germany DTAA came into force in 1997.

India's DTAAs with Slovenia and Lithuania provide for a 15% WHT rate on dividends, except in cases where the company in receipt of the dividends directly holds at least 10% of the capital of the company paying the dividends. In such case, the prescribed dividend WHT rate is 5%. India's DTAA with Slovenia came into force in 2006 and the DTAA with Lithuania came into force in 2013 (i.e. 15 years and 22 years after the India-Netherlands DTAA was signed). However, at the time these DTAAs were signed/came into force (i.e. in 2006 and 2013, respectively), Slovenia and Lithuania were not members of the OECD, nor were these countries members of the OECD when the India-Netherlands DTAA was signed (back in 1989). Slovenia became a member of the OECD in 2010 (i.e. 4 years after the India-Slovenia DTAA was signed), whereas Lithuania became a member of the OECD in 2018 (i.e. 5 years after the India-Lithuania DTAA was signed). Further, India's DTAA with Columbia, which came into force in 2015 (i.e. 17 years after the India-Netherlands DTAA was signed), provides for a 5% WHT rate for dividends (without any minimum holding criteria). Columbia was not a member of the OECD when this DTAA was signed/came into force (in 2015), and only became a member of the OECD as recently as 2020.

| Treaty partner | Treaty in force | Dividend WHT rate | OECD member status |
|---|---|---|---|
| Netherlands | 1989 | 15% | 1961 |
| Germany | 1997 | 10% | 1961 |
| Slovenia | 2006 | 5% (≥ 10% shareholding) | 2010 |
| Lithuania | 2013 | 5% (≥ 10% shareholding) | 2018 |
| Colombia | 2015 | 5% | 2020 |

## Delhi High Court ruling of 22 April 2021

Based on the MFN clause in the India-Netherlands DTAA and the dividend WHT rates prescribed in the Slovenian, Lithuanian and Columbian DTAAs, two Dutch companies applied for WHT certificates seeking a 5% WHT rate on dividends received from their respective Indian subsidiaries in 2020. The Indian tax authorities issued WHT certificates for the rate of 10% based on the WHT rate for dividends prescribed in the India-Germany DTAA, reasoning that, since Slovenia, Lithuania and Columbia were not OECD member countries when the India-Netherlands DTAA was signed, these DTAAs could not be relied upon to lower the dividend WHT rate in the India-Netherlands DTAA. The Dutch companies appealed to the Delhi High Court against the WHT certificates issued by the Indian tax authorities.

On 22 April 2021, the Delhi High Court set aside the WHT certificates issued by the Indian tax authorities and directed the tax authorities to issue fresh WHT certificates with a lower WHT rate of 5%. The Delhi High Court firstly observed that the MFN clause in the India-Netherlands DTAA, which is part of the Protocol thereto, is an integral part of the DTAA and therefore, no separate notification is required to apply the MFN provisions. More importantly, the Court observed that the use of the word "is" in the sentence, "which is a member of the OECD", as stated in the MFN clause, requires countries to be OECD members when the source taxation in India is triggered, and not at the time the India-Netherlands DTAA was signed.

The Court referred to Decree No. IFZ 2012/54M dated 28th February 2012, issued by the Directorate General for Fiscal Affairs of the Netherlands, declaring that the dividend WHT rate under the respective DTAA is 5% with effect from 21 July 2010. In this context, the Court stated that, "the best interpretative tool that can be employed to glean the intent of the Contracting States in framing Clause (IV)(2) of the Protocol would be as to how the other contracting State (i.e., the Netherlands) has interpreted the provision". Accordingly, "for efficient and fair application of the India-Netherlands DTAA", the Court held that, "a common interpretation should be applied to ensure consistency and equal allocation of tax claims between the Contracting States". Lastly,

the Court emphasized that, while interpreting international treaties including tax treaties, “the rules of interpretation that apply to domestic or municipal law need not be applied, for the reason that international treaties, conventions and tax treaties are negotiated by diplomats and not necessarily by men instructed in the law”. The Indian tax authorities have since appealed against this Delhi High Court judgement to the Supreme Court of India.

## Circular of the Indian Ministry of Finance on MFN clauses in Indian-DTAAs

On 3 February 2022, the Indian CBDT issued a Circular stating their interpretation on the MFN clause in the India-Netherlands DTAA (along with the MFN clauses in India’s DTAAs with France, Switzerland, Sweden, Spain and Hungary). In the Circular[3], the CBDT has laid down its criteria to assess whether the benefit of the lower rate or restricted scope of source taxation rights in relation to certain items of income (such as dividends, interest income, royalties, fees for technical services, etc.) provided for in India’s DTAAs with a particular country (“Country 2”) are available to another country (“Country 1”) via an MFN clause in its DTAA with India. These criteria are as follows:

I. the DTAA with Country 2 is entered into after the signature/entry into force (depending upon the language of the MFN clause) of the DTAA between India and Country 1;
II. Country 2 is a member of the OECD at the time of signing the DTAA with India;
III. India limits its taxing rights in its DTAA with Country 2 in relation to rate or scope of taxation in respect of the relevant items of income; and
IV. a separate notification has been issued by India, importing the benefits of the DTAA with Country 2 into the DTAA with Country 1 as required by the provisions of sub-section (1) of Section 90 of the Indian Income Tax Act, 1961.

Based on the above criteria, the dividend WHT rates prescribed under India’s DTAAs with Slovenia, Colombia and Lithuania (“Country 2”) cannot be imported into India’s DTAA with the Netherlands (“Country 1”) because these countries (“Country 2”) were not members of the OECD at the time of signing their respective DTAAs with India (as stipulated in point ii above). Thereby, according to the CBDT, the effective dividend WHT rate under the India-Netherlands DTAA should be 10% (based on the rate prescribed in the India-Germany DTAA as (i) this DTAA was signed/entered into force after the India-Netherlands DTAA and (ii) Germany was a member of the OECD when the India-Germany DTAA was signed).

Summarized in the table below is the reasoning provided by the CBDT in support of its viewpoint regarding the application of MFN clauses in India’s DTAAs with the Netherlands, France, Switzerland, Sweden, Spain and Hungary.

| Topics addressed in the Circular | CBDT’s position & reasoning |
|---|---|
| Regarding the unilateral decrees/bulletins/ publications of the Netherlands, France and Switzerland vis-à-vis the effective dividend WHT rates under their respective DTAAs with India | The Circular refers to the decree issued by the Directorate General for Fiscal Affairs, International Fiscal Affairs, Netherlands (Decree No. IFZ 2012/54M, dated 28th February 2012), the French official bulletin of Public finances-Taxes (Bulletin Officiel des Finances Publiques-Impots) published by DGFIP on 4th November, 2016 and the publication by the Federal Department of Finance, the Swiss Confederation on 13th August, 2021.<br><br>In this context, the CBDT Circular states that since at best these unilateral decrees/bulletins/ publications were issued by the respective governments of the Netherlands, France and Switzerland (unilaterally) without (bilateral) consultation with the Indian government, these publications only represent the views of the respective governments for providing relief from the Netherlands/France/Swiss tax in the Netherlands/France/Switzerland, and cannot be seen as binding on the Government of India in respect of curtailing the tax liability under the respective DTAA.<br><br>The decree/bulletin in question is not in accordance with the respective DTAAs and the lower tax rate in the India-Slovenia DTTA cannot be imported into these treaties by virtue of the MFN clause as Slovenia was not a member of the OECD when India had entered into DTAA with it. Reliance on the mere fact that Slovenia is an OECD member State at the time of applicability of the MFN clause defeats the object and purpose of the MFN clause. |

[3] Circular No. 3/2022, F.No.S03/1/2021-FT&TR-1, Government of India, Ministry of Finance, Department of Revenue, Central Board of Direct Taxes (FT&TR-I).

| Topics addressed in the Circular | CBDT's position & reasoning |
|---|---|
| | Since these decrees/bulletins were passed without any discussion with India, it would not have any effect on curtailing the tax liability that is payable to India under the respective tax treaty. India has also communicated its position vis-à-vis the Dutch Decree and the French Bulletin to the governments of the Netherlands and France. The CBDT Circular states that the concern expressed by India to these countries, on this issue, has remained unaddressed. There has been no response from The Netherlands and France to India's interpretation of MFN clause conveyed to them. |
| Regarding point ii of the aforementioned criteria laid down by the CBDT in respect of the applicability of the particular MFN clauses. | According to the CBDT Circular, in a plain reading of the MFN clauses in India's DTAAs especially with respect to with the abovementioned countries, it is clear that there is a requirement that the third State (i.e. Country 2) is to be a member of the OECD both, at the time of conclusion of the treaty with India as well as at the time of applicability of MFN clause. Therefore, it is clarified that for applicability of the MFN clause, the third State (i.e. Country 2) has to be an OECD member State on the date of conclusion of DTAA with India. |
| Regarding the date on which the reduced rate comes into effect & the interplay with the intention of the MFN clauses under consideration. | The CBDT Circular points out that the MFN clauses under consideration stipulate that the reduced rates take effect from the date of entry into force of an Indian DTAA with a third State. Thus, according to the CBDT Circular, the declaration in the (unilateral) decree/bulletin/ publication of the Netherlands, France and Switzerland that the reduced rates should be effective from the date on which the third State became a member of OECD is unfounded.<br><br>The Circular further states that, the fact that these countries could not have made the reduced rates effective from the date of entry into force of the Indian DTAA with the third State as that third State was not a member of the OECD on such date of entry into force is a clear indication that it is not the intention of these MFN clauses to extend the benefit of India's DTAAs with third States which are not members of OECD when India enters into DTAAs with these States. |
| Regarding the notification requirement under Section 90 of the Indian Income-tax Act, 1961 | The CBDT Circular refers to the requirement under sub-section (1) of section 90 of the Indian Income-tax Act, 1961 that a DTAA or an amendment to a DTAA are implemented after specific notification in the Official Gazette. In the case of Azadi Bachao Andolan (2004,10 SCC) the Supreme Court of India has observed that DTAA provisions come into force on the date of issue of notification of such DTAA. The Supreme Court also made it clear in the judgment that the beneficial provision of sub-section (2) of section 90 springs into operation once the notification is issued.<br><br>(It may be noted that India has not issued any notifications importing the lower dividend WHT rates prescribed under its DTAAs with Slovenia, Lithuania and Colombia into its DTAAs with the Netherlands, France or Switzerland, but further that there are several Indian case laws/ court decisions that indicate that the Protocols of DTAAs are an integral part of the DTAAs and therefore, no separate notification is required to apply MFN provisions contained in the Protocols to Indian DTAAs). |
| Regarding the selective import of concessional rates under MFN clauses | The CBDT Circular alleges that some jurisdictions have been selective in invoking and applying the MFN clauses under consideration, which the provisions of the relevant DTAAs, read with the Rules of interpretation of international treaties do not permit.<br><br>India's DTAAs with Slovenia and Lithuania consist of a split rate of tax for dividends (as in, 5 / 15%) - the beneficial rate of 5% on dividend income is applicable only if the company (other than a partnership) receiving the dividends holds directly at least 10% of the capital of the company paying the dividends. The CBDT Circular states that this was communicated to the relevant authorities of the Netherlands, France and Switzerland, and even though these countries have taken this into account in their (unilateral) decree/bulletin/publication (by providing that the rate of 5% will be applicable only when the condition of 10% ownership is satisfied), there is no sound rationale/basis for the selective import on account of not switching to 15% tax rate in other cases. |

Interestingly, the CBDT Circular also states that India has already communicated its position with respect to the Dutch Decree and the French Bulletin to the governments of the Netherlands and France. The CBDT Circular states that the concern expressed by India to these countries, on this issue, has remained unaddressed. There has been no response from The Netherlands and France to India's interpretation of MFN clause conveyed to them. This is of particular interest, and we will be keeping an eye out for announcements from these countries regarding treaty-amendment-negotiations with India.

The reasoning and position taken by the CBDT on this issue are debatable; the future will show if and to which extent the CBDT Circular will hold up in Indian courts. The decision of the Indian Supreme Court in the case of the two Dutch companies (which is expected in a few months) will be important for the Indian tax authorities at ground level. Another case on the same/similar topic, which also addresses the issue regarding the notification requirement (under Section 90 of the Indian Income-tax Act, 1961) is also pending before an Indian court. We expect that French, Swiss and Netherlands companies will challenge the CBDT Circular in court.

## Summary & key takeaways

- On 3 February 2022, the Indian CBDT issued a Circular stating their interpretation on the MFN clause in the India-Netherlands DTAA (along with the MFN clauses in India's DTAAs with other European/OECD member countries). The Circular states that the effective WHT rate on dividends under the India-Netherlands DTAA should be 10% (and not 5%).
- The reasoning and position taken by the CBDT on this issue are debatable. The decision of the Indian Supreme Court in the case of the two Dutch companies (which is expected in a few months) will be important for the Indian tax authorities at ground level. Likewise, Swiss and French MFN-clause related cases will also become relevant for Dutch MNE's as part of the Circular will/may be discussed by the Indian courts in these cases.
- In the meanwhile, Dutch parent companies receiving dividends from their Indian subsidiaries could consider postponing the declaration and payment of dividends, temporarily, in the interest of certainty with regard to the applicable dividend-WHT rate. Alternatively they could consider either one of the following approaches:
  - The Indian subsidiary could withhold and pay 10% tax on dividends paid to the Dutch parent company (based on the CBDT Circular), and the Dutch parent company could subsequently make a refund claim for the "excess" 5% tax deducted and paid (based on the Delhi High Court ruling).
  - There could be a case for 5% WHT on dividends based on the Delhi High Court decision, which has not yet been confirmed/overruled by the Supreme Court. For this, the management of the Indian subsidiary should be of the same mindset (i.e. agree to withhold and pay 5% tax on dividends paid to the Dutch parent company, and to support with litigation if the Indian tax authorities choose to challenge the WHT rate applied).


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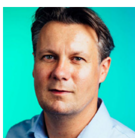


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