CBDT INTERFERENCE IN THE HIGH COURT INTERPRETING THE MFN CLAUSE OF DTAA

I. Introduction

The process of interpreting terms in Double Taxation Avoidance Agreements **(hereinafter "DTAA")** has been a source of considerable litigation, particularly during the past decade. However, in 2021, the Hon'ble Delhi High Court rendered a precedent-setting ruling favouring taxpayers in the case of *Concentrix Services Netherlands B.V. v. ITO (TDS)*, (hereinafter "*Concentrix*") extending certain advantages granted to companies in Slovenia, Columbia, and Lithuania under India's DTAA with those countries. The ruling was based on an interpretation of the DTAA's "Most Favoured Nation" clause **(hereinafter "MFN")** in the Indo-Netherlands DTAA.

Numerous further judgements were rendered by the High Courts and Tribunals based on the *Concentrix ruling*. In some of these rulings, the Revenue Department said that it has not accepted the High Court's verdict and is appealing it to the Supreme Court. However, the courts rejected this line of reasoning. As a result, the Central Board of Direct Taxes **(hereinafter "CBDT")**, by **Circular No. 3 of 2022, dated 3 February 2022**, set tight criteria for interpreting the MFN provision in the DTAA, thus nullifying the *Concentrix's* jurisprudence.

II. A Brief Overview of DTAAs

A DTAA is a tax treaty that has been legally signed and approved between two countries, or between more than two states, as a bilateral treaty or as a multilateral treaty. DTAA's primary objective is to avoid double taxation for organisations and persons with activities and taxable income in several signatory countries. According to Section 90(2) of the Income-tax Act, 1961, the Act's provisions apply to an assessee covered by a DTAA solely to the extent that they are more advantageous to that assessee. In other words, an assessee may rely on either the applicable DTAA or the Income-tax Act, whichever is most advantageous to it.

There is a wealth of law pertaining to the interpretation of DTAAs that Indian courts have established. In *Azadi Bachao Andolan v. Government of India*, the Supreme Court concluded that the provisions of DTAAs would apply to the circumstances to which they relate, even if they conflicted with the Income-tax Act, 1961. Additionally, in *CIT v. PVAL Kulandagam Chettiar*, the

Supreme Court emphasised that in the event of a disagreement between the terms of a DTAA and the Income-tax Act, the DTAA provisions will prevail over the Act, as provided in section 90(2) of the Act.

III. What exactly is an MFN clause?

India has concluded DTAAs with many nations, the majority of which, particularly European states and Organization for Economic Cooperation and Development (hereinafter "OECD") members, include an MFN provision. Given that the current dispute concerns the interpretation and implementation of an MFN provision, it is critical to first grasp what that clause includes.

Though each MFN clause in different DTAAs is worded differently, the underlying provision remains the same: if India enters into a subsequent DTAA with another OECD Member State after signing or entering into force of the DTAA with the first State (depending on the language of the MFN clause), the beneficial treatment extended to it shall be extended to the first State as well, provided that India limits its source taxation rights in relation to certain transactions.

IV. What Provision has Fallen into Controversy?

Now that the DTAA and MFN clause principles have been explored, the ensuing issue may be better comprehended. Article 10(1) and (2) of the Indo-Netherlands DTAA provide that dividends paid by a resident of one contractual State to a resident of the other contracting State may be taxed in that other State. However, according to the legislation of the contractual State in which the dividend giving corporation is a resident, such dividends may also be taxed. Additionally, if the dividend receiver is the beneficial owner, the tax levied should not exceed 10% of the pay-out's gross amount.

However, it is worth noting that the DTAA in question incorporates an MFN clause. Additionally, it is critical to note that the DTAAs between India and Slovenia, Lithuania, and Columbia call for a maximum withholding of 5% in certain instances. In light of the above, the assessee would undoubtedly argue that the advantage of 5% tax withholding should be extended to firms subject to the Indo-Netherlands DTAA as well.

V. Why has it become Complicated?

While the circumstances above illustrate a straightforward implementation of the MFN clause, it is worth noting that Slovenia, Lithuania, and Columbia were not OECD members at the time the Indo-Netherlands DTAA was signed. These nations subsequently joined the OECD. The Department denied the assessees' plea for reduced tax withholding in the matter of *Concentrix*.

Additionally, the Department maintained that no notice had been issued by the Central Government amending the subject DTAA and extending the MFN advantage offered in India's DTAA with Slovenia, Lithuania, and Columbia to those subject to the Indo-Netherlands DTAA. As a result, persons subject to the Indo-Netherlands DTAA will pay a 10% withholding tax on profits.

VI. The Delhi High Court's Decision

The Delhi High Court utilised the *principles of parity* and awarded the advantage of a reduced withholding tax rate on dividend income, namely 5%, under the Indo-Netherlands DTAA's MFN provision. It instructed that withholding certificates reflecting a 10% rate be revoked and a new certificate indicating a 5% rate be issued.

The Court noted that the MFN clause is a component of the relevant DTAA and that no additional notice is necessary to implement the Treaty's MFN provisions. The Court further clarified that the MFN clause's usage of the term 'is' in 'which is a member of the OECD' requires nations to be OECD members at the time source taxation is triggered in India, not at the time the relevant DTAA was executed. Finally, the Court relied on a clarification made by the Netherlands, which said that the advantage of the 5% tax withholding rate under the India-Slovenia DTAA was applicable due to the MFN provision in the relevant DTAA.

While extending the benefits of the MFN clause, the Court held that common interpretation must be used to ensure consistency and equitable allocation of tax claims between contracting states, because the rules of interpretation applicable to municipal law do not apply because DTAAs are negotiated by diplomats, not necessarily by lawyers. Courts have relied on the High Court's verdict in the *Concentrix case* in a slew of judgements, to interpret the India-Netherlands DTAA (see here and here) and the India-Switzerland DTAA (see here and here).

VII. Circular No. 3 of 2022 by the CBDT

The CBDT issued Circular No. 3 of 2022 on 3 February 2022 in response to multiple submissions requesting clarification on the application and interpretation of the MFN provision in the DTAA between India and the Netherlands and India and France. This Circular effectively limits the scope of the MFN provision, stating that the advantage of the reduced tax rate will be extended only if the following requirements are met:

i. The second treaty (with the third State) is entered into after the signing or entrance into effect of the treaty between India and the first State (depending on the wording of the MFN provision in subject DTAA).
ii. The second treaty is between India and a country that is a member of the OECD at the time the treaty is signed.
iii. India's taxing powers are limited under the second treaty in terms of the rate or extent of taxes on the relevant income items. This means that the assessee benefits more from the provisions of the other treaty.
iv. The Indian Government must make a separate notification incorporating the advantages of the second treaty into the treaty with the first State, as required by section 90(1) of the Income-tax Act, 1961.

Only if all of the aforementioned requirements are met, the advantages conferred by the treaty with the third State may be imported into the treaty with an OECD member state that has an MFN provision. The same shall apply from the date specified in the MFN clause of the DTAA, and only after the appropriate Indian tax laws have been obeyed.

To the advantage of taxpayers, the Circular explains that when a disagreement over this matter has been resolved in the taxpayer's favour by a court, this Circular will have no effect on the execution of the court's ruling.

VIII. Analysing the Situation

As a result of the above debate, it is clear that the 2022 Circular essentially nullifies the Delhi High Court's jurisprudence in the *Concentrix*. However, it should be highlighted that such an imbalanced position should not persist for an extended period of time, since it violates the

fundamental precept of tax law, which is certainty. This matter will be resolved primarily by the Supreme Court this year, particularly given that the Delhi High Court ruling has been relied upon exclusively by the same court's benches and not by other High Courts.

Additionally, it is worth noting that in certain cases, such as *Galderma Pharma* and *Contecna InS.A.ection SA* (cases wherein the Delhi High Court relied on *Concentrix* to interpret the India-Switzerland DTAA), the Revenue contended that it had not accepted the decision in *Concentrix* and was in the process of filing a Special Leave Petition with the Hon'ble Supreme Court. The High Court, however, dismissed this argument. The Court reaffirmed the long-established legal principle that the Department cannot refuse to comply with a binding jurisdictional judgement just because it intends to appeal it. In *Union of India v. Kamlakshi Finance Corpn. Ltd.*, the Supreme Court stated that rulings of higher appellate bodies should be obeyed "unreservedly," and that the mere fact that a judgement is not acceptable to the Department cannot be used as a reason to disregard it.

However, given that the CBDT has published a Circular on the subject, one may reasonably ask which will prevail till the Supreme Court rules on the matter—the Circular or the multiple Delhi High Court judgments?

It is a well-established principle of law that if a CBDT Circular conflicts with a ruling of the Supreme Court or a High Court, the judgement must take precedence over the Circular's contents. Additionally, CBDT Circulars cannot supersede common legal principles and regulations as found in a number of instances, including *CCE v. Ratan Melting and Wire Industries, Pahwa Chemicals (P.) Ltd. v. CCE*, and *Kuthannur Service Co-Operative Bank Ltd. v. ITO*.

IX. Further Developments

The Pune ITAT decided in *GRI Renewable Industries S.L.*, dated 15 February 2022, that the subject Circular No. 3 of 2022 cannot be granted retroactive effect. Of this instance, the Bench was tasked with interpreting the MFN provision in the India-Spain DTAA. It maintained the position established in *Concentrix* that once DTAA is notified, all of its essential components, including the Protocol, are notified automatically. As a result, there is no need to notify the DTAA's individual limbs once again. Additionally, the Court stated that requiring separate notice

for importing favourable treatment from another DTAA violates section 90(1) and the Protocol, which consider the MFN clause as an inherent component of the DTAA.

The ITAT reaffirmed the long-established legal principle that a CBDT Circular is exclusively binding on the Department and cannot bind the ITAT. Finally, the bench stated that since the Circular imposes a new impairment requiring a separate notice, it cannot be applied retroactively to transactions that occurred in past assessment years.

X. Concluding Remarks

According to the Circular, the favourable tax rate of 5% included in some DTAAs would not apply to the treaties mentioned above. This would result in protracted litigation, since taxpayers must have previously planned their investments and overall stance in light of the precedent-setting *Concentrix judgement*. Additionally, it should be highlighted that the Circular would affect earlier cases in which the Courts have concluded that the MFN provision is automatically applicable unless a treaty expressly requires notice.

DTAA's primary purpose is to facilitate business interactions and to provide an equal allocation of tax revenues on income that is taxable in both countries. India just barely avoided international embarrassment by withdrawing their retrospective taxation provisions (this issue has been discussed in detail here). In light of this, the CBDT's actions in releasing a restrictive Circular that contradicts domestic interpretations by regulatory organisations in France and the Netherlands tarnish India's image with foreign investors and in the international trade arena. One can only hope that the Supreme Court resolves this matter this year in order to end the misunderstanding and reassure taxpayers.