

Tribunal's Rules on MFN Clause: Juxtaposed with CBDT's Circular

Article By:

Arijit Ghosh

Recently, the Pune bench of Income Tax Appellate Tribunal ("Tribunal") has ruled in favour of GRI Renewable Industries SL ("Taxpayer") in the appeal filed by the Taxpayer.¹ The Taxpayer was resident in Spain for the financial year 2015-16 and provided certain support services to a company resident in India. The income from provision of such services was characterized as royalty and fee for technical services ("FTS"), and offered to tax in India by the Taxpayer as per Article 12 of the India-Spain tax treaty read with provisions of the Income Tax Act, 1961 ("ITA"). Article 12 of the India – Spain tax treaty provides for a 20% tax rate with respect to royalty / FTS, however the Taxpayer claimed that such income should be taxable at 10% rate, in accordance with the Most Favoured Nation ("MFN") clause in the Protocol to the India – Spain tax treaty read with India – Portugal tax treaty (which provides 10% rate with respect to royalty / FTS). The tax officer did not accept the above contention of the Taxpayer on the ground that no separate notification was issued by the government of India to extend the benefit of lower withholding rate in India – Portugal tax treaty to the India – Spain tax treaty. On appeal, the Tribunal ruled in favour of the Taxpayer and held that royalty / FTS income should be charged at 10%, and no separate notification was required to be issued to extend benefit of MFN clause in India – Spain tax treaty.

MFN CLAUSE IN TREATIES

The applicability of MFN clause in Indian tax treaties has been subject to debate in recent past. The Central Board of Direct Taxes ("CBDT") has also recently released a circular dated February 3, 2022 ("Circular"), clarifying the applicability of MFN clause present in Indian tax treaties.

The Circular was released in response to the unilateral directives issued by France, Netherlands and Switzerland, notifying that the MFN clause in the Protocols to India's tax treaties with these countries would have the effect of modifying and reducing India's withholding rate of tax on dividends as per these treaties to 5% (if the beneficial owner of the dividend is a resident of the other state); on account of the lower 5% rate in India's tax treaties with Slovenia, Lithuania, and Colombia (all of whom have become members of the OECD on subsequent dates after India's treaties with France, Netherlands, and Switzerland came into effect). The Circular also seemed to be a clarification from the CBDT on account of certain judgments of the Delhi High Court² on the issue, which had ruled in favour of the taxpayer; thereby granting the reduced withholding rate (on account of the MFN clause).

The Circular provides certain conditions on the basis of which benefit of the MFN clause can be extended to the taxpayers, and one of the conditions specified therein is issuance of a separate notification to make the provisions of the Protocol effective. The Circular has referred to Section 90 of the ITA for the genesis of this requirement (discussed later in this hotline). It is pertinent to note that the tax authorities have previously also argued this position before the Indian judicial authorities, but have not been successful in this regard.³

BACKGROUND

The tax officer did not dispute the amount or nature of income offered to tax by the Taxpayer. However, he held that the 10% rate from India – Portugal tax treaty cannot be incorporated in the India – Spain tax treaty absent a separate notification, and hence its benefit cannot be extended to the Taxpayer. Further, the dispute resolution panel also concurred with the tax officer's conclusion, and accordingly directed the tax officer to pass the final order. The Taxpayer was aggrieved and challenged the final order before the Tribunal.

Arguments of the Taxpayer:

The Taxpayer claimed a reduced rate of withholding (i.e. 10%, as opposed to the 20% rate in Article 13 of the India-Spain tax treaty) on FTS and royalty on account of the MFN clause in the Protocol to the India-Spain tax treaty read with Article 12 of the India-Portugal tax treaty.

Arguments of the Tax Authorities

The primary argument of the tax authorities was that at the time of notification (and coming into effect) of the India-Spain tax treaty in 1995, or even later, the Protocol to the treaty was not separately notified. The tax authorities have placed reliance on Section 90(1) of the ITA which requires the Central Government to notify any provisions as may be necessary for implementing any agreement or convention (including a tax treaty).⁴

Accordingly, the tax authorities argued that the benefit of the India – Portugal tax treaty was not available to the Taxpayer, however the royalty / FTS earned by the Taxpayer may be taxed at 10% plus applicable surcharge and education cess in terms of section 115A of the ITA, which was more beneficial vis-à-vis 20% rate of tax provided in the India – Spain DTAA.

Ruling of the Tribunal

The Tribunal in the Taxpayer's case had the opportunity to consider the requirement of a separate notification for invoking the MFN clause in the Protocol to the India-Spain tax treaty. Further, reference was also made to the provisions of the Circular in the Tribunal's decision.

The Tribunal dealt with the argument of the tax authorities by reading the plain language of Section 90(1) of the ITA (which merely requires notification for implementation of the agreement i.e., the tax treaty), in consonance with the opening language of the Protocol (where the contracting states to the treaty agree that the provision of the Protocol shall be an integral part of the Convention (i.e., the tax treaty)). Further, the Tribunal also observed that the Protocol was signed and made an integral part of the tax treaty on the same date as the signing of the tax treaty itself.

Consequently, harmoniously interpreting Section 90(1) and the language of the Protocol together, the Tribunal held that there should be no requirement for separately notifying each item which forms an

integral part of a tax treaty (which is already notified and effective) in order to make those integral parts effective as well. The rationale was that notifying the tax treaty would consequently imply that all integral parts of the tax treaty are also automatically notified (and should not require separate notifications);

Consequently, ruling on the binding nature of the Circular, the Tribunal noted the following:

The Circular does not bind the Tribunal: In this context, the Tribunal while citing judgments of the Supreme Court⁵, held that circulars of the CBDT are binding only upon the tax authorities; and not binding upon the taxpayer or the judiciary. Further, the Tribunal found that since the Circular bypasses the confounds of Section 90(1), which only requires notification of the agreement (tax treaty), for its implementation; and does not require each separate integral part of the treaty to be separately notified, the CBDT Circular dated February 03, 2022 cannot bind the Tribunal.

Prospective effect of the Circular: Further, the Tribunal observed that the requirements under the Circular cannot be applied retrospectively. The legal position is settled in so far as a piece of legislation creating and imposing new obligations (or attaching new disabilities) is only applied prospectively, unless the legislative intent expressly provides for a retrospective application. The Tribunal found that since the Circular created new obligations; the same was required to be applied prospectively; and as such, since the Taxpayer's issue in question was prior to the release of the Circular, the same could not apply to them.

ANALYSIS AND CONCLUSION

This judgment is a welcome ruling granting relief to the taxpayer's in the face of the CBDT's suggested retrospective application of the Circular's requirements; and deals with the requirement of notifying under Section 90(1) in great detail. Reliance in this regard (similar to the High Court of Delhi in Concentrix) is also placed on the judgment of the Delhi High Court in Steria India, which held that there is no separate required notification to make the MFN clause in Protocols to tax treaties effective. However, taxpayers relying on these rulings should proceed with caution as Steria India is pending in appeal before the Supreme Court. Given that the repository of rulings by the High Courts and Tribunals on this issue have all largely relied on Steria India, the final position of the Supreme Court will ascertain much anticipated clarity on the matter.

It is noted that the Taxpayer could have adopted to be taxed under provision of the ITA (which provide for a 10% rate (exclusive of cess and surcharge)), instead of availing tax treaty benefit (which provides for a 20% rate (no cess or surcharge applicable)), as the provisions of the ITA were more beneficial to the Taxpayer. However, the surcharge and cess applicable over the 10% rate in the ITA may not be creditable in the resident jurisdiction of the Taxpayer. Hence, the Taxpayer may have sought to invoke the MFN clause in the Protocol to the India – Spain tax treaty, and accordingly be taxed at flat 10% rate.

Further, it is pertinent to note that the Circular mentions that in case a taxpayer has obtained a favourable ruling from any court, the Circular should not affect implementation of court order in such case. It is uncertain whether the Circular refers to past decisions only, or refers to future decisions as well. Moreover, as observed by the Madhya Pradesh High Court in Agrawal Warehousing & Leasing Ltd.⁶, the order of a Tribunal is binding on all the revenue authorities functioning under the jurisdiction of such Tribunal. Hence, even the commissioner and the tax officer in the jurisdiction of Pune Tribunal shall be bound to the decision passed by the Pune Tribunal. Whereas, it is a settled law that circular issued under section 119 of the ITA is binding on all revenue authorities. Similar issue arises

with respect to other conditions regarding applicability of the Circular to the extent it is not in conformity with the Delhi High Court's decision in *Concentrix, Nestle*⁷ and *Deccan Holdings*⁸. Hence, although taxpayers may consider taking the beneficial treatment as per the MFN clause in the relevant tax treaties read with various decisions of the High Court and the Tribunal, it is highly probable that revenue authorities may not allow such treatment, which may lead to further disputes.

FOOTNOTES

¹ ITA No. 202 of 2021

² *Concentrix Services Netherlands B.V. vs. Income Tax Officer TDS & Anr* W.P.(C) 9051/2020 and W.P.(C) 882/2021

³ See, *Steria (India) Ltd. vs. Commissioner of Income-tax-VI*, [2016] 386 ITR 390 (Delhi), *Concentrix Services Netherlands B.V. vs. Income Tax Officer TDS & Anr* W.P.(C) 9051/2020 and W.P.(C) 882/2021

⁴ Section 90(1) reads as

“The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—

(a) for the granting of relief in respect of—

(i) income on which have been paid both income-tax under this Act and income-tax in that country or specified territory, as the case may be, or

(ii) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory, as the case may be, to promote mutual economic relations, trade and investment, or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory, as the case may be, 95[without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory),] or

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory, as the case may be, or investigation of cases of such evasion or avoidance, or

(d) for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory, as the case may be,

and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.”

⁵ *Cycles Pvt Ltd* (1997) 228 ITR 463 (SC)

⁶ *Agrawal Warehousing & Leasing Ltd. vs. Commissioner of Income-tax*, [2002] 257 ITR 235 (Madhya

Pradesh)

⁷ M/S Nestle SA vs. Assessing Officer, W.P.(C) 3243/2021

⁸ Deccan Holdings B.V. vs. ITO, W.P.(C) NO. 11921 OF 2021

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