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India takes tough stand on tax treaties with MFN countries

Synopsis
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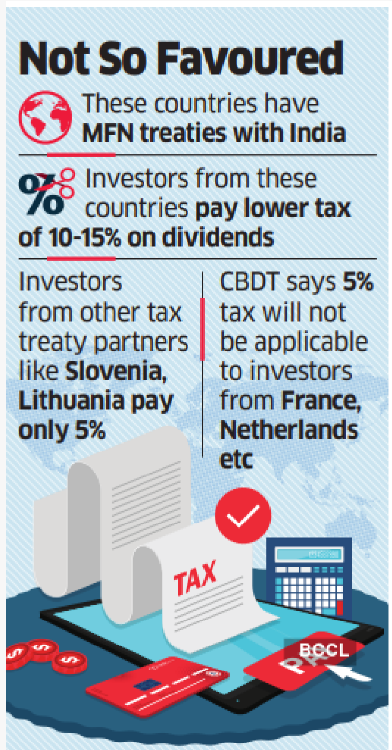
Indian tax authorities have toughened their stand to bar foreign funds and strategic investors from most favoured nation (MFN) jurisdictions like The Netherlands, France, and Switzerland from taking advantage of lower tax offered to investors from some of the other countries who have signed tax treaties with India at a later point.

Conveyed last week by the apex tax body Central Board of Direct Taxes (CBDT), the view goes against a High Court ruling, sends a strong message from India on tax treaties, and could set off a slew of litigation in the coming days.

Several offshore investors had chosen The Netherlands, France and Switzerland to buy equity stakes in Indian companies due to their MFN status with India and the tax benefits that come with it as well as overcome tax hurdles like General Anti-avoidance Rule. Investors from these countries pay only 10-15% tax on dividends and none on capital gains in some cases. The MFN status as per tax treaties with India allow further easing of tax (on dividend and fees) if India agrees on a lower rate under a subsequent treaty with another country as long as the latter is also a member of Organisation for Economic Co-operation and Development (OECD). The rule is aimed towards India maintaining tax parity among the OECD countries it signs tax treaties with.

Thus, after India fixed a lower tax on dividend at 5% in the tax treaties with Slovenia (in 2006), Lithuania (in 2013), and Colombia (in 2015), many investors from France, The Netherlands, Switzerland along with those from Sweden and Spain started evaluating and paying a lower tax (of 5% as against 10-15%) on dividend from Indian companies after the change in the dividend taxation regime since April 2020.



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However, according to the CBDT directive issued to tax offices, investors from The Netherlands, France and other countries will have to continue paying a higher tax on dividends. CBDT believes that a lower tax applicable to Slovenia, Lithuania and Columbia cannot be extended to others as these countries were not OECD members when India had signed the respective treaties with them. For instance, Slovenia became an OECD member in 2010 --- six years after it had signed the treaty with India; Lithuania joined the OECD in 2018 while the tax treaty with India was closed in 2013; the respective years for Columbia are 2020 and 2015.

“This is a significant development for residents of France, Netherlands, Sweden, Spain, Hungary and Switzerland having shareholding in Indian entities.... The CBDT goes a step further by stating that unless a separate notification is issued, benefits from another treaty cannot be imported into a tax treaty having the MFN clause. This is a deviation from how the judiciary viewed the requirement of a separate notification where it was held that if the text of the MFN clause makes it self-operational and does not require a separate notification, no further notification is required to be issued. The tax administration has clarified its stand but given the nature of the interpretational issues and nuances involved, this may not settle the debate just yet,” said Ritu Shaktawat, partner at the law firm Khaitan & Co who along with other tax experts are tracking the development closely.

From a legal perspective, unlike a notification, circulars are not binding on the taxpayer. The taxpayers, said Shaktawat, could still take a different position (by relying on the favorable Delhi High Court rulings on the issue) which, given the clarifications in the circular, will certainly lead to a dispute with the tax office.

According to Parul Jain, who heads funds formation practice at the law firm Nishith Desai Associates, the issue would have to be finally resolved by the Supreme Court of India. “While there seems to be a fair debate regarding applicability of such low tax rates, it seems unjustifiable to require issuance of a separate notification by the Government specifically importing benefits of one treaty into another treaty when a particular tax treaty provides for such automatic substitution. Further, while the government has clarified that the Circular will not apply to taxpayers’ in whose case there is a favourable court decision (Delhi High Court in this case), the issue of applicability of the Circular in the case of taxpayers having jurisdiction in Delhi is expected to be litigative. Apart from multinationals, this Circular will also have an impact on FPIs who are based out of the Netherlands and France.”

The issue assumes significance in the absence of a uniform dividend distribution tax (levied on companies paying dividend) which was scrapped in 2020. With the tax now levied on investors and companies making the payout required to withhold tax before transferring the balance to investors, the actual rates become crucial. Those keen to avoid court feuds would accept the views expressed by the CBDT, but many may not. All non-resident investors would, however, examine whether the credit of Indian taxes would be available against taxes payable in the home jurisdiction. Since the issue intertwines several foreign investors and local companies, the withholding tax rate to be applied would turn into a subject matter of discussions between non-resident shareholders and Indian investee entities.

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