



A TAX TREATY PROBLEM

As economic realities change, negotiated relations among countries must also adapt

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TAX TREATIES ARE not set in stone. The changing contours of legislation and economic circumstances can present interpretive challenges, as observed recently by the Supreme Court. Prior to 1995, India's treaties with France, the Netherlands and Switzerland provided that if it extends the benefit of lower tax rates to other Organisation for Economic Cooperation and Development (OECD) members, that benefit would extend to these three countries. Before 1994, the OECD was a relatively static group and one would imagine India agreed to the terms as it sought foreign capital inflows. Fourteen countries have acceded to the OECD since, including Colombia (2020), Lithuania (2018) and Slovenia (2010).

India, conscious of the economic circumstances in the year of signing the treaty, agreed to special terms with Colombia, Lithuania and Slovenia for the withholding tax on dividends. As it was only in 2020 that India altered treatment of taxable dividends in the hands of the company since 1997, the relative advantages in treaties became relevant. Investors, so far exempt, were now required to withhold taxes on dividends received in India. The accession of the countries to the OECD opened an opportunity for investors from France, Netherlands, and Switzerland to request lower rates. This raised the thorny issue of whether the import of such tax treatment from another treaty could be given automatic effect.

France, the Netherlands and Switzerland issued decrees, under their internal legal

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processes to give effect to lower rates retrospectively from the date when Colombia, Lithuania and Slovenia acceded to the OECD. While Switzerland left open the possibility of reversing such an interpretation, in case India disagreed, the others did not. Nevertheless, these were unilaterally issued and in no way indicated India's position.

In the 2021 *Concentrix* case, the Delhi High Court ruled that the beneficial terms of the treaty could be extended without notification. Proceeding on this basis, though knowing well the possibility of a further appeal before the apex court, taxpayers sought a certificate for low tax deduction at source. Taxpayers did not find it useful to seek clarity through an advance ruling. Perhaps this was due to the costs and time involved and the absence of an independent judicial member in the new Board of Advance Ruling. In February 2022, the Central Board of Direct Taxation (CBDT) issued a circular clarifying its position, yet a favourable ruling by the Court would still be available to the taxpayer. Thus, multiple disputes ensued on the matter.

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The beneficial treatment of dividends also varies across the treaties — it is more generally available to all investors in a treaty with Colombia, whereas the other two restrict the

rate to five per cent for investments of more than 10 per cent in the capital and 15 per cent otherwise. The tax department must clarify the exact tax treatment before its application.

The SC's ruling — that a notification is mandatory to invoke MFN — reverses the tax positions for investors. The response to it reveals that there has been interest among investors of other jurisdictions in seeking this route. In fact, insubstantial FDI inflows from Colombia, Slovenia and Lithuania indicate the redundancy of benefits. Shopping for such beneficial terms has been observed in South Africa where investors from the Netherlands sought and availed lower withholding rates on dividends, based on simultaneous interpretation of treaties with Sweden and Kuwait.

Curiously, despite no or low investment flows, the said benefits were retained. More so, since the India-Finland treaty, signed in 2010 a few months prior to Slovenia's accession, carries an MFN provision that explicitly necessitates the notification by the competent authority. The absence of similar words in the treaties in question is noteworthy.

As economic realities change, relations among countries must also adapt. For now, the circular and SC decision clarify India's treaty approach to MFN. There is however a need for periodic review of tax treaties, especially with respect to their economic benefits, and the enforcement of anti-abuse measures.

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