VOLUME 5 | ISSUE 3

INTERNATIONAL JOURNAL OF ADVANCED LEGAL RESEARCH

DOUBLE TAXATION AVOIDANCE AGREEMENTS: INTERPRETING INDIA'S STANCE IN LIGHT OF 'ASSESSING OFFICER CIRCLE (INTERNATIONAL TAXATION) 2(2)(2) NEW DELHI V. M/S NESTLE SA2023 INSC 928'

- Arlene Noronha[1]

Introduction

Double Taxation Avoidance Agreements (DTAAs) are the linchpins of modern international trade, serving as critical instruments for nations to foster economic collaboration while mitigating the burden of double taxation.[1] These agreements, akin to the way treaties are the currency of international relations, are essential in a globalized economy where taxesare collected through both direct and indirect means. In India, the Income Tax Act of 1961 stands as the foundational legal framework, dictating the interpretation and application of tax laws.[2]

The Supreme Court's landmark decision in *Assessing Officer Circle (International Taxation) 2(2)(2) New Delhi Vs. Nestle SA 2023 INSC 928* provides an interlinked analysis of the interplay between DTAAs and domestic tax legislation. This case comment aims to dissect this ruling, focusing on the India-Switzerland DTAA, particularly the Most Favoured Nation (MFN) clause, to illuminate its implications for taxation, statutory interpretation, and the broader landscape of India's bilateral relations with Switzerland.

Facts of the Case

[1] Student at Amity Law School, Amity University, Noida

This case arises out of a disagreementin the manner of taxation applicable to the dividend distributed by Nestle India to its Swiss parent, Nestle SA. The core area of dispute was the application and interpretation of the MFN clause in the Double Taxation Avoidance Agreement (DTAA) entered into between India and Switzerland. The appellant being the Assessing Officer Circle (International Taxation) and the respondent being Nestle SA.

The respondent had claimed for favourable tax rates on the dividend income based on the MFN clause incorporated in the DTAA. This was further bolsteredby the availability of similar provisions in the DTAA of India with other OECD (Organisation for Economic Co-operation and Development) member countries. The respondent's stance was that the clause in the DTAA essentially enabled Switzerland to reap the beneficial tax rate or restricted fee that was negotiated between India and a third nation, which was also a member of the OECD, in the respective DTAA with the third nation.

Now, India entered into DTAAs with Lithuania on 26 July 2011 and with Colombia on 13 May 2011.Now there was alower dividend tax rate of 5% for shareholding above 10% present in India's DTAA with Lithuania. The respondents claimed that this should retrospectively apply on the respondent, since 5th July 2018, as that was when Lithuania joined the OECD.

And, in a similar manner, the respondent, claimed that India's DTAA with Colombia provides fora general residual tax rate at 5% in the source state,shouldalso retrospectively applyfrom 28th April 2020, when Colombia joined the OECD.

The membership of Lithuania and Colombiawould immediately attract the application of the MFN clause w.r.t Switzerland automatically. Thus, ata lower

rateto their dividend income or a more restricted fee would be the appropriate rate applicable on Switzerland.

The appellant however took a stand that the benefits of MFN clause could not be read with automatic extension, in the manner the respondent was readingthe law. It is at this juncture where the interpretation of the Income Tax Act of 1961 comes into play. The appellanttook the view that the provision, including the MFN clause, has to be mandatorily notified under Section 90 of the Income Tax Act, 1961, to be made effective in India. And since no notification was issued with respect to the particular benefit as claimed by the respondent, there would be no automatic application in this instance.

The Court through its judgment highlighted that there were two primary principles that had to be fulfilled in order for the respondent to receive the benefits of the third-party treaty:

i. "First, the third State with whom India enters into a Convention/DTAA should be a member of the OECD.

ii. Second, India should have, in its Convention/DTAA, executed with the third State, limited its rate of withholding tax, on subject remittances, at a rate lower or a scope more restricted, than the rate or scope provided in the subject Convention/DTAA (that is, the DTAA between India and Switzerland)."

Following the fulfilment of these conditions, the same withholding tax rate or scope as specified in the executed Convention/DTAA will apply as of the date the Convention/DTAA between India and a third State enters into force.

Issues

The main issue was how to understand and use the Most Favoured Nation (MFN) clause in the India-Switzerland Double Taxation Avoidance Agreement (DTAA). The key question was whether the respondent automatically qualified for a lower tax rate on dividends, as stated in India's DTAA with another OECD member country, without any specific notification.

Another important aspect of the case was whether a notification under Section 90 of the Income Tax Act, 1961, was necessary for DTAA provisions, including MFN clauses, to be effective in India. This raised questions about the relationship between international treaty obligations and domestic legal requirements.

Thirdly, the court had to determine the correct interpretation of the word "is" within the MFN clause. Specifically, whether "is" referred to the point in time when the original DTAA was signed, or if it referred to the present time when the benefit was being invoked. This had direct implications for how subsequent treaty changes in third countries were to be applied.

Finally, the case examined the impact of a third country's entry into the OECD on the application of the MFN clause. It was questioned whether such an event automatically triggered the benefits of the MFN clause within an existing DTAA, without any further domestic legislative action. These issues collectively challenged the established understanding of DTAA implementation and highlighted the importance of clarity in treaty language and domestic legal procedures.

Rationale behind the decision:

The main rationale behind the Supreme Court's decision can be summarized as follows:

1. Mandatory Notification under Section 90 of the Income Tax Act

The key principle established is that for any provision of a Double Taxation Avoidance Agreement (DTAA), including a Most Favoured Nation (MFN) clause, to have effect in India, it must be explicitly notified by the Central Government under Section 90 of the Income Tax Act, 1961. This is a crucial precondition for the application of treaty provisions within the Indian legal system. India follows a dualist approach to International Law. Issuing a notification reinforces this approach, giving the government the opportunity to review its stand on the issue at hand as well as its view on international law, at a larger level.

2. Interpretation of the MFN Clause and the Word "is"

   The court determined that the word "is" in an MFN clause refers to the present point in time when the benefit is being claimed, not retrospectively to the date of the original treaty[2]. Therefore, subsequent changes in a third country's treaty or status (like joining the OECD) wouldnot automatically trigger the MFN clause, ratifying the appellant's interpretation of which tax rate would apply.

3. Sovereignty in Treaty Implementation

   There is a reinforcement of India's sovereign right to determine how international treaties are implemented within its borders. The court emphasized that the Indian Parliament, through the notification process, has the authority to ensure that treaty obligations are consistent with domestic law. As mentioned before, India's dualism is safeguarded through measures such as notifications, circulars etc, that does not pave way for immediate and direct implementation of statutes.

4. No Automatic Extension of Benefits

[2] https://api.sci.gov.in/supremecourt/2022/6394/6394_2022_8_1502_47832_Judgement_19-Oct-2023.pdf

The ruling clarifies that the benefits of an MFN clause are not automatically extended by mere entry or enforcement of a treaty between India and a third party. A specific notification is required to give effect to those benefits.

Suggestions:

Judgements are the insight into the nation's interpretation of individual statutes treaties. While signing treaties, nations establish a common ground to reap the benefits of the formalisation of the relationship. However, only when an issue arises is there a real test of the relationship and the manner in which the individual countries interpret the treaties, reflect the nature of how strong the common ground is.

While the judgment addressed key aspects, it could have further elaborated on the "beneficial ownership" principle, especially concerning dividend taxation. A deeper dive into how "beneficial ownership" interacts with MFN clauses would have provided more robust guidance.

Additionally, considering the evolving digital economy, a broader discussion on the concept of "permanent establishment" in relation to DTAA interpretation would have been beneficial, even if tangential to the core MFN issue. These additions would have enhanced the judgment's relevance to contemporary international tax challenges and reflect modern economic realities: As economies evolve, DTAAs need to be reviewed to make sure that they are not being used to increase tax incidence, or to allow for tax avoidance.

The potential for "treaty shopping" and how it might lead to increased tax burdens.Treaty shopping, as colourful as the expression, is defined as the act of a resident from a third country who wishes to avail the benefits of a DTAA between two states. This resident is not from either of the contracting states but through mechanisms in the treaty would seek to tweak it to benefit them.

By exploring how aggressive treaty interpretations can shift tax liabilities, the court could have offered guidance on preventing such scenarios.In such a scenario, the importance of "substance over form" in treaty interpretation would help in emphasizing that the economic reality of transactions should prevail over their legal form. This would help prevent unintended increases in tax incidence.

By addressing these points, the court could have provided a more nuanced and comprehensive understanding of the role of treaties in the broader context of international taxation.

Immediate impact:

The Supreme Court's judgment has indeed created ripples in the tax relationship between India and Switzerland, and has led to actions that may be viewed as negatively impacting aspects of the bilateral relations. Broadly there are three immediate impacts:

1. Switzerland's Response:

In a direct response to the Supreme Court's ruling, Switzerland had taken the step of suspending the unilateral application of the MFN provision in its DTAA with India. In its official statement[3]:

> "In new double taxation agreements, India has agreed to a 5% tax on dividends instead of the 10% agreed with Switzerland. As a result, Switzerland has adopted the lower rate on the basis of the most-favoured-nation (MFN) clause. However, India interprets the MFN provision differently and does not apply it. In order to restore the reciprocity of the

[3] https://www.google.com/url?sa=t&source=web&rct=j&opi=89978449&url=https://www.estv.admin.ch/dam/estv/en/dokumente/international/laender/int-laender-indien-suspension-mfn-en.pdf.download.pdf/int-laender-indien-suspension-mfn-en.pdf&ved=2ahUKEwjo0r-yz7mMAxUvulYBHWoxPEAQFnoECCEQAQ&usg=AOvVaw1bxK2l_ShlxRbbSmSAzKHS

agreement, Switzerland will revert to the previous rate of 10% from 1 January 2025."

Switzerland views the Indian court's interpretation as a matter of concern, particularly regarding the principle of reciprocity in tax treaty application.A direct result of this action would result in an increased tax burden for Indian businesses operating in Switzerland.

2. Potential Impact on Investments:

There are concerns that such disputes could potentially affect the flow of Swiss investments into India.While the immediate impact on existing business operations might be limited, the long-term investment climate could be influenced, and would only be visible in the future[4]. While Switzerland has assured India that "this measure will not affect the free trade agreement between the two countries or Swiss investments in India", time will tell the real story.

3. Overall impact:

In essence, while the judgment itself is a legal interpretation, its practical consequences have led to a change in the application of the DTAA, resulting in a negative impact on the tax relationship between India and Switzerland.

Conclusion

The Supreme Court's judgment in Assessing Officer (International Taxation) vs. M/S Nestle SA was legally sound, reinforcing established principles of Indian tax law and international treaty implementation.

The court's emphasis on the necessity of notifications under Section 90 of the Income Tax Act aligns with the principle that international treaties must be

[4]https://www.businesstoday.in/india/story/switzerland-suspends-most-favoured-nation-clause-in-double-tax-avoidance-agreement-with-india-457253-2024-12-13

explicitly incorporated into domestic law to be effective. This is a reflection of India's dualist approach to International Law.

Furthermore, the court's interpretation of the MFN clause, particularly the definition of "is," provided much-needed clarity, preventing the automatic and retrospective application of benefits based on subsequent treaty changes in third countries.

While it may appear to create a stricter framework, it ensures that treaty benefits are applied consistently and transparently, mitigating potential for ambiguity and disputes[5]. The judgment appropriately balanced international treaty obligations with domestic legal requirements, ensuring a stable and predictable tax environment.

[5]https://www.mondaq.com/india/withholding-tax/1560306/switzerland-suspends-application-of-most-favoured-nation-mfn-clause-for-india-switzerland-tax-treaty