Supreme Court Ruling on MFN Clause in Tax Treaties - A Compelling Case for Review!

Jun 03, 2024

Neeraj K Jain
Senior Partner, Vaish Associates, Advocates

Kunal Pandey
Principal Associate, Vaish Associates, Advocates

The Supreme Court of India in the case of Assessing Officer vs. M/s Nestle SA and Others, elucidated law relating to applicability of the Most Favoured Nation ("MFN") clause in the protocol(s) for availing benefit of a Double Tax Avoidance Treaty ("Tax Treaties") entered into by India which are beneficial and restricted in scope.

The Supreme Court in its decision laid down that issuing a notification by Indian Government is a mandatory precondition for implementation of the MFN clause in the Tax Treaties. Consequently, the Apex Court has upheld the action of denying a part of the benefit, as has been mutually agreed upon by the treaty partners, in the notification issued by Indian Government /authorities. The decision is of staggering implication and contradicts with the shared understanding of the treaty partners and 'Good Faith Principle' in the international convention.

A protocol is an agreement reached by the contracting states and is signed and ratified, in addition to the Tax Treaty clarifies, implement, or modify the treaty provisions; and has as much a binding force as it also forms part of the Treaty.

MFN clauses in Tax Treaties are intended to bring parity, non-discrimination and a level playing field among treaty partners, eg. if a member country grants to another country an advantage/ favorable treatment, the first country is obliged to extend such treatment to all member states. In other words, MFN clause in the Treaty ensures that a treaty partner under one agreement is not subjected to treatment which is less favourable than treatment provided to other treaty partners under similar agreements.

Tax Treaties entered into by India with Spain, France, Belgium, Netherlands, Sweden, Switzerland, Finland and Hungary, consists of MFN clause in the Protocol. While India had notified MFN clauses in all 8 treaties, however, the benefit of MFN clause had been restricted in the notification issued by central government for the Tax Treaties with Spain, France and Belgium only to the rate of tax on 'fees for technical services' and 'royalty' and not to the scope.

MFN clause in the protocol to India-Spain DTAA provides for a beneficial treatment with respect to rate as well as scope for the payments in the nature of Royalty and FTS. However, the notification[1] dated

19.03.2024 restricted the scope of MFN clause thereby not extending the beneficial treatment with respect to Royalty and FTS. Similarly, in case of Tax Treaties of India with France and Belgium the MFN clause provides for a beneficial treatment with respect to rate as well as scope for the payments in the nature of Royalty and FTS. However, vide notifications[2] dated 10.07.2000 and 19.01.2001, respectively, the rate of tax on Royalty and FTS are restricted to 10%.

MFN clauses in Tax Treaties can be 'self-operating' or 'non-self-operating' based on their wordings:

Self-operating MFN clause- (eg. India-Netherland DTAA)

"IV. 2. If after the signature of this convention under any Convention or Agreement between India and a third State which is a member of the OECD India should limit its taxation at source on dividends, interests, royalties, fees for technical services or payments for the use of equipment to a rate lower or a scope more restricted than the rate or scope provided for in this Convention on the said items of income, ***then as from the date on which the relevant Indian Convention or Agreement enters into force the same rate or scope as provided for in that Convention or Agreement on the said items of income shall also apply under this Convention."***

MFN clauses in most of the Tax Treaties entered into by India, eg. France, Spain, Belgium, etc. are worded as self-operating MFN clauses, and thus the benefit of rates or scope as provided in other beneficial treaty should become applicable from the date which the relevant Indian convention or agreement are entered into force.

Non-self-operating MFN clause on the other hand requires further negotiations- (eg. India-Switzerland DTAA)

"*5. With reference to Articles 10, 11, 12 and 22:*

..... If after the date of signature this Amending Protocol, India under any Convention, Agreement or Protocol with a third State which is a member of the OECD, restricts the scope in respect of royalties or fees for technical services than the scope for these items of income provided for in Article 12 of this Agreement, ***then Switzerland and India shall enter into negotiations without undue delay in order to provide the same treatment to Switzerland as that provided to the third State."***

Supreme Court in the case of Nestle SA (supra), answering the question whether the MFN clause is to be given effect to automatically or if it is to only come into effect after a notification is issued concluded that provisions of Tax Treaties and protocols do not confer right upon parties till the time an appropriate notification is issued in terms of section 90(1) of the Income-tax Act, 1961 ('the Act'). The Supreme Court held that for MFN clause in the protocol of the Tax Treaties entered by India to apply, Indian tax administration is required to issue notification in this respect.

The Supreme Court ruling in the case of Nestle SA (supra) laid down that in terms of section 90(1) of the Act for MFN clause of a protocol to the Tax Treaties to apply a notification, specifying the benefits of the beneficial rate or restricted scope provided in a Tax Treaty entered into by India, that can be availed by the taxpayers, relying upon such MFN clause in the treaty is required to be issued. For that purpose, reference has been made to the decision of Supreme Court in the case of UOI v. Azadi Bachao Andolan.

Whether a notification necessary to make the protocol enforceable?

A protocol is an agreement reached by the parties to a tax treaty and signed and ratified by them, in addition to an existing tax treaty. The protocol may be signed simultaneously with the tax treaty or later, and it clarifies, implements, or modifies treaty provisions. With legislative mandate under the Act, every clause of the protocol should effectuate once it is entered into or signed. The language of the protocol in India France Treaty states that it forms an integral part of the treaty.

"At the time of proceeding to the signature of the Convention between France and India for the avoidance of double taxation with respect to taxes on income and on capital, ***the undersigned have agreed on the following provisions which shall form an integral part of the Convention:"***

Since, by virtue of the language of the protocol which forms an integral part of the convention/treaty, India does not have a choice to issue selective notification to restrict/limit the benefit as agreed in the treaty/protocol. In other words, in terms of India-France DTAA there should be no requirement to issue notification to implement the protocol more so, selectively.

The Supreme Court in their "Analysis" beginning with para 38 of the order have referred to Article 253 and Article 73 of the Constitution to hold that "it is when a treaty is enacted by law, or enabled through legislation, which assimilates it, that such provisions are enforceable in India". The Supreme Court in para 72 of the decision concluded as under:

"*72. In the opinion of this court, the status of treaties and conventions and the manner of their assimilation is radically different from what the Constitution of India mandates. In each of the said three countries, every treaty entered into the executive government needs ratification. Importantly, in Switzerland, some treaties have to be ratified or approved through a referendum. These mean that after intercession of the Parliamentary or legislative process/procedure, the treaty is assimilated into the body of domestic law, enforceable in courts. However, in India, either the treaty concerned has to be legislatively embodied in law, through a separate statute, or get assimilated through a legislative device, i.e. notification in the gazette, based upon some enacted law (some instances are the Extradition Act, 1962 and the Income Tax Act, 1961). Absent this step, treaties and protocols are per se unenforceable*."

Article 253 of the Constitution delegates the power to the Parliament to make any law for implementing any treaty, agreement or convention entered into with any country or countries. Article 253 forms part of Chapter I of part XI of the Constitution which provides for "Distribution of Legislative Powers". It is worthwhile to note that Article 253 of the Constitution delegates the power to Parliament to give effect to international agreements entered into by Union.

Article 253 of the Constitution embodies what may be termed as Dualist Practice, as opposed Monist Practice, ie. treaties lack legal force without enabling legislation. Thus, in the context of the Tax Treaties entered into by India, it would be pertinent to note that in compliance to Article 253 the parliament enacted subsection (1) section 90 under the income tax Act as the enabling provision for implementing the international treaties.

Section 90(1) of the Act enables the central government to enter into an agreement with the government of any other country outside India for avoidance of double taxation and may by notification in official gazette make such provision as may be necessary for implementing the agreement.' Further, section 90(2) of the Act provides that where the central government had entered into any agreement with the government of any other country for avoidance of double taxation, the provisions of this Act shall apply to the extent it is more beneficial. Sub-Section (1) of Section 90, therefore, provide that central government may issue notification as may be necessary for implementation of the Tax Treaties. In other words, there is no requirement in section 90(1) for a notification to be issued for making a Tax Treaty enforceable.

Sub-section (2) of section 90of the Act provides for application of the Tax Treaty or the Indian Income tax Act, whichever is more beneficial to the non-resident taxpayer. The aforesaid clearly indicates that once the Tax Treaty or convention is entered into in terms of section 90(1), it shall apply and the protocol being integral part of the Treaty the same should apply. Sub section (2) in section 90 provide for extending the beneficial treatment to the resident of other state while applying treaties entered into with such other countries which reflects clearly the mandate of the legislature to honour Tax Treaty provisions irrespective of the notification issued by the central government.

Further, Article 73 of the Constitution deals with power of the executive to exercise the powers of Government of India by virtue of any treaty or agreement. In other words, Article 73 enables endorsement of the rights under the treaties and agreements, which the executive is obliged to observe as part of its duties. Article 73 of the Constitution places limitations on the executive as well as provide for exercise of right, authority and jurisdiction in consonance with the treaty obligations.

Applying Article 73 the Supreme Court in *Gramaphone Company of India Ltd. vs. Birendra Bahadur Pandey*[3], (referred in para 43 of the decision of the SC) it was laid down that the interpretation of domestic law has to be done within the legitimate limits imposed by treaty obligations. It is because

Article 73 specifically provides that the executive power of the Union shall extend, inter alia, "to the exercise of such rights, authority, and jurisdiction **as are exercisable by the Government of India by virtue of any treaty or agreement."**

Article 51(c) of India's Constitution obligates that *"The State shall endeavour to …. foster respect for international law and treaty obligations in dealings of organized people with one another..."*. The supreme court while dealing with Article 253 of the constitution which is regarding the distribution of powers between the states and the union, did not comment on Article 51 of the constitution which casts an obligation on the state to respect the treaty obligations. Thus, once India had entered into an agreement with another country and mutually agreed to provide concessional treatment to the resident of other country, subsequently the government cannot deny such concessional treatment claimed in accordance with the provisions of such treaty.

Further, the Supreme Court referred to the various decisions in paragraphs 39 to 45, wherein, it is held that in order to effectuate the international treaty or agreement there has to be an enabling law. Pursuant to Article 253 of the Constitution which delegates power to the Parliament for making law for implementing any treaty, agreement or convention entered into with any country or countries, the Parliament has enacted the enabling law in the form of section 90 of the Income Tax Act.

Vienna Convention:

'Pacta Sunt Servanda' or 'Good Faith Principle' in Article 26 of the Vienna Convention on the Law of Treaties, 1969, viz., is that *"Every treaty in force is binding upon and parties to it and must be performed by them in good faith*." Article 27 of VCLT further strengthens the aforesaid principle by providing that "no party to a treaty might attempt to justify its failure to perform any of its international treaty obligations by invocation of its municipal law." *Article 31, 'General Rule of Interpretation', of the Convention too provides that a "treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*".

While India is not a party to the Vienna Convention, it contains many principles of customary international law, and the principle of interpretation, of Article 31 of the Vienna Convention, provides a broad guideline as to what could be an appropriate manner of interpreting a treaty in the Indian context also[4].

Also, the government is obliged to implement the agreement entered into with other states by virtue of **Article 51(c) of the Constitution**. The provisions of Article 51(c) of the Constitution when read with Article 26, 27 and 31 of the Vienna Convention clearly cast an obligation on the contracting State to not only remain bound by the terms of a treaty entered into by it but also obliges the State not to cite internal law (municipal law), as a justification for failure to perform its obligation under a treaty[5].

Decisions of the Constitution Benches of the Supreme Court:

In the case of Kesavananda Bharti v. State of Kerala[6], the 13 judges of the Constitution Bench of the Supreme Court, while observing that in cases of doubt or ambiguity in the provisions of a statute, the courts would interpret the statute as not to make it inconsistent with the established rules of international laws or association/comity of nations, it was held that:

"1467……***It is only in cases of doubt or ambiguity that the courts would interpret a statute as not to make it inconsistent with the comity of nations or established rules of international law,*** *but if the language of the statute is clear, it must be followed notwithstanding the conflict between municipal law and international law which results*."

It may be reiterated that the authority and mandate in sub-section (1) of section 90 of the Act is that **the Central Government may by notification in official gazette make such provisions as may be necessary for implementing the Agreement**. The express language in sub-section (1) of section 90 cannot be read as providing for a mandatory requirement of issuing a notification for making the Tax Treaties entered into by Central Government enforceable. The aforesaid at best would be in realm of doubt or ambiguity and as per the law laid down by the Constitution bench of the Supreme Court in the aforesaid decision would have to interpret in harmony with the established rules of international law.

Further, in the case of ADM Jabalpur v. Shivakant Shukla[7], the Constitution Bench presided by 5 judges observed that if two interpretations of a statute are possible, the court should lean in favour of adopting the interpretation that would make the provisions of statute to be in harmony with the international laws or treaty obligations. Every statute thus must be interpreted to a stretch permitted by its language, so as to make it consistent with the established rules of international law. The court accordingly held as under:

"*542. Equally well established is the rule of construction that if there be a conflict between the municipal law on one side and the international law or the provisions of any treaty obligations on the other, the courts would give effect to municipal law.* ***If, however, two constructions of the municipal law are possible, the courts should lean in favour of adopting such construction as would make the provisions of the municipal law to be in harmony with the international law or treaty obligations. Every statute, according to this rule, is interpreted, so far as its language permits, so as not to be inconsistent with the comity of nations, or the established rules of international law, and the court will avoid a construction which would give rise to such inconsistency unless compelled to adopt it by plain and unambiguous language……..*……."

The law laid down by the Constitution benches of the Apex Court, which is also in sync with the international law, was not relied before the Apex Court in the case of Nestle SA and Others (supra) and, thus the same could not be taken into consideration by the Supreme Court. Consequently, the said ruling delivered in the case of Nestle SA and Others (supra) does not seem to be in harmony and is not aligned to international law. The ruling would have staggering implication, in as much as most of the protocols with MFN clause in the Tax Treaties would become only be partially effective as a part of the benefit promised therein would be denied to the non-resident taxpayers operating in India. Thus, the respondent taxpayers who were the parties in dispute have filed review petitions before the Supreme Court ruling, which are pending disposal.

Supreme Court decision in Azadi Bachao Andolan's case:

The issue under consideration in the case of Azadi Bachao Andolan was to decide the legality of circular no. 789 of 2000, issued by the CBDT to provide certain additional clarifications with respect to the tax treatment of FIIs and other investment funds operating from Mauritius. In para 25 to 27 of the Azadi Bachao Andolan decision, the Supreme Court analysed legality of circular issued by CBDT and in that course made certain observation on the treaty related provisions in the Act.

The Supreme Court in paragraph 46 of the judgment observed that *"upon India entering into a treaty or protocol does not result in its automatic enforceability in courts and tribunals; the provisions of such treaties and protocols do not therefore, confer rights upon parties, till such time, as appropriate notifications are issued, in terms of Section 90(1)".*

The position that Tax Treaties and protocols do not confer rights upon parties till such time an appropriate notification is issued is not discernible from enabling provisions of section 90 (1) which only provide that the Central Government may by notification in the official Gazette, make such provisions as may be necessary for implementing the agreement.

Whereas in the instant case, the issue under evaluation was the enforceability of Tax Treaty provisions in absence of notification issued by the central government. Therefore, the above observation made by the Supreme Court in Azadi Bachao Andolan's case are only obiter dicta which are not in line with the express language of section 90(1) of the Act, and therefore could not be applied to the issue in question in the case of Nestle SA & others (supra).

Conclusion:

A protocol is an integral part of the Tax Treaties and effectuates and modifies them. Also, self-operating MFN clause is provided in most of the Tax Treaties entered into by India. India like other common law jurisdictions, does follow 'dualist practice', as opposed 'monist practice', whereby treaties including Tax Treaties would lack legal force without an enabling legislation. Section 90 of the Act provides for the necessary enabling legislation in terms of Article 253 of the Constitution for entering into and application of the Tax Treaties. While sub-section (1) of section 90 empowers Government to enter into on Tax Treaties with other countries and lays down the object and purpose for which such Treaties must be

entered into, sub-section (2) of section 90 provides for the manner of implementation and application of the Tax Treaties once they are entered into in terms of sub-section (1) of the said section. The aforesaid sufficiently meets the requirements of the 'dualist practice' as enshrined in Article 253 of the Constitution.

In other words, there is no choice or an option to any of the contracting states including India, who is entered into the said convention or agreement to not implement any part of the MFN clause in the protocol as its discretion. Following the decision of the Supreme Court in the case of Nestle SA and others the protocol and MFN clause in respect of Tax Treaties would become inoperative as they would not be implemented so as to benefit non-resident taxpayers in India. However, in the opinion of the authors there is no leeway or privilege in the bilateral agreement, or the municipal law as contained in the Constitution read with the Income-tax Act, not to implement MFN clause in the protocol. Law in this respect has been laid down by the decisions of the Constitution Benches of the Supreme Court in the cases of in the cases of Kesavananda Bharti (supra) and Shivakant Shukla (supra), which are in sync with the legal position and international convention.

The aforesaid in fact, would amount to not honoring the international treaty and would result in failure to perform international treaty obligation, which cannot be justified for the basis of invocation of India's municipal law.

Also, not implementing the bilateral agreement as in the protocol would amount to going back or reneging from an international treaty obligation and could been seen as tracing steps back from the shared understanding mutually agreed between Treaty partners, and not fulfilling International Treaty obligation and thus a promissory estoppel for the non-resident taxpayers.

---

[1] Notification No. 33/2024 F.No. 503/2/1986-FTD-I

[2] Notification No. S.O. 650(E)[NO. 11438(F.NO.501/16/80-FTD)] and Notification S.O. 54 [NO. 20 (F. NO. 505/2/89-FTD)]

[3] *Gramaphone Company of India Ltd. vs. Birendra Bahadur Pandey*

[4] Ram Jethmalani vs. Union of India [TS-306-SC-2011]

[5] Awas 39423 Ireland Ltd. vs. Director General of Civil Aviation [WP(C) 871/2015; Judgment dated 05.03.2015] (Del)

[6] His Holiness Kesavananda Bharati Sripadagalvaru v. State of Kerala and anr.

[7] ADM Jabalpur v. Shivakant Shukla