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An Albatross Around the Neck of Developing Nations - MFN Clause in Tax Treaties

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Abstract

The Most Favoured Nation ("MFN") clause in double taxation avoidance conventions epitomises the basic principle of non-discrimination and intends to bring parity in business and investment opportunities among treaty partner countries and jurisdictions. Inclusion of provisions like MFN and non-discrimination clauses in tax treaties are intended to promote equity among treaty partners. In the context of tax treaties between developed and developing countries, the MFN clauses also act as negotiating tools to bargain for better treaty tax rates.

However, lately these clauses have started demonstrating disadvantageous effects for the source countries, which are mostly developing countries. The MFN clauses generally do not appear to be creating potential risks if they are operational between two equally developed countries but when the relationship is between a developed and developing country, where one partner receives more investments from the other than it makes, such risks are inevitable. Lately, problems have started arising due to various interpretations of the MFN clauses by the courts forcing the source countries to extend benefits of reduced rates and restricted scope to treaty partner countries under the MFN rules. Such beneficial interpretations have gone beyond the basic objective and purpose of the MFN clauses.

In light of recent court cases in South Africa and India, it appears that the MFN clauses are creating opportunities for "reduced taxation" and leading to unintended erosion of tax base of source countries. The problem also lies with the ambiguous drafting and formulations of the MFN clauses, which eventually leads to unexpected negative outcomes for countries who have bound themselves with the future commitments. Therefore, a comprehensive review of existing MFN clauses in tax treaties, their cross connections and possible negative spill over effects to other treaties is the urgent need of the hour for the source jurisdictions.

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L'inclusion dans les conventions en matière de double imposition d'une clause de la nation la plus favorisée (« NPF ») est une incarnation du principe fondamental de la non-discrimination et vise à permettre aux pays signataires de tirer également parti des perspectives en matière de commerce et d'investissement. L'objectif de dispositions telles que les clauses NPF et de non-discrimination dans les conventions fiscales est de favoriser l'équité entre les différents pays signataires. Dans les conventions fiscales conclues entre pays développés et pays en développement, les clauses NPF servent également d'outils de négociation pour obtenir de meilleurs taux d'imposition.

Cependant ces clauses ont aujourd'hui des effets négatifs pour les pays de source des revenus, qui sont pour la plupart des pays en développement. Lorsqu'elles sont appliquées entre deux pays également développés, les clauses NPF ne constituent pas, généralement, une source de danger potentielle, mais lorsque la convention est conclue entre un pays développé et un pays en développement, où l'un des pays reçoit plus d'investissements de l'autre qu'il n'en réalise, le danger est réel. De fait, des difficultés sont apparues récemment en raison d'interprétations divergentes de ces clauses par les tribunaux, qui ont contraint les pays source à appliquer, sur la base des termes contenus dans la clause NPF, un taux d'imposition plus avantageux que celui prévu dans la convention fiscale et à modifier son champ d'application, remettant en cause l'objectif et l'utilité même des clauses NPF.

Il ressort des procédures judiciaires intentées en Afrique du Sud et en Inde que les clauses NPF peuvent aboutir à une réduction de la fiscalité et entrainer une érosion involontaire de la base d'imposition des pays de source des revenus. Le problème réside également dans la rédaction et la formulation ambiguë des clauses NPF, qui entrainent des répercussions négatives inattendues pour les pays ayant pris des engagements

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The views expressed in the article are the personal views of the author and do not, in any way, represent the views of the Government of India.

dans le cadre de ces conventions. Il est aujourd'hui urgent pour les pays source de procéder à un examen approfondi des clauses NPF figurant dans les conventions fiscales existantes, de la manière dont elles s'articulent entre elles et des retombées négatives qu'elles pourraient avoir sur d'autres conventions.

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La cláusula de la nación más favorecida ("NMF") de los convenios para evitar la doble tributación encarna el principio básico de no discriminación y tiene por objeto aportar paridad a las oportunidades empresariales y de inversión entre los países y las jurisdicciones partes en los tratados. La incorporación de disposiciones como las cláusulas de la NMF y de no discriminación en los tratados de tributación pretende promover la equidad entre las partes en los tratados. En el contexto de los tratados de tributación entre países desarrollados y en desarrollo, las cláusulas de la NMF también actúan como herramienta de negociación para contemplar mejores tipos impositivos en los tratados.

Sin embargo, últimamente, estas cláusulas han empezado a manifestar unos efectos negativos en los países de origen, que en su mayor parte son países en desarrollo. Por lo general, no parece que las cláusulas de la NMF estén creando posibles riesgos si son operativas entre dos países con el mismo grado de desarrollo, pero, cuando la relación se establece entre un país desarrollado y otro en desarrollo, donde una parte recibe de la otra más inversiones de las que hace, ese tipo de riesgo es inevitable. Recientemente, se han producido problemas a raíz de diversas interpretaciones de las cláusulas de la NMF por parte de los tribunales que han obligado a los países de origen a ampliar los beneficios de los tipos reducidos y el ámbito de aplicación restringido a los países parte en el tratado con arreglo a las normas de la NMF. Esa clase de interpretaciones beneficiosas han ido más allá del objetivo y el propósito básicos de las cláusulas de la NMF.

A tenor de causas judiciales que han tenido lugar recientemente en Sudáfrica y la India, parece que las cláusulas de la NMF están creando oportunidades de "reducción de impuestos" y están dando lugar a una erosión involuntaria de la base imponible de los países de origen. El problema también radica en la redacción y las formulaciones ambiguas de las cláusulas de la NMF, que finalmente provocan resultados negativos inesperados para los países que están obligados por compromisos futuros. Por consiguiente, en estos momentos, las jurisdicciones de origen necesitan con urgencia un examen exhaustivo de las cláusulas de la NMF existentes en los tratados de tributación, sus relaciones cruzadas y sus posibles efectos secundarios negativos en otros tratados.

Summary for Policymakers

Lately, the source countries, which are mostly developing countries, have started facing negative consequences of the Most Favoured Nation (MFN) clauses mainly due to the interpretative issues related to these provisions in the tax treaties. If the interpretation is in accordance with the objective and purpose of the MFN clause that a source country has agreed to at the time of negotiations, implementation of lower rate of tax or restricted scope under the MFN principle would have been a natural consequence. Recently, in *Concentrix* case, the High Court of Delhi interpreted the MFN clause of India-Netherlands tax treaty by ruling that the third state needs to be a member of the Organisation for Economic Co-operation and Development (OECD) on the date of application of the treaty irrespective of the fact if it was an OECD member or not when the relevant treaty was concluded with the source state. In the Indian context such interpretations are making treaties with Slovenia, Lithuania and Colombia vulnerable as lower dividend taxation rates in these treaties could be very easily imported in other treaties by applying the MFN principle based on the interpretation that at the time of claiming beneficial treatment these countries happen to be members of the OECD irrespective of the fact that they were not so when the treaties were concluded with India. Hence, the need of hour for the source country policymakers is to undertake a comprehensive impact assessment of existing MFN clauses in view of such kind of interpretations which are unfolding potential dangers for the tax base of source countries. The policymakers also need to review these MFN clauses with regard to their formulations and relevance in the present times so that such liberal interpretations, which are defeating the objective and purpose of MFN clauses, could be prevented. There is also an urgent need to revise the source withholding tax rates of vulnerable treaties by raising them to the optimum levels, so that interpretational outreach of MFN clauses is curtailed and the benefit of lower rates and restricted scopes under the MFN rules are given where it is actually due.

Similarly, in *ABC Proprietary Limited* case, the Tax Court of South Africa while interpreting the South Africa-Sweden treaty MFN clause reasoned that in absence of explicit reference to "future contract" in the said MFN clause, the beneficial treatment can be imported from "past contracts" also, which was against the basic objective and purpose of the MFN clause. Therefore, apart from a relook on interpretation issues, unambiguous drafting and formulations of the MFN clauses are also key requirements for policymakers. The source countries containing MFN clauses in their tax treaties need to reassess the negative spill over effects of these clauses and are urgently required to redraft them to remove the interpretational ambiguities. The policymakers of the source countries which are in the process of negotiating MFN clauses have to be very careful in drawing the contours of such clauses as choices made by them today may restrict their future policy objectives.

Further, the policymakers need be extremely careful of any changes being brought up in domestic tax laws and their interplay with treaty obligations of the country under clauses like MFN. In fact, before any intended domestic tax law changes, they should foresee the potential risks under MFN clauses and make the amends wherever it is deemed necessary. The examples cited in this article are indicative of how the MFN issue and its negative spill over effect emerged after the changes in the domestic tax law where the system of dividend taxation was changed from Dividend Distribution Tax (DDT) regime to classical system of dividend taxation.

1. Introduction:

In the field of international trade and international economic relations, the Most Favoured Nation (MFN) principle is the bedrock of non-discriminatory trade policy. Under the World Trade Organization (WTO), the principle of MFN finds place in Article 1 of the General Agreement on Tariffs and Trade (GATT), Article 2 of the General Agreement on Trade in Services (GATS) and Article 4 of Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)[1]. Similarly, the MFN treatment is a common clause in various multilateral trade agreements (e.g. the North American Free Trade Agreement - NAFTA) and investment treaties across the globe. The underlying principle is, if a country extends favourable treatment to another country on a particular subject under a given agreement, it must treat other parties to the agreement equally with regard to that subject.

On the similar lines, the MFN clause in tax treaties also intends to promote non-discrimination and parity in business and investment opportunities among treaty partner countries. The MFN clause does not constitute a standalone treaty article in model tax conventions and tax treaties. The Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital and the United Nations (UN) Model Double Taxation Convention between Developed and Developing Countries do not have standard MFN provisions. These provisions are generally outcomes of negotiations between treaty partners and most commonly find their place either in specific articles or more generally in the protocol of the agreement. Therefore, while reading a tax treaty, the protocol, which is an integral part of the treaty, should never be ignored as agreed provisions therein have the potential of changing the entire allocation of taxing rights between the contracting states. The MFN principle ensures that a treaty partner under one agreement is not subjected to a treatment which is less favourable than treatment provided to other treaty partners under similar agreements. Thus, MFN clauses are generally intended to bring parity, non-discrimination and a level playing field among treaty partners. However, the actual benefits of the MFN clause are also dependent on the fact that whether the agreement is between two equal income level countries or otherwise. In recent times, the MFN provisions in the tax treaties between developed and developing countries have started demonstrating disadvantageous effects for the source jurisdictions. In this article there is an effort to give, firstly, a general overview of the MFN provisions, their formulations and application; and secondly, a special focus on dangers and potential risks of the MFN clauses in view of some key court judgements in South Africa and India giving worrying interpretations of the "*MFN clauses*" for source countries. Further, with the focus on India's tax treaty network, there are concerns as to how MFN clauses have the potential of creating opportunities for "reduced taxation" and how these provisions in the tax treaties are going to expose the source countries to the risk of large-scale tax base erosion.

2. Most Favoured Nation clause - an exception not a general principle

In the context of double taxation avoidance conventions, the MFN clause is not a general principle but an exception. The MFN principle is not a part of model provisions under the Model Tax Conventions; therefore, these rules are not adopted by countries in a routine manner in their tax treaties, as is the case in trade agreements. Under the MFN principle in tax treaties, as a matter of exception, generally a source country commits to provide equal treatment to two non-resident taxpayers with regard to very specific items of the income (most commonly dividend, interest, royalty and Fees for Technical Services/FTS) covered by the relevant tax treaties. At present a large number of tax treaties worldwide contain the MFN clause in some or other form. The most common illustration is when a contracting state provides MFN treatment to residents of the second state, it basically binds itself with a future commitment that whenever it signs a similar agreement with a third state and provides beneficial treatment to that third state by limiting its taxation rights with respect to reduced tax rates/restricted scope/deductions/expenses, it has to grant similar beneficial treatment to the MFN jurisdiction.

There are number of variations in the formulation of these clauses as they are consequences of the negotiations between the treaty partners. Some MFN clauses provide that the third state has to be a member state of the European Union e.g. in Switzerland-Albania Double Tax Avoidance Agreement (DTAA), whereas others require the third state to be member of the OECD e.g. in India-Switzerland DTAA. Others prescribe no specified category of a third state and simply mention that the third state can be "any nation" irrespective of its OECD membership. Similarly, with regard to application, some treaties explicitly provide that the MFN clause will get activated automatically (e.g. Argentina-Belgium DTAA), whereas, others require bilateral intimation/consultation between the competent authorities of the contracting states regarding applicability of the MFN clause (e.g. Chile-Argentina DTAA). Furthermore, some MFN clauses require issuance of explicit notifications to this effect by the source state (e.g. India-Finland DTAA). Thus, with regard to applicability of MFN clause most common following procedural requirements can be observed across the tax treaties:

- Automatic activation of the MFN clause.
- Requirement of intimation by the source jurisdiction.
- Specific notification requirement.
- Bilateral consultation/negotiations/review of article for application of MFN clause.
- Silent with regard to procedures for application of the MFN clause.

With respect to covered income streams under the MFN clause, apart from the most common items of income such as dividend, interest, royalties and FTS, some MFN clauses cover other aspects of taxation also covered by the agreement such as provisions for allowability of deduction of expenses under Article 7 (Business Profits), taxation of income from air transport and shipping business and Permanent Establishments (PE) threshold related matters.

3. Is MFN clause creating an opportunity for reduced taxation and tax base erosion?

The MFN clauses in tax treaties designed with the purpose of non-discriminatory policy among treaty partners, have started to trigger their unexpected negative spill over effects exposing the source jurisdictions to risk of reduced taxation and erosion of their tax bases. Perils of MFN clauses were exposed in a dividend taxation issue between South Africa and the Netherlands in 2019. Similarly, in 2021, these dangers were again demonstrated in a case involving dividend taxation between India and the Netherlands. Details of both cases are briefly discussed in the ensuing paragraphs.

3.1 The South African experience:

The Tax Court of South Africa passed a judgement on June 12, 2019 interpreting the MFN clause provided under South Africa-Netherlands DTAA in favour of the taxpayer and directing the South African Revenue Service (SARS) to refund all the tax withheld on dividend income of Dutch shareholders during the relevant period including the accumulated interest thereon since April 1, 2012. The adjudicated case, *ABC (Pty) Ltd. Vs C:SARS (Case no. 14287)*[2] was between *ABC Proprietary Limited* (ABC), a tax resident of South Africa whose shares were held by a Dutch resident company, and the Commissioner for the SARS. In April 2012, company ABC declared dividends and paid source withholding tax (WHT) at the rate of 5% on these payouts in accordance with the provisions of South Africa-Netherlands DTAA (amended by a protocol in the year 2008). However, in the next years, ABC and its Dutch shareholders took a view that their liability to pay tax on dividend income is 0% in South Africa as per the application of paragraph 10 (MFN clause) of Article 10 (Dividends) of the South Africa-Netherlands DTAA. Accordingly, the taxpayer sought refund from the SARS of all the taxes paid (including interest amount). This interpretation of the MFN clause by the taxpayer was about to bring unintended consequences for the SARS. Though SARS rejected the objections of the taxpayer in 2016, in 2019 the Tax Court of South Africa interpreted the MFN clause in favour of taxpayer and directed the SARS to refund all the taxes withheld along with the interest amount to the taxpayer. Thus, triggering of the MFN clause stripped away South Africa of its right to tax the dividends declared by a resident company to the Dutch shareholders. It is likely that the SARS would have appealed against this judgement before the higher courts of the country.

In order to understand how the MFN clause was triggered and how its spill over effect led to a disastrous outcome for the SARS, it is important to go further into the details. Present case is a classic reminder to the negotiators that how presence or absence of a single word or phrase in tax treaties especially in sensitive clauses like MFN (which binds your tax policy for the future) can lead to unintended and disastrous outcomes. Decisions taken today can limit future tax policy options for the countries. In this case, three DTAAs that South Africa had entered with the Netherlands, Sweden and Kuwait have created a web of interpretations for the MFN clause. Sometime around 2006, South Africa took a decision to substitute the system of dividend tax paid by the resident companies to a system where the liability to pay tax on dividend income was shifted on the recipient (shareholder). During this process, South Africa identified a number of treaty partners in order to revise the existing DTAAs including Netherlands, Sweden and Kuwait. With Netherlands and Sweden, negotiations for amending the protocol were concluded and the revised agreement provided for 5% WHT for participation dividend and 15% for other categories of dividend, effective from December 28, 2008 and March 18, 2012 respectively. Whereas, the protocol to amend South Africa-Kuwait DTAA (signed in 2004 and entered into force in 2006) could not enter into force while the present case was being adjudicated by the Tax Court of South Africa. In fact, as per IBFD database, the said amending protocol with Kuwait is still pending for entry into force[3]. The existing South Africa-Kuwait DTAA[4] of 2006 exempts source-based taxation of dividends under paragraph 1 of Article 10:

> *"Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State who is the beneficial owner of such dividends shall be taxable only in that other Contracting State…"*

This means there will be 0% taxation in South Africa if a company which is a resident of South Africa pays dividends to shareholders resident in Kuwait.

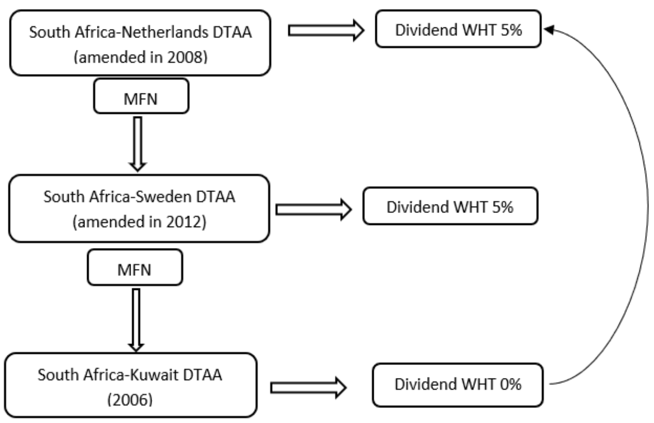
Interplay of the MFN clauses in *ABC Proprietary Limited* case:

In this case taxpayer took a view that the MFN clause provided in two of the DTAAs of South Africa with the Netherlands and Sweden should be read together which entitles the taxpayer to the most favoured treatment documented in the South Africa-Netherlands DTAA (the relevant treaty), thus reducing its tax liability for dividend payouts in South Africa to nil. (See table on ***The MFN Clause*** in the next page.)

By virtue of the MFN clause present in South Africa-Netherlands DTAA, the dividend rates provided under South Africa-Sweden DTAA became applicable here as the amended agreement with Sweden was concluded **after the date of conclusion** of the South Africa-Netherlands DTAA. This interpretation was fair as far as the formulation of the MFN clause is concerned. Whereas the taxpayer, in this case, went a step further to read on MFN clause for dividend taxation in South Africa-Sweden DTAA which provided that if any agreement between South Africa and a third state prescribes exemption or lower rate for source taxation of dividends, the same beneficial treatment shall automatically apply to the South Africa-Sweden DTAA. Thus, applying the said MFN clause, taxpayer sought beneficial treatment provided under South Africa-Kuwait DTAA which provided exemption from source taxation on dividend income. The fact is Kuwait DTAA was entered into force in 2006 i.e. way before the Sweden DTAA (2012). However, one crucial difference between MFN clause in the Netherlands DTAA and Sweden DTAA was absence of the words ***"after the date of conclusion of this convention"*** in Sweden DTAA. Thus, the interpretation was - so far as the MFN clause with Sweden is concerned - if any other contracting state gets beneficial treatment (**whether existing or in the future**), then those benefits also shall apply to Sweden. Eventually in this case, the said interpretation was upheld by the Tax Court of South Africa and it ruled in favour of the taxpayer. The SARS argued in the Court that *the taxpayer is now exploiting what is an entirely unanticipated, unforeseen and unfortunate occurrence to refuse to pay tax in South Africa despite the fact that the contracting parties (South Africa and the Netherlands) never meant this to happen. The consequences are potentially financially disastrous for South*

The MFN Clause	
South Africa-Netherlands DTAA[5] ***Article 10 (10)***	***South Africa-Sweden DTAA[6]*** ***Article 10 (6)***
If under any convention for the avoidance of double taxation concluded ***after the date of conclusion of this Convention*** *between the Republic of South Africa and a third country, South Africa limits its taxation on dividends as contemplated in subparagraph a) of paragraph 2 of this Article to a rate lower, including exemption from taxation or taxation on a reduced taxable base, than the rate provided for in subparagraph a) of paragraph 2 of this Article, the same rate, the same exemption or the same reduced taxable base as provided for in the convention with that third State shall automatically apply in both Contracting States under this Convention as from the date of the entry into force of the convention with that third State.*	*If any agreement or convention between South Africa and a third state provides that South Africa shall exempt from tax dividends (either generally or in respect of specific categories of dividends) arising in South Africa, or limit the tax charged in South Africa on such dividends (either generally or in respect of specific categories of dividends) to a rate lower than that provided for in subparagraph (a) of paragraph 2, such exemption or lower rate shall automatically apply to dividends (either generally or in respect of those specific categories of dividends) arising in South Africa and beneficially owned by a resident of Sweden and dividends (either generally or in respect of those specific categories of dividends) arising in Sweden and beneficially owned by a resident of South Africa, under the same conditions as if such exemption or lower rate had been specified in that subparagraph.*

Africa[7]. Nevertheless, this disaster for South Africa happened.



Thus, in the above case, the South African tax court while interpreting the South Africa-Sweden DTAA MFN clause held that *the residents of Sweden should receive the same preferential treatment as any other party contracting with South Africa applies* ***regardless of when*** *such other state's residents obtain such preference, i.e.* ***irrespective of whether it was before the agreement was concluded with Sweden or afterwards****. When the agreement was concluded with Sweden the residents of Kuwait already had preferential treatment and therefore the residents of Sweden were entitled to the same treatment*[8] (emphasis added). Accordingly, the same treatment was said to be also available to the residents of Netherlands by virtue of South Africa-Netherlands DTAA MFN clause. It is interesting to note that when South Africa had negotiated the MFN clause with Dutch counterparts, they would have surely meant it for a future contract. Similarly, when the MFN clause with Sweden was concluded, the intention must have been for a future commitment to preferential treatment, else they would have already agreed for beneficial rates available in the Kuwait DTAA, which was already in existence when the Sweden DTAA was being negotiated. Probably, following was the intended MFN clause in Sweden DTAA[9] (bold text emphasis added for illustration):

> *"If,* ***in the future*** *any agreement or convention between South Africa and a third state provides that South Africa shall exempt from tax dividends (either generally or in respect of specific categories of dividends) arising in South Africa, or limit the tax charged in South Africa on such dividends (either generally or in respect of specific categories of dividends) to a rate lower than that provided for in subparagraph (a) of paragraph 2, such exemption or lower rate shall automatically apply to dividends (either generally or in respect of those specific categories of dividends) arising in South Africa and beneficially owned by a resident of Sweden and dividends (either generally or in respect of those specific categories of dividends) arising in Sweden and beneficially owned by a resident of South Africa, under the same conditions as if such exemption or lower rate had been specified in that subparagraph."*

Had the case been above i.e. the MFN clause in South Africa-Sweden DTAA had included these three words ***"in the future"***, situation would have been different. The preferential treatment enjoyed by the residents of Kuwait would not have applied to residents of Sweden and consequently, Dutch residents would also not have been entitled to preferential treatment via application of MFN clause in South Africa-Netherlands DTAA. On the other hand, had the SARS been successful in concluding the amending protocol with Kuwait (removing the source tax exemption on dividends) and making the protocol effective before the above issue confronted them, this financially disastrous spill over effect of MFN clause could have been averted. Therefore, the basic question is how far MFN clauses are useful for source jurisdictions? They may have had relevance as a negotiating tool in the past but in the present times, such future commitments under MFN clauses are proving to be strong forces leading the source countries into deep waters.

3.2 The Indian experience:

On April 22, 2021, the High Court of Delhi passed a judgement, considered to be first of its kind, in the case of *Concentrix Services Netherlands BV WP (C) 9051/2020 and Optum Global Solutions International BV WP (C) 882/2021*[10] ("*Concentrix* case") and held that dividend paid by Indian company to its Dutch shareholders is taxable at a withholding tax rate of 5%

by importing lower dividend tax rate available in India-Slovenia DTAA by virtue of the MFN clause present in the India-Netherlands DTAA (which otherwise provides 10% withholding tax on dividend payouts under Article 10 of the said treaty). The Indian tax department strongly argued against invocation of the MFN clause available in India-Netherlands DTAA relying on the fact that all the criteria of the said MFN clause are not fulfilled in the said case. As per the tax department, the basic condition for third state (Slovenia) "to be a member of the OECD" has to be fulfilled not only at the time of application of the said treaty but also at the time when India had signed the treaty with Slovenia. The tax department therefore contended that since Slovenia was not an OECD member when the treaty was signed with India, the MFN clause of India-Netherlands DTAA is not applicable in this case. This was overruled by the court and a decision was given in favour of the taxpayer by ruling that the condition of third state being OECD member has to be fulfilled at the time of claiming the MFN benefit and not at the time of signing of treaty with the said third state. This ambulatory interpretation of the MFN clause, which appears to be beyond the basic intention of the MFN clause in the said treaty, is going to bring music to the ears of foreign investors especially for Dutch investors and many others entitled to MFN treatment under Indian treaties where similar interpretations are possible.

Taxation of dividends has taken the centre stage in India after the Finance Act, 2020 abolished the Dividend Distribution Tax (DDT) under Section 115-O of the Income-tax Act, 1961 on dividends declared, distributed or paid by a domestic company with effect from April 1, 2020. Now, in India the classical system of dividend taxation has been reintroduced under which the domestic companies are not required to pay the DDT and the dividend income is now taxable in hands of the recipients (shareholders) at their applicable tax rates. This has led to various instances, where taxpayers are now exploring the ways and means to get most beneficial tax rates under India's tax treaties by taking the route of MFN clauses, wherever it is available. This article has not gone into the details of the *Concentrix* case. The Delhi High Court (HC) should have considered some other aspects of the interpretation of MFN clause before adjudicating the case. These aspects namely, interpretation of the phrase *"which is a member of the OECD"* by the Court resulting in a retrospective and discriminatory application of MFN provisions; reliance by the Court on a unilateral decree issued by the Government of the Netherlands; application of principle of common interpretation by relying on unilateral interpretation given by the Dutch decree; and violation of good faith principle, are dealt by the author in a separate article titled ***"Applicability of MFN Clause on Dividends: Does Delhi HC settle the dust?"*** published on May 5, 2021.[11] However, here the focus is on how MFN provisions are increasingly becoming a ticking time bomb for developing countries.

<u>Interplay of the MFN clause in *Concentrix* case:</u>

The MFN clause present in subparagraph 2 of paragraph IV of the protocol to the India-Netherlands DTAA (1988) covers dividends, interests, royalties, fees for technical services or payments for the use of equipment and states as under[12]:

*" 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."*

(Emphasis added)

The above cited provision is the most common formulation of the MFN clause available in India's tax treaties. It is a fact that after the signature of India-Netherlands DTAA in 1988, India had entered into DTAA with Slovenia which came into force in 2005 (providing lower rate of tax at 5% for dividend payouts). Slovenia was not a member of the OECD at that time and subsequently it became an OECD member in 2010. In the said case, the High Court of Delhi ruled that since Slovenia is a member of the OECD when the treaty is being applied, the beneficial treatment in respect of dividend taxation which is available to the residents of Slovenia under India-Slovenia DTAA should also be available to the Dutch residents by virtue of the MFN clause in the India-Netherlands DTAA. The Court ruled that the MFN clause shall become applicable from the date when the third State becomes a member of the OECD which is a flawed interpretation of the provisions prescribed in the MFN clause which says the beneficial treatment will be effective from the date on which the treaty with the third state enters into force. The key issue in the said case which was debated in the court was whether the third state needs to be a member of the OECD when the relevant treaty was concluded or it merely needs to be a member of the OECD on the date of application of the treaty. Looking at the objective and purpose of the clause and the intention of negotiators at that point of time, had Slovenia been a member of the OECD at the time of executing the treaty, it is very unlikely that India would have agreed for a lower rate of 5%. India would have settled for similar rates as agreed with other OECD member countries at that time. Thus, agreeing to a lower rate with Slovenia was a conscious decision by India taken after due consideration given to existing MFN clauses (and their objective and purpose) in other Indian treaties. Therefore, such interpretation and broader reach by the High Court of Delhi goes beyond the basic objective and purpose of the MFN clause, violates good faith principle of *"Pacta sunt servanda"*[13] as enshrined in Article 26 of the Vienna Convention on the Law of Treaties and results into discriminatory application of the provisions. It is a commonly accepted principle of interpretation that treaties should be liberally interpreted but such liberal interpretation should not defeat the basic objective and purpose of the MFN provisions.

Without going further into the arguments and counter arguments on the *Concentrix* case in Delhi High court, it is imperative to mention that the phrase ***"third State which is a member of the OECD"*** in Indian MFN provisions is surely going to create a lot of litigation and debate in future. In addition to it, heavy reliance on unilateral Dutch decree[14] by the High Court of Delhi in its judgement is another judicial precedent which will encourage other treaty partners of India to issue such unilateral decrees/interpretations of the MFN clauses. Notably, apart from the Netherlands, the French government has also put in place a similar unilateral decree. The French official bulletin of public finances-taxes[15] published by the Direction Générale Des Finances Publiques (DGFIP), Ministry of Finance, France on November 4, 2016 refers to India's treaty with Slovenia for similar interpretation of the MFN clause in India-France DTAA. These decrees are unilateral interpretations and do not constitute shared understanding between the treaty partners. Here, it is important to place reliance on Article 31 of the Vienna Convention on the Law of Treaties (VCLT) which lays down the general rule of interpretation and states 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. Paragraph 2 of Article 31 of the VCLT (reproduced below), while explaining the "context" for the purpose of interpretation very clearly underlines that unilateral explanation or instruments cannot be used for interpretation of treaties unless the same has been accepted by the other party[16]:

> "2. *The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:*
>
> *(a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;*
>
> *(b)* ***any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty****.*
>
> (Emphasis added)

Thus, unilateral interpretations and explanations on the MFN clause in the form of aforementioned decrees which have not been expressly accepted by the treaty partner should not be used for the purpose of interpretation of the treaties. Therefore, these unilateral decrees have no binding value when it comes to interpretation of treaties, unless it has been accepted by the other treaty partner. But a question worth considering is – if a High Court in India can rely on unilateral interpretation of the Dutch side in its judgement, would it not be advisable that India also issue a circular or clarification as expression of its understanding and interpretation of the MFN clause? This may not settle the issue but this will at least discourage the Courts from relying on one-sided interpretations and may force them to see both sides of the coin. For the time being the Delhi HC judgement is going to stay here and foreign investors will try to get benefitted from it by favourably interpreting the MFN clauses. It is to be seen if the Indian tax department has challenged this ruling before the Supreme Court of India and how this issue will eventually be concluded.

However, setting the precedent of the *Concentrix* case, the High Court of Delhi on June 4, 2021 in *Nestle SA W.P. (C) 3243/2021*[17] yet again invoked the MFN clause under the India-Switzerland DTAA and ruled that the issue under consideration is covered by the High Court's *Concentrix* judgement and by virtue of the MFN clause, the Swiss resident is entitled to 5% dividend tax (not 10% as provided under Article 10 of India-Switzerland DTAA). It is interesting to highlight that while ruling in the *Concentrix* case, the High Court, *inter alia*, heavily relied on the unilateral interpretation given by Government of the Netherlands in its decree and based its judgement on the principle of common interpretation. Whereas, in the present case, no such decree has been issued by the Government of Switzerland and it is not available in the public domain as to how India's treaty partner interprets the applicability of the MFN clause present under India-Switzerland DTAA. In this context, it is surprising to note how the High Court has concluded that the issue is covered by the *Concentrix* judgement and thereby the principle of common interpretation is applicable in this case too.

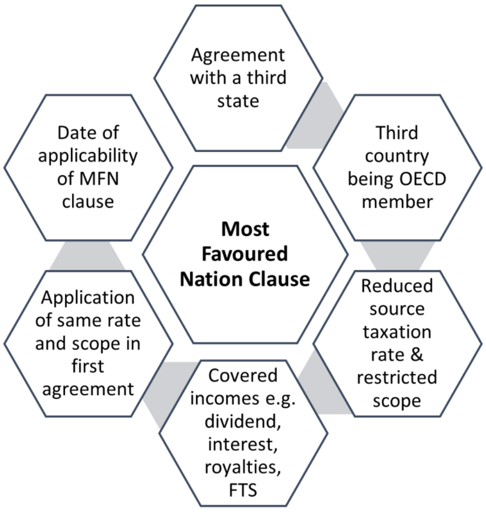
Thus, based on these judgements, as they stand, and if similar interpretation is followed by other courts, India and other source jurisdictions with identical MFN clauses are going to be in harm's way and will lose a lot of tax revenue due to presence of the MFN provisions in their tax treaties.

4. Should we wait for the disaster to happen?

With above instances of unintended and unexpected outcomes of the MFN clauses in South Africa and India, the writing on the wall is quite clear that the MFN clauses in the tax treaties of the capital importing countries are nothing but disasters in waiting. The MFN clauses will generally not create potential risks if they are between two equally developed nations but when the relationship is between a developed and developing country, where one partner (e.g. India & South Africa in this case) receives more investments from the other than it makes, such dangers are inevitable. If South Africa could have concluded the protocol with Kuwait (and removed source tax exemption on dividend payouts) and made it effective well before the issue of *ABC Proprietary Limited* confronted them, South Africa could have saved loss of its tax base. Though, it is understood that the said protocol was concluded from the South African side but the same was pending for ratification at the end of Kuwait. In case of South Africa, surely there will be other treaty partners (developed countries) who would like to seek similar beneficial treatment of "Nil" tax on dividends for their investments in South Africa by applying the existing MFN provisions as the Netherlands did by referring to the treaties like Sweden where MFN clause supposedly (as interpreted by the Tax Court) applies to both existing and future contracts and Kuwait DTAA which exempts source taxation of dividend income.

In the context of Indian tax treaties, potential dangers of MFN clauses have multiplied after the *Concentrix* judgement. In order to understand the MFN clauses and their potential risks in India's vast treaty network, the most common formulation of the said clause in Indian tax treaties can be examined first (see figure on **Most Favoured Nation Clause** in the next page):

On analysis of India's vast tax treaty network, the following broad picture appears to be encompassing MFN clauses in 13 tax treaties out of which 9 are based on the conditionality of the third state being an OECD member. Most of the MFN clauses are silent on procedural requirements for their application (self-operating MFN clauses). Whereas, some require intimation/notification/review/renegotiation requirements before extending the MFN treatment to the treaty partner. (See table in p. 9.)



[Just to illustrate, in the case of Country A-B tax treaty, above formulation of the MFN clause prescribes conditionalities; that Country A should have entered into a double taxation avoidance convention, agreement or protocol with a third state (Country C) after the signature of the agreement with Country B. Country C should have been a member of the OECD (intended condition is country C should have been a member of the OECD at the time of signing of the treaty). If these two conditions are met, and if Country A had reduced its taxation at source on dividends, interest, royalties or fees for technical services to a rate lower than the rate provided for in A-B tax treaty and similarly restricted the scope of these incomes, the same reduced rate and restricted scope as provided for in A-C tax treaty would apply to A-B tax treaty w.e.f. the date on which the A-C tax treaty had entered into force.]

Potential dangers of MFN clauses for India (and other developing nations):

The conditionality of the third state being an OECD member in the MFN clause and its ambulatory interpretation (as in *Concentrix* case) that the third country need not to be an OECD member on the date of signature of the treaty, will further lead to a situation where treaty partners with higher dividend tax rates will try to get the benefit of reduced tax rates by importing lower tax rates from below mentioned three countries which were not members of the OECD when they signed DTAAs with India but became OECD members subsequently.

Countries	Date of entry into force	OECD membership	Dividend WHT
India-Slovenia DTAA	February 17, 2005	July 21, 2010	5%, 15% (dual rate)
India-Lithuania DTAA	July 10, 2012	July 5, 2018	5%, 15% (dual rate)
India-Colombia DTAA	July 7, 2014	April 28, 2020	5% (single rate)

Slovenia and Lithuania DTAA provide 5% dividend tax on participation dividend and the treaty with Colombia provides over all dividend taxation at the rate of 5%. Thus, these three treaties with lower rates of dividend taxation coupled with the fact that all of them have become OECD members after signing of the DTAA with India, makes them vulnerable as the beneficial treatment in the form of lower tax rates in these treaties could be sought by investors/shareholders located not only in the Netherlands but also in Finland, France, Hungary, Sweden and Switzerland by virtue of similar MFN clauses in these treaties. In the case of DTAAs with Belgium and Spain, dividend is not part of covered income stream under MFN clause but they cover royalty and Fee for Technical Services (FTS). Another important point is, application of the MFN clause in Finland DTAA requires issuance of specific notification to this effect by India. Rest of the MFN provisions in aforementioned DTAAs appear to be self-operating with different formulations, hence, case by case examination would be required. In this context, it is also relevant to mention that the Indian tax department maintains that MFN clauses are not self-operating in nature but a specific notification under Section 90 of the Income-tax Act, 1961 is required to give effect to them. However, in *Steria (India) Limited Vs. CIT* case[18], where taxpayer invoked MFN clause in India-France DTAA and sought benefit of restricted scope of FTS by importing "make available" clause from India-UK DTAA, the High Court of Delhi had ruled that the application of the MFN clause provided in the protocol of the treaty is automatic and no separate notification is required. The tax department has not accepted this judgement and has appealed before the Supreme Court of India, the highest court of law in the country.

Thus, interpretation of the MFN clause in a way where OECD membership of the third state is taken into account on the date of application of the treaty rather than the date when treaty was signed, is going to create opportunities for "reduced taxation" and like India, other source countries are also likely to be in a situation to forgo their substantial part of revenue which otherwise they would have rightfully taxed. This loss of tax base is inevitable if some quick measures are not taken to curb the negative spill over effects of the MFN clauses in tax treaties.

Another aspect which is worth giving a thought is, considering the interpretations by Tax Court of South Africa and High Court of Delhi in above discussed cases, if there could be a possibility where the global investors could plan their business affairs and manage/locate their holding structure in such jurisdictions where they can use the MFN clauses for paying substantially lower taxes in the developing countries. With the introduction of "classical system" of dividend taxation in India, foreign investors will be attracted for taking benefit of MFN clauses to enjoy the beneficial tax rate for dividend payouts available in India's treaties with Slovenia, Lithuania and Colombia. On the other side, it is also a fact that if multinational enterprises (MNEs) get into such kind of international tax planning with the sole aim of obtaining tax benefits, they will have to pass the "Form" Vs "Substance" Test and get through domestic anti-abuse rules (such as General Anti-Avoidance Rules/GAAR) and treaty anti abuse rules (such as the Principal Purpose Test/PPT and the Limitation of Benefits/LOB).

The larger question is why MFN provisions are leading to

S. no.	Countries	MFN clause	Covered income	Covered benefits	Third state conditions	Procedural requirements for application
1.	Belgium	Para 1 of Protocol	Royalty and FTS	Lower rate and restricted scope	Member of the OECD	Silent
2.	Finland	Para II of Protocol to the Agreement	Dividend, interest, royalty and FTS	Exemption or lower rate	Member of the OECD	Intimation & notification requirement
3.	France	Para 7 of Protocol to the Agreement	Dividend, interest, royalty and FTS	Lower rate and restricted scope	Member of the OECD	Silent
4.	Hungary	Protocol of the Agreement	Dividend, interest, royalty and FTS	Lower rate and restricted scope	Member of the OECD	Silent
5.	Israel*	Para 2 & 3 of protocol*	Dividend, interest, royalty, FTS and tax on PEs.	Lower rate and restricted scope	Any state	**MFN clauses were removed vide 2017 notification.*
6.	Kazakhstan	Protocol of the Agreement	Dividend, interest, royalty and FTS	Lower rate and restricted scope	Any state	Silent
7.	Netherlands	Para IV of Protocol to the Agreement	Dividend, interest, royalty and FTS	Lower rate and restricted scope	Member of the OECD	Silent
8.	Philippines	Para 4 of Protocol to the Agreement	Air transport and shipping business	Lower/nil rate	Any state	Bilateral consultation & review
9.	Saudi Arabia	Para 9 of Protocol to the Agreement	Allowability of deduction of expenses under Article 7	Removal of restrictions	Any state	Bilateral review
10.	Spain	Para 7 of Protocol to the Agreement	Royalty and FTS	Lower rate and restricted scope	Member of the OECD	Silent
11.	Sweden	Para 3 of Protocol to the Agreement	Dividend, interest, royalty and FTS	Lower rate and restricted scope	Member of the OECD	Silent
12.	Switzerland	Para 4 of Protocol to the Agreement	Dividend, interest, royalty and FTS	Lower rate and restricted scope	Member of the OECD	Renegotiation required for restricted scope of royalty and FTS
13.	United Kingdom	Article 7 (6) of the Agreement	Allowability of deduction of expenses under Article 7	Removal of restrictions	Member of the OECD or state in a comparable stage of development	Bilateral consultation

Source: www.incometaxindia.gov.in

such disastrous situations for developing countries? And should they wait for the disaster to happen? Learning from above discussed two cases is - risk of having MFN clauses in tax treaties outweighs its benefits for the developing countries. Going forward, if at all these provisions are needed, the developing countries negotiating the MFN clauses should take utmost care in drafting of these clauses and undertake a thorough impact assessment of the proposed rules on their tax treaty network before adopting them. For instance, absence of just three words – *"in the future"* in MFN clause of South Africa-Sweden DTAA led the Tax Court of South Africa to rule in the favour of taxpayer and walk away with complete tax exemption on dividend payouts for Dutch investors in South Africa in the said case. As far as India is concerned, to prevent the negative spill over effect of the MFN clauses, there is an immediate requirement of negotiating amending protocols with Slovenia, Lithuania and Colombia raising the dividend tax rates from 5% to reasonable limits (say 10%), as per India's prevailing tax policy, so that India does not lose its tax base due to application of the MFN provisions.

A comprehensive analysis of all the MFN clauses in tax treaties and examination of their cross connections and negative spill over effects over other treaties is urgent need of hour. In fact, in the long run, developing countries should do away with existing MFN clauses by renegotiating the relevant tax treaties. Further, a careful analysis of changes being brought up in domestic tax laws and their impact on tax treaties is very important. In the above examples of India and South Africa, the MFN issue and its negative spill over effect emerged after the changes in the domestic tax law when the system of dividend taxation was changed from Dividend Distribution Tax to classical system of dividend taxation.

5. Will Multilateral Instrument (MLI) change anything?

The MFN provisions not being standalone treaty articles, the MLI will not have any direct impact on them apart from the fact that some items of income covered under the MFN clauses will be impacted by the MLI provided a country has opted for those provisions. For example, Article 8 of the MLI will introduce an anti-abuse rule by prescribing additional temporal threshold of *"365 days minimum holding period"* for the shareholders to avail beneficial rates under treaty. India has opted this provision under the MLI and this will be of significant importance to it in view of the fact that India has recently abolished the dividend distribution tax regime and introduced classical system of dividend taxation in India.

However, as far as possibility of treaty abuse is concerned i.e. the shareholders/investors restructuring their holdings and relocating and routing their investments through countries where they can try to take benefit of the MFN clauses and if such restructuring is done with sole purpose of obtaining tax benefits, the MLI through a new preamble text and Principal Purposes Test (PPT) will definitely be a major anti-abuse instrument to curb such practices apart from the general anti-avoidance rules available in domestic tax law. The new preamble text and the PPT are the anti-treaty abuse measures prescribed under Article 6 and 7 of the MLI as minimum standards. Further, impact of the MLI will depend upon the fact that if a jurisdiction has signed the MLI or not, and if it is a signatory, whether it has notified other treaty partner under its Covered Tax Agreements (CTAs). For example, India and Switzerland both are signatories of the MLI and both have ratified the instrument but Switzerland has not notified India under its CTAs whereas India has done so. Therefore, in this case, even for the minimum standards to apply, bilateral negotiation of a protocol is mandatory.

The new preamble text[19] under the MLI prescribing the purpose of a tax treaty as- *"Intending to eliminate double taxation with respect to the taxes covered by this agreement* ***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 this agreement for the indirect benefit of residents of third jurisdictions)"*, will act as deterrent for tax avoidance practices creating opportunities for *"non-taxation"* and *"reduced taxation"* (emphasis added). Similarly, under the PPT, if the tax department reasonably concludes that obtaining tax benefits was one of principal purposes of such restructuring or tax planning, the treaty benefit of lower rate and restricted scope under the MFN provisions can be denied. Having said this, in the present times, this level of international tax planning by the global companies would not be that easy considering the fact that for creating any such structure or arrangement they will have to fulfil *"substance"* and *"beneficial ownership"* requirements. So, the possibilities appear to be rare for an enterprise to use any MFN jurisdiction as conduit for routing its investments but these are the situations that source countries should not miss to anticipate.

6. Conclusion:

The South African and Indian experience of issues involving dividend taxation under tax treaties, their interplay with MFN provisions and the unfavourable interpretations by the Courts, discussed in above paragraphs, is just one example and an indication of how MFN clauses are proving to be an albatross around the neck of source countries. Sooner they get rid of it, the better!

Endnotes:

[1] Available from www.wto.org.

[2] *ABC (Pty) Ltd. Vs C:SARS (Case no. 14287).* See https://www.sars.gov.za/wp-content/uploads/Legal/Judgments/TC/LAPD-DRJ-TC-2019-04-TCIT-14287-CPT-12-June-2019.pdf.

[3] IBFD Tax Research Platform. Available from https://research.ibfd.org/#/doc?url=/data/treaty/docs/html/tt_kw-za_01_eng_2004_tt__ad1.html.

[4] South Africa-Kuwait DTAA. Available from https://www.sars.gov.za/wp-content/uploads/Legal/Agreements/LAPD-IntA-DTA-2012-52-DTA-Kuwait-GG-29815.pdf.

[5] South Africa-Netherlands DTAA. Available from https://www.sars.gov.za/wp-content/uploads/Legal/Agreements/LAPD-IntA-DTA-2012-59-DTA-Protocol-Netherlands-GG-31795.pdf.

[6] South Africa-Sweden DTAA. Available from https://www.sars.gov.za/wp-content/uploads/Legal/Agreements/LAPD-IntA-DTA-2012-73-DTA-Protocol-Sweden-GG-35268.pdf.

[7] See ABC (Pty) Ltd. Vs C:SARS, supra note. 2.

[8] See ABC (Pty) Ltd. Vs C:SARS, supra note 2.

[9] See South Africa-Sweden tax treaty, supra note 6.

[10] *Concentrix Services Netherlands B.V v. ITO (TDS), [2021] 127 taxmann.com 43 (Delhi HC)*

[11] Available from https://www.taxsutra.com/dt/experts-corner/applicability-mfn-clause-dividends-does-delhi-hc-settle-dust.

[12] Available from https://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx.

[13] Vienna Convention on the Law of Treaties, 1969. Available from https://legal.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf.

[14] Decree of February 28, 2012 [No. IFZ 2012/54M, Tax Treaties, India] published on March 13, 2012.

[15] Official bulletin of public finances-taxes [Legal ID: BOI-INT-CVB-IND-20161104] issued by Direction Générale Des Finances Publiques (DGFIP), France on November 4, 2016.

[16] See Vienna Convention on the Law of Treaties, 1969, supra note 13.

[17] Copy of Judgement *Nestle SA Vs. Assessing Officer Circle (International taxation)-2(2)(2), New Delhi* available at https://delhihighcourt.nic.in.

[18] *Steria (India) Ltd. Vs. CIT [2016] 72 taxmann.com 1 (Delhi HC).*

[19] Text of MLI available at https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf.

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