Elimination of double taxation and Most Favoured Nation clause in tax treaties

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Speaker

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Importance of cross-border taxation

01 Tax landscape undergoing a paradigm shift to a '*substance-over-form*'

02 Key developments: New forms of permanent establishment or taxable presence, Multi-Lateral Instrument, OECD's Two-Pillar solution

03 Increased economic interactions between taxpayers from different countries

04 Tax efficient repatriation of returns

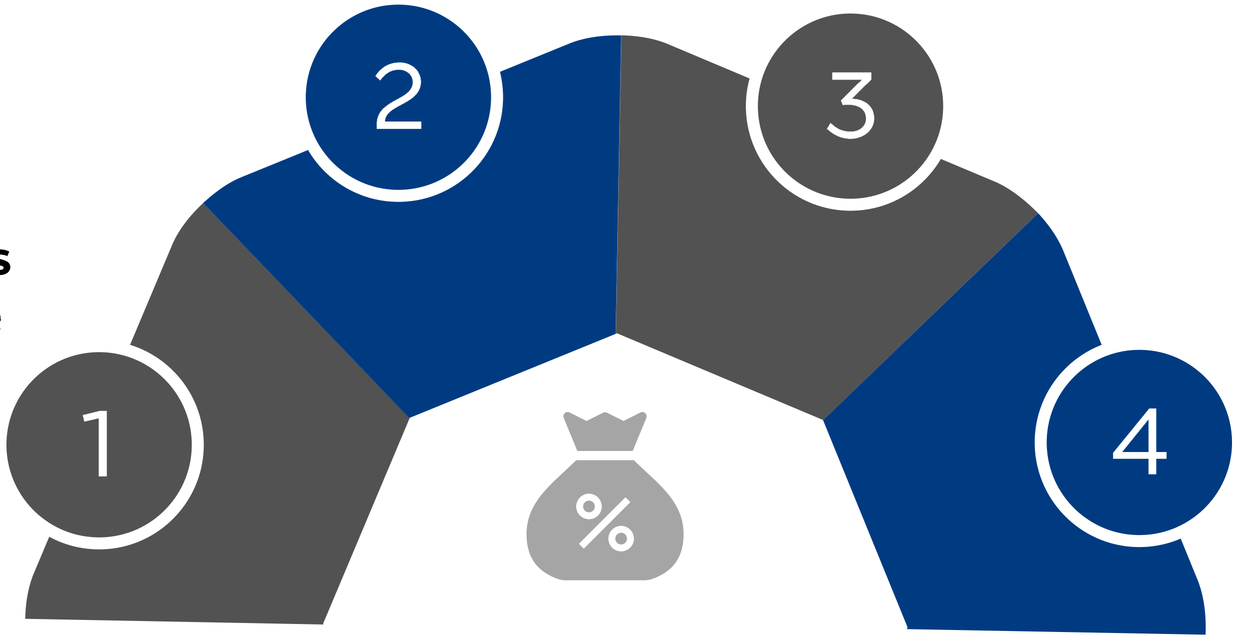
Double taxation | An overview

Two different countries levy taxes on the same income, asset, or financial transaction

Juridical double taxation and Economic double taxation

Role of tax treaties

Challenges posed by double taxation



Juridical double taxation

01 same income is taxed in the hands of same person, in two different jurisdictions

02 Reasons: different tax systems in countries

03 Impact of juridical double taxation

04 Measures to avoid juridical double taxation:

- Bilateral tax treaties
- Unilateral relief
- Tax exemptions
- Tax sparing

Economic double taxation

01 Different persons are getting taxed in respect of the same income, in two or more jurisdictions

02 Harmful effects on economy and cross-border transactions

03 Companies operating in multiple jurisdictions

04 Impact on businesses and individuals

05 Ways to eliminate economic double taxation:
- Tax treaties
- Unilateral relief

06 Complex issue

Principles for elimination of double taxation

Principle of exemption

- Full exemption
- Exemption with progression

Principle of credit

- Full credit
- Ordinary credit

Principle of exemption | Full exemption

01 Suppose the total income to be 100,000, of which 80,000 is derived from residence country R and 20,000 from the source country S

02 Assume that in country R, the rate of tax on an income of 100,000 is 35% and on an income of 80,000 is 30%.

03 Assume further that in country S, the rate of tax is 40%.

Particulars	Full Exemption
Tax in country R	80,000 x 30% = 24,000
Plus: Tax in country S	20,000 x 40% = 8,000
Total taxes	**32,000**
Relief given in country R	**(100,000 x 35%) + (20,000 x 40%) – 32,000 = 11,000**

Principle of exemption | Exemption with progression

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01 Suppose the total income to be 100,000, of which 80,000 is derived from residence country R and 20,000 from the source country S

02 Assume that in country R, the rate of tax on an income of 100,000 is 35% and on an income of 80,000 is 30%.

03 Assume further that in country S, the rate of tax is 40%.

Particulars	Exemption with progression
Tax in country R	80,000 x 35% = 28,000
Plus: Tax in country S	20,000 x 40% = 8,000
Total taxes	**36,000**
Relief given in country R	**(100,000 x 35%) + (20,000 x 40%) – 36,000 = 7,000**

Principle of credit | Full credit

01 Suppose the total income to be 100,000, of which 80,000 is derived from residence country R and 20,000 from the source country S

02 Assume that in country R, the rate of tax on an income of 100,000 is 35% and on an income of 80,000 is 30%.

03 Assume further that in country S, the rate of tax is 40%.

Particulars	Full Credit
Tax in country R	100,000 x 35% = 35,000
Less: Tax in country S	20,000 x 40% = 8,000
Total taxes	**27,000**

Principle of credit | Ordinary credit

01 Suppose the total income to be 100,000, of which 80,000 is derived from residence country R and 20,000 from the source country S

02 Assume that in country R, the rate of tax on an income of 100,000 is 35% and on an income of 80,000 is 30%.

03 Assume further that in country S, the rate of tax is 40%.

Particulars	Full Credit
Tax in country R	100,000 x 35% = 35,000
Less: Tax in country S	Maximum credit allowed 7,000 (i.e. 20,000 x 35%, being the tax rate in State R)
Total taxes	**28,000**

Credit method | Other aspects

01 Identical head of income mandatory?

02 Whether the residence country R is obliged to allow tax credit to taxpayer?

03 Can a taxpayer claim a refund in residence country R, for tax paid in source country S?

04 Can the foreign tax credit exceed the tax liability in the residence country?

05 Can the foreign tax credit be claimed in a different year?

06 Rectification possible?

Tax Sparing Credit

- Slight deviation from normal foreign tax credit rule
- Allows credit for taxes 'spared' in source country (tax incentives etc granted by developing countries)
- Purpose: to ensure that tax incentives are not nullified by residence country taxes
- Reasons:
  - Promotion of Outward Investment
  - Enhanced Global Presence
  - Economic Growth
  - Strengthening bilateral relations
  - Indirect benefits
- Helps governments implement effective policy decisions

Most Favoured Nation clause in tax treaties

01 Pivotal element in international tax treaties

02 Ensuring consistency in tax treatment across countries

03 Ensures that contracting countries treat each other equally, without any discrimination

04 Depends on the specific wording of the clause in the treaty

MFN clause | Pros and cons

Pros of MFN clause:

- Promotes Equality
- Encourages Trade
- Simplifies Negotiations

Cons of MFN clause:

- Limits Flexibility
- Potential for Disputes
- Unintended Consequences

MFN clause | Indian context

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01

Indian tax treaties contain MFN clause, via protocols

02

Practical aspect: what if payor is not comfortable with seller's eligibility to tax treaty relief?

03

Exact implication depends upon the language of MFN clause

Litigation Trajectory

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Steria India- Delhi HC
Indo-France DTAA
Fees for Technical Services

Nestle SA- Delhi HC
Indo-Switzerland DTAA
Dividend

Concentrix Services: Del HC
Indo-Netherlands DTAA
Dividend

Epcos Electric: Del HC
Indo-Spain DTAA
Fees for Technical services

Nestle SA
Supreme Court

Matter de tagged by SC

MFN clause | Indian tax jurisprudence | Pre-CBDT circular judgments

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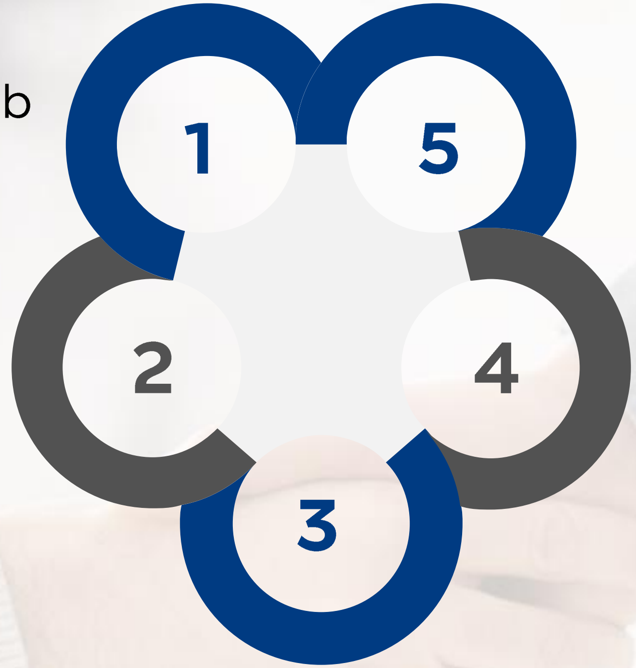
India – Netherlands tax treaty

- 10% tax rate under treaty
- Reduced to 5% due to MFN clause (Slovenia, Lithuania, Colombia)
- Date of their tax treaties with India?
- Date of their OECD membership?

High Court decision: in taxpayer's favour

- Relevance of 'is'

MFN clause | Indian tax jurisprudence | CBDT circular



1. CBDT Circular 3 of 2022 (3rd Feb 2022)
2. What is the relevant date to test other country's OECD membership?
3. Deviation from High Court decision
4. Interplay with foreign country's unilateral decree, bulletin etc
5. Separate notification?

SAMPLE MFN CLAUSE IN PROTOCOL

01

[…], if under any Convention […]signed after 1-9-1989, between India and a third State ***which is a member of the OECD****, India limits its taxation at source on dividends, […] to a rate lower […] than the rate […] provided for in this Convention […] the same rate […] as provided for in that Convention[…] on the said items income shall also apply under this Convention, with effect from the date on which the […] relevant Indian Convention, Agreement or Protocol enters into force […]*

02

Issue: Does the subsequent contracting nation have to be an OECD member as on the date when the protocol was signed? Or does the subsequent contracting nation have to be an OECD member as on the date when the tax benefits are sought to be claimed?

MFN clause | Indian tax jurisprudence | Supreme Court judgment

- Nestle case
- *Arguments of taxpayers:*
  - Tax treaties and protocols already notified by government
  - Language in the relevant tax treaties does not mandate any fresh negotiations or notification
  - Meaning of the phrase '*is a member of OECD*'
  - Executive decrees issued by Swiss, French, and Dutch authorities
- *Arguments by tax department:*
  - India follows a 'dualist approach'
  - Lower rate from a tax treaty can be imported into the primary treaty only if India entered into such tax treaty with an OECD member
  - Executive decrees issued by Swiss, French, and Dutch authorities do not bind Indian revenue authorities
- Supreme Court decision:
  - Past conduct
  - Interpretation of 'is a member'
  - Separate notification required
- Impact?
- March 2024 | India – Spain tax treaty

Supreme Court ruling takeaways

- The MFN Clause only contemplates a scenario where the third contracting nation was a member of the OECD as on the date when the Protocol was signed.
- Distinction between ‘dualist’ and ‘monist’ countries highlighted. Emphasis laid on how India is a dualist nation.
- Benefits under the MFN Clause would not automatically apply in the absence of an enabling legislation (i.e., statute or notification) in domestic law.
- Interpretation of tax treaties cannot be done in the same manner as statutory interpretation. Due regard must be given to the context of provisions, state practice, and political considerations.

MFN clause | MLI

01

Interplay of MFN clause with MLI

02

MLI: Prescribed minimum ownership criterion to be met throughout the 365-day period

03

To avoid treaty shopping

Conclusion

Double taxation | Meaning, Types, Causes, Impact **01**

02 Methods for elimination of double taxation

Most Favoured Nation | Meaning and Litigation **03**

04 Impact

THANK YOU

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