THE MEANING OF «IS»: REFLECTIONS ON NESTLE

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"It depends on what the meaning of the word 'is' is."

Bill Clinton, 1998

On October 19, 2023, the Supreme Court of India issued its decision in *Nestle.*[3] This is a very important decision regarding two issues: whether Indian tax treaties are self-executing, and what is the impact of a Most Favored Nation (MFN) clause in a tax treaty between India and a member of the OECD. The purpose of MFN clause in the Indian tax treaties is to provide the initial OECD treaty partner with a concession—in terms of lowering of rate of tax at source on dividends, interest, royalties, fees for technical services or restriction of scope of royalty or fees for technical services—that is similar to what has been provided to another OECD treaty partner subsequently.[4]

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[3] *Assessing Officer Circle (International Taxation) v. M/s Nestle SA*, Civil Appeal No. 1420/2023, [2023] 155 taxmann.com 384 (SC), available at: https://main.sci.gov.in/supremecourt/2022/6394/6394_2022_8_1502_47832_Judgement_19-Oct-2023.pdf.

[4] *See, e.g.,* the MFN clause under the India-Swiss DTAA/Protocol that provides as follows:

> *…in respect of Articles 10 (Dividends), 11 (Interest) and 12 (Royalties and fees for technical services), if under any Convention, Agreement or Protocol between India and a third State which is a member of the OECD signed after the signature of this Amending Protocol, India limits its taxation at source on dividends, interest, royalties or fees for technical services to a rate lower than the rate provided for in this Agreement on the said items of income, the same rate as provided for in that Convention, Agreement or Protocol on the said items of income shall also apply between both Contracting States under this Agreement as from the date on which such Convention, Agreement or Protocol enters into force.*

The case dealt with two specific issues. **First**, does the MFN clause contained in the double tax avoidance agreement ("DTAA") executed with certain OECD countries (Netherlands, France, and Switzerland) apply automatically in India after the DTAA is ratified, or does it require a special notification under Indian domestic law[5] for the MFN clause to come into effect?

Second, is there any right to invoke such MFN clause based on India's subsequent execution of a DTAA with a third country that was at the point of execution *not* a member of the OECD but became an OECD member at a later date?

The Indian Supreme Court held that:[6]

(a) A notification under Section 90(1) is necessary and a mandatory condition for a court, authority, or tribunal to give effect to a DTAA, or any protocol changing its terms or conditions, which has the effect of altering the existing provisions of law.

(b) The fact that a stipulation in a DTAA or a Protocol with one nation, requires same treatment in respect to a matter covered by its terms, subsequent to its being entered into when another nation (which is member of a multilateral organization such as OECD), is given better treatment, does not automatically lead to integration of such term extending the same benefit in regard to a matter covered in the DTAA of the first nation, which entered into DTAA with India. In such event,

[5] Section 90, Income Tax Act 1961.

[6] *Assessing Officer Circle (International Taxation) v. M/s Nestle SA*, *supra*, at paragraph 88.

> *the terms of the earlier DTAA require to be amended through a separate notification under Section 90.*
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> *(c) The interpretation of the expression "is" has present signification. Therefore, for a party to claim benefit of a "same treatment" clause, based on entry of DTAA between India and another state which is member of OECD, the relevant date is entering into treaty with India, and not a later date, when, after entering into DTAA with India, such country becomes an OECD member, in terms of India's practice.*

OECD and US tax treaties typically do not contain an MFN clause. The problem with MFN clauses in tax treaties is that unlike MFN clauses in bilateral investment treaties,[7] they can cost a country revenue if the investment flows are not reciprocal. For example, suppose country A enters into a tax treaty with country B and the investment flows are not reciprocal, so that more investment flows from country B to country A than vice versa. As a result, country A does not follow the OECD model, because that would result in a loss of revenue since the reduction in withholding taxes on outbound flows will not be matched with lower foreign tax credits on inbound flows. But now suppose that country A enters into a later tax treaty with country C and the investment flows are reciprocal, so that country A is willing to follow the OECD model. The problem is that if the earlier treaty with country B contains an MFN clause, the lower tax rates in the A to C treaty transfer into the A to B treaty and country A will lose revenue.

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[7] For MFN clauses in bilateral investment treaties, *see* Jarrod Wong, *The Application of Most-Favored-Nation Clauses to Dispute Resolution Provisions in Bilateral Investment Treaties*, Asian Journal of WTO & International Health Law and Policy, Vol. 3, No. 1, pp. 171-198, (2008).

Some Indian tax treaties with OECD countries (France, Hungary, the Netherlands, Sweden, Spain and Switzerland) contain an MFN clause, which is intended to provide members of the OECD similar treatment with respect to taxation of certain items with a common treaty partner. India agreed to incorporating the MFN clause in such tax treaties because India wants to attract foreign investment and since the investment flows were typically unbalanced with all OECD countries, India assumed that it will not lose too much revenue from the MFN clause. But that was true before India became an economic powerhouse, so that the investment flows became more balanced or even tilted toward more outbound investment from India. Under those circumstances, suppose India enters into a tax treaty with an OECD country when the investment flows are unbalanced, so that it refuses to follow the OECD model and the withholding tax rates are high, but it agrees to include an MFN clause to attract investment from other OECD countries. Later, India enters into a tax treaty with a non-OECD country when the investment flows are more balanced, so that it agrees to lower withholding tax rates. But if the second country then enters the OECD subsequent to the treaty execution, applying the MFN clause and lowering the withholding taxes in the first treaty would cost India revenue.

Before the Indian Supreme Court settled the controversy in *Nestle*, the leading case on the issue was *Steria India Ltd vs CIT,*[8] where the Delhi High Court had ruled in favor of the taxpayers. In *Steria*, the taxpayer (an Indian company) had made payments to its French affiliate company in return for certain management services. Under the India-France DTAA, the term “fees for technical services” included managerial services. The taxpayer relied on the India-UK DTAA, which

[8] (2016) 386 ITR 390 (Del). *See also Concentrix Services Netherlands B.V. v. Income Tax Officer TDS* [2021] 127 taxmann.com 43 (Delhi); *Deccan Holdings B.V. v. ITO,* (2022) 445 ITR 486 (Del).

expressly excluded managerial services from the term “fees for technical services.” Note that the India-UK DTAA also contained a “make available clause” for a service to be treated as a technical service wherein the service provider must make available technical knowledge, experience, skill, know how or processes to the service recipient or must have developed a technical plan or design. The India-France DTAA, on the other hand, did not have any such “make available” clause, and therefore the term “fees for technical services” had a more restricted scope under the India-UK DTAA. The taxpayer invoked the MFN clause under the India-France DTAA, arguing that the more beneficial definition of “fees for technical services” under the India-UK DTAA ought to apply in its case. The Indian tax department argued that the taxpayer could not invoke the MFN clause until a notification under the relevant Indian domestic law was issued to incorporate the less restrictive definition of “fees for technical services” under the India-UK DTAA into the India-France DTAA. However, the Delhi High Court held that the MFN clause under the India-France DTAA was self-operational and there was no need for the beneficial provisions in some other tax treaty with another OECD country to be separately notified to form part of the India-France DTAA. The Delhi High Court was also of the view that since the India-France DTAA had already been notified under Indian domestic law, there was no need to issue a further notification with respect to a Protocol that amends its provisions. (The MFN clause has been incorporated in the India-France DTAA by way of a Protocol).

The Indian Supreme Court ruling has wide ramifications with respect to applicability of MFN clause, specifically in the context of the “make available” condition with respect to technical services that is not included in most tax treaties, and which taxpayers were claiming in *Steria* by relying on the India-UK DTAA.

This decision impacts taxpayers who are taking a non-taxable position based on the restrictive scope of the term “fees for technical services” (“FTS”) by importing the “make available” clause or lower WHT rates with respect to dividends, interest, and royalties from other DTAAs into their DTAAs. The decision is likely to impact all pending assessments and related proceedings in India where taxpayers have claimed concessions regarding source taxation of interest, royalties, dividends, and FTS by relying on MFN provisions; it may also, perhaps, result in reassessments.[9]

It is now settled (unless the judgment is reviewed by the Court) that the benefit of the MFN provision, incorporated by way of a Protocol in a DTAA, for reduction of rate of tax at source on dividends, interest, royalties, or FTS, or restrictive scope of FTS does not have an automatic application. The terms of the earlier DTAA are required to be amended through a separate notification under Indian domestic law for the MFN clause to take effect.

The issue in *Nestle* concerned parity of treatment via application of the MFN clause as contained in tax treaties with certain OECD member countries (Netherlands, France, and Switzerland). India had initially signed tax treaties with Netherlands (1988 - followed by amendments via Protocol), France (1992 - followed by amendments via Protocol), and Switzerland (1994 - followed by

[9] EY, *Tax Alert - India's Supreme Court rules 'notification' mandatory to invoke Most Favored Nations clause in India's tax treaties (*Oct. 25, 2023), available at: https://www.ey.com/en_gl/tax-alerts/india-s-supreme-court-rules--notification--mandatory-to-invoke-m.

amendments via Protocol) at a time when these countries were already members of the OECD. Subsequently,

India entered into tax treaties with certain other European countries (Slovenia, Colombia, and Lithuania), all of which became OECD member countries a few years after these treaties had been executed.[10] Interestingly, the withholding tax rate on dividends at source was 5 percent in the tax treaties with Slovenia, Colombia, and Lithuania. Meanwhile, the dividend withholding tax rate in tax treaties with certain OECD member countries (including Netherlands, France, and Switzerland) ranged between 10 and 15 percent. Accordingly, taxpayers in OCED treaty partner countries such as the Netherlands, Switzerland, and France made claims for reduced withholding tax on dividends, invoking the MFN clause in their respective treaties.

The Indian tax department took the position that the MFN clause under the initial tax treaty with an OECD country can be available only when the third country with which India executed a tax treaty at a later date was a member of the OECD <u>at the time it signed the tax treaty</u> containing more favorable terms. And that the MFN clause can only be applied if India issues a notification specifying the extent of its applicability to the initial treaty partner. The Indian tax department's position was that the beneficial provisions of tax treaties executed with certain OECD member countries cannot be automatically imported in treaties with other OECD members such as with the Netherlands, France, Switzerland, Sweden, Spain and Hungary by reason of incorporating an

[10] The India-Slovenia DTAA was executed in 2005 and Slovenia became a member of the OECD in 2010. The India-Colombia DTAA was executed in 2011 and Colombia became a member of the OECD in 2020. The India-Lithuania DTAA was executed in 2011 and Lithuania became a member of the OECD in 2018.

MFN clause via a Protocol, without specific amending notification under Indian domestic law.

The Court sided with the Indian tax department on both issues. It held that since India is a "dualist" country, wherein treaties are considered non-self-executing upon ratification and require enabling legislation, a separate notification is required for the MFN clause to be assimilated into municipal law and come into effect. It also held that the word "is" in the MFN clause refers to the state of affairs when the treaty with a third country was signed, not when it is applied, and therefore "is a member of OECD" does not apply to countries that became OECD members *after* the treaty was entered into. The second holding is also consistent with the object and purpose of the MFN clause contained in tax treaties with OECD countries i.e., providing parity of treatment with similar countries as opposed to parity of treatment with a developing country that later became an OECD member due to rapid economic development.[11]

Both holdings have broader implications.

The first holding is important because it emphasizes that India, like other common law countries deriving their laws from the UK and like the US, can override treaties by legislation.[12] That is not true for countries like France, which are "monist" i.e., where treaty provisions are enforceable like municipal law. The

[11] *See* Editor's Note, *Assessing Officer v. Nestle*, International Tax Law Reports, 26 ITLR (2023).
[12] Note that recent decisions of the Indian Income Tax Appellate Tribunal have also indicated that the Indian General Anti Avoidance Rules ("GAAR) override tax treaties. *See, e.g., ACCION Africa Asia Investment Company v. ACIT International Taxation*, ITA No. 1815/Del/2023, available at: https://itat.gov.in/files/uploads/categoryImage/1698408094-ITA%20NO.%201815%20OF%202023,%20ACCION%20AFRICA%20ASIA%20INVESTMENT%20VS.%20ACIT.pdf.

taxpayer's argument that the fact that the initial OECD countries (France, Netherlands, Switzerland) passed decrees/decisions to enforce the MFN clause means that the India has to extend reciprocity was outrightly rejected. The Court held:[13]

> *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.*

This holding is very important because India may choose to implement Pillar One of the OECD/inclusive framework BEPS 2.0 project unilaterally, or even go beyond it and implement formulary apportionment unilaterally, as it had proposed to do before the negotiations on Pillar One commenced.[14] India as a large market will gain revenue from implementing Pillar One, and it is now clear that Pillar One will not be implemented by a multilateral convention since it is

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[13] *Assessing Officer Circle (International Taxation) v. M/s Nestle SA*, *supra*, at paragraph 72.
[14] See Avi-Yonah and Kir, *India's New Profit Attribution Proposal and the Arm's-Length Standard, 93 Tax Notes Int'l 1183 (June 17, 2019).*

highly unlikely such a convention can be ratified by the US and US ratification is required for the convention to come into effect.[15]

To implement either Pillar One or formulary apportionment unilaterally, India must override articles 7 and 9 of its tax treaties that embody the obsolete permanent establishment and arm`s length standards. The *Nestle* decision shows that such an override would probably be upheld by the Indian Supreme Court even if it results in double taxation. That, in turn, will put pressure on the US to grant foreign tax credits to the Indian tax, which it can do by executive action. And it will also put pressure on other large market economies to follow the Indian example because otherwise MNEs will shift their export operations to India since they will pay less tax on exports from India under the formula, and other countries that follow the PE and ALS standards will not be able to tax them.

The second holding is important because it goes against the OECD view that changes in the OECD commentary can be applied to treaties that were ratified before the commentary was changed. While the treaties generally provide in article 3(2) that undefined terms can change their meaning based on later developments, there is no legal basis to apply the commentary retroactively. A treaty is like a contract and should be interpreted based on the situation that existed when it was signed because that was the intent of the parties, who could not be expected to take future developments into account. “Is” means “is”, not “will be”.

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[15] See Avi-Yonah, *Do Not Waste Your Time Deciphering the Multilateral Tax Convention, 112 Tax Notes Int`l 299 (October 16, 2023) ; Avi-Yonah, After Pillar One, British Tax Review 3:243 (2023).*

Finally, it is interesting to see an international tax decision that relies so heavily on international law. In addition to case law, the Indian Supreme Court has also cited the Vienna Convention on the Law of Treaties (VCLT)[16], International Law Commission commentaries[17], and International Court of Justice jurisprudence (dating back to the 1949 International Court of Justice decision in the *Corfu Channel* case).

Relying on the VCLT and the International Law Commission commentaries, specifically the principle of "subsequent practice" i.e., state practice subsequent to the adoption of a treaty confirms and solidifies the intent of the parties to the treaty, the Court reviewed the general practice adopted by the Government of India in issuing separate notifications for applicability of the MFN clause in several instances to ultimately hold that the MFN clause under tax treaties would not be applicable automatically, unless such applicability is notified separately under Indian domestic law (Section 90 of the Income Tax Act 1961). The Court also clarified that the word "is" must be interpreted contextually and held that the benefit of the MFN clause in an earlier tax treaty could only be claimed with respect to a tax treaty that was signed with a third-country that was already a member of the OECD at the time of entering into such tax treaty.

[16] Arguably, the MFN clause is inconsistent with Article 26 of the VCLT on the fundamental principle of *pacta sunt servanda* since they are altering treaty provisions that are decided upon and conceded bilaterally by states during treaty negotiation by invoking future benefits or treaty terms that go beyond the original terms agreed upon by the states in their DTAA. In addition, treaty overrides are clearly a violation of Articles 26 and 27 of the VCLT. See Vienna Convention on the Law of Treaties (1969), available at: https://legal.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf.

[17] Conclusion 3 of The International Law Commission's "Draft Conclusions on Subsequent Agreements and Subsequent Practice in relation to the Interpretation of Treaties" (2018) note that under the scheme of Article 31 of the VCLT, subsequent agreements and subsequent practice, being objective evidence of the understanding of the parties as to the meaning of the treaty, are authentic means of interpretation of treaties. Available at: https://legal.un.org/ilc/texts/1_11.shtml.

Such reliance on international law is important, and is very rare in US international tax cases. International tax law is part of international law.[18] Hopefully other courts, including US courts, will follow.

[18] See Avi-Yonah, *International Tax as International Law, 57 Tax L. Rev. 483 (2004).*