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EY Tax Alert

Switzerland revokes unilateral MFN benefit under India-Switzerland Tax Treaty w.e.f. 1 January 2025

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Executive summary

This Tax Alert summarizes a recent Statement issued by Switzerland Competent Authority[1] (Swiss CA) on 11 December 2024 (2024 Statement) withdrawing Switzerland's unilateral application through earlier Statement published on 13 August 2021 (2021 Statement) of Most Favored Nation (MFN) Clause in India-Switzerland (I-S) Double Taxation Avoidance Agreement (DTAA or Treaty) w.e.f. 1 January 2025.

The 2024 Statement acknowledges the interpretation given by the Supreme Court (SC) of India in the case of Nestle SA[2], wherein the SC held that the benefit of MFN Clause is not applicable in absence of a notification granting such benefit in accordance with the provisions of the Indian Tax Law (ITL). Further, the SC held that the term *'third State which **is** a member of the OECD'* is to be interpreted as being limited to the member states of the Organisation for Economic Co-operation and Development (OECD) at the time when such treaties were entered into with India. Hence, the 2024 Statement acknowledges that the interpretation of MFN clause by Swiss CA through its 2021 Statement is not shared by India. Accordingly, in terms of the right reserved in 2021 Statement to reverse the unilateral interpretation if there is no reciprocity by the Indian CA, the 2024 Statement waives its unilateral application prospectively from 1 January 2025.

Further, the 2024 Statement clarifies the effect of such withdrawal w.e.f. 1 January 2025 on Indian and Swiss tax residents deriving dividend income from Switzerland and India respectively. Indian residents deriving dividend income from Switzerland, on or after 1 January 2025, shall be taxed @10% on such income without giving effect to the MFN clause. However, benefit of lower tax rate of 5% on such incomes as per MFN clause may continue to apply for dividend income earned during the tax years from 2018 to 2024.

Correspondingly, Swiss residents deriving dividend income from India w.e.f. 1 January 2025 shall get higher foreign tax credit up to 10% instead of 5%.

[1] Federal Department of Finance (FDF)
[2] Decision dated 19 October 2023, lead case being that of Civil Appeal No(s). 1420 of 2023; Refer EY Alert titled *"Supreme Court rules notification to be mandatory to invoke most favored nations clause"* dated 21 October 2023

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Background

- India-Switzerland (I-S) Treaty which was originally entered in 1994 was amended vide protocols dated 16 February 2000 and 30 August 2010 (2010 Protocol). As per Dividend Article (Article 10) of I-S Treaty, dividends paid by Indian companies to residents of Switzerland and vice-versa may be taxed in the source country at a rate not exceeding 10% if the recipient is the beneficial owner of such dividend.

- However, the 2010 protocol of the I-S Treaty contains an MFN clause, which states that if India enters into a tax treaty on a later date with a third country, which is an OECD member, providing a more beneficial rate of tax or restrictive scope for taxation of dividends, interest, royalties etc., a similar benefit should be accorded to the I-S Treaty as well.

- Some Indian tax treaties with countries such as Lithuania and Colombia entered post 2010 protocol provide for a lower withholding tax rate of 5% for dividends, subject to certain conditions. Although, these countries were not OECD members when the respective tax treaties were entered into by India, they became OECD members at later date[3].

Switzerland's 2021 Statement

- On 13 August 2021, the Swiss CA issued a statement[4] clarifying that based on the MFN clause in the I-S tax Treaty, Lithuania's and Colombia's accession to the OECD has the effect of retroactively[5] reducing the residual tax rate in the source State for dividends from 10% to 5% for qualified participations under the Treaty.

- The 2021 Statement clarified that Indian residents could claim refunds of excess taxes withheld in Switzerland for tax years 2018 onwards in accordance with the established procedures. It also clarified that Swiss tax residents receiving dividends from Indian sources would be entitled to foreign tax credit (FTC) at 5% from tax year 2021 onwards.

- The 2021 Statement further clarified that the Swiss CA reserves the right to reverse the retroactive interpretation and to readjust the treaty rates prospectively from 1 January 2023 if India were to have a different view as compared to Switzerland.

Interpretation of MFN clause by Supreme Court of India in case of Nestle SA

- Through a ruling dated 22 April 2021, the Delhi High Court in the case of Nestle SA[6] upheld the unilateral interpretation by MFN clause of Swiss CA[7]. The Indian Tax Authority appealed against the ruling before the SC.

- The Central Board of Direct Taxes (CBDT) issued a Circular No. 3/2022 dated 3 February 2022 clarifying its position contrary to 2021 Statement of Swiss CA. The CBDT clarified that the third State must be a member of OECD both at time of conclusion of the DTAA with India as well as at the time of applicability of the MFN clause. Further, a notification under the provisions of ITL is required to implement the provisions of DTAA as also any amendments to DTAA (including MFN clause).

- In the decision dated 19 October 2023 *(supra)*, the SC upheld the CBDT's position and reversed the Delhi HC ruling, thereby laying down law contrary to 2021 Statement of Swiss CA.

- The SC held that in order to invoke the beneficial provisions of a tax treaty pursuant to MFN clause, Indian Tax Authority is required to specifically issue a notification to this effect as per section 90 of ITL. In absence of such specific notification reflecting consequential amendment, MFN provisions cannot be invoked autonomously by the taxpayers. This has the consequence of denying the benefit of lower tax rate or more restricted scope of incomes as per treaty with other country even if such country is an OECD member on the date of signing of treaty with first country.

- On the second issue whether the beneficial tax rate under the tax treaties with Lithuania and Colombia could be applied to other tax treaties with the MFN clause, the SC held that the expression "is" in the sentence *"third state which **is** a member of OECD"* of MFN clause has a present signification and,

[3] e.g. India signed DTAA with Columbia on 13 May 2011, however Columbia became OECD member on 28 April 2020. Similarly, India signed DTAA with Lithuania on 26 July 2011, Lithuania became OECD member on 5 July 2018.
[4] Refer EY tax news dated 26 August 2021 at - https://taxnews.ey.com/news/2021-1570-swiss-authorities-release-statement-on-application-of-most-favored-nation-clause-in-india-swiss-tax-treaty
[5] From the date of accession of Lithuania and Colombia to the OECD
[6] [2021] 127 taxmann.com 43 (Delhi)
[7] Refer EY alert titled *"Delhi HC applies 5% withholding tax under India- Netherlands DTAA on Dividend income pursuant to Most-Favoured-Nation clause"*, dated 23 April 2021

therefore, the third State should be a member of OECD when India enters into a treaty with such third state in order to claim the favorable benefits and obtaining OECD membership on a later date has no significance. Since Lithuania and Colombia were not OECD members when India entered into treaty with these countries, the benefit of lower tax rate of 5% on dividends under India's treaties with Lithuania and Colombia cannot be extended to treaty with Switzerland.

Switzerland's 2024 Statement

- Recently on 11 December 2024, Swiss CA issued 2024 Statement acknowledging that its interpretation of MFN clause is not shared by India in view of the Indian SC ruling.

- Hence, with effect from 1 January 2025, Switzerland waives its unilateral application of MFN clause in the absence of reciprocity from India. Thus, income accruing on or after 1 January 2025 may be taxed in the source State at the rates provided for in the I-S Treaty (i.e. @10% for dividend income) without giving effect to the MFN clause.

- However, the reduced tax rate (pursuant to MFN benefit) as per 2021 Statement remains applicable in Switzerland for income earned during the tax years from 2018 till 2024.

- Accordingly, claims for refund of excess tax withheld in Switzerland for Indian residents and FTC claims by Swiss residents on dividends due from and including 1 January 2025 shall be limited to source state taxation limited to 10%.

Comments

The 2024 Statement issued by Swiss CA brings in parity on source country's tax rate on dividends at 10% for residents of both India and Switzerland w.e.f. 1 January 2025.

For tax years[8] 2018 to 2024, Indian residents are entitled to lower rate of 5% in Switzerland for dividends sourced from Switzerland in view of 2021 Statement unilaterally applying the MFN clause.

Having acknowledged that their own interpretation of MFN is not in accordance with Indian SC decision of 19 October 2023 and CBDT's Circular No. 3/2022, Swiss CA issued 2024 statement to suspend the application of the unilateral application of MFN clause provided earlier in 2021 Statement. While Swiss CA had reserved the right of revocation effective from 2023, the Swiss CA decided to change interpretation prospectively from tax year 2025 and onwards while not changing the application of 2021 Statement's interpretation for the years 2023 and 2024.

The following table summarizes impact of Swiss's 2021 and 2024 statement in Switzerland as the source country or as the country of residence:

Statement	Swiss as a source state	Swiss as a residence state
2021 Statement	• Concessional tax rate of 5% made applicable retrospectively in respect of dividend income accruing on or after 5 July 2018 • The concession remains applicable till 31 December 2024 having regard to 2024 Statement	Restricted FTC @5% for dividend sourced from India by Swiss residents on or after 1 January 2021 till 31 Dec 2024 leading to potential double taxation
2024 Statement	• 10% source taxation for dividend due on or after 1 January 2025	FTC granted @10% to Swiss residents in respect of dividend sourced from India on or after 1 January 2025

As far as India is concerned, SC decision clarifies the correct legal position. Accordingly, Indian tax authority may be entitled to assert source taxation @10% as agreed in the treaty without giving effect to MFN clause. It is likely that even in MAP proceedings, India may maintain its right to source taxation as pronounced by SC.

Indian residents sourcing dividend income from Switzerland may get credit in respect of source taxation suffered in Switzerland as such source taxation is likely to be lower than the view of Indian SC.

MNEs from tax treaty jurisdictions having comparable MFN clauses (like Netherlands, France, Sweden, and Hungary) may evaluate the impact of this development on dividend and other streams of income.

[8] Switzerland follows Calendar year (1st January to 31st December) as Tax year

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