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Some Reflections on the Swiss Response to the Indian MFN Position in Nestlé

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Switzerland has suspended the application of the most favoured nation clause contained in the protocol to its 1994 tax treaty with India. This was done in response to the Supreme Court of India's judgement in *Nestlé*.[1] This action appears to have raised a number of legal questions with respect to reciprocity in tax treaty interpretation and application. It appears to also have raised practical concerns about the impact on Indian businesses with Swiss subsidiaries. Much of the reaction to this development seems to be misinformed or exaggerated.[2] In this article, we address some of these questions and concerns.

1. What is the MFN controversy with Switzerland all about?

Whilst common in trade agreements, most favoured nation provisions are uncommon in bilateral income tax treaties. India's tax treaty with Switzerland is amongst the exception to this norm. It includes an MFN provision, albeit to a limited extent. The MFN provision has had several iterations,[3] the latest having been executed on 30 August 2010. If India agrees, after that date, with a third country which is a member of the OECD to restrict its withholding tax rates for certain items of income,[4] then the same reduced rates would also apply on that item of income under the Swiss-India tax treaty. India had originally agreed in the 1994 tax treaty with Switzerland to a reduced withholding tax rate of 15% on dividends paid by a company which is a resident of India to a Swiss resident. This was further reduced to 10% in the year 2001 when the 2000 Protocol came into force. Thereafter, India concluded tax treaties with Lithuania and Colombia in which India agreed to a reduced withholding tax rate of 5% on dividends.[5] These countries were non-OECD members at the time of conclusion of their treaties with India. Many years later, each of these three countries became a member of the OECD.

The controversy before the Supreme Court was whether the MFN clause in the Swiss treaty required India to extend the 5% withholding tax rate to the Swiss-India tax treaty. According to the Supreme Court, India was not obliged to do so. This was predicated on two reasons. First, the

court reasoned that the word "is" as used in the expression "is a member of the OECD" referred to the static point in time when the 1994 treaty was concluded. Secondly, the court relied on the Vienna Convention on the Law of Treaties ("**VCLT**") which recognises that a "subsequent practice" between treaty partners is relevant for the purposes of interpreting the terms of a treaty. The court observed that India had adopted a practice of notifying the effect of an MFN provision, and granting the benefits only after such notification. This Indian practice, according to the court, qualified as a "subsequent practice" as contemplated in the VCLT.

The MFN controversy revolves around the question of whether these two reasons adopted by the court are correct.

2. What was Switzerland's response to the Supreme Court judgement?

The Swiss competent authorities had published a statement on 13 August 2021 that the MFN benefits would be available to Indian recipients of dividends from Swiss companies as from the date of Lithuania's accession to the OECD on 5 July 2018. In pursuance of this unilateral statement, Switzerland imposed a withholding tax rate of 5% (instead of 10%) on such dividends.

Switzerland responded to the Supreme Court judgement on 11 December 2024. It acknowledged that the Indian tax authorities, in light of the Supreme Court judgement, did not share the Swiss competent authorities' view. Noting both reasons adopted by the Supreme Court, it observed the absence of reciprocity in applying the MFN provision and suspended the MFN provision with effect from 1 January 2025. Consequently, Indian residents receiving dividends from companies which are residents of Switzerland will be subjected to a withholding tax of 10%.

3. Does Switzerland's invocation of reciprocity imply the abandonment of its own interpretation of the MFN clause in the Swiss-India tax treaty in favour of India's interpretation?

There appears to be a lack of clarity insofar as what reciprocity means in the realm of tax treaties. The intuitive understanding may be that it is a reciprocal interpretation of a particular tax treaty provision. However, this is too simplistic. Reciprocity does not mean that both countries must interpret a given provision identically. In fact, tax treaties are largely interpreted by domestic courts of a treaty partner, and through the lens of that country's domestic laws.[6] Reciprocity merely means that both contracting parties adhere to that treaty, even if their interpretations of the terms may differ. Suspension of a treaty provision is hardly the appropriate response should a contracting state disagree on the correctness of the other state's interpretation of a treaty provision. Article 25(3) provides for a mechanism for competent authorities to endeavour to resolve such differences through the mutual agreement procedure, which may not be strictly constrained by the

judicial position in a contracting state.[7]

It is important to recognise that the Swiss Authorities have not adopted a reciprocal interpretation of the MFN clause, but have invoked reciprocity as a ground for suspending the application of the MFN clause in its entirety. This is in response to the Supreme Court's observation that the notification of an effect of an MFN provision was mandatory, and that it had become a subsequent practice in terms of the VCLT. The term used in the VLCT is "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation". Clearly, the VCLT requires consensus amongst the treaty partners, and the Supreme Court was gravely mistaken in treating a unilateral practice of the Indian tax authorities as a "subsequent practice". This is especially so when there was no acquiescence by India's treaty partners towards India's unilateral practice.

Although it is worded mildly, Switzerland's suspension of the MFN clause as a reciprocal measure reflects a very critical view of the position upheld by the Supreme Court. The VCLT prescribes the suspension of the whole or part of a treaty only as a consequence of the *breach* of a treaty.[8] Switzerland's action may not be of material significance to taxpayers, but reflects its perception that the Supreme Court's characterisation of a "subsequent practice" is not in good faith. It appears that this perception reflects the international consensus in this regard.

4. Does Switzerland's response imply a greater tax burden on Indian residents receiving dividends from Swiss companies?

Some countries exempt from tax dividends received by an entity from a company in which it has a substantial shareholding (5% in the Netherlands; 10% in Switzerland) as a means to avoid economic double taxation. The MFN controversy, in respect to dividends, was relevant primarily for recipients who were residents of countries adopting such a participation exemption. In such cases, a higher withholding tax translates to a higher tax burden.

This issue does not usually arise in situations in which the recipient of dividends is a resident of a country which does not adopt a participation exemption. Such countries are usually required by their tax treaties to provide a credit for taxes withheld on dividends in the other jurisdiction. India is one such country. Dividends received by companies which are residents of India from foreign companies are taxed at a minimum income-tax rate of 15%,[9] and a maximum rate of 30%.[10] A 10% withholding tax in Switzerland on dividends paid by a Swiss resident company would be fully creditable, reducing the Indian recipients effective tax liability in India to between 5% and 20%. The global tax liability of such an Indian recipient of dividends would remain constant irrespective of whether Switzerland imposes withholding taxes at the rate of 5% or 10%.

[1] *Assessing Officer v. Nestlé SA & Ors.,* 2023 INSC 928.

[2] See: Prabash Ranjan, "*Nestlé judgment jolts Swiss MFN provision*", Hindustan Times, 26 December 2024, available at https://www.hindustantimes.com/opinion/nestl-judgment-jolts-swiss-mfn-provision-101735225622315.html

[3] The tax treaty has had three iterations of the MFN clause. The original version was contained in paragraph 3 of the 1994 Protocol, which was replaced by Article 15, paragraph D of the 2000 Protocol (having effect between 16 February 2000 and 30 August 2010), which was further replaced by Article 11 of the 2010 Protocol (having effect since 30 August 2010).

[4] These items of income are: dividends, interest, royalties and fees for technical services. See: Article 11 of the 2010 Protocol.

[5] Whilst India also concluded a similar tax treaty with Slovenia in 2003, that treaty was not relevant to this controversy because the latest version of the MFN clause considers only Indian tax treaties with third states concluded after 30 August 2010.

[6] See: Paragraph 11 to 13 of the Commentary on Article 3 of the 1995-2017 OECD Model Tax Convention.

[7] See: Paragraph 35 of the Commentary on Article 25 of the 2017 OECD Model Tax Convention.

[8] Article 60 of the VCLT.

[9] Section 115BBD of the Indian Income-tax Act, 1961.

[10] Domestic companies with a turnover of more than INR 4 billion are taxed at a rate of 30%, whereas those with a turnover not exceeding INR 4 billion are taxed at the rate of 25% in India.

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