Switzerland Suspends MFN Status to India

For Prelims: **Most Favoured Nation Clause**, **Double Tax Avoidance Agreement**, **Withholding Tax**, **Organisation for Economic Cooperation and Development**, **Income Tax Act, 1961**, **Trade and Economic Partnership Agreement**, **European Free Trade Association**, **International Monetary Fund**, **Tax Evasion**, **World Trade Organization**, **Free Trade Agreements**.

For Mains: Significance of Most Favoured Nation Clause and Double Taxation Avoidance Agreements in international taxation.

Source: BS

Why in News?

Switzerland has decided to **rescind its unilateral application of the most-favoured-nation (MFN) clause** in its **Double Tax Avoidance Agreement (DTAA)** with India.

- Switzerland will revert to the earlier **withholding tax rate** of **10%** on Indian entities starting **1st January 2025**.

What are Key Facts Regarding MFN Clause in DTAA?

- **DTAA between India and Switzerland: DTC IN-CH (India-Switzerland Direct Tax Convention)** was signed on **2nd November 1994**, to avoid double taxation on income between India and Switzerland. It was revised in **2000** and **2010.**
    - **Article 11** of the **2010 protocol** contains the **MFN clause**, which forms the basis for **withdrawal of the MFN status by Switzerland under DTAA**.

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FACT SHEET

Nov 2, 1994: Switzerland and India sign the original Double Taxation Convention (DTC IN-CH)

Feb 16, 2000: First amending protocol to the DTC IN-CH

Aug 30,2010: Second amending protocol to the DTC IN-CH

May 13, 2011: India-Colombia Double Taxation Agreement signed; Lower dividend rates included

July 26, 2011: India-Lithuania Double Taxation Agreement signed; 5% withholding tax included

July 5, 2018: Lithuania joined OECD

April 28, 2020: Colombia joined OECD

2021: Delhi High Court upholds application of residual tax rates considering MFN clause

October 19, 2023: Supreme Court of India reverses Delhi High Court's ruling

- **MFN Clause in Protocol:** The MFN clause ensures that **lower tax rates** offered by India to any **third-country** Organisation for Economic Cooperation and Development (OECD) **member** automatically apply to Switzerland as agreed upon after the 2010 protocol.
    - The MFN clause aimed to maintain **parity** in taxation rates.
- **Reason for Switzerland's MFN Withdrawal:** After the 2010 protocol, India signed DTAA with two OECD members i.e., **Lithuania** (5% tax rate on dividends) and **Colombia** (5% general tax rate on dividends).
    - However, the same **concessional tax rate was not extended to Switzerland**.
    - Following the Indian Supreme Court's ruling in 2023, Switzerland acknowledged the **lack of reciprocity** in its MFN clause interpretation and decided to revert to the earlier **10% withholding tax rate** starting 1st January 2025.
- **India's Response:** India claimed that the MFN clause **does not apply automatically** unless officially **notified** under **Section 90 of the** Income Tax Act, 1961.
    - It further argued that the clause applies only to countries that were **OECD members at the time of signing** the 2010 protocol.
    - In October 2023, India's Supreme Court ruled that **Lithuania and Colombia** joining the **OECD after 2010** does not trigger the MFN clause, so India need not lower its dividend tax rates to 5%.
        - **Lithuania and Colombia** joined the OECD in **2018 and 2020** respectively.
- **Future Taxation under DTAA:** From 1st January 2025, the withholding tax rate will be 10% as the MFN clause no longer applies. **5%** tax rate valid for the period **2018-2024**.
- **Impact on Investments and Trade:** Switzerland clarified that this decision will not affect the **free trade agreement** between India and Switzerland or Swiss investments in India.
    - **India and EFTA** have signed the Trade and Economic Partnership Agreement (TEPA) in 2024 under which India will receive **USD 100 billion as foreign direct investment (FDI) in 15 years.**
        - EFTA (European Free Trade Association) consists of Iceland, **Switzerland,** Norway, and Liechtenstein.

India-Switzerland Investment Scenario

- According to the **Ministry of Commerce and Industry** Switzerland’s investment flows in India amounted to **USD 9.95 billion between 2000 and 2023** making it the **12th largest investor in India.**
- According to the **[International Monetary Fund (IMF)]** Swiss investment stocks in India amounted to **USD 35 billion in 2021.**
  - According to the IMF, **Switzerland** is the **8th largest recipient of Indian FDIs** stocks, amounting to **USD 3.7 billion.**
- Over **330 Swiss companies**, including Nestle, ABB, Novartis, Roche, UBS, and Credit Suisse, have invested in India across sectors like **machinery, pharmaceuticals, finance, construction, sustainable technologies, and ICT services**.
- Nearly **140 Indian companies**, including **TCS, Infosys, HCL Tech, and Wipro**, have investments in about 180 entities in Switzerland, mainly in **technology (32%) and life sciences (21%).**

Switzerland

- **Switzerland**, officially the **Swiss Confederation**, is a small **mountainous country** in **Central Europe**, known for **Alps mountains**, lakes, and valleys.
- It is a landlocked country bordered by **France, Italy, Austria, Germany, and Liechtenstein.**
- It has been well-known for centuries for its **neutrality.**
  - As a result, Switzerland, particularly Geneva, is a **popular headquarters location** for international organizations, such as the International Committee of the Red Cross and the **United Nations**.
  - It is **not** a member of the **European Union** **and** **NATO**.
- It is also known for its **secretive banking sector.**

What can be the Impact of Suspension of MFN Status with India?

- **Increased Tax Liabilities:** Indian businesses operating in Switzerland may face **higher tax liabilities** as withholding tax on dividends from Switzerland will rise to **10% from 5%.**
  - **Withholding Tax (retention tax)** is an obligation on the individual (either resident or non-resident) to **withhold or deduct tax** when making payments e.g., in the form of **dividends, interest, and royalties**.

- **Cross-Border Tax Disputes**: The suspension could lead to **disputes** between India and Switzerland regarding the **interpretation of the treaty provisions.**
- **Protectionism in Taxation**: Switzerland's move reflects a **broader trend** of countries, including India, adopting **stricter tax treaty interpretations** to protect domestic revenues.
  - This decision could be seen as part of a global shift where countries are adopting more **protectionist policies** to safeguard their **tax bases.**
- **Evolving International Tax Norms**: The decision may push other countries to follow **uniformity** in tax treaty negotiations, ensuring that all parties align on **essential clauses like MFN.**

What is a Double Tax Avoidance Agreement (DTAA)?

- **About:** DTAA is a **bilateral or multilateral agreement** between two or more countries aimed at **avoiding double taxation** of the same income.
  - It ensures that income is not taxed by both the country of **residence** and the country of **source.**
- **Objectives of DTAA**:
  - **Double Taxation Avoidance:** Prevents paying taxes twice on the same income.
  - **Fiscal Evasion Prevention:** Enables information sharing to **combat tax evasion.**
  - **International Trade Encouragement:** Promotes **cross-border business** with clear tax rules and reduced liabilities.
- **Mechanisms of DTAA:**
  - **Residency and Source-based Taxation:** DTAA defines tax rights for both residence and source countries.
  - **Credit Method:** Tax paid in the source country is credited in the residence country.
  - **Exemption Method:** Income is taxed in one country and may be exempt in the other.
- **India's DTAA: India has one of the largest networks of DTAAs consisting of over 94 comprehensive DTAAs and eight limited DTAAs.**

What is MFN Status?

- **About: MFN** refers to a **trade status** granted by one country to another, ensuring **non-discriminatory trade** between them.
  - It does not mean **preferential treatment**, but guarantees that the recipient country will not face disadvantages compared to other trade partners of the granting country.
- **MFN and WTO**: MFN is a key principle of **World Trade Organization (WTO) rules**.
  - Under WTO rules, if a country grants special status to one trade partner, this status **must be extended to all WTO members**.
- **Non-Discriminatory Trade:** MFN ensures that countries treat each other equally by offering the **same trade conditions** including:
  - **Lowest** possible **trade tariffs** and trade barriers.
  - **Highest import quotas**
  - Increased market access
  - Improved conditions for the flow of goods
- **Exceptions to MFN:**
  - **Free Trade Agreements (FTAs):** Countries in a **FTA** offer **special concessions** to each other, excluding non-members.
  - **Regional Trade Agreements (RTAs):** Member countries negotiate **better terms** among themselves, often excluding non-members.

Conclusion

- Switzerland's decision to suspend the MFN clause in its DTAA with India marks a **significant shift** in international taxation, highlighting the **evolving global norms** in tax treaties. This change could increase tax liabilities for Indian entities operating in Switzerland and impact cross-border investment flows, while underscoring the need for clear treaty interpretations.

Drishti Mains Question:

Q. Discuss the role of Double Tax Avoidance Agreements (DTAAs) in preventing double taxation and fiscal evasion.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims

Q. With reference to India's decision to levy an equalization tax of 6% on online advertisement services offered by non-resident entities, which of the following statements is/are correct? (2018)

1. It is introduced as a part of the Income Tax Act.
2. Non-resident entities that offer advertisement services in India can claim a tax credit in their
3. home country under the "Double Taxation Avoidance Agreements".

Select the correct answer using the code given below:

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2

Ans: (d)

Q. A great deal of Foreign Direct Investment (FDI) to India comes from Mauritius than from many major and mature economies like the UK and France. Why? (2010)

(a) India has preference for certain countries as regards receiving FDI

(b) India has double taxation avoidance agreement with Mauritius

(c) Most citizens of Mauritius have ethnic identity with India and so they feel secure to invest in India

(d) Impending dangers of global climatic change prompt Mauritius to make huge investments in India.

Ans: (b)

Mains

Q. Comment on the important changes introduced in respect of the Long-term Capital Gains Tax (LCGT) and Dividend Distribution Tax (DDT) in the Union Budget for 2018-2019. (2018)