anagrampartners

RAJESH SIMHAN
AFAAN ARSHAD
AVANI MAHESHWARI

Anagram Partners

rajesh.s@anagrampartners.in
afaan.a@anagrampartners.in
avani.m@anagrampartners.in

If you have any questions regarding the matters discussed in this publication, please contact the attorney(s) listed above or call your regular contact at Anagram.

WHAT GOES AROUND …COMES AROUND

Background

The Mumbai bench of the Income Tax Appellate Tribunal ("**ITAT**") recently delivered a consolidated ruling[1], concerning the taxability of lease rentals received by Irish aircraft lessors from InterGlobe Aviation Limited ("**IndiGo**"), an airline operator based in India, under the India – Ireland Double Taxation Avoidance Agreement ("**Ireland DTAA**").

Central to this ruling is the ratio that the Multilateral Instrument ("**MLI**") provisions cannot be read into an existing Double Tax Avoidance Agreement ("**DTAA**") unless there is a specific notification amending the DTAA under Indian Law. The ruling reinforces the principle laid down by the Supreme Court in *Nestle SA*[2] that treaty amendments must clear the threshold of incorporation into domestic law before they can impact taxpayers' rights. It should be noted that in *Nestle SA*, it was the Government that had argued that treaty amendments needed to be separately notified for them to apply. This same argument has now been relied upon by the taxpayer resulting in the ITAT holding that MLI provisions cannot be applied with respect to tax treaties absent separate notification amending the DTAAs.

The MLI enables sovereign governments to incorporate agreed minimum standards to counter treaty abuse while retaining sufficient flexibility to preserve specific tax treaty policy objectives. The MLI has been devised by the Organisation for Economic Co-operation and Development ("**OECD**") as part of its Base Erosion and Profit Shifting Action Plans ("**BEPS Action Plans**"), which intended to bridge the gap between where value is created and where income is taxed. The purpose of the MLI is to overcome the protracted nature of bilateral treaty re-negotiations. For the provisions of the MLI to apply, each member state is required to deposit an instrument of ratification (notification) with the OECD specifying the treaties it designates as covered tax agreements, together with the amendments or reservations it proposes with respect to each treaty. Where a counterparty to the treaty also identifies the same bilateral treaty as a covered tax agreement and agrees to the same amendments, then it can be said that consensus has been reached, and the provisions of the MLI would apply. Consequent to this India has deposited its instrument of ratification covering around 93 tax treaties entered into by

1 *TFDAC Ireland II Limited vs. Deputy Commissioner of Income Tax*, International Tax, Circle 4(1)(2), Mumbai, 1198/Mum/2025.

2 *Assessing Officer (I.T.) v. Nestle SA* (2023) 458 ITR 756.

India.

This case involved the applicability of Articles 6 and 7 of the MLI, which essentially prescribe the Principal Purpose Test ("**PPT**") under which tax treaty benefits can be denied if it is reasonable to conclude that obtaining the benefit was '*one*' of the principal purposes of any arrangement or transaction that resulted in the benefit, unless it is established that granting the benefit would be in accordance with the '*object and purpose*' of the relevant tax treaty.

Factual Matrix

The lead assessee, TFDAC Ireland II Limited, is an Irish incorporated company holding valid tax residency certificates ("**TRCs**") issued by the Irish Revenue authorities, and part of an international aircraft leasing group. In 2019, it entered into dry operating lease agreements with IndiGo Airlines for three aircraft, whereby the aircraft were to be re-delivered to the lessor upon the expiry of the lease term. The issue was around the Indian taxability of the lease rentals paid by IndiGo to the assessee under the dry operating lease. The key positions adopted by the assessee were:

- *No Royalty:* Lease rentals did not constitute '*royalty*' under Article 12(3)(a) of the Ireland DTAA, which specifically excludes payments for the '*use*' of aircraft.
- *No Permanent Establishment ("**PE**"):* No PE existed in India as per Article 5 of the Ireland DTAA; therefore, business profits were taxable only in Ireland.
- *Exempt under Article 8(1):* In any event, the lease rentals were exempt under Article 8(1) of the Ireland DTAA, as they constituted income from the operation of aircraft in international traffic.

The Indian tax authorities questioned the availability of treaty relief, citing possible treaty abuse under the MLI and characterizing the leases as finance arrangements or royalty/interest income, as well as alleging the existence of a PE in India.

ITAT's Ruling: Key Findings per Issue

Applicability of Articles 6 and 7 of the MLI

In addressing this issue, the ITAT considered the following:

- Whether the provisions of the MLI can be read to restrict the applicability of the Ireland DTAA in the absence of a separate notified protocol to that DTAA; and
- If the answer to the first is in the affirmative, whether the PPT test is satisfied.

On the issue of the application of the MLI provisions, the assessee contended that no specific notification under section 90(1) of the Income-tax Act, 1961 ("**ITA**") has been issued incorporating the MLI's provisions into the said DTAA. The revenue argued that since the MLI has been duly notified and that the Ireland DTAA is a covered tax agreement, Articles 6 and 7 (the PPT provisions) automatically apply.

The ITAT held that although the MLI was notified, the mere fact of such notification does not by itself, amend the provisions of the Ireland DTAA in the absence of any notification under section 90(1) of the ITA specifically incorporating Articles 6 and 7 into the Ireland DTAA. Any other interpretation would render the statutory scheme of section 90(1) of the ITA otiose and also run contrary to the binding precedent in

Nestle SA, which squarely holds that each modification to an international treaty with the effect of altering existing rights must itself be the subject of a distinct notification.

In addition, the ITAT also went into the issue of the scope of the '*PPT*'. The ITAT looked at two different aspects:

- *Firstly*, it looked at the commercial substance and rationale for the entity set up in Ireland. The ITAT observed, *inter-alia*, (i) as per established legal principles,[3] a valid TRC issued by the Irish tax authorities constitutes conclusive evidence of tax residency for the purposes of treaty relief, (ii) Ireland has been a hub for aircraft leasing for more than 40 years and is home to 19 of the 20 largest lessors in the world, (iii) the strategic location of Ireland serves as a strategic gateway between Europe and North America facilitating efficient access to key aviation markets, (iv) the directors, bankers, company secretary and administrator of the assessee were Irish, and (v) the company being an SPV was managed by a reputed service provider, i.e. Apex Group Limited and merely because it was managed by the Apex Group and that its ultimate parent was based in the Cayman Islands, would not affect its ability to obtain treaty relief. Therefore, there were enough commercial considerations for the assessee to operate out of Ireland and the mere availability of treaty benefits does not by itself taint the arrangement from a PPT perspective.
- *Secondly*, the ITAT looked at whether the object and purpose of the treaty was to provide such benefit in the case of aircraft rentals. In this regard, the ITAT held that Articles 8 and 12 of the Ireland DTAA (discussed below) were specifically intended to exclude aircraft leasing from the ambit of source-country taxation. Accordingly, the benefit derived by the assessee was held to be in consonance with the object and purpose of the DTAA, and therefore could not be denied by invoking the PPT.

Operating lease vs Finance lease

The ITAT also examined the nature of the lease arrangement to determine whether the payments constituted finance charges and fell within the meaning of '*interest*' under Article 11 of the Ireland DTAA.

Based on its review of the lease agreements, the ITAT held that the lease agreements lacked basic features of financial lease: there was no option to purchase, no transfer of ownership and return of the aircraft was mandated at the end of the lease period. The ITAT also rejected the Revenue's argument that since under the Irish depreciation rules, an aircraft can be depreciated to nil over 6-8 years, any lease exceeding 8 years must be a financial lease. The ITAT observed that depreciation rules of a foreign sovereign are accounting / tax norms internal to that sovereign and have no bearing on the juristic allocation of title and risks under the parties' contract as applied in India.

On the basis of the above, and similar judicial precedents,[4] the ITAT concluded that the lease was an operational lease and not a financial lease and therefore could not be characterized as '*interest*' under Article 11 of the Ireland DTAA.

Existence of PE and applicability of Article 8 on Aircraft rental

The ITAT also addressed the issue of whether the presence of the aircraft in India would constitute a fixed place permanent establishment (PE) under Article 5 of the Ireland DTAA. The assessee countered that mere ownership or contractual protections

3 *UOI v. Azadi Bachao Andolan*, (2004) 10 SCC 1.

4 *Celestial Aviation Training 15 Ltd. v. ACIT, International Tax*, Circle 1(2)(1), New Delhi, ITA No. 1478/DEL/2025, AY 2022-23).

did not amount to a PE since operational control and business activities in India were exclusively with IndiGo. Having analysed the facts against the canvas of settled legal principles - particularly the Supreme Court's rulings in *Formula One*[5], *E-Fund*[6] and the recently pronounced *Hyatt*[7] judgment – the ITAT held that the lease arrangement did not create a fixed place PE for the Assessee in India, due to the following reasons:

- Operational control including deployment, routing, scheduling and crewing vested exclusively with Indigo and hence the aircraft was at the disposal of Indigo and not the assessee;
- No business activity of the lessor was carried out through the aircraft in India and the leasing business (including negotiations, contract execution, management etc.) was conducted from Ireland;
- Rights retained by the assessee such as periodic inspection, ensuring compliance with standards, and re-possession in case of default are standard lessor protections safeguarding the value of the asset, and not an indicia of asset being in at the disposal of the lessor; and
- Unlike in *Hyatt*, where the Supreme Court found that the foreign enterprise' business was carried out through the alleged PE, no such conduct was established in the present case.

After concluding on the primary issue, the ITAT proceeded to consider Assessee's alternative argument that lease rental were covered by Article 8(1) and therefore taxable exclusively in Ireland. The ITAT analyzed the wordings of Article 8(1) which reads as:

> *'Profits derived by an enterprise of a Contracting State from the operation or rental of ships or aircraft in international traffic and the rental of containers and related equipment which is incidental to the operation of ships or aircraft in international traffic shall be taxable only in that Contracting State.'*

The ITAT observed that the text of Article 8 is notable in two respects. First, it uses the terms '*operation*' and '*rental*' disjunctively, treating them as independent income-generating activities. Second, it does not impose any requirement that the rental be ancillary to the lessor's own operation of ships or aircraft. This wording marks a clear departure from the narrower formulation found in the OECD Model Convention. The deliberate adoption of such language by the Contracting States signals a clear policy choice to extend exclusive taxing rights over rental income from ships and aircraft as a distinct category, when such assets are utilized in '*international traffic*'.

The ITAT further considered what constitutes '*international traffic*' and held that, as the leased aircraft formed part of both domestic and international sectors, the rental income falls within the protective ambit of Article 8(1). The ITAT further held that even if Assessee had a PE in India, Article 8(1) of the DTAA would nonetheless require the profits from such rentals to be taxed only in the State of residence, Ireland. The operation of Article 8(1) of the Ireland DTAA fortifies the non-taxability of lease rentals in India.

Analysis and Key Takeaways

The ITAT reaffirmed the Supreme Court's ruling in *Nestle SA*, holding that in the absence

5 (2017) 394 ITR 80 (SC).

6 (2018) 13 SCC 294.

7 *Hyatt International Southwest Asia Ltd. v. Addl. Director of Income Tax* in Civil Appeal No. 9766 of 2015 (SC)

of a separate notification under section 90(1) of the ITA, specifically incorporating Articles 6 and 7 of the MLI, those provisions of the MLI could not be invoked by the Revenue.

However, this is likely to result in significant challenges for the Government since the MLI was ratified in 2019 without such notifications being issued.

- If the Government now issues a notification in respect of all of its treaties, the question that arises is whether the provisions of the MLI apply in respect of transactions that have been undertaken since 2019. Further, this will lead to a situation where issues relating to '*PPT*' and other anti-abuse provisions introduced under the tax treaties due to MLI will keep getting challenged on the basis of this ruling at least for the period between 2019 and the period until when the Government issues a notification.
- If the Government fails to undertake such notification and challenges the ruling before the High Court, the Government's own stance in *Nestle* on the requirement for such ratification can be held against it. It will also lead to a situation where there is uncertainty over any treaty interpretation and application of MLI provisions on a go forward basis.

The ruling, in fact, is an indication that the Government ought not to have taken the approach before the Supreme Court in the case of Nestle on the requirement of ratification of each tax treaty in respect of any amendments.

The ruling also provides the first clear indication that even if the MLI were to apply, the '*PPT*' as set out in the MLI provisions will not be read in an expanded manner so as to apply it in all cases. The ITAT has adopted a pragmatic approach to the application of the '*PPT*' by looking at (i) the rationale for the benefit under the treaty and whether the same was intended by the parties to the treaty; and (ii) whether the dominant purpose of the taxpayer supported by objective facts was to obtain the treaty benefit, in making the determination of how the '*PPT*' should be applied. This approach provides much needed certainty on how Indian courts will continue to look at the issue in future and provide clear guidance for parties while undertaking transactions.