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Tax Flash News

26 August 2025

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Principal Purpose Test cannot be invoked sans specific notification for incorporating MLI provisions into the tax treaty

Executive summary

The OECD/G20 adopted the Multilateral Instrument (MLI) to implement tax treaty related measures to prevent base erosion and profit shifting, including the Principal Purpose Test (PPT). As per the PPT provision, a treaty benefit shall be denied if one of the principal purposes of any arrangement/ transaction was to obtain that benefit—unless it can be established that granting such benefit aligns with the purpose and intent of the relevant treaty provision.

India and Ireland ratified and notified the MLI in 2019, designating the India-Ireland tax treaty (the Treaty) as a Covered Tax Agreement (CTA) under the MLI.

In the case of *TFDAC Ireland II Limited*[1], the Revenue denied the Treaty benefit alleging that the taxpayer was a shell entity and was incorporated in Ireland with the principal purpose of obtaining the Treaty benefits.

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[1] *TFDAC Ireland II Limited* v. *DCIT (International Tax)* (ITA No. 1198/Mum/2025)

The Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) relying on the Supreme Court's ruling in *Nestlé SA*[2], held that a separate notification under the Income-tax Act, 1961 (the Act)[3] is a mandatory requirement for giving effect to the MLI provisions sought to be incorporated into the Treaty. Even though the MLI had been notified and the Treaty was designated as CTA, in the absence of such notification, the PPT or other MLI provisions cannot be invoked to deny the Treaty benefits.

Facts of the case

The taxpayer, a tax resident of Ireland, was engaged in the business of aircraft leasing. In February 2019 (i.e., prior to the MLI becoming effective with respect to the Treaty on 1 April 2020), it entered into dry lease agreements with an Indian airline (the lessee).

For the financial year 2021-22, the taxpayer filed 'Nil' tax return, asserting that the lease rentals constituted business profits, and in the absence of a permanent establishment (PE)[4] in India, the rental income was taxable only in Ireland under the Treaty[5].

Alternatively, as per Article 8 of the Treaty (dealing with the taxability of the profits derived from the operation of aircraft in international traffic), its rental income was taxable only in Ireland and not in India[6].

However, the Revenue alleged that the principal purpose was to avail the Treaty benefit. In addition, the leased aircrafts constituted fixed place PE in India and 25 percent of gross lease rentals was attributable to the Indian PE. Alternatively, the Revenue re-characterised the operating lease as a finance lease and treated the income as interest.

Taxpayer's contentions

Principal Purpose Test

The Supreme Court in the *Nestlé SA* decision has held that a notification under the Act[7] is a necessary and mandatory condition to give effect to a treaty or any protocol changing its terms which has the effect of altering the existing provisions of the law.

The MLI was notified in India in 2019, but no separate notification was issued under the Act to incorporate PPT provisions into the Treaty. Accordingly, the PPT cannot be invoked to deny the Treaty benefit.

[2] *Assessing Officer (International Taxation)* v. *Nestle SA* [2023] 458 ITR 756 (SC)
[3] Section 90(1)
[4] Article 5
[5] Article 7
[6] Article 8(1)
[7] Section 90(1)

Its business activities were genuine and commercially driven as outlined below:

- It was incorporated in 2018 and entered into lease agreements in 2019, i.e., before the MLI came into effect.
- The Treaty was entered 'for promotion of trade' and aircraft leasing is one of the most significant and established industries operating from Ireland. Ireland was chosen for well-recognised commercial reasons given its established aviation ecosystem, professional infrastructure and strategic location.
- The taxpayer, being a special purpose vehicle (SPV), was managed by a licensed Irish service providers, had Irish directors, and operated bank accounts in Ireland. Outsourcing of administrative functions is a standard industry practice, not indicative of the treaty abuse. Relied upon Bombay High Court's decision in *Bid Services (Mauritius) Ltd.*[8] which supported the use of SPVs for genuine commercial purposes.
- Leasing operations extended to China and Korea, demonstrating that India was not the sole focus.
- Leased aircrafts were registered in its name (as lessor) with the Directorate General of Civil Aviation (DGCA) in India.

Permanent Establishment

The presence of aircraft in India did not constitute a fixed place PE as the leasing business was carried out from outside India and not through the aircrafts. Further, the aircrafts were not at the taxpayer's disposal as the lessee had full operational control of the leased aircrafts.

Income from operation of aircraft

Even if lease rentals are regarded as taxable business profits, Article 8 of the Treaty allocates taxing rights solely to Ireland. The leased aircrafts formed part of the lessee's integrated fleet and were deployed interchangeably on domestic and international routes. Such integration necessarily brought them within the scope of "international traffic" as envisaged under the Treaty.

Operating lease v. finance lease

Lease was operating lease (and not finance lease) as the lease agreements did not contain any purchase option at the end of the lease term or residual value

[8] *Bid Services Division (Mauritius) Ltd*. v. *AAR* [2023] 453 ITR 461 (Bombay)

clause. The lessee was obligated to redeliver the aircraft at the end of the lease term.

The right to sub-lease conferred upon the lessee (subject to taxpayer's consent) did not by itself transform an operating lease into a finance lease.

The DGCA prescribes the economic life of an aircraft at approximately 20 years or 60,000 landing cycles. Though the Irish depreciation rules allow the cost of an aircraft to be depreciated in six to eight years, such rules may influence book value in a given jurisdiction; they do not determine economic life of an aircraft (which, in India, is guided by the DGCA).

Revenue's contentions

Principal Purpose Test

Both India and Ireland have notified the MLI and designated the Treaty as CTA. Consequently, the MLI provisions, including PPT, apply automatically without the need for a separate notification. Although, the synthesised text of the Treaty prepared by India and Ireland, is not a legal instrument, it reflects their mutual understanding of how the MLI modifies the Treaty.

Applying the PPT to the facts of the case, the taxpayer was not entitled to the Treaty benefits:

- The ultimate parent entity was based in the Cayman Islands, a tax-free jurisdiction.
- The taxpayer's directors held positions in multiple other Irish companies.
- The choice of an SPV in Ireland did not establish Ireland as a genuine operational base in the absence of infrastructure or employees.
- Day-to-day management was outsourced; and certain lease management functions were contracted to a London-based entity.

Permanent Establishment

The leased aircrafts constituted fixed place PE in India as they represented a place of business in India at the taxpayer's disposal for conducting its leasing business. The taxpayer retained ultimate control over the aircraft through its rights of repossession and inspection.

Income from operation of aircraft

The Treaty provisions relating to taxability of income from aircraft operations were not applicable in the instant case since the taxpayer was a pure lessor with no airline operations of its own. The leased aircrafts were predominantly used on domestic routes within India and thus, did not qualify as being operated in ”international traffic”.

Operating lease v. finance lease

The lease arrangement exhibited features of a finance lease, including risk allocation, non-cancellable terms, and sub-leasing rights. Further, under Irish depreciation rules, the cost of an aircraft can be depreciated in six to eight years, and therefore any lease exceeding eight years should be treated as a finance lease. The Special Bench ruling in *InterGlobe Aviation Ltd.*[9] not applicable in the instant case as the observations therein on the characterisation of lease rentals was casual and not part of the core decision.

Tribunal’s decision

In the absence of separate notification under the Act, the PPT provisions cannot be invoked against the taxpayer to deny the Treaty benefits.

The Tribunal further concluded that the taxpayer did not have a PE in India. In addition, rental income from aircrafts was not taxable in India by virtue of the article under the Treaty dealing with the taxation of income from operation of aircraft.

MLI provisions not applicable sans notification

Although the MLI has been notified, the consequence/ impact of the MLI on the Treaty is not separately notified. The Revenue’s approach of treating the PPT as self-executing in the Treaty is unsustainable.

While the Revenue acknowledges that the MLI alters tax treaties, it bypasses the essential legal requirement outlined in the *Nestlé SA* decision—namely, a distinct notification under the Act that formally incorporates those changes into the law.

[9] *InterGlobe Aviation Ltd.* v. *ACIT* [2022] 95 ITR(T) 586 (Delhi)(SB) - This case related to the disallowance of supplementary rent paid for use of leased aircrafts under operating lease on account of non-deduction of tax at source.

The synthesised text of the Treaty which incorporates the MLI provisions into the CTA is merely an expository compilation intended to facilitate understanding of the MLI. It has neither been notified under the Act nor as admitted by the Revenue, is a binding legal instrument.

The OECD also recognised the role of each jurisdiction's domestic law in determining how the MLI takes effect. It expressly acknowledges that a "synthesised text" is a non-binding explanatory aid; it does not, and cannot, supplant the requirement for a legally valid act of incorporation in each jurisdiction.

The Tribunal gave its finding on other arguments (set out in the ensuing paragraphs), assuming that the MLI amends the Treaty and the PPT is read into the Treaty.

Tax Residency Certificate (TRC)

In the absence of any compelling reasons, the TRC will be presumed to be valid ground for allowing the Treaty benefit even after the notification of MLI.

Principal Purpose Test

As per the OECD Commentary[10], where investment decision is driven by legitimate commercial objective such as operational efficiency, the mere availability of treaty benefit does not, by itself, taint the arrangement.

The PPT is not intended to deny treaty benefit where the transaction aligns with the intended purpose of the relevant Treaty provision. The Treaty consciously departs from the OECD and UN Model Conventions in so far as it limits the source-country's taxing rights in respect of aircraft leasing income[11]. Therefore, even if the PPT provisions are read into the Treaty, granting the tax benefit remains consistent with the object and purpose of the relevant Treaty provision and thus, the PPT provision should not result in denying the Treaty benefit.

While the quantum of tax benefit may be a relevant contextual factor, it is not by itself determinative for the purposes of PPT. In the instant case, the Revenue has not presented any objective evidence to show that the dominant purpose of the arrangement was to obtain Treaty benefits in a manner contrary to the Treaty's intent.

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[10] OECD BEPS Action Plan 6
[11] Article 8

The Tribunal rejected the Revenue's argument that the Treaty benefits should be denied solely because the taxpayer's ultimate parent company is not an Irish company. The Revenue's allegation that the income will be shifted to a tax-free jurisdiction is unsupported by the facts. There is no payment by the taxpayer to its parent or group companies, except for the arm's length debt obligations and administrative expenses.

It is not necessary for the SPV to have employees on its payroll; the appointment of independent management service providers is duly recognised under the Indian law.

Based on the facts, the Tribunal concluded that the taxpayer performed substantial commercial functions and was not merely a conduit.

No Permanent Establishment in India

Taxpayer's business is that of dry leasing aircraft – an activity executed entirely from Ireland, with negotiations, contract execution, and management undertaken outside India. The aircraft, though valuable business assets, did not serve as a 'place' through which the taxpayer's leasing business was carried on in India.

The aircrafts were placed at the disposal of the lessee, which operated them for its own commercial purposes. Operational control over the aircraft, including deployment, routing, scheduling, and crewing, vested exclusively with the lessee. The absence of taxpayer's personnel or operational infrastructure in India further reinforced the absence of a fixed place PE.

The rights retained by the taxpayer such as periodic inspection, ensuring compliance with maintenance standards, and repossession in default are standard lessor protections safeguarding the value of the asset, not indicative of the asset being at the lessor's disposal for carrying on business in India.

Rental income not taxable in India

The Treaty provides that profits derived by an Irish enterprise from both operation or rental of aircraft in international traffic is taxable in Ireland. The OECD Model Convention only refers to operation of aircraft, not rental.

Where both Contracting States have deliberately deviated from the OECD Model Convention to include “rental” as an alternative to “operation,” the treaty language must be interpreted in its plain and ordinary meaning. Imposing additional conditions—such as requiring the lessor to be an operator in international traffic, or that the rental activity be subordinate to such operation—amounts to reading into the provision words that are not present in the treaty text.

Further, to avail Treaty benefit, it is important that aircraft must be used on international routes and not operated solely on domestic routes. The Treaty does not stipulate any predominance or threshold of international usage. Since the lessee is an international carrier airline and leased aircraft formed part of a fleet used on both domestic and international routes, the Treaty benefit is available and accordingly the rental income was not taxable in India.

Nature of lease – Operating lease

Income from leasing of aircrafts was not taxable as interest since the lease was in the nature of operating lease (and not finance lease).

Operational risks with the lessee do not amount to the ownership risks. The lease agreement allows termination on default, which is consistent with an operating lease. The right to sub-lease only with the lessor’s (i.e. the taxpayer’s) consent showed that ownership was not transferred.

Irish depreciation rules are irrelevant to the legal nature of the lease in India.

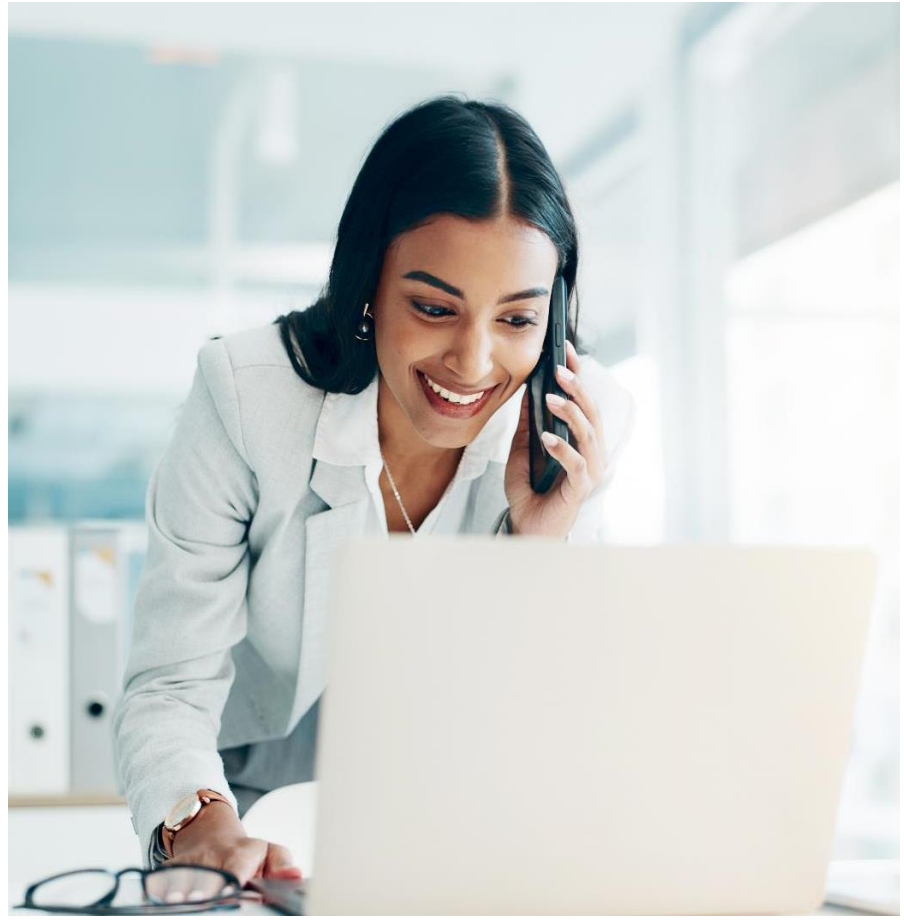
RBI Circular No. 24/2002 (dealing with aircraft leases) draws a clear administrative distinction between a finance lease akin to ECB (where the lessee has a right to purchase at the end of the term) and an operating lease, which contains no such end-of-term acquisition mechanism.

The observation in the Special Bench decision in *InterGlobe Aviation* was not casual but a clear finding on characterisation and taxability of lease rentals.

Our comments

The Tribunal’s decision reinforces that MLI provisions cannot override treaty benefits without specific notification under the Act.

Also, the Tribunal’s recognition of the commercial rationale behind the taxpayer’s choice of jurisdiction, reinforces the principle that genuine business operations with economic substance should not be penalised under anti-abuse provisions.



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