Tax Insights & Commentary
Analysis

India Court Decisions on MLI Require Separate Notifications

March 4, 2026, 3:00 PM GMT+5:30

Recent rulings by India's Supreme Court and the Income Tax Appellate Tribunal Mumbai have altered the landscape of international tax treaty implementation in India, potentially undermining the 2020 implementation of the OECD's Multilateral Instrument (MLI), a groundbreaking tool designed to simultaneously codify anti-abuse measures and prevent Base Erosion and Profit Shifting without having to renegotiate each treaty individually. This article examines the implications of these rulings by exploring how they may reshape India's approach to preventing treaty abuse and their impact on multinational enterprises operating within its borders.

By requiring separate government notifications for each treaty modification, these rulings challenge the enforceability of MLI provisions and raise critical questions about the application of the principal purpose test in cross-border tax arrangements. Notification for each Covered Tax Agreement (CTA) will challenge the status of MLI during the period from the combined notification in Aug. 2019 to the date of separate notification for each CTA per se. MLI would be enforceable in the treaty partners' jurisdictions whereas it would not have become enforceable in India for want of a separate notification. These situations may lead to unintended consequences.

Multilateral Instrument

As one of the first signatories of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* with the Organization for Economic Cooperation and Development, India submitted a list of 93 tax treaties to designate as CTAs.

India's Supreme Court in *Nestle SA* (TS-581-SC-2024) clarified that before giving effect, every modification of a tax treaty requires formal notification for incorporation into the domestic law by the government under §90(1) of the Income-tax Act, 1961. More recently, the ITAT Mumbai in the Sky High case echoed the Supreme Court's *Nestle* ruling about the requirement for separate government notification in order to have the MLI's legal impact on the India Ireland Double Tax-Avoidance Agreement, even though the DTAA is part of 93 CTAs which were notified to the OCED in a combined manner in Aug. 2019. In the same ruling, the Mumbai court held that the principal purpose test rule can't deny intended treaty benefits arising out of mutually deliberated understandings of the treaty partners.

Case Background

Facts. The assessee, an Irish resident company engaged in the business of leasing aircrafts (with valid Irish tax residency certificates), entered into a dry operating lease agreement in Feb. 2019 (before the MLI provisions became effective on Apr. 1, 2020) with an Indian airline company for a specified period, after which the aircraft would be redelivered to the assessee.

The DTAA between India-Ireland was notified in the official gazette on Feb. 20, 2002; the MLI was notified on Aug. 9, 2019. Although the India-Ireland DTAA is a CTA within the meaning of the MLI, the consequences of the MLI (including the changes accepted by Ireland) haven't been separately notified by way of a protocol to the India-Ireland DTAA.

The Irish company filed its return of income declaring nil taxable income asserting:

- Lease rentals didn't constitute "royalty" within Art. 12(3)(a) of the India-Ireland DTAA, which expressly excludes payments for the use of aircraft;
- In the absence of a permanent establishment in India, as defined under Art. 5, the income constituted business profits taxable exclusively in Ireland under Art. 7; and
- Income was exempt under Art. 8(1) of the DTAA as being derived from the operation of aircraft in international traffic.

The assessing officer and Dispute Resolution Panel both ruled that:

- The PPT under the India-Ireland DTAA pursuant to the MLI (Arts. 6 and 7) wasn't satisfied;
- Art. 8 of DTAA (derived from the operation of aircraft in international traffic) was inapplicable because the Indian airline was a domestic airline and the leasing activity wasn't connected with international traffic; and
- The assessee had a permanent establishment in India, not Ireland, in the assessment.

Main Issues. The main issues discussed here pertain to the following:

- Whether a separate notification is required as per the Supreme Court's ruling in *Nestle* to incorporate a modification brought in through MLI on the DTAA; and
- Whether under Arts. 6 and 7 of the MLI, the assessee wasn't eligible to the benefits of the India-Ireland DTAA by virtue of principal purpose test.

Rival contentions. Assessee strongly contended that Ireland is a well-established aircraft leasing jurisdiction with the requisite expertise and globally recognized ecosystem in the said activity. Because the company had a valid tax residency certificate that made the structure commercially justified, it argued that invoking the PPT was unwarranted and MLI can't be enforced in respect of the DTAA in the absence of a separate notification.

India's Department of Revenue contended that no separate notification was required as all the CTAs, including the DTAA with Ireland, was part of the combined notification issued in 2019. Revenue found that the assessee's structure was mainly created to obtain the tax benefit under the DTAA and therefore denied the same under the PPT rule.

Decision. The ITAT held that the modifications brought in through the MLI in a particular CTA must have separate notifications rather than through the government's 2019 combined notification for all the CTAs. This requirement is a legal obligation arising out of the principle laid down by the Supreme Court in the case of *Nestle SA*, where it was held that a notification under §90(1) of the Income Tax Act, is necessary and a mandatory condition for a court, tribunal, or an authority to give effect to a DTAA, or any protocol changing its terms that has the effect of altering the existing provisions of law.

A modification brought in by MLI vis-a-vis a specific CTA requires separate notification. In the absence of the notification of the India-Ireland DTAA, the tribunal held that the PPT rule applied by the tax authorities was never enforceable.

The tribunal also held that the synthetized text of a DTAA isn't a legally binding document and only a facilitating document. Hence Revenue's reliance on the synthetized text of India-Ireland DTAA as a valid notification was held to be legally unsustainable.

Though the MLI is meant to bring modification in a swift and efficient manner so as to implement the minimum standard such as the prevention of treaty abuse in the respective CTAs, India's separate notification requirement for each CTA as per the principle described in *Nestle*'s case is mandatory.

The ITAT examined whether PPT can be invoked at all and considered the OECD's commentary on Art. 29(9) dealing with the PPT rule through illustrative examples as to what is driven by legitimate commercial objectives. Accordingly, investment decisions driven by business expansion, operational efficiency or access to resources are legitimate in nature and incidental availability of any treaty benefits doesn't by itself taint the arrangement. The OECD commentary states that PPT can't be automatically invoked in every case to deny the treaty benefits where the ultimate parent entity of the taxpayer happens to be a resident of a third country.

The ITAT appreciated the commercial substance of the assessee's investment and operational arrangement with its Irish subsidiary in terms of substantive commercial functions, adequate personnel and genuine expenditure in carrying out its business activity. Any treaty benefit availed by the assessee in line with the treaty's relevant provisions' object and purpose can't be brought under the PPT's radar.

The Tribunal relied on the case of *Bid Services*, wherein the Bombay High Court held that in transnational investments, the use of tax efficient structures is common. The business and commercial purposes for such structures need to be recognized appropriately. Revenue is entitled to examine the commercial substance and genuineness of such structures. However, it was held that the burden is entirely on Revenue to demonstrate that such structures are setup to achieve a fraudulent dishonest purpose to defeat the law. Revenue must discharge its initial burden thoroughly before invoking the PPT rule against any structure.

The PPT isn't meant to negate benefits that are intended to be availed as in the present case wherein Arts. 8 and 12 of the DTAA specifically provide removing aircraft leasing income from the ambit of source country taxation. An assessee claiming such treaty relief from source country taxation is only availing a benefit that is intended to be availed so by the treaty itself. Accordingly, it was held that PPT can't be invoked in the present case.

Impact of Judgement

Notification. The *Nestle* judgment mandates a separate government notification in respect of each CTA relating to MLI modifications. Even if the government makes notifications today, there would be a question regarding the period from August 2019 (when the MLI was notified) until the dates when separate notifications were given in respect of each specific CTA.

The notification requirement might create many unintended consequences. In the past, when reviewing the tax treaty history, there would have been instances where amending protocols or modification would have become effective without a separate notification. Is it possible to question such specific cases and instances now in light of *Nestle*'s judgment? Otherwise, is it to be construed that the court's judgment is prospective in nature and may not impact similar instances/situations of the past?

Bilateral tax treaties will have a dent on the good faith principle when such a unilateral approach is taken by one of the treaty partners. This judgment lays the road map as to what could be the ideal approach for bringing protocols and modifications of tax treaties/DTAAs into effect even in the context of the MLI.

PPT Rule. The PPT rule isn't meant to be applied in a casual manner questioning every investment structure solely on the basis of the availment of treaty benefits. Tax authorities should examine the objective component of the PPT rule which creates a carve out or an exception to such cases where treaty benefits availed by the taxpayer are in line with the object and purpose of relevant treaty provisions. Treaty benefits which are intended to be availed by the residents of the treaty jurisdiction cannot be questioned and denied by treating such benefit as the principal purpose of the arrangement. In a particular arrangement, there could be different principal purposes, one might be driven by commercial justification and the other one may be for deriving the treaty benefits etc. Allocating weightage for each principal purpose is highly subjective and an onerous task.

Despite Revenue establishing that obtaining treaty benefits is one of the principal purposes, whether such treaty benefit is in accordance with the object and purpose of the relevant provisions of the treaty is also important. Unless Revenue proves how the treaty benefit isn't in accordance with the object and purpose of relevant provisions, the PPT can't be invoked.

Of course, the taxpayer has the burden of proving that the benefit availed under the treaty provisions is in line with the object and purpose of relevant provisions. Guidance given in the OECD commentary to Art. 29(9) in the form of illustrative examples as to investments/arrangements driven by commercial purpose or otherwise is critical both for the taxpayer and Revenue. An assessing officer can easily invoke the PPT rule, unlike General Anti- Avoidance rule provisions, which are generally governed by checks and balances, such as the concurrence of higher authorities and reference to approving panels like in India.

Even under the PPT Rule, Revenue should demonstrate how a particular arrangement/structure is meant only to avail an unintended treaty benefit so as to be rejected. In the absence of the same, summary denial of treaty benefits under the PPT rule cannot stand the test of legal scrutiny before the courts of law as per *Bid Services (supra)* case.

Governments justifiably should prescribe detailed norms for the application of the PPT rule to provide taxpayers guidance and achieve its avowed objective of the prevention of treaty abuse strictly in warranted and appropriate cases.

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