

# Tax Hotline

April 15, 2022

## LUFTHANSA: CHARGES FOR COLLECTION OF USER DEVELOPMENT FEES DO NOT CONSTITUTE INCOME FROM THE OPERATION OF AIRCRAFT

- Delhi Tribunal rules that collection charges earned by the taxpayer for collection of user development fees on behalf of the Airports Authority of India did not constitute income from the operation of aircraft.
- Collection charges were paid merely for providing the service of collection of user development fees.

The Income Tax Appellate Tribunal at Delhi ("**Delhi Tribunal**") ruled that collection charges received by Lufthansa German Airlines ("**taxpayer**") from the Airports Authority of India ("**AAI**") for collecting user development fees ("**UDF**") cannot be construed as income derived from the operation of aircraft under Article 8 of the India-Germany tax treaty ("**tax treaty**").

### CASE SUMMARY

The taxpayer was an international air transport operator which was a resident of Germany. It had a branch office in India, through which it carried on its Indian operations. The taxpayer earned its income from the operation of passenger and cargo aircraft internationally. It also earned collection charges from the AAI for collecting UDF<sup>1</sup> from the passengers on behalf of AAI and passing it on to AAI. Whilst these collection charges were paid to AAI in respect of both arriving and departing passengers, the personnel at the taxpayer's branch in India collected these charges only in respect passengers departing from India. The collection charges were paid by AAI to the taxpayer by way of a discount (set-off) in the UDF which had to be passed on by the taxpayer to AAI.

Article 8 of the tax treaty states that "profits from the operation of ships or aircraft in international traffic<sup>2</sup> shall be taxable only in the state in which the place of effective management of the enterprise is situated. Therefore, profits earned from the operation of aircraft in international traffic, which is effectively managed in Germany are taxable exclusively in Germany, even if they were attributable to a permanent establishment ("**PE**") in India.

The issue before the Delhi Tribunal was whether the collection charges constituted profits from "operation of aircraft". If so, India would be restricted from taxing the income by virtue of Article 8 of the tax treaty. If not, Article 7 would govern the allocation of taxing rights between India and Germany, under which the profits may be taxed in India to the extent they were attributable to a PE in India.

The taxpayer argued that the nomenclature "collection charges" was inaccurate and that it was but a "discount" provided to the taxpayer for collecting the UDF and passing it on to the AAI within a stipulated period of time. This "discount" allowed by the AAI to the taxpayer is not taxable under Article 8 of the tax treaty as it is income derived from the "operation of aircraft in international traffic."

The Revenue, on other hand, argued that the collection charges were earned by the taxpayer for rendering the service of collecting and passing on the UDF to AAI, and were not derived from the "operation of aircraft in international traffic". The revenue noted that the collection charges were collected for a commercial activity independent from the business of operation of aircraft. The Revenue also argued that "discounts" are not covered within the scope of Article 8 of the tax treaty and therefore the submission of the taxpayer that collection charges, being "discounts", should be exempt from taxation by virtue of Article 8 of the tax treaty is erroneous.

The Delhi Tribunal accepted the Revenue's position and held that regardless of its nomenclature, collection charges constituted service fee paid by the AAI to the taxpayer for collection and passing on of the UDF by Tax taxpayer to AAI. It held that the collection charges cannot be said to be income derived from the "operation of aircraft in international traffic."

### ANALYSIS

The question of what constitutes profits from the "operation of aircraft in international traffic" is controversial. Therefore, this case is an important jurisprudential development on the issue.

A speaking order or a reasoned order is an important component of the principles of natural justice.<sup>3</sup> Respectfully, it appears that the reasoning provided by the judgement leaves something to be desired.

One of the grounds of appeal was that the collection of UDF from the passengers on behalf of the AAI is an activity incidental / ancillary to the "operation of aircraft" and therefore the collection charges are exempt from taxation under Article 8 of the tax treaty. Clearly, this argument is derived from paragraph 4 of the Commentary on Article 8 of the OECD Model, the importance of which for interpreting tax treaties has been underscored by the Supreme Court in

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Engineering Analysis.<sup>4</sup> However, the judgement does not reveal any examination of whether the collection of UDF was indeed ancillary to the “operation of aircraft” by the taxpayer.

Whilst the judgment concludes that collection charges constituted “business income”, it does not analyse whether the taxpayer indeed had a PE in India and the extent to which profits, or for that matter losses, may be attributable to such a PE, if any. Even if one may to assume that the branch office in India constituted a PE through which the collection charges were being earned, it would be crucial to determine whether such activity could be viewed as being “preparatory or auxiliary” in nature, so as to be able excluded from the definition of a PE by Article 5(4) of tax treaty.<sup>5</sup>

Further, Article 7 of the tax treaty provides that only so much of the “profits” shall be taxable in India as is attributable to the PE in India. In this context, the judgment appears to have missed discussing an important ground of appeal raised by the taxpayer. More than 60-65% of the passengers were returning passengers from whom the UDF were not collected by the Indian branch, but were payable by the taxpayer. The ground of appeal reveals that the UDF were to be paid to the AAI for both incoming and outgoing passengers. However, they were collected and paid by the Indian branch office of the taxpayer only for outgoing passengers. Accordingly, it may be argued that only those collection charges which were paid in respect of collection of UDF from outgoing passengers could be considered to be attributable to the PE in India.

The judgment may not have examined either the facts or the law adequately, presumably in an attempt to simplify the issues at hand. It is likely that the taxpayer may appeal the decision before the Delhi High Court to correct this anomaly.

— Afaan Arshad & Dr. Dhruv Janssen-Sanghavi

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<sup>1</sup> As noted by the Delhi Tribunal in this judgment: “The UDF is levied at the Indian airports as a measure to increase revenues of the airport operator. The UDF is levied to bridge any revenue shortfall so that the airport operator is able to get a fair rate of return on investment. The quantum of UDF varies from airport to airport and the rate of UDF at airports is determined by the Airports Economic Regulatory Authority of India (AERA) for major airports and ministry of civil aviation for not major airports. Presently UDF collection charge at a flat rate of Rs.5/- per passenger (all inclusive) is allowed to airlines subject to payment of UDF collection to AAI within 15 days of receipt of bill”

<sup>2</sup> Article 3(1)(i) of the Germant Treaty: “the term “international traffic” means any transport by a ship or aircraft operated by an enterprise which has its place of effective management in a Contracting State except when the ship or aircraft is operated solely between places in the other Contracting State”.

<sup>3</sup> Kranti Associates Pvt. Ltd. & Ors. v. Masood Ahmed Khan and Ors., 2010 (95) AIC 139

<sup>4</sup> *Engineering Analysis Centre of Excellence Private Limited v. CIT*, Civil Appeals 8733-8734 of 2018. See para 159: “Such persons and/or assesseees can thus place reliance upon the OECD Commentary for provisions of the OECD Model Tax Convention, which are used without any substantial change by bilateral DTAAAs, in the absence of judgments of municipal courts clarifying the same, or in the event of conflicting municipal decisions.”

<sup>5</sup> 4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include,—

- (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise ;
- (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery ;
- (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise ;
- (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise ;
- (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character ;
- (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. [Emphasis Supplied]

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