THE RULE OF FORCE OF ATTRACTION: PROPRIETY IN INTERNATIONAL TAX JURISPRUDENCE

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The Force of Attraction rule has been a contentious issue in International Taxation for many years now. Although the OECD model expressly rejects the rule, the UN model still seems to condone a limited version. As upheld by the decision of the Mumbai tax tribunal in Linklaters LLP, the language in some of the Indian treaties surely seem to point towards the existence of this rule. The author proceeds to examine the rule – its rationale and the principle behind its application in India and aims to show how the rule is inadmissible according to established norms of International taxation and why the UN model should be amended to such effect that the application of this rule is made redundant, so as to bring about uniformity in International tax treaties across the world, irrespective of model convention followed.

I. INTRODUCTION

‘The Force of Attraction’ rule in Double Taxation Avoidance Agreements (hereinafter referred to as DTAA) has been a point of debate for tax practitioners and academicians all over the world for quite a while now. Although this issue has been of global relevance, it did not come to India’s notice till very recent as taxpayers were shrewd enough to try and avoid coming under the ambit of this rule. Recently though, this issue was revisited by the Mumbai bench of the Income Tax Appellate Tribunal, the highest fact-finding authority in India under the Income Tax Act, in Roxon¹, wherein it was held that the rule was incorporated in Article 7 of India’s DTAAAs and that it applied to income earned by any taxpayer who has established a Permanent Establishment (hereinafter referred to as PE). More recently, the ‘L’ bench of the Mumbai tribunal, in

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¹ DCIT v. Roxon, 291 ITR AT 275.
Linklaters\textsuperscript{2}, upheld this position and applied the rule on profits earned by a UK law firm which were ‘indirectly attributable’ to a service PE which they had constituted in India according to provisions of Article 5 of the Indo-UK DTAA. The Tribunal held that the usage of the expression ‘indirectly attributable’ in Article 7 was material proof as to the existence of the ‘Force of Attraction’ rule in the DTAA. Although practitioners have been critical of this order owing to the increased scope of taxation for the activities of their clients, academics have hailed this order as revolutionary in Indian tax jurisprudence as it envisages the most basic tenets of taxation i.e. if the income is earned in relation to a country, the country has the right to tax it. This order also re-affirmed India’s stamp upon pure source-based taxation, a philosophy which is proven by the removal of the necessity of ‘rendition of services in India’ for income deemed to accrue or arise in India, via the retrospective amendment made to S. 9(1) of the Income Tax Act, 1961. Incidentally, this philosophy of source-based taxation in India through S.9 has also been re-affirmed in Linklaters\textsuperscript{3}, and later in Ashapura Minichem\textsuperscript{4}. The author finds a misnomer in such interpretation as he believes that the application of said rule leads to certain unintended incongruities in basic principles of interpretation of DTAAs.

II. LINKLATERS LLP V. ITO: A CHANGE IN TIDE

Linklaters LLP is a law firm, a limited liability partnership which is a resident of the United Kingdom. Although it has offices all over the world, it has no physical presence or fixed base as such in India. Linklaters rendered legal advisory services to certain clients in the United Kingdom, whose operations extended to India and such services were performed both from outside India and from within India as on certain occasions, personnel were deployed to India for the rendition of services. It is interesting to note that a limited liability partnership firm is fiscally transparent for tax purposes in the United Kingdom and its income is taxed in the hands of its partners. Linklaters filed nil income in its return as it contended that it was not taxable in India either under the Income Tax Act, 1961 or under the treaty. This case was heard by the Mumbai bench of the Income Tax Appellate Tribunal.

\textsuperscript{2} Linklaters LLP v. ITO (Int’l Taxation), [2010] 6 Taxman 38 (Mumbai - ITAT).

\textsuperscript{3} Ibid.

\textsuperscript{4} Ashapura Minichem Ltd. v. ADIT – International Taxation, (2010) 131 TTJ (Mum) 291.
The Tribunal, without directly going into the treaty, dealt with domestic law first, as the Act provides that the treaty will only be considered if beneficial to the assessee. Under Indian domestic law, the consultancy services provided by the assessee would amount to ‘technical services’ as under S. 9(1)(vii). As per the retrospective amendment made to S. 9(1)(vii) of the Act through the Finance Act, 2010, such services need not be rendered in India, but merely ‘utilized’ in India, eliminating the need for any physical presence in India for the taxation of technical services. Hence, under the domestic law, the Tribunal held that Linklaters would be liable to tax for all services performed by it which were ‘utilized’ in India.

Nevertheless, the Tribunal held that in spite of Linklaters being fiscally transparent in the U.K, it was liable to benefits of the Indo-UK DTAA as under Article 4. The rationale behind this was that although there would be no juridical double taxation, since the income of the firm is being taxed in the hands of the partners in the U.K, economic double taxation occurs. Moreover, since the activities of the firm in India constituted a service PE as under Article 5(2)(k), the Tribunal held that it would be taxed under Article 7 for profits earned by it. In a path breaking decision, the Tribunal ruled that since the Indo-UK DTAA uses the expression ‘profits directly or indirectly attributable’, the term ‘indirectly’ invites application of the Force of Attraction principle, thereby inviting to tax not just profits attributable to the PE, but also all profits earned by the firm in relation to India.

Therefore, in essence, the Tribunal has applied the same principle as is applicable under the domestic law in India through Article 7 of the Treaty. Although the ruling with respect to treaty benefit which appreciates ‘economic double taxation’ is avant garde in India, the ruling with respect to Article 7 is debatable. The author completely concurs with the former part of the decision and shall only deal with the latter part in the following sections.

III. RULE OF ‘FORCE OF ATTRACTION’ AND ITS APPLICATION

The rule of ‘Force of Attraction’ (hereinafter referred to as FoA) emanates from the concept of Permanent Establishments in DTAAAs. Although the PE concept is provided for in Article 5 of the OECD and UN Models, there is no single exhaustive definition provided in the Models or in

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the Commentaries. In *Visakhapatnam Port Trust*\(^6\), the Andhra Pradesh High Court has tried to define the concept of PE using the following words:

“the words "permanent establishment" postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.”

Profits of an enterprise carried on in the country of residence are generally taxed only in such country, unless those profits are derived in part from a business in the other country which is conducted through a PE. Article 5, in both the OECD model convention\(^7\), and the UN model convention\(^8\) deal with the concept of PE. A PE can be a fixed place of business, an installation PE, a dependant agent or a service PE. Until recently, the concept of service PE was included only in the UN model. Although it still does not feature in the OECD Model convention, as from 2008, the OECD model permits a Service PE too, under its Commentary update\(^9\). A service PE occurs when personnel are deployed for business purposes to the other country for a specific period of time, as is dictated by the DTAA. *Linklaters*\(^10\) is such an instance, where conditions for a service PE were satisfied.

There are two conceivable methods for attribution of profits to a PE – the direct method and the indirect method. The direct method is the only method prescribed by the OECD model. Prior to 2008, the OECD Model Commentary\(^11\) laid down a functional arm’s length approach for profit

\(^6\) CIT v. Visakhapatnam Port Trust, 144 ITR 146.


\(^10\) Supra, note 2.

attribution to a PE in consonance with the 1979 Transfer Pricing Report\textsuperscript{12}. Thinking on the application of the arm’s length principle has evolved as reflected in the 1995 OECD Transfer Pricing Guidelines\textsuperscript{13}, and considerable experience has been gained as a result of this. In July 2008, the OECD released its first report on attribution of profits to permanent establishments\textsuperscript{14}. As reflected by the modified 2010 report\textsuperscript{15}, the authorized OECD approach provides for a ‘functionally separate entity’ approach. This approach, by modifying the old Paragraph (hereinafter denoted by ¶) 2 to Article 7, does not limit the profit attributed to the PE by reference to the profit of the enterprise as a whole because the PE is deemed to be a “distinct and separate” enterprise. Under the indirect method, the income of the permanent establishment is calculated as a fraction of the total profits earned by the enterprise. The new authorized OECD approach through the 2010 report is proof to the fact that the direct method is the only method approved of by the OECD model and commentary at present. ¶ 1 of the OECD Model Commentary to Article 7 also expressly provides that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State that are not attributable to the permanent establishment. This concept seems more in line with one of the general purposes of treaties as described by Avi-Yonah i.e. to implement the consensus underlying the international tax regime by limiting the ability of source countries to tax active income attributable to a PE\textsuperscript{16}.

The basic principle of the FoA rule is simple - when an enterprise is said to have a PE in another country, it exposes to taxation, the entire income that it earns from carrying on activities in that other country, whether or not through that PE. This principle embodies a vociferous application of source-based taxation and capital importing countries or developing countries have supported this rule in their tax treaties for a long time. It tries to disincentivize an enterprise from taking undue advantage of a PE by routing transactions directly from their country. Although the

\textsuperscript{12} OECD, Transfer pricing and multinational enterprises: report of the OECD Committee on Fiscal Affairs, 1979, OECD: Paris.


The practice of using this rule was prevalent till very recent, international co-operation in order to bring forth uniformity to DTAAs has reduced the incidence of its application, particularly for countries that follow the OECD model. Therefore, through the commentary on ¶ 1, as mentioned before, the 2010 version of the OECD model commentary completely discounts the rule and mentions that although

“some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected by international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on.”

Nevertheless, India, primarily being a capital-importing nation, follows the UN model and not the OECD model for its DTAAs. Although the OECD model and its commentary have been held to be persuasive for the purpose of interpretation of Indian DTAAs, the fact that the OECD model discounts the FoA rule does not discount its usage in Indian DTAAs.

Articles 7(1)(b) and 7(1)(c) of the UN Model Convention provide for the FoA rule in the following words:

“(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business

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18 Supra, note 6.
activities carried on in that other State of the same or similar kind as those
effectuated through that permanent establishment”

These two categories clearly embody the FoA rule. The UN Model commentary on Para 1 of
Article 7 also substantiates the same, wherein it is mentioned that the force of attraction principle
is not removed due to necessities of developing countries and that the model would allow limited
application of this rule upon fulfillment of the following conditions:

“if an enterprise has a permanent establishment in the other Contracting State for
the purpose of selling goods or merchandise, sales of the same or a similar kind
may be taxed in that State even if they are not conducted through the permanent
establishment; a similar rule will apply if the permanent establishment is used for
other business activities and the same or similar activities are performed without
any connection with the permanent establishment.”

Therefore, the UN Model incorporates the limited force of attraction rule. This principle is
incorporated by India in various treaties. This provision is also applicable to the India-Finland
DTAA, which came in question in Roxon. In the SNC Lavalin decision, in relation to the
Indo-Canada DTAA which also incorporates this provision, the Delhi Tribunal held that the
DTAA incorporated the restricted ‘Force of Attraction’ principle and that the reference to sale of
goods or merchandise in Article 7(1)(b) included the rendering of services.

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19 Surrey, Stanley S., United Nations Model Convention for Tax Treaties Between Developed and Developing
Countries: A Description and Analysis, Selected Monographs on Taxation, Volume 5, IBFD, Amsterdam, 1980, at
p.16.


21 India’s DTAA’s with Australia, Belarus, Belgium, Bulgaria, Canada, Cyprus, Denmark, Finland, Germany,
Indonesia, Kenya, Mongolia, Norway, Poland, Portugal, Romania, Spain, Sri Lanka, Tanzania, Thailand, Turkey,
The U.S and Zambia contain this provision.

22 Supra, Note 1.

There are a few other treaties which are worded a bit differently\(^\text{24}\). Article 7 of the Indo-UK DTAA falls under this category. ¶1 of Article 7 of the treaty provides that:

“The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enter price may be taxed in the other State but only so much of them as is directly or indirectly attributable\(^\text{25}\) to that permanent establishment.”

In the Linklaters decision, the Tribunal opined that the expression ‘profits directly or indirectly attributable’, as has been used in the Indo-UK DTAA, is congruent to the rule of FoA as provided under Article 7 of the UN Model Commentary. Therefore, applying the FoA rule in full force, the Tribunal allowed taxation upon the entire profits relating to services rendered by the assessee, whether rendered in India or outside India, in respect of Indian projects. The rationale behind the Linklaters order and the author’s analysis will feature further into this article.

The Force of Attraction principle is also acknowledged in Articles 11 and 12 of the UN Model\(^\text{26}\), wherein wording similar to ¶1 of Article 7 has been repeated in ¶4. ¶4 of Article 12 has been reproduced below:

“The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to

\(^{24}\) India’s DTAAs with China, Japan, Malta, Oman, Singapore, Switzerland, The U.K, Ukraine, Uzbekistan and Vietnam.

\(^{25}\) Emphasis provided by the author.

\(^{26}\) Surrey, Supra Note 19, at p. 34.
Hence, in cases where income from Interest or Royalties is involved, where the beneficial owner of income by the way of interests or royalties carries on his business in the other Contracting State through a PE, the FoA rule is applicable.

It is also interesting to note that the FoA rule has been specifically exempted from certain Indian DTAAAs. Article 7(1) of the treaties with Cyprus and Sri Lanka provide that it does not apply if the enterprise proves that such sale or activity could not have been reasonably undertaken by the PE. Moreover, Article 7(1) of the DTAAAs with Indonesia and New Zealand do not contain the ‘other activities’ part, overtly excluding the FoA rule. On an analysis of treaties signed by various countries, the FoA rule is very rarely found, and if present, is present as an anti-avoidance measure.

For academic purposes and in order to examine further the incidence of the FoA rule, we need to have a brief look at the 3rd model convention, which was made by the United States for its treaties with other countries, the US model. Generally, Article 7 ¶ 2 of the US model overtly rejects the FoA rule as it provides that profits that are to be attributed to a PE shall include only profits derived from the assets or activities of the PE. Some US treaties, notably the US-Turkey DTAA, has created confusion regarding this issue as although Article 7 overtly rejects the FoA rule through this provision, a protocol attached to Article 7 provides for the same conditions that are provided in Articles 7(1)(b) and 7(1)(c) of the UN model i.e. prescribing a limited FoA rule. This has led to many issues in interpretation.

IV. RATIONALE BEHIND THE FoA RULE AND THE LINKLATERS ORDER: THE INDIAN SCENARIO

With respect to attribution to a PE, the UN Model principally believes in a Capital and Labour Import Neutrality (CLIN) approach as opposed to the Capital and Labour Export Neutrality (CLEN) approach of the OECD Model. CLEN is a concept by which an investor has neutrality

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irrespective of source jurisdiction of income i.e. he pays the same total tax irrespective of whether he earns the income from a domestic source or a foreign source. CLIN is a concept of neutrality by which capital funds originating in various jurisdictions should compete at equal terms in the capital markets of any country, therein giving every nation a right to tax equally any income earned within its territory\(^{28}\).

The rule of FoA can be seen as a far-reaching application of CLIN by the UN model, wherein the remnants of the rule have been retained to promote source based taxation\(^{29}\). Several developing nations favoured this approach as they had difficulty in the exact attribution of profits to a PE owing to the large import of capital\(^{30}\). The purpose of the provision is in part, to prevent avoidance of income which should be attributed to the PE through tax structuring. As per Skaar, the FoA rule was justified in archaic American tax treaties by using the argument that an enterprise, by establishing a PE had “brought itself under the other state’s taxing jurisdiction to an extent which was qualitatively different from the casual or invisible presence of enterprises without a PE.”\(^{31}\) Several authors believe that the approach in the rule where similar sales or similar business activities are considered helps in the identification of business transaction for the purpose of attribution\(^{32}\).

As far as the Linklaters order is concerned, as has been pointed out by the author, India is a country that emphasizes on source-based taxation. This fact is evidenced by the provisions of domestic law in India i.e. the Income Tax Act, 1961, which provide for taxation of non-residents having business in India. By the provisions of Subsection (2) of Section 5, the income of a non-resident from whatever source derived is includible in the total income if it is received or deemed to be received in India or if it accrues or arises or is deemed to accrue or arise to him in India during the year. Section 9(1) defines the circumstances in which income is deemed to accrue or


\(^{30}\) See Supra, Note 20, Commentary on Article 7.

\(^{31}\) Skaar, *Supra* Note 9, at p. 336-337.

arise in India. Subsection (1) of Section 9 defines in clause (i), income which shall be deemed to accrue or arise in India. Sub clause (i) is in turn, distributed into four categories. These categories cover income accruing or arising, whether directly or indirectly: (i) Through or from any business connection in India; (ii) Through or from any property in India; (iii) Through or from any asset or source of income in India; or (iv) Through the transfer of a capital asset situated in India. Therefore, primary, for the taxation of non-residents, the domestic law relies on the concept of “business connection”, which is wider than the PE concept. Further, provisions of Section 9(1)(v),(vi) and (vii) lay down that interests, royalties and fees for technical services are taxable in India for non-residents as long as they are ‘utilized’ in India. Also the amendment made to these provisions through the Finance Act, 2010 has added an explanation which provides that the services need not be ‘rendered’ in India and that they need not be through a PE.

The Indian attitude towards taxation of non-residents is evident from these provisions, that any income that a non-resident draws, that has an Indian connection will be taxed by India. This fact is further proven by the much famed decision of the Bombay High Court in Vodafone\(^{33}\). The Indian position on this aspect is not unique in any way. Through S. 864(c)(iii) of the Internal Revenue Code, the United States implements the FoA rule in its domestic law by providing that all income that is effectively connected to a business or commercial activity in the U.S is liable to tax there. Having said that, S. 864(c)(ii) also provides a cutback or an exception on this rule to certain passive income articles.

Therefore, one may come to the conclusion that the rationale including expressions like ‘indirectly attributable’ in its treaties must also be the same i.e. to promote source-based taxation through the FoA rule. Looking from that angle, the decision in Linklaters is justified as this seems to be the only logical intent of the governments while constructing the treaty. Since the new retrospective amendment provides a clarification to the ‘Rendered v. Utilized’ debate in favour of the latter, very stringent source based taxation occurs through Indian domestic law. Non-residents looking to undertake business in India lean on the tax treaties to escape the wide nature of such tax liability by establishing PEs in India. As it is generally understood that only profits attributable to PE are to be taxed, they saw Article 7 as a kickback to the old Indian

\(^{33}\) Vodafone International Holdings B V v. Union of India & Anr, [2008] 175 Taxman 399 (Bom.)
position, favouring territorial nexus for taxation, as per the Supreme Court’s decision in *Ishikawajima-Harima*[^34], the effect of which in turn has been nullified by the above mentioned amendment. One can only assume that the Indian Government, while including the expression ‘indirectly attributable’ in its treaties, wanted to prevent this outcome. One may infer that this was the rationale for the inclusion of the FoA rule in Indian treaties and for the decision given by the Tribunal in Linklaters.

The effect of this decision has been that consultancy firms have terminated assignments in India, so as to not constitute a service PE. If every enterprise decides to act along the same lines in fear of taxation in India, it will invariably reduce globalization i.e. the influx and efflux of knowledge and information in the country and will cause detriment to its economic progress. Conversely, as India is a growing global market, enterprises would wish to continue their activities in India and their interests have to face a new tax burden owing to the reversal of *Clifford Chance*[^35], which accepted the position in *Ishikawajima-Harima*[^36], through Linklaters. What way out does a non-resident enterprise have if it wishes to provide consultancy services in India?

**V. ISSUES THAT ARISE ON APPLICATION OF FORCE OF ATTRACTION RULE IN TAX TREATY INTERPRETATION**

Before proceeding as to what are the specific issues with the FoA rule, it is paramount to understand why the OECD model chose to overtly omit this rule. The OECD Model omits it through the expression ‘profits directly attributable to a PE’ in Para 1 of Article 7 and provides an explanation for the same in express terms in the Model Commentary[^37].

Klaus Vogel, in his famed treatise on DTAA[^38], has mentioned that taxation of profits that are attributable to the PE is to be preferred over the FoA rule as it proceeds through the enterprise’s

[^34]: *Ishikawajima Harima Heavy Industries ltd v. Director of Income Tax, Mumbai, AIR 2007 SC 929.*

[^35]: *Clifford Chance v. DCIT, 318 ITR 237*

[^36]: *Supra, Note 34.*

[^37]: *Supra, Note 17.*

organizational structure and does not restrict entrepreneurial freedom of disposition by the fictitious allocation of profits in a general manner.

Developed nations have taken a stance that the rule of FoA for attribution will be eliminated from their treaties. Article 7 of the US Model overtly rejects the FoA rule and most treaties entered into by the United States excludes the rule\(^{39}\). Moreover, any form of attribution of source taxation rights which are not based on the ‘effective situation’ test has been deemed to be violative of European Community law\(^{40}\).

The FoA rule it applies to any non-resident entity that works through a PE. But the rule does not apply to any and all entities – it applies only to entities covered by Article 7, which deals with business profits. For further understanding, let us look at ¶ 6 of Article 7 of the UN Model Convention, which provides that:

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\text{“Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article.”}
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Therefore, it can be understood that Article 7 is a general provision and that if profits include items of income which are dealt with specifically elsewhere in the Treaty, it shall not apply. It is an accepted canon of interpretation that a specific provision always trumps a general provision\(^{41}\) and the same applies to Article 7.

Arvid Skaar, in his revered treatise on Permanent Establishments\(^{42}\), talks of a very fundamental principle of taxation i.e. taxation of a particular income should not change only according to the entity that is being taxed, if the income is being earned in the same manner. Moreover, Adam Smith’s well established principle of ‘horizontal equity’ prescribes that a fair tax is one that

\(^{39}\) Article 7 of the India-US treaty incorporates the FoA rule as per the UN Model. This is also explained in the Technical Explanation to the treaty.


\(^{42}\) Skaar, *Supra*, note 9.
treats similarly situated persons alike\textsuperscript{43}. This principle is largely on the ‘ability to pay’ basis i.e. those with equal ability to pay should pay equally\textsuperscript{44}. Although this is a more equitable concept than a legal one, the jurisprudential force of this principle is strong and should apply to tax treaties emanating from various multi-lateral conventions. This has also been upheld as a form of inter-resident equity by Musgrave, where he propounds that in the absence of benefit taxation, people in equal positions (capacity to pay) should pay the same tax\textsuperscript{45}.

In order to proceed with our analysis, we must examine Article 14 of the UN model convention, which deals with Independent Personal Services. This Article was removed from the OECD model and cases it dealt with are now covered by a combination of Articles 5 and 7. In other words, the ‘fixed base’ test in Art. 14 has been replaced by the PE test in Art. 5 and business profits attributable to the PE based on Art. 7(1) of the OECD Model Convention may be taxed in the source country.

In 1996, the OECD Committee set up a working group to examine a number of problems involved in the application of Article 14, dealing with Independent Personal Services. The Working Group recommended in its report in 2000\textsuperscript{46} that the Article be eliminated from the OECD Model convention owing to several factors. After examining the PE test in Article 7 (through Article 5) and the fixed base test in Article, the Committee felt that there was no practical difference between the two Articles and that there was no policy justification for the sustenance of two independent articles. The Committee believed that since there was no discernible difference between them, it was manifestly unjust to treat professional partnerships


\textsuperscript{45}See Mclure, Sinn, Musgrave, \textit{Supra} Note 28, at p. 66.

\textsuperscript{46}See OECD, \textit{Issues Related to Article 14 of the OECD Model Tax Convention}, 2000
and individual professionals in a different manner from incorporated companies. Such a differentiation would not be consonant with present times owing to the exponential increase in cross-border services. Thus, the removal of such a differentiation was one of the main reasons why the OECD chose to omit this article from the OECD Model Convention. Owing to the omission of Article 14, the same rule applies to individuals, firms and companies as per the OECD model and hence, the rule of horizontal equity is not violated.

The UN Tax Committee recently decided to retain Article 14, with an alternative available for those wishing to delete it.

Article 14, ¶ 1 of the UN model Convention provides:

“1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

(a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or

(b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.”

It can be understood that the two tests provided by Article 14 of the UN Model are analogous to the PE test provided in Article 5 of the OECD model. Article 14(1)(a) corresponds to the fixed

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base PE in Article 5 of the OECD model and Article 14(1)(b) corresponds to the service PE alternative provided in the 2008 model commentary update. In a sense, an individual, by operating through a fixed base in the source state or through services performed for a particular time period in the source State, creates a fictional PE even under Article 14, which expressly makes only such profits taxable as that is attributable to this fictional PE.

Since the UN model still retains this Article, Indian treaties generally include an article for independent personal services, proven by its presence in the Indo-UK treaty (as Article 15), which was in question in *Linklaters*\(^{49}\). The Indo-UK treaty, in order to avoid ambiguity, specifically uses the word ‘individual’ in Article 15 (of this treaty), making Article 15 the applicable provision when an individual’s income is concerned. So, according to Article 15, an individual’s income is to be taxed only by the State of residence except if he has a fixed place of business or if his stay in the other State exceeds a particular time limit, wherein only such profits that are attributable to his fixed place of business or to his commercial activities in the other Contracting State during his stay are to be taxed by the source State. This is where the inequality comes in if the FoA rule is given full application in Article 7 as per the UN model convention.

Let us take the example of the *Linklaters* decision\(^{50}\). Since Linklaters is a limited liability partnership, Article 15 did not apply to it. Hence, Article 7 was the applicable provision. Linklaters created a service PE in India through deployment of personnel in India for more than a period specified in the treaty and for the purpose of that PE, profits attributable to it will be the profits earned by the activity of the personnel in India. As the FoA rule is applicable to Article 7, all profits earned by Linklaters with relation to India, whether or not through the service PE, are taxable in India. Now, let us introduce a hypothetical. Suppose instead of a law firm, the concerned entity was an individual by the name of Mr. Linklater, who performed the same services as in the case and was present in India for the same amount of time. As he is an individual, Article 15 becomes applicable to him. According to the attribution rules provided by Article 15 (or Article 14 of the UN model convention), if his stay exceeds a particular period of time, only such profits that were gained by him during his stay in India are to be taxable. This

\(^{49}\) *Supra*, Note 2.

\(^{50}\) *Ibid.*
provides for a situation where identical income earned through identical activities are taxed in a different manner owing to the change in entity i.e. as the entity changes from firm to individual. Similarly, if Linklaters was a general partnership firm as opposed to an LLP, income earned by the partners would be taxed under Article 15 as independent personal services. In such a case, no force of attraction would apply. Interestingly enough, Linklaters was a general partnership firm and not an LLP during the concerned assessment year, which means that the inequality is of large significance in this case. Therefore, an interpretation of a treaty applying the FoA rule cannot be consonant with the object and purpose of the provision, as its purpose could not have been one that results in such strange results.

Furthermore, as has been mentioned earlier, ¶4 of Articles 11 and 12 inculcate the rule of Force of Attraction and in this respect differs from the OECD Model Convention. Interestingly, ¶4 of Article 10, which deals with income from dividends, does not include the FoA rule and reproduces the same provision as is used by the OECD Model for Articles 10, 11 and 12. ¶4 is provided below for clarity:

“The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.”

Therefore, the UN Model has included the FoA rule with respect to income from interest and royalties and has retained the provision (as is present in the OECD Model for all 3 of these articles) only for Article 10 dealing with dividends. The OECD Model Commentary on Para 4 of Article 10\textsuperscript{51} (which is the same as that in the UN Model) clarifies that this provision does not provide for the rule of Force of Attraction. The UN Model Commentary does not provide an

\textsuperscript{51} OECD, Model Tax Convention on Income and on Capital: Commentary on Article 7, 2010, at Para 31. See also Para 82 where Italy has made a reservation on this paragraph and wishes to implement the FoA rule.
explanation for such a differentiation and there seems no plausible explanation as to why such an inequality should be sustained.

Before going into application of the Force of Attraction rule to UN Model treaties in general, let us examine its application to the Indo-UK treaty through the expression ‘indirectly’. Article 31 of the Vienna Convention provides that a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. Although one might argue that the Convention is not binding on India on account of it not being a signatory, the Mumbai bench of the Tribunal themselves, in the highly appreciated *Hindalco* case\(^\text{52}\), has applied the provisions of the Convention for the purpose of interpretation of tax treaties. Moreover, owing to state practice, the provisions of the Convention with respect to interpretation are considered customary international law\(^\text{53}\).

A literal interpretation of the treaty, providing for the expression ‘indirectly attributable’ might suggest that the FoA rule should come into play. This position is further substantiated by the acceptance of the FoA rule by the UN Model Commentary. Vogel and Prokisch have opined that since it is almost impossible to determine a single object or purpose for the treaty, it is more apt for each provision to be interpreted as per its object and purpose\(^\text{54}\).

Francis Bennion, in his treatise on Statutory Interpretation\(^\text{55}\) has opined that:

> “The interpretation of a Treaty imported into municipal law by indirect enactment was described by Lord Wilberforce as being ‘unconstrained by technical rules of English law, or by English legal precedent, but conducted on the broad principles’

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\(^{52}\) *Hindalco Industries Ltd v. ACIT*, 94 ITD 242.

\(^{53}\) See Becerra, A. González, *The Interpretational Approaches to the Vienna Convention - Application to (Tax) Treaty Analysis*, 65 Bull. Intl. Taxn. 10 (2011), Journals IBFD; see also Thiel v. Commissioner of Taxation (1990), 171 CLR 338, an Australian decision wherein the Vienna Convention was held to apply to it although it was not a signatory as the Convention signified Customary International Law.

\(^{54}\) See Vogel, Klaus, Prokisch, Rainer G., *Interpretation of Double Taxation Conventions*, Vol. LXXVIIa, Cahiers de droit fiscal international, Deventer: Kluwer, 1993, at p. 22; See also Skaar, *Supra* Note 9, at p. 42.

of general acceptation'. This echoes optimistic dictum of Lord Widgery, C.J. that the words 'are to be given their general meaning, general to lawyer and laymen alike .......... the meaning of diplomat rather than the lawyer'."

In the instant case, the object and purpose of including the expression may perhaps point towards an interpretation favouring the FoA rule. Nevertheless, Article 31 requires one to look at not merely the ordinary meaning in light of its object and purpose, but also in the context of the treaty. In order to accentuate this point, the author will use an excerpt from Brian J. Arnold’s article on the Interpretation of tax treaties:

“Ambiguity and vagueness in language cannot be resolved on the basis of the ordinary or plain meaning of the words because the meaning is unclear. The meaning can be determined only by reference to the context, and the context includes the purpose for which the words are used...The meaning of all language is dependent on the context in which it is used. This is why the literal interpretation of any language, including statutes and treaties, without regard to its context is so flawed.”

In order to examine the context in which the treaty has been entered into, one has also to examine the diplomatic history of the treaties signed by the United Kingdom. Although the intention behind the wording of this provision can hardly be satisfactorily proven, it seems implausible that they intended for the provision of a fully-fledged FoA rule to be implemented as none of the other treaties signed by the U.K feature this rule. This is further proven by a guidance document released by Her Majesty’s Revenue and Customs on cross-border VAT changes, wherein although in the context of VAT, the HMRC has clarified that the UK has never sanctioned or allowed the implementation of the FoA rule. It has been argued that the principle of reciprocity requires tax treaties to be interpreted “in accordance with the common intention

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and understanding of both contracting states”\textsuperscript{58}. Hence, it might me that it was never the intention of the United Kingdom to include the FoA principle in Article 7 of the treaty, hence making such an interpretation, violative of the principle of reciprocity. Nevertheless, as opined by Skaar, although certain developed nations like the UK or the US do not accept certain principles based on the UN model, they allow such principles to be present in their treaties with developing nations\textsuperscript{59}. Therefore, even such an interpretation is inconclusive.

Notwithstanding this, since the UN model specifically provides for conditions for application of the limited FoA and since such provisions are overtly mentioned in the provision, it seems implausible that the Indo-UK treaty, instead of importing those very words, would use a more ambiguous expression such as ‘indirectly connected’ to inculcate the same meaning. This would mean that these treaties have a broader rule of FoA than what is provided for in the UN Model itself, which is a strange result as the UN Model in itself is used as the primary base for interpretation of this term. Therefore, reading the FoA rule to the expression ‘indirectly’ as in the Indo-UK DTAA is in itself an issue of contention.

Having said that, as long as Article 14 of the UN Model convention is retained, the inculcation of imposing a tax burden on profits beyond what is attributable to a PE into Article 7 of the UN model is in itself not consistent with the concept of uniformity in taxation. One can only reasonably presume that the principle of interpretation that leads to inequality according to the entity being established has led the OECD to eliminate Independent Personal Services from within the ambit of its model, and also to the establishment of the service PE concept as per the 2008 Model Commentary update. Therefore, the new OECD model aimed to eliminate the differentiation between goods and services, as this gap is decreasing day by day\textsuperscript{60}. Considering this aspect, the FoA rule is not congruent with modern practices of International taxation. Although countries try to implement CLIN in their domestic law through strong source rules, the OECD Model Convention has always been based on CLEN and the PE concept is strong.

\textsuperscript{58} See Edwardes-Ker, Michael, \textit{Tax Treaty Interpretation}, In-Depth Publishing, 1995, at Chap. 5, ¶. 5.03; \textit{see also} ¶. 12 of the Commentary to Art. 3(2) of the OECD Model.

\textsuperscript{59} Skaar, \textit{Supra} Note 9, at p. 36.

evidence to that fact. One of the main advantages of the CLEN approach is that it promotes horizontal equity\textsuperscript{61}. Therefore, such an approach is manifestly against the Authorized OECD Approach. Furthermore, as has been mentioned in detail, it is not a sound practice for the source country to impose a larger tax burden upon a particular entity over another. Although developing countries have advocated the retention of the FoA rule owing to need for revenue, it is hardly equitable that a company or a limited liability partnership (owing to its separate existence) is discriminated against and has to incur a larger tax liability as compared to an individual or a general partnership as under the UN Model.

The rationale behind such a move can only be considering the larger amount of profits earned by companies and firms as opposed to individuals. But such a consideration cannot be considered a just reason to maintain such an inequality. Nevertheless, promoting source based taxation is essential for revenues in certain developing nations. Therefore, even if the interests of these nations are to be considered, the only viable option is the elimination of Article 14 from the UN Model Convention as such a distinction is not required in the present scenario. But in such a case, the current Article 7 will apply to individuals and general partnerships, which will increase tax burden a large number of individuals, and would not be advisable for these nations as it would substantially affect investment. Hence, it is only prudent that additionally, the remnants of the FoA rule are removed from Article 7 of the UN Model.

The removal of the FoA rule would also be in the interest of uniformity in tax treaties on a global basis as it will help plug the gaps between the OECD and UN Models. This in turn will give a boost to International tax jurisprudence in itself as it would help develop a uniform body of law. Pistone believes that owing to the significant role played by the OECD Model Convention and the Commentaries in leveling out the differences across the tax treaties of not just OECD member states, but also with and between non OECD member States, the provisions of the OECD Model have become a settled body of soft law and an expression of internationally

accepted tax treaty practice. Therefore, the UN Model and the principles enshrined within it are slowly losing significance in the modern world. Elimination of the FoA rule would help develop the OECD principle of attribution as an established tax treaty practice.

Before concluding, the author would also like to point towards the fact that even if this inequality as established earlier is overseen, the order in Linklaters does not stand as good law. Although the commentary to Article 7 in the UN model seems to condone the FoA rule, ¶ 14 of the UN Model commentary to Article 5 stipulates in express terms that only profits attributable to the PE can be taxed in case of a service activity. Therefore, in a case where a service PE is constituted, like in Linklaters, the FoA rule cannot be applied even if the UN Model is applied.

VI. CONCLUSION

So, in the interest of congruity of tax treaties, Linklaters needs to be thought over and India needs to take a position which is in consonance with global standards. Furthermore, the author would like to point out that this error lies fundamentally not in the interpretation of the Tribunal, but in the UN model itself and that in the interest of correcting this major inequality, the commentary needs to be corrected so that the remnants of the FoA rule in tax treaties are removed, so as to bring out uniformity among the OECD and the UN model countries. If the UN wishes to implement the FoA rule in the interest of developing countries, it will have to make changes such that there is scope for the rule in Article 14, which will put various individuals at a fresh tax risk. So, it can only be reasonably concluded that in the instant case, the best option is to phase out the FoA rule from the UN Model and its commentary.

Notwithstanding this change, till there is such a correction, one can only hope that Indian tax jurisprudence will not mark its stamp of approval over any interpretation which is contrary to the

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63 Supra, Note 2.

64 Govind, Supra Note 60.
most paramount tenets of international taxation and that the position of law laid down in Linklaters will not stand the test of time.