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**Pakistan – A Globalized Tax World:
An Analysis of Its International
Tax Practice**

Geerten M.M. Michielse



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TABLE OF CONTENTS

PREFACE	iii
EXECUTIVE SUMMARY	iv
Part I Double Tax Agreements	1
General Introduction	1
International Tax Provisions in Domestic Legislation.....	1
Double Tax Agreements	2
Effects of Economic Globalization	3
Residency	5
Domestic Definition.....	5
<i>Resident individuals</i>	5
<i>Resident companies</i>	6
<i>Resident associations of persons</i>	7
Treaty Definition.....	7
<i>Resident individuals</i>	7
<i>Resident companies and associations of persons</i>	8
Recommendations.....	9
Sourcing of Income	9
Concept of Geographical Source	9
Permanent Establishment.....	11
<i>Domestic definition</i>	11
<i>International Definition</i>	13
<i>Profit allocation</i>	14
<i>Specific business activities</i>	16
<i>E-commerce activities</i>	16
<i>Banking and financial activities</i>	18
<i>Shipping and air transportation</i>	21
<i>Turnkey projects</i>	22
<i>Recommendation</i>	23
Other Sources with “Intangible” Character	24
International Profit Allocation (Transfer Pricing)	25
Transfer Pricing Concept	25
Associated Persons.....	26
Arm’s Length Principle.....	27
Customs valuation – a useful alternative?	29
Advance Ruling	29
Recommendations.....	30
Other Issues.....	31
<i>Protection of Investment Incentives</i>	31
<i>Domestic tax incentives</i>	31
<i>International issues</i>	31
Exchange of Information	32

Dispute Resolution.....	34
Reduction of Withholding Tax Rates	35
Foreign Tax Credit.....	35
“Most Favored Nation” – clauses	36
Part II Trade Agreements	37

APPENDICES

APPENDIX 1: Selection of International Tax Provisions in the Income Tax Ordinance 2001.....	39
APPENDIX 2: Double Tax Agreements Concluded by Pakistan	53
APPENDIX 3: DBA – Withholding Tax Rates on Royalty and Technical Service Fees	54
APPENDIX 4: DBA – Withholding Tax Rates on Dividends and Interest.....	56
APPENDIX 5: DBA – Tax Sparing Credits	58
APPENDIX 6: List of Trade Agreements Concluded by Pakistan.....	59

PREFACE

“In many developing – and developed – countries, governments all too often spend too much energy doing things they shouldn’t do. This distracts them from what they should be doing.”

Joseph E. Stiglitz (in: “Globalization and its Discontents”)

This report responds to a request by the Government of Pakistan to the World Bank under the tax policy and administration work. The research was executed under supervision of the Andrew Young School of Policy Studies at Georgia State University in the United States. The information used in this research was obtained during a one-week visit to Pakistan (Islamabad and Karachi) in December 2007. I would like to thank Dr. Ather Maqsood Ahmed, Member (Fiscal Research and Statistics), Mr. Usman Khalid Mirza, Member (Direct Taxes), and Mr. Mehmood Alam, Member (Customs), and the rest of the CBR staff and Mr. Mukhtar Ahmad Gondal, Director General, and his staff at the Large Taxpayer Unit in Karachi for very fruitful discussions. Furthermore, I wish to thank Dr. Ahmad Khan, former Member (Tax Policy) for the extensive discussions we had on various issues of international tax policy. Finally, I wish to acknowledge the helpful assistance of Mr. Kasper Richter, Senior Economist at the World Bank, and to express my gratitude for the assistance provided by Mr. Naeem Ahmed of the Federal Board of Revenue.

EXECUTIVE SUMMARY

The Government of Pakistan is considering an extensive tax and administrative reform by 2009 and asked the World Bank to provide a discussion paper on several technical issues. This report is dealing with the international aspects of the tax system: (a) the double tax agreements, and (b) the trade agreements.

Double Tax Agreements

The Income Tax Ordinance 2001 (hereinafter: Ordinance) contains a number of provisions dealing with international issues of the domestic tax system. They lay the basis for the protection of the domestic tax base. In addition, Pakistan has concluded over 50 double tax agreement which complement these domestic rules. The total system in place is to a large extent in line with international practice. The Ordinance has Income Tax Rules attached in which implementation rules are given for individual provisions of the Ordinance. Regarding the international provisions only implementation rules are given regarding transfer pricing. Implementation rules on other important provisions are lacking.

Recommendation:

- Introduction of detailed Regulations on international provisions in the Income Tax Ordinance 2001;
- Establishing of drafting team composed of LTO-staff, FBR-staff, and external expert(s).

However, due to economic globalization, some flaws in the international tax system have occurred over the last two decades. Not only Pakistan is facing these practical difficulties, other countries do also and no readily available solutions are available yet. The residency of multinational operating enterprises becomes increasingly arbitrary as management has more flexibility – due to technological developments – to determine where it wants its effective place of management. Also the geographical source concept is under pressure from economic globalization. The liberalization of capital markets makes it for instance easier to shift around financial instruments through which income is created and therewith the geographical source of this income. Other concepts, like for instance “permanent establishment”, are no longer adequate to economically link profit to a geographical area; whether a server or website through which e-commerce is carried on establishes a permanent establishment is a good example. Allocation of profits to a permanent establishment is also getting more difficult, especially in case of international banking and the global trading in new financial instruments. Pakistan also have to deal with presumptive taxation situations (e.g. shipping and air transportation) which may cause problems on the international level. Finally, the concept of “transfer pricing” shows practical difficulties. It is hard to find comparable uncontrolled prices for intercompany transactions and other alternative methods also have their drawbacks. The *ex post* approach puts a heavy administrative burden on both taxpayer and tax officer.

Recommendation:

- Identification of staff in LTO’s (operational level) and FBR (policy level) to deal with more specific international issues (e.g. transfer pricing) and to enable them to gain

more experience in this area and maintain their experiences in a changing environment;

- Limit the use of the transfer pricing provision to exclusively anti-avoidance situations by introduction of a reference system to specialized staff in LTO's;
- Education effort of LTO and FBR staff on specific international issues, partly through external conferences and/or tailor-made courses.

Although DTAs currently come with a brief summary, it is international practice that DTAs are joined by more detailed implementation rules. These rules contain – amongst other – rules how to apply the reduced withholding tax rates (either by a reduction-at-source through providing a statement of residence *ex ante* or by a refund procedure *ex post*).

Recommendation:

- Introduction of extensive Explanatory Memorandum (including implementation rules for e.g. reduced withholding tax rates) attached to Double Tax Agreements;
- Establishing of drafting team composed of LTO-staff, FBR-staff, and external expert(s).

Trade Agreements

Pakistan has recently (in 2006 and 2007) concluded Free Trade Agreements (FTAs) to further reduce its tariffs. In the last decades tariffs were already reduced from 125% to 25%. Pakistan chooses to conclude bilateral free trade agreements, as WTO failed to break down tariffs by most-favored-nation (MFN) clauses, and gradually reduces its tariffs to 0-5% over the next 5 years. The revenue foregone can relatively easy

been established as custom data should be available on the current trade with the FTA-countries. Whether the conclusion of these FTAs has, however, resulted in increased foreign direct investment (FDI) is doubtful. First, it is too early to have data available as these FTAs are very recently concluded. Second, other influences may also play a role in the development of FDI (e.g. shifts in trading patterns). Third, the main countries with which an FTA has been concluded – India and China – have not (yet) a very substantial trading with Pakistan.

Even if a correlation can be established, one could ask whether a negative or neutral correlation would lead to change Pakistan its policy? Globalization forces reductions (or even abolition) of tariffs as an autonomous process.

Recommendation:

- Economists may establish a baseline by comparing current revenue and FDI – preferably by country and/or industrial branch – and calculate the revenue foregone after full implementation of the FTAs (reduction of all tariff lines). Any reasonable effects can – in my opinion – not be measured within the next decade and will not have any impact on trade policy.

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“Having tax treaties is sometimes not an advantage to a country, but not having them is always a disadvantage”

Part I Double Tax Agreements

General Introduction

International Tax Provisions in Domestic Legislation

Pakistan has a modern income tax act which contains – amongst other – all necessary domestic provisions that should be in place to safeguard its domestic tax system in the world of international business. The Income Tax Ordinance of 2001 (hereinafter: Ordinance) was developed with technical assistance of the IMF. The key-provisions, like for instance residency, geographical source, and international profit allocation, are in place and well structured. In addition, a set of provisions that protects the Pakistan tax base from being eroded, like for instance transfer pricing and thin capitalization provisions are also in place. Finally, the Ordinance 2001 contains domestic withholding taxes on critical payments abroad, such as management fees and interest payments. An overview of all the international tax provisions in the Ordinance is provided in appendix 1.

Double Tax Agreements

Under Section 107 of the Ordinance, the Federal Government may enter into double tax agreements (hereinafter: DTA) with other countries. The importance of DTAs is fourfold: (1) it provides certainty to international investors, (2) it provides clear income allocation rules, (3) it spells out the method of double tax relief, and (4) it contains clear rules on the taxation of investment income. Pakistan has concluded over 50 “sound” DTAs with third countries. A list of all DTAs and their date of entry into force is provided in appendix 2. The UN model convention is used by Pakistan as the starting point for these the negotiations. This model convention is typically used between developed countries and developing countries or between developing countries amongst themselves. In addition, Pakistan has entered into a multilateral agreement with Bangladesh, Bhutan, India, the Maldives, Nepal, and Sri Lanka – South Asian Association for Regional Cooperation (hereinafter: SAARC) – which contains provisions on the exchange of information and assistance in the tax collection.

Subsection 2 states that any DTA provision – notwithstanding any provision under domestic law – has effect in so far as they provide for: double tax relief, the determination of Pakistan source income of nonresidents, the allocation of income to Pakistan sources, the determination of income, and the exchange of information. This means that – in accordance with international practice – the DTA provisions prevail over domestic tax provisions. The domestic tax legislation of the country of residence (establishing an unlimited tax liability for its residents) will be limited by the provisions

of a DTA by providing some taxing rights to the country of source. In those cases, Pakistan will provide for a foreign tax credit relief to alleviate potential double taxation.¹

Effects of Economic Globalization

In a world of increased economic globalization geographical borders become more translucent. The number of businesses that is engaged in cross border activities increases. Due to the technological revolution of the last decades (the rise of internet and e-commerce), this process has even been strengthened. Certain business activities can now easily be geographically (re-)placed at the will of the taxpayer. Capital became more movable as a result of advancing liberalization and deregulation of the capital markets, whereas labor maintained its relative fixation to a certain geographical area.

International taxation dates back to the late 20s of the last century. It was the first industrialization wave of the late 1900s that resulted – after World War I – in the need to develop rules how to solve collision of national tax systems. The Mexican (1943) and London (1946) model treaties of the League of Nations were the first attempts to develop such international rules. These rules were based on the fundamental difference in tax treatment between resident and nonresident persons. International principles as for instance “residence” and “geographical source rules” were introduced. In the meanwhile these model treaties have been replaced by the OECD model convention (and also the UN model convention) which still uses these original concepts. Although these concepts

¹ Section 103 of the Ordinance provides for an ordinary foreign tax credit, i.e. a tax credit is provided for the lesser of the foreign income tax paid or the Pakistan tax payable in respect of the income. Pakistan does not recognizes excess foreign tax credits.

have been modified over the years to keep up with economic developments, they seem to become increasingly flawed.²

In my opinion³ there are three major flaws in the international concepts and why their rules cannot keep up with the economic globalization: the concept of residence, the geographical sourcing of income, and the accounting rules that determine taxable profit. As we will see later, the concepts of residence and geographical source depend on the facts and circumstances. With help of new technologies, multinational operating taxpayers are increasingly able to arbitrarily decide whether they want to establish residence and/or source income in a certain jurisdiction. In addition, international tax rules have relied heavily on the arm's length principle where it comes to profit allocation issues. This method establishes a heavy burden on the tax administration and taxpayers equally as it is a delusion to find the arm's length (uncontrolled) price. At best a bandwidth can be established as even market prices are influenced by each and every individual.⁴ Furthermore, the concept seems to be theoretically wrong: there are economic reasons why certain activities are performed within the multinational enterprise rather than having them outsourced. From a tax perspective, it therefore does not make much sense to neglect these economies of scale altogether by using the comparable uncontrolled price. As the method is defining the transfer price *ex post*, it finally creates a heavy information burden and creates evidence issues.

² Vito Tanzi, *Globalization, Technological Developments, and the Work of Fiscal Termites*, © 2001, Brooklyn Journal of International Law, Volume XXVI, No. 4, p. 1261-1284.

³ Prof. Dr. G.M.M. Michielse, *Anachronismen en andere waanideeën – De effecten van de economische globalisering op het internationale belastingrecht*, © 2007, Sdu Fiscale & Financiële Uitgevers, Amersfoort, p. 1-28.

⁴ E.g. two individuals buying a car, whereas one of them is willing to forego all his (or his wife's) wishes just to take the showroom car by the next morning at a lower price than the other person whose new car has to be ordered with all the required specifications.

Residency

Domestic Definition

In Section 81 and further of the Ordinance it is defined under what circumstances a person is treated as a resident in Pakistan. It further states that a nonresident person is any person not being a resident.

Resident individuals

A resident individual is any individual who is present in Pakistan:

- a) for a period or periods amounting in aggregate to 182 days or more in the tax year;
- b) for a period or periods amounting in aggregate to 90 days or more in the tax year and who – in the four years preceding the tax year – has been in Pakistan for a period of, or periods amounting in aggregate of 365 days or more; or
- c) is an employee or official of the Federal Government or a Provincial Government posted abroad in the tax year.

Although the Income Tax Rules 2002 – a set of regulatory implementation rules attached to the Ordinance – do not contain any guidance in respect of how to count the number of days being present in Pakistan. In most situations it will be clear whether an individual is present in Pakistan or not. As the borders with both Afghanistan and India are (more or less) closed, the issue of individuals living abroad and having their regular employment (or other activity) in Pakistan will rarely occur. A clear solution, however, need to be designed regarding the first and last day of stay in Pakistan.

Resident companies

A resident company is any company that:

- a) is incorporated or formed under any law in force in Pakistan;
- b) has the control and management of the affairs of the company situated wholly or almost wholly in Pakistan at any time in the year; or
- c) is a Provincial Government or local authority in Pakistan.

As a general rule all companies established under Pakistani laws are resident companies. Any other company will be treated as a resident company if control and management⁵ of the affairs is situated in Pakistan. Again, there is no guidance found in the Income Tax Rules 2002 regarding the term “central management and control”. In other Commonwealth countries, like for instance the United Kingdom or Australia, a similar approach is used. Control normally rests with the directors who carry out leading functions and manage the company’s business at the highest level. As a rule, this power is not within the competence of the shareholders. One must distinguish superior management, which is the prerogative of the directors, from the immediate day-to-day management of the company’s business. The latter must not be considered as forming part of the central management and controlling power. In Australia case law has specified some factors that make it possible to determine where the central management and control of a company are exercised⁶:

- the company directors’ domicile;
- the board meetings’ place;

⁵ *Beers Consolidated Mines Ltd. Versus Howe* (1906) A.C. 455.

⁶ *Koitaki Para Rubber Estates versus Federal Commissioners of Taxation* (1941) 64 C.I.R. 15, 241.

- the place where the company's general policy is developed, it being understood that the directors do not follow the directions of a higher authority.

The following criteria are considered as subsidiary tests:

- the place where dividends are declared;
- the place where general meetings are held;
- the fact that the company operates a bank account in the country;
- the place where the company's books and corporate seal are kept.

Although the shareholders' residence is not relevant, it might impact the central place of management if the shareholders exercise management and control of the company that they supplant the management responsibilities of the directors.⁷

Resident associations of persons

A resident association of persons is any association of persons if the control and management of the affairs of this association is situated wholly or partly in Pakistan at any time in the year.

Treaty Definition

Resident individuals

DTAs contain – amongst other – rules that allocate taxing rights to either the state of residence and/or the state of source. Therefore, it is of utmost importance to know where a person maintains his/her residency to enable application of these allocation rules.

The DTA definition of residence, however, will not limit any consequence (i.e.

⁷ *Malayan Shipping Company versus Federal Commissioner of Taxation* (1946) 71 C.I.R. 156.

being unlimited liable to tax) of having a residency in Pakistan according to domestic laws.

In general, the UN model convention follows in Article 4 the domestic definition as long as this definition is based on domicile, residence, place of incorporation, place of management or any other criterion of a similar nature. In case an individual is resident of both Contracting States, paragraph 2 provides for a tie-breaker rule. In such cases the State in which the individual has a permanent home available is recognized as the state of residence for application of the DTA. If he has a permanent home in both States, the centre of vital interests (i.e. the place where his personal and economic relations are closer) is decisive. If a centre of vital interests cannot be established, nor a permanent home is not available in either State, the place of habitual abode will be decide the individual's place of residence. Ultimately nationality will serve as a tie-breaker if such an habitual abode cannot be established or occurs in both States.

Resident companies and associations of persons

In most of its DTAs Pakistan has adopted the concept of effective place of management as the tie-breaker provision. The concept of "effective place of management" is slightly different from its domestic concept of "central place of management and control". The OECD Commentary provides an interpretation of what is considered the effective place of management as it states that "[t]he place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decision, the place where the

actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management.”⁸

Recommendations

The Income Tax Rules 2002 do not make sufficiently clear how to count the days individuals are present in Pakistan. Neither do they contain guidance as to the interpretation of “central place of management and control”. Therefore, implementation rules are needed to further clarify these concepts.

The DTAs concluded by Pakistan are not accompanied by detailed implementation rules and therefore it is unclear how terms like “permanent home”, “centre of vital interests”, “habitual abode”, and “effective place of management” are going to be interpreted. Also in this respect it is necessary to further clarify these terms by adding more detailed implementation rules to DTAs.

Sourcing of Income

Concept of Geographical Source

The source rules are important as they form the link between a geographical area (tax sovereignty) and income. In Section 101 of the Ordinance a set of source rules has been identified which link certain income to Pakistan: for instance the availability of a permanent establishment (business income), the place where the activities which

⁸ OECD Model Tax Convention on Income and on Capital (condensed version), © 2005, OECD Publications, Paris, p. 82.

generated the income take place (employment income), and the place where the assets are located out of which the income is subtracted (dividend, royalty, technical service fee).

Sources have to meet certain requirements to become effective. Administrative simplicity is needed for both tax administration and taxpayers. Substantial economic factors must be available to establish an economic link between income and a certain location. Source rules need to be neutral – i.e. acceptable for Pakistan if formulated in the same way by another State – as to avoid international double taxation. The State that creates a source should have the intention to tax the income from that source to avoid double non taxation. Finally, the formulation of a source requires that the full control over the source determination lies with the legislator rather than the taxpayers (avoids arbitrary behavior).

Income is an economic concept (i.e. income is the total amount of consumption increased by the net changes in savings). For tax purposes income is defined under either the source concept⁹, the accretion concept, and/or the trust concept.¹⁰ Pakistan applies the source concept as can be seen in Section 11 of the Ordinance. Income consists of the following categories: salary, income from property, income from business, capital gains, and income from other sources. Income as such does not have a geographical source, but rather the instrument through which income is generated construes its geographical source. As the origin of income and/or the instruments can easily be (re-) placed, sometimes income does not have an unequivocal geographical source.

Some income can be sourced relatively easy as the instrument through which it is generated has a “tangible” character, for instance business assets (machinery), others are

⁹ The English language is quit confusing as the word “source” is used in two different meanings. Here we mean the origin of the income flow, rather than the geographical linkage;

¹⁰ Victor Thuronyi, *Comparative Tax Law*, © 2003 Kluwer Law International, The Hague, pp. 235-236.

more difficult to allocate as their character is more “intangible”, for instance financial activities and services. Liberalization of the financial markets in combination with technological developments (internet and e-commerce) have blurred the geographical source.

Permanent Establishment

Domestic definition

Section 101 of the Ordinance contains a list of income which is sourced in Pakistan. Business income of a resident person is sourced in Pakistan to the extent to which the income is derived from any business carried on in Pakistan. This seems to be a territorial approach on business taxation. Business income of a nonresident person is only sourced in Pakistan to the extent to which it is directly or indirectly attributable to:

- a) A permanent establishment of the nonresident person in Pakistan;
- b) Sales in Pakistan of goods or merchandise of the same or similar kind as those sold by the person through a permanent establishment in Pakistan; or
- c) Other business activities carried on in Pakistan of the same or similar kind as those effected by the nonresident through a permanent establishment in Pakistan.

As a result of (b) and (c), the “force of attraction” approach is applied which widens the possibility to include nonresident business into the Pakistani tax system.

A permanent establishment is defined in Section 2, No. 41 of the Ordinance and means a place of business through which the business of the person is wholly or partly carried on, and includes:

- a) A place of management, branch, office, factory or workshop, other than a liaison office except where the office engages in the negotiations of contracts (other than contracts of purchase);
- b) A mine, oil or gas well, quarry or any other place of extraction of natural resources;
- c) A building site, a construction, assembly or installation project or supervisory activities connected with such site or project;
- d) The furnishing of services, including consultancy services, by any person through employees or other personnel engaged by the person for such purpose, but only where activities of that nature continue for the same or a connected project within Pakistan for a period or periods aggregating more than ninety days within any twelve-month period;
- e) A person acting in Pakistan on behalf of the person (hereinafter referred to as the “agent”) other than an agent of independent status acting in the ordinary course of business as such, if the agent:
 - (i) Has and habitually exercises an authority to conclude contracts on behalf of the other person;
 - (ii) Has no such authority, but habitually maintains a stock-in-trade or other merchandise from which the agent regularly delivers goods or merchandise on behalf of the other person; or
- f) Any substantial equipment installed, or other asset or property capable of activity giving rise to income.

International Definition

There are a few remarkable issues in this domestic definition if compared with the common international definition found in DTAs. First, a building or construction site is treated as a permanent establishment as from the first day of activity, rather than after a threshold elapses of (usually) 183 days.¹¹ Second, service activities in excess of 90 days also constitute a permanent establishment.¹² Third, domestic law seems to provide for a force of attraction rule that – once a nonresident taxpayer has a permanent establishment at his disposal in Pakistan – all his business conducted in Pakistan will be automatically allocated to this permanent establishment. This force of attraction rule is not protected in the DTAs concluded by Pakistan. Finally, the DTAs typically contain a provision which exempt certain permanent establishments from being treated as such. This is the case if facilities are used solely for:

- a) the purpose of storage or display 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 or display;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

¹¹ The DTAs with Egypt, Indonesia, Nigeria, and Tunisia, deem a building or construction site of more than 3 months a permanent establishment, whereas the DTAs with Iran, Ireland, Malta, Poland, and Turkmenistan require a period of more than 12 months before a permanent establishment is deemed. In the DBA with Romania a period of 9 months is included.

¹² This is safeguarded only in the DTAs with Azerbaijan (183 days), Belgium, Finland (6 months), Italy, Jordan, Kyrgyz Republic, Lebanon, Morocco (1 month), Nepal (183 days), Netherlands (4 months), Philippines, Sweden (6 months), Switzerland (6 months), Thailand (183 days), Turkmenistan (183 days), Ukraine, and Vietnam (6 months). In the DTAs with Japan, Libya, and the United States a fixed place of business is required.

- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for 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 under a) through e) provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

The fact that the domestic definition of a permanent establishment is broader than the definition under DTAs, provides Pakistan some yield in negotiating international tax agreements (the broader definition can for instance be used to bargain with other countries for lower withholding tax rates).

Profit allocation

Section 105 of the Ordinance contains detailed rules to allocate profit to a permanent establishment in Pakistan. In principle the separate entity method is used, in which the permanent establishment is deemed to be a distinct and separate person from the nonresident person of which it is a permanent establishment. The arm's length principle laid down in Section 78 of the Ordinance is therefore applicable (see below). Expenses – whether incurred in Pakistan or elsewhere – related to the permanent establishment – including executive and administrative expenses – are deductible.

The following payments from the permanent establishment to its headquarters or to another permanent establishment of the nonresident person (other than towards reimbursement of actual expenses incurred by the nonresident person to third parties) are not deductible:

- a) Royalties, fees or other similar payments for the use of any tangible or intangible asset by the permanent establishment;
- b) Compensation for any services including management services performed for the permanent establishment; or
- c) Profit on debt on moneys lent to the permanent establishment, except in connection with a banking business.

The deduction for head office expenditure is limited to a proportion of the total head office expenditure related to the same proportion of turnover of the permanent establishment related to its worldwide turnover. Head office expenditure means any executive or general administration expenditure incurred by the nonresident person outside Pakistan for the purpose of the business of the permanent establishment operated in Pakistan. Any interest paid by the nonresident person on debt to finance the operations of the permanent establishment and/or insurance premium paid in relation to such debt are not deductible.

According to Section 104 of the Ordinance 2001 deductible expenditures incurred by a person in deriving foreign-source income can only be deductible against that income. In case this results in a foreign-source loss, this loss must be carried forward to the following tax year and set off against the foreign source income chargeable in that tax

year, and so on, but no foreign loss is carried forward to more than 6 years immediately succeeding the tax year for which the loss was computed.¹³

Specific business activities

E-commerce activities

An area of concern is the development of e-commerce by nonresident companies in Pakistan. The term “e-commerce” refers to a wide range of commercial activities carried out through the use of computers, including on-line trading of goods and services, electronic fund transfers, on-line trading of financial instruments, electronic data exchanges between companies and within a company. As originally e-commerce focused mainly on the “back office” aspects of commerce that made the most use of the new technology, it is the retail transactions which have taken over rapidly. Currently a wide variety of e-commerce is carried out over the internet: the sale of goods, the provision of services (e.g. banking, health care), the sale or licensing of software, the downloading of entertainment (e.g. movies, books, music), the provision of information (e.g. LEXIS/NEXIS database), the provision of advertising, gambling, and around the clock global trading in financial instruments.

In 2001 the OECD published a paper¹⁴ in which it analyzed the attribution of profit by an enterprise distributing products etc. over the internet through a web site hosted on a server situated in a permanent establishment in another country. Four different situations were distinguished and analyzed. The first situation is the extreme case of a stand-alone computer server performing automated functions (in particular,

¹³ First-in-first-out rule.

¹⁴ OECD Discussion Paper on *Attribution of Profit to a Permanent Establishment involved in Electronic Commerce Transactions*, © 2001, OECD Publications, Paris, p. 1-34.

online processing of transactions and transmission of digitized products) without the presence of personnel in the permanent establishment. The second situation examines the case of multiple servers performing identical tasks. The third situation assumes the presence of personnel in the permanent establishment to provide online services and maintain the server. The last situation assumes that the development of the hardware and software used by the permanent establishment was entirely performed in the permanent establishment.

In summary, it was found that the under the arm's length principle, the amount of profit to be attributed to the permanent establishment will be related to the nature of the functions that it performs (taking into account the assets used and risks assumed). Given the importance of intangible assets in the earning of profits from e-commerce activities, it is also essential to determine which part of the enterprise economically "owns" or has created the intangible assets used by the permanent establishment. In the context of the stand-alone computer server (and the multiple server variation), the functional and factual analysis is likely to show that the permanent establishment is performing only routine functions and is reliant on other parts of the enterprise to provide the intangible assets necessary for it to perform most, if not all, of those functions. Accordingly, the activities of the permanent establishment are very unlikely to warrant it being attributed with a substantial share of the profit associated with the distribution activities of the enterprise conducted through the server. Further, it was suggested that the nature of this type of server-permanent establishment, especially its lack of personnel, is likely to mean that tasks performed by the server would likely be conducted under a "contract service provider" arrangement that would leave all substantial assets and risks with the head

office and attribute to the permanent establishment the profits associated with the physical operation of the computer server. Under an alternative interpretation of the arrangement, whereby the permanent establishment is considered to be instead an “independent service provider”, the conclusion would be similar, given the need for the permanent establishment to recognize, in computing profit, the arm’s length value of the tangible and intangible property that it uses and that were contributed to it by other parts of the enterprise.

Where personnel are present in the permanent establishment to perform maintenance and online services tasks, the quantum of the profit attributable to the permanent establishment would be commensurate with what independent service providers would be expected to earn in a similar situation. Finally, the last variation (in-house development of server and web site) is likely to produce a more substantial attribution of profit to the permanent establishment, as it assumes sufficient development risks to be considered as the economic owner of the intangible property developed to operate the server and the web site and, therefore, is entitled to the profit associated with the exploitation of such property.

Banking and financial activities

International banks and financial institutions make often use of permanent establishments rather than setting up foreign subsidiaries as they can easier meet regulatory requirements set by the financial authorities.¹⁵ The business of international banks and financial institutions is different from any other multinational business.

¹⁵ E.g. capital and financial assets of the head office may be taken into account to also cover transactions entered into by the permanent establishment.

Traditional activities are the borrowing and on-lending of money. Recently other financial activities like for instance the global trading of financial instruments have been added. The most important functions performed in a traditional banking business are (a) the acquisition of funds and the creation of a financial asset (providing of loans), (b) the risk-taking functions related thereto (including supervision of the management of the bank's overall capital and risk exposure), and (c) support or "back office" functions (general management, development of IT-infrastructure, human resources, etc.).

Global trading is the capacity of financial institutions to execute customers' orders in financial products in markets around the world and/or around the clock. This activity includes, amongst other underwriting and distributing products on a worldwide basis, acting as a market-maker in physical securities and in derivative instruments, acting as a broker for client transactions on stock and commodities exchanges around the world, and developing new products to meet the needs of the financial institution's clients. The income earned from these activities consists of interest and dividends received with respect to the inventory it is required to maintain in order to perform those services. Financial institutions usually make also profit by correctly forecasting the movement in market variables (e.g. interest rates, exchange rates or prices) that affect the value of their portfolio. Global trading activities typically take place in more than one of the three main time zones. For the tax issues involved it is crucial that financial products are offered to customers in more than one jurisdiction (even within one time zone). As in the more traditional banking business, also in global trading some characteristic functions

are undertaken, such as the marketer functions¹⁶, the trader function¹⁷, the treasury function¹⁸, and the “back office” function.

The profit which banks and financial institutions receive is not only related to the performance of those functions, but also reflects the assets used and risks assumed in performing those functions. They use physical assets (branch premises, computer systems, etc.) and intangible assets (name, reputation, and logo of the bank). The allocation of these assets to a permanent establishment is – in principle – identical with that of other businesses. However, the risk assumption is of critical importance in the banking business. The creation of a financial asset (loan) involves the assumption of a number of different types of risk by the bank, of which the credit risk¹⁹, the market interest rate risk²⁰, and the market foreign exchange risk²¹ are considered the most important. Banks and financial institutions need “capital”, i.e. the ability to absorb any losses due to the realization of assumed risks. “Capital” refers to funds placed at the bank’s disposal by investors who are prepared to accept some higher level of risk in respect of their investment in exchange for an economic return which is expected to be significantly higher than the risk-free rate.

¹⁶ The marketer is responsible for running the deal, including ensuring that the transaction receives all necessary clearance within the financial institution and closing the deal with the customer with the result that this function generally gives rise to the assumption of credit risk.

¹⁷ The trader determines the price at which he is willing to take a deal onto his book. He/she sets the parameters in negotiation with the marketer, but does not deal directly with the customer. The trader may additionally be responsible for the management of the market risk that arises from those transactions once they are entered on the institution’s books.

¹⁸ The treasury is responsible for ensuring that the financial institution has sufficient funds to meet its payment obligations but does not have excess cash that is not being used profitably.

¹⁹ The risk that the customer will be unable to pay the interest or to repay the principal of the loan.

²⁰ The risk that market interest rates will move from the rates used when entering into the loan agreement.

²¹ The risk that, where the loan is made in a currency other than the domestic currency of the bank (or the currency of the borrowing), the exchange rate will move from the rate used when entering into the loan agreement.

Banks and financial institutions are regulated by Governments and are required to have minimum amounts of capital (regulatory capital) based on the risks they assume. Those government rules are introduced to protect the customers and to maintain the integrity of the financial system. These requirements often result in a mandatory reserve for nonperforming loans. There might be even other restrictions such as for instance the requirement to invest regulatory capital in certain assets considered to be “safe” (e.g. government bonds). As regulatory requirements may differ between jurisdictions, consequently the jurisdiction in which the financial asset is booked for accounting purposes need not be the same jurisdiction in which any of the functions necessary to create or maintain the asset were performed. This may cause allocation issues for both tax administration and taxpayers.

Finally, banking business attempts to earn profit by making use of an interest spread on incoming and outgoing interest payments. This profit margin can be improved if not all the funds lent to the customer are borrowed. This implies that the bank uses some of its own financial resources (“free” capital). The amount and the allocation of this “free” capital to the permanent establishment is often subject to disputes between tax administration and taxpayers.

Shipping and air transportation

Section 7 of the Ordinance creates a presumptive tax base for nonresident persons engaged in shipping and/or air transportation (either as owner or charterer). This approach was adopted by Pakistan in the 80s as a result of presumptive taxation of these activities by competitors like for instance Thailand and the Philippines. Taxable profit is fixed on the gross amount received or receivable (whether in or out of Pakistan) for the

carriage of passengers, livestock, mail or goods embarked in or outside Pakistan. It seems irrelevant whether this business is carried on through a permanent establishment or not.

Under most of the DBAs concluded by Pakistan, the right to tax income from shipping and/or air transportation is granted to the state of residence of the company. In a few DTAs a limited right (50% of the tax rate) is given to the state of source.²² The newer DTAs concluded by Pakistan contain the presumptive basis of taxation for those activities; as a consequence no issues arise. In earlier DTAs, however, the question arises how the presumptive tax basis should be allocated to the source country in case the place of effective management is located in Pakistan and the latter is obliged to provide for double tax relief. Similar issues may arise in other areas where Pakistan taxes certain business activities on a presumptive basis.

Turnkey projects

A turnkey project is a project in which separate entities are responsible for setting up a plant or equipment (e.g. trains/infrastructure) and for putting it into operation. It can include contractual actions at least through the system, subsystem, or equipment installation phase and may include follow-on contractual actions, such as testing, training, logistical, and operational support. Turnkey projects can also be extended, known as turnkey plus, where there is perhaps a small equity interest by the supplier and it will later on continue its operation through a management contract or licensing.

The tax issue at stake here is that taxpayer often contends that the contract is a divisible one and that there can be no tax liability in Pakistan for the offshore supply of equipment and services. Business income can only be taxed in Pakistan if the nonresident

²² This is the case in the DBAs with Austria, Bangladesh, Denmark, Finland, Hungary, Italy, Korea, Philippines, Singapore, Sri Lanka, Sweden, and Switzerland.

taxpayer has a permanent establishment and only to the extent that such income could be directly or indirectly attributable to the activities of that permanent establishment. The taxpayer contends that its permanent establishment had nothing to do with the offshore supply of materials and services and that the mere presence of the permanent establishment cannot attract tax liability in Pakistan, when the permanent establishment is not actually connected with the offshore supplies, more so when the DTA concerned has no force of attraction clause.

The tax authorities, however, contend that the contract was a composite and integrated one and that the nonresident taxpayer is liable to pay tax in Pakistan for the offshore supplies as well. It further argues that the offshore and onshore elements of the contract are so inextricably linked, that the breach of the offshore element would result in the breach of the whole contract. The dominant object of the contract is the execution of a turnkey project and the question whether the title to the goods supplied passes offshore or within Pakistan is secondary to the execution of the contract.

There are currently no provisions in the Income Tax Rules that will guide the tax authorities in those situations.

Recommendation

It is clear from the discussions at the LTU Karachi that the staff is lacking up-to-date information about the developments in doing business in a globalized environment. Not only guidance on new developments like for instance e-commerce, banking and financial activities is missing in the Income Tax Rules (policy level), but they also have a need for sharing experiences with other tax administrations and for practical training on those new issues that they face (operational level).

The Income Tax Rules should be extended with guidelines covering e-commerce, banking and financial activities and their profit allocation to permanent establishments. Furthermore, it is necessary to include provision regarding the approach towards turnkey projects. This could be based on recently published draft reports by the OECD on these topics.²³

Other Sources with “Intangible” Character

Income of which its geographical source can be simply moved in and out a certain jurisdiction is prone to tax arbitrage by (especially) multinational operating companies. Income from financial activities, factoring, licensing, insurance and technical or management services can be re-routed through low tax jurisdictions to minimize the tax burden. The instruments, through which this income is geographically sourced, are very movable and it requires just some paperwork to relocate those instruments (e.g. a loan agreement or trademark) in another jurisdiction. Typically this relocation of income flows results in a deductible expense in Pakistan (at a current corporate tax rate of 35%) and a corresponding income in the “low” tax jurisdiction.²⁴

Section 6 of the Ordinance resolves this issue at least with respect to royalty payments and technical or management service fees paid to nonresidents. Those payments are subject to a withholding tax of 15%. In most DBAs Pakistan reduces this rate to 10% (see appendix 3). On all other payments made to nonresidents, including dividends, interest and insurance premiums, there is a withholding tax of 30% to secure

²³ OECD Discussion drafts on Article 7 (Business profits): The attribution of profits to permanent establishments – Parts I-IV, © 2005 (June) and 2006 (December), OECD Publications, Paris.

²⁴ Any tax jurisdiction which applies an effective tax rate of less than 35% will do for this purpose. This means that not only the typical tax haven jurisdictions, but also most Western jurisdictions will be attractive. The average corporate tax rate in the OECD countries is currently approximately 20-25%.

the Pakistani tax base. This withholding tax rate is in most DBAs reduced to 10-15% (see appendix 4).

Base erosion as a result of excessive interest deduction is protected by Section 106 of the Ordinance (thin capitalization). According to this provision a deduction is disallowed for the profit on debt paid by a foreign-controlled resident company directly or indirectly to its controlling parent company on that part of the debt which exceeds the debt-to-equity ratio of 3:1. A foreign-controlled resident company is a resident company in which 50% or more of the underlying ownership of the company is held by a nonresident person either alone or together with an associate or associates. Furthermore, the rule provides clear definitions of what is considered debt and equity for the purpose of determining the debt-to-equity ratio. As the thin capitalization rule only denies interest deduction, it forms part of the profit determination provision and will therefore not be affected by the application of DTAs.²⁵

International Profit Allocation (Transfer Pricing)

Transfer Pricing Concept

Section 108 of the Ordinance gives the Commissioner, in respect of any transaction between associated persons, the possibility to distribute, apportion or allocate income, deductions or tax credits between those associated person to reflect the income that those persons would have realized in an arm's length transaction. The Commissioner is defined by Section 2 No. 13 of the Ordinance as a person appointed as a Commissioner of Income Tax and includes a tax officer vested with all or any of the powers, and

²⁵ In case the thin capitalization rule re-qualifies nondeductible interest into a profit distribution, this results in a profit allocation correction and is covered by Article 9 (transfer pricing) of the DTA.

functions of the Commissioner. These seems to include a wide range of tax officials spread over the regional tax offices who have to deal with transfer pricing issues.

Transfer pricing should be approached as a mere anti-avoidance rule to tackle international tax planning. The first line of attack would be “substance-over-form”. Questions like for instance what are the underlying activities for paying technical service fees and who is performing those services, may already be sufficient to bring down a structure. Subsequently special attention should be given to transactions with companies located in tax haven countries. In this respect a second line of attack can be followed: the introduction of withholding taxes and thin capitalization rules (both of which are in place in the current Income Tax Ordinance). Especially the way Pakistan has adopted a withholding tax on management and technical service fees and maintains this withholding tax under its DTAs deserves respect.

Transfer pricing is the third line of attack and focuses on the international profit allocation. Transfer pricing is a sensitive issue²⁶ as tax officers typically lack sufficient business skills and economic information to judge the pricing of intercompany transactions. On the other hand, the fact that those intercompany transactions should be regarded carefully is due to the possibility of tax avoidance. It requires special and continued attention from the tax authorities and should be applied only at last resort.

Associated Persons

The term “associates” is defined in Section 85 the Ordinance. As a general rule, two persons are associates where the relationship between them is such that one may

²⁶ Sensitive in the sense that it can easily be misused by the tax authorities to raise easy tax revenues if forced to by their government, bother multinational enterprises in creating uncertainties with respect to their tax liability and therefore harmful to foreign direct investments.

reasonably be expected to act in accordance with the intentions of the other, or both persons may reasonably be expected to act in accordance with the intentions of a third person. To clarify this general rule, sub-section 3 provides examples of associates.

A shareholder in a company and that company are associates, if the shareholder – either or together with an associate or associates – controls either directly or indirectly 50% or more of the voting power, the rights to dividends, or the rights to capital in the company. Two companies are also treated as associates, if a person – either alone or together with an associate or associates – controls either directly or indirectly 50% or more of the voting power, the rights to dividends, or the rights to capital in both companies. Finally, members of an association of persons and the association are treated as associates, if the member alone or together with an associate or associates controls 50% or more of the rights to income or capital of the association.

In practice, it is often difficult to get adequate information from taxpayers to enable verification of those relationships. This may partly be solved by exchange of information provisions in DTAs, but outside the DTA protection, tax officers may find it impossible to detect those relationships.

Arm's Length Principle

As mentioned before, Section 108 of the Ordinance allows the Commissioner to make profit corrections in situations where associates have not dealt with each other at arm's length. The arm's length method refers to an independent market price: the comparable uncontrolled price (CUP). This principle is also laid down in Article 9 of the OECD- and UN model conventions and consequently in DTAs concluded by Pakistan.

Pakistan has laid down implementation regulations in Rule 20 through 27 of the Income Tax Rules 2002. Rule 22 grants the Commissioner a wide discretionary power to apply international standards, case law and guidelines issued by various tax-related internationally recognized organizations. This seems to refer to the OECD Guidelines on Transfer Pricing²⁷, but does not exclude all kind of other documents issued by organizations that operate on a worldwide scale.²⁸

In Rule 23 the arm's length standard is defined. The results on transactions between associated persons should be consistent with the results that would have been realized if unrelated persons had engaged in the same transactions under the same conditions. The rule allows the Commissioner to apply the comparable uncontrolled price method (Rule 24), the resale price method (Rule 25), and the cost plus method (Rule 26). The Commissioner has the authority to determine which of those methods lead to the most reliable transfer price taking into account all facts and circumstances. If none of these methods lead to a reliable result, the Commissioner may use the profit split method (Rule 27). Ultimately, the Commissioner has the discretionary power to decide whether that method will lead to a reliable transfer price or he may use any other method that is consistent with the arm's length standard.

In practice, these rules cause problems. The comparable uncontrolled price is rarely available and certainly arbitrary in cases of intangible assets and service fees. The alternative resale price method requires a comparable gross margin for similar businesses (conducting activities directly to the general market). The other alternative method

²⁷ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995-2000), © 2001 OECD Publications, Paris, pp. 1-261.

²⁸ E.g. BIAC, the Business and Industry Advisory Committee to the OECD, or the IBFD – International Bureau of Fiscal Documentation – through its staff publications.

requires a comparable mark up for similar businesses (typically conducting production type activities). In both methods information on branch-specific profit margins should be available to the tax administration. This information is not available in Pakistan.

Customs valuation – a useful alternative?

A question often raised is whether the Tax Administration could use the customs valuation method as basis for determining the transfer price. There is no systematic equivalence between transfer pricing and customs valuation methods while certain common concepts and elements do overlap in both methods. The two sets of rules have differences in many aspects (regarding agency objectives²⁹, operational functions, methodologies³⁰, treatment of certain costs and charges, etc.). However, as far as the acceptability of the transfer price set for imported goods (and related intangibles) between related parties or associated enterprises is concerned, as a principle, both transfer pricing and customs valuation seek to determine transfer pricing at an arm's length level, in essentially the same terms. Although similarities can be seen, it is still not widespread accepted to use customs valuation methods to determine the transfer price.

Advance Ruling

Since 2003³¹, Section 206A of the Ordinance has been introduced allowing for advance rulings. Under this provision the Central Board of Revenue (CBR) may – on application in writing by a nonresident taxpayer – issue to the taxpayer an advance ruling

²⁹ The customs officer's natural inclination will be to verify whether the value declared by an importer should be increased in order to collect more duties, while a tax official's natural inclination will be to verify whether the value declared by a resident should be decreased in order to limit the tax deductible amount.

³⁰ Customs generally determines the value of the goods at the time of importation with respect to individual transactions based on information at that time, whereas in practice transfer pricing practitioners often determine the value of the goods based on aggregated transactions, where appropriate, and quite often using information available at the year end.

³¹ Finance Act, 2003.

setting out the Commissioner's position regarding the application of the Income Tax Ordinance to a transaction proposed or entered into by the taxpayer. The taxpayer has the obligation to make a full and true disclosure of the nature of all aspects of the transaction relevant to the ruling and the transaction has to proceed in all material respects as described in the taxpayer's application for the ruling. The ruling is binding on the Commissioner with respect to the application to the transaction of the law as it stood at the time the ruling was issued. Until the end of 2007 only six advance rulings have been granted; all of them dealing with the tax liability of certain transactions as for instance the receipt of a payment as a result of a merger, the performance of seismic data processing services, payments for sales in Pakistan without having a permanent establishment, etc.

Recommendations

The wide range of tax officers who deal with transfer pricing issues need to be limited. Suggested is to set up special teams of 2-3 persons in the LTUs (Karachi and Lahore) who should become specialists in the application of transfer pricing issues. Other tax officers outside this specialist teams should refer cases which they feel include a transfer pricing issue to such team. On the policy level (Federal Board of Revenue) a special team on transfer pricing should be established to monitor the international developments in the area of transfer pricing.

Furthermore, additional guidance should be provided in the Income Tax Rules 2002 on how to apply the various methods to establish the reliable transfer price. In this respect the various reports³² issued by the OECD could be very helpful to extend the implementation rules.

³² See for instance FN 19 and FN 23.

Finally, the possibility to enter into advance rulings given by Section 206A of the ordinance could be used to sign so-called Advance Pricing Agreements (APA). Those agreements have been introduced in international practice to provide certainty to multinational enterprises regarding the pricing of their internal transactions. Similar conditions can be applied as is current done for advance rulings. However, if the authorities want to explore the introduction of APAs in the near future some adjustments need to be made.

Other Issues

Protection of Investment Incentives

Domestic tax incentives

Under the second Schedule (Exemptions and tax concessions) to the Ordinance, several exemptions and tax holidays are available, but all of them seem to (have) run out of application. There are still several industries and/or business activities which apply to reduced tax rates according to part II of this Schedule.

Section 23 of the Ordinance provides for an initial allowance of 50% of the cost of newly acquired plant and machinery, not being road transport vehicles (except if the vehicle is plying for hire) and furniture. Assets that are allowed to be expensed are also excluded from the initial allowance. This initial allowance reduces the depreciation base of these business assets.

International issues

For foreign investors from countries that exempt foreign-source income from income tax (such as the Netherlands and other West-European countries), tax incentives

in the form income tax reductions are beneficial. However, for foreign investors from countries that tax income on a worldwide basis and provide a tax credit for foreign tax paid (such as the United States or the United Kingdom), income tax incentives, such as a lower corporate income tax rate or reduced withholding taxes, may yield less benefit if tax is owed in the home country on the income earned abroad, unless tax sparing credits are provided in the DTAs (see appendix 5). Even if this income were taxable in the source country, businesses would be able to claim a tax credit for income tax paid abroad up to the level of taxation in the home country (the actual crediting mechanism may be more complicated than this, as under the United States' basket system of crediting income tax paid abroad). However, income tax reductions in the source country still offer some advantage, particularly to the extent that the source country's tax rate is higher than the home country's tax rate and the income tax in the home country is deferred on income until it is remitted to the home country, as is generally the case.

Exchange of Information

All DTAs concluded by Pakistan contain an exchange of information article in accordance with Article 26 of the UN model convention. However, whether and to what extent the Pakistani tax authorities can obtain information from abroad depends on the domestic legislation of that other State. Pakistan is also party in a multilateral agreement on avoidance of double taxation and mutual administrative assistance in tax matter concluded by the governments of the SAARC Member States.³³ In Article 5 of this agreement an exchange of information provision in accordance with article 26 of the UN model convention is adopted.

³³ South Asian Association of Regional Cooperation; the member states are Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka.

Exchange of information is essential for the application of DTAs and to ensure a correct and speedy application of domestic tax legislation. It assists the tax authorities to ascertain the facts in relation to which the DTA is to be applied. It also provides information relevant to the application of domestic tax laws, even where there is no question of the application of any particular provision of the DTA. In this manner, exchange of information helps to prevent tax avoidance and evasion, which is increasingly important as the economic globalization continues.

There are three main forms that exchange of information may take: on request (i.e. when a tax administration asks specific questions relating to a particular case), automatic (systematic sending of information concerning specified items of income), and spontaneous (e.g. passing on information obtained during examination of a taxpayer's affairs and which might be of interest to the other State). In addition, alternative methods can be followed, for instance simultaneous examinations of a group in two or more countries, participation in foreign tax audits, exchange of auditors, visit of authorized representatives of competent authorities, presence of fiscal attachés abroad, industry wide exchange, etc.

On the other hand, exchange of information should be subject to limitations. Typically exchange of information is provided on the basis of reciprocity and can only be provided the other contracting State if there is a legal basis for it in the domestic legislation of the providing country. In this regard the fiscal secrecy, bank secrecy, professional confidentiality, and the protection of trade and business secrets should be respected. The exchange of information comes often with certain taxpayer's rights, for instance the notification, consultation, and intervention rights.

Regarding the possibility for Pakistan to provide information to other countries, Section 216, subsection 3 (q) of the Ordinance allows the disclosure of taxpayer information by an officer of the tax administration to an authorized officer of the government of any country outside Pakistan with which the Government has entered into a DTA in pursuance of that agreement. There are no detailed rules included in this provision, and there is a need for developing detailed guidelines in this area.

Dispute Resolution

Conflicts between taxpayers and tax administration on International tax issues are following the same appeal procedure as disputes on domestic tax issues. The taxpayer can file appeal in first instance with an appeal commissioner (only appeal possibility within the CBR). The second (factual) instance is formed by the income tax Appeal Tribunal. In addition, a (provincial) High Court decides in first instance on constitutional and/or legal disputes. Decisions by the high court can be finally appealed by the Supreme Court. Their decisions are binding on all parties.

Pakistan has tried on a number of occasions to introduce alternative dispute resolution procedures to reduce the number of taxpayers going into appeal procedure. These attempts were blocked as they lack sufficient possibility for taxpayers to judicial appeal. The alternative of mediation – which has been used in other common law countries like for instance Canada, Australia and New Zealand – was discussed. Mediation has been successfully used in cases where technical issues were mingled with personal issues between tax officer and taxpayer, and where the last issues could be eliminated. Mediation is typically ordered by the judge upon the parties.

Reduction of Withholding Tax Rates

Most DTAs which has been concluded by Pakistan contain reduced withholding tax rates for dividend, interest, royalty, and technical service fees. Typically, DTAs are accompanied by implementation regulations that contain provisions which method taxpayers should use to effectively realize this reduction. The nonresident taxpayer can either provide the payer in the State of source with a proof of residence issued by the tax authorities in the State of residence in order to enjoy the reduced withholding rates immediately at source, or file a tax return after having received the net payment and claim back the excess withholding tax. There is a need in Pakistan to issue regulation on this issue.

Foreign Tax Credit

Section 103 of the Ordinance provides for the relief for double taxation in the form of an ordinary tax credit. This means that a tax credit is provided for the lesser of the foreign income tax paid or the Pakistan tax payable in respect of the foreign sourced income. Pakistan does not provide for an excess foreign tax credit, meaning that if the domestic tax debt exceeds the foreign tax credit, no carry forward or cash refund is granted.

The first issue is whether the credit limitation uses and overall or per-country method. In the first case the limitation is based on the taxpayer's overall foreign income, whereas in the latter the limitation is computed separately on the basis of the income and the taxes arising in each foreign country. A second issue is whether the foreign tax can be regarded as an "income" tax or – even more principle – whether the foreign payment is a "tax" (e.g. oil and gas payments). Finally, an issue may raise when income is not realized

in the same tax period in both countries. Neither of these issues has been addressed in the Ordinance (or Income Tax Rules 2002).

“Most Favored Nation” – clauses

In some DTAs a “Most Favored Nation”-clause has been introduced in respect to the royalty provision.³⁴ Such provisions become redundant as soon as a lower withholding tax rate is agreed in a subsequently negotiated DTA. This is not good practice as it results in an unilateral reduction of the withholding tax rate on royalties³⁵ and will not help Pakistan in the long run to establish its own international tax policy.

³⁴ See for example in the additional protocol attached to the DTA with Italy regarding the Articles 11 and 12.

³⁵ The rate reciprocity with Italy (30%) has been broken as Pakistan negotiated a lower rate with Yemen (10%).

Part II Trade Agreements

“As Pakistan already reduced its custom duties over the last decades from 125% down to maximum 25% currently, the revenue foregone by concluding free trade agreements should no longer be a serious issue.”

Mr. Jamshid Khan (Ministry of Commerce)

Pakistan has concluded two preferential trade agreements (PTA); one with the Islamic Republic of Iran (2004) and another one with the Republic of Mauritius (2007). The latter has not yet entered into force. Both PTAs are of a limited scope as they provide for tariff reduction against approximately 70 tariff lines.

More extensive free trade agreements (FTA) has been concluded with SAFTA³⁶ (2004), Sri Lanka (2004), China (2006), and Malaysia (2007). The last one not (yet) being into force. These FTAs provide for tariff reductions on a broad basis over a period of 3-5 years. At first sight the SAFTA agreement including India would be the most important one. However, due to the fact that the border between India and Pakistan is completely closed, the revenue impact is negligible. Another important FTA is the one with China, but cross border trade in that region (the far North) is not yet sizeable to have much impact on revenue either. Finally, one has to bear in mind that the reduction of the tariff is scheduled over a period of 3-5 years, which means that the full impact will only be seen after 2012 at the earliest.

³⁶ SAFTA stands for South Asian Free Trade Area which was concluded by the South Asian Association for Regional Cooperation comprising Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka.

The Government requested an analysis between the foregone revenue and the increase of trade by concluding these agreements. In my opinion the following issues must be raised: (a) no data are yet available regarding the trade effects as the PTA and FTA are just very recently (or not at all) entered into force; (b) a separate research for each country (or even per industry branch) has to be performed; (c) even if comparison between FDI-information per country between past investment and investments made after enactment of the agreements is possible, one might separate also other elements that might have been influential in those changes.³⁷ In my opinion, this economic study cannot yet be conducted.

Finally, one could ask what would be the consequence for any possible outcome; either there is a positive correlation between concluding FTA's and FDI or there is not. In either situation I doubt very much that Pakistan has a choice. Globalization forces countries to reduce (or even abolish) their custom duty and tariff depending on the markets they have to compete. This is also one of the goals of the WTO. As The only relevant tax policy question would be how much revenue is foregone as this may have to be recovered by some other tax measures.

³⁷ E.g. other developments in international trade patterns, like for instance price changes on the world market, or indirect effects caused by a redirection of trade patterns by third countries (provided that the rules of origin apply).

APPENDIX

APPENDIX 1: Selection of International Tax Provisions in the Income Tax Ordinance 2001

Section 6 – Tax on certain payments to non-residents

- (1) Subject to this Ordinance. A tax shall be imposed, at the rate specified in Division IV of Part I of the First Schedule, on every non-resident person who receives any Pakistani-source royalty or fee for technical services.
- (2) The tax imposed under sub-section (1) on a non-resident person shall be computed by applying the relevant rate of tax to the gross amount of the royalty or fee for technical services.
- (3) This section shall not apply to –
 - (a) any royalty where the property or right giving rise to the royalty is effectively connected with a permanent establishment in Pakistan of the non-resident person;
 - (b) any fee for technical services where the services giving rise to the fee are rendered through a permanent establishment in Pakistan of the non-resident person; or
 - (c) any royalty or fee for technical services that is exempt from tax under this Ordinance.
- (4) Any Pakistani-source royalty or fee for technical services received by a non-resident person to which this section does not apply by virtue of clause (a) or (b) of sub-section (3) shall be treated as income from business attributable to the permanent establishment in Pakistan of the person.

Section 7 – Tax on shipping and air transport income of a non-resident person

- (1) Subject to this Ordinance, a tax shall be imposed, at the rate specified in Division V of Part I of the First Schedule, on every non-resident person carrying on the business of operating ships or aircraft as the owner or charterer thereof in respect of –
 - (a) the gross amount received or receivable (whether in or out of Pakistan) for the carriage of passengers, livestock, mail or goods embarked in Pakistan; and
 - (b) the gross amount received or receivable in Pakistan for the carriage of passengers, livestock, mail or goods embarked in Pakistan.
- (2) The tax imposed under sub-section (1) on a non-resident person shall be computed by applying the relevant rate of tax to the gross amount referred to in sub-section (1).
- (3) This section shall not apply to any amounts exempt from tax under this Ordinance.

Section 42 – Diplomatic and United nations exemptions

- (1) The income of an individual entitled to privileges under the Diplomatic and Consular Privileges Act, 1972 (IX of 1972), shall be exempt from tax under this Ordinance to the extent provided for in that Act.
- (2) The income of an individual entitled to privileges under the United Nations (Privileges and Immunities) Act, 1948 (XX of 1948), shall be exempt from tax under this Ordinance to the extent provided for in that Act.
- (3) any pension received by a person, being a citizen of Pakistan, by virtue of the person's former employment in the United Nations or its specialized agencies (including the International Court of Justice) provided the person's salary from such employment was exempt under this Ordinance.

Section 43 – Foreign government officials

Any salary received by an employee of a foreign government as remuneration for services rendered to such government shall be exempt from tax under this Ordinance provided –

- (a) the employee is a citizen of the foreign country and not a citizen of Pakistan;
- (b) the services performed by the employee are of a character similar to those performed by employees of the Federal Government in foreign countries; and
- (c) the foreign government grants a similar exemption to employees of the Federal Government performing similar services in such foreign country.

Section 44 – Exemptions under international agreements

- (1) Any Pakistani-source income which Pakistan is not permitted to tax under a tax treaty shall be exempt from tax under this Ordinance.
- (2) Any salary received by an individual (not being a citizen of Pakistan) shall be exempt from tax under this Ordinance to the extent provided for in an Aid Agreement between the Federal Government and a foreign government or public international organization, where –
 - (a) the individual is either a non-resident individual or a resident individual solely by reason of the performance of services under the Aid Agreement;
 - (b) if the Aid Agreement is with a foreign country, the individual is a citizen of that country; and
 - (c) the salary is paid by the foreign government or public international organization out of funds or grants released as aid to Pakistan in pursuance of such Agreement.

- (3) Any income received by a person (not being a citizen of Pakistan) engaged as a contractor, consultant, or expert on a project in Pakistan shall be exempt from tax under this Ordinance to the extent provided for in a bilateral or multilateral technical assistance agreement between the Federal Government and a foreign government or public international organization, where –
- (a) the project is financed out of grant funds in accordance with the agreement;
 - (b) the person is either a non-resident person or a resident person solely by reason of the performance of services under the agreement; and
 - (c) the income is paid out of the funds of the grant in pursuance of the agreement.

Section 50 – Foreign-source income of short-term resident individuals

- (1) Subject to sub-section (2), the foreign-source income of an individual (other than a citizen of Pakistan) –
- (a) who is a resident individual solely by reason of the individual’s employment, and
 - (b) who is present in Pakistan for a period or periods not exceeding three years, shall be exempt from tax under this Ordinance.
- (2) This section shall not apply to –
- (a) any income derived from a business of the person established in Pakistan; or
 - (b) any foreign-source income brought into or received in Pakistan by the person.

Section 51 – Foreign-source income of returning expatriates

Any foreign-source income derived by a citizen of Pakistan in a tax year who was not a resident individual in any of the four tax years preceding the tax year in which the individual became a resident shall be exempt from tax under this Ordinance in the tax year in which the individual became a resident individual and in the following tax year.

Section 78 – Non-arm’s length transactions

Where an asset is disposed of in a non-arm’s length transaction –

- (a) the person disposing of the asset shall be treated as having received consideration equal to the fair market value of the asset determined at the time the asset is disposed; and
- (b) the person acquiring the asset shall be treated as having a cost equal to the amount determined under clause (a).

Section 81 – Resident and non-resident persons

- (1) A person shall be a resident person for a tax year if the person is –
- (a) a resident individual, resident company or resident association of persons for the year; or
 - (b) the Federal Government.
- (2) A person shall be a non-resident person for a tax year if the person is not a resident person for that year.

Section 82 – Resident individual

An individual shall be a resident individual for a tax year if the individual –

- (a) is a resident of Pakistan for a period of, or periods amounting in aggregate to, one hundred and eighty-two days or more in the tax year;
- (b) is present in Pakistan for a period of, or periods amounting in aggregate to, ninety days or more in the tax year and who, in the four years preceding the tax year, has been in Pakistan for a period of, or periods amounting in aggregate to, three hundred and sixty-five days or more; or
- (c) is an employee or official of the federal Government or a Provincial Government posted abroad in the tax year.

Section 83 – Resident company

A company shall be a resident company for a tax year if –

- (a) it is incorporated or formed by or under any law in force in Pakistan;
- (b) the control and management of the affairs of the company is situated wholly or almost wholly in Pakistan at any time in the year; or
- (c) it is a Provincial Government or local authority in Pakistan.

Section 84 – Resident association of persons

An association of persons shall be a resident association of persons for a tax year if the control and management of the affairs of the association is situated wholly or partly in Pakistan at any time in the year.

Section 101 – Geographical source of income

- (1) Salary shall be Pakistan-source income to the extent to which the salary –
- (a) is received from any employment exercised in Pakistan, wherever paid; or

- (b) is paid by, or on behalf of, the Federal Government, a Provincial Government, or a local authority in Pakistan, wherever the employment is exercised.
- (2) Business income of a resident person shall be Pakistan-source income to the extent to which the income is derived from any business carried on in Pakistan.
- (3) Business income of a non-resident person shall be Pakistan-source income to the extent to which it is directly or indirectly attributable to –
 - (a) a permanent establishment of the non-resident person in Pakistan;
 - (b) sales in Pakistan of goods or merchandise of the same or similar kind as those sold by the person through a permanent establishment in Pakistan; or
 - (c) other business activities carried on in [Pakistan of the same or similar kind as those effected by the non-resident through a permanent establishment in Pakistan.
- (4) Where the business of a non-resident person comprises the rendering of independent services (including professional services and the services of entertainers and sportspersons), the Pakistan-source business income of the person shall include (in addition to any amount treated as Pakistan-source income under sub-section (3)) any remuneration derived by the person where –
 - (a) the remuneration is paid by a resident person or borne by a permanent establishment in Pakistan of a non-resident person; and
 - (b) the aggregate gross amount (before deduction of expenses) of the remuneration is sixty thousand rupees or more.
- (5) Any gain from the disposal of any asset or property used in deriving any business income referred to in sub-section (2), (3) or (4) shall be Pakistan-source income
- (6) A dividend shall be Pakistan-source income if it is paid by a resident company.
- (7) Profit on debt shall be Pakistan-source income if it is –
 - (a) paid by a resident person, except where the profit is payable in respect of any debt used for the purposes of a business carried on by the resident outside Pakistan through a permanent establishment; or
 - (b) borne by a permanent establishment in Pakistan of a non-resident person.
- (8) A royalty shall be Pakistan-source income if it is –
 - (a) paid by a resident person, except where the royalty is payable in respect of any right, property, or information used, or services utilized for the purposes of a business carried on by the resident outside Pakistan through a permanent establishment; or
 - (b) borne by a permanent establishment in Pakistan of a non-resident person.

- (9) Rental income shall be Pakistan-source income if it is derived from the lease of immovable property in Pakistan whether improved or not, or from any other interest in or over immovable property, including a right to explore for, or exploit, natural resources in Pakistan.
- (10) Any gain from the alienation of any property or right referred to in sub-section (9) or from the alienation of any share in a company the assets of which consist wholly or principally, directly or indirectly, of property or rights referred to in sub-section (9) shall be Pakistan-source income.
- (11) A pension or annuity shall be Pakistan-source income if it is paid by a resident or borne by a permanent establishment in Pakistan of a non-resident person.
- (12) A technical fee shall be Pakistan-source income if it is –
- (a) paid by a resident person, except where the fee is payable in respect of services utilized in a business carried on by the resident outside Pakistan through a permanent establishment; or
 - (b) borne by a permanent establishment in Pakistan of a non-resident person.
- (13) Any gain arising on the disposal of shares in a resident company shall be Pakistan-source income.
- (14) Any amount not mentioned in the preceding sub-sections shall be Pakistan-source income if it is paid by a resident person or borne by a permanent establishment in Pakistan of a non-resident person.
- (15) Where an amount may be dealt with under sub-section (3) and under another sub-section (other than sub-section (14)), this section shall apply –
- (a) by first determining whether the amount is Pakistan-source income under that other sub-section; and
 - (b) if the amount is not Pakistan-source income under that sub-section, then determining whether it is Pakistan-source income under sub-section (3).
- (16) An amount shall be foreign-source income to the extent to which it is not Pakistan-source income.

Section 102 – Foreign source salary of resident individuals

- (1) Any foreign-source salary received by a resident individual shall be exempt from tax if the individual has paid foreign income tax in respect of the salary.

- (2) A resident individual shall be treated as having paid foreign income tax in respect of foreign-source salary if tax has been withheld from the salary by the individual's employer and paid to the revenue authority of the foreign country in which the employment was exercised.

Section 103 – Foreign tax credit

- (1) Where a resident taxpayer derives foreign-source income chargeable to tax under this Ordinance in respect of which the taxpayer has paid foreign income tax, the taxpayer shall be allowed a tax credit of an amount equal to the lesser of –
 - (a) the foreign income tax paid; or
 - (b) the Pakistan tax payable in respect of the income.
- (2) For the purposes of clause (b) of sub-section (1), the Pakistan tax payable in respect of foreign-source income derived by a taxpayer in a tax years shall be computed by applying the average rate of Pakistan income tax applicable to the taxpayer for the year against the taxpayer's net foreign-source income for the year.
- (3) Where, in a tax year, a taxpayer has foreign-source income under more than one head of income, this section shall apply separately to each head of income.
- (4) For the purpose of sub-section (3), income derived by a taxpayer from carrying on a speculation business shall be treated as a separate head of income.
- (5) The tax credit allowed under this section shall be applied in accordance with sub-section (3) of section 4.
- (6) Ant tax credit or part of a tax credit allowed under this section for a tax year that is not credited under sub-section (3) of section 4 shall not be refunded, carried back to the preceding year, or carried forward to the following tax year.
- (7) A credit shall be allowed under this section only if the foreign income tax is paid within two years after the end of the tax year in which the foreign income to which the tax relates was derived by the resident taxpayer.
- (8) In this section, -
 - “*average rate of Pakistan income tax*” in relation to a taxpayer for a tax years, means the percentage that the Pakistani income tax (before allowance of the tax credit under this section) is of the taxable income of the taxpayer for the year;
 - “*foreign income tax*” includes a foreign withholding tax; and
 - “*net foreign-source income*” in relation to a taxpayer for a tax year, means the total foreign-source income of the taxpayer charged to tax in the year, as reduced by any deductions allowed to the taxpayer under this Ordinance for the year that –
 - (a) relate exclusively to the derivation of the foreign-source income; and

- (b) are reasonably related to the derivation of foreign-source income in accordance with sub-section (1) of section 67 and any rules made for the purposes of that section.

Section 104 – Foreign losses

- (1) Deductible expenditures incurred by a person in deriving foreign-source income chargeable to tax under a head of income shall be deductible only against that income.
- (2) If the total deductible expenditures referred to in sub-section (1) exceed the total foreign-source income for a tax year chargeable to tax under a head of income (hereinafter referred to as a “foreign loss”), the foreign loss shall be carried forward to the following tax year and set off against the foreign-source income chargeable to tax under that head in that year, and so on, but no foreign loss shall be carried forward to more than six tax years immediately succeeding the tax year for which the loss was computed.
- (3) Where a taxpayer has a foreign loss carried forward for more than one tax years, the loss for the earliest year shall be set off first.
- (4) Section 67 shall apply for the purposes of this section on the basis that –
 - (a) income from carrying on a speculation business is a separate head of income; and
 - (b) foreign source income chargeable under a head of income (including the head specified in clause (a)) shall be a separate head of income.

Section 105 – Taxation of a permanent establishment in Pakistan of a non-resident person

- (1) The following principles shall apply in determining the income of a permanent establishment in Pakistan of a non-resident person chargeable to tax under the head “income from Business”, namely: -
 - (a) The profit of a permanent establishment shall be computed on the basis that it is a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the non-resident person of which it is a permanent establishment;
 - (b) subject to this Ordinance, there shall be allowed as deductions any expenses incurred for the purposes of the business activities of the permanent establishment including executive and administrative expenses so incurred, whether in Pakistan or elsewhere;
 - (c) no deduction shall be allowed for amounts paid or payable by the permanent establishment to its head office or to another permanent establishment of the non-resident person (other than towards reimbursement of actual expenses incurred by the non-resident person to third parties) by way of:

- (i) royalties, fees or other similar payments for the use of any tangible or intangible asset by the permanent establishment;
 - (ii) compensation for any services including management services performed for the permanent establishment; or
 - (iii) profit on debt on moneys lent to the permanent establishment, except in connection with a banking business; and
- (d) no account shall be taken in the determination of the income of a permanent establishment of amounts charged by the permanent establishment to the head office or to another permanent establishment of the non-resident person (other than towards reimbursement of actual expenses incurred by the permanent establishment to third parties) by way of:
- (i) royalties, fees or other similar payments for the use of any tangible or intangible asset;
 - (ii) compensation for any services including management services performed by the permanent establishment; or
 - (iii) profit on debt on moneys lent by the permanent establishment, except in connection with a banking business.
- (2) No deduction shall be allowed in computing the income of a permanent establishment in Pakistan of a non-resident person chargeable to tax under the head “Income from Business” for a tax year for head office expenditure in excess of the amount as bears to the turnover of the permanent establishment in Pakistan the same proportion as the non-resident’s total head office expenditure bears to its worldwide turnover.
- (3) In this section, “head office expenditure” means any executive or general administration expenditure incurred by the non-resident person outside Pakistan for the purposes of the business of the Pakistan permanent establishment of the person, including –
- (a) any rent, local rates and taxes excluding any foreign income tax, current repairs, or insurance against risks of damage or destruction outside Pakistan;
 - (b) any salary paid to an employee employed by the head office outside Pakistan;
 - (c) any traveling expenditures of such employee; and
 - (d) any other expenditures which may be prescribed.
- (4) No deduction shall be allowed in computing the income of a permanent establishment in Pakistan of a non-resident person chargeable under the head “Income from Business” for –
- (a) any profit paid or payable by the non-resident person on debt to finance the operations of the permanent establishment; or
 - (b) any insurance premium paid or payable by the non-resident person in respect of such debt.

Section 106 – Thin capitalization

(1) Where a foreign-controlled resident company (other than a financial institution [or a banking company]) has a foreign debt-to-foreign equity ratio in excess of three to one at any time during a tax year, a deduction shall be disallowed for the profit on debt paid by the company in that year on that part of the debt which exceeds the three to one ratio.

(2) In this section, -

“foreign-controlled resident company” means a resident company in which fifty per cent or more of the underlying ownership of the company is held by a non-resident person (hereinafter referred to as the “foreign controller”) either alone or together with an associate or associates;

“foreign debt” in relation to a foreign-controlled resident company, means the greatest amount, at any time in a tax year, of the sum of the following amounts, namely:-

- (a) The balance outstanding at that time on any debt obligation owed by the foreign-controlled resident company to a foreign controller or non-resident associate of the foreign controller on which profit on debt is payable which profit on debt is deductible to the foreign-controlled resident company and is not taxed under this Ordinance or is taxable at a rate lower than the [corporate rate] of tax applicable on assessment to the foreign controller or associate; and
- (b) the balance outstanding at that time on any debt obligation owed by the foreign-controlled resident company to a person other than the foreign controller or an associate of the foreign controller where that person has a balance outstanding of a similar amount on a debt obligation owed by the person to the foreign controller or a non-resident associate of the foreign controller; and

“foreign equity” in relation to a foreign-controlled resident company and for a tax year, means the sum of the following amounts, namely:-

- (a) The paid-up value of all shares in the company owned by the foreign controller or a non-resident associate of the foreign controller at the beginning of the tax year;
- (b) so much of the amount standing to the credit of the share premium account of the company at the beginning of the tax year as the foreign controller or a non-resident associate would be entitled to if the company were wound up at that time; and so much of the accumulated profits and asset revaluation reserves of the company at the beginning of the tax year as the foreign controller or a non-resident associate of the foreign controller would be entitled to if the company were wound up at that time; reduced by the sum of the following amounts, namely:-
 - (i) The balance outstanding at the beginning of the tax year on any debt obligation owed to the foreign controlled resident company by the foreign controller or a non-resident associate of the foreign controller; and

- (ii) where the foreign-controlled resident company has accumulated losses at the beginning of the tax year, the amount by which the return of capital to the foreign controller or non-resident associate of the foreign controller would be reduced by virtue of the losses if the company were wound up at that time.

Section 107 – Agreements for the avoidance of double taxation and prevention of fiscal evasion

- (1) The Federal Government may enter into an agreement with the government of a foreign country for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income imposed under this Ordinance and under the corresponding laws in force in that country, and may, by notification in the official Gazette make such provisions as may be necessary for implementing the agreement.
- (2) Where any agreement is made in accordance with sub-section (1), the agreement and the provisions made by notification for implementing the agreement shall, notwithstanding anything contained in any law for the time being in force, have effect in so far as they provide for –
 - (a) relief from the tax payable under this Ordinance;
 - (b) the determination of the Pakistan-source income of nonresident persons;
 - (c) where all the operations of a business are not carried on within Pakistan, the determination of the income attributable to operations carried on within and outside Pakistan, or the income chargeable to tax in Pakistan in the hands of nonresident persons, including their agents, branches, and permanent establishments in Pakistan;
 - (d) the determination of the income to be attributed to any resident person having a special relationship with a nonresident person; and
 - (e) the exchange of information for the prevention of fiscal evasion or avoidance of taxes on income chargeable under this Ordinance and under the corresponding laws in force in that other country.
- (3) Notwithstanding anything in sub-sections (1) or (2), any agreement referred to in sub-section (1) may include provisions for the relief from tax for any period before the commencement of this Ordinance or before the making of the agreement.

Section 143 – Non-resident ship owner or charter

- (1) Before the departure of a ship owned or chartered by a nonresident person from any port in Pakistan, the master of the ship shall furnish to the Commissioner a return showing the gross amount specified in sub-section (1) of section 7 in respect of the ship.
- (2) Where the master of a ship has furnished a return under sub-section (1), the Commissioner shall [, after calling for such particulars, accounts or documents as he

may require,] determine the amount of tax due under section 7 in respect of the ship and, as soon as possible, notify the master, in writing, of the amount payable.

- (3) The master of a ship shall be liable for the tax notified under sub-section (2) and the provisions of this Ordinance shall apply to such tax as if it were tax due under an assessment order.
- (4) Where the Commissioner is satisfied that the master of a ship or non-resident owner or charterer of the ship is unable to furnish the return required under sub-section (1) before the departure of the ship from a port in Pakistan, the Commissioner may allow the return to be furnished within thirty days of departure of the ship provided the non-resident owner or charterer has made satisfactory arrangements for the payment of the tax due under section 7 in respect of the ship.
- (5) The Collector of Customs or other authorized officer shall not grant a port clearance for a ship owned or chartered by a non-resident person until the Collector or officer is satisfied that any tax due under section 7 in respect of the ship has been paid or that arrangements for its payment have been made to the satisfaction of the Commissioner.
- (6) This section shall not relieve the non-resident owner or charterer of the ship from liability to pay any tax due under this section that is not paid by the master of the ship.

Section 144 – Non-resident aircraft owner or charter

- (1) A non-resident owner or charterer of an aircraft shall be liable for tax under section 7, or an agent authorized by the non-resident person for this purpose, shall furnish to the Commissioner, within forty-five days from the last day of each quarter of the financial year, a return, in respect of the quarter, showing the gross amount specified in sub-section (1) of section 7 of the non-resident person for the quarter.
- (2) Where a return has been furnished under sub-section (1), the Commissioner shall [, after calling for such particulars, accounts or documents as he may require,] determine the amount of tax due under section 7 by the non-resident person for the quarter and notify the non-resident person, in writing, of the amount payable.
- (3) The non-resident person shall be liable to pay the tax notified under sub-section (2) within the time specified in the notice and the provisions of this Ordinance shall apply to such tax as if it were tax due under an assessment order.
- (4) Where the tax referred to in sub-section (3) is not paid within three months of service of the notice, the Commissioner may issue to the authority by whom clearance may be granted to the aircraft operated by the non-resident person a certificate specifying the name of the non-resident person and the amount of tax due.

- (5) The authority to whom a certificate is issued under sub-section (4) shall refuse clearance from any airport in Pakistan to any aircraft owned or chartered by the non-resident until the tax due has been paid.

Section 152 – Payments to non-residents

- (1) Every person paying an amount of 150[royalty] or fees for technical services to a non-resident person that is chargeable to tax under section 6 shall deduct tax from the gross amount paid at the rate specified in Division IV of Part I of the First Schedule.
- (2) Subject to sub-section (3), every person paying an amount to a non-resident person (other than an amount to which sub-section (1) applies) shall deduct tax from the gross amount paid at the rate specified in Division II of Part III of the First Schedule.
- (3) Sub-section (2) does not apply to an amount –
- (a) that is subject to deduction of tax under section 149, 150, 153, 155 or 156;
 - (b) with the written approval of the Commissioner, that is taxable to a permanent establishment in Pakistan of the non-resident person;
 - (c) that is payable by a person who is liable to pay tax on the amount as representative of the non-resident person under sub-section (3) of section 172; or
 - (d) where the non-resident person is not chargeable to tax in respect of the amount.
- (4) Where a person claims to be a representative of a non-resident person for the purposes of clause (c) of sub-section (3), the person shall file a declaration to that effect with the Commissioner prior to making any payment to the non-resident person.
- (5) Where a person intends to make a payment to a non-resident person without deduction of tax under this section, the person shall, before making the payment, furnish to the Commissioner a notice in writing setting out –
- (a) the name and address of the non-resident person; and
 - (b) the nature and amount of the payment.
- (6) Where a person has notified the Commissioner of a payment under sub-section (5) and the Commissioner has reasonable grounds to believe that the non-resident person is chargeable to tax under this Ordinance in respect of the payment, the Commissioner may, by notice in writing, direct the person making the payment to deduct tax from the payment in accordance with sub-section (2).
- (7) Sub-section (5) shall not apply to a payment on account of –
- (a) [on] import of goods where title to the goods passes outside Pakistan, except an the import that is part of an overall arrangement for the supply of goods, their installation, and any commission and guarantees in respect of the supply where –

- (i) the supply is made by the head office outside Pakistan of a person to a permanent establishment of the person in Pakistan;
 - (ii) the supply is made by a permanent establishment of the person outside Pakistan to a permanent establishment of the person in Pakistan;
 - (iii) the supply is made between associates; or
 - (iv) the supply is made by a resident person or a Pakistan permanent establishment of a non-resident person; or
- (b) educational and medical expenses remitted in accordance with the regulations of the State Bank of Pakistan.

Section 206A – Advance Ruling

- (1) The [Board] may, on application in writing by a non-resident taxpayer, issue to the taxpayer an advance ruling setting out the Commissioner's position regarding the application of this Ordinance to a transaction proposed or entered into by the taxpayer.
- (2) Where the taxpayer has made a full and true disclosure of the nature of all aspects of the transaction relevant to the ruling and the transaction has proceeded in all material respects as described in the taxpayer's application for the ruling, the ruling is [binding] on the Commissioner with respect to the application to the transaction of the law as it stood at the time the ruling was issued.

APPENDIX 2: Double Tax Agreements Concluded by Pakistan

Country	Date of signature	Country	Date of signature
<i>Austria</i>	04-08-2005	<i>Morocco</i>	18-05-2006
<i>Azerbaijan</i>	10-04-1996	<i>Nepal</i>	25-01-2001
<i>Bahrain</i>	27-06-2005	<i>Netherlands</i>	24-03-1982
<i>Bangladesh</i>	15-10-1981	<i>Nigeria</i>	10-10-1989
<i>Belarus</i>	23-07-2004	<i>Norway</i>	07-10-1986
<i>Belgium</i>	17-03-1980	<i>Oman</i>	12-06-1999
<i>Bosnia & Herzegovina</i>	24-08-2004	<i>Philippines</i>	21-04-1979
<i>Canada</i>	24-02-1976	<i>Poland</i>	25-10-1974
<i>China</i>	15-11-1989	<i>Portugal</i>	23-06-2000
<i>Denmark</i>	22-10-1987	<i>Qatar</i>	06-04-1999
<i>Egypt</i>	16-12-1995	<i>Romania</i>	27-07-1999
<i>Finland</i>	30-12-1994	<i>SAARC³⁸</i>	07-12-2004
<i>France</i>	15-06-1994	<i>Saudi Arabia</i>	02-02-2006
<i>Germany</i>	14-07-1994	<i>Singapore</i>	13-04-1993
<i>Hungary</i>	24-02-1992	<i>South Africa</i>	26-06-1998
<i>Indonesia</i>	07-10-1990	<i>Sri Lanka</i>	05-10-1981
<i>Iran</i>	27-05-1999	<i>Sweden</i>	22-12-1985
<i>Ireland</i>	01-04-1973	<i>Switzerland</i>	03-12-1959
<i>Italy</i>	24-06-1984	<i>Syria</i>	16-03-2001
<i>Japan</i>	17-02-1959	<i>Tajikistan</i>	13-05-2004
<i>Jordan</i>	09-03-2006	<i>Thailand</i>	14-08-1980
<i>Kazakhstan</i>	23-08-1995	<i>Tunisia</i>	18-04-1994
<i>Korea</i>	13-04-1987	<i>Turkey</i>	14-11-1985
<i>Kuwait</i>	30-06-1998	<i>Turkmenistan</i>	20-10-1994
<i>Kyrgyz Republic</i>	29-04-2003	<i>United Arab Emirates</i>	07-02-1993
<i>Lebanon</i>	27-02-2003	<i>United Kingdom</i>	24-11-1986
<i>Libya</i>	09-01-1975	<i>United States</i>	01-07-1957
<i>Malaysia</i>	29-05-1982	<i>Uzbekistan</i>	22-05-1995
<i>Malta</i>	08-10-1975	<i>Yemen</i>	02-03-2005
<i>Mauritius</i>	03-09-1994	<i>Vietnam</i>	25-04-2004

³⁸ SAARC: South Asian Association for Regional Cooperation (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka); limited treaty on exchange of information and assistance in tax collection.

APPENDIX 3: DBA – Withholding Tax Rates on Royalty and Technical Service Fees

Country	Royalty		Technical Service		Remarks
	Domestic rate	DTA rate	Domestic rate	DTA rate	
<i>Austria</i>	20	10	20	10	
<i>Azerbaijan</i>		10		-	
<i>Bangladesh</i>	10	15	10	-	
<i>Belgium</i>	15	0/15/20	-	-	DTA rates depend on kind of royalty
<i>Bosnia & Herzog.</i>		15		-	
<i>Canada</i>	25	15/20	-	-	CAN: 15%; PAK: 20%
<i>China</i>	10	12.5	10	12.5	
<i>Denmark</i>	30	12	-	12	
<i>Egypt</i>	20	15	20	15	
<i>Finland</i>	28	10			Royalty incl. technical service fee
<i>France</i>	33.3	10	33.3	10	
<i>Germany</i>	21.1	10			Royalty Incl. technical service fee
<i>Hungary</i>	0	15	0	15	
<i>Indonesia</i>	20	15	6	15	
<i>Iran</i>		10		-	
<i>Ireland</i>	20	0	-	-	
<i>Italy</i>	30/(22.5*)	30	-	-	* effective rate (75% in basis)
<i>Japan</i>	20	0	20	-	
<i>Kazakhstan</i>		15		-	
<i>Korea</i>	25	10	25	-	
<i>Kuwait</i>		10		-	
<i>Libya</i>		0		-	
<i>Malaysia</i>	10	15	10	-	
<i>Malta</i>	0	0/10	-	-	DTA rate depends on kind of royalty
<i>Mauritius</i>	10	12.5	10	-	
<i>Nepal</i>		15			Royalty incl. technical service fee
<i>Netherlands</i>	0	5/15	0	-	Low rate for literary, artistic and scientific royalties
<i>Nigeria</i>	10	15	10	-	
<i>Norway</i>	0	12	0	12	
<i>Oman</i>		12.5		12.5	
<i>Philippines</i>		15/25		-	Low rate in preferred areas
<i>Poland</i>	20	15/20	20	-	DTA rate depends on kind of royalty
<i>Portugal</i>	15	10			Royalty incl. technical service fee

APPENDIX 3: Withholding Tax Rates on Royalty and Technical Service Fees
(continued)

Country	Royalty		Technical Service		Remarks
	Domestic rate	DTA rate	Domestic rate	DTA rate	
<i>Qatar</i>		10			Royalty incl. technical service fee
<i>Romania</i>	16	12.5	16	10	
<i>Singapore</i>	10	10	20	10	
<i>South Africa</i>	12	10			Royalty incl. technical service fee
<i>Sri Lanka</i>		20		-	
<i>Sweden</i>	0	10	0	10	
<i>Switzerland</i>	0	0	0	-	
<i>Saudi Arabia</i>	15	10	5/20	-	
<i>Syria</i>		10/15/18		-	DTA rate depends on kind of royalty
<i>Tajikistan</i>		10		-	
<i>Thailand</i>		10/20		-	Low rate for literary, artistic and scientific royalties
<i>Tunisia</i>	15	10	15	-	
<i>Turkey</i>	20	10	20	-	
<i>Turkmenistan</i>		10		-	
<i>UAE</i>		12		12	
<i>United Kingdom</i>	22	12.5	-	12.5	
<i>United States</i>	30	0	-	-	
<i>Uzbekistan</i>		15		-	
<i>Yemen</i>		10		10	
<i>Vietnam</i>		15		15	

APPENDIX 4: DBA – Withholding Tax Rates on Dividends and Interest

Country	<i>Dividend</i>		<i>Interest</i>	
	Domestic rate	DTA rate	Domestic rate	DTA rate
<i>Austria</i>	25	10/15 ³⁹	25	15
<i>Azerbaijan</i>		10		10
<i>Bangladesh</i>	15	15	0/5/10	15
<i>Belgium</i>	25	10-15	15	15
<i>Bosnia & Herzegovina</i>		10		20
<i>Canada</i>	25	15-20	25	15-25
<i>China</i>	10	10	10	10
<i>Denmark</i>	28	15	0	15
<i>Egypt</i>	0	15/30	20/32	15
<i>Finland</i>	28	12/15/20	0	10/15
<i>France</i>	25	10/15	16	10
<i>Germany</i>	21.1	10/15	0	10/20
<i>Hungary</i>	0	15/20	0	15
<i>Indonesia</i>	20	10/15	20	15
<i>Iran</i>		5		10
<i>Ireland</i>	20	10/0	20	0
<i>Italy</i>	27	15/25	12.5/27	30
<i>Japan</i>	20	0/6.25/15	15	0
<i>Kazakhstan</i>		12.5/15		12.5
<i>Korea</i>	25	10/12.5	25	12.5
<i>Kuwait</i>		10		10
<i>Libya</i>		0		0
<i>Malaysia</i>	0	15/20	15	15
<i>Malta</i>	0	15	0	10
<i>Mauritius</i>	0	10	15	10
<i>Nepal</i>		10/15		10/15
<i>Netherlands</i>	15	10/20	0	10/15/20
<i>Nigeria</i>	10	12.5/15	10	15
<i>Norway</i>	25	15	0	10
<i>Oman</i>		10/12.5		10
<i>Philippines</i>		15/25		15
<i>Poland</i>	19	0/15	20	
<i>Portugal</i>	20	10/15	20	10
<i>Qatar</i>		5/10		10
<i>Romania</i>	16	10	0/16	10
<i>Singapore</i>	0	10/12.5/15	15	12.5

³⁹ First rate applies to qualifying participations; second rate applies to all other situations.

APPENDIX 4: DBA – Withholding Tax Rates on Dividends and Interest (continued)

Country	<i>Dividend</i>		<i>Interest</i>	
	Domestic rate	DTA rate	Domestic rate	DTA rate
<i>South Africa</i>	0	10/15	0	10
<i>Sri Lanka</i>		15		10
<i>Sweden</i>	30	0/15	0	15
<i>Switzerland</i>	35	0/6.25/15	35	
<i>Saudi Arabia</i>	5	5/10	5	10
<i>Syria</i>		10		10
<i>Tajikistan</i>		5/10		10
<i>Thailand</i>		15/25		10/25
<i>Tunisia</i>	0	10	20	13
<i>Turkey</i>	15	10/15	10/15	10
<i>Turkmenistan</i>		10		10
<i>United Arab Emirates</i>		10/15		10
<i>United Kingdom</i>	0	15/20	20	15
<i>United States</i>	30	0/15	30	0
<i>Uzbekistan</i>		10		10
<i>Yemen</i>		10		10
<i>Vietnam</i>		15		15

APPENDIX 5: DBA – Tax Sparing Credits

Country	Tax sparing credit	Remarks
<i>Austria</i>	X	
<i>Bangladesh</i>	X	Both countries
<i>Belgium</i>	X	
<i>Denmark</i>	X	
<i>Egypt</i>	X	Both countries
<i>France</i>	X	Limited to 10 years, has been expired
<i>Hungary</i>	X	Both countries
<i>Indonesia</i>	X	Both countries
<i>Italy</i>	X	Both countries up to 25%
<i>Japan</i>	X	Limited
<i>Kazakhstan</i>	X	Both countries
<i>Korea</i>	X	Only for dividends, interest, and royalties
<i>Malaysia</i>	X	Both countries
<i>Mauritius</i>	X	Both countries
<i>Netherlands</i>	X	Certain taxes
<i>Norway</i>	X	Has been expired
<i>Oman</i>	X	
<i>Philippines</i>	X	Both countries
<i>Qatar</i>	X	Both countries
<i>Romania</i>	X	
<i>Singapore</i>	X	Limited by both countries
<i>Sri Lanka</i>	X	Both countries
<i>Switzerland</i>	X	Conditional
<i>Thailand</i>	X	Both countries
<i>Tunisia</i>	X	Both countries
<i>Turkey</i>	X	Both countries
<i>Turkmenistan</i>	X	Both countries
<i>United Kingdom</i>	X	Limited to 10 years from the introduction of Pakistan incentive
<i>Uzbekistan</i>	X	Both countries

APPENDIX 6: List of Trade Agreements Concluded by Pakistan

Preferential Trade Agreements (PTA):

Iran	04-03-2004	limited number of tariff lines affected
Mauritius	30-07-2007	limited number of tariff lines affected

Free Trade Agreements (FTA):

Sri Lanka	01-08-2002	limited (pre-SAFTA)
SAFTA	06-01-2004	gradual reduction of all tariff lines over 5-8 years
China	24-11-2006	gradual reduction of all tariff lines
Malaysia	29-05-2007	gradual reduction of all tariff lines starting 2008