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‘Frequently Asked Questions on cross border transactions and tax treaties’

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Support to Governance in Pakistan Programme
Tax Reform Component

House No. 4, Street No.14-A, F-7/2 Islamabad - Pakistan
T +92 (51) 260 8988 - 90
F +92 (51) 260 8987
I www.giz.de

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Frequently Asked Questions (FAQ)*

Q. What are cross-border transactions and their Tax Consequences?

Cross border transactions encompass transfer of goods, services, capital, and technology. As such transactions transcend more than one country there are multiple taxation claims on income from these transactions. As a consequence same income is taxed twice. Further, as the national taxation laws differ in terms of the scope and basis of income taxation, economic double taxation occurs unless the adverse effects of primary adjustment are offset through the secondary adjustment by the other state.

Q. Is Pakistan Taxation System in line with tax treaty practices?

Pakistan taxation system is to a large degree in line with the international practice**.** The Income Tax Ordinance 2001 contains several 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 several Agreements for Avoidance of Double Taxation which complement these domestic rules.

Q. What are the significant international aspects of Income Tax Ordinance 2001?

The following provisions of the Income Tax Ordinance, 2001 deal with the taxation of income arising on international economic transactions and aim at safeguarding the domestic tax system in the world of international business.

- Section 107 empowers FBR to Conclude Tax Treaties
- Section 44 and 53 provides tax exemption
- Rule 15 of IT Rules explains Relief from Foreign Income Tax
- Section 101 (3) defines as to what is Pakistan Source Business Income
- Section 2 (41) defines PE
- Rule 18 of IT Rules defines ‘Royalties’, Fees for Technical Services
- Section 101(4) explains taxation of Income from Independent Services
- Section 101 (5) explains the taxation of Capital Gains
- Section 101 (6) explains taxation of Dividends
- Section 101 (7) explains taxation of Interest
- Rule 19 of Income Tax Rules explains Mutual Agreement Procedure

* Based on the issues raised during the Seminars on ‘Cross Border Transactions and Tax Treaties’ organized by the Federal Board of Revenue and GIZ in March/April 2012

Q. How many income tax treaties are currently in force in Pakistan?

Pakistan has 54 Tax Treaties with other countries**.** These Treaties provide certainty to international investors, specify clear income allocation rules, spell out method of double tax relief, and contain clear rules on the taxation of investment income. Following common practice among developing countries, Pakistan uses the UN model convention. In addition, Pakistan has entered into a multilateral agreement with SAARC Countries which encompasses 'exchange of information' and 'assistance in the area of tax administration and enforcement'.

Q. Do tax treaties generally follow the OECD or another model?

Pakistan generally follows the UN Model Convention.

Q. Have the treaties to be incorporated into domestic law before they take effect?

Pakistan tax treaties are approved by the Cabinet and notified under the authority vested in the federal government by the Income Tax Ordinance 2001.

Q. What are the Tax Treaty Objectives?

The prime object of a Tax Treaty is to provide for the tax claims of two Governments both legitimately interested in taxing a particular source of income either by assigning to one of the two the whole claim or else by prescribing the basis on which the tax claim is to be shared between them. Tax Treaties aim at eliminating the double taxation of certain income where a resident of one country derives income from a source of another country.

The other object of the double taxation agreement is to prevent tax avoidance and fraud by exchanging information.

Q. How have the Tax Treaty Models developed?

Model Convention applicable to all countries was first prepared by the Fiscal Committee of the League of Nations in 1927. The Committee deliberated thereon in its meetings in Mexico (1945) and London (1946). Based on these deliberations, the model conventions were published in Geneva in April 1946. These drafts were made the starting point by Organization for European Cooperation and Development (OEED) and its successor Organization for Economic Cooperation and Development (OECD). The draft was published in 1963, which is called the Model Convention of 1963. Based on practical experience, this model was revised in 1974 and 1977.

In view of the fact that the OECD Model Convention emphasized mostly on exclusive taxation in the country of residence, in 1969, the UN ECOSOC through the UN Ad-hoc Group of Experts on Tax Treaties initiated discussion on the OECD Model Convention. In 1980, it finally published the UN Model Convention.

Q. What is 'economic double taxation'?

Where two different legal persons are taxed on the same income or other taxable item by more than one State, it results in what is termed as 'Economic double taxation'. This may occur, for example where two States take different views of the profits made in transactions between a subsidiary resident in one of the States in its transactions with a parent company in the other State, so that at least some part of the profits on the transaction are taxed in both States. Article 9 of Pakistan's Treaties modeled after UN Model Convention seeks to address this sort of double taxation of related entities.

Q. What is Foreign Tax Credit?

Tax credit is a credit given for foreign tax in calculating the amount of tax to be paid in a person's country of residence. Where the tax in the source country of the income equal or greater degree in the country of residence, a taxpayer need not pay to its residence country any amount of tax on that income. Where the residence country tax is higher, the amount of foreign tax is deducted from the amount of local tax otherwise to be paid.

Q. What are the causes of double taxation and how it is avoided?

Double Taxation occurs mostly because of one or more of the following reasons: dual residency claim, dual source claim, competing residence/source claims, and adjusting profits claims. It is avoided by allocating taxing rights to one or the other country, allocating taxing rights to both countries with limitation in source state providing tax relief in source state where income is taxed in both states, and providing *'Tie Breaker Provisions'* in cases of 'dual residence'.

Q. What is 'juridical double taxation'?

"Juridical double taxation" occurs where the same legal person is taxed twice on the same income or other taxable item by more than one State. A common situation is where the source country taxes a payment as it flows to a person (by dividend or interest withholding tax for example, which is in effect a tax on the recipient collected by a withholding agent such as the company paying the dividend) and the residence state of the recipient also taxes that person on the same item as part of his or her worldwide income. The allocation of taxing rights combined with the effect of Article 23 is designed to prevent such juridical double taxation as far as is possible.

Q. What is 'Source State' as against the 'State of Residence'?

The State where, for the purposes of a treaty, a taxable amount is regarded as arising. As rules in national law about where an amount arises differ (e.g. some might look to where the profits that become a dividend are made as the source of a dividend, whereas others may look to the State from which the dividend is paid, Pakistan's Tax Treaties modeled after the UN Model Convention provide implied or specific rules.

For example, a State A – State B tax treaty, if it was based on the UN Model Convention, would allow State B as the source State to impose a limited withholding tax on dividends paid by companies resident in State B to residents of State A (see Article 10), but would prohibit State B from imposing a tax on dividends paid to a resident of State A by a company resident in State C, even if those dividends were paid out of profits earned by the corporation in State B (see Article 21).

Source States may, under general international tax law, tax income sourced in that State. The resident state may then provide an exemption or credit for tax paid in the source State under domestic law. A tax treaty often limits or prevents source state taxation, and also generally provides that the state of residence must give a credit or exemption for tax paid in the source State under Article 23.

Q. What is ‘Source’ Taxation?

It is the tax on an item of income imposed in the State wherein that income is derived.

Q. What is the general classification of Income for taxation purposes under tax treaties?

Source country has been given the right to comprehensively tax income from immovable property situated in a state and gains from such property; income of PE and gains from its alienation except PE maintained for international air and shipping traffic; income from activities of artists and athletes; income from independent personal services attributable to FB and gains from its alienation; remuneration in respect of employment in private sector (including Directors’ Fee unless it does not meet the prescribed conditions’

On the contrary, investment income viz. Dividends, Interest and royalties are subject to limited taxation in the state of source.

Business profits of an enterprise are however taxable in the source country only if the non-resident enterprise maintains a permanent establishment in the source country.

Q. What is ‘Dual Residence’ and how is it settled?

The situation wherein a person, being either an individual or a juridical person, is determined "resident" under the domestic tax laws of both the Contracting States which could lead to juridical double taxation i.e. both states taxing the person as their resident. The provisions of Article 4(2) of the Tax Treaties modeled after UN Model Convention provide the ‘Tie-Breaker Rules’ to solve such situations by treating the person as resident, for purposes of the treaty, of only one of the States.

Q What are the ‘Tie-Breaker’ Rules for resolving cases of Dual Residence?

These rules, as contained in Article 4(2) of Pakistan Tax Treaties, seek to determine a single residence for tax treaty purposes where a person is a resident for national law purposes under the national tax laws of both treaty States. That can most obviously happen when the two States apply different tests for residency. The tie-breaker rules do not themselves affect the situation at national tax law generally, although national laws sometimes expressly provide that certain tax benefits are not available to its resident who is regarded as a resident solely of the treaty partner State under the relevant treaty's tie-breaker rules.

Q. How do you resolve issues of dual residence of Juridical Persons?

Where a juridical person is treated resident in both the contracting states by virtue of their respective criteria, the place of effective management gets the priority. However, if the place of effective management cannot be determined or it is deemed to exist in more than one state, it is determined through Mutual Agreement between the contracting states.

Q. What is the Place of Effective Management?

Place of Effective Management is essentially deemed as the country where highest level of recurring operational management decisions is taken.

Q. What are the Key Factors in determining a Place of Effective Management?

A place of effective management is generally where key management and commercial decisions necessary for the conduct of a business are in substance made and given - ordinarily where the directors meet to make decisions relating to the management of the company. Determination of a place of effective management is a question of fact. Relevant factors taken into account by the courts have include: where the centre of top level management is located; where the business operations are actually conducted; legal factors such as the place of incorporation, the location of the registered office, public officer, etc.

While the guidance from *Central Management & Control* and the *Place of Management* indicates the place of effective management will ordinarily lie with the directors, in certain circumstances these strategic decisions and powers may be exercised by others.

Q. How should Tax Treaties be interpreted - by the 'application of ordinary rules of statutory interpretation' or 'generally accepted Rules of International Law?

It is universally accepted that while interpreting Tax Treaties, these must be read keeping in mind their primary objectives and interpreted more liberally and with extended construction. National Tax Statutes generally incorporate DTAs to avoid conflict.

Q. Whether a Tax Treaty over-rides the National Law?

Tax Treaty provisions over-ride those of the national taxation law. The "*Treaty Over-rides*" equally refers to enactment of subsequent national legislation which conflicts with obligations undertaken in the prior binding Tax Treaty. While interpreting Tax treaties, generally, preference is for Ambulatory rather than, Static Approach in treaty interpretation.

Q. Can a Tax Treaty impose a higher tax burden than that in the National Law?

There is consensus that Tax Treaties only provide relief from tax; these do not impose a higher charge than under the National Law; reduction in tax rates or exemption granted under National Laws continues to operate even if the Tax Treaty entitles the state to tax a particular income.

Q. How are the taxable profits of a permanent establishment determined in Pakistan?

The taxable profits of a branch are computed in the manner similar to a resident of Pakistan, except that income from carrying on business by the non-resident in a country other than Pakistan is not relevant.

Q. Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

There would be no withholding tax.

Q. How does Pakistan address the issue of preventing tax avoidance? For example, is there a general anti-avoidance rule or a disclosure rule imposing a requirement to disclose avoidance schemes in advance of the company's tax return being submitted?

There are many specific anti-avoidance provisions in the Income Tax Ordinance 2001 directed against perceived tax avoidance in particular circumstances. There is no general requirement to disclose an avoidance scheme in advance of the filing of a tax return. There are no registration requirements in respect of 'tax shelters' either.

Q. What are the anti-abuse rules / anti-avoidance laws?

These connote National Taxation Laws intended to prevent taxpayers from avoiding tax or abusing tax laws for the sole purpose of obtaining a reduction, avoidance or deferral of tax.

Q. What is Accelerated Competent Authority Procedure ("ACAP")

ACAP is a taxpayer's request for the competent authority's assistance for subsequent filed, but yet to be audited taxation years on the same issue with a view to prospectively resolve double taxation as well as alleviate the burden of a separate audit and MAP process.

Q. What are advance pricing arrangements?

APA is the arrangement that determines, in advance of intra-group transactions an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.

Q. What is Arm's length principle?

Arm's length principle represents the agreed international standard for determining transfer prices for tax purposes and incorporated in Article 9 of the OECD/UN Model Conventions for the Avoidance of Double Taxation of Income and Prevention of Fiscal Evasion. Incorporated therein is the 'arm's length range' which is 'a range of figures that are acceptable for establishing whether the conditions of a controlled transactions are arm's length'.

Q. What are the Associated/Related enterprises, companies, or parties?

Two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9 (1a or 1b) of the Model Conventions with respect to the other enterprise.

Q. Who is the competent authority for tax treaty purposes?

"Competent authority" is a term used in tax treaties to identify the person who represents the State in the implementation of the treaty. It is defined under Article 3 of a tax treaty. Competent Authority in case of Pakistan is identified in the Income Tax Ordinance 2001. The competent authority has certain specific functions under the treaty, including acting as a contact point for both taxpayers and the other competent authority in Mutual Agreement Procedure.

Q. What are the Controlled transactions?

Transactions between two enterprises that are associated enterprises with respect to each other.

Q. What is Correlative adjustment?

It is a term used in the transfer pricing context and represents an adjustment that increase or decrease in the tax imposed on one member of the group of controlled taxpayers correlating to the 'primary adjustment' made in respect of another member of the same group.

Q. What are the 'Independent enterprises'?

Two enterprises are independent enterprises with respect to each other if they are not associated enterprises with respect to each other.

Q What is Transfer pricing?

The terms and conditions applying in transactions between associated enterprises are. It involves adjustment to the tax liability of an enterprise when a tax jurisdiction applies the arm's length principle to transactions between associated enterprises in a transfer pricing case. There are several methods including: Comparable uncontrolled price (CUP) method, Cost plus method, Re-sale Price method, Profit split method, and Traditional transaction methods used to determine the arm's length price.

Q. What is Permanent Establishment?

Permanent establishment underlines that a state has a right to tax a foreign enterprise if it has a PE in that state. There are three types of PE i.e. *Basic Rule PE*: Business activity performed through a fixed place of business; *Construction PE*: Where *Basic Rule PE* does not exist but the business activity of the enterprise comprises performance of a construction or installation project at a building site for a prescribed period or more; and *Agency PE*: Where *Basic Rule PE* and/or *Construction PE* does not exist but business is conducted through a person authorized to conclude contracts for or on behalf of a foreign enterprise under prescribed conditions.

A branch, office, factory, mine or gas or oil well, quarry or any other places of extraction of natural resources, prima facie, constitute *Basic Rule PE*. There is a general consensus that real estate, building, plant/machinery/equipment, ships, aircraft, drilling rigs, computers; vending machines, telephone exchanges, automatic filling stations, receiving and transmitting radio equipment and other non-staffed activities; machinery and equipment of certain significance; and extraction of all natural resources that are stationery extracted on-shore or off-shore can be deemed as PE.

The *construction clause* PE covers activities of construction, installation, assembly projects not meeting Basic Rule PE. Duration Test serves as the primary criteria for treating such activities as PE. *Projects at one or more sites* constitute a PE if one or more projects last longer than prescribed period. Place where such activities are performed is *the Place of Business*. *Relocation of projects* e.g. road construction, row of houses, laying of pipeline, deemed to exist even if several clients involved.

Agency Clause PE is constituted where an enterprise carries on business through a dependent agent. Agency Clause replaces the Fixed Place of Business Test and requirement of a business activity (i.e. Negative List); it does not require personal representation. Agent's connection (residence/habitual abode) with source state required. Agent must have the authority to bind the principle. Agency can be based on a contract between agent and principal authorizing the Agent

to act subject to Principal's instructions OR employment. General Authority means that Agent is empowered to perform all acts of a special class or series as opposed to particular acts. Agent must be legally and commercially dependent upon the principal.

Independent Agents do not constitute PE unless they act outside their course of business. An Agent must habitually use his powers to conclude contracts to constitute PE. Authority is deemed to be exercised where a person authorized to negotiate a contract binding the enterprise even if the contract is signed by other person in the other state of residence of enterprise.

Associated enterprises do not constitute PE. A subsidiary PE may be constituted under the same conditions that create a PE for unrelated enterprises. However, a subsidiary PE is created if it is authorized to conclude contracts for or on behalf of the enterprise (parent company) and all conditions under *Agency Clause* are satisfied.

Q. What is the principle of taxation of business profits under Tax Treaties?

Under section 101(3) of the Income Tax Ordinance 2001, business income of a non-resident person is treated as Pakistan-source income to the extent it is directly or indirectly attributable to its PE in Pakistan of the non-resident, sale of goods and merchandise of the kind sold by the person through a PE in Pakistan, other business activities of the kind as those effected by that person through its PE in Pakistan, or any business connection in Pakistan.

The Tax Treaties modify the above principle to the extent that while the primary right of taxation of foreign source income vests with country of residence, the other state has the right to tax only if the enterprise carries on business therein through a PE in Pakistan. Depending upon the provisions of a Tax treaty, such income is taxable in the other state to the extent a) income attributable to PE (attribution principle); b) income attributable to PE as well as income earned by the enterprise through direct sale of goods of similar nature (mild force of attraction principle); c) all income of the enterprise (force of attraction Principle).

Q. What constitutes income of air and shipping enterprises from international traffic?

Essentially it is the income from carriage of passengers or cargo in international traffic. However, this being undue restriction in view of the development of shipping and air transport for practical considerations, it is mostly accepted to extend the scope of income from international traffic to income from those activities which by reason of their nature or their close relationship with profits directly obtained from transport may all be placed under a single category. These include: profits from leasing a ship or aircraft on charter fully equipped, manned and supplied; income from wet-lease of a ship or aircraft contrary to that from lease on bare-boat basis treated which is treated as Royalty Income under Art 12 except when it is occasional source of income for the enterprise; sale of passage tickets on behalf of other enterprise; operation of bus service connecting a town with airport; advertising and commercial propaganda; and transporting goods by trucks connecting a depot with a port or airport.

Q. What constitutes 'Independent Services'?

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Independent personal services include: scientific, literary, artistic and educational services; and activities of physicians, lawyers, architects, accountants which are of independent nature performed by individuals rather than the enterprises. Income from independent personal services is distinguishable from royalties, commercial and industrial profits. Commercial and industrial activities and professional services performed in employment are excluded from the scope of Article 14 of the Tax treaties.

Q. How is the concept of Fixed Base distinguished from Permanent Establishment?

Concept of Fixed Base is substantially identical to the term PE. Taking the conditions of PE as a starting point, Fixed Base requires that there must be available .a Place of Business at a certain location (not necessarily the lease required); the Place of Business should be used for a reasonable duration; activities conducted through the Place of Business must be covered under the relevant Treaty Article; activities performed are not of Preparatory or auxiliary activities with respect to the core activities; the Place must be instrumental in the performance of activities of professional.

Notwithstanding the similarities between PE and Fixed Place, these are not inter-changeable. They refer to different activities and significant differences in time period required to constitute PE or Fixed Place – the later requiring much shorter period

Q. What are the significant considerations while giving tax credit for the foreign tax?

It is imperative that while giving the tax credit for the tax paid in the source country, tax authorities must ensure that the tax for which credit is being claimed is covered under the treaty, whether it has been actually paid, assessment order has been issued by foreign tax authority, it is final tax payable in respect of that income, certificate of tax withheld by payer of investment and employment income is available. The tax credit must be limited to the tax payable in country of residence in cases of 'economic double taxation'. Finally, the foreign exchange conversion rate in respect of foreign tax must be on a consistent basis.

Q. What is the process of seeking information under the Exchange of Information Article?

Tax Treaties provide an accepted legal basis for bilateral exchange of information for tax purposes. Article 26 creates an obligation to exchange information relevant to the correct application of tax treaties as well as for purposes of the administration and enforcement of domestic tax laws of the contracting states.

In formulating their requests, the requesting state should demonstrate the foreseeable relevance of the requested information which the requested state cannot refuse. Bank secrecy is not incompatible with the requirements of Article 26.

Where information is exchanged it is subject to strict confidentiality rules and that it can only be used for the purposes provided for in the convention.