COUNTRY NOTE

Pakistan: Bracing for BEPS

Muhammad Ashfaq Ahmed*

The article spatially juxtaposes the BEPS Project and the recommendations package handed down thereunder in Pakistan and critically appraises its response at two levels: ideational and practical. It is argued that the ideational lens of sovereignty, efficacy, and legitimacy through which the BEPS phenomenon and its outcomes are being keenly looked at elsewhere has not really spiced Pakistan's response to the Base Erosion and Profit Shifting (BEPS) proposals or the public policy debate surrounding them. At the practical level, it critically maps the BEPS-specified areas that Pakistan has already chartered and those that remain unchartered. The ideational level strings obliquely steer the debate at the practical level.

Keywords: Pakistan & BEPS, BEPS and Sovereignty, BEPS and Legitimacy, BEPS Implementation, International Tax Reform.

1 Introduction

The extant international tax order that had started to evolve around the end of World War I and the creation of League of Nations appeared to have lost its luster and run out of vitality and efficacy at the dawn of the twenty-first century. The Organization for Economic Cooperation and Development[1] (OECD), on the advice of the G20[2] in 2013, geared itself into the Base Erosion and Profit Shifting (BEPS) Project to come up with a comprehensive plan to make up for the efficacy deficit. In fact, the BEPS Project might not only be a comprehensive reform of the international tax regime but possibly also a first step toward standardization, if not harmonization, of nearly two hundred national tax systems into a well-knit international tax system that leaves few blind spots and hiding places for potential transnational delinquents. In its more conservative measure, it has set the global agenda for a new comprehensive international tax standard. Thus, BEPS has emerged as an international fiscal system de-novo of mega proportions. BEPS implies tax avoidance ploys that make use of mismatches and gaps in tax laws to shift incomes from the State to which they belong to other (preferably) no or low tax jurisdictions.[3] These deliberate strategies aimed at avoiding taxes are tantamount to undermining the integrity of tax systems in that the enterprises that conduct business across jurisdictional boundaries acquire a competitive advantage vis-à-vis the entrepreneurs that operate only in domestic markets. This predictably leads to a situation of moral hazard in the market whereby compliant taxpayers acquire incentives to evade when they see multinationals legally doing the same at will and with impunity.

The BEPS Project design, in its very initial phase, was expanded and rendered more inclusive through the induction of developing countries. Then, over the next couple of years, extensive work was carried out in fifteen identified areas of taxation – later called the 15 BEPS Action Plans – resulting in the formulation of firm sets of proposals. These proposals are to be implemented by national governments within their own jurisdictions. It is understandable that the mode, manner, and pace of implementation of the BEPS proposals would vary in different jurisdictions. This is because the 'proposed design of international tax reform … is intended to assist countries in implementing a cohesive global approach, but each country uses their tax system to influence taxpayer behavior to achieve their own social and

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* The author is an IRS-Pakistan officer, and is currently posted as Director General, International Taxes, Federal Board of Revenue, Islamabad; he holds PhD in Political Economy. Email: muhammad.ashfaq@fbr.gov.pk.

1 The current thirty-six members of the OECD are Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, South Korea, Latvia, Lithuania, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States.

2 The current members of the G20 are Australia, Canada, Saudi Arabia, United States, India, Russia, South Africa, Turkey, France, Germany, Italy, United Kingdom, China, Indonesia, Japan, and South Korea.

3 Kerrie Sadiq, Adrian Sawyer & Bronwyn McCredie, *Jurisdictional Responses to Base Erosion and Profit Shifting: A Study of 19 Key Domestic Tax Systems*, 16(3) eJournal of Tax Research (2019).

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economic goals'.[4] Since the implementation of the BEPS proposals 'is not necessarily occurring consistently', it is imperative that variances in implementation are brought out, benchmarked, and measured to enrich informed scholarship and well-rounded international response; hence, this article on Pakistan.

In view of the higher marginal utility of each additional unit of tax revenue for developmental needs, it has been averred that BEPS concerns may be a lot more important for developing countries than those that are developed.[5] This is where BEPS is coming under critical appraisal. While there is a broad consensus on BEPS being a potent force, there is wide variance in its perception of being an entirely a halcyon and wholesome affair. Perhaps the most germane criticism on the BEPS initiative is with regard to the way it intercedes with *sovereignty* of states, particularly developing ones, its *legitimacy*, and *efficacy.*

The article is planned into eight sections. While section I introduces the topic, section II brings in the ideational concepts sovereignty, legitimacy, and efficacy. Section III deals with the digital economy, BEPS concerns in connection therewith, and Pakistan's response – howsoever edgy and checkered. Section IV deals with *Coherence*, i.e. the first of the three thematic pillars into which 15 BEPS Actions are classified covering Actions 2, 3, 4, and 5 taking out BEPS risks and Pakistan's reaction to mitigate those risks. Section V covers the second thematic pillar, i.e. *Substance* taking stock of BEPS risks under Actions 6, 7, 8, 9, and 10 and the measures put in place by Pakistan thus far to mitigate those risks. Section VI appraises developments taking place in Pakistan on account of the third thematic pillar *Transparency and Certainty*, comprising Actions 11, 12, 13, and 14. Section VII covers the crosscutting Action 15, i.e. the Multilateral Instrument. Section VIII summarizes the debate by drawing ideational plausible insights into the way the country is bracing for the BEPS impact and by concluding the debate centred on sovereignty, legitimacy, and efficacy in Pakistan.

2 Theoretical underpinnings

Sovereignty, in the fiscal domain, may operationally be defined as the State's autonomy to design its tax system while considering its own social, legal, economic and political imperatives, and independently of any external influence or pressure. However, globalization, digitalization, and mobility of capital, incomes, and tax persons almost freely across geographical boundaries have rendered the designing of a tax system by one State in isolation of and without impacting others almost impossible. 'Now, more frequently than not, one country's exercise of sovereignty overlaps, interferes with, or even impedes that of another.'[6] Against this backdrop, the BEPS recommendations emanating from the OECD – an elite club of developed countries, howsoever good or beneficial for developing countries – tend to undercut the sovereignty of States with a tinge of implied coercion. It has been averred that 'in a world in which countries' relative influence and power are unequal, the attempt by a country – or a group of countries – to establish standards that others will follow comes close to the notion of an illegitimate intervention in a nation's power of self-determination'.[7] This is particularly relevant to non-OECD member countries. These views tend to gain traction when seen in the context that the 'BEPS Project is not committed to inter-nation equity'.[8] Burgers and Mosquera, writing on corporate taxation and BEPS in relation to developing countries, have stated that 'developing countries might perceive fairness in relation to corporate income taxes differently from developed countries'.[9] Rocha has gone to the extent of suggesting that BEPS outcomes might actually foster some sort of international tax imperialism.[10]

In many ways connected with the subject of sovereignty is the matter of legitimacy of BEPS prescriptions and the process of their incorporation into the national tax systems of a large number of countries. The most comprehensive and granular definition of legitimacy comes from Fritz Scharpf.[11] In order to effectively operationalize the concept, he splits legitimacy into *input legitimacy*, connoting 'government by the people', and *output legitimacy*, implying 'government for the people'.[12] Valderrama's contextualizing input legitimacy argues that it 'will take into account transparency, participation, and representation of developing (non-OECD) countries in the setting of the agenda and the drafting of the content of the OECD … BEPS

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4 *Ibid.*

5 Ernesto Crivelli, Ruud de Mooij & Michael Keen, *Base Erosion, Profit Shifting and Developing Countries*, 72(3) Public Finance Analysis (2016).

6 Marcus Livio Gomes, *Book Review: Tax Sovereignty in the BEPS Era by Sergio Andre Rocha & Allison Christians*, 46(2) INTERTAX (2018).

7 *Tax Sovereignty in the BEPS Era*, International Taxation XXXIII (Sergio Andre Rocha & Allison Christians, eds, Wolters Kluwer 2017).

8 Ramon Tomazelia Santos & Sergio Andre Rocha, *Tax Sovereignty and Digital Economy in Post-BEPS Times*, in *Tax Sovereignty in the BEPS Era*, , *International Taxation* (Sergio Andre Rocha & Allison Christians ed., Wolters Kluwer 2017).

9 Irene Burgers & Irma Mosquera, *Corporate Taxation and BEPS: A Fair Slice for Developing Countries?*, 1 Erasus L. Rev. (Aug. 2017).

10 Sergio Andre Rocha, *The Other Side of BEPS: 'Imperial Taxation' and 'International Tax Imperialism' in Countries*, in *Tax Sovereignty in the BEPS Era*, International Taxation (Sergio Andre Rocha & Allison Christians ed., Wolters Kluwer 2017).

11 Fritz W. Scharpf, *Governing in Europe: Effective and Democratic?* 7 (Oxford University Press 1999).

12 Scharpf, *supra* n. 12.

multilateral instrument'.[13] Likewise, to him, output legitimacy 'will also take into account the differences in objectives and resources between OECD and non-OECD (developing) countries'.[14] He goes on to emphasize the point that 'international organizations do not have the consent of the citizens, but of the states that may decide to become members of the international organization'.[15] However, the way countries are aligning with BEPS, the question mark on the entire initiative becomes galvanized – until, of course, States are implied to inherently carry legitimacy of the underlying citizenry.

Likewise, there is wide-going cynicism regarding efficiency of the BEPS Project outcomes. It is insinuated that these motley proposals do not have to go far and that they contain limited potential. Azam has also expressed scepticism about the efficacy of BEPS recommendations stating that the 'effectiveness of these domestic norms in reducing corporate tax avoidance … is extremely limited'.[16] The BEPS Plan's efficacy can be analysed in terms of three mutually exclusive strands. Firstly, it is more favourable to developed countries; secondly, it is more favourable to developing countries; and thirdly, it is neutral in its beneficial outcomes across the developed/developing country divide. Firstly, the position that BEPS outcomes are more beneficial to developed countries is majorly based on what BEPS seeks to cover rather than what it does not. It has been majorly argued that the BEPS Project does not try to interfere with the allocative rules that are primordially tilted in favour of the developed countries and that until and unless the foundations are ameliorated, the superstructure erected thereon would continue to be skewed. Secondly, the argument that it is more beneficial to developing countries appears rather psychological. Azam doubts that 'a wide range of countries will adopt these modifications in their treaties because the changes benefit developing, capital-importing, source countries at the expense of more developed, capital-exporting countries'.[17] It appears stemming from the denouement of the century-old international taxes regime which coercively favoured developed, capital-exporting, and residence countries at the expense of the less developed, capital-importing countries. A substantial amount of scholarship has already been generated to contend that there are deep-rooted anti-developing country biases in the extant international taxes regime.[18] Thirdly, that it is neutral in its fiscal and systemic outcomes is the OECD's position and is generally the official position of most inclusive group jurisdictions and others that are trying to implement the BEPS package. Shorn of all additives, it would not be all that incorrect to state that the third is the predominant position adopted by the bulk of the OECD and Global Forum members.

The approach adopted to conduct this study is to frame the issue in both national and international contexts, bring out the essence of the proposals made by the OECD under the relevant BEPS Action, and then summarize Pakistan's position towards implementation (or non-implementation) of the recommended solutions on various tax matters. A critique of Pakistan's response would provide an illustrative peek into a typical developing country response to the BEPS tax reform package which could potentially help academia, the OECD, and other multilateral fora to refine their future course of action and the developing countries to better shape and sharpen their responses to an OECD-sponsored potpourri of the international tax reform agenda. The overarching concepts of sovereignty, legitimacy, and efficacy mildly steer the debate on the dry tax matters. The underlying premises that hold the ensuing discussion together are that sovereignty, though deep-down somewhere is still extremely relevant, in a developing country perspective, it has not yet emerged on its intellectual horizons to impede implementation of the fiscal legislation; that input legitimacy is implied in a democratic dispensation and that is also true of Pakistan; that output legitimacy is directly linked to government performance and service delivery which, theoretically speaking, should improve once revenue numbers improve as a result of anti-BEPS measures that are introduced and enforced to their full effect; that all the measures introduced into the tax laws were never tagged as imported which made them sail through the legislative process smoothly[19];and that (individual) states, particularly developing ones, have impliedly accepted knowledge superiority of the multinational fora by implication the OECD, and Pakistan is no exception.

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13 I. J. Mosquera Valderrama, *Legitimacy and the Making of International Tax Law: The Challenges of Multilateralism*, 7(3) World Tax J. (2015).

14 *Ibid.*

15 *Ibid.*

16 Rifat Azam, *Ruling the World: Generating International Tax Norms in the Era of Globalization and BEPS*, Suffolk Univ. L. Rev. L, no. 4, 581 (2017).

17 Azam, *supra* n. 16.

18 *See*, for instance, Muhammad Ashfaq Ahmed, *U.N. M.T.C: Was the Source Rule Surrender on Article 8 a Blunder? The Case Study of Pakistan*, 48(1) Intertax (2020); Sergio Andre Rocha, *International Fiscal Imperialism and the "Principle" of the Permanent Establishment*, 68(2) Bull. Int'l Tax'n (2014); Jose Antonio Alonso, *International Tax Cooperation and Sovereign Debt Crisis Resolution: Reforming Global Governance to Ensure No One is Left Behind*, CPD Background Paper No. 41 ST/ESA/2018/CPD, no. 41 (23).

19 There is, however, notable exception with regard to OECD Guidelines on Transfer Pricing, which have specifically been mentioned with the Rules.

3 Digital economy

3.1 *Action 1 – Tax Challenges of Digital Economy*

The inescapable reality of the digitalization of the economy is the result of a transformative process brought about by a near-universal use of information and communication technology (ICT) into entrepreneurship which has made technological solutions cost-effective, easier to implement, and widely standardized while, in the course, improving business processes and incentivizing innovation across most economic sectors.[20] BEPS Action 1 was dedicated to identifying the challenges that digitalization poses for the application of existing international tax rules and exploring new options to meet those challenges, taking into account both direct and indirect taxes and adopting a full-spectrum approach.[21] The Action 1 report entitled 'Addressing the Tax Challenges of the Digital Economy'[22] takes stock of the progress made thus far, fiscal issues connected therewith, and the tax solutions arrived at by the international community vis-à-vis ensuring adequate taxation on the digital economy:

> The deliberations on Action 1 led the international tax community to a couple of important realizations: firstly, that it was not possible to ring-fence the digital economy from the rest of the economy as the digital economy now constituted the economy itself, and secondly, that while the digital economy exhibited certain distinctive traits, it modified with old business models and nurtured new ones, giving rise to "related but different issues" which could broadly be categorized as (a) BEPS issues and (b) broader tax challenges. In connection with BEPS issues, unanimity was evolved to the understanding that the digital economy posed no unique BEPS issues; it only aggravated those already existing. In the BEPS framework, these concerns were addressed in a cross-cutting fashion by (i) modifying the definition of a permanent establishment (PE) with particular reference to the agency PE and that of the "preparatory and auxiliary activities" as used in Paragraph 4 and 4.1 of Article 5 of the OECD Model Tax Convention (MTC); (ii) amplifying the transfer pricing (TP) regime through delineation of the actual transaction, intangibles, special approach on high tax to value intangibles, and the scope of profit-splitting; and (iii) improving and expanding the scope of controlled foreign company (CFC) legislation to digital sales. With regard to broader tax challenges, in the domain of indirect taxes, it was resolved to collect value added tax (VAT) at destination and to ensure a simplified mechanism for ensuring collection where the consumer resided and to modify the exceptions to PE status whether or not it raised BEPS concerns. In order to address broader tax challenges, in the area of direct taxes, a few soft suggestions were also made to national governments to decide on the significant economic presence test (SEPT) as opposed to the physical presence test (PPT) application of withholding tax to various digital market transactions and the imposition of an equalization levy. National governments were to consider introducing these in their domestic laws as additional safeguards against BEPS risks keeping in view their respective treaty obligations made at bilateral and multilateral levels. Pakistan's most robust response to mitigate digital economy risks has been through the imposition of a withholding tax on all offshore payments on account of digital services. Through Finance Act, 2018, a new clause (22B) captioned as "fee for offshore digital services" was inserted into section 2 of the Income Tax Ordinance, 2001 (I.T.O. 2001), to define and mean:

any consideration for providing or rendering services by a non-resident person for online advertising including digital advertising space, designing, creating, hosting or maintenance of websites, digital or cyber space for websites, advertising, e-mails, online computing, blogs, online content and online data, providing any facility or service for uploading, storing or distribution of digital content including digital text, digital audio or digital video, online collection or processing of data related to users in Pakistan, any facility for online sale of goods or services or any other online facility.[23]

The fees for offshore digital services were geographically sourced in Pakistan correspondingly through insertion of sub-section of (12A) in section 101 of the I.T.O. 2001.[24] Moreover, not only was a direct chargeability created through an amendment in sub-section (1) of section 6 of the I.T.O. 2001[25] but also a withholding tax at the rate of 5% on the gross amount was imposed to be collected by every 'banking company or a financial institution remitting outside Pakistan an amount of

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20 OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project* 11 (Paris: OECD Publishing 2015).

21 Sadiq, Sawyer & McCredie, *supra* n. 3.

22 OECD, *supra* n. 20.

23 PK: s. 2(22B) of Pakistan, *The Income Tax Ordinance, 2001*, (Islamabad: FBR, 2001) inserted vide Finance Act, 2018.

24 PK: s. 101(12A) of Pakistan, *supra* n. 23, inserted vide Finance Act, 2018.

25 PK: s. 6(1) of Pakistan, *supra* n. 23, inserted vide Finance Act, 2018.

offshore digital services'.[26] However, an exception to the levy was created in respect of the fees that arose as a result of the services that were 'rendered through a permanent establishment in Pakistan of the non-resident person'.[27] It has been averred that the OECD is not a great supporter of tax enforcement through financial institutions.[28]

The BEPS Action 1 report, after analysing nexus and data challenges emanating from the digitalization of the economy, exhorted that the prescriptions such as SEPT, withholding tax, and actualization levy were made with the caveat that jurisdictions could introduce them in their domestic laws as additional safeguards against BEPS while having due regard to multinational or treaty obligations.[29] Thus, it can safely be contended that Pakistan's overall new legal mechanism put in place to manage and mitigate the digital economy risks, though edgy and ad hoc, is in sync with the new international standard.[30] This is simply because the SEPT, which 'is increasing in popularity as a long-term solution', has virtually been put on the back-burner in favour of the 'withholding taxes (including equalization levies)' which 'are regarded as interim solutions'.[31] There is a lot of blind faith in withholding taxes as a panacea to many ills being created by globalization and the digitalization of the world economy, but one must not forget what excessive utilization of withholding taxes can do to a tax system; Pakistan itself is an illustration of this.[32]

The value of offshore digital services remitted out of Pakistan during T/Y 2019 comes to Rs. 2,636 million with a corresponding tax being deducted at Rs. 131 million in approximately hundred cases. During the debate on the Finance Act 2018 in the parliament, which continued for over a fortnight, none of the members of the National Assembly spoke for or against the imposition of the withholding tax validating the premise that ideational aspects of tax measures being introduced as anti-BEPS in the domestic legislation never actually bothered the Pakistani intelligentsia. To reorder the priorities, not only would a significant thrust have to be made to modify a substantial number of Pakistan's bilateral double taxation agreements (DTAs) incorporating SEPT but the capacity of the tax administration would also have to be built to deal with tricky digital economy issues with all its ethereality and uncertainties.

4 Coherence (Actions 2-5)

Under the first thematic pillar *Coherence*, BEPS Action 2–5 dealing with Hybrid Mismatch Arrangements, CFC legislation, Interest Deductions and other Financial Payments, and Countering Harmful Tax Practices, respectively, are bunched and analysed in this section.

4.1 *Action 2 – Hybrid Mismatch Arrangements*

Aggressive tax planning by multinational enterprises (MNEs) often includes exploitation of variances in tax treatment of entities and transactions in two or more jurisdictions under their respective tax codes resulting in double non-taxation, double-deduction, or long term tax deferrals – in tax-tongue dubbed as hybrid mismatches.[33] BEPS Action 2 was geared to develop rules and regulations that could effectively neutralize hybrid instruments and entities by improving model tax treaty provisions as well as domestic tax policy designs. The work under Action 2 culminated in the shape of a comprehensive report entitled 'Neutralizing the Effects of Hybrid Mismatch Arrangements'.[34] The prescriptions made under the Action 2 report can be analysed by bifurcating them into the proposals that look to tinker with domestic laws and those that chart out changes to the OECD MTC for subsequent negotiations and incorporation into bilateral DTAs by national governments.

In connection with the domestic tax regime, linking rules have been proposed that align the tax treatment of an instrument or entity with its tax treatment in the counterparty jurisdiction.[35] The rules are designed to apply automatically with a primary rule and a secondary (or defensive) rule. The primary rule implies that governments deny the taxpayer the deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction, or it is also

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26 PK: s. 152(1C) of Pakistan, *supra* n. 23, inserted vide Finance Act, 2018.

27 PK: s. 6(3)(b) of Pakistan, *supra* n. 23, inserted vide Finance Act, 2018.

28 Sp Van Zyl, *The Collection of Value Added Tax on Cross-Border Digital Trade – Part 2: VAT Collection by Banks* 2 (University of South Africa 2013).

29 OECD, *supra* n. 20, at 17.

30 The cross-cutting BEPS recommendations pertaining to digital economy and to CFC legislation and transfer pricing are covered under their respective heads i.e. 'Designing Effective Controlled Foreign Company Rules' (Action 3); and 'Aligning Transfer Pricing Outcomes with Value Creation' (Action 8–10).

31 Adolfo Martín Jiménez, *BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties*, in *Tax Working Papers* (Cadz (Spain): University of Cádiz 2018).

32 Muhammad Ashfaq Ahmed, *Pakistan: Withholdingization of the Economic System: A Source of Revenue, Civil Strife or Dutch Disease+?*, 56(VI) Pak. Dev. Rev. (2019).

33 Sadiq, Sawyer & McCredie, *supra* n. 3, at 14.

34 OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2* (2017).

35 *Ibid.*, at 11.

deductible in the counterparty jurisdiction.[36] Then, if the primary rule is not applied, the counterparty jurisdiction can generally apply a defensive rule requiring the deductible payment to be included in the income or denying the duplicate deduction depending on the nature of the mismatch.[37] The corrective recipe under BEPS Action 2 looks to ensure that hybrid instruments and entities as well as dual resident entities are not exploited to unduly obtain the benefits of tax treaties and that the treaties do not prevent the application of the changes made to domestic tax laws.[38] Azam has skeptically argued that the 'implementation of these amendments in bilateral tax treaties … have medium prospects', there would 'not be a substantial impact resulting from these changes in mitigating the core challenges of corporate tax avoidance' and, further, that these 'instruments are unlikely to limit the use of hybrid mismatches or the avoidance of PE status'.[39] However, the real challenge would be the actual enforcement of protective gear against BEPS ploys which are likely to put in place by the MNEs to outmanoeuvre the BEPS protective gear.

4.2 *Action 3 – CFC Rules*

Over the past few decades as physical distances shrank both geographically and virtually, the world transformed into one global village. While globalization gave rise to mass-scale economic opportunities, it also created space for economic agents to resort to aggressive tax planning to minimize their liabilities in their respective jurisdictions. One of the ploys exploited by tax persons to reduce their tax liability was by parking their incomes in no or low tax jurisdictions without having to repatriate them back to where actual owners or the parent entity resided. The mechanism devised by the international community to fight this menace called the CFC legislation aims to take stock of the incomes that are parked in offshore low tax jurisdictions, i.e. away from the parent entity's jurisdiction. The first CFC legislation was enacted in 1962 in the United States wherefrom other countries like the United Kingdom and Germany took the clue and replicated CFC regulations in their internal tax codes. Avi Yonah dubbed this phenomenon as 'constructive unilateralism'.[40] BEPS Action 3 was assigned to look into the existing CFC legislation as enforced by various countries and come up with a comprehensive set of rules to be adopted by countries in their domestic tax codes. The OECD published the BEPS Action 3 report titled 'Designing Effective Controlled Foreign Company Rules'.[41] The report, in fact, does not contain specific recommendations but a set of building blocks that are designed to ensure that jurisdictions that choose to have CFC legislation must put in place the rules that effectively prevent taxpayers from shifting income into foreign subsidiaries with substantive outcomes of tax evasion or tax deferral.[42] Varanasi and Nagappan have rated the CFC to be an 'effective and internationally accepted measure to address BEPS' risks.[43]

In 2018, Pakistan rolled out its first CFC legislation in the form of section 109A of the I.T.O. 2001,[44] which becomes applicable to returns for the tax year 2019.[45] A few factors appear to have prompted this policy change. Firstly, a lax enforcement of tax laws in combination with an equally sloppy enforcement of foreign exchange regulations was conveniently allowing siphoning and parking of funds in offshore jurisdictions. Secondly, the developments that took place in the field of international taxation had left the tax system anachronistic and out of sync with reality. Lastly, the Pakistan tax system works on the basis of total world income coupled with a credit method to alleviate double taxation which warranted a shift from receipt-based to accrual-based taxation. Nevertheless, the matter continues to be debated: 'what CFC regimes are meant to achieve and why CFC regimes are found to offer appropriate solutions to the identified underlying structural issues'.[46] According to section 109A of the I.T.O. 2001, a 'controlled foreign company means a non-resident company, if (a) more than fifty percent of the capital or voting rights of the non-resident company are held, directly or indirectly, by one or more persons resident in Pakistan or more than forty percent of the capital … or voting rights of the non-resident company are held, directly or indirectly, by a single resident person in Pakistan; (b) tax paid, after taking into account any foreign tax credits available to the non-resident company,

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[36] *Ibid.*, at 47.

[37] *Ibid.*, at 44.

[38] *Ibid.*, at 11.

[39] Azam, *supra* n.16, at 579.

[40] Reuven S. Avi-Yonah, *Constructive Unilateralism: US Leadership and International Taxation*, University of Michigan Public Law & Legal Theory Research Paper Series, Paper No. 463 (2015), http://papers.ssrn.com.

[41] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3–2015 Final Report, 0.E.C.D/G20 Base Erosion and Profit Shifting Project* (Paris: OECD Publishing 2015).

[42] OECD, *supra* n. 47.

[43] Samira Varanasi & Meyyappan Nagappan, *Financial Budget for 2016–2017: Has India Put Its BEPS Foot Forward?*, 44(6&7) Intertax 556 (2016).

[44] PK: s. 109A of the Income Tax Ordinance, 2001, was inserted vide Finance Act, 2018.

[45] PK: Federal Board of Revenue's Circular No. 13 of 2019, dated 20 Aug. 2019.

[46] Daniel W. Blum, *Controlled Foreign Companies: Selected Policy Issues – or the Missing Elements of BEPS Action 3 and the Anti-Tax Avoidance Directive,* 46(4) Intertax (2018).

on the income derived or accrued, during a foreign tax year, by the non-resident company to any tax authority outside Pakistan is less than sixty percent of the tax payable on the said income under this Ordinance; (c) the non-resident company does not derive active business income; and (d) the shares of the company are not traded on any stock exchange recognized by law of the country or jurisdiction of which the non-resident company is resident for tax purposes.'[47]

The other recommended building blocks like CFC exemptions and thresholds; definition of CFC income; method of computation and attribution of income; and the prevention and elimination of double taxation were also built-in into the regulations. Pakistan's CFC legislation effectively subsumes and internalizes legal concepts such as *de minimis* thresholds, anti-avoidance requirements, and tax exemptions. Accordingly, only those CFCs that would fall within the nexus of the legislation are subject to effective tax rates that are meaningfully lower than those applied in Pakistan. In a nutshell, Pakistan's CFC rules being near-fully BEPS Action 3-compliant promise a robust anti-abuse mechanism. However, the omission of firms and PEs from the nexus of the CFC rules may be a serious downside of the legislation. Bilal has attributed the success of the tax amnesty scheme, 2018, inter alia, to the CFC rules whereby 'any income from investment in foreign entities has been made taxable'.[48] Zaidi has reckoned it as 'the most important change in the taxation laws of Pakistan since 1922', and equated it with Pakistan 'entering into a new phase of taxation' which was 'the result of the change in commercial and economic environment of the world'.[49]

4.3 *Action 4 – Interest Deductions and Other Financial Payments*

Traditionally, MNEs have been susceptible to devising tax planning ploys that are more aggressive as compared to those operating only within national geographical boundaries. One of the modes through which MNEs dilute their tax liabilities in source states is by adjusting the debt of individual group companies through intra-group financing arrangements by deploying instruments that are interest-deductible and escape restrictions on interest deductibility.[50] It has been posited that the 'influence of tax rules on the location of debt within multinational groups' is well-established and that 'groups can easily multiply the level of debt at the level of individual group entities via intra-group financing'.[51] Contextually, an MNE's behaviour could potentially give rise to BEPS risks in three situations in which they (a) place higher levels of third party debt in high tax countries; (b) use their own funds (intragroup loans) to generate interest deductions in excess of the group's actual third party interest payments; and (c) abuse third party or intragroup financing to fund a generation of tax exempt incomes. BEPS Action 4 was exclusively geared to address this risk.

The work done under BEPS Action 4 culminating into the report titled 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments' prescribes several best practices and proposes a plan that mitigates debt-related tax evasion risks.[52] The report prescribes a two-pronged approach consisting of the *group ratio rules* and the *fixed ratio rules*. The group ratio rules stipulate that the availability of interest deduction within the group is limited to the overall third party interest expense incurred by the group after which the interest expense allocated to an entity is correlated with the economic activity undertaken by that entity. This mechanism is expected to ensure that an entity's net deductions are directly linked to the taxable income produced by its economic activities. The fixed ratio rules, on the other hand, warrant that the deductions for interest (and other payments economically equivalent to interest) are limited to a percentage of the earnings before interest, taxes, depreciation, and amortization (EBITDA) which could be the ratios between ten and 30%. If a jurisdiction does not introduce group ratio rules, it could apply fixed ratio rules to multinationals and domestic groups without improper discrimination. The group ratio rules and fixed ratio rules can be combined to allow an entity a net interest expense above a country's fixed ratio to the level of net interest/EBITDA ratio of its group. It goes without saying that intragroup interest payments also attract transfer pricing rules that seek to limit the amount of interest payable to group companies sans appropriate substance to risk-free return on the funding.

The most significant check within the Pakistan tax system to counter BEPS ploys may be the rules pertaining to thin capitalization. The tax law lays down a comprehensive set of provisions covering various aspects of the instrument. Section 106(1) of the I.T.O. 2001 stipulates that in case 'a foreign-controlled resident company … or a branch of a foreign company operating in Pakistan, has a foreign debt-to-foreign equity ratio in excess of three to

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[47] Pakistan, *supra* n. 23.

[48] Bilal Hassan, *Pakistan: Recent Developments in Taxation of Foreign Income and Assets in Pakistan*, 21(2) Derivatives & Financial Instruments (2019).

[49] M. Shabbar Zaidi, *Offshore Income and Assets of Pakistanis and the Finance Bill 2018: End of Tax Exemption Regime-II*, Business Recorder (20 May 2018).

[50] For instance, compulsory convertible debentures and other guaranteed debt instruments.

[51] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4–2015 Final Report* 11 (Paris: OECD Publishing 2015).

[52] OECD, *Limiting Base Erosion Involving Tax Deductions and Other Financial Payments, Action 4–2016 Update: Inclusive Framework on B.E.P.S, OECD/G20 Base Erosion and Profit Shifting Project* (Paris: OECD Publishing 2017).

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'.[53] A foreign-controlled resident company, in turn, is defined as an entity 'in which fifty per cent or more of the underlying ownership of the company is held by a non-resident person … either alone or together with an associate or associates'.[54] The law also defines the relevant key concepts like 'foreign debt' and 'foreign equity' and devises a reasonably elaborate machinery to operationalize itself.[55] In the case of intra-group payments, interest is taxed at 10% and a corresponding deduction is allowed to the resident entity. In all genuine cases of continued loss-making or other statutory exemptions, the recipients of debt could approach the Commissioner IRS for an exemption certificate. In case the recipient has no presence in Pakistan, the withholding tax of 10% would constitute the final discharge of liability. The thin capitalization safety net comes into play in the case of a foreign-controlled resident company and in the case of a PE alike with effect from 1 July 2008.[56]

This is an area of concern for the Pakistan tax administration as a significant amount of potential revenue haemorrhages each year on account of manipulated outpayments as interest and other similar expenses and consequential deductions at the going corporate rate. BEPS Action 4 proffers Pakistan an important opportunity in that it not only supplies much-needed intellectual anchors and instruments in a ready-to-cook form but also takes the pressure off both revenue mandarins and the ruling coalitions in case any significant resistance is mounted from any interest group.[57] Pakistan has yet to introduce any of the targeted ratio rules into its tax code in spite of the fact that the problem is sizeable.[58]

4.4 *Action 5 – Countering Harmful Tax Practices*

The risk of preferential tax regimes being used for artificial profit shifting has generally been considered to be significant. A preferential regime typically offers some form of tax preference vis-à-vis the general tax law in the relevant jurisdiction in the form of a reduction in applicable tax rates, reduction in tax base, or some other benefit that could potentially result in a reduced tax liability. Such a jurisdiction need not necessarily be a low tax jurisdiction simply because a preferential regime can replicate features of a low tax jurisdiction. This matter was taken up under BEPS Action 5 for appropriate analysis and resolution and also reckoned as a minimum standard. The BEPS Action 5 report, 'Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance',[59] broadly straddles two strands: one, the identification through a peer review of preferential regimes which can facilitate base erosion and profit shifting; and two, compulsory spontaneous exchange of relevant information on taxpayer-specific rulings which may give rise to BEPS concerns.[60]

The Action 5 report, for a general principle, avers that preferential regimes should be allowed only if there is substantial activity in the relevant jurisdiction. The underlying objective is to realign taxation of profits with the substantial activities that generate them. The report divides preferential regimes into IP non-IP regimes. After considering several approaches, the report settles on the use of the nexus approach. In respect of IP regimes, specifically the regimes relating to patents and their equivalents, the report suggests that the benefits should only be granted regarding income arising from IP where actual R&D is undertaken by the taxpayer itself. The income should be eligible for a tax benefit in proportion to the ratio between the qualifying expenditure and the overall expenditure. The qualifying expenditure has been defined to include expenditures on the work done by the entity itself or by another related entity but excludes expenditures on acquisition of IP or on the outsourcing of work to a related party. Incidentally, in the context of the exclusion of outsourcing to related parties, a question for Pakistan is whether it could affect the outsourcing of work to captive R&D centres in Pakistan. For non-IP regimes, a different test has been applied for various industries to assess the link between income qualifying for benefits and the core activities necessary to earn the income. Illustratively, the sectors covered by the Action 5 report include shipping and fund management industries.

Coming to the lack of transparency in rulings, the report suggests compulsory spontaneous exchange of information and specifically identifies a few categories of rulings such as those pertaining to preferential regimes,

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[53] PK: s. 106 of Pakistan, *supra* n. 23.

[54] PK: s. 106(2) of *ibid.*

[55] PK: s. 106 of *ibid.*

[56] The amendment was introduced in s. 106 of the I.T.O. 2001 through Finance Act, 2008.

[57] OECD, *supra* n. 52.

[58] India recently introduced s. 94B entitled as 'Limitation on interest deduction in certain cases' into the Income Tax Act, 1961, vide the Finance Act, 2017, to address BEPS risks.

[59] OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5–2015 Final Report* (2015).

[60] Sadiq, Sawyer & McCredie, *supra* n. 3, at 10.

transfer pricing, and PE status that ought to be exchanged. Depending on the type of rulings, the persons or jurisdictions with whom those are required to be shared widely vary. In any case, these rulings must be exchanged with the jurisdiction of the ultimate parent or the immediate parent of the entity and/or of the jurisdiction of the related party or parties with whom the transaction is carried out. The idea is that all affected jurisdictions should have a sense of the nature of the ruling and should be able to see if there is any harmful profit shifting taking place. Importantly, the Action 5 report does not automatically bind anyone until legislation has been enacted for this purpose. Therefore, it remains to be seen when the precise laws that Pakistan and other jurisdictions legislate in this regard. Pakistan believes that there are no preferential tax regimes that could give rise to BEPS concerns and that no rulings were issued other than advance rulings in a few case-specific situations.

5 Substance (Actions 6-10)

The second thematic pillar *Substance* covers BEPS Actions 6–10 that deal with the prevention of tax treaty abuse, avoidance of PE status, and transfer pricing, respectively. This selection benchmarks Pakistan's progress on each one of them.

5.1 *Action 6 – Preventing Tax Treaty Abuse*

The abuse of tax treaties, particularly tax treaty shopping, has been well recognized as one of the most important BEPS risks. MNEs looking to indulge in treaty abuse undermine the tax base and deprive developing countries of much-needed tax revenues. It was in this context that Action 6 of the BEPS Project was dedicated to appraise and analyse tax ploys and strategies that are designed to abuse tax treaties and devise effective counter-measures on this count. 'The aim of the Action,' Sadiq et al. explained, 'was to develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.'[61] The BEPS Action 6 report entitled 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances' came up with a workable plan to deal with the menace of tax treaty abuse.[62] It is pertinent to mention that Action 6 is one of the four BEPS minimum standards and is subject to peer review.

While the overarching objective remained the elimination of double taxation without creating opportunities for tax evasion and double non-taxation, mainly three recommendations stemmed from the BEPS Action 6 work. Firstly, contracting States have been advised to incorporate in the preamble to their treaties a formulation clearly articulating 'the intent to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements'.[63] Secondly, the insertion of a limitation of benefits (LOB) provision has been recommended to imply that the benefits accruing from and under a particular tax treaty would only be entitled to legitimate persons whose status would be decided based upon objective criteria such as legal nature as well as ownership in and nature of the activities of the residents of the contracting States. Thirdly, a general anti-abuse rule (GAAR) based on the principal purpose of the transaction or arrangement was recommended to address other forms of abuse not covered by an LOB, e.g. conduit financial frameworks.

Accordingly, Pakistan has adopted the reformulated paragraph 3 of Article 4 of the OECD MTC, as amended in 2017, into Pakistan Model DTA[64] to limit treaty benefits in all inappropriate situations. Moreover, Pakistan has opted for the LOB provision in the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI). By virtue of amendment in section 109(1) of the I.T.O. 2001, the Commissioner IRS, with effect from tax year 2018, has been empowered to 'disregard any entity or a corporate structure that does not have an economic or commercial substance or was created as part of the tax avoidance scheme'.[65] The term 'tax avoidance scheme' has also been defined to mean a 'transaction where one of the main purposes of a person in entering into the transaction is the avoidance or reduction of any person's liability to tax under this Ordinance'.[66] The reduction in a person's tax liability has also been defined as 'a reduction, avoidance or deferral of tax or increase in a refund of tax and includes a reduction, avoidance or deferral of tax that would have been payable under th[e] Ordinance, but are not payable due to a tax treaty for the avoidance of double taxation'.[67]

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[61] *Ibid.*, at 11.

[62] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project* (Paris: OECD Publishing 2015).

[63] OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 – 2015 Final Report OECD/G20 Base Erosion and Profit Shifting Project* (Paris: OECD Publishing 2015).

[64] The Pakistan Model DTA refers to the Draft Model Convention transmitted to negotiation partners as the base document, which is intrinsically based on the UN MTC, but here and there, tinkered with Pakistan-specific modifications.

[65] PK: s. 109(1)(d) of Pakistan, *supra* n. 23.

[66] PK: s. 109(2) of Pakistan, *supra* n. 23.

[67] PK: s. 109(3) of Pakistan, *supra* n. 23.

Pakistan, by virtue of being a member of the Inclusive Framework, is committed to the minimum standard, has signed the MLI and opted for the preamble statement set out in Article 6 of the MLI[68] and the PPT as designed in Article 7 of the MLI.[69] Pakistan, at the time of signing of the MLI, notified the OECD sixty-three of its treaties as MLI-covered treaties except those with Hong Kong and Brunei, which were yet not enforced. Expectedly, when Pakistan ratifies the MLI, the existing sixty-three DTAs or any additional DTAs enforced by then will be notified to the OECD – the depository of the MLI, meaning thereby that Pakistan's entire network of existing treaties would be MLI-covered as long as they also receive the requisite counter-party coverage. Pakistan's response to the implementation of BEPS Action 2 prescriptions, at both treaty and domestic legislation levels, has not yet been rolled out as the very existence and intensity of BEPS concerns are being gauged.

5.2 *Action 7 – Avoidance of PE Status*

It is a known fact that tax reduction strategies of trans-border business operators majorly hinge on avoiding the status of a PE in the source State. This is simply because treaties generally ordain that business profits of a foreign entity are taxable in a State only to the extent that the entity in that State has a PE to which the profits are attributable. BEPS Action 7 was specifically mandated to study the problem, identify gaps in the relevant legal infrastructure, and suggest means to enable taxation of profits where they belong and arise. The report 'Preventing the Artificial Avoidance of Permanent Establishment Status'[70] presented under BEPS Action 7 makes specific recommendations on this count, laying proper focus on amending the definition of a PE and better understanding the contractual obligations between enterprises working closely but located in different jurisdictions.

Pakistan responded to the BEPS prescriptions on limiting the scope of exclusions to the PE definition listed in paragraph 4 of Article 5 of the OECD MTC only to those activities that are factually of a 'preparatory or auxiliary' character by amending its Model Draft pronouncing its base negotiating position. Likewise, a new anti-fragmentation provision was brought in to ensure that it was no longer possible to benefit from those exceptions through the fragmentation of business activities among closely related enterprises, e.g. warehousing. Resonating paragraph 4 and the new paragraph 4.1 of Article 5 of the OECD MTC, sub-clause (e) of clause (41) of section 2 of the I.T.O. 2001 has comprehensively been reformulated to include all recommended and desired elements in the PE's definition.[71]

The definition of an agency PE has likewise been brought in tune with BEPS proposals and re-written to the effect that the 'persons habitually concluding contracts that are in the name of the enterprise or that are to be performed by the enterprise, or habitually playing the principal role leading to the conclusion of such contracts which are routinely concluded without material modification by the enterprise, can lead to a permanent establishment for the enterprise'.[72] The substance of the new principle is that any person who acts 'in a Contracting State on behalf of an enterprise'; and in the process 'habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise'; and that the 'contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise'.[73] This mechanism was supplemented through introduction of anti-fragmentation rules into domestic legislation which is essentially a substantive reflection of paragraph 4.1 of Article 5 of the OECD MTC, inserted in 2017.[74]

It was posited that, by virtue of the new paragraph 4.1 in the OECD MTC, the exceptions listed in paragraph 4 thereof would 'not apply to a place of business that would otherwise constitute a permanent establishment where the

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[68] Art. 6 of the MLI reads: 'Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions;' … 'Desiring to further develop their economic relationship and to enhance their co-operation in tax matters.'

[69] Art. 7 of the MLI (as adopted by Pakistan) reads: 'Where a benefit under a Covered Tax Agreement is denied to a person under provisions of the Covered Tax Agreement (as it may be modified by this Convention) that denial or part of the benefits that would otherwise be provided under the Covered Tax Agreement where the principal purpose or one of the principal purposes of any arrangement or transaction, or f any person concerned with an arrangement or transaction was to obtain those benefits, the competent authority of the Contracting Jurisdiction that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement. The competent authority of the Contracting Jurisdiction to which a request has been made under this paragraph by a resident of the other Contracting Jurisdiction shall consult with the competent authority of that oter Contracting Jurisdiction before rejecting the request.'

[70] OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7- 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project* (Paris: OECD Publishing 2015).

[71] PK: s. 2(41)(e) of Pakistan, 'The Income Tax Ordinance, 2001,' inserted vide Finance Act, 2018.

[72] OECD, *Model Tax Convention on Income and on Capital: Condensed Version, 2017,* 103 (Paris: OECD Publishing 2017).

[73] *Ibid.*

[74] PK: s. 2(41)(g) of Pakistan, 'The Income Tax Ordinance, 2001.' inserted vide Finance Act, 2018.

activities carried on at that place and other activities of the same enterprise or of closely related enterprises exercised at that place or at another place in the same State constitute complementary functions that are part of a cohesive business operation'.[75] It was further explicated that the purpose of the new paragraph was to prevent an enterprise or a conglomeration of associated enterprises from fragmenting a cohesive business operation into pieces so as to argue that each one is only engaged in a preparatory or auxiliary activity.[76] The mischief of the anti-fragmentation rule as introduced in Pakistan is a lot wider and does not restrict itself to only limiting the interpretation and application of 'preparatory or auxiliary activities'. The nexus of 'cohesive business operation' is extensive as it not only 'includes an overall arrangement for the supply of goods, installation, construction, assembly, commission, guarantees or supervisory activities' and other principal activities that are undertaken or performed by the person or the associate of the person but also the supply of goods that are 'imported in the name of the associate or any other person, whether or not the title to goods passes outside Pakistan'.[77] This can prove to be a significant anti-BEPS provision in Pakistan.

The artificial avoidance of PE status in developing countries also has a different but equally important dimension. Much of the tax evasion that MNEs perpetrate in developing countries may be due to gaps in the operative legal regime, but it is also due to lack of capacity of the developing country tax administrations to crack into complex, multi-layered, and sophisticated BEPS ploys. It was intriguingly observed that, in order to take undue advantage of weak audit enforcement capacity of developing country tax administrations, MNEs have gone to the extent of having artificial PEs in source States so as to get passive incomes like dividend, interest, and royalties taxed on net rate rather than on an applicable withholding rate.[78] Pakistan's innovative counter-response has been to eliminate paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, and paragraph 4 of Article 7 of the OECD MTC or their equivalents in UN MTC and corresponding provisions of the DTAs.[79]

5.3 *Actions 8-10 – Transfer Pricing*

The single most important BEPS risk that may have historically caused maximum revenue pilferage internationally is certainly MNE intragroup transfer pricing. A 'transfer price' implies the price at which various entities within a multinational group deal with each other. It has been averred that MNEs exploit transfer pricing practices 'to separate income from the economic activities that produce it and to shift it to low-tax jurisdictions'.[80] The greater the BEPS risks posed by TP, the harder it is to mitigate them. Moreover, the impact of TP is consistently being accentuated by the fact that, in a globalized economy, both the value and volume of intra-group trade is continually rising. The world has traditionally relied upon TP rules for tax purposes that were 'concerned with determining the conditions, including price, for transactions within an MNE group resulting in the allocation of profits to group companies in different countries'.[81] These rules were centred on the principle of arms' length. With time, it has been realized that the existing rules are subject to misuse in that their application might not necessarily result in outcomes that align taxation of profits with the locus of value creation.

The OECD has been engaged with the subject of TP for over four decades now. The Transfer Pricing and Multinational Enterprises 1979[82] was the pioneering work in this connection, which was repealed by the OECD Council in 1995. Then there were other reports that addressed TP issues in the context of specific topics. These reports were Transfer Pricing and Multinational Enterprises – Three Taxation Issues 1984[83] and Thin Capitalization 1987.[84] The guidelines included in these reports also drew upon the deliberations undertaken by the OECD on the proposed transfer pricing regulations in the United States.[85] However, it was increasingly felt that the OECD's TP Guidelines were losing luster, relevance, and effectiveness. Thus, BEPS Actions 8–10 were entrusted the task of reappraising the existing TP guidelines and rendering them in sync with current realities of business practices in the world of commerce and business. Broadly speaking, Action 8 dealt with intangibles, Action

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[75] OECD, *supra* n. 72, at 103.

[76] *Ibid.*

[77] PK: 'Explanation' to s. 2(41)(g) of Pakistan, *supra* n. 74.

[78] Muhammad Ashfaq Ahmed, Na Li & Peter Mellor, *China-Pakistan Double Taxation Agreement and China-Pakistan Economic Corridor*, 72(8) Bull. Int'l Tax'n (2018).

[79] Illustratively, Pakistan successfully negotiated this counter-measure in its DTA with Moldova in 2011.

[80] Sadiq, Sawyer & McCredie, supra n. 3, at 17.

[81] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project* (Paris: OECD Publishing 2015).

[82] OECD, *Transfer Pricing and Multinational Enterprises* (1979).

[83] OECD, *Transfer Pricing and Multinational Enterprises* (1984).

[84] OECD, *Thin capitalisation* (Paris: OECD Publishing 1987).

[85] OECD, *Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations: A Report* (Paris: OECD Publishing 1993).

9 with allocation of risks and the resulting allocation of profits to those risks, and Action 10 with residual high-risk areas – including low value adding transfers, e.g. management fees and head-office expenses. The Actions 8–10 report 'Aligning Transfer Pricing Outcomes with Value Creation' summarizes the extensive work on TP and makes solid proposals.[86] In a nutshell, BEPS recommendations under Actions 8–10 majorly focus on:

(1) Accurate delineation of intra-group transactions through careful analysis of contractual obligations in conjunction with evidence of actual conduct of the related parties.
(2) Functional analysis of the contract/transaction by deploying the newly recommended six-step analytical framework with risks forming its central pillar with a view to determining that the party which assumes a risk should also control the risk and ought to also have the requisite financial capacity to assume the risk.
(3) Non-allocation of more than risk-free returns and even lesser if the transaction does not make economic sense to an entity of a cash-rich MNE group supplying funds without controlling corresponding financial risks.
(4) Determination of commercial rationality of arrangements that would be agreed between related parties under comparable economic circumstances and, if found devoid of substance, the tax administrations were to disregard such transactions.

Pakistan has put in place a robust set of provisions to counteract aggressive TP ploys orchestrated by MNEs in the shape of section 108 'Transactions between associates' and section 109 'Recharacterization of income and deductions' of the I.T.O. 2001. In order to fortify the pre-existing anti-TP regimes, the Finance Act, 2018, added clause (d) to sub-section (1) of section 109 supra empowering the Commissioner IRS to 'disregard an entity or a corporate structure that does not have an economic or commercial substance or was created as part of the tax avoidance scheme'.[87] The substance-over-form standard is more an anti-abuse device camouflaged within TP rules than a real TP rule. The OECD, in its collection-oriented BEPS package that was drafted, decided to eliminate this standard from the TP Guidelines because it posed a lot of compatibility issues with the arm's length standard.[88] In section 109(2), 'tax avoidance scheme' was also redefined to mean 'any transaction where one of the main purposes of a person in entering into the transaction is the avoidance or reduction of any person's liability to tax under this Ordinance'.[89] Pakistan has also introduced legislative changes necessary to enable the tax administration to receive and transmit country-by-country reports in all qualifying cases.[90] In spite of the fact that a state-of-the-art legislation is in place and that the latest OECD guidelines can be inducted into utilization under the ambulatory approach yet capacity constraints of the tax administration to be able to purposefully use all the tools that are placed at its command continue to be a major cause of concern.

6 Transparency and certainty (Actions 11-14)

The BEPS's third thematic pillar *Transparency and Certainty* covers Actions 11–14 that deal with 'Measuring and Monitoring BEPS', 'Mandatory Disclosure Rules', 'Country-by-Country Reporting', and 'Dispute Resolution', respectively, and are dealt with in this section.

6.1 *Action 11 – Measuring and Monitoring BEPS*

In spite of the fact that fiscal implications of BEPS are now perceptibly significant, systematically measuring them remains a serious challenge. The OECD had estimated the magnitude of BEPS on account of corporate income tax (CIT) roughly between four and 10% globally, i.e. between USD 100 and USD 240 billion per annum. It was argued that, owing to the fact that 'developing countries have a greater reliance on CIT revenues, estimates of the impact on developing countries, as a percentage of GDP, are higher than for developed countries'.[91] BEPS Action 11 was dedicated to measuring and monitoring BEPS across jurisdictions. The BEPS Action 11 report, 'Measuring and Monitoring BEPS', devises a framework under which the OECD would continue to stay engaged with national governments.[92] Generally, BEPS is also believed to be 'tilting the playing field in favor of tax-aggressive MNEs, exacerbating the corporate debt bias, misdirecting foreign direct investment, and reducing the financing of needed public infrastructure'.[93] The report

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[86] OECD, supra n. 81.

[87] PK: s. 109(1)(d) of Pakistan, *supra* n. 23.

[88] *Ibid.*

[89] *Ibid.*

[90] This subject will be dealt with under the relevant BEPS Action 13.

[91] OECD, *Measuring and Monitoring BEPS, Action 11–2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project* (Paris: OECD Publishing 2015).

[92] OECD, *infra* n. 100.

[93] *Ibid.*

using different data and metrics gleans indicators of BEPS activity that highlight BEPS' behaviours.

The BEPS Action 11 report mandates the OECD to work with governments to report and analyse more CIT statistics and to present them in an internationally consistent manner. In this connection, statistical analyses based upon Country-by-Country reporting data have the potential to significantly enhance the economic analysis of BEPS risks. Pakistan has already signed a Country-by-Country – Multilateral Competent Authority Agreement (CbC-MCAA) and is exchanging Country-by-Country reports with other jurisdictions. It is expected that, like elsewhere, the improvements in the availability of data will ensure that Pakistan's policy planners would be better equipped to measure and monitor BEPS with a greater degree of certainty and validity and devise policy tools accordingly.

6.2 *Action 12 – Mandatory Disclosure Rules*

Actionable tax information is any tax administration's most valuable raw material. Thus, a timely sharing of comprehensive and relevant information on various cross border aggressive tax planning strategies as well as about their users and promoters becomes critically important in busting those schemes effectively in an international setting. BEPS Action 12 was assigned to appraise 'the tools designed to increase the information flow on tax risks to tax administrations and tax policy makers'.[94] The Action 12 report 'Mandatory Disclosure Rules' (MDRs), inter alia, prescribes 'the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules'.[95] It further prescribed a modular framework that can capacitate jurisdictions without MDRs to lay out a regime that suites them to gather early information on potentially harmful tax planning ploys and their users.[96] Although the prescription package under BEPS Action 12 does not constitute a minimum standard yet, it has been urged that, if a country decides to legislate and enforce the MDRs, those should be flexible enough to balance its needs for better and timelier information with the additional compliance burdens loaded on taxpayers.[97]

It has been proposed that jurisdictions looking to introduce the MDRs ought to (a) impose a disclosure requirement on both the promotor and the taxpayer or impose a primary responsibility to disclose on either the promotor or the taxpayer; (b) include a mixture of specific and generic hallmarks; (c) establish a mechanism to track disclosures; (d) link the timeframe for disclosure to the scheme being made available to taxpayers when the obligation to disclose is imposed on the promoter; (e) link it to the implementation of the scheme when the obligation to disclose is imposed on the taxpayer; and (f) promulgate penalties to ensure compliance.[98] The report builds on the OECD's Forum on Tax Administration's earlier (and ongoing) work towards enhancing information sharing through Joint International Tax Shelter Information and Collaboration Network (JITSIC Network). Although this is an important BEPS concern, nothing much has yet been done in Pakistan on the adoption of MDRs as stipulated under the Action 12 report. It has been argued that the 'novelty of this Action, along with the difficulty of convincing corporations to accept and implement recommendations, could be primarily responsible for inactivity here'.[99]

6.3 *Action 13 – Country-by-Country Reporting*

The OECD's TP Guidelines as amended from time to time usually faced challenges at the implementation level majorly due to the non-availability of cross-country data in a standardized and uniform manner. BEPS Action 13 was exclusively assigned to work out modalities of critical data sharing on MNEs and their utilization by tax administrations across countries in a hassle-free manner. The BEPS Action 13 report, 'Transfer Pricing and Country-by-Country Reporting', delivers elaborate guidelines and a framework for sharing of various data by MNEs to respective administrations and then by the latter amongst themselves.[100] In fact, essentially, 'the Action developed rules regarding transfer pricing documentation to enhance transparency for tax administrations'.[101]

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[94] OECD, *Mandatory Disclosure Rules, Action 12 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project* (Paris: OECD Publishing 2015).

[95] OECD, *infra* n. 101.

[96] *Ibid.*

[97] *Ibid.*

[98] *Ibid.*

[99] Sadiq, Sawyer & McCredie, *supra* n. 3, at 17.

[100] OECD, *Transfer Pricing and Country-By-Country Reporting, Action 13–2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Profit (OECD Publishing, 2015).

[101] Sadiq, Sawyer & McCredie, *supra* n. 3, at 12.

Under the BEPS-installed CbC reporting regime, MNEs are liable to provide the tax administrations with high-level information regarding their global business operations and transfer pricing policies in a 'master file' that is to be available to all relevant tax administrations. Additionally, a detailed transactional transfer pricing documentation would be supplied in a 'local file' vis-à-vis intra-group transactions beyond a certain threshold. Large MNEs would be liable to file CbC reports therein annually and for each tax jurisdiction in which they conduct business that contain all essential information including but not limited to the amount of revenues earned, profits before tax, income tax paid, aggregates of employees, etc. All MNEs with an annual consolidated group revenue equal to or exceeding EUR 750 million have been mandated to annually exchange CbC reports on an automatic basis through the tax administrations of the jurisdictions in which they reside. Although, Varanasi and Nagappan have argued, 'If such data is made fully accessible without any restrictions or controls, it may raise concerns regarding potential misuse of such information by private competitors'[102] yet this is a change of mega proportions in the way MNEs have historically conducted business and how tax administrations taxed them.

Pakistan's response to international developments has been rather prompt, signing a CbC-MCAA on 27 June 2017, and is committed to the world community to exchange data about MNEs' business operations taking place inside its jurisdiction. Through a flurry of changes in legislative and sub-legislative regimes, a comprehensive internationally compatible legal infrastructure was set out to enable the tax administration to transmit and receive CbC reports in all eligible cases. Section 108 of I.T.O. 2001 was also amended by incorporating the following enabling provisions.[103]

In addition, Pakistan added Chapter VIA entitled 'Documentation and Country-by-Country Reporting Requirements' consisting of three parts, namely, Part I 'Preliminary', Part II 'Country-by-Country Reporting Requirements', and Part III 'Documentation Requirements'[104] in the Income Tax Rules, 2002 (I.T.R. 2002). Pakistan has so far enforced notifications on all resident constituent entities divulging therein particulars of their ultimate parent entity (UPE) or surrogate parent entity (SPE) liable to file CbC reports on their behalf. The resident MNEs claiming to be UPEs or SPEs have been tasked to fulfil their legal obligations of CbC reporting. In the 2018 exchange cycle, Pakistan received CbC reports from sixteen jurisdictions, which is likely to go up as more and more jurisdictions fulfil internal procedures and join the transmission platform. Given the fact that Pakistan's economy is relatively less globalized, the CbC reports are going to have limited impact and utility in the near future.

6.4 *Action 14 – Dispute Resolution*

A quick and cost-effective resolution of disputes has always been an important strive of the international taxes framework. Both the UN MTC and OECD MTC carry Article 25 on the Mutual Agreement Procedure (MAP) that aims to facilitate the resolution of issues faced by taxpayers covered under a bilateral agreement through mutual consultation between competent authorities. It is generally believed that MNEs have been at the receiving end of the overwhelming reform of the international tax system by virtue of significantly enhanced reporting requirements. The BEPS Action 14 report, 'Making Dispute Resolution Mechanisms More Effective',[105] looks to render the MAP mechanism autonomous of the ordinary legal remedies available under domestic law, ensure that treaty obligations related to the MAP are fully implemented in good faith, guarantee the implementation of MAP related administrative processes to a maximum degree, assure taxpayers that they can access a MAP when eligible, provide timely and complete reporting of MAP statistics based on the new MAP statistics reporting framework, and publish their MAP profiles pursuant to an agreed template.[106]

Pakistan, being part of the BEPS Inclusive Framework, is committed to the implementation of Action 14 and, in the MLI, has opted for non-binding arbitration until 2020. Although, the OECD has apparently played a balancing act by presenting arbitration in the MLI as a pro-taxpayer outcome of the BEPS plan yet, in reality, when viewed from the prism of the protracted tax dispute resolution scene across the globe, there is every possibility of its also turning out to be a redeeming option for tax administrations. It is true that there is reluctance in Pakistan in relation to committing the State to more international arbitration which understandably stems from its failures at the international level in non-tax arbitration.[107] In the wake of wide-going implementation of BEPS prescriptions, it is likely that tax litigation would increase manifold, and arbitration is most likely to emerge as an answer to the additional litigation workload for which Pakistan and other

Notes

[102] Varanasi & Nagappan, *supra* n. 49, at 557.

[103] PK: s. 108(3),(4),&(5) Income Tax Ordinance, 2001, which were added vide Finance Act, 2018.

[104] PK: Chapter VIA Income Tax Rules, 2002 inserted vide Notification No.1191(1)/2017, dated 16 Nov. 2017.

[105] OECD, *Making Dispute Resolution Mechanisms More Effective, Action 14–2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2015).

[106] OECD, *supra* n. 112.

[107] M. Ashfaq Ahmed, *National Report: Pakistan*, in: *International Arbitration in Tax Treaty* (M. Lang & J. Owens eds, IBFD 2018).

developing countries would have to prepare themselves sooner than later. It is expected that arbitration essentially being less procedural, more objective, and fact-based would encourage both the tax administrations and taxpayers to be judicious and just in their conduct and develop quicker dispute resolution regulations.

Pakistan has recently upgraded its Alternative Dispute Resolution (ADR) regime that was originally introduced in 2001 to offer an additional window for expeditious resolution of tax disputes. The ADR as originally enshrined in law was only recommendatory in nature as the tax administration reserved its right to sidestep the ADR Committee's recommendations and proceed to pursue litigation in tax courts; and the taxpayers had to compulsively follow suit. It is due to this very flaw in the ADR system that it did not prove any effectiveness towards alleviation of taxpayers' hardships. In 2018, it was proposed to make the ADR decision binding for both the tax administration as well as the taxpayer. Moreover, the revamped ADR regime was to go into gear only after both litigant parties had withdrawn their cases pending in courts. In order to energize the system, the composition of the ADR Committee was also reconstituted to include a retired judge of a High Court, a representative of the tax administration, and experts from the tax professionals' community. The period in which the ADR had to be finalized was also reduced from 180 to 120 days. In the case that a decision was not delivered within the stipulated time limit of seventy-five days, the ADR Committee was to stand dissolved, the appeals withdrawn would stand restored, and the appellate courts would proceed to decide upon the disputes within a period of six months. The changes made to the ADR system through Finance Act 2018 failed to attract taxpayers into opting for the alternative mechanism. In this connection, Pakistan has signed the MLI by opting Article 16 of MLI, which implies non-binding arbitration despite the fact that Pakistan has already signed mandatory arbitration in its treaties with Kazakhstan, Hong Kong and, lately, Switzerland, but none of them has yet been operationalized. On the other hand, Pakistan's MAP regime is not in good shape as a non-resident taxpayer hardly ever triggers it. Only a serious enquiry could establish if Pakistan's tax justice system is efficient and trusted or if its MAP is less preferred for lack of efficiency and empathy.

It is obvious that developing countries would feel stressed while walking headlong into arbitration as an overwhelming alternative mechanism of tax dispute resolution – uncontrolled, extensive, and expensive – as it resembles a multi-headed monster to them. The developing States' anxiety majorly stems from their lack of capacity and resources needed to protect their legitimate fiscal interests against mighty MNEs of powerful States which, in turn, is anchored in their past hundred years' of experience in international taxation centred mainly on the fiction of the PE and the predatory principle of residence-based taxation.[108] It is plausible that developing countries under the UN MTC Article 25 would feel safer as it keeps the State in control of things to a relatively greater degree. It has been prophesized that 'it is no more a matter of "if" but "when" the ad-hoc arbitration panels disjointedly emerged here and there evolve into an "international tax court" with permanent international judges or arbitrators and a fixed judicial organization deriving its raison d'être from the collective will of the comity of nations'.[109]

7 Multilateral instrument

7.1 *Action 15 – Multilateral Instrument*

The ambitious international taxes reform agenda devised under the BEPS Plan needed to be implemented with the least cost and at the fastest possible pace. In this connection, BEPS Action 15 was assigned the task of devising a workable mechanism of streamlining the implementation of the BEPS measures related to tax treaties in a seamless manner. The BEPS Action 15 report, 'Developing a Multilateral Instrument to Modify Bilateral Tax Treaties',[110] devises a cost-effective and workable solution for quick implementation of the international taxes reform program chalked out under BEPS Actions 1–14. Pakistan provisionally signed the MLI on 27 June 2017. At the time of signing of the MLI, the government tactfully evaded the point of sovereignty or legitimacy being raised. The choices that Pakistan made to various MLI articles are listed in Table 1.

Table 1 Pakistan's Position on MLI Articles

#	MLI Article	Position Taken (Opted in/ Opted out)
(i)	Article 3 (Transparent entities)	Out
(ii)	Article 4 (Dual-resident entities)	Out
(iii)	Article 5 (Elimination of double taxation)	Out
(iv)	Article 6 (Purpose of a covered tax agreement – preamble)	In

Notes

108 Ahmed, *supra* n. 114.

109 *Ibid.*

110 OECD, *supra* n. 69.

#	MLI Article	Position Taken (Opted in/ Opted out)
(v)	Article 7 (Prevention of treaty abuse)	In
(vi)	Article 8 (Dividend transfer transaction)	Out
(vii)	Article 9(1) (Capital gains from alienation of shares in entities deriving value principally from immovable property)	Out
(viii)	Article 12 (Artificial avoidance of PE status through commissionaire arrangements and similar strategies)	Out
(ix)	Article 13 (Artificial avoidance of PE status through specific activity exemption)	Out
(x)	Article 16 (Mutual Agreement Procedure)	In
(xi)	Article 17 (Corresponding relief)	In

In brief, Pakistan's approach to the MLI is quite cautious as it has opted in for only Articles 6, 7, 16, and 17 as opposed to India, which has opted in for all MLI Articles except Articles 3 and 5.[111] At the time of signing of the MLI, Pakistan reported 63 out of 65 of its enforced DTAs as covered tax agreements (CTAs). Out of sixty-three of Pakistan's DTA partners, thirty-seven have counter-notified Pakistan in their list of CTAs.[112] However, five jurisdictions have excluded it from their CTAs' list.[113] Pakistan's remaining DTA partners have not yet signed the MLI.[114] Presently, internal procedures are being fulfilled to ratify the MLI at an early date.

8 Conclusion

The scoping appraisal carried out in the article reveals that Pakistan's approach to the BEPS prescription has been cautious, conservative, and measured. While some good progress has been achieved, substantial work still needs to be done in some key areas. The debate on Pakistan's response to the BEPS initiative can be summarized not only in terms of the practical steps taken, those that are still being contemplated, and the ideational concepts of sovereignty, efficacy, and legitimacy. On the digital economy, while imposition of withholding tax on the fees for offshore digital services having quite a broad definition is a good start, the challenge of inserting the SEPT into the enforced DTAs – at least, the most relevant ones – remains a formidable challenge. To counter BEPS risk on account of hybrid mismatches, Pakistan has not only started to incorporate an effective LOB in its DTAs but has also introduced a robust PPT provision in the domestic tax statute. Likewise, Pakistan may have done well by putting in place strong CFC legislation; the omission of firms and PEs from its purview remains a spot of bother. Pakistan's thin capitalization rules may well be in place, however, it needs to introduce group ratio rules to induce an EBITDA effect into the tax compliance culture. Likewise, Pakistan's performance in the peer review process on countering harmful tax practices could be reckoned satisfactory as it received no adverse observations, but discretion would have to be exercised going forward while extending category-specific or region-specific tax incentives.

Pakistan has also done well on the account of preventing tax treaty abuse by opting for the LOB and PPT provisions as prescribed in the MLI yet, given the size of revenue pilferage taking place on this count, a lot more needs to be done on the treaty network itself. Further, the amendments to the definition of a PE to forestall MNEs' aggressive profit shifting ploys is impressive, but a real difference could be made by effectively building the capacity of the tax administration to interpret and implement tax treaties more professionally. The legislative improvements on TP augur well but only to the extent that those are backed up by capacity building of the tax administration in requisite areas. The pace of implementation of the BEPS package is understandably faster in developed countries compared with developing ones. However, given the nature of the initiative, the countries lagging behind would soon start to feel the heat. Thus, Pakistan would not be in a position to long avoid implementing proposals on measuring and monitoring BEPS, MDRs, and revitalizing its MAP regime. It would also have to exercise choices with reference to other MLI Articles as the ratification draws close; this would significantly expand the agenda.

Notes

[111] S. Rao, *Coverage of OECD Multilateral Instrument on India and Its Top 10 Tax Treaty Partners in Terms of Foreign Direct Investment*, 46 Intertax 5 (2018).

[112] These are Austria, Belgium, Canada, China, Czech Republic, Denmark, Egypt, Finland, France, Hungary, Ireland, Italy, Japan, Kazakhstan, South Korea, Kuwait, Malaysia, Malta, Mauritius, Morocco, Netherlands, Nigeria, Poland, Portugal, Qatar, Romania, Saudi Arabia, Serbia, Singapore, South Africa, Spain, Sweden, Tunisia, Turkey, Ukraine, United Arab Emirates, and the United Kingdom.

[113] These jurisdictions are Germany, Hong Kong, Indonesia, Norway, and Switzerland.

[114] Pakistan's DTA partner jurisdictions that have not yet signed the MLI are Azerbaijan, Bahrain, Bangladesh, Belarus, Bosnia & Herzegovina, Brunei, Iran, Jordan, Kyrgyz Republic, Lebanon, Libya, Nepal, Oman, Philippines, Sri Lanka, Syria, Tajikistan, Thailand, Turkmenistan, Vietnam, and Yemen.

On the ideational side, it is clear that, in Pakistan, the questions of sovereignty and legitimacy have not necessarily been allowed in the public debate. Pakistan has deftly handled the BEPS implementation process by keeping it non-controversial as far as the sovereignty matter was concerned. In connection with the efficacy, the BEPS package has impliedly been accepted as beneficial to Pakistan hence, its reasonably fast-paced implementation. On legitimacy, it is suffice to state that the increase in revenue numbers would contribute towards enhancing the government's output legitimacy – much-needed commodity in a developing country perspective.