Chapter 26

Pakistan

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26.1. Anti-BEPS measures before the BEPS Project and policy impact of the BEPS Project

The promulgation of the Income Tax Ordinance, 2001 (the Ordinance) marked a significant shift in the treatment of non-residents operating in Pakistan with or without a permanent establishment (PE). Not that the tax codes that held the field prior to 2001 did not have any regime built in for the purpose;[1] they did, but during the present century, it has increasingly been felt that the legal instruments deployed have either grown anachronistic or leave too much room for tax avoidance – particularly by multinational enterprises (MNEs). Various tax codes that have remained in force for almost a century and a half[2] did have some tools in place to tax non-residents in respect of certain types of income arising to them, but all were deficient in one respect or another. Moreover, constant refinement, improvement and innovation of the tools of international taxation at various multilateral institutions, particularly the OECD and the UN, left them outmoded and irrelevant.

The Ordinance, which was "developed with technical assistance of the IMF",[3] included key provisions, such as "residency, geographical source, and international profit allocation", and a set of instruments "that protects the Pakistan tax base from being eroded", such as "transfer pricing and thin capitalization", and "domestic withholding taxes on critical payments abroad, such as management fees and interest payments".[4] It has thus been reckoned that now "Pakistan has a modern income tax act which contains,

* This chapter represents the legal situation as per 30 June 2017.
1. This included the PK: Income Tax Act, 1922; and PK: Income Tax Ordinance, 1979.
2. I.e. since 1861, when the law to tax income was first promulgated by the British India Government.
3. G.M.M. Michielse, *Tax Provisions and The Global Economy*, in *The Role of Taxation in Pakistan's Revival* p. 209 (J. Martinez-Vazquez & M.R. Cyan eds., Oxford U. Press 2015).
4. Id., at p. 209.

amongst others, all necessary domestic provisions that should be in place to safeguard its domestic tax system in the world of international business".[5]

However, there is a general perception – both inside and outside the tax administration – that, in reality, Pakistan's fiscal base is constantly being eroded. Furthermore, the country is being deprived of its legitimate resources on account of a legal regime that is visibly deficient in some key areas; for instance, Pakistan's extensive tax treaty network allows MNEs to undertake aggressive tax planning, and the tax administration, which is somewhat old-fashioned, is failing to keep pace with finer improvements taking place across the globe in the international tax arena.[6] In Pakistan, the judicial tradition has historically followed legislative trends in that first legislation is put in place by the legislature, after which the executive branch (the Federal Board of Revenue) issues guidelines and circulars to this purpose. The judiciary appraises these guidelines and circulars, etc. handed down by the executive branch, or examines its ramifications in judicial review proceedings.

Contextually, a point in study is the *Westminster* principle, which allowed freedom to taxpayers to plan their tax affairs in such a way as to reduce their tax liability, and which has – to date – been followed by superior courts in Pakistan.[7] Having been a British colony, Pakistan's legal system stems from and is couched in the common law tradition, and has historically followed important judicial pronouncements and doctrines enunciated therein. Of late, the *Westminster* rule has gone through major reconsideration and modification internationally, in terms of both judicial pronouncements and policy research as manifested by the *Ramsay* decision[8] and the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, respectively, yet it remains to be seen how Pakistan's judicial system will respond to and interpret deliberate tax avoidance ploys in the post-BEPS scenario, and how it will enunciate new doctrines that can help protect its fiscal base and interests.

Pakistan's tax system has historically been prone to base erosion and profit shifting on account of misuse of PE status, and the substantially large tax treaty network aggravated the situation. In this regard, three prominent

5. Id., at p. 209.
6. This is also evidenced in below-par revenue effort measured in terms of the tax:GDP ratio, which consistently runs below 10%.
7. UK: House of Lords (UKHL), 7 May 1935, *Inland Revenue Commissioners v. Duke of Westminster*, (1936) A.C. 1, 19 T.C. 490.
8. UK: UKHL, 12 Mar. 1981, *W.T. Ramsay v. Inland Revenue Commissioners*, (1982) A.C. 300.

loopholes can be identified. First, section 2(41)(c) of the Ordinance defines an "agency PE" in respect of a person acting in Pakistan on behalf of another person, if the former person "has and habitually exercises an authority to conclude contracts on behalf of the other person; and has no such authority, but habitually maintains a stock-in-trade or other merchandise from which the agent regularly delivers goods or merchandise on behalf of the other person".[9] Illustratively, a new legal concept of "indenting commission agent" was created by the law for which a withholding tax rate of 5% was prescribed and declared a final discharge of tax liability. Section 154(2) of the Ordinance stipulates that "[e]very authorized dealer in foreign exchange shall, at the time of realization of foreign exchange proceeds on account of the commission due to an indenting commission agent, deduct tax from the proceeds at the rate" of 5%.[10]

Of late, this has emerged as a significant tax avoidance ploy on the part of MNEs as they – instead of establishing an office, branch, outlet or sales point inside Pakistan that could be treated by the tax administration as a PE – choose to operate through an agent who, although working on behalf of the non-resident principal fulfilling the preconditions of the PE, invokes and takes advantage of the "indenting commission" clause, thereby funnelling the total price of the transaction out of the country tax-free, offering, in the process, a meagre 5% of the "contrived" commission revenue by the indenter.

A second loophole is seen where the time threshold for a so-called construction PE has aggressively been fixed at a period or periods aggregating more than 90 days in any 12-month period.[11] This is not too tenable a stance when viewed within the context of the prevailing principles of international taxation.

Finally, a third loophole arises because no time-threshold has been prescribed for a so-called service PE, as "the furnishing of services, including consultancy services, by any person through employees or other personnel engaged by the person for such purpose",[12] would constitute a PE immediately, then and there. Additionally, banks question only foreign currency remittances, which can be a source of erosion of the tax base. This needs a comprehensive institutional policy recalibration at the state level, as disparate

9. PK: Income Tax Ordinance, 2001, Fed. Bd. of Rev. 2001 [hereinafter ITO].
10. Id.
11. Id.
12. Sec. 2(41)(d) ITO.

treatment of remittals can leave room for money launderers, as well. The BEPS framework is being viewed as an opportunity and panacea to overcome most of the base erosion and profit shifting ploys.

On the flip side, Pakistan has also put in place some protective mechanisms. For instance, attempts to erode the fiscal base have been thwarted through the imposition of withholding tax upfront on quite a number of transactions. Unidentifiable residual transactions are subject to an upfront withholding tax of 20%. The examples of identifiable transactions charged to withholding tax include payments on account of insurance premiums or reinsurance premiums to a non-resident person;[13] payments on account of advertisement services to a non-resident media person relaying (advertisements) from outside Pakistan; and disbursements on account of foreign-produced commercials for advertisement on any television channel or any other media, directly or through an agent or intermediary to a non-resident.[14] In typical situations of misuse of PE status aimed at eroding the tax base and shifting of profits to nil or low-tax jurisdictions, the Commissioner of the Inland Revenue Service (the Commissioner) has the authority to resort to recharacterization of transactions under section 108 of the Ordinance.

Mechanisms have been put in place to protect the withholding tax regime. First, before undertaking remittals, all remitters must seek the Commissioner's approval and exemption, and if the Commissioner declines such a request, the applicant remitter must withhold tax at applicable rates. Second, in the case of a default of withholding taxes, the amount will be denied as an expense under section 21(c) of the Ordinance. Pakistan is certainly in a position to plug the gaps in its legal regime and strengthen its defence mechanism taking into account the BEPS Action 7 Final Report recommendations.[15]

This chapter presents an extensive survey to map specific anti-BEPS measures that are extant within Pakistan's tax system in the pre-BEPS environment and identifies gaps that could possibly be bridged as an outcome of, and under the influence of the BEPS Project. Besides, if there is a country that so desperately needs the BEPS Project and what it stands for in terms of its potential to preserve the fiscal base, it would be Pakistan.

13. PK: Circular 25 of 1980.
14. Sec. 152(1AA) and (1AAA), and sec. 152A ITO.
15. OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.

26.2. Measures against hybrid mismatch arrangements: BEPS Action 2

In the pre-BEPS environment, hybrid mismatches – those involving transactions as well as those involving entities – were not addressed at a deliberate and conscious level by the Pakistan tax regime. However, illustrations of ploys that can serve to undermine the country's fiscal base and shift abroad legitimate income that could otherwise be taxed in Pakistan, and in turn, could well be classified as hybrid mismatches, are found interspersed in the tax code. The tax law stipulates that, subject to certain conditions, "any amount received as a loan, advance, deposit for issuance of shares or gift by a person in a tax year from another person … otherwise than by a crossed cheque drawn on a bank or through a banking channel … shall be treated as income chargeable to tax".[16] It may not be a typical illustration of a hybrid mismatch, but it has proven to be an effective tool against tax avoidance until, of course, the anti-avoidance regime is bolstered through insertion of express measures to counter hybrid mismatch arrangements – a debate in which respect has already been catalyzed by the BEPS Project.

Likewise, under Pakistan's tax system, dividends are taxed at a flat rate of 12.5%, except for banking companies in respect of which dividends are taxed at the normal rate. The definition of dividends has been kept as broad as possible in order to pre-empt any avoidance ploys through the creation of mismatches of either instruments or entities. For tax purposes, the term "dividends" includes:
- "any distribution by a company of accumulated profits to its shareholders, whether capitalized or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets, including money of the company";
- "any distribution by a company, to its shareholders of debentures, debenture-stock or deposit certificate in any form, whether with or without profit, to the extent to which the company possesses accumulated profits whether capitalized or not";
- "any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalized or not";
- "any distribution by a company to its shareholders on the reduction of its capital, to the extent to which the company possesses accumulated profits, whether such accumulated profits have been capitalized or not";

16. Sec. 39(3) ITO.

- "any payment by a private company as defined in the Companies Ordinance, 1984 … or trust of any sum … by way of advance or loan to a shareholder or any payment by any such company or trust on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company or trust, in either case, possesses accumulated profits"; and
- "remittance of after tax profit of a branch of a foreign company operating in Pakistan".[17]

In fact, the broader scope of the definition of dividends would neutralize many a potential avoidance ploy through upfront application of withholding tax. Nonetheless, in light of Pakistan's economy, following globalization and steep inflows of MNEs in the wake of foreign direct investment (projects) in the CPEC, the OECD's work in the field – particularly in the BEPS Action 2 Final Report (Action 2)[18] – would need to be assimilated, internalized and implemented in order to guard the country's tax turf. Although expanding the definition of dividends would not per se constitute a bulwark against hybrid mismatches, it would certainly make it difficult for tax planners to plot their tax avoidance ploys that are based on aggressive financial instrumentalization. In spite of the fact that Pakistan has already signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (2017)[19] (MLI), the Federal Board of Revenue (the tax administration) has been cautious in incorporating recommendations from the BEPS Project in different areas of taxation – including those under Action 2.

26.3. Controlled foreign company rules: BEPS Action 3

Pakistan does not have CFC rules as envisaged under the BEPS Action 3 Final Report (Action 3).[20] However, Pakistan has broad residence rules that aim to cover CFC situations, for instance where a Pakistan resident company has a subsidiary overseas and income is parked in the subsidiary aboard because it is subject to little or no tax. The Ordinance defines a "foreign-controlled resident company" as an entity in which at least 50% of

17. Id., at sec. 2(19).
18. OECD/G20, *Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.
19. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017), Treaties IBFD [hereinafter MLI].
20. OECD/G20, *Designing Effective Controlled Foreign Company Rules – Action 3: Final Report* (OECD 2015), International Organizations' Documentation IBFD.

the underlying ownership of the company is held by a non-resident person, either alone or together with an associate or associates.[21]

The definition of “company” under section 80(2)(b) of the Ordinance is inclusive and covers a company as defined in the law pertaining to incorporation of companies, as well as “a body corporate formed by or under any law in force in Pakistan”. However, this provision also covers “a body incorporated by or under the law of a country outside Pakistan relating to incorporation of companies”.[22] As the taxability of a company in Pakistan is essentially dependent on its residence status, section 83 of the Ordinance clearly lays down separate sets of criteria for companies incorporated in Pakistan and those that are incorporated outside its territorial jurisdiction. Companies that are incorporated in Pakistan would be resident for tax purposes under any circumstance. But, if a company is registered in a jurisdiction other than Pakistan, it will be treated as a company resident for tax purposes only if the control and management of its affairs “is situated wholly in Pakistan at any time in the year”.[23]

The latter rule has a few practical implications. First, it is difficult to determine when a company established elsewhere has the control and management of its affairs situated in Pakistan during the year. Second, the “wholly-owned” situation, on its very face, appears insufficient to efficiently curb abuse, as it might be easier for an overseas shell company to move only a part of management – say, just one director – abroad, so as to steer clear of the rule. Third, the rule is not neutral, in that it does not provide for an identical treatment for Pakistani companies having their control and management situated in a foreign country and that country treating them as being resident for tax purposes.

Moreover, there is no express provision in the tax law to stipulate as to whether a foreign-controlled resident company would be taxed in Pakistan on its global income or only its Pakistan-source income, and the matter has not yet been adjudicated by the superior courts. It is generally believed that, keeping in view Pakistan’s current capital exportability, its legal regime to deal with CFCs and similar situations is just fine for the time being, and therefore, no new measures are likely to be pursued in this area in compliance with the recommendations under Action 3.

21. Sec. 106(2) ITO.
22. Id., at sec. 80(2)(iv)(b).
23. Id., at sec. 83(c).

26.4. Interest deductions and other financial payments: BEPS Action 4

The most important check, within the existing Pakistan tax system, to counter BEPS ploys, may well be the thin capitalization rules. Tax law includes a comprehensive set of provisions covering various aspects of thin capitalization. Section 106(1) of the Ordinance stipulates that if 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 3:1 at any time during a tax year, no deduction will be allowed for the profit on debt paid by the company in that year on that part of the debt which exceeds the 3:1 ratio.[24] A foreign-controlled resident company, in turn, is defined as an entity in which 50% 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.[25] The law also defines relevant key concepts such as "foreign debt", and "foreign equity", and devises a reasonably elaborate mechanism for the application of thin capitalization rules.[26]

In the case of intra-group payments, interest is taxed at 10% and a corresponding deduction is allowed to the PE. In all genuine cases of continued loss-making or other statutory exemptions, the recipients of debt may approach the Commissioner for an exemption certificate. If the recipient has no PE in Pakistan, the withholding tax of 10% would constitute a final discharge of tax liability.[27] Prior to 2008, the thin capitalization safety net would come into play only in the case of a foreign-controlled resident company, and not in the case of a PE where, in fact, much of the base erosion through interest and other financial payments takes place.

This anomaly was rectified in 2008 through inclusion of the words "or a branch of a foreign company operating in Pakistan" in the law.[28] This change in law was amplified by stating that profit on foreign debt payable by a foreign-controlled resident company in excess of a 3:1 foreign-debt-to-equity ratio is not allowed as an expense under section 106 of the Ordinance as there was no such restriction on branches of foreign companies not incorporated under the Companies Ordinance, 1984. To provide a level playing field to all operations of foreign companies, the thin capitalization rules

24. Id., at sec. 106.
25. Id., at sec. 106(2).
26. Id., at sec. 106.
27. Clause 5A of Part II of Second Schedule ITO.
28. Id., at sec. 106(1).

have been made applicable to the branches of foreign companies operating in Pakistan.[29]

This is an important area for the tax administration, as a significant amount of potential revenue is haemorrhaging each year on account of manipulated out-payments as interest and other similar expenses and consequential deductions at the going corporate rate. The BEPS Project provides a critical window of opportunity, in that it not only supplies much-needed intellectual anchors as well as instruments in a ready-made form, but also takes the pressure off both tax authorities and political elites if any significant resistance is mounted from any quarter.[30]

The BEPS Action 4 Final Report,[31] instead, envisages an EBITDA (earnings before interest, tax, depreciation and amortization) connected provision for thin capitalization. EBITDA has been considered to be an effective gauge of a company's operating profitability as a percentage of its total revenue, and by implication its ability to pay tax in a given jurisdiction. As EBITDA allows a fixed-ratio rule which includes a corridor of possible ratios of between 10% and 30%, as well as a group ratio rule under which a country may apply an uplift of up to 10% to the group's net third-party interest expense to avoid double taxation, it is apparently a fairer method to arrive a reasonable tax liability.

However, Pakistan has not yet made any significant move toward implementing an EBITDA-connected rule. Nevertheless, it would be advisable for Pakistan to develop and promulgate EBITDA rules as soon as possible in order to protect its fiscal turf.

26.5. Countering harmful tax practices: BEPS Action 5

Admittedly, the Pakistan tax system would need to do quite a bit to comply with the recommendations set out in the BEPS Action 5 Final Report (Action 5), namely requiring substance in respect of all preferential regimes and improving transparency through spontaneous exchange of rulings with third countries under existing frameworks to render them in sync with

29. PK: Circular 5 of 27 Aug. 2008.
30. OECD/G20, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update: Inclusive Framework on BEPS* (OECD).
31. OECD/G20, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.

international best practices. In consequence to BEPS Project deliberations sponsored by the OECD/G20 over the past several years, the general awareness, understanding and sensitivity to base erosion and tax avoidance has significantly increased in developing countries. In this connection, internationally, tax administrations are feeling increasingly jittery when confronted with concerns about preferential regimes that are prone to being used as BEPS ploys, the implications in respect of which become accentuated manifold as a result of "a lack of transparency in connection with certain rulings".[32] A broad consensus now appears to have evolved to the effect that the substantial activity requirement used to assess preferential regimes should be strengthened in order to realign taxation on profits with the substantial activities that generate them.

Amongst various approaches that have been agreed upon as being effective, the nexus approach is perhaps the most significant. This approach originally developed in the context of IP regimes, such that a taxpayer is allowed to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying R&D expenditures that gave rise to the IP income.[33] Essentially, the nexus approach uses expenditure as a proxy for activity, and builds on the principle that because IP regimes are designed to encourage R&D activities and to foster growth and employment, a substantial activity requirement should ensure that taxpayers benefitting from these regimes did actually engage in such activities and did incur actual expenditures on such activities. The same principle could also be extended to other preferential regimes, so that those regimes would also be required to pass the substantial activity test.

The Pakistan tax system does not appear to provide for qualifying non-IP regimes in the identified areas, such as headquarters regimes; distribution and service centre regimes; financing or leasing regimes; fund management regimes; banking and insurance regimes; shipping regimes; and holding company regimes. Pakistan, as part of the OECD "inclusive framework", is currently undergoing the peer-review process in respect of the identified minimum standards.

To supplement anti-BEPS prescribed measures, Pakistan requires improving transparency and exchange rulings in areas such as preferential regimes; advance pricing arrangements and transfer pricing; unilateral downward

32. OECD/G20, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD [hereinafter *Action 5 Final Report* (2015)].
33. Id.

adjustments; PEs; related-party conduits; and other matters giving rise to BEPS concerns with other tax administrations having a stake in the transaction.[34] Pakistan would need to do a lot of difficult preparatory work before being able to exchange rulings in respect of all prescribed harmful tax practices in terms of improving its dispute resolution regime. Traditionally, section 24 of the Ordinance has been invoked to deal with intangibles and prescribes an elaborate regime, although this is not based on the nexus approach.[35] Albeit not expressly, tax law appears to make a fine distinction in that *intangibility* occurs when one owns it or one has incurred expenditure on its R&D and is entitled to a gain or loss on its disposal; *royalties*, on the other hand, arise when one uses an intangible developed by someone else, and a right to use is acquired for payment based on the periodicity of the use. The regime needs substantial improvement during the BEPS implementation phase. It appears that, among all 15 BEPS Actions, Pakistan would find implementing the Action 5 recommendations[36] to be the most challenging, because a substantial amount of preparatory work needs to be done before Pakistan can bilaterally and multilaterally exchange significant rulings and the related information to the benefit of all the parties concerned.

In spite of the fact that this is a key area in the conceived coherence paradigm under the BEPS Project, Pakistan has not made a significant move towards incorporating the framework for the exchange of rulings that could give rise to BEPS concerns into the domestic tax system. Pakistan was admitted to Global Forum on Exchange of Information for Tax Purposes (Global Forum) as its 111th member in 2013. After going through the peer review process, under which it was rated "largely compliant", Pakistan joined the Global Forum in June 2015. This also helped Pakistan's effort to become a signatory to the Convention on Mutual Administrative Assistance in Tax Matters (Convention on Mutual Administrative Assistance). Although Pakistan always included article 25 or 26 in its income tax treaties, the practical implementation of this particular provision of law has, admittedly, never been its strength. This may be because of overall systemic rigidities in the socio-economic political structures of the state, which nurture a pronounced propensity for secrecy, a weak enabling legal regime, and an administrative inability to execute the requirements of exchange of information at both the national and international level in order to share the actionable bits of information and accept the actionable information received from treaty partners and other domestic sources. In this context, the Global Forum may have already done considerable good for Pakistan's tax system.

34. Id.
35. ITO.
36. *Action 5 Final Report* (2015).

The first tinkering with the traditional tax information regime came when, in 2015, the pre-existing subsection (1) of section 107 was replaced to align it with the new burgeoning realities at the international level. The spadework done by way of peer reviews for membership by the Global Forum and the signing of the Convention on Mutual Administrative Assistance would come in handy towards implementation of Action 5 recommendations.[37]

26.6. Implementation of transfer pricing suggestions (BEPS Actions 8-10 and 13) and mandatory disclosure rules (BEPS Action 12)

Pakistan's anti-transfer pricing regime, at both a legal and implementation level, is visibly deficient. At the legal level, the legal regime is archaic and insufficient, while at the implementation level, the tax administration lacks critical capacity to deal with sophisticated tax avoidance ploys put in place by MNEs. Section 108 of the Ordinance (transactions between associates), stipulates that the "Commissioner may, in respect of any transaction between persons who are associates, distribute, apportion or allocate income, deductions or tax credits between the persons as is necessary to reflect the income that the persons would have realized in an arm's length transaction".[38] In turn, under section 78 of the Ordinance (non-arm's length transactions), where an asset is disposed of on non-arm's length basis, "the person disposing of the asset shall be treated as having received consideration equal to the fair market value of the asset determined at the time the asset is disposed; and the person acquiring the asset shall be treated as having a cost equal to the amount determined"[39] in the case of the person disposing of the asset.

The mechanism to apply the afore-mentioned substantive provisions of law was devised in Rules 20-27, i.e. Chapter VI (transfer pricing) of the Income Tax Rules, 2001 (the Rules). These rules provide four methods, namely the comparable uncontrolled price method, the resale price method, the cost-plus method and the profit split method,[40] through which the arm's length principle can be implemented via recharacterization of transactions planned and undertaken among associates. Not only does the Commissioner have "a wide discretionary power to apply international standards, case laws, and

37. Through PK: Finance Act, 2016, sec. 107 ITO was amended to enable the federal government to, in addition to income tax treaties, also enter into tax information exchange agreements, multilateral conventions and other frameworks such as the Global Forum.
38. Sec. 108(1) ITO.
39. Id., at sec. 78.
40. PK: Income Tax Rules, 2001, Fed. Bd. of Rev. 2002, Rules 20-27 [hereinafter ITR].

guidelines issued by various tax-related internationally recognized organizations", he also "has the authority to determine which of those methods lead to the most reliable transfer price taking into account all facts and circumstances".[41] There is a general understanding in the tax administration that the pre-BEPS anti-transfer pricing tax regime as summarized above is quite in line with the international best practices as documented in OECD Transfer Pricing Guidelines, the UN Manual on Transfer Pricing and the World Bank handbook on transfer pricing.[42] However, there is an equally strong feeling that there is need to substantially improve and update it in sync with the latest developments at the international level – particularly the BEPS Final Reports on Actions pertaining to transfer pricing.[43]

In response to the developments taking place under the umbrella of the BEPS Project, two significant changes were introduced in the domestic tax regime. First, every taxpayer entering into a transaction with its associate must maintain a Master File and a Local File containing documents and information as prescribed; keep and maintain prescribed country-by-country reports, where applicable; keep and maintain any other information and documents in respect of transactions with its associate as prescribed; and keep the files, documents, information and reports as prescribed.[44] Second, any taxpayer that enters into a transaction with its associate must furnish, within 30 days, the documents and information to be kept and maintained if required by the Commissioner.[45]

These changes, as noted, are aimed at implementing the recommendations of the BEPS Action 13 Final Report (Action 13) on country-by-country reporting.[46] However, even a cursory analysis of the recent changes in law reveals that those changes are deficient in that information supposed to be maintained and supplied to the tax administration for reporting, does not rest on an "if required by the Commissioner" basis; rather, it must be compulsorily supplied, so that the same could then be shared with the stakeholders as

41. Michielse, *supra* n. 3, at p. 234.
42. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), International Organizations' Documentation IBFD; United Nations, *Practical Manual on Transfer Pricing for Developing Countries* (2017); and J.L. Cooper et al., *Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners* (World Bank 2016).
43. OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports* (OECD 2015), International Organizations' Documentation IBFD.
44. Sec. 108 ITO.
45. Id., at sec. 108.
46. OECD/G20, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.

required. Pakistan is currently involved in the process of peer review of the implementation of the Action 13 minimum standard (country-by-country reporting). The prescribed questionnaire has been furnished covering all three areas of focus, namely domestic legal framework; exchange of information framework; and confidentiality, consistency and appropriate use, to be used by the Country-by-Country Reporting Group when re-evaluating Pakistan's compliance with the minimum standard. Otherwise, in substantive terms all material changes made to the International Guidelines on which the Commissioner must rely are covered in the Rules by way of a mobile approach, which implies as amended up to and existing at that particular time.[47]

In order to comply with the policy recommendations under Action 13, Pakistan is in the process of putting in place an elaborate set of rules by inserting a new Chapter – IVA ("Documentation and Country-by-Country Reporting Requirements") into the Rules which, broadly speaking, comprises three parts. Part I deals with the preamble and other preliminaries, Part II covers country-by-country reporting requirements and Part III prescribes the documentation requirements. Pakistan, as a member of the inclusive framework, has already signed the Multilateral Competent Authority Agreement (MCAA) for exchange of country-by-country reports and, therefore, is complying with the prescribed minimum standard.

It has been argued that the "lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide",[48] and Pakistan is no exception. It has also been equally emphatically asserted that "early access to such information provides the opportunity to quickly respond to tax risks through informed risk assessment, audits, or changes to legislation or regulations".[49] The BEPS Project, therefore, stipulates "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".[50] The jurisdictions that already do not have mandatory disclosure rules in place, taking a lead from the BEPS Action 12 Final Report, have an opportunity to devise a set of rules in line with their capacity and requirements. The goal would be to devise a clear, understandable and

47. Rule 22 ITR.
48. OECD/G20, *Mandatory Disclosure Rules – Action 12: 2015 Final Report* p. 13 (OECD 2015), International Organizations' Documentation IBFD.
49. Id., at p. 13.
50. Id., at p. 9.

balanced set of rules so as to offset additional compliance costs, if any, for taxpayers through additional tax revenue and measureable improvements in the tax administration.

These rules must also look to constantly innovate in terms of new counter-instruments, as well as eradicate obsolete risks. The reporting requirements prescribed should be different from, and in addition to other standard (in most cases, statutory) reporting requirements. The most critical features of reporting, namely what to report, when to report and the consequences for non-reporting, must also take into account international tax planning schemes.

In Pakistan's context, the reporting requirements, if and when devised, could cover areas such as thin capitalization; loans and dividends paid out to directors; transactions undertaken with associates; and dealings with non-residents. Although the very reporting requirements that have recently been laid down in the law with regard to transfer pricing, need substantial improvement and alignment with international standards, almost the entire set of rules on mandatory disclosure prescribed under the BEPS Project needs to be implemented with commitment.[51] However, progress towards framing such rules and putting them in place is slow – indeed, almost imperceptible.

26.7. Implementation of the Multilateral Instrument: BEPS Action 15

Pakistan has already become a signatory to the MLI.[52] The choice to sign the MLI appears to have been based on standard advantages of amending the entire treaty network through a cost-effective, time-efficient and a widely accepted mechanism. The government, in its desire not to toss the issue entirely into the public domain, has moved rather cautiously. The draft choices that Pakistan has made to date pertain only to minimum standards. Pakistan does see substantial value in ratifying and enforcing the MLI, and thereby effectively protecting its tax base. Given the fact that the country is headed for elections in mid-2018, it is likely that the MLI's ratification will be taken up by the new government.

51. Id., at p. 9.
52. Pakistan signed the MLI on 7 June 2017.

In the meantime, the tax administration has a substantial amount of work to do as to what treaties to include and which ones to exclude on account of their being archaic and therefore too different and incompatible. Moreover, the tax administration would also need to take a considered decision as to whether it would prepare consolidated versions of the relevant tax treaties. It is generally believed that Pakistan's earlier exposure to OECD frameworks and peer reviews thereunder, such as the Global Forum and the Convention on Mutual Administrative Assistance, has come in handy, and is helping it through the MLI process.

26.8. Specific issues regarding tax treaty provisions: BEPS Actions 2, 6, 7 and 14

Section 108 of the Ordinance empowers the government to enter into tax treaties with other countries. However, it does not expressly impose any precautionary measures against unauthorized claiming of benefits under such treaties by persons that are not entitled thereto. Such measures must necessarily be agreed at the time of negotiation of the particular tax treaty and its implementation. Accordingly, lately a limitation-on-benefits rule has started to be incorporated in Pakistan's tax treaties. Nonetheless, under the general tax principles, treaty shopping could always be denied by piercing the veil. Section 109(2) empowers the Commissioner to recharacterize a transaction or an element thereof, or disregard it completely "where the form of the transaction does not reflect the substance", and, prima facie, the transaction "was entered into as part of a tax avoidance scheme". In turn, the term "tax avoidance scheme" has been defined 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 tax liability under this Ordinance".[53]

Pakistan has been dealing with visibly widespread exploitation of its tax treaty network, but this could be due more to deficient administrative capacity than deficiencies in the legal regime. The BEPS Project provides a clear roadmap and recommendations that could help nations overcome the menace of treaty shopping.[54] Provisions such as a limitation-on-benefits rule and a general anti-avoidance rule (GAAR), in a variety of forms, have recently started to make their way into Pakistan's tax treaties, which are

53. Sec. 109(2) ITO.
54. OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.

currently going through the process of ratification and enforcement. It is generally hoped that Pakistan will slowly incorporate necessary instruments in line with BEPS recommendations in its legal regime and take steps to correspondingly build capacity within the tax administration.

It has been argued that "the mutual agreement procedure (MAP) is of fundamental importance to the proper application and interpretation of tax treaties, notably to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty",[55] and that the BEPS Action 14 Final Report is geared "to strengthen the effectiveness and efficiency of the MAP process", as it would "minimize the risks of uncertainty and unintended double taxation by ensuring the consistent and proper implementation of tax treaties, including the effective and timely resolution of disputes regarding their interpretation or application through the mutual agreement procedure".[56] Pakistan has already put in place elaborate MAP rules as contained in Rule 19D of the Income Tax Rules, 2002.[57] In addition, of course, to the set channels of appeals and MAP rules, a non-resident person could pursue the alternative route of alternative dispute resolution mechanisms.[58]

Still, some additional mechanisms available to taxpayers include a redress of grievances under section 7 of the Federal Board of Revenue Act, 2007,[59] and a representation to the Federal Tax Ombudsman, who may step in to respond to all instances of maladministration. These cost-effective and quick mechanisms of redress of complaints and resolution of issues are equally available to non-resident persons operating in Pakistan. In most recent treaty negotiations between Pakistan and other countries such as Croatia, Ethiopia, Moldova and Senegal, an arbitration clause has come up for discussion. However, additional costs associated with arbitration as yet another means of dispute resolution remains an issue to be resolved.

In the form of an advance ruling, the tax law provides another convenient and cost-free window specifically to non-residents for the determination of tax liability prior to a transaction's being carried out in reality.[60] Advance rulings are issued at the head office level by the competent authority, on

55. OECD/G20, *Making Dispute Resolution Mechanisms More Effective – Action 14: 2015 Final Report* p. 15 (OECD 2015), International Organizations' Documentation IBFD.
56. Id., at p. 9.
57. Rule 19D ITR.
58. Sec. 134A ITO.
59. Federal Board of Revenue Act, 2007, Fed. Bd. of Rev. 2007, sec. 7.
60. Sec. 206A ITO.

behalf of the Commissioner. Thus, if a non-resident taxpayer had made a full and true disclosure of the nature of all aspects of the transaction relevant to the ruling and the transaction proceeds in all material respects as set out in the non-resident's application, the ruling will be "binding on the Commissioner with respect to the application to the transaction of the law as it stood at the time the ruling was issued".[61] For reasons yet to be determined, this does not appear to be a preferred option by the non-residents intending to enter Pakistan, as so far only nine rulings have been issued in the more than 15 years that the provision has been in place.[62] The scope of the rulings that have so far been issued is also quite limited, as most – if not all – "deal with the tax liability of certain transactions as for instance the receipt of a payment as result of a merger, the performance of seismic data processing services, payments for sales in Pakistan without having a permanent establishment".[63]

As noted, Pakistan's economy is at a crossroads. Under substantial CPEC-induced foreign inflows, MNEs are likely to pursue hybridization of instruments and entities in a way that suits them. This will seriously test the efficacy of the tax administration. The BEPS Project environment is an opportunity to build its capacity and prepare itself for the looming challenge. Pakistan would also need to incorporate a limitation-on-benefits rule in its tax treaties and preferably do so through application of the MLI. Likewise, measures against treaty shopping in both the legal and administrative domains, would have to be put in place. Similarly, Pakistan's dispute resolution mechanism needs to be improved; the fact that it is on the statute books does not mean that it is also delivering. Despite the fact that elaborate MAP rules are in place, MAP proceedings have hardly ever been concluded to resolve issues facing various sets of taxpayers – particularly, non-residents.

It is evident that a good part of this chapter deals with mapping of the pre-BEPS scenario within Pakistan's extant tax regime. This is so for two reasons. First, a benchmarking of what is already in place would clearly indicate and identify as to what is required to be done. Second, as so far only a miniscule set of changes has been introduced in the tax law which could directly or indirectly be ascribed to the BEPS Project, there limited room for critique and analysis of initiatives induced by the BEPS Project.

61. Sec. 206A ITO.
62. *See* www.fbr.gov.pk.
63. Michielse, *supra* n. 3, at p. 235.

Although Pakistan does realize the importance of the BEPS policy prescriptions and what could be achieved thereunder, their failure to address issues such as fees for technical services, and turnkey or composite projects from the BEPS agenda, prompts one to question its efficacy and egalitarianism in an international context. There is also a realization that the capacity of the tax administration, as in other developing countries, will be tested. The mushrooming of international frameworks, voluntary in nature yet mandatory in implications, are causing developing countries to walk into them without due diligence or adequate rigour, and without properly comprehending the likely fallout. The true test of their capacity will come when they are to discharge their responsibilities as signed and committed under those frameworks. The international community – the UN and OECD included – will perhaps need to do much more than merely offering training courses to tax administrators from developing countries.