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The China-Pakistan Avoidance of Double Taxation Agreement and the China-Pakistan Economic Corridor

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In this article, the authors review the principal features of the China-Pakistan tax treaty and its impact on the China-Pakistan Economic Corridor project.

1. Introduction

The China-Pakistan Economic Corridor project (CPEC), established in 2013 and operational from 2016, will bring unprecedented levels of Chinese investment to Pakistan. The primary aim of the multidimensional, multifaceted and multibillion dollar (USD 61 billion) programme is to provide land route connectivity between the China and Arabian Seas. Governing the tax consequences of this investment is a tax treaty (the Treaty)[1] over two and a half decades old. The Treaty, this article suggests, has grown anachronistic and is ill-suited to accommodate a project as mammoth, fast-paced and diverse as the CPEC.[2] Exacerbating the challenges is the outdated Pakistani domestic tax law, designed with no conception of investment of this sort.[3]

This article is divided into four sections. Section 1. provides a background to the CPEC. Section 2. explores the timeline and historical build-up of the Treaty. Section 3. identifies gaps, shortcomings and downsides, not only from the two countries' perspectives, but also from that of international developments that have taken place since the Treaty was signed. Section 4. concludes the debate with brief recommendations.

2. Treaty Timeline and Architecture

2.1. Introductory remarks

Pakistan and China negotiated and signed the Treaty on 15 November 1989, which subsequently took effect on 1 July 1990. Since its original implementation, three Protocols were also signed on 19 June 2000, 17 April 2007 and 8 December 2016, amending and modifying various legal provisions of the Treaty to reflect and address the economic needs of both countries prevailing at the relevant times.

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1. *Agreement between the Government of the People's Republic of China and the Government of the Islamic Republic of Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (15 Nov. 1989), Treaties IBFD [hereinafter: China-Pakistan Treaty 1989] . The treaty entered into force on 15 November 1989 and took effect from 1 July 1990.
2. For a discussion of the broader legal, economic and social issues involved in the China-Pakistan Economic Corridor project (CPEC), *see*, for example, A. Qureshi, *China/Pakistan Economic Corridor: A Critical National and International Law Policy Based Perspective*, 14 Chinese Journal of International Law 4, pp. 777-799 (2015); R. Hameed, *Pakistan and China: Partnership, Prospects and the Course Ahead*, 14 Policy Perspectives 1 (*Pakistan and its Neighbors*), pp. 3-22 (2017); S. Mustafa & A. Zafar, *China Pakistan Economic Corridor: Importance and Challenges for Pakistan and China*, 2 International Journal of Social Science and Economic Research 11, pp. 5059-5068 (2017); R. Shapiee & R. Idrees, *China Pakistan Economic Corridor (CPEC); Most Valuable Dream for Pakistan through Economic Integration in the Region but May Not Become True without Upgradation of Physical Infrastructure and Legal System!*, 8 Beijing Law Review 4, pp. 481-498 (2017); and J.-M. Blanchard, *China's Twenty-First Century Maritime Silk Road Initiative and South Asia: Political and Economic Contours, Challenges and Conundrums*, in *China's Maritime Silk Road Initiative and South Asia: A Political Economic Analysis of its Purposes, Perils, and Promise* pp. 1-31 (J.-M. Blanchard ed., Springer 2018). On specific taxation and commercial concerns raised by the project, *see* N. Jamal, *The Cost of CPEC*, Dawn (12 Mar. 2017), available at https://www.dawn.com/news/1320028 (accessed 23 Jan. 2018). More generally, the project can be seen as a key element in the long-term emergence of the Indian Ocean region as a leading economic centre in the modern era: *see* R. Kaplan, *Monsoon: The Indian Ocean and the Future of American Power* (Random House, 2010); and A. Friedberg, *The New Great Game* (Review of R. Kaplan, *Monsoon: The Indian Ocean and the Future of American Power*), New York Times (19 Nov. 2010), available at http://www.nytimes.com/2010/11/21/books/review/Friedberg-t.html (accessed 23 Jan. 2018).
3. PK: Income Tax Ordinance, 2001, National Legislation IBFD.

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Having attained their independence almost simultaneously in the late 1940s, by the time the Treaty was signed in 1989, the patterns and trajectory of economic development in both Pakistan and China had been quite similar. It was asserted in 1984 that at "an aggregative statistical level, the development performance of China and Pakistan has been strikingly similar" in that "the overall and sectoral growth rates have been quite close in the two countries, although per capita income has increased faster in China due to a slower rate of population growth".[4] Nevertheless, it was posited that "the per capita incomes of the two countries are of the same order of magnitude – Pakistan's per capita GNP at current prices was US$248 in 1978-79, and China's was US$253 in 1972 – and the time span during which development has taken place is comparable; since 1947 in the case of Pakistan and 1949 … in the case of China".[5] Select economic development indicators of Pakistan and China during the initial four decades of their history are plotted in Table 1.

Table 1: Economic growth rates in China and Pakistan to 1980[6]

	GDP (%)	Per capita (%)	Agriculture (%)	Industry (%)
Pakistan (1950-80)	4.8	1.8	3.0	10.4
China (1952-78)	4.5-6.0	2.5-4.0	3.2	11.2

This was in spite of the fact that China had a far better developed industrial base than Pakistan by the mid-1980s, when the Chinese economy started to take a significant upward surge.[7] It may not be out of place to mention also that the then apparently comparable performance of macro-indicators tended to conceal wide variations in both societies' relative experience of economic development. For instance, it had been noted at the time that the "relative equality of China contrasts strikingly with the extremes of wealth and poverty to be found in Pakistan".[8]

In the context of the long-established close diplomatic relations between the two countries and market liberalization reforms being commenced in each in the 1980s, early steps to reach a taxation agreement commenced from late 1986, such as an expression of intent to sign the Treaty, exchange of preferred draft treaties and so forth, with the first round of treaty negotiations properly being held in early 1988. The Treaty would thus add to the then small number of treaties that Pakistan had already entered into predominantly with OECD member countries and be one of China's earliest after its first such treaty (with Japan) in 1983.[9]

At this point, "in view of the comparative state of development of the two countries, the Pakistan side viewed these negotiations as between a developing country and a relatively more developed country which is likely to achieve accelerated development in the foreseeable future".[10] Pakistan's immediate reasons for signing the Treaty were seen in terms of there being "some projects with Chinese participation" that had already been sanctioned in Pakistan and the hope that "there would be an increase in such collaboration in the future".[11] Similarly, it was reported that "substantial technical fees have also been paid out from Pakistan sources to Chinese entities, which in the absence of a tax treaty would be taxable at full rates in Pakistan".[12] Likewise, the issue of treatment of Chinese air enterprises in Pakistan also needed settlement. "While Chinese airlines have not so far furnished any return of income, under our tax laws their Pakistan source income is subject to tax at the rate of 3% of the gross amount" – this was seen as a matter which "need[ed] to be settled within the framework of a tax agreement".[13] For its part, China probably viewed its own economic development rather conservatively. The negotiations, "held in a friendly atmosphere of mutual understanding, were based on a draft Convention furnished by the Chinese side",[14] which, in turn, was essentially based on the United Nations Model Double Taxation Convention Between Developed and Developing Countries (1980, since revised in 2001, 2011 and 2017) (UN Model), with modifications.[15] It would therefore not be incorrect to state that both governments used the UN Model to negotiate the Treaty.

2.2. Treaty timeline

The Treaty may be one of the most hard-fought and long-negotiated tax treaties entered into by either country. The Treaty, as originally implemented, was finalized in four rounds:

4. V. Lippit, *Economic Development in China and Pakistan: A Comparative Perspective*, 14 Journal of Contemporary Asia 2, p. 171 (1984).
5. Id.
6. Id.
7. Id.
8. Id.
9. J. Li, *The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates*, 8 Florida Tax Review 7, p. 679 (2007).
10. A. Akmal, *Note for the Chairman – First Round of Negotiations on Pakistan-China Tax Treaty – Beijing, February 20-March 5, 1988* (Pakistan, Central Board of Revenue, 1988).
11. I. Imtiazi, *Summary for the Finance Minister – Agreement for the Avoidance of Double Taxation between Pakistan and People's Republic of China* (Pakistan, Central Board of Revenue, 1986).
12. Id.
13. Id.
14. Akmal, *supra* n. 10.
15. At the time, China was also a predominantly capital-importing economy and, in treaty negotiations with OECD member countries in particular, sought to ensure inclusion in tax treaties of various source country protections from the *UN Model Double Taxation Convention between Developed and Developing Countries* (1980), Models IBFD [hereinafter: UN Model]. Moreover, Chinese negotiators had "caught on to the basics of tax treaty negotiations very quickly and with foreign governments competing for opportunities in post-socialist China were in a strong negotiating position" (L. Jin & R. Krever, *Dividing the Spoils of Foreign Investment: China's Shifting Tax Treaty Policy*, 23 New Zealand Journal of Taxation Law and Policy 3, p. 354 (2017)). China's subsequent economic development into a capital-exporting nation has been found to be associated with a shift towards China's implementation of tax treaties that now more closely conform to the *OECD Model Tax Convention on Income and on Capital*, Models IBFD.

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(1) the first round of negotiations was held in Beijing from 20 February to 5 March 1988, and consensus was arrived at with regard to articles 6 (Income from immovable property), 9 (Associated enterprises), 13 (Capital gains), 14 (Independent personal services), 16 (Directors' fees), 18 (Pensions), 19 (Government service) and 22 (Other income);

(2) the second round was held in Islamabad from 18-22 September 1988. The important issues on which agreement evolved during this round were articles 4 (Resident) and 18 (Artists and athletes);

(3) the third round was conducted in Beijing from 3-8 April 1989. The issues that were resolved were permanent establishment, shipping and air transport, independent personal services, elimination of double taxation, non-discrimination, territorial extension and entry into force; and

(4) the fourth and final round of negotiations held from 20-25 September 1989 in Islamabad, and helped resolve outstanding issues pertaining to business profits, dividends, interest, royalties and fees for technical services.

The extent of the negotiations, spanning over four rounds – two each in Islamabad and Beijing – and 33 (gross) days, certainly makes the Treaty the most hard-fought and closely-negotiated one that Pakistan has entered into with any country. Nevertheless, it was reported after the first round that the negotiations "based on a draft Convention furnished by the Chinese side" had been conducted "in a friendly atmosphere of mutual understanding",[16] and after the second and third rounds, "in a very friendly atmosphere"[17] and "in a very cordial atmosphere",[18] respectively. It was also hoped after the third round that the "Pakistan side will strive to strike a reasonable bargain which is commensurate with Pakistan's revenue interests and also reflective of the traditional close and cordial relations which have always been a source of pride for the two countries".[19] The Treaty was finally signed during Chinese Premier Li Peng's official visit to Pakistan by Sahabzada Yakub Khan, Minister of Foreign Affairs of Pakistan, and Qian Qichen, Minister of Foreign Affairs of China, in Islamabad on 15 November 1989 and entered into force on 27 December 1989.[20]

2.3. First Protocol

The First Protocol to the Treaty was signed on 19 June 2000, a little over a decade after the Treaty's original implementation. The major driver triggering consultation for signing the Protocol was the major reform that the government of China had brought about in its tax laws and administration at the time.[21]

The First Protocol sought to change the formulation of the "taxes covered" and the definition of "competent authority" for both countries. The Protocol also sought to allocate the taxation rights on "wages, salaries, or other similar remuneration derived by employees of airlines or shipping company of a Contracting State stationed in the other Contracting State" under article 16 of the Treaty to the "Contracting State of which they are nationals".[22] Apart from certain procedural changes, article 24 (Elimination of double taxation) was also altered to make further provisions for tax sparing credits.

2.4. Second Protocol

The Second Protocol to the Treaty, signed on 17 April 2007, was solely directed at broadening the scope of exemption on interest earned by Chinese banks by including (i) the Export-Import Bank of China; (ii) the Agricultural Development Bank of China; and (iii) the China Development Bank, by expanding the list of "State Banks" that were reciprocally exempted by both countries on income earned in each other's jurisdiction.[23] However, the list of State Banks in respect of Pakistan was left with its extant narrow scope, referring only to the State Bank of Pakistan.

2.5. Third Protocol

The Third Protocol to the Treaty, signed on 8 December 2016, again sought to expand the scope of exemption on interest income for Chinese State Banks through the inclusion of two further financial entities, namely (i) the Industrial and Commercial Bank of China; and (ii) the Silk Road Fund, albeit only relating to interest income earned in Pakistan from the energy projects referred to in the China-Pakistan Economic Corridor Energy Projects Cooperation Agreement, signed in Beijing on 8 November 2014.[24] This brought the number of exempt Chinese banks to seven against only the one in respect of Pakistan as originally agreed between the two countries.

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16. Akmal, *supra* n. 10.
17. S. Hassan, *Note for the Chairman – Second Round of Negotiations on Pakistan-China Tax Treaty – September 18-22, 1988, Islamabad* (Central Board of Revenue, 1988).
18. G. Yazdani Khan, *Note for the Finance Minister – Third Round of Negotiations on Pakistan-China Tax Treaty – April 3-8, 1989 – Beijing* (Central Board of Revenue, 1989).
19. Id.
20. As set out in Central Board of Revenue Notification No. 920(I)/1989, dated 27 December 1989. The Treaty became effective on 27 December 1989 in China and on 1 July 1990 in Pakistan.
21. Y. Rafiq, *Pakistan Amends Agreement with China*, Finance & Markets (16-22 Aug. 1999).
22. *Protocol to the Agreement between the Government of the People's Republic of China and the Government of the Islamic Republic of Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* art. 3 (19 June 2000), Treaties IBFD.
23. *Second Protocol to the Agreement between the Government of the People's Republic of China and the Government of the Islamic Republic of Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* art. 1 (17 Apr. 2007), Treaties IBFD [hereinafter: China-Pakistan Protocol 2007].
24. *Third Protocol to the Agreement between the Government of the People's Republic of China and the Government of the Islamic Republic of Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* art. 1 (8 Dec. 2016), Treaties IBFD [hereinafter: China-Pakistan Protocol 2016]. (Notified in Pakistan by S.R.O145(I)2017, dated 16 February 2017.)

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The Third Protocol involved four rounds of negotiations; the first in Beijing in June 2015, the second in Beijing in August 2015, the third in Beijing in November 2015 and the fourth in Islamabad in September 2016.

3. Treaty Appraisal

3.1. Introductory remarks

In this section, the article analyses the Treaty in detail, primarily from the perspective of its partners in the context of the developments that have taken place on various issues over the past three decades.

The critique of the various provisions enshrined in the Treaty focuses broadly on three areas, which are: (i) deviations from the UN Model (assuming that it is more favourable to developing countries); (ii) international best practices as reflected in various institutional reports and the views of experts and practitioners of international tradition; and (iii) the authors' personal insights in the field.

3.2. Title of the Treaty

At the outset, it can be noted that the title of the Treaty has fallen out of sync with international developments in the field. As more and more countries have adopted a system of "unilateral relief", not only has the expression "the avoidance of double taxation" become redundant, but the operationalization of a tax treaty, under normal circumstances, is not necessarily needed to eliminate double taxation.[25] The UN Model leaves to the choice of the negotiating states "the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion" or merely describing the treaty as one "with respect to taxes on income and on capital".[26] Since both Pakistan and China have put in place credit method provisions in their domestic tax systems to eliminate double taxation, the expression has become redundant and liable for pruning to make it more aligned with the latest trends in international taxation.

3.3. Article 1 (Personal scope)

Article 1 of the Treaty is entitled "Personal scope". In 1999, the title of article 1 of the UN Model was changed from "Personal scope" to "Persons covered", as the former only obliquely communicated the scope of application of the Treaty. Since any treaty must, as a threshold matter, "specify the types of persons or taxpayers" to which it applies, the formulation of the article was suitably altered "to convey the correct scope of the Convention".[27]

Moreover, the current formulation of article 1 of the Treaty, which is standard text under both the UN and OECD Models, does not cover partnerships. The negotiating states therefore have been "left free to examine the problems concerning partnerships in bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate".[28] Given the fact that Pakistan's tax system admits that the partnership commonly known as an "association of persons" (AOP) is a legitimate tax status, it would be desirable if a suitable corresponding provision were negotiated and incorporated into the Treaty.

More importantly, since, in accordance with the government of Pakistan's rules and regulations implemented through the Pakistan Engineering Council (PEC), Chinese entrepreneurs, in the same way as all other foreign investors, are obliged to form joint ventures (JVs) with Pakistani counterparts, it is warranted that the Treaty be appropriately amended by inserting special provisions admitting hybrid partnerships or JVs between resident and non-resident persons. This is important in view of the fact that, until recently, JVs that were compulsorily formed under PEC rules had created substantial hardship for Chinese corporations, given that JVs so formed were treated as resident partnerships and charged tax under the presumptive tax regime in outright contravention of article 7.3 of the Treaty. In Pakistan, the issue has partly been resolved by amending section 92 of the Income Tax Ordinance (ITO) 2001.[29] Similarly, in China, the Treaty is interpreted to cover both "individuals" and "enterprises" under Chinese domestic laws, where social organizations, associations and foundations, such as private, not-for-profit enterprise unities, charitable organizations and pension funds, are all included in the concept of "enterprises", but partnerships are not generally treated as persons under the Treaty.[30]

3.4. Article 4 (Resident)

Article 4.3 of the Treaty uses the standard UN Model formulation, yet it lacks the requisite scope to deter taxpayer attempts at taking undue advantage of the Treaty through treaty shopping and other similarly intended ploys. It would therefore be relevant for consideration to be given to the replacement of the existing article 4.3 with the OECD-prescribed formulation that has an anti-BEPS tinge, which reads:

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25. Pakistan allows unilateral relief to Pakistani tax residents on taxes paid on income earned in non-treaty countries. *See* PK: Income Tax Ordinance (ITO) 2001, sec. 103 (Foreign tax credit), National Legislation IBFD.
26. United Nations, *Commentary on the UN Model Double Taxation Convention between Developed and Developing Countries* p. 5 (United Nations 2011), Models IBFD [hereinafter: UN Commentary].
27. Id., at p. 41.
28. Id.
29. A proviso was added to sec. 92 of the ITO 2001 pursuant to PK: Finance Act, 2014.
30. State Administration of Taxation (SAT), China, *Explanation of the Provisions of the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and the Protocol*, SAT Circular (*Guo Shui Fa*) (2010) 75, issued by the SAT on 26 July 2010.

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> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting State.[31]

With the CPEC set to open previously unimagined vistas of business opportunities in novel and unusual geographic and commercial settings, the Treaty is also likely to be put to the test with a range of transactions with legal or not-so-legal purposes, highlighting the need for comprehensive anti-abuse provisions.

3.5. Article 5 (Permanent establishment)

3.5.1. Article 5.2(f)(/5.3(c)) (Exploration & Production (E&P Sector) PE)

Although article 5.2(f) of the Treaty expands the scope of "permanent establishment" (PE) to cover "a mine, an oil or gas well, a quarry or any other place of extraction of natural resources", it is simply "an indication that a permanent establishment may well exist; it does not provide that one necessarily does exist".[32] Granted, "a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities"[33] could not be reached at both UN and OECD levels, yet it was prescribed that "the Contracting States may agree upon the insertion of specific provisions".[34]

Accordingly, developing and resource-rich countries (including Australia) generally desire that a self-standing provision to create an exploration and production (E&P)-sector PE is negotiated and incorporated into their tax treaties.[35] It is a fact that this particular provision can be hard to sell, yet Pakistan has successfully negotiated and incorporated it into a number of its treaties. Interestingly, the China-India tax treaty includes an equivalent provision,[36] yet the Treaty does not, leaving a significant hole in the fiscal partitioning of potential revenues to be generated during the CPEC and post-CPEC periods. Accordingly, in the wake of the CPEC and the offshore opportunities that it opens up in the E&P sector, it is most desirable for both countries that a specific E&P-sector PE provision is negotiated into the Treaty at the earliest opportunity.

3.5.2. Article 5.3 (Building and Construction PE)

The Treaty adopts the approach that a building or construction project will give rise to a PE where the project has a duration of more than six months, in line with the period provided for under the UN Model. However, while it has been found that China's treaty policy, as reflected in the terms of treaties replaced or revised since original implementation, has involved an "unambiguous" move to adopt the longer 12-month period of the OECD Model,[37] it may be in Pakistan's interest, in the context of the CPEC, to retain the existing period provided under article 5.3 in any new treaty or revision that it negotiates with China.

3.5.3. Article 5.3(b) (Services PE)

Astonishingly, the Treaty does not include the UN Model's article 5.3(b) or its equivalent, popularly dubbed the "Services PE".[38] Such a provision is brought into a treaty to enable a signatory state to tax income from the "furnishing of services" where it arises.

The term "furnishing of services" is generally taken in a broader sense and is believed to cover both *material* and *professional* services. Material services involve activities conducted by an enterprise through its employees to provide the community with the use of facilities such as electric power, water, transport, telephones and Internet connectivity. Professional services include banking, insurance, shipping, consultancy, manpower, telecommunications and data processing and other activities of a similar nature that "depend wholly or largely upon the contribution of professional knowledge and skill".[39]

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31. OECD, *Commentary on the Model Tax Convention on Income and on Capital* p. 89 (OECD 2014), Models IBFD [hereinafter: OECD Commentary].
32. UN Commentary, at p. 105.
33. OECD Commentary, at p. 99.
34. Id.
35. Art. 5.3(c)'s often-used formulation to create an Exploration and Production Sector permanent establishment ("E&P Sector PE") reads: "The term 'permanent establishment' is deemed to include: (c) activities carried on by the enterprise in the other Contracting State, which consist of, or which are connected with, the exploration or exploitation of natural resources situated in that other state, but only where activities of that nature continue for a period or periods aggregating more than [30] days in any 12-month period commencing on or ending in the fiscal year concerned." Similarly, Australia's treaty with China, for example, recognizes that a PE will also include "a structure, installation, drilling rig, ship or other equipment used for the exploration or exploitation of natural resources, or in activities connected with that exploration or exploitation, but only if so used continuously, or those activities continue, for a period of more than 3 months" (*Agreement between the Government of Australia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* art. 5.3(c) (17 Nov. 1988), Treaties IBFD).
36. The relevant China-India provision reads: "[…] an installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 183 days" (*Agreement between the Government of the Republic of India and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* art 5.2(i) (18 Jul. 1994), Treaties IBFD).
37. Jin & Krever, *supra* n. 15, at p. 358.
38. Art. 5.3(b) of the UN Model reads: "The term 'permanent establishment' also encompasses: (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned."
39. A. Khan, *Cross Border Transactions and Tax Treaties: Theory and Practice* p. 99 (Petrosin 2000).

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While Pakistan more often than not has been successful in including this provision in its treaties with other countries, irrespective of their level of development, it failed to have it incorporated in the Treaty. In the context of the CPEC, given its wide-ranging and all-encompassing scope from building bridges, roads, hydropower projects and mobile communications to the development of ports, installation of wind-power plants, administration of stock markets and the rendering of banking services, the absence of the provision from the Treaty attains serious significance.

On the flipside, China has signed this provision with a number of countries, including, but not limited to, Australia, Barbados, Canada, Cyprus, France, Germany, Hong Kong, India, Italy, Japan, Korea, Luxembourg, Mauritius, the Netherlands, Russia, Saudi Arabia, Seychelles, Singapore, Switzerland, the United Kingdom and the United States. Significantly, however, where China has negotiated replaced or revised treaties subsequent to their original implementation, it has been found that while, overall, "China gained taxing rights over profits from service activities in treaties with OECD countries (the countries most likely to provide services into China)", its revised treaties with non-OECD countries have generally gone the other way.[40]

By way of comparison with Central Asian former Soviet nations, it can also be noted that some variation in practice has been found on the inclusion of the services PE provision in treaties, both within such countries and on the proportional use of the provision between countries (on the latter point, "Tajikistan [having] given up taxing rights over provision of services in more of its tax treaties than any others in the group and Kazakhstan the least").[41]

It would therefore be desirable for China to consider negotiating the provision into the Treaty, but it may be an issue the particular terms of which will involve significant negotiation.

3.6. Articles 6 (Income from immovable property) and 14 (Capital gains)

The present provision is standard and broadly reflects the international consensus on the issue that such income is generally attributable to the source country.

However, in the context of primary production, it can be noted that as the CPEC unfolds and Chinese enterprises start entering Pakistan to conduct "corporate agriculture",[42] the existing domestic legal infrastructure is likely to come under stress and require serious improvement since agricultural income is essentially exempt at present in Pakistan.[43] By contrast, since China taxes residents on the basis of their worldwide income, the Pakistan exempt income will eventually be taxed in China when Chinese residents receive such income from immovable property in Pakistan.

Moreover, since capital gains arising from the sale of immovable property are also essentially exempt in Pakistan at the moment, taxation of these gains is likely to fall to China, which may pose serious jurisdictional challenges to that polity with interprovincial ramifications. Article 14(1) of the Treaty allows Pakistan to tax such capital gains derived from the alienation of immovable property situated in Pakistan should such taxation be imposed under Pakistani law.

3.7. Article 7 (Business profits)

The Treaty adopts the conventional approach of allocating rights to tax business income to the residence state unless the business is carried on in the source state through a PE. However, where the business is conducted in the source state through a PE situated therein, the source state is assigned the right to tax business income under the Treaty on the basis of the force-of-attraction principle found in the UN Model, allowing source state taxation of income attributable to the PE, as well as of income from identical sales and other similar kinds of activities carried on through the PE.

However, the Treaty largely undermines the effect of the force-of-attraction principle by innovatively stating in article 7.1 that the same would not come into play "if the enterprise proves that such sales or activities could not have been undertaken by the permanent establishment".[44] Pakistan has already suffered heavily on account of splitting contracts, supplies being conducted through direct disbursal mechanisms and the creation of multiple subsidiaries. Since this issue is also being handled under the BEPS initiative, including in the context of measures to deal with taxpayer avoidance of attribution of income to PEs, and both Pakistan and China are actively engaged with the OECD on the BEPS Project, this issue is likely to be resolved to a certain degree.

It can also be noted that article 7.3 of the Treaty currently includes significant restrictions on the deduction of expenses in the calculation of PE profits provided for under the UN Model. This area is also one, however, in which it has been surmised, based on China's evolving treaty practice, that "China is starting to become more open towards entering into [treaties] using OECD Article 7.3" with its deduction rule being more generous to the residence state,[45] which would clearly be unfavourable to Pakistan in the context of the CPEC.

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40. Jin & Krever, *supra* n. 15, at p. 360.
41. T. Hwong et al., *Tax Treaty Trends in Central Asian Former Soviet Nations*, 66 Bull. Intl. Taxn. 10, p. 547 (2012), Journals IBFD.
42. The term refers to large tracts of arable lands being leased out to foreign corporations that commit to bringing in capital and state-of-the-art expertise to cultivate and conduct agriculture on modern lines.
43. Sec. 41 ITO 2001. For further discussion of tax compliance challenges in Pakistan more generally, *see also* B. Hassan, *In Search of Tax Policy to Improve Taxpayer Compliance in Pakistan*, 23 Asia-Pac. Tax Bull. 6, pp. 1-7 (2017), Journals IBFD.
44. Art. 7.1. China-Pakistan Treaty 1989.
45. J. Khoo, *China's Evolution as a Capital Exporter: A Shift in Tax Treaty Policy?*, 37 Hong Kong Law Journal 3, p. 909 (2007).

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3.8. Article 8 (Shipping and air transport)

From Pakistan's perspective, if one were to identify one loophole in the Treaty that needed a correction on an urgent basis – more so in the context of the CPEC – it would be article 8.

The subject of article 8, captioned as "International traffic", has been relevantly defined as "any transport by a ship or aircraft operated by an enterprise which has its place of effective management in a Contracting State".[46] According to international standards, for income earned from "international traffic", i.e. from "services" that are rendered either on high seas or in space, the source rules *are* linked to the place of origin of such services or the provider's place of residence (or effective management), as may be mutually agreed upon between the states concerned. Accordingly, taxing rights over income from international traffic are allocated in one of the following ways: (i) to the residence state (or the state in which the place of effective management of the enterprise is located or wherein ships or aircraft are registered); (ii) to the source state; or (iii) to both states on a shared basis. The international treaty network presents manifestations of all three modes of allocation of taxing rights on shipping and air transport business. In the treaties concluded by Pakistan, the first and third modes are used, with the Treaty resorting to the first mode only.

It is argued that the abdication of source taxation has had serious and concrete implications for the Pakistani fisc, the country's shipping industry and its connected sub-industrial and business base and the economy of the country. First, Pakistan, with a population of over 200 million and international trade in the vicinity of USD 75 billion, but having a shipping capacity of a meagre *nine* ships, would never be able to derive any substantive fiscal benefits from the Treaty. By contrast, China, being a maritime power with a coastline of 14,500 kilometres, 35 major and over 2000 minor ports and shipping capacity amongst the top three countries in the world, is the only beneficiary of the extant fiscal arrangement. Thus, the CPEC poses a challenge to the existing bilateral fiscal equanimity through article 8 of the Treaty. As activities at Gwadar Port pick up and an increasing number of ships start loading and offloading there, the cost of exemptions will be increasingly high for Pakistan. Moreover, the cost of exemptions on this count could become practically unbearable as other countries for which Pakistan has abdicated source taxation join the CPEC.

With the CPEC gaining momentum, it is important that the two countries act jointly to gain a true understanding of the nature and importance of this matter, as article 8 in its current form distributes fiscal returns from the shipping economy in a directly uneven manner in China's favour. Moreover, the definition of "international transport" as provided in article 3.1(i) of the Treaty should also be expanded to cover railways, trucking and other means of communication in addition to the existing air transport and shipping to reflect the reality related to the CPEC, with article 8 as a whole being based on a sharing of source taxation instead of the existing residence taxation.

3.9. Article 9 (Associated enterprises)

The broad purpose of article 9 is to ensure that transactions between associated enterprises located in more than one jurisdiction are conducted on an arm's length basis so that undue profits are not shifted out of the country under disguised arrangements.

Although the Treaty provision reflects international standards, Pakistan's own anti-transfer pricing regime, both at the legal and implementation levels, which eventually feeds into and determines the effectiveness of the Treaty provision, is manifestly deficient. At the legal level, the regime is archaic and insufficient, and at the implementation level, the tax administration lacks critical capacity to deal with sophisticated tax avoidance ploys put in place by multinational enterprises (MNEs). Section 108 of the ITO, entitled "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".[47] Section 78 of the ITO, entitled "Non-arm's length transactions", in turn stipulates that where an asset is disposed of on a 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".[48] Not only does the Commissioner have "a wide discretionary power to apply international standards, case laws, and guidelines issued by various tax-related internationally recognized organizations", but 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".[49]

Chinese entrepreneurs have a peculiar business model of their own: it is horizontally and vertically integrated, with financing, plant and machinery, technical expertise, semi- and unskilled labour, raw materials and intangibles all being supplied by Chinese corporations to other Chinese corporations (wherever they are located). Since most of these corporations are state-owned enterprises (SOEs), it becomes extremely difficult to apply article 9 of the Treaty. The extent to which Chinese corporations have been able to minimize their profits reported in Pakistan is likely to become more apparent, given that the Pakistan Federal Board of Revenue has been releasing annual tax payment information on all corporations since 2014[50] and that Pakistan recently enacted country-by-country reporting with effect from

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46. Art. 3.1(i) China-Pakistan Treaty 1989.
47. Sec. 108(1) ITO 2001.
48. Id., at sec. 78.
49. G. Michielse, *Tax Provisions and the Global Economy*, in *The Role of Taxation in Pakistan's Revival* p. 234 (J. Martinez-Vazquez & M. Rasool Cyan eds., Oxford U. Press 2015).
50. *See* the taxpayer directory published by the Pakistan Federal Board of Revenue every year since 2014, available at http://www.fbr.gov.pk/CategoryLayoutList.aspx?view=Category%5bDocuments%5d%20With%20List%20Layout&ActionID=742&ArticleID= (accessed 25 Jan. 2018).

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1 July 2017.[51] Of course, Pakistan's own tax incentive regime may have contributed to any such situation, but the Chinese business model appears to be a significant factor in difficulties of proper determination of income of such entities in local jurisdictions. In addition, one important feature of China's position on transfer pricing rules is that MNEs must allocate to China "reasonable profits" reflecting their "location specific advantages" (LSAs) providing benefits arising from China, and China expressly stated such position in the UN Transfer Pricing Manual in 2013.[52] Conversely, however, with Chinese entrepreneurs investing in Pakistan, in particular in the context of the CPEC, the LSA factors that China has argued to date could become the arguments of Pakistan being in the position of the source state.

Thus, tax disputes might arise if China and Pakistan cannot reach alignment in applying their transfer pricing rules in addition to the terms of article 9. There is a general understanding in the tax administration that the pre-BEPS anti-transfer pricing taxation regime as summarized above is no longer quite in line with international best practices as documented in the OECD Guidelines, the UN Manual on Transfer Pricing and the World Bank Handbook on Transfer Pricing, and an equally strong feeling that there is a need to substantially improve and update this regime consistently with the latest developments at the international level, particularly the BEPS reports on actions pertaining to transfer pricing.[53]

3.10. Article 10 (Dividends)

The Treaty allocates the primary right to tax dividends to the residence state but allows a limited right to the source state to impose a maximum of 10% tax on the gross amount of dividends paid "if the recipient is the beneficial owner of the dividends".[54] This is more or less an internationally accepted standard under which "the primary right of taxation vests with the country of residence of the recipient" and the "source country has the limited taxation right by way of charging tax as a percentage of the gross amount of dividends".[55] The justification for "assigning the primary tax right to the country of residence is that the capital giving rise to such income emanates from the country of residence of the recipient", but since "the source country … also contributes towards income generation", it is assigned a limited right to tax.[56]

Taxation of dividends as enshrined in the Treaty, from Pakistan's perspective, has three problems. First, it lacks a *substantial capital/ interest clause* to safeguard the economy against in-and-out portfolio investment shocks. "Lower rates are generally provided where the recipient company holds substantial interest in the payer company".[57] The rationale behind applying "lower tax rates is that the payments of profits by a subsidiary to its foreign parent company should be taxed less heavily to avoid recurrent taxation and to facilitate international flow of investment"[58] on a more solid and long-term basis. With 40% of the share capital of the Pakistan Stock Exchange, alongside management already being in the hands of a Chinese consortium of stock exchanges,[59] at some level, the Treaty provision in this context may give rise to the risk of creating additional incentives for short-term speculative portfolio investments in Pakistan, which, together with close integration of the market with other international exchanges, leaves the economy vulnerable and exposed to unnecessary shocks. Second, article 10.4 of the Treaty, essentially prescribing the full rate of taxation to the source state "where the recipient of income has a strong business connection with that country by way of existence of a permanent establishment or a fixed base",[60] though theoretically considered favourable to developing (source) countries, effectively works against Pakistan and erodes its tax base in view of the country's extremely deficient tax system. Third, the Treaty, in the absence of a limitation on benefits (LOB) provision, is prone to misuse and treaty shopping by persons not entitled to avail themselves of the benefits under it.[61]

On the Chinese side, the challenge is more on how to interpret the term "beneficial owner" in this article, as this term remains undefined in Chinese domestic law and Chinese tax treaties, although it is used in every Chinese tax treaty. Thus, while interpreting this term, one has to rely on the Chinese State Administration of Taxation (SAT), which is the highest tax authority in China, to give practical guidance on identifying tax avoidance schemes, in particular relating to treaty shopping. To date, the SAT has issued three guidance documents

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51. *See* EY, *Pakistan Implements Formal Transfer Pricing Documentation and Country-by-Country Reporting Requirements*, Global Tax Alert (News from Transfer Pricing) (7 Aug. 2017), available at http://www.ey.com/gl/en/services/tax/international-tax/alert--pakistan-implements-formal-transfer-pricing-documentation-and-country-by-country-reporting-requirements (accessed 25 Jan. 2018), noting the enactment of relevant provisions in PK: Finance Act, 2016 and the release of draft guidance by the Federal Board of Revenue in June 2017. For further discussion of these requirements, *see* I. Haq, *Pakistan: Issuance of CbC Reporting and TP Documentation Requirements*, 25 Intl. Transfer Pricing J. 2, p. 158 (2018), Journals IBFD, and I. Haq, *Pakistan: Scope of CbC Reporting and TP Documentation Requirements*, 25 Intl. Transfer Pricing J. 4 (2018), Journals IBFD.
52. United Nations, *Practical Manual on Transfer Pricing for Developing Countries*, S.T/E.S.A/347, pp. 376-379 (UN 2013). *See also*, for example., C. Cheng et al., *China's New Transfer Pricing Guidelines and BEPS*, International Tax Review (4 Dec. 2015), discussing the State Administration of Taxation's proposed limited adoption of BEPS initiatives in draft discussion document entitled *Special Tax Adjustments* of 17 Sept. 2015, available at http://www.internationaltaxreview.com/Article/3511707/Chinas-new-transfer-pricing-guidelines-and-BEPS.html (accessed 24 Jan. 2018).
53. OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Report* (OECD 2015).
54. Art. 10.2 China-Pakistan Treaty 1989.
55. Khan, *supra* n. 39, at p. 180.
56. Id.
57. Id., at p. 181.
58. Id.
59. D. Hussain, *PSX Sells 40% Stake to Chinese Consortium*, Dawn (23 Dec. 2016), available at https://www.dawn.com/news/1304006 (accessed 24 Jan. 2018).
60. OECD Commentary, p. 148.
61. The formulation of a standard limitation on benefits (LOB) provision is as follows: "Benefits under this Article shall not be granted if the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or rights in respect of which the dividends are paid was to take advantage of this Article by means of that creation or assignment".

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for or relating to the interpretation of this term,[62] which set out an approach of combining both objective criteria conforming with OECD views and a subjective review in line with the substance-over-form doctrine.[63] Thus, Chinese tax authorities have significant discretionary power when reviewing whether Chinese residents may qualify as beneficial owners and be entitled to the Treaty benefits.

3.11. Article 11 (Interest)

As in the case of dividends, the Treaty allocates the primary right to tax interest income to the residence state, but then allows a limited right to the source state to impose tax at a maximum rate of 10% on the gross amount of interest paid "if the recipient is the beneficial owner of the interest".[64] The principle underlying the allocation of primary taxation rights to the residence state is identical to that for dividends, in that the capital giving rise to such income emanates from the country of residence of the capitalist. Furthermore, while there is no complete consensus on the issue, generally, states refrain from levying tax on interest income derived by other states and some of their wholly-owned entities (e.g. a central bank established as a separate entity), at least to the extent that such interest income is derived from activities of a governmental nature.[65] This treatment may be justified under the customary international law principle of sovereign immunity, whereby "a sovereign state (including its agents, its property and activities) is, as a general rule, immune from the jurisdiction of the courts of another sovereign state".[66] Since there is a lack of consensus at the international level as regards the "precise limits of the sovereign immunity principle", many states "would not recognize that the principle applies to business activities", and still, others would "not recognize any application of this principle in tax matters".[67]

In the context of the Treaty, however, exemption under the sovereign immunity principle has been extended to a large number of financial institutions, which also, chiefly unilaterally, emerges as a major cause of concern in Pakistan. Article 11.3 originally exempted the governments and the State Banks of both states (in China's case, the People's Bank of China and the Bank of China) on a reciprocal basis. However, the Second Protocol to the Treaty, in 2007, substantially extended this provision by allowing exemption for "local authorities, financial institutions and agencies … which are agreed upon from time to time by the competent authorities" and including in the definition of "State Banks" the Export-Import Bank of China, the Agricultural Development Bank of China and the China Development Bank.[68] Subsequently, as noted in section 2.5., under the Third Protocol to the Treaty, the Industrial and Commercial Bank of China and the Silk Road Fund were also brought into the definition of "State Banks" in respect of the income that "they derive from loans in Pakistan for the Energy Projects mentioned in the CPEC Energy Projects Cooperation Agreement signed at Beijing on November 8, 2014",[69] even though the former is not wholly owned by the Chinese government but is a joint-stock limited company publicly listed on both the Shanghai and Hong Kong Stock Exchanges.[70]

These general exemption arrangements have also been even further extended by the specific recent action of the government of Pakistan, in which it invoked its powers under clause (75) of Part I of the Second Schedule to the ITO to exempt "profit on loans borrowed by Government of Pakistan under Facilities Arrangement US$ 700 million on 20th September, 2016 from M/s China Development Bank Corporation".[71] This provides a rare documented case of the government of Pakistan first entering into a purely commercial-based, debt-creating borrowing arrangement on non-competitive terms and then specifically exempting the arrangement from taxation in Pakistan.

As a final point, the Treaty, again, in the absence of an LOB provision, is prone to misuse and treaty shopping by persons not entitled to avail themselves of the benefits under it in relation to transactions involving interest.[72]

3.12. Articles 12 (Royalties) and 13 (Fees for technical services)

Both articles on Royalties and Fees for Technical Services (FTS), in their general approach, reflect near-international consensus on these incomes prevailing at the time of the signing of the Treaty.[73] However, as a specific matter, articles 12.4 and 13.4 lay down that if a foreign resident company (or individual) earns such royalties or FTS in Pakistan through a PE or fixed base, this income will not be taxed under their respective heads of income on a gross basis, but as business income on a net basis. While these provisions are available under both the OECD and UN Models and have been supported as being egalitarian in nature and operation and apparently aimed at protecting the fiscal base of developing countries, nevertheless, in practical terms, they could very well prove counterproductive, particularly in the case of Pakistan and the CPEC. A potential problem is that a recipient Chinese company, among other things, could claim expenses to

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62. CN: SAT, Notice of the State Administration of Taxation on How to Understand and Determine the "Beneficial Owners" in Tax Treaties (Circular 601/[2009]), issued by the SAT on 27 Oct. 2009; CN: SAT, Opinion to the State Tax Bureaus of Hubei Provinces and Others for Implementing the Dividend Provisions and Beneficial Owners Concept under the Tax Arrangment between Mainland China and Hong Kong SAR (*Shuizonghan* 165[2013]), issued by the SAT on 12 Apr. 2013; and CN: SAT, Notice of the State Administration of Taxation on How to Determine the "Beneficial Owners" in Proxy Investments (Circular 24/[2014]), issued by the SAT on 21 Apr. 2014.
63. N. Cormac Sharkey, *China's Tax Treaties and Beneficial Ownership: Innovative Control of Treaty Shopping or Inferior Law-Making Damaging to International Law?*, 65 Bull. for Intl. Taxn. 12, pp. 655-661 (2011), Journals IBFD.
64. Art. 11.2 China-Pakistan Treaty 1989.
65. OECD Commentary, at p. 208.
66. Id., at p. 59.
67. Id.
68. China-Pakistan Protocol 2007.
69. Art. 1 China-Pakistan Protocol 2016.
70. *See* the website of the Industrial and Commercial Bank of China, available at http://www.icbc-ltd.com (accessed 26 Dec. 2017).
71. Federal Board of Revenue, Notification/S.R.O 658(I)/2017 of 13 July 2017.
72. *See supra* n. 61 for the formulation of a standard LOB provision.
73. For further discussion of these rules and treaty provisions, *see* H. Bukhari & I. Haq, *Pakistan: Taxation of Royalties, Fees for Technical Service, Dividends and Interest*, 19 Asia-Pac. Tax Bull. 4, pp. 251-256 (2013), Journals IBFD.

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arrive at a net income by establishing a "paper PE". It has already been argued that "difficulties arise where the withholding tax is applied exclusively to income paid to non-residents".[74]

3.13. Article 24 (Elimination of double taxation): Tax sparing

Although most countries currently have built-in mechanisms in their domestic tax systems for the elimination of double taxation, traditionally, the "first and the foremost purpose of tax treaties" has been "to avoid double taxation of income arising on international economic transactions".[75] Both the OECD and UN Models prescribe almost identical options to eliminate double taxation. The UN Model also "addresses the developing countries' concerns relating to the defects of the foreign tax credit method resulting in partial relief to the enterprises otherwise subjected to low or nil taxation in these countries",[76] giving optional allowance for tax sparing by residence countries.

Tax sparing is important as, in order to attract capital and investment, countries give concessions. If a tax credit is restricted to the tax paid, this incentive given to investors is neutralized by the residence state. To ensure that the benefit continues to apply, the residence state agrees to give credit not only for the tax paid, but also for that which would have been paid had that incentive not been there. Thus, tax sparing goes beyond the pure tax credit method and takes into account the potential tax that would have been payable. The effectiveness of the tax incentive measures put in place by developing countries is therefore partly achieved through a tax "sparing credit", by which a developed country grants a tax credit not only for the tax paid, but also for the tax spared through incentive legislation in the developing country.[77] It has been noted that tax sparing can provide economic benefits to residence states through enhanced overseas investment opportunities. In this respect, China recently resumed the practice after having strongly pursued such provisions prior to 2008.[78]

Pakistan has traditionally sought the inclusion of tax sparing provisions in treaties with developed countries. Accordingly, when Pakistan insisted upon the tax sparing credit in negotiations for the Treaty in this case, China "indicated that matching tax credit could be adopted on a mutual basis".[79] At the end of the third round, it was "agreed that in relation to the tax paid in respect of dividends, interest and royalties, the amount of tax paid shall be deemed to be the amount equal to the rates finally adopted in the Treaty in respect of the said three sources of income".[80] The article also provided tax sparing on a reciprocal basis, which was justified on the basis that "Pakistan would be the major beneficiary of this provision since the flow of services and technology is expected to be directed from China to Pakistan in the foreseeable future".[81]

However, since the implementation of the Treaty, China has effectively neutralized some of the sparing provisions through the elimination of its then incentives for foreign investment by Chinese resident entities. For instance, the tax sparing credit, as envisaged in article 24.1(c)(i) of the Treaty, was contingent on the tax incentives specifically provided in China's tax laws, which, however, became void from 1 January 2008.

With the CPEC gaining momentum, tax-free zones in Pakistan taking shape and capital and expertise flowing rapidly across borders in greater volumes, economic development will only be encouraged to the optimal extent with appropriate foreign tax credits, tax incentives and tax sparing regimes in both countries.[82] Thus, a renegotiation of the tax sparing provision appears inevitable for these states in the near future.

3.14. Article 26 (Exchange of Information)

A tax treaty is envisaged not only as an agreement to provide for sharing of taxing rights between states and the prevention of double taxation, but also to thwart any schemes or arrangements for tax evasion aimed at the selection of a jurisdiction from which to derive revenues that will be taxed on favourable terms, or even aimed at evasion of taxation in full or in part in one or both jurisdictions party to the treaty in question. Article 26 looks to set out parameters of exchange of tax information between the two states by laying down the type of information that can be exchanged and the circumstances under which this can occur.[83]

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74. Khan, *supra* n. 39, at p. 321.
75. Id., at p. 290.
76. Id.
77. Id.
78. N. Li, *Tax Sparing: Use It, But Not as a Foreign Aid Tool*, 45 Intertax 8/9, pp. 546-555 (2017).
79. Akmal, *supra* n. 10.
80. Khan, *supra* n. 18.
81. Id.
82. For an analysis of the potential benefits and costs of the proposed special economic zones in Pakistan envisaged under the CPEC, *see* K. Khan & S. Anwar, *Special Economic Zones (SEZs) and CPEC: Background, Challenges and Strategies*, paper presented at the 32nd Annual General Meeting and Conference of the Pakistan Society of Development Economists: *China-Pakistan Economic Corridor and Regional Integration*, Islamabad, 13-15 Dec. 2016, available at http://pide.org.pk/psde/index.php/14-sample-data-articles/127-32nd-agm-papers (accessed 22 Jan. 2018). A role for tax incentives in developing countries has been acknowledged, subject to appropriate limits, controls and transparency measures. In connection with this, *see* E. Zolt, *Tax Incentives in Developing Countries: Maximizing the Benefits and Minimizing the Costs*, in *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*, 2nd ed., pp. 523-569 (A. Trepelkov, H. Tonino & D. Halka eds., United Nations 2017). *See also* A. Maqsood Ahmed & R. Ather, *Study on Tax Expenditures in Pakistan*, World Bank Policy Series on Pakistan PK 21/12 (2014), available at https://openknowledge.worldbank.org/bitstream/handle/10986/18671/871030NWP0Box30ditures0in0Pakistan.pdf?sequence=1&isAllowed=y (accessed 22 Jan. 2018). On the need for improvements to the administration of the corporate tax credit provisions in Pakistan, *see also* B. Hassan, *In Search of Tax Policy to Boost Investment in Pakistan*, 24 Asia-Pac. Tax Bull. 2 (2018), Journals IBFD.
83. UN Commentary, at p. 435 et seq.

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Actionable tax information from international sources is of particular importance to tax administrations, due to the relatively larger revenues involved and the deterrent effect that its usage can generate. Furthermore, “in view of the increasing internationalisation of economic relations, the Contracting States have a growing interest in the reciprocal supply of information on the basis of which domestic taxation laws have to be administered, even if there is no question of the application of any particular article of the Convention”.[84] Given the fact that developing countries are more prone to be a target of base erosion and profit shifting, exchange of information (EOI) attains even greater importance for these countries, although it has been noted that “the whole EOI process in its practical application and effectiveness is something of a ‘black box’, operating in the shadows more than the light”.[85]

However, it is interesting to note that when, following the strengthening of the international EOI standard in 2005, the Second Protocol to the Treaty was signed in 2007, article 26 was neither negotiated nor aligned with international best practices prevailing at the time. Likewise, after further revision of the EOI standard in 2012, when the Third Protocol to the Treaty was signed in 2016 after prolonged negotiations that spanned over two years and four rounds, article 26 again was not subject to any amendments.

In the current international environment of widespread implementation of information exchange arrangements, failure by any country to participate or keep pace with such developments only creates room for unfavourable inferences to be drawn. In order to bring transparency, prevent fraud and optimize the collection by both countries of taxes properly owing, particularly in the wake of the rapidly increasing volume of cross-border transactions, it is essential and of paramount importance that article 26 of the Treaty is upgraded and enforced at the earliest opportunity through a Protocol or comprehensive revision of the Treaty.

3.15. Assistance in the collection of taxes

In its present form, the Treaty does not provide any mechanism for mutual assistance in the recovery of tax arrears. A separate such article was incorporated into the OECD Model in 2007 and subsequently adopted in the UN Model in 2012. Keeping in mind the huge number of cross-border transactions being undertaken and businesses being set up under the CPEC, as well as the possibility of a significant increase in tax arrears and defaults due to the project, the inclusion of article 27 of the OECD Model into the Treaty is warranted.

4. Conclusion

Having been drawn up nearly three decades ago, the Treaty is now manifestly outdated in terms of both its terminology and the inadequacy and incomplete coverage of many of its provisions, exposed to an increasing extent by a flurry of developments at the international level in the arena of interstate taxation and the enormous economic challenges and opportunities brought by the CPEC project.

The critique in this article has shown not only that the Treaty has grown anachronistic and is incapable of withstanding as massive a jolt as the CPEC, but also that it can be concluded that the tax systems of both Pakistan and China – to the extent that they must be efficacious enough to handle the CPEC and the issues arising therefrom – are not, in their current forms, ready for the CPEC behemoth.

Thus, the Treaty between these two countries should be renegotiated in totality rather than simply “amended” through the application of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting or tinkered with through further protocols. Such retrofitting would only complicate the existing problems posed by the Treaty by creating further distortions and rendering its comprehension and implementation difficult on both sides of the border.

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84. OECD Commentary, at p. 397.
85. M. Lennard, *The UN Model Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments*, 15 Asia-Pac. Tax Bull. 1, p. 10 (2009), Journals IBFD.

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