

Taxation of Cross Border Business Transactions under
Pakistan's National Laws and Conventions for the Avoidance
of Double Taxation of Income with Other States



By

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71-FSL/LLM-ITL/F06

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This is certified that we, the undersigned members of the *Viva-Voce* Examination Committee, have read and duly evaluated the Dissertation having titled as **Taxation of Cross Border Business Transactions under Pakistan's National Laws and Conventions for the Avoidance of Double Taxation of Income with Other States**. Whereby, this Dissertation is submitted by **Mr. Faisal Bin Khurshid** having Registration No. 71-FSL/LLM-ITL/F06 in partial fulfillment of the requirements for the award of Degree in Master of Laws (LLM).

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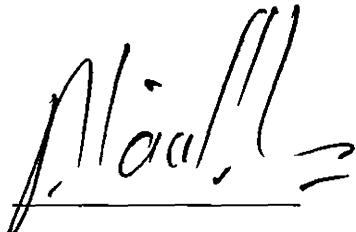


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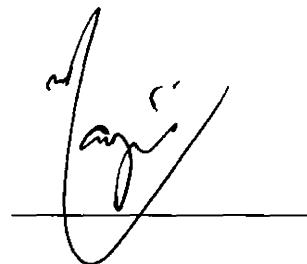
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Declaration

I, Faisal Bin Khurshid son of Muhammad Khurshid Anwar having Registration No. 71-FSL/LLM-ITL/F-06 do hereby, solemnly affirm and declare as under:

"That the material accompanying Dissertation in whole, part(s) or in any form thereof has never been printed, used, disseminated or published by me or under my guidance, instructions or supervision. On my honour, I submit this work in good faith and pledge that I have neither given nor received reprehensible aid in its completion. Furthermore, nothing has been concealed, withheld or stated wrong therein."



Deponent

Further affirms and declare as under:

"That the contents accompanying this declaration are correct and true to the best of my knowledge as well as belief. Furthermore, nothing has been concealed, withheld or stated wrong therein."



Deponent

Dedication

With great humility and respect
I dedicate this humble attempt of mine

To

My Respected Parents;

Mr. & Mrs. Khurshid Anwar

Wherefore, I do not find lexis
to express my deepest gratitude
for their unstinted affection and all time support.

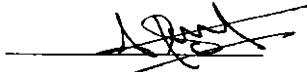
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I am equally indebted to my supervisor Colonel ® Muhammad Younus Esq., Assistant Professor of Law, Faculty of *Shari'ah* and Law, IIUI, but for whose parental supervision, this task could not be accomplished with this ease. I would also like to acknowledge my debts to all my great teachers for their generous support and to all wherefrom I have learnt a lot throughout my life.

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Faisal Bin Khurshid

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Abstract

Taxation of Cross Border Business Transactions under Pakistan's National Laws and Conventions for the Avoidance of Double Taxation of Income with Other States

By

Faisal Bin Khurshid

Chair: Colonel ® Muhammad Younus Esq.

The 40th President of United States of America (1981-1989), Ronald Wilson Reagan was reported to believe that "*the government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.*" Anecdotal evidence suggests that the state's economy is scrupulously evaluated by computing tax revenue or from the government's expenditure to the GDP ratio. Among volley of questions, it is hard question for the GoP that '*how to enhance the altitude of tax revenue and who bears the burden thereof*'. Albeit the tax revenue is a spinal column in state's economy; taxation is an obscure field having serious issues with respect to trans-border business income. This study attempts to highlight the significance of taxation of trans-border business activities, avoidance of double taxation, provides the practical insight of Pakistan's tax system in line with myriad tax regimes and presents an epigrammatic portrayal of its application to foster the FDI. In the pages to come, economic perspective *inter alia* with issues relating to residency of person, income and sources thereof, PE and status thereof, and activities in digital age particularly in Pakistani context are also assayed. Pursuant to economic perspective, the GoP applied numerous measures for *allocation of resources and redistribution of income*.

It is noteworthy that altitude of tax collection in Pakistan is incredibly low thereby, a low level and high volatility of tax revenues has badly choked the government's abilities to compete in digital age. In fact, Pakistan's law and order situation has badly suffered in recent past, whereby the law related services are deteriorated by virtue of dearth of attention as well as resources and subsequently, the judicial system is at the verge of collapse. Hereby, a sort of '*bureaucratic cholesterol*' clogged the arteries

which energize the economy¹ and foster the FDI. By virtue of phenomenal growth in international trade, major chunk of trans-border businesses are rendered by MNCs having single control and command. It also accelerated the movement of goods, services, and technologies as well as integrated the national economies into international one. Under such repercussions, it is necessary for taxes to be just and good.

Certain jurisdictional frictions come in field on the application of different tax laws while dealing with the same subject matter. Besides, pursuant to certain potential overlaps, the importance of alignment between the Income Tax Laws, Model Conventions and DTAs provisions has also been dilated in this study. The DTAs to which Pakistan is party, has also been assayed and an analysis of upheavals in course of its implementation has also been made. The study also investigated the profit allocation matrix between the source and the host states, yet when both the states have overlapping jurisdictions. The dissertation also enclosed with the issues relating to transfer pricing, which requires coordination mechanism among the treaty partners pertaining to alleviate frictions to evade taxes. In response to resolve the Transfer Pricing related issues, cohesive and congenial measures are required to be formulated by GoP.

This dissertation is recapitulated by keeping in view the prospects of enhancement of tax revenue and governance of tax collection mechanism. To obliterate the disparities among the enabling provisions of tax regimes and discourage the tax evasions as well as provide built-in tax flexibilities to avoid double taxation, the advantageous way forward for Pakistan is that GoP should formulate concrete mechanism for tax collection to foster the FDI and the state economy.

¹ Vito Tanzi, "The Changing Role of the State in the Economy: A Historical Perspective", WP/97/114-IMF, (1997).

Glossary

In this Dissertation (except where the context otherwise requires), the following expressions, where capitalized, shall have the following meanings:

- 1.1** “**AIR**” means All India Reference;
- 1.2** “**ALP**” means Arm’s Length Principle;
- 1.3** “**AoP**” means Association of Persons;
- 1.4** “**APA**” means Advance Pricing Agreement;
- 1.5** “**BIA**” means Bilateral Investment Agreements;
- 1.6** “**BoD**” means Board of Directors;
- 1.7** “**CIT**” means Commissioner of Income Tax;
- 1.8** “**CPC**” means Civil Procedure Code;
- 1.9** “**CPM**” means Cost Plus Method;
- 1.10** “**CUP**” means Comparable Uncontrolled Price Method;
- 1.11** “**DC**” means Developed Country;
- 1.12** “**DTAs**” means Double Tax Agreements;
- 1.13** “**FBR**” means Federal Board of Revenue, Pakistan;
- 1.14** “**FDI**” means Foreign Direct Investment;
- 1.15** “**FTAs**” means Free Trade Agreements;
- 1.16** “**FTO**” means Federal Tax Ombudsman, Pakistan;
- 1.17** “**GDP**” means Gross Domestic Product;
- 1.18** “**GNP**” means Gross National Product;
- 1.19** “**GoP**” means Government of Pakistan;
- 1.20** “**ICJ**” means International Court of Justice;
- 1.21** “**IMF**” means International Monetary Fund;
- 1.22** “**IT**” means Information Technology;
- 1.23** “**LDC**” means Less Developed Country;

1.24 “MFN” means Most Favored Nation;

1.25 “MNCs” means Multinational Companies;

1.26 “MNE group” means a group of associated companies having business establishments in two or more than two countries;

1.27 “MNE” means an Multinational Enterprises, which is a part of a MNE group;

1.28 “OECD” means Organization for Economic Co-operation and Development, a multilateral organization having 34 members;

1.29 “OECD-MC” means OECD Model Convention;

1.30 “OECD-TPG” means OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010;

1.31 “OEEC” means Organization for European Economic Co-operation, which reformed as OECD in September 1961;

1.32 “PE” means Permanent Establishment;

1.33 “PLD” means Pakistan Law Digest;

1.34 “PSM” means Profit Split Method;

1.35 “RPM” means Resale Price Method;

1.36 “SAARC” means South Asian Association for Regional Co-operation;

1.37 “SAFTA” means South Asian Free Trade Area;

1.38 “SC” means Supreme Court;

1.39 “The Ordinance” means Income Tax Ordinance, 2001;

1.40 “The Rules” means Income Tax Rules, 2002;

1.41 “TNMM” means Transactional Net Margin Method;

1.42 “TP” means Transfer Pricing;

1.43 “TPM” means Transfer Pricing Manipulation;

1.44 “UN” means United Nations;

1.45 “UN-ECOSOC” means UN-Economic and Social Council;

1.46 “UN-MC” means UN-Model Double Taxation Convention between Developed and Developing Countries, 1980;

1.47 “WTO” means World Trade Organization;

1.48 “WWW” means World Wide Web; and

1.49 “VAT” mean Value-Added Tax.

Interpretation

- a) References in this Dissertation to the ‘Income Tax Laws’ includes the Ordinance and the Rules.
- b) References in this Dissertation to the ‘Model Conventions’ includes OECD-MC and UN-MC.
- c) Words in the singular include the plural and vice versa.
- d) Words importing any gender include every gender.

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xxxi Vijay Narian Singh vs. State of Bihar - AIR 1984 SC	19
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Chapter 1

Prologue

Franklin Delano Roosevelt, the 32nd American President (1933 - 1945), believed that "*Taxes, after all, are dues that we pay for the privileges of membership in an organized society.*" In point of fact, taxes are the financial charge having sanctions of civil or criminal nature, which is levied on persons (both natural and juridical) by the sovereign. But the economists antagonized to this contemplation by referring the taxes to a non-penal subject matter because the resources are compulsorily transfer from private to public sector having levied on pre-determined criteria and undetermined benefits in return. As far as the modern tax policies are concern; they focus on the taxes which would be progressive, neutral, and equitable. However, revenue, redistribution, reprising and representation are essential components as well as guiding principles of taxation.

- i. Revenue: Taxes are the main source of income for a government to finance public utilities as well as social projects and the smooth running of its affairs.
- ii. Redistribution: Taxes serve the purpose of eliminating income disparities among various classes of society and help in optimal allocation of resources, such as, the capital is more productive in the classes where capital to labour ratio is low.
- iii. Reprising: Taxes are levied to focus on externalities by encouraging or discouraging in market e.g. carbon tax levied on petroleum products, to discourage pollution.
- iv. Representation: Accountability of ruling elites by their subjects, which is based on American revolutionary slogan "no taxation without representation", e.g. element of accountability is higher in direct taxation as compared to indirect taxation.

Notwithstanding the abovementioned essential attributes of an ideal tax policy, the overall socio-economic and political considerations have a very strong interplay in shaping the taxation policy of a country. The strong economic players influence the bases and extent of taxation on income, goods and services, the rate structure and built-in tax flexibilities. The 'reward and award' programs, while serving the

promotion of priority economic areas, also dilute the equity and neutrality aspects of tax policy. The compliance cost varies depending upon the adequacy or otherwise of the institutional capacity and personnel skills. The overall tax culture and status of rule of law effects the tax yield in terms of converting the potential tax bases to real tax bases.

Anecdotal evidence suggests that during the last two decades of the 20th century, by virtue of digital technologies, investment flow steps into international market. Resultantly, the manifestation of the economies transformation has become so variegated but the tax laws remain confined to be national. In fact, the emergence of taxation systems cannot be coincidental; rather it requires long-term cohesive measures in order to attain craving objectives.

In response to the row upon taxation of income, which is accrued from trans-border economic activities, and its adversative impact regarding smooth flow of capital, goods, and services, are the rationale to articulate legal provisions for the prevention or elimination of double taxation. Undoubtedly, it is necessary because unilateral measures in said respect are scarce. In order to mitigate adversative impact, bilateral conventions are an alternative remedy. The international taxation system deems to be an integral part of domestic tax system which develops in line with its policy objectives. Hence, taxation nomenclature manifests the astronomical territorial 'slice' out of global earnings 'pie'.

History of bilateral conventions is spanning over 80 years. Under the aegis of League of Nations, being an avant-garde, international efforts were initiated, which was pursued by the OEEC and from September 1961 by OECD as its immediate successor. In 60s UN, in league with the tax experts from its member states, started assaying the tax treaty needs of the developing as well as the threshold states with respect to associated issues. Pursuant to the said efforts, by virtue of reconciling various approaches relating to taxation of income of trans-border economic activities, Model Conventions were drafted.¹

1. UN, *Model Double Taxation Convention Between Developed and Developing Countries*, (vol. 19: ST/ESA/102, United Nations, New York, 1980) having File URL: <http://catalogue.nla.gov.au/Records/200455>, which was accessed on 30-07-2010.

1.1 An Odyssey²

On appeal of Brussels International Financial Conference 1920, League of Nations through its Financial Committee in 1921 assayed the economic aspects of international double taxation with regards to eliminate it. The minutes of the meetings (1923 to 1927), which were attended by the Government Experts, purports to draft four *Bilateral Conventions* along with *commentaries thereon*, which are hereinbelow:

- i. *Prevention of Double Taxation in the Special Matters of Direct Taxes Dealing with Income and Property Taxes;*
- ii. *Prevention of Double Taxation in special matters of Succession Duties;*
- iii. *Administrative Assistance in Matters of Taxation; and*
- iv. *(Judicial) Assistance in the Collection of Taxes.*

These Agreed Draft Documents were shared with the member states for comments thereon, which were, later on, discussed at greater length in the General Meeting of the Government Experts at Geneva in October 1928. Pursuant to the minutes of said meeting, Council of League of Nations appointed a Permanent Fiscal Committee to formulate taxation rules for an allocation of business income of entities, which are associated with international operations. Consequently, the *Draft Convention for Allocation of Business Income between States for the Purpose of Taxation* was prepared in June 1933 and revised in June 1935. Moreover, results of fore-draft were tendered to the Regional Tax Conference in June 1940 and July 1943 at Mexico which espoused the Model Bilateral Conventions for the:

- i. *Prevention of Double Taxation of Income and Protocol thereto;*
- ii. *Prevention of Double Taxation of Successions and Protocol thereto; and*
- iii. *Establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Direct Taxes and Protocol thereto.*

Consequently, said Conventions were redrafted in 1946 at London, which are popularly known as 'London Draft Conventions' and attained a status of 'a definite

2. "Introduction to UN-Model Double Taxation Convention," xv-xix having File URL: <http://unpan1.un.org/intradoc/groups/public/documents/un/unpan002084>, which was accessed on 30-07-2010.

improvement on the Model Conventions, 1928.³ The UN, in October 1946, established a Fiscal Commission to "study and advise UN-ECOSOC in the field of public finance, particularly in its legal, administrative and technical aspects".⁴

On February 25 1955, the Council of OEEC inculcated its first recommendations concerning double taxation. In July 1958, it established Fiscal Committee to develop a draft convention for the avoidance of double taxation of income and capital along with concrete proposals for its implementation. It was recognized that the 'efforts to eliminate double taxation needed to go beyond the field of periodic taxes on income and capital'. In 1963 and 1966, OECD prepared a report on *Draft Double Taxation Convention on Income and Capital* and published the *Draft Convention for Avoidance of Double Taxation on Estates and Inheritances*, respectively, which was substantially revised and improved and published as the 1977 *Model Double Taxation Convention on Income and Capital*.

1.2 Model Conventions

1.2.1 OECD: Model convention of the OECD urged the basic norms, criteria and mechanism regarding avoidance of double taxation and prevention of fiscal evasion with respect to taxation on income and capital. By scope, it provides coverage to the taxes on income and sources thereof and capital as well as to ascertain the residential status. It also articulates *modus operandi* for rights of the signatories regarding taxation, which are subject to type and nature of income and capital, and certain conditions. Moreover, issues relating to recipients' country of residence or beneficiary of the income or the source state or a third country are also dilated. It assigns the exclusive taxation right either to the country of source or residence, or in the alternative which provides for revenue sharing between both states e.g. profits of PE would be fully taxed in the country of source; royalties and fee for technical services are essentially taxable in the country of residence except where the recipient has a PE or fixed base in the source country; and apportionment of tax shares implies a choice,

3. League of Nations, Fiscal Committee, *Report on the Work of Tenth Session of the Committee*, From March 20 to 26, 1946 (London: C.37, M.37, 1946.11.A), 8.

4. UN-ECOSOC: Resikytuib 2(3) of 1 October, 1946.

for income derived from foreign country, between the criterion of source and residence.

The objective of the OECD-MC has to eliminate double taxation i.e. the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject and for identical periods. It also attempts to resolve the issues relating to economic double taxation i.e. taxation of same income (i.e. associated enterprises) but ignored the serious economic issues e.g. dividends. In order to discourage discrimination and encourage exchange of information, the OECD-MC entails the code of conduct, which is incumbent on signatories. In addition to available remedies under the domestic law, mutual agreement procedure is envisaged by the OECD-MC for facilitating taxpayer to eliminate the double taxation. In order to resolve controversies, most of European states prefer to arbitration when competent authorities are unable to reach the agreement.

1.2.2 United Nations: As per the ECOSOC resolution no. 1273 (XVIII) of August 4, 1967, UN-AD *hoc* group of experts on tax treaties drafted the *UN-Model Double Taxation Convention between Developed and Developing Countries 1980*. Pursuant to the ECOSCO Resolution 1721 (L III), the Group of Eminent Persons eruditely reported to believe that the provisions of model convention are "*an amount to an international agreement on taxation*".⁵ In fact, the OECD provided a base-line for UN-MC with certain modifications as well as technical expertise.

Under the UN-MC source principle has more weightage as compared to the OECD-MC by providing compromising mechanism between source and residence principles. It inculcates 'rewards and awards' from double taxation e.g. foreign tax credit or exemptions. It also dilates the scope of PE, incorporates the force of attraction principle then attribution principle for taxation of business profits, empowers the source country to share part of tax revenues arising from international traffics' income, providing the concept of secondary adjustment of profits in case of associated enterprises, entitles the source country to levy withholding tax on royalties and know-how fees, and remuneration from personal services.

5. United Nations, *The Impact of Multinational Corporations on Development and on International Relations* (UN Publications, Sales No. E 74 II A.5), 92.

1.3 Income Tax Laws

By virtue of growth in international trade, serious conceptual issues are encountered with regard to taxes. Mere reliance on domestic laws is not sufficient but an ample legislation is required to facilitate incessant access to global market in return an unimpeded flow of FDI to the national market. In order to an improvement on income tax policy and practice of Pakistan, the IMF facilitated with technical assistance specifically for the protection of its domestic taxing system in line with international business. On 13 September, 2001, an Ordinance was enforced to regulate taxation of income in Pakistan which referred to as Income Tax Ordinance, 2001. Pursuant to said enactment, set of rules called Income Tax Rules, 2002, for an effective execution of the Ordinance's provisions, were also formulated. The Income Tax Laws articulate *modus operandi* to ascertain, categorically, jurisdiction, income and its jurimetrics, rates of taxation and built-in flexibilities regarding national and international transactions.

- i. **Jurisdiction**: The objective of every statute is to execute its provisions in certain geographical area. Under the Income Tax Laws residency Person, PE and international traffic business by non-resident persons are the main factors, which provide certain geographical area to ascertain tax jurisdiction.
- ii. **Income and its Jurimetrics**: The rules to determine sources of income hold fundamental status in taxation as well as mandatory for sphere of tax jurisdiction. Every income, which is derived from any source within, without or beyond the country is liable to tax e.g. residents' foreign sources income (i.e. short-term individual or returning expatriates), non-residents' Pakistani sources income, and geographical sources income are part and parcel of sources of income, which are subject to tax under the Income Tax Laws.
- iii. **Tax Rate**: The Income Tax Laws urged the rules for determination of residential status, source rules, basis and manner of income computation, exemptions and exclusions, etc. It prescribes the tax rates on the total income as well as on various components of income, such as, dividends, interest, royalties, know-how fee, and many more particularly arising to non-resident persons in Pakistan. In case of royalties borne by and technical service fee rendered through a PE in Pakistan maintained by the recipient non-resident

person, these rates become especially important for tax purposes. Persons holding the business of international traffic are bound to furnish returns having specified tax rate charged on their gross amount on the information furnished by them. In case of consideration received by discarding of any asset under a non-arm's length transactions the difference between the income arising on such transaction and that, which would have otherwise arisen if, the said transaction was on arm's length basis constitutes as the additional income of the recipient.

- iv. **Built-in Flexibilities:**⁶ Notwithstanding the afore-mentioned, privileges and immunities are granted to diplomats of foreign missions and UN employees and foreign governments are not taxed on their income in almost all tax jurisdictions including Pakistan. Such salaries and pensions are clearly excluded from the heads of income liable to tax under the Ordinance. By virtue of reciprocity, tax exemptions are granted to privileged Pakistani officials in foreign states. Individuals working in Pakistan under international treaties and under Aid Agreements with foreign government or public international organization or individuals providing expert services to the Government of Pakistan are also tax exempt. Foreign source salaries have also exemption in taxation, if the individuals have already paid their income tax in source foreign state and taxpayers permitted to claim tax credit of an amount equal or less to income tax paid.⁷
- v. **Miscellaneous:** The Income Tax Laws delegate powers to the Government of Pakistan to enter into DTAs. There are set of provisions, to protect the tax base from erosion.

1.4 Treaties –At a Glance

"Treaty is a legal binding agreement deliberately created by, and between, two or more subjects of international law who are recognized as having treaty making capacity. Generally a treaty is an instrument governed by international law and once

6. Chapter III, Part VII, Income Tax Ordinance 2001.

7. Section 102 of the Income Tax Ordinance 2001.

*it enters into force, the parties thereto have legally binding obligations in international law.*⁸

In common parlance, states prefer to be a party of bilateral tax agreements or tax treaties for the sake of certainty for the taxpayers as well as for the tax authorities on global transactions. The objective of tax treaties are the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income and capital. This helps in promotion of international trade and provides certainty in taxation, which further provides concrete mechanism in disputes resolution of taxation and eliminates the factors of tax discrimination. International aspect of tax treaties has two-fold:

- i. Double Tax Agreements: Generally, the tax treaties are result of tax conventions for the prevention of double taxation and fiscal evasion. DTAs are formal bilateral tax agreements having dual nature i.e. (a) a contract between two sovereign states for the purposes of allocating taxing rights; and (b) as an integral part of signatories' domestic tax laws in order to entail a unique piece of legislation. Under the DTAs operational taxes does not levied but override domestic income tax provisions. Basically, the DTAs provide firmness to FDI having patent income allocation rules and concrete methods of double tax relief on investment income. Moreover, monetary, fiscal, social and other important policies of signatories are main factors for concluding the DTAs.

At present, Pakistan has party to 57 DTAs having the UN-MC as an instrument for negotiations. The provisions of DTAs, drafted in line with the Ordinance, were effectively implemented for the double tax relief, determination of non-residents' Pakistan source income, allocation of income to Pakistan source and exchange of information. It shows that DTA provisions prevail over domestic tax provisions. Under the DTA provisions source state holds some taxing rights by curtailing unlimited taxing rights of resident country e.g. a foreign tax credit relief to alleviate potential double taxation by the Ordinance.⁹

⁸ Martin Dixon, *Text Book on International Law*, 4th Edition, (London: Blackstone Press Ltd., 2000), 51.

⁹ Section 103 ITO 2001 enunciates an ordinary foreign tax credit i.e. a tax credit is provided for the lesser of the foreign income tax paid or the Pakistan tax payable in respect of the income. Pakistan does not recognizes excess foreign tax credits.

ii. Trade Agreements: Pakistan reduced its tariffs by signing the FTAs. Philosophy behind inclination towards the FTAs by Pakistan is malfunctioning of WTO to crash the tariffs by the MFN clauses. Custom Duty revenue foregone by tariff reduction is easily discernable in relation to the current trade with the FTA signatories because these FTAs are concluded in near past and relevant figures is conveniently available.

1.5 Economic Globalization

At present, world is on the surge of great 'technological revolution' in contrast to the 'industrial revolution' in their terms of scope and effects. Several businesses cross border lines and variety of business activities can be effortlessly replaced at the discretion of the taxpayer. However, economic globalization is greater than before, which is a bond of economics and globalization. Hereby, 'Globalization' will be evaluated generally and 'Economic Globalization' specifically.

Globalization stands for free movement of ideas, people, goods and services, and convergence of culture worldwide. However, the convergence of culture is rapid in those regions, which are more exposed to the globalization. It is an increasing integration of economies globally, especially by means of trade and financial flows. Hereinbelow are the main flows which characterizes globalization:

- i. Goods: Flow of goods in terms of inward or outward are called imports and exports, respectively. Goods are pivot in shaping economy by holding significant proportion of revenue in the state's treasury, net exports play significant role to attain a high or low level economic equilibrium.
- ii. Services: Services are part of tertiary sector which supports the economic operations within and beyond the border. As economic activities increased, they demand and create more sophisticated services to cope with market trends. Development literature points out the stages of growth.¹⁰ The share of services increase as economies move away from lower to higher stage. Technological and economic development enhanced the market activities across border which resultantly increased the flow of services.

10. Rostow's Stages of Growth, *Todaro/Smith-Economic Development*, (Eighth Edition, Addison Wesley), 112.

- iii. Financial and Capital Flows: In response to expansion of financial market, enormous quantity of financial assets is invested globally on different projects. Resultantly, it provides option to investors for investment beyond the country of residence subject to profit ratio. It is true that these improvements in economic system invent new horizon of business activities but existing legal regime finds no compatibility with this expansion. Capital flow depends on the financial, physical and human capital, and finally elevated globalization, as FDI in elevating the infrastructure of economies. According to economic development literature capital is diminishing marginal return to scale that boosted flow from DCs to LDCs.¹¹
- iv. Technology: IT becomes an important mode of communication among the masses. Cyber helps the masses to access the inventions and innovations taking place around the globe, this rapidly improves the consumers' taste as well as emergence of e-commerce.
- v. Globalization: It is most commonly being discussed in development, trade and international political economy. It is a process by means of which economies of the nations become increasingly integrated that leads to a global economy and economic policy-making e.g. WTO. In strict economic sense, globalization is the increased openness of economies to international trade, financial flow and FDI.

1.5.1 Effects of Economic Globalization: It has a great impact on daily lives of human beings and the significant effects are as under:

- i. Product Market: Presently, international market emerged through national market expansion and simply, it becomes the place where variety of international brands are in the reach of consumers e.g. BMW, Levis etc.
- ii. Culture: Globalization has narrowed down the cultural diversity that persists in the world before it. Therefore, people holding different nationalities and cultures embrace modernism e.g. inclination towards western couture and food connoisseurs prefer to take Chinese, or Italian meals instead of folk.

11. R.M. Solow, (1956), "A Contribution to the Theory of Economic Growth", *Quarterly Journal of Economics* (1970): 65 -94.

- iii. Legislation: Pursuant to international market, international legal regimes have also been formulated that maintained juristic equilibrium among the persons e.g. ICJ and Interpol etc.
- iv. Language: Presently, English becomes the *lingua franca* which erased all communication constraints between international firms and people.
- v. Information: IT sector has a very short history; it pampered masses with consciousness about instant changes that occurred throughout the world e.g. recent caricatures controversy flashed out the economies of Nordic Countries.
- vi. Finance: Financial expansions probably initiated to finance mega projects around the globe and made lending and borrowing feasible.
- vii. Politics: Political stability is *raison d'être* for country's economy and needs comprehensive measures to formulate the effective long term economic policies, this will work as a magnet for FDI.

Globalization revolution brought institutional changes in the same manner as occurred in the case of language, culture and taste etc. Economic globalization obliterates trade barriers and made smooth flow of economic goods and services. In contrast, mercantilist philosophy enunciates a restricted kind of openness of globalization, which is due to limited facilities and technologies. Borders became translucent, economic needs and opportunities enhanced the interaction of people and business entities. Moreover, off the peg laws find no compatibility with this economic bond. Prior to the free trade regime, it is necessary to examine the business activities, whereby, there were limited quantity of exports and imports under the prescribed rules and no need to determine the source of income and tax reforms in law. Once restrictions were abolished on free movement of businesses and freedom to outsource or establish their businesses across border lines, tax reforms became imminent.

Prior to globalization, domestic legal regime had a great impact on the trade, which vary from country to country. By virtue of free trade in terms of globalization, the myriad tax reforms must be compatible with the laws of sovereign states. The impact of economic globalization on institutions is that it has converged institutions with each other besides their old laws for taxation. It has now crystal clear that social and economic change process is not a process of discrete series but a process of

continuous series, which is difficult to separate one step from other or unable to distinguish one time from other. Therefore, these changes tends to occur for reforms but still needs a lot of review with respect to making it more beneficial, compatible and just.

Last but not the least, there is a need to consider the concern of different groups. Globalization process is initiated and motivated for the economic interest of private sector. As far as tax collection is concerned, it is the interest of governments to generate revenue for public utilities as well as protection of its own interests. Row arises here. Beside this row, the need to stream line taxing system both in the favour private and public interest becomes imperative. Myriad taxing laws tried to obliterate the primary disparities from the taxing system. In order to obtain required objectives, the concepts of 'residence', 'geographical source rules' and 'accounting rules for profit determination' were developed and inculcated in Model Conventions. In changing economic scenarios modifications in above said concepts are natural. Resultantly, these modifications paved to flaws¹² relating to scope and definitional aspects of above said concepts but rules are not align with the dire needs of economic globalization. Whereas, first both concepts are subject to factual and circumstantial elements which facilitates the multinational taxpayers in determination of their respective residential and/or source of income in specific tax jurisdiction. But last concept, rules for accurate allocation of income to multi-tax jurisdictions, the ALP mechanism strengthens the international tax rules, which is an outcome of profit allocation mechanism. However, it places ample encumbrances on the tax authorities and its subjects.

12. Vito Tanzi, *Globalization, Technological Developments, and the Work of Fiscal Termites*, (Brooklyn Journal of International Law 2001, vol. XXVI, No. 4), 1261-1284.

Chapter 2

Residency of Person

Adam Smith propounded that "*the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities.*"¹³ Subjects are pivot in shaping state's geometry. However, status of the subjects is ascertained by the concept of residency, which is defined as the act or fact of living in a given place for some time.¹⁴ By virtue of diversity jurisdictions, conflict of laws bifurcated domicile and residential status of a person, whereby both are used interchangeably but are not synonyms of each other.

Except for the US and Philippines, which also imbibe the citizenship as the basis of taxation of income, all other countries follow 'Residence' as the primary basis of income tax. The Ordinance imposes tax liabilities on resident persons for their income accrued from global operations and on non-resident persons for income accruing in Pakistan. Generally, the expression 'Person' includes an individual and a company, firm and AoP, which are incorporated, formed, or established under the state laws. It may further include nationals, foreign governments as well as their political subdivisions, and public international organizations.¹⁵

The apex courts of Pakistan have laid down the dictum by interpreting different definitions of 'Person', which are provided by Article 260 of the Constitution of Islamic Republic of Pakistan, 1973¹⁶ and Section 3(39) of the General Clauses Act, 1897.¹⁷ It also includes the expressions, such as, an artificial person, natural person, juristic person and legal person (i.e. a private limited company or any other corporation or body having the status of legal entity).

In contrast, Model Conventions purport the rules for allocation of taxing rights to the states (i.e. residence and / or source) which becomes operative on maintainability of

13. Adam Smith, *The Wealth of Nations* (New York: Random House, 1965), Book V, Chapter II, Pt II, v. ii, 825, Para. 3.

14. Bryan A. Garner, *Black's Law Dictionary*, 8th ed., (Thomas West Publishers, USA 2004) 1335.

15. Section 80 read with section 81 of the Income Tax Ordinance, 2001.

16. PLD 1981 FSC 23.

17. 1999 PTD 4126.

persons' residency. The term 'Resident of a Contracting State or the other Contracting State' elaborates that any person¹⁸ by virtue of domicile, residence, place of incorporation and management, or any other criterion of a similar nature is tax subject under his respective national laws.¹⁹ In addition, residential status is a decisive factor in dispute resolution which occurs in consequences of dual residency and taxation in both the countries (i.e. residence and source). In such events, States claim persons' residency under their respective national laws having base on personal affiliations with the concerned State.

2.1 Individual

The expression 'person' includes the natural person as well as juristic / juridical person which refer only to an individual.²⁰ Despite of physical and mental status, any 'natural person' or a 'human being'²¹ is an individual. Under Pakistani taxing regime, stay duration and computing mechanism of days are the key elements to impose tax. By virtue of stay comprising 183 (in aggregate) or more days in a tax year, individual's income is liable to tax. The stay duration depends on presence for a whole day or part thereof during the tax year. Hereinbelow are the days that would compute as whole days of individual's presence in Pakistan, whether he is present wholly or partly on such days:²²

- i. both the days of arrival and departure from Pakistan;
- ii. a public holiday;
- iii. a day of leave, including sick leave; and

18. Sub-Para a, Para 1, Article 3 of UN-Model Convention.

19. Article 4(1) of Model Conventions *"for the purposes of this convention, the term "resident of a Contracting State" means any person who, under the law of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature."*

20. Supra Note 17.

21.32, ITR 198, 208.

22. Section 82 of the Income Tax Ordinance, 2001 read with rule 14 of the Income Tax Rules, 2002.

iv. a day when ordinary course of individuals' activity is infringed by any abnormality occurred in Pakistan e.g. strikes, lock-out or sit-ins etc. or a holiday spent for the duration of or *ante-dated* to such activity.

Example:

On June 1, 2010, Mr. John, for the first time, visited Pakistan on company's special task and left Pakistan on September 30, 2010.

Issue: How the residential status of Mr. John will be determined for tax purposes during the tax year, which was ended on June 30, 2011, in Pakistan?

As per section 82 of the Ordinance read with Rule 14 of the Rules, the days of stay during the tax year from June 2010 to June 2011 are computed in the manner hereinbelow:

Description Srl. No.	Month	Days
01	July 2010	31
02	August 2010	31
03	September 2010	30
04	Total	92

However, the total stay period of Mr. John in Pakistan is computed 92 days, which are less than the ceiling line i.e. 183 days in tax year 2011. In these circumstances, Mr. John will deem to be a non-resident person for tax purposes and not liable to pay tax.

Notwithstanding the above-mentioned rule, the duration of transit between two different places outside Pakistan does not deem to as part thereof. In event, when the number of individuals exceeds from one e.g. partnership, then each individual will be treated as separate taxpayer in the same manner and procedure as mentioned in the Ordinance but evaluation in line with element of non-discrimination.²³

23. Section 82 read with Section 86 of the Income Tax Ordinance, 2001.

By virtue of domicile, residence, place of management and incorporation criterion individual is an important subject of taxing regime. Article 4 (1) of the UN-MC entails various modes of individual's personal attachments with a particular state where he has full tax liability under that state's tax laws against his world income. On these grounds, an individual is a resident of a contracting state with regards to full tax liability on the basis of any one of the criteria embodied in former part of said article. The later part of the same paragraph excludes an individual from being a resident of contracting state because of not being domiciled in that state and subject to limited taxation on income accrued from that state's sources or to capital situated therein e.g. foreign diplomats etc.²⁴

2.2 Doctrine of Tie-Breaking

The jurisdictional frictions paved by the dual residential claims of the States are not a big deal. In order to resolve aforesaid controversies, Doctrine of Tie-Breaking is incarnated in the model treaties for the sake of defining and determining residential status of a person in one or the other state.²⁵ The 'Tie-Breaking' Rules assayed various criteria, which are elucidated hereinbelow:

2.2.1 Permanent Home: It is the place, which is owned or possessed by an individual on permanent basis and continuously dwells *therein*²⁶ and pivot in determining the residential status of any individual. Under the paragraph 2 (a), article 4 of the Model Conventions, the contracting state holds privilege in which the individual's permanent home is situated. The row on dual permanent home in states or in neither of the state concludes in favor of the state where the personal and economic relations of the person are closer. When a person has permanent home in one state and he intends to set-up second home in the other state while retaining the first then his 'center of vital economic interest' shall be considered and resultantly that lies in the

24. Paragraph 8 of the OECD Commentary on Article 4.

25. Paragraph-2, Article 4 of the UN-Model Convention.

26. Paragraph 12 of the OECD Commentary on Article 4.

favor of the first state.²⁷ The dictum laid by different courts on the said issue is provided as under:

- i. The taxpayer was a Canadian University professor. During his one-year sabbatical leave he went to England wherein, he filed his income tax returns on the basis that he was not a resident in Canada. Both countries were treaty partners.

Therefore, the applicant was assessed an ordinary resident in Canada on the score that during his absence Applicant/Taxpayer had rented-out his house in Canada.

The Tax Review Board held that: "It is clear that the Applicant has a permanent home available to him in Canada upon his return from his leave and vacation in the UK."²⁸

The social and economic factors hold distinction among other ancillary factors of the 'center of vital economic interest' e.g. individual's family and social relations, occupations, cultural, or place of business. By virtue of personal acts of an individual, social factor prevails over the economic factor because later depends on the former.

- ii. Several Dutch cases provide supportive evidence to above claim, where an individual works in State A and resides in the State B:

- a. Brief Facts:²⁹ The taxpayer works in Germany but his family is residing in the Netherlands, which is composed of his spouse and kids. A cause of action accrued between the states upon exercising their tax jurisdiction and determination of 'center of vital interest'.

Issue: Whether taxing right vested in the Netherlands or Germany?

While culminating, the Court observed that the Applicant / Taxpayer had strong family bond in the Netherlands and it is evident that 'center of vital

27. Paragraph 15 of the OECD Commentary 1992 on paragraph 2(a) of Article 4.

28. William H Magee vs. MNR (80 DTC 1403).

29. BNB 1964/287, Amsterdam, 5th March, 1964.

interests' of the taxpayer is attached to the same place, however, Applicant / Taxpayer is subject to the Netherlands tax jurisdiction.

b. Brief Facts:³⁰ Taxpayer works in Germany as a manager of German subsidiary of a Dutch company. The taxpayer has strong family bond in the Netherlands and he is an employee of Dutch parent company in the course of his professional work.

On culmination, the Court inclined towards the Netherlands because the family of Applicant is resides therein which deems to be a 'center of vital interest'.

2.2.2 Habitual Abode: Habitual abode is second in preferential list, which is applicable in two situations. Firstly, where the permanent home of an individual is available in both contracting states and it is difficult to determine his place of vital economic interests. Secondly, the individual's permanent home is not available in any contracting state. In both cases, the country where the tax-subject holds a 'habitual abode' has privileged right to become the country of residence of that individual. The cumulative stay of an individual will considered while exercising tax jurisdiction that covers a sufficient length of time to treat him as resident.

The Courts and commentaries on Model Conventions do not interpret the term 'habitual abode' in sufficient manner. Some Indian Courts interpret the expression 'habitual abode' in their respective judgments as under:

- i. "Habitually" means, "repeatedly or persistently" i.e. frequent commission of acts or omission of the same kind. The idea of habit involves an element of persistence and tendency to repeat the acts of same class or kind."³¹
- ii. "Mere temporary residence or residence by compulsion at place, however long, cannot be equated to or treated as a place of an ordinary residence."³²

30. BNB 1967/675, Amsterdam, 14th September, 1967.

31. Vijay Narian Singh vs. State of Bihar, (AIR 1984 SC. 1334).

32. Bhagya lakshmi vs. K. Narayana Rao, (AIR 1983 Mad. 9)

Under the Model Conventions, habitual abode is invoked to emphasize on the time span spent in both signatory states. It is pertinent to refer here that this approach is simple, convenient and broader rather than the complex approach of domicile.

2.2.3 Nationality: Nationality test applies in the third stage of the doctrine. National means and includes:

*"all the individuals, possessing the nationality of the contracting states and all the legal persons, partnerships and associations deriving their status as such from the lack of face in a contracting state."*³³

Despite of the situations enunciated in habitual abode test, the individual possess a habitual abode in both signatories or does not possess in neither of them, this leads to row between the signatories. In such event, preference would be given to the country, whose nationality he hold and fall under the ambit of tax jurisdiction of the state.

2.2.4 Mutual Agreements: Under Article 25 of the UN-MC, it is mandatory for the competent authorities of the signatories to settle the question of residential status through mutual agreement procedure. It is the last resort to determine the fate of an individual enjoying dual nationality when all of the above tests become futile to decide the tax jurisdiction. In response to feeble application of afore mentioned rules, the competent authorities of signatories utilize this provision to meet the ends of natural justice and resolve the matter through mutual agreement amicably. Following are the cases in which mutual consultation can be invoked:

- i. Application of the teachers' exemption;
- ii. Existence of PE as well as profit attributable to such PE;
- iii. Interpretation of provision in a treaty providing matching relief for tax spared;
- iv. Residency of taxpayer for treaty purposes;
- v. Source of an item of income;
- vi. TP issues;
- vii. Whether payments described as being made for services or the rent of the

33. Article 24 (2) of the UN- Model Convention.

equipment were correctly so described or these were payments for the use of an intangible right such as royalties;

viii. Whether the air transport and shipping profits article applies to leased ships or air-craft; and

ix. Whether the non-discrimination article applied.

2.3 Company

In jurisprudential context a company means;

*"a 'legal person' or 'legal entity' separate from, and capable of surviving beyond the lives of its members."*³⁴

Any body incorporated under the Companies Ordinance, 1984 or any existing company in Pakistan referred to as the Company.³⁵ A company also is an AoP having common object(s) for the purposes of business and profitable gain. Moreover, any entity including *modaraba*,³⁶ *a trust, co-operative and financial societies* which established as a company under Pakistani law leads to a resident company of Pakistan.

By virtue of incorporation and central control and management vested in Pakistan, company falls under the ambit of Pakistani tax authorities.³⁷ The registration criterion provided by law seems an inadequate solution while determining the residential status of a company. Consequently, Income Tax Laws inculcates the concept of 'place of central control and management' for company. In addition, all the companies incorporated under foreign state laws or foreign associations, which are declared by the FBR as company,³⁸ are also resident companies of Pakistan. In accordance with the said provision, these aforesaid foreign companies fall under the ambit of Pakistani

34. "Salomon vs. Salomon and Co. (1897) AC", quoted in Avtar Singh, *Company Law*, (Lucknow: Eastern Book Company, 1999), 1.

35. Sub-section 7, Section 2 of the Companies Ordinance, 1984.

36. Sub section a & b (definition of Modaraba) read with sub section c (definition of Modaraba company) of Section 2 of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980.

37. Section 83 of the Income Tax Ordinance, 2001.

38. Section 2(16) of the Income Tax Ordinance, 1979.

tax jurisdiction if they hold their 'central place of control and management'³⁹ in Pakistan for the purposes of routine affairs during the tax year.⁴⁰

The 'central place of control and management' is the place where the directors settle down important matters of the company. It is their prerogative right to hold and control prime affairs of company. The magnitude of 'central control and management' is based on certain factors⁴¹, which are elucidated hereinbelow:

Major Factors:

- i. Place of domicile that are possessed by the company's directors;
- ii. Place where BoD held its meetings; and
- iii. Place where general policy of the company formulates.

Minor Factors:

- i. Place where the dividends are declared by the company;
- ii. Place where the general meetings of the company are held;
- iii. Place of operation of fiscal account; and
- iv. Place where the company's books and corporate seal is kept.

In contrast, the shareholders are odd-man out from routine affairs of company. But their residential status paved impediments in exercising management and control of the company because they supplant the management responsibilities of the directors.⁴²

On contrary to internal organizational attitude and substance as a natural person holds, law purports 'Person' as a 'Corporation'. Consequently, these simple accidental relationships are an outcome of the activities performed in the name of the corporation having no essence except what the law permits to do. As a result, of an agreement between two companies, explicit relationship established among various stakeholders of each company because the stakeholders are the actual owners of assets

39. De Beers Consolidated Mines Ltd. vs. Hawe, (1906), STC-198 (HL).

40. Section 80 (2 - b) read with Section 83(*A Resident Company*) of the Income Tax Ordinance 2001.

41. Koitaki Para Rubber Estates vs. Federal Commissioner of Taxation, (1940) 64 CIR. 15.

42. Malayan Shipping Company vs. Federal Commissioner of Taxation, (1946) 71 CIR. 156.

which a company possesses on its name. The taxing of a company is based on its residential status.

In order to determine the residential status of company, certain impediments are natural because the company does not possess any residence like an individual. The seminal UK case, which is commonly known as *De Beers*,⁴³ provided the rules for determination of residential status of a company. The court held that residential status of a company could be determined on an analogy relating to an individual. In fact, "a company cannot eat or sleep, but it can 'keep house' and do business" and its place of residence is the place where "the central management and control actually abides."⁴⁴

2.4 Association of Persons

By virtue of an association having common interest, when two or more persons join hands to produce income, profit or gains as an objective is called 'Association of Persons'. Similarly, on contrary to partnership, when co-adventurers are bonded together having common interest also leads to an AoP and will be accessible as an 'AoP'.⁴⁵ It does not seem rational that to restrict the AoP in technical sense but it should be construed in its plain ordinary meaning in order to combine persons for the promotion of joint venture. However, this line of reasoning is elaborated by the dictum laid by the Court, which is to be shown as under:

Brief Facts:⁴⁶ George and 11 others jointly purchased the lottery tickets. On draw fortunately one of them won the second prize. In fact, the cause of action accrued on the event of assessment for tax purposes.

Issue: Whether the persons should be treated as body of individuals or co-owners individually?

43. Please refer to *supra* note no. 39.

44. *Ibid.*

45. Re Elias 3 ITR 408; G Murugesan and Bros. vs. CIT, 1973, 88 ITR 432 (SC).

46. 2001 PTD 3800 [CIT vs. George and 11 others, 241 ITR 636-Madras High Court (India)- 1996 (Reference No. 90 of 1996)].

Whereby, the Tax Officer held that the persons should be assessed in the status of body of individuals and the Tribunal held that they were liable to be assessed as co-owners individually.

However, on reference, the Hon'ble High Court observed that the prize money was assessable in the status of AoP in accordance with the provisions of sub-section 24, section 2 of the Income Tax Act, 1961. Section provides two conditions for assessing the income under the status of AoP, which are as follows:

- i. joint venture should be present; and
- ii. The objective of the joint venture would to earn income.

Hence, both the elements had been satisfied in this case and the persons are assessed as AoP.

In contrast, the co-sharer of an estate,⁴⁷ widows succeeding to the estate of deceased,⁴⁸ shareholders jointly receiving dividends from shares⁴⁹ does not constitute an AoP, as they does not form a unit for the promotion of any joint venture to earn income, profits or gains.

In accordance with the definition purported under the Ordinance, the AoP includes *a firm, a combined Hindu family, any artificial person and body of persons formed under foreign law* having control and management of the affairs in Pakistan at any time in the year.⁵⁰ On the other hand, Article 4 (3) of the UN-MC deals with the companies and AoP, and ignored their legality as a person. Both are subject to taxation as a resident company in more than one state because of having different criterion based on residence e.g. registration, management and control or place of effective management by each state. Herein, management and control means *defecto* control and management and not merely the rights or power to control and manage.⁵¹

47. CIT v. Raja Rattan Gopal, 1966, 59 ITR 728 (SC).

48. CIT v. Indria Bal Krishna, 1960 39 ITR 546 SC

49. G Murugeson and Bros. vs. CIT, 1973, 88 ITR 432 (SC).

50. Definition - Association of Persons as provided by Section 80 (2 – a) read with Section 84 of ITO, 2001.

51. Bhimji R. Nait vs. Commissioner of Income Tax (1946) 14 ITR 334, Bombay.

BoD deems to be corporation's 'head and brain', and local control exercised by the directors of the company that tends to form a resident company. As far as partnership is concerned, none of the above factors play decisive role in determining the residential status of the partnership except the place of registration of the partnership.⁵²

The 'place of effective management' is the place, where the company's top brass perform operational activities, which is similar to the concept of 'central control and management'. Numerous tax conventions accord the taxing right to the different signatories based on location of the 'place of management' of the entrepreneur, some to its "place of effective management" and some to the "fiscal domicile of the operator".⁵³ The relevant Para of the OECD Commentary providing an interpretation of the 'effective place of management' is being reproduced hereinbelow:

*"The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons, (for example a board of directors), makes its decision. It could also be the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management."*⁵⁴

52. Swedish Central Railway Co. Ltd. Vs. The Thompson 1925 AC 495.

53. OECD, *Model Tax Convention on Income and on Capital (condensed version)*, (Paris: OECD Publications, 2005), 82.

54. *Ibid.*

Chapter 3

Income - an Economic Perspective

Alfred E. Neuman rhetorically stated that "*Today, it takes more brains and effort to make out the income tax form than it does to make the income.*" Prior to all, 'income' is an economic idea and technically defined as "the total amount of consumption increased by the net changes in savings." In other words, it is a sum of marginal propensity to consume plus marginal propensity to save. However, these definitions purport two components of income i.e. 'consumption and savings', wherein former exist even in the absence of an income. Moreover, an income and geographical location shares a concrete relationship having based on economic factors to which we refer the 'market'.

3.1. Jurimetrics of Income

It is gospel truth that taxation management and income shares a strong bond, which is developed by the source principle. In order to enhance efficiency of organizational ease, the positive moves should be in pipeline. Every source state has prerogative to levy tax but their domestic legislation governing avoidance of double taxation should be impartial and acceptable by the other states. In accordance with the taxation laws, jurimetrics of income are hereinbelow:

- i. Salary;
- ii. Income from Property;
- iii. Income from Business;
- iv. Capital Gains; and
- v. Income from Other Sources.

The taxation regime, in line with the above concepts, *inter alia* provides three geographical source rules of income as an initial point for taxation.⁵⁵

3.1.1. Wage Income: An amount, which is received or paid; against the performance of a specific activity (i.e. services) in a specific spectrum (i.e.

⁵⁵. Section 11 read with section 101 of the Income Tax Ordinance, 2001.

employment) by the employer to the employee is called wage income i.e. salary. It includes remunerations of whatsoever type, allowances, reimbursement amount, and payment as pension(s) or annuity in whatsoever manner.⁵⁶

3.1.2. Business Income: An income, which is accrued from the business activities of business concerns, is called Business Income. In Pakistani perspective, income accrued from based activities, as a source state, is chargeable to tax subject to the provisions of residential status i.e. resident and non-resident person(s). Thus includes, the profit(s) (inclusive of debts) or gain(s) in persons' income, which is accrued from business activities, like for instance, trade and services (i.e. technical, professional, leasing and financing). Further includes, the valuation of benefits at market standards, (accrued from business ties), an amount (paid, payable or received) by financial institutions; under the property's lease agreement, distributions made under mutual fund or a Private Equity.⁵⁷

3.1.3. Property Income: By virtue of capability of ownership, every 'Thing' constitutes a property. Conceptually, property holds three components i.e. the 'Property Holder'- having an absolute legal title, the 'Beneficiary'- having right to get benefits, and the 'Ownership'- itself.⁵⁸ Moreover, property has further bifurcations i.e. tangible and intangible, which are elucidated below:

- i. **Tangible Property:** Every corporeal source of income, which is accrued in Pakistan, is subject to tax. Thus includes, the chattels (goods) - a moveable thing and land - an immovable thing. The income accrued therefrom is in form of rent and gains through alienation of property. Rental Income is subject to tax, when received by a person as rent of Pakistan's source property. It also includes exploring rights of natural resources.⁵⁹ Income crop up by the gains from sale, alienation, or dispose-off of capital asset (i.e. immovable property) is called capital gains. These assets specifically utilized for the purposes of

56. Section 12 sub-section 2 of the Income Tax Ordinance, 2001.

57. Section 18 of the Income Tax Ordinance, 2001.

58. There are three rudimentary elements of ownership missing of any of them does not conclude ownership i.e. utendi means Right to use, Fruendi means Right to get benefit and Abutendi means Right to dispose off.

59. Section 15 of the Income Tax Ordinance, 2001.

business in Pakistan and such gains are chargeable to tax as under the head
"Capital Gains."⁶⁰

ii. Intangible Property: Every property having incorporeal nature is subject to tax⁶¹ against the income accrued from Pakistan based source. Dividends are an ordinary form of income, which is paid to the shareholders by the companies. In Pakistani perspective, on reimbursement of dividends by the resident companies to the shareholders leads to Pakistan's source of income taxation. In case of reimbursement of 'Royalties and Technical Service Fee' by the resident person are also sources of income, but it excludes the payments relating to any right, property, information used or services consumed for business purposes outside Pakistan and borne by a PE of non-resident in Pakistan.

Market in digital age is more liberalized and cyber governs as well as performs economic activities. E-commerce diminished producers' procurement cost and distributors' easy access to market in more effectual manner than past. Currently, freight and shipping service providers developed IT based service system to made accuracy in their deliveries. All the financial institutions provide e-banking system instead of establishing a brick and mortar branch network. Despite of being income generating sources, it is troublesome to determine geographical source of income in technological sector.

3.2. Premise of Permanent Establishment

Among volley of questions, it is an important question that can a host country charge taxes from foreign entrepreneur under international taxing regime or not; and if yes, than under what circumstances. In response to such queries, the PE concept was developed to cater the income arising from cross border business activities. Prior to all, the PE concept was introduced by German domestic law and later on they adopted

60. Section 37 of the Income Tax Ordinance, 2001.

61. Section 39 of the Income Tax Ordinance, 2001.

it in their bilateral international tax treaties.⁶² However, the court interpreted the term PE in the following words:

*"the existence of a substantial element of an enduring of permanent nature of foreign enterprise in another country which can be attributed to a fixed place of business in the country. It should be of such a manner that it would amount to virtual projection of the foreign enterprise of one country into the soil of another country."*⁶³

Under section 2 (41) of the Ordinance and Article 5 of Model Conventions purports the subject matter of PE having aim to eliminate double taxation. These provisions emphasize on the permanence and firmness relating to the execution of business activities which enables the states (i.e. source and residence) to negotiate *thereupon*.

3.2.1. Types of PE: Both the provisions purports three types of PE, which are to be shown, as under:

- i. Assets Type;
- ii. Activity Type; and
- iii. Agency Type.

3.2.2. Basic Rule PE: In line with the above types, *inter alia*, includes three rules which determine the operational activities of the foreign entrepreneurs, whereby all the DTAs are concluded in the light of these rules and to be shown in following order:

- i. Any business activities performed at 'fix place' is called 'Basic-rule PE'. This requires several requirements for its establishment however; missing any one of its pre-requisite does not form PE.
- ii. Any constructional or installation activity based at a building site for a (un)determined period is called 'Construction-PE'. It excludes the projects of shorter duration and applies in the absence of basic-rule PE.
- iii. Any authorized agent, for or on behalf of an entrepreneur, conclude contract leads to PE of said entrepreneur. This rule comes in field when both the above stated rules are unavailable or irrelevant.

62. A.A. Skaar, *Permanent Establishment - Erosion of a Tax Treaty Principle*, (Oslo 1991), 72.

63. Commissioner of Income Tax vs. Visakhapatnam Port Trust (1983) 144 ITR 140 (AP).

3.3. Asset Type PE

Under article 5 (1) and section 2 (41) of Model Conventions and the Ordinance, respectively, the general definition of PE is provided i.e.:

"a fixed place of business through which the business of an enterprise is wholly or partly carried on."

Whereas, '*a fixed place*' of business is pivot in constituting the PE and simultaneously, contains numerous stipulations which act as a litmus test, *inter alia*, includes:

- i. Place of Business Test;
- ii. Location / Geographical Test;
- iii. Right of Use Test;
- iv. Permanence Test; and
- v. Business Activity Test.

3.3.1. Place of Business Test: The phrase '*place of business*' is not dilated by both the regimes. In order to constitute the '*place of business*', all the physical objects must be compatible while performing business activities,⁶⁴ e.g. *premises*,⁶⁵ *facilities* or *installations*.

- i. *Prima Facie* of the PE: Under both the regimes, there are certain establishments, which are deemed as *a priori* in forming PE. Thus, the positive list 'includes'⁶⁶ *a place of business, a brand, an office, a factory, a workshop, and a mine, gas or oil well, a quarry or any other place of extraction of natural resources*.⁶⁷ Mere ownership of a substantial physical object, which is used particularly for business activity but not as a '*place of business*' e.g. real estate, plants, machinery and equipment, ships, aircraft, drilling rigs and

64. Paragraph 4 relating to Art. 5 of the OECD Commentary-1992.

65. The term 'premises' means a real property, a place where goods are sold, or services are rendered including an office, a warehouse, a godown, a work place, a factory or a commercial establishment.

66. Words used in Model Conventions "includes especially"...

67. Article 5(2) and section 2(41-a and b) of Model Conventions and Income Tax Ordinance, 2001, respectively.

computers etc., does not lead to PE. However, a vending machine, a telephone exchange, automatic filling stations, equipment for receiving and/or transmitting radio signals and other non-staffed facilities, may lead to PE on fulfilling certain conditions.

On contrary to the '*positive list*', moveable assets (i.e. machinery and equipments), which can be a '*place of business*' are excluded. The judicial and administrative dictums are antagonized on constitution of '*place of business*' by light portable equipment.⁶⁸ In contrast, some of the states give weightage to moveable assets as a place of business e.g. drilling rigs, ships and aircrafts etc. However, installation of heavy machinery is compulsory to form a PE, when used as substantial equipment in routine operational activities by the contractors.

- ii. **A Place of Extraction of Natural Resources:** The element of static nature is indispensable in the process of extraction of natural resources from offshore and onshore.⁶⁹ As far as '*place of extraction of natural resources*' (i.e. a mines, oil or gas well, quarries etc.) is concerned, it is also inculcated in the '*positive list*' leading to PE.
- iii. **Intangible Assets:** Person holds intangible assets in shape of bank accounts, securities, software and patents etc. These assets have a great impact on business activities in source states but do not serve as '*a places of business*'. But computer and/or software are the '*place of businesses*' when used in business operations as a factory or a patent(s) (not for leasing purposes) by an entrepreneur.

3.3.2. Location / Geographical Test: The geographical test is based on spatial and temporal permanence. It helps in determining a '*fixed*' place of business as well as shares a linkage between '*place of business*' and a '*specific geographical point*' e.g. petroleum oriented business.

68. Danish Administrative Tax Tribunal's Decision (1987); Norwegian Supreme Court in Alaska, Rt. 1984, 99.

69. Klaus Vogel, "Double Tax Treaties" Article 5, Para 53, (Deventer/Boston, 1991).

- i. **Base Theory:** Under this theory, a particular base (i.e. place) is required for performing core business activities in the source state. Notwithstanding a specific place, the activities performed as well as justifiable by its nature e.g. construction of roads and laying of pipelines etc. and re-location of business activities e.g. circuses, carnivals, music, tours, etc. but in line with timeframe are the subject matter of Base Theory.
- ii. **Attraction Theory:** A core business activity performed outside the '*place of business*' of the same tax jurisdiction but not being used for preparatory or auxiliary business activities also refer to a '*place of business*'. However, certain business activities e.g. rigs (preventive maintenance and quality control), leads to PE, which is based on sufficient grounds i.e. an ordinary activity that performed in an office or same facility on the rig.
- iii. **Peripatetic Place of Business:** It is true that no comparison exists between the '*peripatetic*' and a '*fixed*' place of business e.g. pedestrian or street vendors. However, the '*spatial delimitation approach*' is an admissible factor with respect to the offshore business activities by tax authorities. Notwithstanding presence in a particular area for certain length of time, hereby an operational pitch for a moveable '*place of business*' leads to a PE.⁷⁰ The rigs and street vendors or outdoor market or a fair⁷¹ are those business activities which on a regular basis erect booths and move from one place to another, even than they leads to a PE.
- iv. **International Transportation:** Articulated vehicles and buses also hold a '*place of business*' as well as leads to PE-taxation. Notwithstanding the mere delivery of goods at a terminal, an office to recruit and supervise the employees, to dispatch information to the drivers and ticket selling by transporters are the sufficient grounds to constitute a PE.⁷² The basic rule-PE

70. Edwards Ker Michael, *The International Tax Treaty Service* (Dublin, 1990), (However, Canada, Denmark, France, Japan, Norway and USA accepted this position).

71. Paragraph 4.5 relating to Art. 5 of the OECD Commentary 1992.

72. Paragraph 5 relating to Art. 5 of the OECD Commentary 1992.

excludes the business activities of international shipping and aviation unless
and until them itself has a fixed location.

3.3.3. Right of Use Test: Under both regimes, legal stipulation for the '*right of use test*' i.e. ownership, lease etc. are provided. Prior to constituting a PE, entrepreneurs must have an easy access i.e. '*right to use*' to the place of business. Mere usage of a '*place of business*' does not validate to constitute a PE but it must qualify as the status of enterprises' '*place of business*'.

- i. **Profit Sharing Agreements:** Under the profit sharing ties, it is not compulsory for a non-resident person to participate actively in business operations. In fact, different modes of profit sharing demands a special attention e.g. partnerships (i.e. general, limited and silent), joint ventures, trusts etc. In partnerships, assessment of one partner regarding '*right of use*' relating to '*fixed place of business*' is sufficient to meet the same requirements of remaining partners situated in other state. Generally, joint ventures have an exception to the extent that a foreign venture performs its business activity in the source state, in order to have a PE. Although the net profits of the joint ventures are shared between the partners accordingly.⁷³ While trust's beneficiaries and members of a co-operative, not to involve in the business, wherein the capital is invested for being a PE.
- ii. **Arm's Length Relations:** In order to operate business at arm's length, the physical presence is required in the source state. Mere business activities performed by an independent entrepreneur from other state can not lead to PE. Hereinbelow are some examples in support of above said claim:
 - a. Place of clients' facility used by an enterprise as a '*fixed place of business*' which needs physical presence for an assignment in the source state.
 - b. Business assets i.e. tangibles (plant, machines and equipment etc.) and intangibles, which are leased-out from a '*fixed place of business*' in the source state and also holds the '*right of use*' therein.

73. European Tax Vol. 12, 72 (1972); Dutch Court Decision No. 161/72 MS.

- c. Generally, owners have no '*right of use*' on bare-boat charter so there will be no PE. Notwithstanding, time charter leaves a substantial influence on the use of the leased equipment and a PE is constituted.⁷⁴
- d. The '*right of use test*' could not be satisfied by the facilities regarding *advisors, customers abroad, dwelling and home offices*. Notwithstanding, hotel room oriented business activities under a specific contract with the hotel are deemed to as an activity, which is performed '*through*' a '*fixed place of business*'.

3.3.4. Permanence Test: In order to constitute PE, the '*place of business*' should be '*fixed*' having a particular situs. In lexical meaning, the '*permanent*' connotes permanency and regularity or something more than casual or occasional. The Canadian Court laid down a dictum that Belgian resident holds a PE in Canada irrespective of the short duration of the project.⁷⁵ The courts of Pakistan and India held that where a person has not intended to go out of business but during the period of interruption passes out the business or its assets, the income is assessable as business income.⁷⁶

In accordance with the provisions of the OECD-MC, the permanence is an '*ad infinitum continuing*' instead of '*perpetual*'. However, the expressions '*permanence*' and '*temporary*', regarding '*right of use*' of '*place of business*' are subject to longer and shorter period of time, respectively. Regardless of the temporal nature of the place of extraction of natural resources, the '*Basic Rule*' leads to PE; however, taxpayer's intention to use the '*place of business*' on permanent basis is adequate to concur a basic rule PE.

3.3.5. Business Activity Test: For the sake of core business activity, it is good for an enterprise to perform through the '*place of business*' in line with certain parameters to form PE e.g. management, production and distribution, and exploitation

74. A.A. Skaar, Please refer to *supra* note 61.

75. *Les Enterprises Blaton - Aubert Societe - Anonyme vs. MRN*, 73 DTC 500 P(FCTD) - (Judgment is based on para 6, Art. 5 of the OECD commentary 1992: 'the '*permanency*' establishes the rule that even a contract of short duration may constitute PE').

76. *CEPT vs. Shri Lakshmi Silk Mills Ltd.*, (1951) 20 ITR 451 (SC); *CIT vs. Vikram Cotton Mills Ltd.*, (1977) 106 ITR 829 (All.); and *Sri Ram Mahadeo Prasad vs. CIT*, (1961) 42 ITR 211 (All.).

of natural resource.⁷⁷ It is not out of place to mention here that the text of treaties does not elaborate the cohesive definition of '*Business Activity*'. In fact, the national laws classify the income as business profits and respective definitions move towards the double taxation. However, both regimes provide the nexus between the '*place of business*' and performance of business activity '*through*' place of business. An existence of a '*place of business*' can be determined by proper serving of business activity at the '*place of business*'.

It is better for the business or trade income that it must be prominent among the rest of incomes e.g. rental income, royalties, interest, dividend, income from dependent and independent personal services etc. In accordance with the provisions of Basic Rule PE, business income accrued from international traffic, agriculture and forestry are excluded from source state taxation. The former is subject to tax in the state, in which an 'effective management' place exists and both later are subject to tax as an income accrued from real estate.⁷⁸

- i. The 'Negative List': No PE, when the preparatory and auxiliary nature of businesses executed from a '*fix place of business*'. However, such activities fall under the ambit of 'negative list'.⁷⁹ Thus enlisted activities includes, *purchasing, storage, display and delivery of stocks of goods and merchandise, storage for the processing purposes of goods by another enterprise, to provide facilities regarding gathering of an information, research and development, advertising and public relations, and managerial activities.*

Same is the case with the activities, which are performed at entrepreneur's representative office and confined only for preparatory and auxiliary nature, also does not lead to PE. Mere researching, facilitating with information or maintaining liaison lacks the characteristic of commerce and trade therein so they are not liable to tax. But the certain activities are subject to tax, the activities extended to the domain of rendering consultation and other services or liaison to third person, which is engaged by the representative office.

77. Paragraph 24 of Art. 5 of the OECD Commentary 1992.

78. Article 6 of the Model Conventions.

79. Article 5(4) of the Model Conventions.

3.4. Activity Type

This type is placed over the both types because certain business activities are deemed as a *periori* to lead a PE, which includes the *supervisory activities* relating to a *building site, construction, assembly and installation of project(s)* along with the *furnishing of services (i.e. consultancy services by an employees of entrepreneur or any personnel engaged for construction work or installation of a projects)*.⁸⁰ Hereinbelow are the certain issues regarding the Activity Type/construction clause which antagonized the PE status and requires to be dilated in line with prevailing economic environment:

Issue No. 1: *Is there any coherence shared by the Activity and Basic Types PE?*

The coherence factor between the both is blurred which provides a leeway for numerous contemplations and possess dichotomy juristic opinions. Notwithstanding the pre-requisites contained in Art. 5(1), in majority opinion a building site, construction, or installation project may leads to a PE. In contrast, under the minority opinion, this type is associated with 'Asset Type PE' subject to qualifying certain requirements of later.

Notwithstanding the pre-requisites of Basic Rule PE, the prescribed period of the project leads to PE under the 'construction type'. However, the former possesses primacy, due to absences of its pre-requisites, over the later. In DTAs, when construction clause is not part thereof it is essential to qualify all the conditions of the basic rule PE.

Issue No. 2: *Does there any eminence exist between single and multiple sites?*

The 'place of business' is the place, which is used for the construction/installation of projects i.e. a building site, in order

80. Para 3, Article 5 of Model Conventions read with Section 2 (41-c, d and f) of the Income Tax Ordinance, 2001.

to constitute a '*construction-PE*'.⁸¹ However, time threshold is required for the projects' execution in multiple sites and each of them, separately leads to a '*construction-PE*'. Under the said provision, the complications occurred in PE-taxation of multiple sites e.g. where a 13 month task, which is based on two connected project and each one is less than 12 months.

The UN commentary on this point enunciates that an identification of several contracts is permitted if the contracts "*form a coherent whole commercially and geographically*".⁸² Geographical unity is required for the core business activity performed at the same location and re-location of the business place. In case of commercial unity, there are certain factors required to determine operational activities of a project, like for instance, a contract, the client, the time-factor and the constructional entity.

In contrast, the OECD regime presents commercial and geographical coherence, a building site considered to be a single unit even if it is based on several contracts e.g. orders placed by several persons for the construction of houses, which are located in a queue at a construction site, this constitute a single unit. The commercial and geographical coherence is not compulsory in the contracts, wherein existence of the former is necessary but the operational activities may be performed at different locations, under certain circumstances as to be one project.

Issue No. 3:

What is the time threshold (i.e. initial, interruption and termination)?

Under all the discussion laws, there is no coherence exists regarding time threshold. E.g. OECD-MC, UN-MC and the

81. Paragraph 18 relating to Art. 5, of the OECD Commentary 1992.

82. *Ibid.*

Ordinance purports 12, 6 and 3 months time length for the construction of building and installation of projects for PE taxation, respectively.

The set-up established by an organization '*through*' the '*fixed place of business*' on permanent basis leads to PE taxation. However, the '*set-up*' means, when the unit is ready to commence production or start manufacturing of goods.⁸³ However, the commencement of working period of business activity at the *building site, construction or installation project* starts from the date/day of '*preliminary activities*' of work by the contractor(s). It includes testing and adjustment of machinery and equipment pertaining to the construction and cleaning of scavenges from the site. The first day of an employee's arrival or delivery of an equipment or building material at the site, (if earlier), will tends to commence the working period for the purposes of the project. But permanently quitting of the last employee or removal of scavenges from the site; the said site ceases to exist, if later.

Whereas, the working period includes '*temporary*' and '*seasonal*' interruption(s) e.g. material or labour shortage and bad weather, which is based on regularity and minimum time period (for each season). There is no distinction observed between commercial and non-commercial interruptions. The elements of normal or abnormal interruptions e.g. vacations, weekends, sit-ins, strikes, deferred material delivery etc. are the part of working period. However, the repetition of business activities should be distinguished from interruptions in conducting one business assignment, the latter are considered as a working time.

83. 1999 PTD 4126.

By virtue of termination of the business activities through winding-up the current business or maintenance and repair of facilities etc., a PE ceases to exist.⁸⁴ An income accrued on the closing down of a PE will be subject to taxation even an operational part of the business became closed. Any income accrued even after the closing down is attributed to tax in the state in which PE exists. Not being contrary to treaty, the signatories can charge tax on the recapture of capital gains that accrued after the termination of PE.

Issue No. 4: *What sort of business activities leads to constitute a building, construction or installation project?*

Under both regimes, the expressions '*building site, construction and installation project*' are not dilated and includes supervisory and planning activities carried out by the contractor.

Building: Conceptually, building means and includes any structure which holds a certain space within walls designed for inhabitation or shelter, storage, trade, manufacture, workshop, business, teaching and without walls, an open air swimming pool, a roofless large stadium, construction of roads, canals, bridges, laying of pipelines and excavation and dredging.

Construction: It is a complex activity which includes the application of technical know-how, material and skill of trained personnel e.g. construction of dams, bridges, etc.

Installation: It means and includes, 'installation of plant, machinery or equipment'. The covenants of an agreement to sell relating to machinery, requires installing and inspecting, the machinery therein and violation occurred, this tends to breach of the contract.

⁸⁴ Please refer to *supra* note 72 & paragraph 6 relating to Art. 5 of the OECD Commentary - 1992.

Services: Services possess two forms i.e. 'Material services and Professional services'. By virtue of material services, the service providers furnish services in shape of electricity, water and sanitation, gas, telecommunication, transportation, bank relating matters, consultancy, manpower and data processing etc. to the community. However, the services productivity must be in line with an industrial and commercial viability. The professional services are composed of professional knowledge and skills. However, the same is relating to consultancy services for the same or connected project(s) in order to attaining PE status.

Under the 'constructional approach', it is intricate to determine that to whom the contributed work refers i.e. to building, a ship or to actual construction project. However, the construction and installation shares the same nature and part of business activity. But the 'functional approach' eliminates the chances of collective contribution towards the new construction.

In fact, the work proceeding to an '*actual construction*' i.e. scaffolding, erection of barracks, excavation and dredging, demolition etc. and the work following the '*construction*' i.e. maintenance and repair work etc. along with the activities performed during the '*construction project*' e.g. supervision, are collectively applicable in the prescribed period tendering to an activity as construction-PE.

3.5. Agency Type

The bond between an '*agent*' and a '*principal*' constitutes an '*agency*'. In order to levy tax, law extended the scope of taxation to agency PE. Herein, a person himself acts as a '*fixed place of business*' in a contracting state being an *agent* of the other contracting state's entrepreneur. This clause is effective even in an absence of the '*fix place of business*' of an entrepreneur and also has an ability to replace the conditions thereof. As per section 2 (41-e) of the Ordinance and art. 5(5) of Model Conventions, a person habitually exercises an authority to conclude contracts on behalf of the other person as well as maintains (in that contracting state) a stock of goods or merchandise as part thereof and regularly delivers the goods or merchandise on behalf of the enterprise.

Moreover, the 'Agency Test' is an additional support for determination of an organizational status regarding PE of one state in the other state. Since 1899, 'Agency Clause' was part of treaties but in span of 1920s 'agency clause' was altered and excluded the 'independent agents'. Philosophy of inclusion of the 'dependent agents' in the definition of PE is to prevent the "side stepping" of the "asset" or '*fixed place of business test*', if it is not so than it is easy for a foreign business to performs though a '*fixed place of business*' of a resident agent and avoids PE. Notwithstanding an access to '*right of use*' to a '*fixed place of business*', an agent and the principal holds the same '*fixed place of business*' which leads to PE. This point is also supported by both regimes. However, an agent resides in one state and moves for daily work to another state (not being as a traveling agent), leads to an 'Agency PE'.

3.5.1. An Agent: Regardless of any considerations, every person being major and having sound mind is competent to be a party of an agreement, whereas, the agency is also concluded through an agreement. The definitions provided under section 182 of the Contract Act 1872, an agent and the principal means;

"an agent is a person employed to do any act for another or to represent another in dealings with third persons"; and

"the principal is a person for whom such act is done, or who is so represented."

In simple words, an 'agent' is a person who represents and acts 'for and on the behalf' of others and the 'principal' is a person who appoints and authorizes another person 'for and on his behalf'. By virtue of 'agency', relationship of master and servant is established between the 'principal' and an 'agent'. In accordance with the said provision, the authorized agent is bound to do all the lawful acts, which are compulsory to be done under the agency clause. Under the agency type PE, it is mandatory that there must be nexus between the source territory and the agent's residential territory. Notwithstanding the signing place, signatures and/or mere authority, the principal is bound for the acts of an agent relating to contractual obligations. Hence, all such acts will have the same effect and legal consequences, as these acts are done by the principal in person.⁸⁵

85. Section 226 of the Contract Act 1872.

On contrary to an agreement to sell, under an agency agreement, an agent sells the property in line with the instructions and directions of the principal. He is not supposed to sell the said property on his own because the legal title of said property is dealt with the principal. In addition, any loss, which is occurred due to the agent under the agency agreement, the same is indemnified by the principal.⁸⁶

3.5.2. Dependent Agent: The dependent agent is a person, who is legally and commercially dependent upon the principal. Under the dependent agency bond, an effectual faculty of an agent regarding the position of the principal relating to the third party is necessary. However, a broker, general commission agent or agent of an independent status acting in an ordinary course of business of an entrepreneur of one state accomplish a business in the other state, alone will not leads to a-PE. The sufficient authority, which is habitually exercised by the dependent agent for binding an entrepreneur to participate in the business activity of the other country, is also necessary. Whereas, the dependent agent does not need a '*fixed place of business*', hence the treaties requires a transient presence, in terms of habitual.

The principal has the powers to pass directions to an agent(s) which proves the legal dependence. In order to forms a commercial dependency, comprehensive directions must be present to form an agency PE. The Principal also holds an extensive control and sanctions over the agent's books, cash-in-hand, litigations and support of the agent's business e.g. reimburse expenses incurred by agents, permission to use the principal's equipment or facilities or provide guarantees on behalf of agents' crediting, are an evidence of commercial dependence.

3.5.3. Independent Agent: The permanence is an element, which is essential for conduction of business as well as for an 'establishment' of 'a place of business'. But it is not possible through a broker, commission agent or an agent of general nature and of independent status acting in an ordinary course of business. In fact, the commercial independence is an outcome of discretionary power of attorney vested in an agent. In light of the OECD commentary, an independent agent means;

- i. he is independent of the enterprise both legally and economically manner; and

86. Beaker Gray & Co. vs. CIT - (1983) 139 ITR 203 (Cal); and Punjab State Cooperative Supply & Marketing Federation Ltd. vs. CIT - (1981) 128 ITR 189 (Punj. & Har.).

ii. he acts in the ordinary course of his/her business when acting on behalf of the enterprise.⁸⁷

In response to the query that whether or not, an agent acting for and on behalf of an enterprise, which is only his client, can still be regarded as independent, the OECD commentary under Para 38 purports that:

"Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person connote be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents."

3.5.4. The Authorization: The authority conferred by the principal has dichotomy forms i.e. actual and apparent authority. The actual authority must be in expressed or implied forms; former is in shape of verbal or written form and later is in shape of factual circumstances. E.g. Corporation - by virtue of positions, executives have authority to make decisions which are binding on the corporation.

Regardless of the bond between the principal and the purported agent, the words or conduct of the principal leads to a rational person in the position of third party, by believing that the agent holds an authority to act is known as apparent/ostensible authority. The "doctrine of holding out" presents that creation of an impact by the principal that an agent has authority not being an actual one and the third party is protected by the reasonable acts. Court laid the dictum that:

"Ostensible or apparent authority is merely a form of estoppels, indeed, it has been termed agency by estoppels and you cannot call in aid an estoppel unless you have three ingredients:

- (i) a representation,*
- (ii) reliance on the representation, and*
- (iii) an alteration of your position resulting from such reliance."*⁸⁸

⁸⁷ Para - 37 on Art. 5 of the OECD - Commentary 1992.

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In absences of authority, agent acts *agent* of principal leads to an agency, when principal owns the covenants of an agreement concluded by the agent, but not the activities regarding solicitation and negotiating contracts.⁸⁹

88. Rama Corporation Ltd. vs. Proved Tin and General Investments Ltd-[1952] 2 QB 147.

89. Lower Court of Amsterdam in BNB (1979/190).

Chapter 4

Taxation of Business Profits

John Maynard Keynes, a British economist (1883 - 1946), had profound belief about the taxation that "*the avoidance of taxes is the only intellectual pursuit that still carries any reward.*" Article 7 of the Model Conventions purports the taxation of business profits but the text of the said provision does not dilate the expressions '*profits, business, and enterprise*'.⁹⁰ In fact, Article 3 (2) of the Model Conventions manifests that:

"any term not defined in the convention shall, unless the context otherwise requires, has the meaning which it has for the purpose of the laws in force in the State relating to taxes".

In accordance with the said provision, it is mandatory that all the blurred expressions of the Model Conventions shall be interpreted in line with legislation of the Contracting States⁹¹, except where the context otherwise requires.⁹²

4.1. Profit Allocation

It is reported to believe that the PE, as distinct person from parent organization. Both the regimes purport the comprehensive rules for profit allocation of a PE. These rules are supported by the separate entity concept in line with the ALP provisions. However, the law permits to deduct the expenses which incurred globally by the PE.⁹³

4.1.1 Profit: It means an income, which is derived by an enterprise in ordinary course of business.⁹⁴ The précised definitions of '*industrial or commercial*' profits are included in the DTAs, which are signed by Pakistan during the era of fifties and

90. Paragraph 1 of Article 7 of the Model Conventions.

91. Dutch Supreme Court decision in HR 10 June 1981; BNB 1981/242.

92. A.A. Skaar, *The National Norwegian Report, International Fiscal Association Conference*, (1993), 507.

93. Section 105 (a and b) read with Section 78 of the Income Tax Ordinance, 2001.

94. Para 32 of the OECD Commentary on Article 7.

sixties.⁹⁵ However, the text of said DTAs excluded the investment income i.e. interests, dividends, royalties and know-how fees, capital gains, etc.

The theory of 'Real Income' entails the consequences of income accrual which depends on the activities subject to the situations. In fact, taxes are not levied on tax subjects due to certain conducts, which are based on the *ipse dixit*. In response to the controversy i.e. "*whether the profits accrued due to the fluctuations of exchange rate of foreign company's assets, are subject matter of profits and gains of a business*", the court held that '*no profit or loss accrued by an incomparable positions leads to the tax computation*'.⁹⁶ However, the income accrued by commercial assets' exploitation leads to the taxpayers' business income, as their profit.⁹⁷

4.1.2 Business: It means an occupation or a profession which occupies the time, attention and labour of a person having intentions to make profit. In broader sense, it is an activity (manual or mercantile), which is carried out with the intentions to make profit and further classified from the liberal arts or learned profession or agriculture.⁹⁸ It also requires a constant flow of transactions having the profits as an essential element in commercial activity. In order to elaborate the term 'profession', the Court held in a case, which is titled as "Safdar Jung Hospital vs. Kuldip Singh Sethi" that:

*"A profession ordinarily is an occupation requiring intellectual skill while painter uses both. In any event, they are not engaged in an occupation in which employer and employees co-operate in the production or sale of commodities or arrangement of their production or sale or distribution and their services cannot be described as material services."*⁹⁹

4.1.3 Impact of Profit Allocation on PE: Allocation of profits relating to the PE, notwithstanding rather clear policy pronouncement in the relevant treaty provisions, leads to row among the competent authorities. The OECD regime is

95. E.g. DTAs with Japan, Australia and United States of America.

96. House of Lords in Petition vs. Marine Midland Ltd. (1981) AC 362.

97. CEPT vs. Shri Lakshmi Silk Mills Ltd. (1951) 20 ITR 451 (SC).

98. State of Punjab vs. Bajaj Electricals Ltd. (1968) 70 ITR 730 (SC).

99. AIR 1970 SC 1407.

inclined towards the taxation of *profits*, which are credited to the PE. In contrast, the UN-MC protagonist to the '*force of attraction rule*' instead of '*attribution principle*'. By virtue of '*force of attraction rule*', the source states are permitted to charge tax on business profits, which are accrued from (a) activities directly undertaken by the PE; (b) sale of goods or merchandise of the same or similar kind by the enterprise itself as those sold through that PE; or (c) other business activities of the same or similar kind as those affected through the PE. Moreover, the UN regime agreed with omission of such profits, which are carried out beyond the domain of PE. In order to invoke the said rule, the profits indirectly credited to PE shall be ascertained in same manner as the profits directly credited to PE.

On this vary point, both the regimes find no concurrence. In the UN opinion, the said principle helps in preventing tax evasion and eliminating the difficulties regarding the business quarries relating to transactions, which were managed by the head office or a PE. In contrast, the OECD regime emphasizes on the sense of proportion in PE taxation because the said principle does not assay an atmosphere, which is conducive to efficient administration of business.

4.1.4 Legal Perspective on Certain Situations: Under the treaty law, different tax treatments are available regarding the payments relating to PE and its head office. In fact, the OECD regime antagonized to the 'distinct and separate enterprise' concept. In accordance with the said provision, certain payments are exempted from deductions, which are to be shown as under:¹⁰⁰

- 1) **Payments of Royalties and Interests:** As per treaty regime, all the payments, which are made by the PE against the utilization of any tangible or intangible asset(s) to its head office, are exempted from deductions. It is only because both are the same entity. However, this provision excludes the business of banking sector as exception i.e. inter-branch advances for interests because "making and receiving advances is narrowly related to the ordinary business of such enterprises".

100. Section 105 (c) of the Income Tax Ordinance, 2001.

2) Compensation for or on behalf of Services: No deduction is allowed for any commission or compensation for or on the behalf of services, which are provided by the head office, PE or *vice versa*, e.g. advertising expenses and fee for good management etc.

- Advertising Expenses: Treaty Law only permits deductions of such portion of expenditures, which is incurred on subject matter of PE only, although it may have paid all the advertising expenses on the company's behalf including its head office. Herein, an issue arises that, if the head office and PE are the separate non-related entities and provide commission based services, then whether an increase in profits of PE is a notional commission or otherwise. On this point, the OECD regime argues that the determination of an appropriate 'commission or profit element' of PE is difficult, hence all auxiliary services provided by a PE to its head office or *vice versa* are chargeable subject to cost.¹⁰¹
- Fee for Good Management: Is it possible to determine any part of enterprise's total profit that would have accrued by exercising good management?

The "distinct and separate enterprise" concept provides a concrete base for argumentation regarding the profit element relating to management services but the "practical considerations weigh heavily against it".¹⁰² According to OECD, head office holds right on the part of PE's profits (when company's head office and business exists in different country through a PE), which are attributable to the directors' skillful management at head office.

4.2 E-Commerce

At present, digital technologies grasped the global business environment. By virtue of impressive technological developments, the '*bricks and mortar*' transactions are substituted by the '*clicks and mortar*' transactions. Hereby, the vendee simply '*log-*

101. Paragraph 4 of Article 5 of the Model Conventions.

102. E.g. In Canada - US treaty, it is spelled out that "the mere provision of executive, managerial or administrative facilities or services" does not warrant the attribution of any business profits to PE.

on' to vendors' portal, which acts as a communication device like a landline or facsimile. Thus, an e-commerce transactions includes; sales, deliveries and services of intangible commodities e.g. e-magazines, music, games, software and travel services etc as well as of tangible commodities e.g. apparels, vehicles and books etc.

As a matter of accepted principle that the prevailing taxation regime is equipped to entertain the issues relating to properties of corporeal nature, which are performed through the '*bricks and mortar*' business concerns. In fact, globalization, e-commerce and record increase in the tax havens foster the financial crisis¹⁰³ and resultantly, which spread a daunting specter on the myriad taxing regimes. Most of the nations believe that the impact of e-commerce has prevailage over the taxing rules.¹⁰⁴ It is reported to believe that nations hold divergence regarding the enabling provisions relating to profit allocation to PE. The developed nations are protagonist to ameliorate the traditional taxation concepts, laws and norms in line with the dire needs of e-commerce. In contrast, the developing nations are protagonist to embrace the taxation norms which apply simultaneously to e-commerce (i.e. 'clicks') and trans-border business activities (i.e. 'mortar'). Although, divergence exists but the tax amelioration must comply with the time-honored taxation policies along with the neutrality and inter-nation equity norms.

In fact, the internet possesses an unfettered and anonymous character which paved the ways for tax evasion in profits of e-transactions. All the taxing regimes are committed to give considerations to the quadruple areas of e-commerce taxation which includes; corollaries of web server and web site hosting facilities in a country, the spirit of transactions relating to digital products and profits attached to a web server. It is true that the issues of digital age are multifarious which designed the threshold questions relating to e-commerce and tax incumbents have routine encounter with the said issues. Whereas, the issues are as under:

- a. Whether trade through web server may leads to a PE or not? and
- b. To what extent the tax treaty rules and conceptual framework applies?

103. Reuven S. Avi-Yonah, *Globalization, Tax, Competition and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573, 1578-80 (2000).

104. Arthur J. Cockfield, *Balancing National Interests in the Taxation of Electronic Commerce Business Profits*, 74 Tul. L. Rev. 133; 137-38 (1999).

As a matter of an accepted principle that only a fixed and permanent place of business constitutes a PE. The OECD commentary relating to Article 5 infuses all the aspects of a '*place of business*' which incorporates; any premises, facilities or the installations used to carry on the enterprise's business (whether or not they are used exclusively for that purpose). In accordance with the said provision, The Netherland's Supreme Court, ('Hoge Raad') held that:

*"the nature of the establishment is irrelevant regardless of whether that place is a building, part of a building, a few rooms in a building, a tent, a hut or another area separated from the outside world..... it is appropriate to assess the fixed nature of the place of business based on its relative fixedness as regard the period of time during which the enterprise or the business is carried on in an establishment within a state."*¹⁰⁵

On the basis of analogy, apart from its nature i.e. mobility, movable web server, telecommunication equipment¹⁰⁶ and a web site serving as the business hub on regular basis leads to a PE.

The Dutch Supreme Court and the Court of Appeals give weightage to the concept of "fixed in geographical sense". It has been held that the said concept is absent from the mobile place of business e.g. a ship or an oil rig. It relocates promptly from one State's territory to another¹⁰⁷ and similar quality is also possessed by a web server. However, in case a server is (re)located within the border of the State on a regular basis (having an element of permanence), it leads to an availability of fixed centre of business as well as existences of PE in that state - wherein, permanence meaning "permanently available to the business"¹⁰⁸ and the *place of business* must 'equipped' for the conduct of business.

105. HR October 13, 1954, NR. 11908, BNB 1954/336.

106. It includes a capable net works, telephones lines, satellite dishes, etc, which enables an access to internet and the web site of an enterprise.

107. HR April 3, 1974, NR. 17 259, BNB 1974/172 Hof's Garvenhage September 10, 1990, NR. 90/4287, BNB 1992/51.

108. Under paragraph 4 Article 5 of the OECD commentary, it is irrelevant that whether the place of business is at the disposal of the enterprise by way of ownership, rent or otherwise.

Notwithstanding what is mentioned above, element of *permanence* lacks in telecommunication equipment, which is used by an enterprise for business purposes because it is a part of state's infrastructure but not available to an enterprise. In fact, the requirement for the *place of business* is not mentioned by the OECD regime. It only purports to require a PE presence, the business or any part thereof must be carried on via *place of business* concerned. It is point of fact that the web server, web sites and telecommunication equipments does not satisfy the PE criteria. According to Para 10 of Article 5 of the OECD commentary, PE can be formed by automatic equipment.¹⁰⁹ By analogy, a fully automatic operating web server would constitute a PE if the business of the enterprise is carried on (mainly) through the web server.

Issue: Whether an internet service provider (ISP) is an agent?

Under the fiscal doctrine, an ISP probably will not constitute a dependent agent of an enterprise. It is generally not authorized to conclude contracts on behalf of an enterprise or to habitually exercise this right, as required under Article 5(5) of the OECD-MC. Even if it authorized to conclude contracts, it would be an independent agent because an ISP acts for its own business. Due to such reasons, it would not lead to a dependent agent.¹¹⁰

Precisely, a fully automated web servers constitutes a PE, in fact, having mobility nature which relocates it to tax haven creates a vagaries fiscal problem. In the current conceptual framework, it is unlikely that this problem can be overcome entirely except that the international community formulates explicitly to what extent the quantitative tests¹¹¹ can be a tool in determining

109. The Commentary states: "but a PE may nevertheless exists if the business of the enterprise is carried out mainly through automatic equipment, the activities of personnel being restricted to setting up, operating, controlling and maintaining such equipment".

110. Selected Tax Policy Implications of Global Electronic Commerce, issued by the U.S. Treasury Department, November 1996.

111 A.A Skaar, *Permanent Establishment - Erosion of a Tax Principle*, (Oslo 1991), 283.

whether a PE exists or not. The tax literature recommends¹¹² that the activities, which are transacted via a web server, are expected activities under Article 5(4) of the Model Conventions; for instance, merely the web server becomes the medium of communication through which the goods and services are transacted. Regardless of the activities performed through a web server, resultantly it does not lead to a PE. Consequently (apart from levying a withholding tax), only the state where the company is residing can levy taxes on the income generated though e-commerce (worldwide).

4.3 Financial Market

By objective, the financial services market infuses with intermediation among the investors, the safe investment technologies and entrepreneurs associated with tax obligations. Prior to present financial crunch, the way in which digital technologies has undergone, a complete transformation has been occurred in the state of taxation relating to financial services market. However, the OECD commentaries assayed those issues, which were arisen from liberalization and globalization of financial market. It is appropriate for the state authorities to comprehend with the different forms of financial services market, like for instance, modes of business and taxing, and continual morphing of their operations. It is quintessential for the states to dilate the definitions of above said terms in line with taxation.¹¹³

Legally 'banking' means, an acceptance of deposits in monitory unit in order to further investment, which can be reimbursed or withdrawn on demand and a 'banking company' means, which is associated with the banking business including its branches and subsidiaries operating outside but incorporated inside a particular

112 L. Hinnekens, *Looking for an Appropriate Jurisdiction Framework for Source state Taxation of International Electronic Commerce in the Twenty First Century*, Inter Tax Volume 26 (June-July 1998) and M. Vink, *Substantial International Corporate Income Taxes*, (Caught in the web: Fiscal Actualiteiten) FED. 1998

113 Please refer to "Recent Developments in Multistate Taxation of Banks and Financial Institutions", by Warren, Gorham & Lamont, *Journal of Multistate Taxation and Incentives*, vol. 18, no. 9 (January 2009) having File URL: <http://www.grantthornton.com/staticfiles/GTCom/files/services/Tax%20services/SALT/Recent%20developments%20in%20multistate%20taxation%20of%20banks.pdf>, which was accessed on February, 5 2011.

country (Pakistan).¹¹⁴ In order to attain the objectives, following are the core business activities of this sector:

- i. Acquisition of capitals and funds;
- ii. Generation of financial asset(s) by providing loans;
- iii. Functions relating to risks, which include a supervision of the management of the bank's overall capital and risk exposure;
- iv. Functions regarding supportive or 'back office', for instance, general management, development of IT-infrastructure, HR etc.; and
- v. Operational functions with the help of subsidiaries.

As a matter of an acknowledged principle, the deposits foster the financial institutions, which are effortlessly transformed in the form of cash, cheques and credit as well as debit cards. Being a capital oriented, the financial services market is capable to bear losses due to realization of assumed risks. In fact, numerous risks are associated to its activities, which is an outcome of financial asset i.e. loan. In order to tackle assumed risks, the appropriate measures are the major secret behind the profit attribution to financial market.

By the end of year 2007, re-pricing of credit risk and a liquidity squeeze has influenced the global capital market. The financial crunch of USA also effected the global financial institutions with respect to losses relating to the sub-prime mortgage investments. The IMF figures¹¹⁵ reveals that more than \$1.3 trillion of bad loans was written-off from 2007 to June 2009 and additional write-downs of \$1.5 trillion are expected in next few years. The USA banks had write-down \$1 trillion from the total of \$2.8 trillion and European banks for \$1.6 trillion. Up to the June 2009, the USA banks bore about 60% of sub-prime related losses and more than of the 40% by European countries.

In fact, the tax havens provided space to the offshore banks which paved subversive economy as well as crime and indicted to offences of tax evasion as well as money

114. Section b read with Sub section c of Section 5 of the Banking Companies Ordinance, 1962, Pakistan.

115. International Financial Services London Research, *Banking 2010*, (London: February, 8 2010), 2. Having File URL: http://www.thecityuk.com/media/2372/IFSL_Banking_2010.pdf, which was accessed on 5th February, 2011.

laundering. The business activities in digital age dilated outsourcing, off-shoring and functions regarding development of IT related services. Astonishingly, United States hold dominance over the offshore market having 70% of its activities and the same dominance is enjoyed by the United Kingdom in Europe.¹¹⁶

The financial instruments are an addition to the global trading. Conceptually, it is an activity, which is performed by the financial institutions for execution of orders for and on the behalf of clients regarding financial products in global market. In which, it acts as a market-maker in securities and financial derivatives, agent for clients' transactions on stock and commodities exchanges, and develops new products according to requirement. However, an income accrued from fore-activities consists of 'interest and dividends'. Portfolio management is a major source of generating profits by financial institutions, e.g. forecasting regarding the movement of interest, exchange rate and prices. In accordance with said movements, these adjustments bring changes in the value of their portfolio. Generally, it is possible that these activities may proceed in more than one time zone and it is crucial, in taxation context, to facilitate clients with financial products in more than one jurisdiction (even within one time zone).

4.4 International Transportation

Income of international transportation falls under the domain of income from services having its source in the place where services are rendered. By scope, these services are performed at high seas and the space. Moreover, 'source rule' or the operators' place of residence has pivot in determining the taxation of this mode. In treaty perspective, the taxing right of an income has following approaches:

- i. Taxing right, exclusively vested in the country of residence or the enterprise's place of effective management or the place where ships or aircrafts are registered.
- ii. Taxing right, exclusively vested in the country where income arises.
- iii. Taxing right, revenue sharing between the countries of source and residency or place of effective management of the enterprise.

116. Please refer to page 6 *ibid*

It is preferred by the certain states to combine the 'residence' and 'place of effective management' criterion. Under the Para 3 of the OECD commentary on Article 8, it is reported to believe that the states having the 'place of an effective management' holds primary taxing right. This observation is based on the state's abilities to charge taxes on the total profits of an enterprise. However, in events when the state 'place of effective management' does not holds an ability to charge taxes than the taxing right vested onto the residence state. In fact, neither the rules regarding PE nor the taxation of business profits applies in any of the above situation.

As a matter of an accepted principle, the state in which the 'place of an effective management' of an enterprise is situated has the taxing right.¹¹⁷ By scope, the operation of ships, aircrafts, motor vehicles and inland water transport are included in the domain of international traffic by Model Conventions. In fact, the terms of international traffic, profits of the air and shipping enterprises are not assayed by the Model Conventions. However, all such blurred expressions shall be interpreted in line with accepted national or international rituals.

According to Pakistani taxation regime, it is recommended that the rules of presumptive taxation applies to taxation of income from international transportation (both as owner or charterer), which *inter alia* means application of a rate structure to the gross receipts received or receivable from anywhere for the carriage of passengers, livestock, mail or goods embarked. According to Article 8(1) of the OECD-MC, the profits accrued from operations of ships and aircrafts in international traffic are taxed only in the country of residence or the place where an effective management of the enterprise is situated. In contrast, the UN-MC stipulates that such income is subject to tax in the source country. Pursuant to the above principle, Pakistan has followed an amalgam of multiple approaches including exclusive taxation in the country of residence or source as well as equal sharing of revenues by both the states.¹¹⁸

117 OECD-MC and UN-MC (Alternate A and B), Article 8 (1, 2 and 3).

118 E.g. the DTAs with Austria, Bangladesh, Denmark, Finland, Hungary, Italy, Korea, Philippines, Singapore, Sri Lanka, Sweden, and Switzerland.

The Model Conventions on the operational activity of ships or inland water ways purports that if the 'place of an effective management' of an enterprise is situated in abroad than the tax is to be charged where the home harbour of the ship or boat is situated. But if the home harbor cannot be determined than the taxing right vests in operator's country of residence.¹¹⁹ In order to determine the fate of enterprises, which are not particularly associated with business of international traffic, the OECD under Para 2 of its commentary on Article 8 states that:

"if such enterprise has a foreign country PE exclusively concerned with the operations of its ships or aircrafts, there is no reason to treat such establishments differently from the PE of enterprises engaged exclusively shipping, inland waterways or air transport."

4.5 Turnkey Projects

Under the international business practices, it is matter of fact that the enterprises opt for split contracts in order to reduce their taxation exposure in the source countries. For instance, an enterprise is a party to an agreement for the designing, fabrication, manufacture and supply of plant and machinery, and separate agreement among the same parties for the construction of infra-structure, assembly and installation of plant, personnel training, etc. By divergence of opinion, the developed states protagonist to splitting contracts because the former activities are performed in their domain and only they have right to tax. On the contrary, the developing world, including Pakistan, insisted to treat both contracts as a single 'Turnkey Project'. In fact, all such activities are part of customers' focused requirements, which are inseparable and tax subject of host country.

By objective, 'Turnkey Projects' are the contractual liabilities among the company of an industrialized country and a customer of a developing country having following forms:

- i. To develop crucial and exhaustive engineering;
- ii. To supply equipment and spare parts;
- iii. To provide services of construction, installation and supervision;

¹¹⁹ Article 8 (3) of the OECD-MC, 1992 and Article 8 (3) in Alternate A and Article 8 (4) in Alternate B of the UN-MC, 1980.

- iv. Staff training;
- v. Expertise; and
- vi. Rights to use.

Except for the supply of equipment and spare parts, right of use and expertise, the states perceive that all the other objects are related to the technical services, which are equally provided by the parent company and country of recipient e.g. development of crucial and exhaustive engineering. By virtue of providing technical services, it is complex to articulate the tax of the staff posted to recipient's country. Thus, developed and developing countries have diametrically opposing stances on said issue.

Under the developed world's opinion, it is mandatory for the supplier company's residence country to apply the principle of world income. In accordance with the said provision, the net amount of contract payments constitutes industrial profits, which are subject to tax in that particular state. In event of providing such services by an individual or group of individuals, their agreed remuneration will be taxing subject as 'income derived from independent professional services'.

In contrast, the developing world's purports that the WHT applies to the total gross amount of the payment or part thereof as arising from such contracts. However, in certain cases, countries resort to full taxation of such payment(s) treating these as 'industrial profits' and subject to tax on the net basis after allowing estimated deductions and proven individual expenses. In order to charge taxes on the same income, in the country (i.e. both supplier and recipient), leads to double taxation of such remuneration where the country of residence may not allow the foreign tax credit. Therefore, given the diversity in underlying principle regarding taxation of income in the respective states, the double taxation can be reduced but not prevented. This occurs only because the foreign tax credit applies only to "foreign income" in accordance with the law of supplier's country. Evidently, the credits regarding foreign taxes relating to services (i.e. crucial engineering) performed in the parent company is not considered as tax on foreign income.

The UN proceeded in a different modus operandi regarding taxation relating to 'technical services', when these services do not fall under the ambit of PE. In pursuance thereof, the UN-MC provides that when the stay regarding personnel

performance relating to rendering of 'technical services' exceeds the prescribed period of six months, the counterpart of the contract is deemed as a PE and the host country holds the right to collect taxes applicable to such payments.¹²⁰

Dissimilar understandings of the tax authorities (i.e. both developed and developing) tend to an 'unavoidable' economic double taxation. Mostly, MNCs involved in an income splitting by segregation of contract, especially in a contracting business e.g. one for the sale of goods and the other for work and labour. Notwithstanding the doctrine propounded by Lord Tomlin in *IRC v. Duke of Westminster* (also followed in several Indian cases) splitting of transactions without economic contents is not permissible.

Presently, special emphasis is being given to the matters relating to turnkey projects along with their amicable solutions by tax conventions among European and developing states. Whereby, in agreements relating to supply of plant and machinery subject to tax in the supplier's country and the host country holds right to tax in respect of the difference, if any, between the arm's length price and the price given in the contract. Likewise, the host country, subject to the provisions of Article 5 (3) of the UN-MC, holds right to charge tax on the contract value relating to the provision of 'technical services' (if such provision exists in the relevant tax treaty). In case, Article 14 provisions are relevant, taxation in the host country shall be subject to the fulfillment of the conditions laid therein.

¹²⁰ Article 5(3) read with Article 7 of the UN-MC.

Chapter 5

Transfer Pricing

Benjamin Franklin reported to believe that "*There is no kind of dishonesty into which otherwise good people more easily and frequently fall than that of defrauding the government.*" An impressive achievements in the trade sector has an out-come of digital technologies, haulage, wipe-out tariff barriers, simplicity in trans-national exchange of assets (i.e. goods and capital) and emergence of WTO. Apart from the development, these achievements paved to defraud the governments in digital genre. Factually, in the year 1960 and 1982, international trade in assets had contributed 10% and 22% to GNP, respectively.¹²¹ This economic integration was pivot for the launching of MNEs. By vigorous participation of intangibles and multi-tiered services, the mercantile transactions are impressively elevated among the different arms of same corporation. At present, nearly five hundred MNEs hold dominance over the 90% and 50% of the global FDI and trade, respectively e.g. Coca-Cola, Gillette etc.¹²²

In legal context, the MNE is an enterprise which holds (wholly or partly) a control and manages the income, which is accrued from the assets in multi-nations.¹²³ Furthermore, it is incorporated in one state (i.e. the 'home state') and transacts beyond the home state with the help of branches, subsidiaries¹²⁴, affiliates¹²⁵, joint ventures and PE in other state, (i.e. the 'host state'). The transactional architecture is designed among its different arms, which is also known as 'intra-group' or 'intra-firm' transactions. On contrary to the enabling provisions of an open market for unrelated entities, these transactions are articulated by bonding of market and group's collective

121 Evans Thomas G., Taylor Martin E. and Holzmann Oscar (1985), *International Accounting and Reporting*, (Macmillan Publishing Company New York/Collier Macmillan Publishers London), 3.

122 Paul Kirkbride and Karen Ward, *Globalization: The Internal Dynamic*, (John Wiley and Sons Ltd., 2001), 4.

123 Peter Muchlinski, *Multinational Enterprises and the Law*, (Blackwell Oxford UK and Cambridge USA, 1999), 12.

124 A company, which is wholly or partly owned and/or controlled by Parent Company.

125 It is an entity, which is partially or wholly owned and controlled by MNE. It further includes subsidiaries, branches, joint ventures or any legal entity under partial or complete control. quoted by Jerry M. Rosenberg, *Dictionary of International Trade*, (Published by John Wiley and Sons Inc., 1994), 6.

interests force. By estimation, above than 60% of transactions leads to 'intra-firms'¹²⁶ and above than 30% of exports, particularly in technological sector (i.e. chemicals, machinery and transportation equipments), are contributed by developing countries.¹²⁷ By forces of collective interests, MNE-group regulates the emergent global transactions in order to manipulate the prices, *inter alia*, to avoid taxes. In common parlance, this mechanism is known as '*transfer pricing*', '*internal prices*', '*accounting prices*' or '*inter-corporate transfer prices*'.

In literal context, the TP is a trans-national business transaction among the interrelated business concerns subject to the prices at which an enterprise transfers physical goods and properties of intangible character or render services to associated enterprises.¹²⁸ In jurisprudential context, it is a scheme which artificially manipulates the prices of in-house transactions among interlinked entrepreneurs in order to alter or shift the true business profit. However, the TP is compared with the market/ '*arm's length price*', which is the price of same transaction in the open market among the unrelated third parties.¹²⁹

The controversies relating to transfer pricing are commonly reported, since remote past. Among the seminal cases, the dictum laid by the Monopolies Commission of United Kingdom is a matter of *par excellence*. Whereby, the commission accused the 'Hoffman-La-Roche' (pharmaceutical company) for manipulation of its prices than to international market.

Cutting long story short, the pharmaceutical company charged high prices for the medicines, such as 'Librium and Valium', in the UK than to international market. In line with the TP mechanism, the evidence corroborated that 'Hoffman-La-Roche' (parent company) had manipulated the prices of afore said medicines and demonstrated a reduced profit with respect to its UK subsidiary i.e. 'Roche Products'. The head office of the said pharmaceutical company calibrated the prices of raw

126 Roy Rohatgi, *The Basic International Taxation*, (Kluwer Law International, 2002), 412.

127 Sol Picciotto, *International Business Taxation- A Study in Internationalization of Business Regulation*, (Weidenfeld and Nicolson, 1992), 171.

128 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 2010, Para 11, 19.

129 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer* - (Second Edition), (the Hague/London/New York: Kluwer Law International, 2002), 55.

materials for the UK in accordance with taxation instead of manufacturing cost. By towing transfer pricing line, the said pharmaceutical company indulged in tax evasion. It was culminated that the said company should cut down the prices of afore said medicines up to 40% and 25%, respectively.¹³⁰

5.1. Premises of the TP

Transfer pricing is an arguable topic of international taxation pertaining to changing scenario and requires a concrete policy measures for the solution of issues annexed *therewith*. Article 9 of the Model Conventions inculcates the concept of the TP, which is a mechanism of tax avoidance along with evasion and different approaches to ascertain the profit among related entities. Since 1979, the OECD regime provides guideline with respect to the TP of multinational enterprises and tax administration. In the year 1988, the UN published a report on 'International Income Taxation and Developing Countries'. The said report purports the tax base of developing nations for the TPM by MNEs along with suggested the mechanisms relating to *intra group* transactions. Subsequently, the 'UN Conference on Trade and Development' (UNCTAD) also published a report on TP in 1999.

Similarly, the Ordinance under Section 108 read with Section 109 also dilated the said concept, in order to authorize the tax administrations to *distribute, apportion or allocate income or tax credits*, in line with ALP guidelines, *inter alia*, re-characterize a transaction or part *thereof* made for tax avoidance. Subsequently, the Rules are formulated to provide procedure for the implementation of the Ordinance in chapter VI rules 20 to 27, such as, the methods i.e. CUP, RSP, CPM and PSM. Particularly, the rule 22 of the Rules enunciates that the authorities hold discretionary power to streamline the TP in accordance with the international norms. The rationale which induces the MNEs to avoid taxes is as under:

- i. It is true that the taxation holds a crucial status in the country's economy. In fact, the corporate community penchant for tax avoidance. As a result the tax related scams are higher than all the conventional crimes. Legislations

130 C.R. Greenhill and E.O. Herbolzheimer, (1981) *Control of Transfer Prices in International Transactions: The Restrictive Business Practices Approach, & Multinationals Beyond the Market, Intra-Firm Trade and the Control of Transfer Pricing* ed. Robin Murray (Harvester Press), 187-188 and "Hoffmann-La-Roche vs. Stanley Adam" quoted in Newbigging, Eric, *Corporate and Individual Ethics*, (Bedford: Cranfield School of Management, Cranfield University, Bedford MK43 OAL, UK 1986), 7 & 8 having file URL at <https://dspace.lib.cranfield.ac.uk/bitstream/1826/471/2/SWP1787.pdf>, which was accessed on 21-8-2009.

provides no shelter to the tax avoidance but the taxes are avoided by means of treaty shopping, tax havens and the TP.¹³¹

- ii. The concurrent application of nationality and residency principles by multi-tax jurisdictions paved to double taxation and induces the MNEs to avoid taxes.
- iii. By virtue of incorporation, the MNCs are subject to domestic tax provisions. The fluctuations may occur in the provisions of myriad tax regimes which includes, tax rates, accounting norms and computation techniques of taxable income. The said built-in flexibilities aid MNEs to manage their internal transactions and curtail their overall global tax obligations. E.g., by end of the year 1998, the 'Rupert Murdoch's News Corporation' had paid 6% of tax on their global income. Despite of possessing earned profits of £1.4 billions, they had not paid even a single penny as a corporate tax in UK, since June 1987.¹³²
- iv. The MNEs are protagonist to the transfer of business profits to the tax heavens due to tax rewards and awards which include nominal credentials as well as the disclosure policies, no implementation and enforcement of fiscal laws and pervasive corruption.

5.2. Trans-National Operations *at a glance*

Transfer pricing holds a crucial role in taxing architecture. By virtue of income and expenses, TP helps in determining the taxable profits of interlinked entities in multi-tax jurisdictions. The purposes for the execution of TP understandings among the different arms are to enhance the MNE's profits. By ignoring the cost, these prices possess arbitrary nature having following purposes:

- a. To increase, the prices in shape of 'over-pricing' or 'high transfer price' in order to enhance total 'post-tax profit ratio'; and
- b. To decrease, the prices in shape of 'under-pricing' or 'low transfer price' in order to reduce 'pre-tax profit ratio'.

Such type of understandings of the parties is further elucidated by the following case study, (in which all the cases to come are sequel of preceding case).

131 Please refer to supra note 7, 343.

132 Noreena Hertz, *The Silent Takeover, Global Capitalism and the Death of Democracy*, (London: William Heinemann London, 2001), 7.

The Upstream is a subsidiary in the host country having fully controlled by the MNE (i.e. the 'Downstream') in the home state. At the same time MNE is also the head office of the subsidiary. Under an agreement, the Upstream agreed to supply the Laptops to the Downstream. Whereas, the sale consideration, (i.e. price of the Laptop), deems to be the TP. The cost, which is incurred on per Laptop, by the Upstream is \$1000. The corporate tax rates of the host and home country are @ 20% and 60%, respectively.

i. Taxes are Honored: The Upstream supplied @ \$2000 per laptop to the Downstream, which is also referred to the TP. In the said transaction, the Upstream generated the profit of \$1000 on each laptop i.e.,

$$\$2000 - \$1000 = \$1000$$

By further vending the laptop @ \$3000, the Downstream generated the profit of \$1000 on each laptop, i.e.

$$\$3000 - \$2000 = \$1000$$

Table - I

		The Upstream	TP in \$	The Downstream	Total in \$
Description Category	Cost in \$	Host Country	2000	Home Country	Vending Price in \$
	1000				
Pre-Tax Profit in \$		1000		1000	2000
Tax Rate		20%		60%	
Tax Paid in \$		200		600	800
Post-Tax Profit in \$		800		400	1200

Hence, the collective *pre-tax* profit of the both entities is \$2000, i.e.

$$\$1000 + \$1000 = \$2000$$

In accordance with the enabling tax rates of each country, the Upstream and the Downstream have paid tax of \$200 @ 20% and \$600 @ 60% on their

respective profits, respectively. However, the overall tax, which is paid by the MNE is \$800;

$$\text{i.e. } \$200 + \$600 = \$800$$

After paying taxes, the *pre-tax* profit (i.e. \$2000) is reduced than of the *post-tax* profit by \$1200;

$$\text{i.e. } \$2000 - \$800 = \$1200$$

Resultantly, the *post-tax* profit ratio of the Downstream is lesser than the Upstream due to the variations in tax rates and the overall *post-tax* profit ratio accrued by the MNE is 40% of the vending price.

5.2.1. Diminutive Tax Responsibility: As a matter of an accepted principle that the MNEs' transfer their businesses to low tax jurisdictions in order to enhance *post-tax* profit ratio by adopting an over-pricing or high transfer price mechanism.

- Do a Swap:** By keeping in mind the data of preceding table, herein, the TP is \$2800. In this case, the *pre-tax* profits ratio moves to the Upstream instead of the Downstream and the overall tax liability is reduced up to \$480 i.e.

$$\$360 @ 20\% + \$120 @ 60\% = \$480.$$

Table-II

		The Upstream	TP in \$	The Downstream	Total in \$
Description	Cost in \$			Vending Price in \$	
Category	1000	Host Country	2800	Home Country	3000
Pre-Tax Profit in \$		1800		200	2000
Tax Rate in %		@ 20 %		@ 60 %	
Tax Paid in \$		360		120	480
Post-Tax Profit in \$		1440		80	1520

As far as the *pre-tax* profit is concern, it is still unchanged i.e. \$2000. In contrast, the *post-tax* profit is enhanced up to \$1520 (i.e. \$2000 - \$480) from the preceding profit of \$1200.

Hence, the Upstream contributed \$1440 and the Downstream is to \$80, and the overall *post-tax* profit is now 51% of the vending price. By simple increase in TP from \$2000 to \$2800, an MNE enhanced its overall *post-tax* profit from \$1200 to \$1520.

ii. Say No, to Tax: In this case, (by keeping in mind the data of Table-I), the Downstream adopted the transfer/purchasing price as its vending price i.e. \$3000. Now the overall taxes are \$400 and *post-tax* profit is \$1600, which is contributed only by the Upstream. A part from its share in profits, the Downstream contributed zilch in generating profit.

By simple shifting of profits in low tax jurisdiction, the MNE generated more profit than preceding both situations and paid no tax in home state and the overall *post-tax* profit is now \$1600.

Table-III

	The Upstream		TP in \$	The Downstream		Total in \$
Description Category	Cost in \$ 1000	Host Country	3000	Home Country	Vending Price in \$ 3000	
Pre-Tax Profit in \$		2000		000		2000
Tax Rate in %		@ 20 %		@ 60 %		
Tax Paid in \$		400		000		400
Post-Tax Profit in \$		1600		000		1600

5.2.2. Other Maneuvers relating to Diminution of Taxation: In order to enhance *post-tax* profit ratio, the MNEs transfer their businesses to those states which permits admissible expenses against income, such as, high '*depreciation rates*', tax benefits relating to '*set off*' and business losses etc.

i. As a sequel of the previous proceedings, herein, the TP is enhanced to \$4000. In said transaction, the profit accrued by the Upstream is \$3000. Meanwhile, the Downstream fixed its vending price even below the transfer/purchasing price i.e. \$3000 and suffered a loss of \$1000 on per transaction. Consequently, it helps in diminution of taxes even for other profitable operations, which are performed by the Downstream. Resultantly, the MNE had paid overall less tax.

Table-IV

		The Upstream		TP in \$	The Downstream		Total in \$
Description Category	Cost in \$	Host Country	4000	Home Country	Vending Price in \$		
	1000				3000		
Pre-Tax Profit in \$		3000		- 1000		2000	
Tax Rate in %		@ 20 %		@ 60 %			
Tax Paid in \$		600		- 600		000	
Post-Tax Profit in \$		2400		- 400		2000	

By virtue of rebate, the tax liability of the Downstream is diminished. In contrast, the Upstream paid \$600 @ 20% as tax on its profit of \$3000. Thus, the overall *post-tax* profit is \$2000.

ii. Mere overpricing by the Upstream enables the Downstream to claim high tax rebate which decreases its taxable income. In this case, the former accrued a profit of \$4000 and the later bear a loss of \$2000. The Upstream has paid a tax of \$800 on profits while the rebate is claimed by the Downstream.

However, the home country tax laws provided tax rebate of \$1200 and the host country charged tax of \$800. Hence, the *post-tax* profit ratio is increased than all the preceding four situations i.e. \$2400.

Table-V

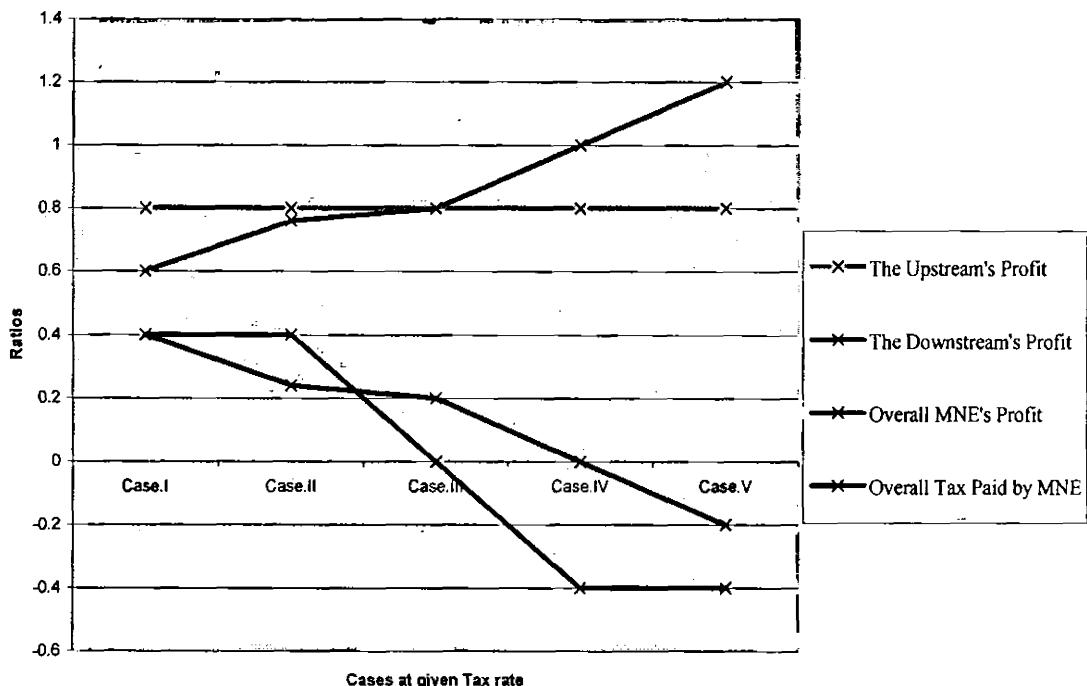
		The Upstream	TP in \$	The Downstream	Total in \$
Description Category	Cost in \$	Host Country	5000	Home Country	Vending Price in \$
	1000				3000
Pre-Tax Profit in \$		4000		- 2000	2000
Tax Rate in %		@ 20 %		@ 60 %	
Tax Paid in \$		800		- 1200	- 400
Post-Tax Profit in \$		3200		- 800	2400

5.2.3. Spectrum Analysis: In order to enhance *post-tax* profit ratio, the MNEs transfer their businesses to different states. The hereinabove case study assayed that mere changes in cost and prices by the entities altered the whole profit texture.

- i. In accordance with data of Table-I, the Upstream sold the laptops with 100% increased cost to the Downstream. By virtue of increased cost, the overall *post-tax* profit ratio accrued by the MNE is 40% of the vending price.
- ii. As per data reported in Table-II, the Upstream sold the laptop with 180% increased cost to the Downstream. By virtue of increased cost, the overall *post-tax* profit ratio accrued by the MNE is 50.7% of the vending price and 10.7% of preceding profit.
- iii. Accordance to Table-III, the Upstream vended the laptop with 200% increased cost to the Downstream. By virtue of increased cost, the overall *post-tax* profit ratio accrued by the MNE is 53.3% of the vending price, which is 13.3% and 2.6% of preceding profit of Table-I and II, respectively.
- iv. Under the Table-IV, the MNE bore a loss but still the overall *pre-tax* profit was retained at \$2000. By virtue of manipulation, the MNE claimed the rebate in the home country and enhanced its overall *post-tax* profit ratio to 66.7% of the vending price and 26.7% of preceding profit in Table-I.

v. As per Table-V, the MNE again bore a loss but still overall *pre-tax* profit was retained at \$2000. By virtue of manipulation, the MNE claimed the rebate in home country and enhanced its overall *post-tax* profit ratio to 80% of the vending price and 40% of preceding profit in Table-I.

Spectrum Analysis



Wherefore, premises considered, the *post-tax* profit of the Downstream is lesser than the Upstream due to the variations in tax rates and the TP. The graph purports that the tax paid by the MNE decreases as the overall MNE's profit increases. It is a result of manipulation of prices and variations in tax rates. Hence, the overall *post-tax* profit ratio of the MNE is maximum from 40% to 80% of the vending price.

Cutting long story short, it can be referred to an inverse relationship between MNE's profit and tax collection from MNE under the circumstances when price manipulation is allowed. The above said diagram purports the trend of tax collection from the MNE and overall profit *thereof*. In fact, the overall profit and tax collection line shows exactly same movement in opposite directions. However, the profit line moves upward and at the same moment the tax collection line moves downward.

Resultantly, at the same time upstream's profit remains constant whereas downstream's profit declines sharply.

5.3. Arm's Length Principle

The open market forces hold a significant role in ordinary course of business. On contrary, in case of *associated enterprises*, such prices are settled by the collective interest forces of the parties. Therefore, the pendulum of such forces swings between the poles of overpricing or underpricing. Under the said scheme, it is prerogative of the parties to determine the ceiling of both poles with their mutual consideration. Resultantly, such determinations are inappropriate, abnormal and unfair. The ALP theory purports as under:

*"the closest approximation of the working of an open market in cases where the property, such as, goods and assets (i.e. tangible and intangible) is transferred or services are rendered between associated enterprises."*¹³³

It is unjust that if the tax authorities on their self-assessment believe that the prices are manipulated by the MNEs. By objective, the 'Arm's Length Price' wipes-out the disparities from the prices (i.e. transfer and market) in order to determine actual market price of same transactions of unrelated parties in independent capacity. The OECD regime defines 'Arm's Length Price' as under:

*"the price which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market."*¹³⁴

The componential analysis of the above definition inculcates the 'comparability features' with respect to transactions, which are to be shown as below:¹³⁵

- i. Property and Services Features:¹³⁶ It includes, for the property of tangible character - its physical features, quality, reliability, availability and the volume

¹³³ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 1.14, 36.

¹³⁴ OECD, *Report on Transfer Pricing and Multinational Enterprises-1979*, Para 2.

¹³⁵ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 1.36, 43.

¹³⁶ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 1.39, 44.

of supply; in case of services - its nature and extent *thereof* and for intangible property - its mode of transaction e.g. licensing or sale, property's type e.g. industrial design, copyrights, its duration and degree of protection and lastly anticipated benefits accrued by property's utilization.

- ii. Functional Features:¹³⁷ In order to determine the 'arm's length prices', it is necessary to consider the functions performed by the associated entities. It includes, assets utilized, significant economic activities e.g. designs, manufacturing, assembly, research and development etc and assumed risks relating to market, investments and interest rate variability etc.
- iii. Contractual Features: The 'arm's length prices' are necessarily being considered in the private law relating to contractual obligations and its legal effects *thereof*.
- iv. Economic Features:¹³⁸ The compulsory elements involve in market comparability are, like for instance, geographic location, size of market, extent of competition, availability of substitute goods and services, level of demand and supply, consumer purchasing power, production cost, date and time of transactions etc.
- v. Strategic Features:¹³⁹ It is true that business norms have great contribution in ascertaining comparability of TP. A corollary aspects provides that the 'arm's length price' establishes on the data available or accessible to the taxpayer at the time of transactions. It includes innovation and development of new product, degree of diversification, risk aversion, assessment of political changes, prevailing labour laws etc.

5.4. TP Correction Methods

By scope, the TP Methods in line with the ALP provides a *modus operandi* for ascertaining the commercial and financial relationships of *associated entities*.

137 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 1.42, 45.

138 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 1.55, 48.

139 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 1.59, 50.

Primarily, TP methods have dichotomy, such as 'Traditional Transaction Method' and 'Transactional Profit Method'.¹⁴⁰

5.4.1 Traditional Transaction Method: By virtue of transactional analysis, it facilitates to ascertain the variations which occurred in the prices of controlled and comparable uncontrolled transactions of commercial and financial relationships of associated entities. In fact, the ALP provisions provide assistance in event of altering the prices in the comparable uncontrolled transactions from the prices of controlled transactions. However, the 'Traditional Transaction Method' and 'Transactional Price Method' are synonyms of each other and further classified as under:

- i. **Comparable Uncontrolled Price Method:** Under this method, it is expedient to compare the prices, which are transacted among related enterprise under the controlled and uncontrolled transactions in comparable status. These transactions occur among the entities of same organization or with the third party and among two independent third parties. In case, the price variations occurred in the transactions (i.e. controlled and uncontrolled), this means that the TP matured among the enterprises are not in line with the ALP. The process of comparability holds internal and external factors. The internal operational factors regarding transactions of *associated enterprises* within MNE or with unrelated third party are called 'internal CUP' or 'internal price comparison'. In contrast, the external operational factor relating to the transactions among the unrelated third parties having no nexuses with an MNE is called 'external CUP' or 'external price comparison'.¹⁴¹ The *pros* and *cons* of the CUP are as under:¹⁴²
 - a. The CUP has significance that no variation occurred among the controlled and uncontrolled transactions as well as with open market price.
 - b. The CUP provides correct adjustments in order to remove differences.

¹⁴⁰ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 2.1, 59.

¹⁴¹ Roy Rohatgi, *The Basic International Taxation*, (Kluwer Law International, 2002), 415.

¹⁴² OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 2.14, 63.

- c. The 'Comparables' are pivot for the CUP but antagonized in case of immense transactions among intra-group.
- d. Apart from the end-users, the MNEs do not incline towards the disparate business concerns e.g. intangible properties, petroleum industries etc. In the said point, an element of comparables with regard to intermediate transactions is unusual.
- e. Apart from the MNEs distinctive business architecture, it is difficult to ascertain accurate comparables and does not apply on the transactions of semi-finished goods which require the value addition.

ii. **Resale Price Method:** By objective, this method is expedient to determine the prices, which are paid to the related entity by the reseller against the purchase of a product and further vended it to an unrelated entity. In accordance with the provisions of this method, it is mandatory to settle the buying price in such a manner that the margin accrued by the reseller should be composed of vending and operational costs along with profit *thereon*. Hence, the price at '*arm's length*' for the transactions among related entities is the remainder which obtained after the subtraction of the gross margin along with relevant adjustments connected to the procurement, such as, custom duties. It is effective in transfer of refined goods as well as in absence of goods comparables and not any sort of value addition, prior to resale, by the liaison. Following are the some basic aspects which contributes in ascertaining an appropriate mark-up, such as:¹⁴³

- a. The operational value along with the risks taken and expertise needed by the liaison;
- b. An addendum with respect to IPRs, such as, Patents;
- c. The liaison enjoys an exclusive sale rights; and
- d. The comparable 'mark-ups' on same transactions among unrelated entities.

The drawbacks of the Resale Price Method are as follows:

¹⁴³ Alan W. Stroud and Colin D. Masters, *Transfer Pricing*, (Butterworth's London, Dublin and Edinburgh, 1991), 43.

- a. It is not effective, in case, when the liaison indulged in an activity of value addition prior to further vending.
- b. In event of delay or time gap occurred between the buying and reselling along with certain market changes leads to troubles.
- c. It has an erroneous kick-off, in such event when the final price is enhanced by an artificial mode for an ulterior motives e.g. monopoly.

iii. **Cost Plus Method**: By scope, the CPM is utilized to determine the price, which is incurred on the property or services by the vendor or purveyor and suitable profit accrued *thereon* in line with the market forces. Resultantly, this is achieved by the addition of markup on costs lead to 'Arm's Length Price' of controlled transactions. It is an appropriate mode of transaction for the partly-completed products, services as well as long-standing vending and purchasing arrangements.¹⁴⁴

5.4.2 Transactional Profit Methods: By virtue of this approach, it efficiently examines the profit accrued from specific transactions with respect to commercial and financial relationships of related entities. The OECD-TAG refers this method to as 'Transactional-Based Profit Methods' which determines the Arm's Length Price. It further classified as under:

- i. **Transactional Net Margin Method**: Conceptually, it is used to ascertain the profit, which is accrued from the controlled transactions occurred among an associated entities on a fraction base, like for instance, sales, cost or assets.¹⁴⁵ Simply, it is the ratio among the profit, which is accrued from the controlled transaction having some base, such as, sales, assets or capital is determined e.g. profits to the sales and assets ratio.¹⁴⁶ However, the TNMM under OECD-TPG contrast the net profit margin of controlled with uncontrolled transactions but the former does not suggest fore-scheme because this leads to the contrast of transactional basis net margins at eleventh hour i.e. the places where

¹⁴⁴ Chris Adam and Peter Graham, *Transfer Pricing: A UK Perspective*, (Butterworth's London, Edinburgh and Dublin, 1999), 21.

¹⁴⁵ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 2.58, 77.

¹⁴⁶ Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, 2nd ed., (Kluwer Law International, the Hague/London/New York, 2002), 66.

*"transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all."*¹⁴⁷

By hierarchical application, the transactional approach holds preference on the profit based methods. The OECD regime provides a 'hierarchy of results' which would be in comparison with the United States 'best method rule', which is implemented for excellent representation of these approaches regarding the TP. This method also provides support to the transfer of partly-finished and finished products and in rendering of services in event of none application of RPM. The *pros* and *cons* of the TNMM are as under:¹⁴⁸

- a. The net margin holds minimum influenced by the transactional discrepancy than to the price in CUP as well as margin in RSM.
- b. No requirement of functional determination regarding performance as well as assumed risks and simplicity in its nature i.e. in controlled transaction only analyzes single party.
- c. No access of information regarding comparable transactions by the taxpayer.
- d. Easily manipulated by tax administrations and their subjects as preferred by selecting the suitable comparable entrepreneurs in this regard.

ii. **Profit Split Method:** Under this method, the total global income accrued by means of controlled transactions that carried-out by an associated enterprises from their joint economic activities are computed. Later on which distributed according to their respective share. Under the OECD regime, there are two different approaches with respect to splitting the profits, which are as under:¹⁴⁹

A. **Contribution Profit Split Analysis:** It analyze the qualified input in profit by each member of a controlled group, which is accrued from an

¹⁴⁷ Jinyan Li, *Transfer Pricing Methods, International Taxation in the Age of Electronic Commerce: A Comparative Study* Chapter 1, 110.

¹⁴⁸ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 2.62-2.65, 78 & 79.

¹⁴⁹ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 2.118, 96.

integrated transactions and valued on the footing of the activities and risks undertaken by each member. However, the joint profits are distributed between the members of the controlled group on the *pro-rata* basis with respect to their shares.

B. Residual Profit Split Analysis: It analyzes the joint profits of the controlled group due to having a shared economies of scale or the group's owned unique and valuable assets. It examines in two phases:

*"initially each member of the controlled group is allocated sufficient profit to provide it with a basic return appropriate to type of transactions it undertook (primarily measured by traditional methods). Secondly, calculating residual profits based on analysis of how it might have been allocated among independent enterprises."*¹⁵⁰

According to the OECD-TPG the functional analysis of entities must be in consideration while ascertaining their share and evaluation on the basis of external market data. However, it is contrary to the 'unitary taxation form' wherein profit allocation between entities of MNE is based on a *pre-determined* formula which evolves around the numerous factors of production such as assets utilized, manpower employed, sales etc but ignoring the ALP.

The PSM possess some advantages, which are as under:¹⁵¹

- a. It elucidates the highly integrated operations where one sided approach is not suitable. It holds a specific and unique factors, which are present in MNE but absent in comparables of independent enterprises.
- b. Both the parties in transactions are analyzed properly which erase the factors of unrealistic profit.

In real sense, the application of the PSM is difficult because it is less direct and less reliable than the traditional methods as well as not an easy to

¹⁵⁰ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 2.121, 97.

¹⁵¹ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Paras 2.109 to 2.113, 93 & 94.

determine the allocation of cost to the property and services rendered in controlled transactions among related parties.¹⁵²

5.5. Advance Pricing Agreement

The APA is a *modus operandi* which articulates to resolve the row relating to TP among the taxpayer(s) and tax administration in anticipation. In fact, the conventional administrative, judicial and treaty architecture regarding solution of TP matters are appendage by the APA.¹⁵³ It also assists in solving the row arose by Article 7 of the OECD-MC, like for instance, PE, allocation problems and branch operations.¹⁵⁴

It is pertinent to refer here that the APA under the TPG may be formed in unilateral and bilateral or multilateral modes. In event of analyzing the Arm's Length Price among the single tax administration and its subjects lead to unilateral APA and by mutual agreement, among the competent tax authorities of two different tax regimes lead to a bilateral APA. The TPG strongly recommends that:

*"wherever possible, an APA should be concluded on a bilateral or multilateral basis between the competent authorities through the mutual procedure of the relevant treaty."*¹⁵⁵

Prior to all, the United States presented the APA procedure in 1991, which was later on adopted by rest of the nations.¹⁵⁶ Pakistan introduced the said concept under section 206 -A of the Ordinance having titled as 'Advance Ruling'.¹⁵⁷ It possess the ability to eliminate the elements of uncertainty, to reduce the compliance cost, provides a deliberate opportunity in complex tax issues along with amicable solution and erase issues of double taxation in less possible time frame.¹⁵⁸ Parallel to abilities,

152 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 2.114, 95.

153 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 4.123, 168.

154 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 4.131, 170.

155 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Para 4.162, 178.

156 Chris Adam and Peter Graham, *Transfer Pricing: A UK Perspective*, (Butterworths London, Edinburgh and Dublin, 1999), 45.

157 Finance Act 2003, which is available at fbr.gov.org.

158 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Paras 4.142-4.145, 173-174.

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certain issues disable the application of APA, like for instance, unpredictable market conditions, clash on APA findings relating to numerous transaction, absences of corresponding among the multi-tax administrations and counterfeiting in APA conclusions.¹⁵⁹

¹⁵⁹ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- 2010*, Paras 4.147 - 4.150, 174 - 176.

Chapter 6

Built-in Flexibilities

Adam Smith had been profoundly believed that "*every tax ought to be levied at the time or in the manner, in which it is most likely to be convenient for the contributor to pay.*"¹⁶⁰ By objective, the DTAs circumvent the double taxation of income which accrued from the trans-border economic transactions. In fact, law concentrated on the issues, which are associated with the prevailing scenarios. In order to grant tax 'rewards and awards' to the entities, the developing states adopted the mechanism of 'Foreign Tax Credit', which also envisage 'Tax Sparing Credit'. The UN regime is penchant to the lacunas in foreign tax credit mechanism while providing partial relief incentive to the entities, which are otherwise subject to low or nil taxation in the host states. Generally, the tax relief granted by the states is subject to provisions of its overall taxing policy in line with the taxation architecture. It is significant to report that DTAs provides an accommodating mechanism for unification of dissimilar taxation system for mitigating the double tax issues.

6.1. Tax Awards and Rewards

Article 23 of the Model Conventions inculcates the taxation relief incentives, which includes; exemption and credit method. The said provision regulates the issues, which are relating to residency and source states. Like for instance, when the resident person of one signatory state earns an income from the other signatory state (i.e. source state), wherein he is not a resident as per definition of Model Conventions but his income is subject to tax in such other state. Mostly, the resident states (including Pakistan) imbibe to provide tax credit for the taxes paid in the other states. By towing the similar line, the USA grants tax credit only for the tax, which is actually paid by its resident enterprises on income abroad. In fact, national laws have no so long arms in order to extend credit for tax payable in the other state(s) but only to grant exempted/waived as part of national policy. In contrast, the states, like the Netherlands and the other West-European states, imbibe to provide tax exemptions on foreign source income of their resident enterprises, which are investing abroad. In

¹⁶⁰ In The Wealth of Nations, Book V Chapter II Pt II, p. 826, Para. 5.

recent years, almost all developed countries incorporate a sunset clause in their tax treaties as to the application of 'Tax sparing Provision'.

6.1.1. Exemption Method: The underlying principle of this method purports that the resident state imposes partial or nil income tax on income, which is tax subject of the source state or the state wherein the relevant enterprise or person maintains PE or fixed base (FB). Furthermore, this principle is bifurcated with respect to its applicability, which is hereinbelow:

- i. Full Tax Exemption: By virtue of this method, the state of residence grants an exemption to the income from taxation, which is tax subject of source state in either case, while determining the rest of income for taxation purposes.
- ii. Exemption with Progression: The state of residence provides exemption to the income from taxation, which is tax subject of source state in either case. But the said state retains the right to consider tax income while determining the rest of income for taxation purposes.

6.1.2. Credit Method: The underlying principle of this method inculcates that the total income of taxpayer will be calculated by the resident state including the income, which is tax subject of the source state or the state that maintains PE or FB. Under this method, it is allowed to deduct afterwards from its own tax for the tax paid in the other state. Furthermore, this principle is bifurcated with respect to its applicability, which is hereinbelow:

- i. Full Credit: The deductions are allowed by the resident state with respect to the amount of total income tax paid in the other state although, which is a tax subject of later state.
- ii. Ordinary Credit: The deductions are controlled by the resident state with respect to the amount of tax paid in the other state to the extent of its own tax, which deems to be tax subject of later state.

6.1.3. Tax Sparing Credit: An impressive development in technological sector compelled the tax authorities to revise their taxation architecture. Primarily, in 1957, the provisions of Tax Sparing were introduced in the treaty between United States and Pakistan, which was later on rejected by the US Senate. In general parlance, the Tax Sparing mechanism includes the reduction of tax in source state as well as fixation of

the amount of 'deemed paid' WHT on passive income. The Rule 19-C of the Rules provides the concrete procedure for obtaining certificate of Tax Sparing Credit.

Under the tax sparing method, the developing states provide assurance to the developed state regarding the exemption from tax incentives normally in form of tax holidays. Furthermore, this principle to be claimed by satisfying certain criteria, which is hereinbelow:

- i. The presence of PE is compulsory in the state coming up with tax incentives i.e. tax holidays.
- ii. The tax sparing credit would be only for those incentives, which are provided by the DTA. However, the period of tax holidays or other incentives must be in line with determined period.
- iii. These provisions does not attract the government interest nor to exporting companies.

6.2. Exchange of Information

By scope, information holds an important source in digital age and particularly, in taxation perspective, just like a 'stock-in-trade'. It is true that gathering of information is a difficult assignment regarding operational activities of trans-national business concerns. Undoubtedly, the geographical distances and enforcement of national tax laws are the difficult elements regarding gathering of information relating to the tax subjects. However, unilateral tax legislations resolve these issues through exposé of relevant information by MNCs and implementation of concrete rules relating to income reallocation in events of failure of utilizing ALP. It is pertinent to refer here that the 'transparency' and 'exchange of information' are co-related ideas. Significantly, 'exchange of information' becomes more effectual when clubbed with regulatory structure, existence of relevant and reliable information and capabilities of states in gathering of informations.

The expression "Taxes Covered" as enunciated in Article 1 / 2 of Model Conventions contemplates as well as classifies the term 'Exchange of Information' as provided in Article 26 of the Model Convention. In order to cooperate, the States extend this concept to other taxes as well. In case of Pakistan, pursuant to Section 216 (3-q) read with Section 107 of the Ordinance, the authorized person may disclose the

information relating to taxpayer to foreign tax authorities. This provision is in line with the Article 26 of the Model Conventions, which is based on reciprocity principle. Like for instance, clause 5 of multilateral agreement, which is signed between Pakistan and Saarc States.

Pursuant to the bilateral / multilateral tax treaties, 'Exchange of Information' is a tool, which is utilized for the prevention of fraud and evasion of taxes. The provisions for the exchange of information are necessary for carrying out the provisions of Model Conventions as well as national laws of the signatory states. Notwithstanding what is mentioned above, law antagonized to such information, which is contrary to the public policy, sovereignty and protection of vital interests of the States and even when requested for disclosure of trade and processes, business, industrial, commercial or professional secret. It is worthy to note that national laws purport secrecy provisions and supply of information leads to infringement of respective secrecy provisions.

In treaty perspective, information supplied would be fully protected and disclosed only to the authorities concerned for the tax assessment or collection, and purposes, which are covered by a treaty. Therefore, following pre-requisites must be followed by the states while making request to its counterpart.

- i. Provide assurance to the sending State, *inter alia* with the secrecy provision, that the received information will be used only for tax purposes; and
- ii. Follow the administrative as well as legal norms of both States, in event of information as a variety nature and whose supply needs administrative measures.

6.2.1. Modes of Exchange of Information: In fact, law does not elaborate the modes of exchange of information. In general parlance, the information is transmitted by routine/automatic transmittal, on request, on discretionary initiative of transmitting State and on mutual consultation among the authorities.

- i. Routine/Automatic Transmittal: It is a routine mode of exchange of information which takes place among the signatories relating to different categories of income such as dividends, interests, remuneration, royalties and rents, etc. This mode of exchange encompasses transactions relating to treaty

itself, special legislation as well as administrative aspects of transmitting state
and economic relations of both states.

- ii. Transmittal on Request: In this mode of exchange of information the signatory make a request to its counterpart to provide information relating to particular taxpayer, such as, certain situational and activity aspects, specific transaction or any ordinary character information. Pursuant to the request, the requesting country should provide the cogent reasons for asking the information along with detailed bio-data of the taxpayer (if available) to its counterpart which enables the other to understand the underlying cause of investigations.
- iii. Transmittal on Discretionary Initiative of transmitting State: This mode is based on the discretionary initiative of competent authorities of transmitting country. The information relates to a particular facet of a taxpayers' situational and liability aspects with respect to recipient country as well as other taxpayers, specific mode of transactions or conduct thereof. It contains sufficient information which identifies and locates the foreign client along with attachments of supportive documents.

6.3. Dispute Resolution Mechanism

The row among the subjects or the subjects and the governing bodies, (as the case may be), is common feature of the society. In order to amicably resolve the disputes, which accrue between the parties, Article 25 of the Model Conventions on "*Mutual Agreement Procedure*" provides a concrete mechanism for this purpose. Simply, it is a remedy, which is available to the tax subjects and would be availed on the occurrence of individual/collective grievance(s). The MAP architecture provides a medium regarding the grievance(s) relating to the resident persons of the States in events of non-compliance of treaty provisions as well as a mechanism for eliminating double taxation, which is not covered by the Convention. It is pertinent to refer here that the MAP is extensively utilized for the resolution of complexities which arises due to the unacceptable (disputed) application of DTAs with respect to taxpayers' affairs.

In events of non-compliance of the Convention provisions, the taxpayers can opt for litigation in both States or go for the MAP having objectives of amicable solution of

dispute by the competent authorities. In order to eliminate double taxation, the process of mutual consultation is generally invoked in the issues hereinbelow:

- i. Issues relating to the TP and residency of tax subjects;
- ii. Issues relating to existence of PE as well as profits attributable thereof;
- iii. Issues relating to sources of income and its allocation;
- iv. Issues relating to international traffic with respect to application of profit article to leasing thereof;
- v. Issues relating to applicability of non-discrimination article;
- vi. Issues relating to interpretation of Model Convention provisions; and
- vii. Issues relating to interpretation of treaty provisions which provides matching relief for tax spare.

Notwithstanding the remedy provided by the domestic legislation, under Article 25 of the Model Conventions, the taxpayers are entitled to exercise the remedy of MAP. It is correct that the competent authority's procedure is not a substitute to the remedies available under national legislation for redressal of grievances. But it is an additional service, which is provided by the authorities in order to resolve the issues of double taxation under the treaties. In accordance with the said provision, the grievance application is moved before the competent authorities of a signatory state of which the person is a resident and it is duty of the competent authority to resolve it. In case, the competent authority of the signatory fails to meet the ends of justice in captioned matter then the said matter will be referred to its counterpart for satisfactory solution thereon. If an aggrieved person is not satisfied with the orders/acme of the case, he may opt for the appeal under its national tax legislation. The time limitation factor is pivot in the MAP proceedings i.e. the time limit in which the procedure is invoked and time limitation of domestic legislation of signatories that may intervened by the competent authorities to give effectuality to results achieved.

By virtue of lackness of satisfaction, sometimes the courts are not inclined to make the decisions of competent authorities as rule of court. The courts of Belgium, Sweden and England have held that the courts must interpret the treaty provisions independently irrespective of any mutual interpretation.

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In line with the international efforts, the Ordinance of Pakistan also envisages legal nomenclature in events of row among the parties on trans-national taxation matters. The aggrieved party may institute an application before the court of first instance i.e. Tax Commissioner appointed by the Federal Board of Revenue for redress of grievances. In event of unsatisfactory findings by the court of first instance, the aggrieved party opts for the Appeal before the Income Tax Appeal Tribunal.

Chapter 7

A Practical Insight to Cross Border Business Taxation

*"The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person..."*¹⁶¹

Adam Smith

At present, Pakistan has fifty seven operative DTAs encompassing developed and developing countries in all regions of the globe. Almost all these DTAs, with the exception of those with the USA and Japan which await revision for over several decades, are modeled around the UN-MC.

Before proceeding further, it is imperative to reiterate that taxation is an unbiased phenomenon, whose use or abuse (deliberately or otherwise) composes it an innocuous commercial practice or cognizable offence. Aeon of the corporate history demonstrates that the business concerns penchant to reduce their taxes. In fact, they does not deliberately swindle tax administrations but through the acceptable practices, similar as those in line with acceptable administrative or commercial practices.

Taxation system must be planed with attitude to tax, prepare with aptitude to collect taxes, and participate with servitude or alacrity to pay taxes.

- i. Planning with attitude to tax is pivot in the state's economy, which is measured by the tax-to-GDP ratio having base on the type of government and nature of the state, the role it wants to play in the individual life of its citizens, the type of economy, etc.
- ii. In order to prepare with aptitude to collect taxes are the blend of law and tax administration. However, the best tax policy leads to a failure if not implemented in an appropriate manner. In Pakistani perspective, presently, the tax-to-GDP ratio hovers between 9 – 10%, well below the prospective of 60% increase in revenue at the current GDP level.

¹⁶¹In The Wealth Of Nations, Book V, Chapter II, Pt II, p. 825, Para. 4.

iii. Participation with servitude or alacrity in order to pay taxes is essentially a political question. In fact, a major chunk of legislatures does not bother to pay any sort of tax but they are yearning for 'others' to do so. However, the 'others' are not selected on the basis of their ability to pay taxes but because of their lack of ability to resist unfair taxes.

The preceding study dilated the 'International Aspects of Taxation of Business Income' with reference to the Model Conventions read with the Ordinance while keeping in view the effects of economic globalization. Similarly, the preceding study assayed that the Pakistani taxation system, to large extent, is in line with the international practices as well as changing economic scenarios. It is pertinent to refer here that the rules under Pakistani legislation regarding enforcement of procedures and practices relating to international tax provisions are, however, have mostly not been prescribed. Absence of Guidelines on 'Inter-company Transfer Pricing' is on significant example. While most countries issue '*Implementation Guidelines on DTAs*', these do not exist in case of Pakistan. Consequently, the enforcement of international tax provisions under Pakistani legislation and the DTAs are at the 'sweet will' of the tax authorities which creates extensive litigation proceedings before the adjudicator fora and dispute resolution among the treaty partners.

Under Article 3 of the Constitution of the Islamic Republic of Pakistan 1973, it is incumbent on the State to eliminate the exploitation among the subjects of Pakistan. It is also mandatory for the State to ensure an execution of the fundamental principle i.e. "from each according to his ability to each according to his work". By objective, the said provision envisages the intent that the crucial goal of the State is the welfare of the masses along with the advancement of whole community. Alas! Contrary to the said fundamental principle the GoP does not succeeded in developing a rational taxation system.

The latest round of reforms was started in the initial years of the preceding decade. Among volley of questions, it is an important query that whether the said reforms are perceptible in shape of change in the institution of FBR or not? A lot! The aid under the aegis of myriad financial regimes consumed on the training of the bank officers, luxurious cavalcades form home-office-home, and web browsing for social networking. It is a matter of fact that the facilitation of the workforce is a convivial step, but for what? By objective, it enables the workforce to achieve fair taxation,

which could generate enough resources for the national welfare. Again, have the FBR achieved their goal? Are they on the right path to achieve it? Alas, the answer is a big 'NO' having bold 'N'.

The FTO reported to believe that in year 2010 they received 1446 individual complaints against the glitches of the FBR. Whereby, 87% (i.e. 1261) of the complaints were decided by December 31, 2010, wherein 83% was in favour of the taxpayers. In 2009 PKR94 million was refunded in 231 individual taxpayer complaints but PKR1, 972 million was refunded in 2010, which is more than 21 times than preceding year. The averments made by the FTO, while quoting these figures, that the problem is systemic which requires concrete policy measures on the part of the FBR. However, the FBR has become more lethargic and the lethargy is inbuilt in the tax law.

The aptitude of DTAs is to provide a decent level of certainty to fiscal environment to the FDI across tax jurisdictions. However, several other factors to finalize the DTAs include the monetary, fiscal, social and other important policies of the signatories. These objectives are proposed to be achieved through various essential components of the DTAs, which are briefly analyzed along with recommendations below:

- i. Residency of Person;
- ii. Income and Sources thereof;
- iii. Permanent Establishment;
- iv. Activities in Digital Age;
- v. Taxation of Business Profits' Allocation;
- vi. Transfer Pricing;
- vii. Built-in Flexibilities;
- viii. Exchange of Information; and
- ix. Dispute Resolution Mechanism.

The significant aspect of these essential components is that the issues manifested by the economic globalization, undoubtedly, do not provide an easy solution particularly relating to herein above elements in digital age. However, the challenges intensified by the 'Clicks and Mortar' business concerns (i.e. international financial market and

e-commerce) are composed of conceptual and practical issues. In the ever changing economic and social scenarios, the significant flaws regarding international concepts relating to scope and definitional aspects of *residency*, *geographical source of income* and *accounting rules for the determination of taxable profits* are, easier said than done, to align with the economic globalization. At present, the enduring efforts which are in the pipe line of international forums, for instance IFA, OECD and UN, strive to overt the most optimal and appropriate solutions for such issues.

Notwithstanding that Pakistan has regularly participated in international forums like IFA, OECD and UN, FBR has not articulated guidelines regarding the systematic and unswerving execution of DTA procedures and practices. It is therefore imperative aspect of our recommendations to prescribe the comprehensive Rules and Regulations for appropriate and seamless enforcement of international taxation provisions contained in Pakistani legislature as well as the DTAs.

7.1. Epilogue

7.1.1. Residency of Person: Section 82 of the Ordinance read with Rule 14 of the Rules purports the 'Period of Stay' (i.e. 183 days) relating to '*Resident Individual*' for tax proceedings. In fact, the text of these provisions does not dilate the counting mechanism of 'Period of Stay', particularly, the '*first and/or last*' day(s) of stay for an Individual presence in Pakistan. The Commentary to the OECD/UN MC, however, clearly explains that both the first and the last day(s) of stay are to be considered towards counting the 'period of stay' in respective treaty countries. Hence, the following recommendation.

- i. Recommendation: The counting mechanism regarding 'Period of Stay' should be clearly dilated with words like 'inclusive of both days' in the text of Rule 14 of the Rules. In fact, this will remove the disparities or conflict, if any, between the national and international provisions and subsequently minimizes the inducement for interpretation of statute(s).

The "*doctrine of tie-breaking*" (i.e. "Permanent Home", "Habitual Abode", "Centre of Vital Interests" and "Effective Place of Management") is stipulated in Model Conventions. In Pakistani legislation, interpretation of terms included in the "*doctrine of tie-breaking*" with respect to DTAs is blurred. Contrary to the national statute wherein the term '*control and management of affairs*' relating to the company is

enunciated for the purposes of determining 'corporate residence', most Pakistan DTAs incorporate the concept of '*effective control and management*'.

ii. Recommendation: The above being important aberrations, need to be resolved in line with the requirements of economic globalization. Undoubtedly, failure to resolve the above stated issue has the potential to depart from the relevant provision of the internationally accepted notions regarding the 'corporate residence' particularly where Pakistan, in the absence of DTAs, resorts to the application of domestic law provisions.

7.1.2. Income and Source thereof: The provisions of section 101 of the Ordinance have the inherent potential of being misinterpreted because of their vagueness. Thus, the need to review these provisions in order to avoid double non-taxation of income from cross border transactions.

7.1.3. Permanent Establishment: The subject matter of PE is provided by section 2 (41) of the Ordinance and Article 5 of Model Conventions. It aims at clearly delineating the level of presence and the extent of activities of a non-resident enterprise in a state to entitle that state to tax the income generated by these activities therein. As also to ultimately eliminate the chances of double taxation as well as highlighting permanence for execution of business activities this enables the states to negotiate thereon. For this purpose, both the Ordinance and DTAs clearly identify the form and type of activities which render an enterprise constitute PE.

While the examples of the 'form of business' clearly constituting PE are contained both in paragraph 5 (2) of the OECD-MC, UN-MC and all Pakistani DTAs modeled thereof, the provisions of activities-related PEs generally differ particularly in terms of the 'period rendering such activities as PE' in the Ordinance, model treaties and Pakistan's DTAs i.e. varying from 3-12 months within a fiscal year or the duration for completion of the project. The type of activities covered under the relevant provisions also differ in so far as they may or may not encompass the entire spectrum of activities like construction, installation, assembly projects and the management, supervision and/or personnel training.

The PE definition as provided under the Ordinance also shares some of the provisions of Article 5 of DTAs but the terms like *the maintenance of warehouses* and *agricultural cultivations* etc. are missing therefrom.

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Such kind of situation creates major conflict in the taxing provisions in the national laws and the DTAs. However, the DTAs does not legislate the law; absence of these provisions from national statute renders the treaty provisions redundant. Hence the need to reconcile the provisions of the Ordinance with the relevant DTA provisions in case GoP is serious in taxing the income arising from activities terms like *the maintenance of warehouses and agricultural cultivations* etc.

There are several other issues relating to PE, which is analyzed herein below:

In activity type PE, factor of coherence does not exists regarding the time threshold provided by the Ordinance under section 41 (c) relating to "*a building, construction or installation of project*" and the DTAs' provisions to which Pakistan is party. Some examples of inconsistency between the provisions governing time length of PE activities are herein below:

Srl. No.	State	Building Site or Construction Etc.	Service Activities
01	Austria	<i>"If it lasts more than 6 months".</i>	
02	Belgium		Six Months
03	Canada	<i>"More than 3 months"</i>	<i>"More than 3 months"</i>
04	China	<i>"Continue for more than 6 months".</i>	
05	Finland		Six Months
06	France	<i>"Continues for more than 183 days".</i>	
07	Iran	<i>"Continue for more than 12 months"</i>	
08	Italy		<i>"More than 1 Month"</i>
09	Morocco	<i>"Lasts more than 6 month"</i>	<i>"More than 1 Month"</i>
10	The Netherlands		Four Months

Again in activity type PE, complexities are natural with respect to taxation of multiple sites or agreements having divisible character because law does not provide coverage to the activities relating to offshore services and supplies of equipment. In Pakistani perspective, business income of a non-resident person(s) is subject to taxation if a person holds a PE and income accrued therefrom should directly or indirectly attributed to the activities thereto. In the absence of *force of attraction* clause in the DTAs, it is rather difficult to determine the PE taxation when PE is merely present in Pakistan. In such cases, the taxpayers approach the matter in a manner that their PE has not actually participated in the activities relating to offshore services and supplies; hence, they are not subject of taxation in Pakistan.

According to the UN Commentary, an identification of several contracts is permitted if the contracts "*form a coherent whole commercially and geographically*". In line with this phenomenon, according to the tax administration of Pakistan, the agreements are coherent whole commercially and geographically in the form of concrete document which also bounds the non-resident person before the tax authorities for their offshore supplies. In case of fore-issue, the elements relating to offshore and onshore activities are clubbed in an agreement and breach of any one of them leads to the breach of the whole agreement.

In asset type-PE, the location is based on spatial and temporal permanence that determines a '*fixed place of business*'. It possess linkage between '*place of business*' and a '*specific geographical point*' e.g. petroleum oriented business. However, it is matter of fact that impact of force of attraction theory is prominent in Pakistani legislation. All the auxiliary business activity of non-resident taxpayer performed through PE in Pakistan shall be automatically allocated to that PE. However, the DTAs to which Pakistan is party do not provide coverage to the force of attraction theory – yet another departure from the national laws..

- i. Recommendation: The disparities between the national and international practices regarding 'Time Threshold' should be removed, so that the inducement for interpretation of statute(s) and litigation is minimized.
- ii. Recommendation: The DTAs provisions ought to preferably provide coverage in line with the concept of *force of attraction* theory – if not full force of attraction, at least *partial force of attraction* principle thus bringing into tax

net income arising from rendering of activities or sale of goods substantially similar to those carried out or goods sold by the PE.

- iii. Recommendation: The Rules should be drafted to topple issues like taxation of onshore and offshore activities in line with commentaries thereon as provided by OECD and UN.

7.1.4. Activities in Digital Age: Undoubtedly, the '*clicks and mortar*' activities gripped the world business environment. The prevailing Pakistani taxation regime is equipped to tackle the '*bricks and mortar*' transactions having tangible character and authorities do not possess required information regarding their subjects of digital age. The internet possesses an unfettered and anonymous character which facilitated the tax evasion or tax avoidance.

- i. Recommendation: It is dire need of the present time that clear rules regarding quadruple areas of taxation relating to e-commerce, particularly to ISPs and web site hosting facilities in Pakistan should be drafted.
- ii. Recommendation: The discussion on taxation issues relevant to e-commerce in contrast to that related to international banking is rather scanty, which requires a more detailed discussion on the said topic. A comprehensive study is therefore recommended.

Primarily, asset allocation with respect to a PE is similar for all other businesses. Despite establishment of foreign subsidiaries, PE is preferred by financial markets for the smooth unfettered flow of their business. In fact, this can easily entertain the statutory requirements which are formulated by the national financial authorities. It is a matter of fact that financial markets possess an *entrée* to financial resources and *pivot* in implementation of tax avoidance rules in actual 'spirit along with the letter of the law'.¹⁶² By objective, the statutory rules protect public-at-large as well as maintain integrity of economic structure in a transparent manner which helps in accountability process.

¹⁶² See, Article "Code of Practice on Taxation for Banks"- having File : URL: <http://www.elexica.com/briefdoc.aspx?id=7564&code=18df8d4a08241a05>, which was accessed on 5th February, 2011.

iii. Recommendation: In order to mitigate the assumed risks, it is mandatory for the government to regulate the financial architecture by purporting high standard professional services for it's strengthening and 'regulatory capital'.

It is generally true that the financial market tend to comply with the obligations to maintain reserves with regards to non-performance of loans and safe investment of 'regulatory capital' i.e. government bonds. However, jurisdictional issues may be created by fluctuation in regulatory provisions among tax authorities because there are possibilities regarding financial assets reserved for accounting purposes does not possess the same jurisdiction. It creates allocation issues for tax authorities as well as its subjects. Generally, the banks generate profit by utilizing the interest spread on incoming and outgoing interest payments, which can be increased by maintaining lending and borrowing mechanism. It impliedly means a bank also utilizes its own financial resources i.e. 'free capital'. However, an amount and allocation of 'free capital' to PE may create dispute between the tax authorities and tax subject.

iv. Recommendation: It is quintessential for the 'Banking Products' to be dilated in line with economic globalization because both the national statute and DTAs are silent thereon.

The provisions relating to 'Turnkey Projects' in the Ordinance as well as most DTAs are silent or, at best, treat income accruing from both the supply and service, assembly and installation components of these projects sourced in the host country. On the contrary, several of the recent DTAs treat income accrued from the supply component sourced in the country where the 'plant, machinery and equipment is designed and fabricated.

v. Recommendation: The underling principle in agreements having divisible character regarding activities relating to offshore services and supplies is the execution of turnkey project. However, may authorities formulate clear rules governing the turnkey projects to avoid unnecessary enforcement issues or for that matter discourage in-flow of desired level of investment.

7.1.5. Profit Allocation: The provisions under Pakistani law relating to the allocation of business profits by adopting the '*separate entity approach*' is contrary to the generally accepted principle underlying DTAs.

Pakistani DTAs provide multiple approaches regarding the taxation of air and shipping profits, such as taxation in the country of residence, or country of source, or sharing of tax between the two states. It is pertinent to refer here that post-1980, all the DTAs to which Pakistan is party follow the 'presumptive basis' of taxation which was otherwise incorporated in the national taxation law through the Finance Act 1980. DTAs concluded prior to such enactment, followed the 'net basis' of taxation which is reported to have not been yielding much revenues to Pakistan on income of air and shipping enterprises operating through Pakistan.

Thus, the element of controversy is eliminated where the treaty partners follow the '*presumptive basis of taxation*' but controversy may arise where the signatories to the DTAs follow the 'net-basis of taxation' of such income.

- i. Recommendation: In the recent years, 'presumptive basis of taxation' is also adopted in the national laws in respect of certain 'investment and business incomes'. Undoubtedly, this raised problems in enforcement of DTAs; hence the need to develop clear and definite arrangements with tax treaty partners.

7.1.6. Transfer Pricing: The underling principle relating to adjustment of profits in case of intra-group transactions where the profits of resident enterprise are shifted through artificial structuring of financial and commercial transactions is provided under article 9 of the DTAs. The DTAs essentially envisage that the international practices/procedures developed at OECD would serve as broad Guidelines for articulating TP Regulations to be developed by individual countries. In Pakistan, Rule 20 to 27 of the Rules stipulates rather scanty and definitely inadequate TP Guidelines. The Tax administration, based on prices charged in third party un-related transactions erroneously deemed as ALP, adjust the difference between the price charged in intra-group transactions and third party transactions towards the declared profits of the resident enterprise. This approach, especially followed in the pharmaceutical companies, has led extensive litigation creating problems both for the revenue as well as taxpayers.

Importantly, income tax laws and customs duty law follow significant conflicting approaches in valuation of imported materials/products. Whereas the customs duty law attempts to raise the import price particularly in intra-group transactions, section 108 of the Ordinance empowers the Commissioner of Income to adjust the prices

downward in intra-group transactions. There have been instances of both upward and downward pricing adjustments in respect of the same products by the respective Tax Authorities leading to double jeopardy in case of the same taxpayer.

Importantly, the Tax Authorities in Pakistan have consistently ignored the underlying principle of adjustment of intra-group transactions as embodied in the national taxation laws as well as in the OECD Guidelines which are binding on the countries following tax treaty provisions contained in the OECD/UN MCs. It is important to note that both the national taxation law and the DTAs require the comparison of conditions reflected in the commercial and financial aspects of the Group and Unrelated business transactions, identify the differences if any, determine the arm's price in case the identified differences are 'material' in accordance with any of the four methods embodied in the national taxation law and/or Internationally accepted Transfer Pricing Guidelines, and the difference between the price charged through the intra-group transactions and the arm's length price added to the declared profits of enterprise subject of transfer pricing adjustment.

- i. Recommendation: The disparities among the tax rates should be minimized; resultantly inducement factor regarding transfer of business profits will also be diminished.
- ii. Recommendation: Pakistan must earnestly endeavor to establish comprehensive Guidelines on Inter-Company Transfer Pricing.
- iii. Recommendation: In the absence of taxation rules or international supervisory organization, certain controversies come forward regarding the jurisdictional row, disputes on valuation, harmful tax competition and problems relating to compliance, enforcement and recovery. It is suggested to establish an institute e.g. International Tax Organization by the regimes like UN or OECD as such was in pipe line the UN in 2001. However, it is not merely a notion but may become in existence in near or remote future. The scope of the ITO should provide technical assistance, a forum to establish international tax norms, to maintain tax surveillance, to restrain harmful tax competition and arbitration of tax disputes.

7.1.7. Built-in Flexibilities: In remote past, the national tax incentives have been protected through open ended '*tax sparing credit*' provisions of the DTAs. In recent

years, the '*sunset clause*' was incorporated in the relevant tax treaty provisions and the tax authorities need to examine the question of extending tax exemptions, tax credits and sector/area specific tax holidays.

The Income Tax Laws are mostly silent or very scantly deal with the DTAs provisions concerning non-discrimination, information exchanges and dispute resolution of issues arising from enforcement of DTAs. This aspect requires very comprehensive resolution through Rules/Regulations and detailed procedures.

Investment income in particular is liable to limited taxation in the source country, in the absence of the permanent establishment/fixed base of the recipient. A comprehensive arrangement in terms of issuance of withholding certificates in the source country is required.

The foreign tax credit provisions exist both in the Income Tax Laws as well as the DTAs. However, a detailed procedure taking into account various aspects of granting the 'foreign tax credit' has not been developed. Unfortunately, most of the personnel are not familiar with various issues connected therewith. It is an important issue and needs to develop the detailed Guidelines in the said area. In some of the DTAs, for instance one between Pakistan and Italy signatories agreed to incorporate 'most favored nation provision' in respect of Royalty Article. Such provisions become redundant as soon as a lower tax rate was agreed in the subsequently negotiated tax treaties. This practice should be avoided as it does not help a country in long term.

By objective, taxes are meant to generate revenue in order to run the state's affairs, which is one of the major sources of income having base on two-folds i.e. earned and unearned income. The unearned income is composed from natural resource, foreign aid and foreign debt. Some countries hold rich natural resources or an option to have opportunity to get aid or debt from abroad. This constitutes an unearned income as major source of these countries. However, the rest of the countries retain taxes as their major source of income.

In fact, the countries having unearned income as their major source are less dependent on its subjects for revenue generation. So, it purports less bargaining power between the rulers and the subjects in such states. Whereas, the sufficient bargaining power can only be found in those countries wherein earned income is their major source and the said state governments are answerable to their citizens for their policies and state

affairs. By keeping in mind the concept of bargaining power, we can imagine the quality of governance in both kinds of states.

This line of thinking, the taxes are not merely to generate revenue but a tool to enhance quality of governance as well as an indicator thereof. So we come to the point that states should be more dependent on earned income or should have more earned income as their source of revenue.

Pakistan is encountered with the low tax to GDP ratio which deteriorates the conditions of governance and needs the reforms. The said reforms, firstly, relates to existing tax system particularly in tax collection and secondly, enhancement of tax net through expansion in economy (i.e. injecting bulk of people and sectors of economy).

The gloomy side of existing tax system, which needs reforms, is the huge part of revenue composed of indirect taxes. It is worse in the sense that major part of aggregate demand is inelastic, which is eventually paid by the poor class of economy. On the other hand the direct taxes' collection system is feeble. The more sectors of economy can be brought under the ambit of tax net through reform (i.e. bringing informal sector), expansion through exploitation of natural resources and through encouraging the new sectors, like for instance, telecom sector.

Last but not the least, it is crucial to induct the bulk of population under tax net. Another quirk in the taxation system is the gender gap, whereby 99% of the taxpayers' toll is composed of the male members of Pakistani society. However, 51% of the Pakistani population is femininity based but even then female taxpayers are less than 1%. The rationale behind the said tax evasion is that the females' labour force participation rate is dismal.

It is strange to ignore that Pakistani society has affluent women, like for instance, Fahmida Mirza, Sumaira Malik and Tahmina Doltana (landed gentry), Marvi Memon and Sharmila Farooqui (scions of female political mavericks), and Dr. Maleeha Lodhi (intellectual elite). This visible minority of enfranchised women obscures the said fact and very small cohort alacrity to share Pakistani tax revenue from domestic sources or the said cohort is reluctant to do so. Resultantly, the government of cash-strapped state has no other option instead of borrowing from myriad donors to keep the wheel of life churning in Pakistan.

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It is crucial to streamline the provisions of the Income Tax Laws which addresses the systematic underreporting of incomes. It is incumbent on the GoP to formulate policies governing labour force in order to engage volume of women in said arena and this should be enough to separate the country from the multitude. It is not strange to quote that if the females are tangential in same manner then there is little hope of an economic miracle in Pakistan. It should be remembered that Pakistan requires women workers in order to elevate the productivity as well as tax revenue.

In case, if the tax-to-GDP ratio increased in Pakistan, it automatically enhances the earned income and on the other end the role of state as an agent shrinks. Wherefore, the reforms will encourage the private sector and the GoP is more depending on its subjects which further leads to good governance.

In this global environment, the net export comprises huge portion of any country's GDP. Similarly, no country can stay isolated due to specialization and industrialization. Better internal taxation system encourages privatization, private investment and improves quality of governance. Resultantly, all these elements encourage the FDI and international trade in shape of imports and exports.

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