Taxation of:
Foreign Source Income of a Resident
&
Pakistan Source Income of a Non-resident in Pakistan

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Presentation Objectives

To discuss the dynamics governing taxability of foreign source income of a resident and Pakistan source income of a non-resident in Pakistan.

The presentation takes into account various instances where foreign source income becomes taxable in Pakistan as well as various incomes earned by non-resident person that may be taxed as their Pakistan sourced income.

Principles of Taxation in Pakistan

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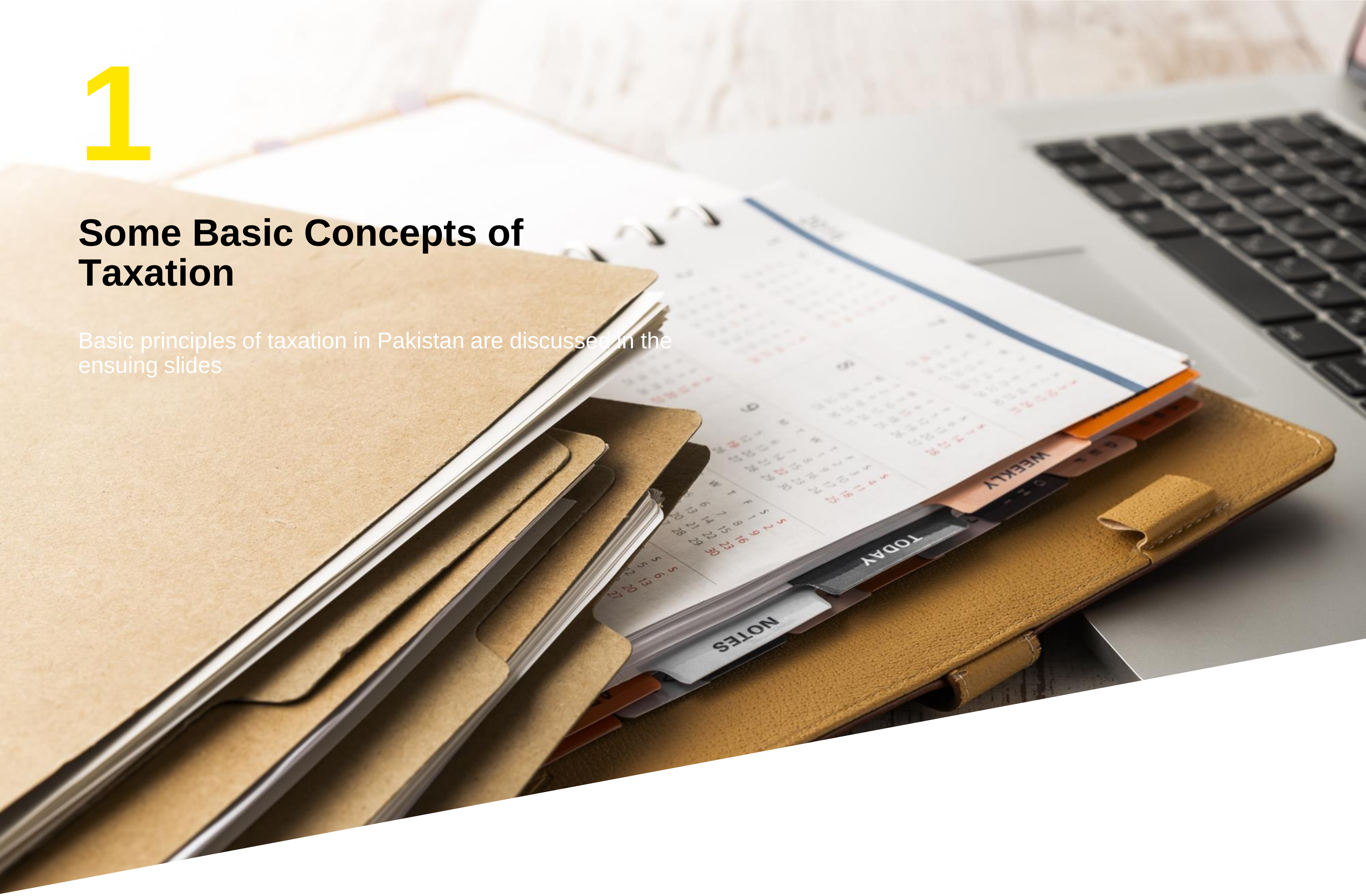

1

Some Basic Concepts of Taxation

Basic principles of taxation in Pakistan are discussed in the ensuing slides

Principles of Taxation in Pakistan

Taxation in Pakistan is based on a persons residential status

Taxation of Income

A resident person is taxed on both Pakistan sourced income and foreign sourced income.

Non-resident person is taxed on its Pakistan sourced income only.

Absolute and Fictional Income

It is imperative to note that income may be classified as Pakistan source either as:

a) Absolute – meaning that the income has actual source in Pakistan; or
b) Fictional – meaning that it becomes Pakistan sourced income based on the status of the payer in Pakistan.

Any income that is not classified as Pakistan source would be treated as foreign source income for the purposes of taxation.

Resident Person for a Tax Year is a:

- Resident individual
- Resident company
- Resident Association of Persons
- The Federal Government

❖ An individual shall be a resident individual for a tax year if the individual is:
  - present in Pakistan for an aggregate period of 183 days or more in a tax year;
  - an employee or official of the Federal Government or a Provincial Government;
  - being a citizen of Pakistan is not present in any other country for more than one hundred and eighty-two days during the tax year or who is not a resident taxpayer of any other country.

❖ A company shall be a resident company, if:
  - It is incorporated in Pakistan;
  - It is a Provincial Government or a Local Government;
  - if the control and management of the affairs of the company is situated wholly in Pakistan at any time in the year, even if it is not incorporated in Pakistan.

❖ An association of person shall be resident in Pakistan if the control and management of the affairs of the association is situated wholly or partly in Pakistan at any time in the year.

Principles of Taxation in Pakistan

Absolute Income

Section	Character of Income	Comment
101(1)	Salary	From employment exercised in Pakistan; or paid to a Government employee wherever such employment is exercised
101(2)	Business Income of a resident person	When income is derived from business carried on in Pakistan
101(3)	Business Income of a non-resident person	When income is directly or indirectly attributable to a permanent establishment or any other business connection in Pakistan
101(5)	Gains on disposal of business assets	Disposal of business assets in Pakistan
101(6)	Dividend Income	When paid by a resident company; or remittance of after tax profit by a branch of a foreign company operating in Pakistan
101(9)	Rental Income	When it is derived from the lease of immovable property in Pakistan or from any other interest in or over immovable property, including a right to explore for, or exploit, natural resources in Pakistan.
101(10)	Alienation or disposal of immovable property	Referred to in 101(9)
101(13)	Disposal of shares	Gain on disposal of shares of a resident company

Principles of Taxation in Pakistan

Fictional Income

Section	Character of Income	Comment
101(4)	Independent Services rendered by a nonresident person	If paid by a resident person or born by the permanent establishment of a nonresident person
101(7)	Profit on Debt	If paid by a resident person or born by the permanent establishment of a nonresident person
101(8)	Royalty	If paid by a resident person or born by the permanent establishment of a nonresident person
101(11)	Pension or annuity	If paid by a resident person or born by the permanent establishment of a nonresident person
101(12)	technical fee	If paid by a resident person or born by the permanent establishment of a nonresident person
101(12A)	fee for offshore digital services	If paid by a resident person or born by the permanent establishment of a nonresident person
101(13A)	Insurance/reinsurance Premium	Paid by an insurance company to an overseas insurance or re-insurance company.
101(14)	Any other amount	Paid by a resident person or borne by a permanent establishment in Pakistan of a non-resident person

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Taxation of Foreign Source Income of a Resident Person

A brief introduction to the various kinds of foreign incomes and their taxation in the hands of a resident person is provided in the ensuing slides.

Examples of Foreign Source Income

What is foreign sources income?

An amount shall be foreign source income to the extent it is not a Pakistan source income.

Salary	from exercise of employment outside of Pakistan.
Business Income	from operations outside Pakistan, undertaken through a branch or a permanent establishment
Dividends	received from a non-resident company
Profit on Debt	received from a non-resident outside Pakistan
Rental Income	derived from property located outside Pakistan
Capital gains	from disposal of assets, including immovable property, shares of foreign companies etc. held outside Pakistan

Exemption to taxability of Foreign Source Income

Foreign source salary

Any foreign-source salary received by a resident individual shall be exempt from tax if the individual has paid foreign income tax in respect of the salary.

Foreign Sourced Salary Derived by Individuals leaving Pakistan

Where a citizen of Pakistan leaves Pakistan during a tax year and remains abroad during that tax year, any income chargeable under the head “Salary” earned by him/her outside Pakistan during that year is exempt from tax.

Foreign Sourced Income of Returning Expats

Foreign-source income of returning expatriates (citizens of Pakistan who were not resident in Pakistan during any of the preceding four tax years) shall be exempt from tax in the first tax year of residence and the succeeding tax year.

Foreign Tax Credit

What is foreign tax credit

- In case a resident tax payer pays any foreign tax; in a foreign jurisdiction, in respect of its foreign source income and such income also becomes taxable in Pakistan (because of residence), the taxpayer is entitled to claim credit for tax paid in foreign jurisdiction.
- Foreign tax credit is available only against the foreign source income chargeable to tax.

How is foreign tax credit calculated?

Foreign tax credit is allowed for an amount equal to the lesser of:

(a) the foreign income tax paid; or

(b) the Pakistan tax payable in respect of the income.

Foreign tax credits shall be calculated separately for each head of income

Need to note:

- Pakistan tax payable in respect of foreign source income derived by a taxpayer in a tax year shall be computed by applying the average rate of Pakistan income tax applicable to the taxpayer for the year against the taxpayer's net foreign-source income for the year.
- Any unutilized foreign tax credit or part of a tax credit shall not be refunded, carried back to the preceding tax year, or carried forward to the following tax year
- A foreign tax credit is only available if the foreign income tax is paid within two years after the end of the tax year in which the foreign income to which the tax relates was derived by the resident taxpayer.

Foreign Tax Losses

Deductible expenditures incurred by a person in deriving foreign-source income chargeable to tax under a head of income shall be deductible only against that income.

01

Expenses incurred to earn foreign source income, taxable under a particular head of income can only be claimed against that income

02

The foreign loss shall be carried forward to the following tax year and set off against the foreign source income chargeable to tax under that head in that year, and so on, but no foreign loss shall be carried forward to more than six tax years immediately succeeding the tax year for which the loss was computed.

03

Where a taxpayer has a foreign loss carried forward for more than one tax year, the loss for the earliest year shall be set off first.

Controlled Foreign Company

What is a Controlled Foreign Company (CFC)?

Generally, a CFC is a corporate entity that is registered and conducts operations in a different jurisdiction other than the residency of the controlling owners and is involved in –

- earning substantial passive income; and
- is subject to substantial lower taxation than in resident state.

In Pakistan a foreign company shall be classifiable as a CFC if:

- more than 50% of its capital or voting rights are directly or indirectly held by Pakistani resident persons or if more than 40% of such capital or voting rights is held by a single Pakistani resident person;
- Tax paid, after taking into account any foreign tax credits available to the non-resident company on income derived or accrued, during a foreign tax year, by the non-resident to any tax authority outside Pakistan is less than 60% of the tax payable on the said income in Pakistan;
- Does not derive active business income; and
- Shares are not traded on foreign stock exchange.

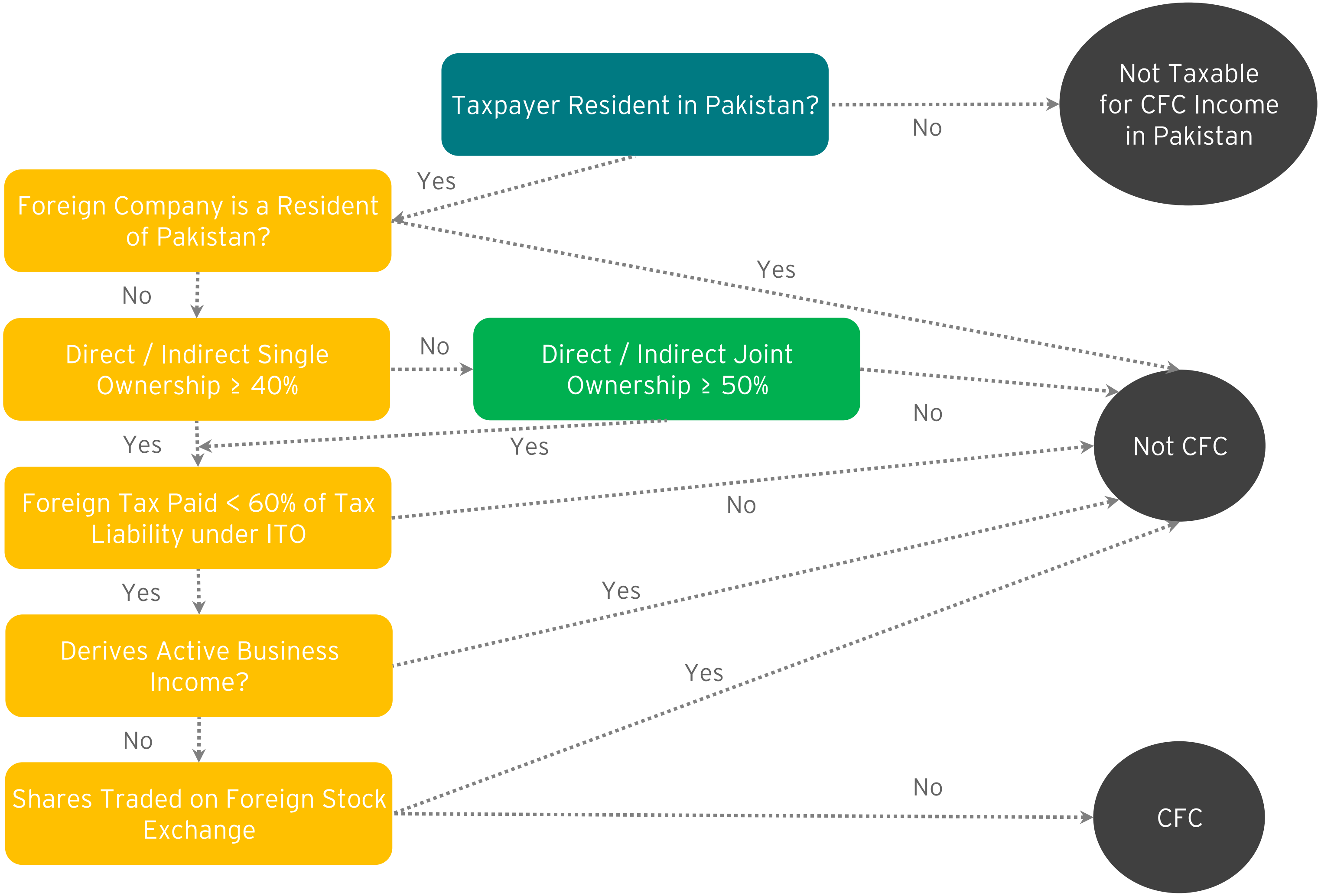
What is Active Business Income?

A CFC will be treated to have derived active income if income from following sources is less than 20%:

- Dividend, Interest, Property, Capital Gain, Annuity; Royalty; Supply of goods or services to an associate, Sale or licensing of intangibles, and Management, holding or investment in securities and financial assets
- Derives principal income under “income from business” in country/ jurisdiction of residence.

2 Foreign Source Income of a Resident Person

Controlled Foreign Company



Controlled Foreign Company

Taxability of CFC income

- Income of a CFC is an amount equal to the taxable income of that company determined in accordance with the provisions of the Ordinance as if such CFC is a resident company;
- BEPS action plan recommends that rules of the parent jurisdiction should be applied to compute CFC income to be attributed to the shareholders;
- The income attributable to a person; holding interest in a CFC, is proportionate to the percentage of his/her capital or voting right, whichever is higher;
- The amount of attributable income shall be treated as zero, if the capital or voting rights of the resident person is less than ten percent;
- Income of a CFC shall be treated as zero, if it is less than ten million Rupees;
- Such attributable income shall be taxed at the rate specified in Division III of Part I of the First Schedule (rate for “dividends” – currently 15%).

Avoidance of Double Taxation

- The income attributable to a CFC and taxed in Pakistan under section 109A of the Ordinance shall not be taxed again when the same income is received in Pakistan by the resident taxpayer.

Tax credit

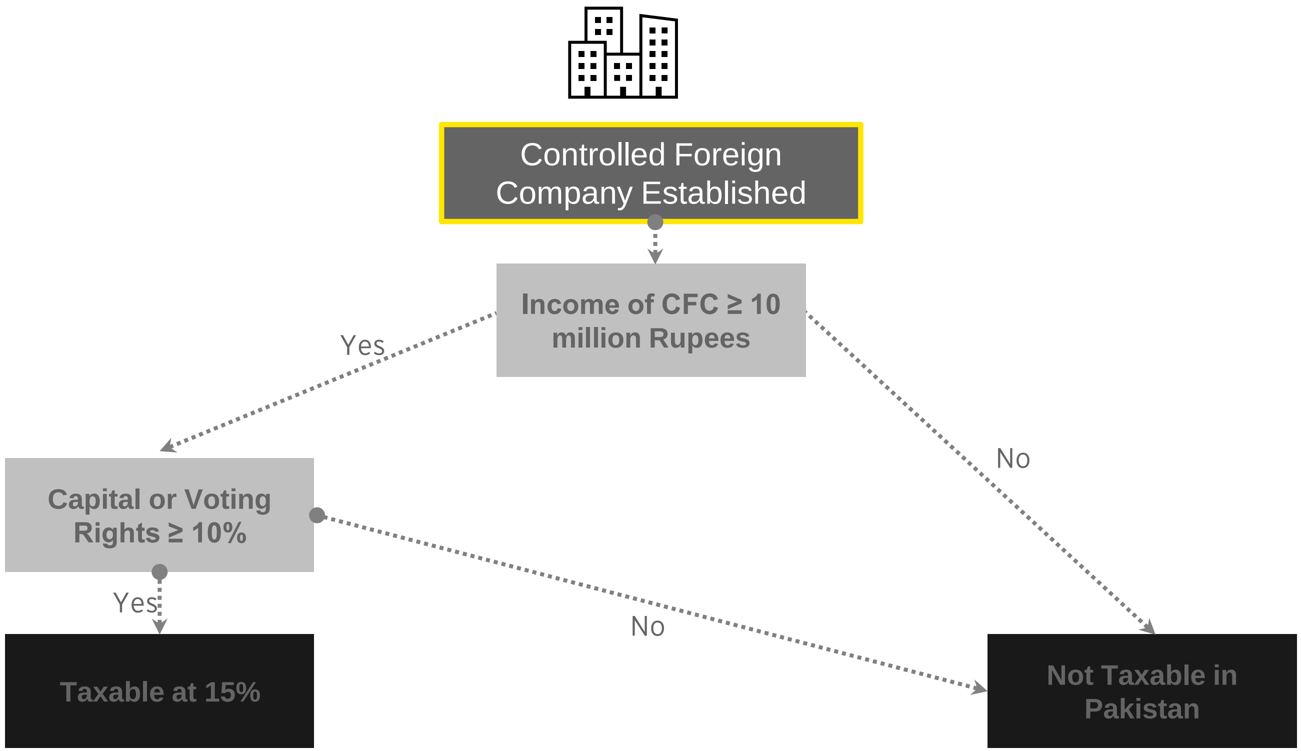
- Where tax has been paid by the resident person on the income attributable to a CFC and in a subsequent tax year the resident person receives dividend distributed by the CFC, after deduction of tax on dividend, the resident person shall be allowed a tax credit equal to the lesser of:

i) foreign tax paid, as defined in sub-section (8) of section 103, on dividends; and

ii) Pakistan tax payable, as defined in section 103, for the tax year in which the dividend is received by the resident taxpayer.

2 Foreign Source Income of a Resident Person

Controlled Foreign Company



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Taxation of Pakistan Source Income of a Non-resident

A brief introduction to the taxation of non-residents in Pakistan is provided in the ensuing slides.

3 Taxation of Pakistan Source Income of a Non-resident in Pakistan

Various Sources of Income of a Non-Resident

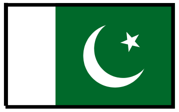
- Salary
- Income from Business
- Capital Gains
- Dividends
- Profit on Debt
- Others

Taxation of Salary

What is salary?

Salary is any amount received by an employee from exercise of his/her employment.

When does salary become Pakistan sourced?



Irrespective of where the salary is paid or whether or not the employer has a presence in Pakistan, salary shall be Pakistan sourced if it is received from exercise of employment in Pakistan.

All allowances received by an employee in relation to his employment are fully taxable.
All perquisites (benefits in kind) provided to an employee in relation to his employment are taxable at in accordance with the prescribed rule..

Salary is taxed on a receipt basis.

<u>Taxation of Short Term Resident Individuals</u>

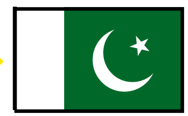
The foreign sourced income of an individual who is a resident solely because of his employment and is present in Pakistan for a period not exceeding three years is exempt from tax in respect of his / her foreign source income unless such income is brought into or received in Pakistan.

Various Sources of Income of a Non-Resident

What is "Income from Business"?

Income from Business includes profits and gains of any business carried on by a person at any time in a year.

When does business income for a non-resident become Pakistan sourced?



<u>General Rule</u>

Business income is Pakistan sourced to the extent it is directly or indirectly attributable to:

i. A PE of a non-resident *[Attribution Principle]*

ii. Sale of goods or rendering of services of same or similar kind to those being sold or rendered by the PE in Pakistan *[Limited Force of Attraction Principle]*

iii. Any business connection in Pakistan

iv. Cohesive business operations

<u>Independent services:</u>

Consideration for rendering of independent services (including professional services and the services of entertainers and sports persons), is categorized Pakistan source when the remuneration is paid by a resident person or borne by a PE of a non-resident person in Pakistan. Therefore, even if the non-resident does not have a PE in Pakistan, such fee becomes taxable in Pakistan. *[Unlimited Force of Attraction Principle]*

Permanent Establishment (PE)

Permanent Establishment (PE) of a non-resident refers to any place of business through which the activities of the non-resident is wholly or partly carried on

A non-resident having a PE in Pakistan is dependent on the following broad categories:

1 **Self Extension**

E.g.: branch of a non-resident company or furnishing of services including through employees or other personnel or entity.

2 **Holding of an Asset**

E.g.: holding of Exploration License/Mining Lease, any equipment installed, asset or other assets capable of activity giving rise to income.

3 **Relationship**

E.g.: engaging with a dependent agent, cohesive business operations.

Following may not be regarded as a PE:

❖ **Liaison Office**

- A liaison office is merely involved in performing negotiations with clients, and not involved in concluding contracts on behalf of a non-resident company in Pakistan.

❖ **Subsidiary**

- Merely having a subsidiary of a non-resident company does not in itself be regarded as a PE.

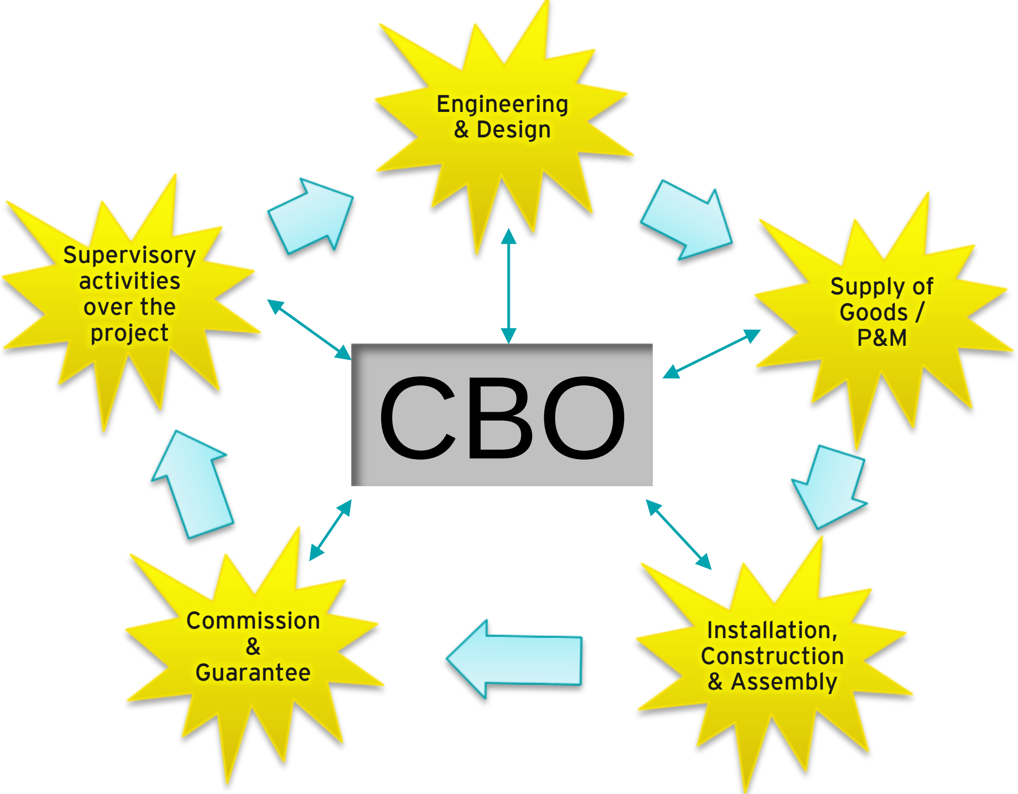
❖ **Independent Agents**

- An agent acting in the ordinary course of business, not exclusively working for one principal.

Cohesive Business Operations (CBC) and Business Connection (BC)

Cohesive Business Operations (CBO)

- includes an overall arrangement for the supply of goods, installation, construction, assembly, commission, guarantees or supervisory activities and all or principal activities are undertaken or performed either by the person or the associates of the person;
- supply of goods include the goods imported in the name of the associate or any other person, whether or not the title to the goods passes outside Pakistan



Business Connection (BO)

constitute a real and intimate relationship between business activities carried on by a non resident outside the territorial jurisdiction of India, which yields profits or gains, and some activities carried on within the country which contributes directly or indirectly to the earning of such profits or gains.

Special provisions relating to computation of income of a PE

Basic principles relating to computation of income from business derived by a non-resident person through its PE in Pakistan remains the same for such similar income derived by a resident person. However, the following principles needs consideration

- Profits of PE should be computed on the basis that PE is a separate entity from the non-resident person.
- Expenses incurred by the PE in the course of performing its business activities, including executive and administrative expenses, shall be allowable deduction when computing taxable income.
- No deduction shall be allowed for payments that are made to the head-office of the PE or to another PE of the non-resident person by way of:
  - Royalties, fees or other similar payments for use of any tangible or intangible asset by the PE;
  - Compensation for any services including management services performed for the PE; or
  - Interest (also referred to as "Profit on Debt") on loans made to the PE, except in connection with a banking business
- Similarly, a PE's income shall not include any payment received by it from the head-office or another PE by way of:
  - Royalties, fees or other similar payments for use of any tangible or intangible asset;
  - Compensation for any services including management services performed by the PE; or
- Head office expenses are admissible only to the extent of an amount in proportion to the Pakistan turnover to worldwide turnover
- Interest (also referred to as "Profit on Debt") on loans made by the PE, except in connection with a banking business.
- No deduction shall be allowed in computing the income of a permanent establishment in Pakistan of a non-resident person chargeable under the head "Income from Business" for –
  - any profit paid or payable by the non-resident person on debt to finance the operations of the permanent establishment; or
  - any insurance premium paid or payable by the non-resident person in respect of such debt.

Capital Gains

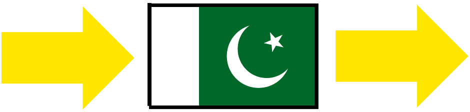
What is “Capital Gains”?

Gains arising on disposal of capital assets are capital gains.

“Capital Asset” means property of any kind held by a person, whether or not connected with a business, but does not include:

- Stock in trade;
- Assets entitled to depreciation and amortization; and
- Movable property for personal use, with certain exceptions

When do capital gains become Pakistan sourced?



<u>Property</u>

Any gains from alienation of any property or right from immoveable property or from any shares in a company which consists directly or indirectly of immoveable property is deemed as Pakistan sourced income.

<u>Shares</u>

Disposal of shares in a resident company is Pakistan sourced income.

Gains arising on disposal of securities including listed shares are taxed at differing rates depending on holding period.

“Security” means share of a public company, voucher of Pakistan Telecommunication Corporation, Modaraba Certificate, an instrument of redeemable capital, debt Securities, unit of exchange traded fund and derivative products.

The taxability for various categories of assets is provided on the next slide.

Taxability of Gains on various categories of Capital Assets

Type of Asset	Taxability
Securities including listed shares	Capital gains on disposal of securities are taxed depending on holding period of securities. Capital gains are calculated as: A – B A = consideration received on disposal B = cost of acquisition
Immoveable Property	The gain arising on disposal of immovable properties is to be charged to tax at various rates depending on the following categories: open plots, constructed property, and flats. No gains are taxed when the holding period exceeds six years for open property, four years for constructed property, and two years for flats.
Capital assets (including shares of private company) not being securities and immovable property	Capital gains on disposal of capital assets and shares of private company are taxed at applicable tax rates, as part of taxable income of the taxpayer for the year. The gains are calculated as: A – B A = consideration received on disposal B = cost of acquisition
Disposal of assets outside Pakistan	Please see the next slide.

Gain on disposal of assets outside Pakistan

It is imperative to note that before the introduction of Finance Act 2018, gains arising from an indirect transfer of assets were generally not taxable under the local tax laws. However such gains are now subject to tax in Pakistan.

Gains arising from disposal or alienation of an asset located in Pakistan is Pakistan sourced income of the non-resident.

Assets are deemed to be located in Pakistan if:

- **The shares/interest derive their value, directly or indirectly, wholly or principally, from the assets located in Pakistan, and their value exceed PKR 100 million, and represent at least 50% of the value of all the assets owned by the non-resident company.**
- **The shares/interest disposed or alienated represented 10% or more of the share capital of the non-resident company.**

Other requirements for taxation of gain arising on indirect disposal include the following:

- Where the assets of the non-resident company are not wholly located in Pakistan, only income to the extent that is reasonably attributable to such assets located in Pakistan would be taxable;
- The rate of tax applicable on the transaction is the higher of:
  - 20% of the gain (i.e. fair market value less cost of acquisition of the asset); or
  - 10% of the fair market value of the asset; and
- The buyer is required to withhold tax at the rate of 10% of the fair market value of the asset;
- Where the assets in Pakistan are held through a resident company, such resident company:
  - shall collect tax (@10% of FMV or 20% of gain, as the case may be, as noted above), from the non-resident company within thirty days of the transaction of disposal or alienation of the asset by such non-resident company. However, where the buyer has deducted and paid tax at the time of acquiring the asset from the non-resident company, tax credit for the same shall be allowed in computing and collecting the tax from the non-resident company.
  - shall provide the prescribed information to the Commissioner Inland Revenue within 60 days of the date of transaction;
- Where the tax has been withheld by the buyer or collected by the resident company, no tax shall be payable by the non-resident company in respect of the gain under the head “Income from Business” or “Capital Gains”.

Taxation of Pakistan Source Income of a Non-resident in Pakistan

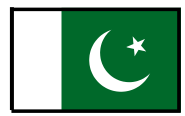
Various Sources of Income of a Non-Resident

Dividends

Profit on Debt

Royalty

When do dividends, profit on debt, royalty become Pakistan sourced?



Dividends

1. Paid by a resident company

2. Remittance of after tax profits of a Branch in Pakistan of a foreign company, with certain exceptions

The rate of tax for Dividends is 15%

Profit on Debt

1. Paid by a resident person*

2. Borne by a PE of a non-resident person in Pakistan

*** Except where the profit is payable in respect of any debt used for business of a resident person outside Pakistan through a PE**

Varies rates, depending on the category of tax payer. For certain non-resident not having a PE in Pakistan, the rate of tax for Profit on Debt is 10%, as a final discharge of tax liability

Royalty

1. Paid by a resident person*

2. Borne by a PE of a non-resident person in Pakistan

*** Except where royalty is payable in relation to any right, property, information used, or services utilized for business of a resident person outside Pakistan through a PE**

The rate of tax for Royalty is 15%

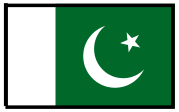
Various Sources of Income of a Non-Resident

Rental Income

Fee for Technical Services

Fee for Offshore Digital Services

When do fee for technical services and fee for offshore digital services become Pakistan sourced?



Derived from the lease of immovable property in Pakistan whether improved or not, or from any other interest in or over immovable property, including a right to explore for, or exploit, natural resources in Pakistan.

1. Paid by a resident person*

2. Borne by a PE of a non-resident person

***except where the fee is payable in respect of service utilized in a business carried on by the resident person outside Pakistan through a PE**

1. Paid by a resident person*

2. Borne by a PE of a non-resident person

***except where the fee is payable in respect of service utilized in a business carried on by the resident person outside Pakistan through a PE**

Taxed on net income basis.

The rate of tax for fee for technical services is 15%.

The rate of tax for offshore digital services is 10%.

Taxation of Salary

Salaried Taxpayers:

Whose income chargeable under the head “salary” exceeds 75% of their total taxable income for the year. The following rates shall apply:

S#	Taxable Income	Rate of Tax
1	Where taxable income does not exceed Rs.600,000/-	0%
2	Where taxable income exceeds Rs. 600,000 but does not exceed Rs. 1200,000	2.5% of the amount exceeding Rs. 600,000
3	Where taxable income exceeds Rs.1,200,000 but does not exceed Rs. 2,400,000	Rs. 15,000 + 12.5% of the amount exceeding Rs. 1200,000
4	Where taxable income exceeds Rs.2,400,000 but does not exceed Rs. 3,600,000	Rs.165,000 + 22.5% of the amount exceeding Rs.2,400,000
5	Where taxable income exceeds Rs.3,600,000 but does not exceed Rs. 6,000,000	Rs. 435,000 + 27.5% of the amount exceeding Rs.3,600,000
6	Where taxable income exceeds Rs.6,000,000	Rs.1,095,000 + 35% of the amount exceeding Rs.6,000,000

Non- Salaried Taxpayers:

Whose quantum of taxable salary versus the total taxable income falls short of 75%, such individuals are taxed as per the following slab rates:

S#	Taxable Income	Rate of Tax
1	Where taxable income does not exceed Rs.600,000/-	0%
2	Where taxable income exceeds Rs. 600,000 but does not exceed Rs. 800,000	7.5% of the amount exceeding Rs. 600,000
3	Where taxable income exceeds Rs.800,000 but does not exceed Rs. 1,200,000	Rs. 15,000 + 15% of the amount exceeding Rs. 800,000
4	Where taxable income exceeds Rs.1,200,000 but does not exceed Rs. 2,400,000	Rs.75,000 + 20% of the amount exceeding Rs.1,200,000
5	Where taxable income exceeds Rs.2,400,000 but does not exceed Rs. 3,000,000	Rs. 315,000 + 25% of the amount exceeding Rs.2,400,000
6	Where taxable income exceeds Rs.3,000,000 but does not exceed Rs. 4,000,000	Rs. 465,000 + 30% of the amount exceeding Rs.3,000,000
7	Where taxable income exceeds Rs. 4,000,000	Rs. 765,000 + 35% of the amount exceeding Rs. 4,000,000

Taxation of Pakistan Source Income of a Non-resident in Pakistan

Rate of tax applicable on business income

Companies Income Tax Rates

Serial No.	Type of Company	Rate
1	Small company	20%
2	Banking company	39%
3	Any other company	29%

Questions?

Thank you!