TAXATION OF NON-RESIDENT TAXATION AND DOUBLE TAXATION AGREEMENT BETWEEN PAKISTAN AND AOTCA COUNTRIES

I would like to thank the organizing committee of the AOTCA Conference for inviting me to present my paper on Non-Resident Taxation with reference to the Double Taxation Agreement entered between Pakistan and the AOTCA Countries. It is indeed a great privilege for me to be a co-speaker with Dr. Ishrat Hussain, the Honorable Governor of State Bank of Pakistan and to be addressing the top tax consultants of the Asia Pacific countries. In this presentation I have made an attempt to highlight the Taxation of the non-citizens of Pakistan and the non-residents in the light of the provisions of the Income Tax Ordinance, 2001 and also compare the provisions of avoidance of double taxation. Pakistan has entered with the member countries of AOTCA and their impact in the light of the case laws decided by the Pakistani Courts.

The Income Tax Ordinance, 2001 has basically changed the concept of International Taxation keeping in view the Pakistan's basic goal to attract foreign investment. An effort has been made to design the provisions of the new Income Tax Ordinance, 2001 in such a manner that they attract foreign investment and provide hassle free flow of international trade. Although, in the first part of my paper I shall be discussing the provisions, which provide for taxation of foreign entities in Pakistan but at this juncture I feel that it is appropriate to point out that the under section 107 of the new Income Tax Ordinance, the Federal Government has been empowered to enter into an agreement with the Government of Foreign Countries for avoidance of double taxation and prevention of fiscal evasion with respect of taxes, on income, imposed under this ordinance.

The Federal Government has also been authorized to notify such agreements for their implementation. It has been categorically affirmed that the agreement and the provisions made by such notification for implementing the agreement shall override, the provisions contained in any law for the time being in force. These provisions for the following situations:

(a) Relief from the tax payable under the Ordinance.

(b) The determination of the Pakistan-source income of non-resident persons :

(c) Where all the operations of a business are not carried on within Pakistan, the determination of the income attributable to operations carried on within and outside Pakistan, or the income chargeable to tax in Pakistan in the hands of non-resident persons, including their agents, branches, and permanent establishments in Pakistan.

(d) The determination of the income to be attributed to any resident person having a special relationship with a non-resident person ; and

(e) The exchange of information for the prevention of fiscal evasion or avoidance of taxes on income chargeable under the Ordinance and under the corresponding laws in force in that other country.

It may be noted that Superior Courts of various countries in numerous cases have approved the view that provisions of agreement overrides the general provisions of law on the basis of maxim "Special laws override General laws" .

With this background I would now like to outline the concept of taxation of foreign entities including foreign individuals who have become residents for the purpose of Pakistani Tax Laws. Sub-sections (5) & (6) of section 11, which is titled Heads of Income defines as to which income of residents and non-residents are taxable in Pakistan. These sub-sections are reproduced as under:

"Section 11: (5) The income of a resident person under a head of income shall be computed by taking into account amounts that are Pakistan-source income and amounts that are foreign-source income.

(6) The income of a non-resident person under a head of income shall be computed by taking into account only amounts that are Pakistan-source income."

This is a new concept as far as the Pakistani Tax Code is concerned and by this concept the Pakistan has adopted the Source Principle while legislating the fiscal statutory provisions of International Taxation. As a consequence of the adoption of the above principle, the Pakistani source income and the foreign source income have been defined in sections 101, 102, 103, 104 and taxation of non-resident is dealt with section 105 to understand the implications of the above provisions, it will be appropriate to reproduce the above provisions of law:

101- Geographical source of income:
(1) Salary shall be Pakistani source of income to the extent to which the salary-
(a) is received from an employment exercised in Pakistan, wherever paid; or

(b) is paid by or on behalf of the Federal Government, a Provincial Government, or a local authority in Pakistan wherever the employment is exercised.

(2) Business income of a resident person shall be Pakistan source income to the extent to which the income is derived from any business carried on in Pakistan.

(3) Business income of non-resident person shall be Pakistan source income to the extent to which it is directly or indirectly attributable to-

(a) a permanent establishment of the non-resident person in Pakistan

(b) sales in Pakistan of goods or merchandise of the same or similar kind as those sold by the person through a permanent establishment in Pakistan or

(c) other business activities carried on in Pakistan of the same or similar kind as those effected by the non-resident through a permanent establishment in Pakistan.

(4) Where the business of a non-resident person comprises the rendering of independent services (including professional services and the services of entertainers and sports person) the Pakistan source business income of the person shall include (in

addition to any amounts treated as Pakistan source income under sub-section 3 any remuneration derived by the person where -

a) the remuneration is paid by the resident person or borne by a permanent establishment in Pakistan of a non-resident person and

b) the aggregate gross amount (before deduction of expenses) of the remuneration is sixty thousand rupees or more.

(5) Any gain from the disposal of any asset or property used in deriving any business income referred to in sub-sections (2), (3) or (4) shall be Pakistan source income.

(6) A dividend shall be Pakistan source income if it is paid by a resident company.

(7) Profit on debt shall be Pakistan source income if it is-

a) paid by a resident person, except where the profit is payable in respect of any debt used for the purposes of a business carried on by the resident outside Pakistan through a permanent establishment; or

b) borne by a permanent establishment in Pakistan of a non-resident person.
(8) A royalty shall be Pakistan source income if it is-

a) paid by a resident person, except where the royalty is payable in respect of any right, property, or information used, or services utilized for the purposes of a business carried on by the resident outside Pakistan through a permanent establishment; or

b) borne by a permanent establishment in Pakistan of a non-resident person.

(9) Rental income shall be Pakistan source income if it is 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.

(10) Any gain from the alienation of any property or right referred to in sub-section (9) or from the alienation of any share in a company the assets of which consist wholly or principally, directly or indirectly, of property or rights referred to in sub-section (9) shall be Pakistan source income.

(11) A pension or annuity shall be Pakistan source income if it is paid by a resident or borne by a permanent establishment in Pakistani of a non-resident person.

(12) A technical fee shall be Pakistan source income if it is-

a) paid by a resident person, except where the fee is payable in respect of services utilized in a business carried on by the resident outside Pakistan through a permanent establishment; or

b) borne by a permanent establishment in Pakistan of a non-resident person.

(13) Any gain arising on the disposal of shares in a resident company shall be Pakistan source income.

(14) Any amount not mentioned in the preceding sub-sections shall be Pakistan source income if it is paid by a resident person or borne by a permanent establishment in Pakistan of a non-resident person.

(15) Where an amount may be dealt with under sub-section (3) and under another sub-section (other than sub-section (14), this section shall apply-

a) by first determining whether the amount is Pakistan source income under that other sub-section; and

b) if the amount is not Pakistan source income under that sub-section, then determining whether it is Pakistan source income under sub-section (3).

(16) An amount shall be foreign source income to the extent to which it is not Pakistan source income.

102. Foreign source salary of resident individuals.

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

(2) A resident individual shall be treated as having paid foreign income tax in respect of foreign source salary if tax has been withheld from the salary by the individual employer and paid to the revenue authority of the foreign country in which the employment was exercised.

103. Foreign Tax Credit

(1) Where a resident taxpayer derives foreign source income chargeable to tax under this ordinance in respect of which the taxpayer has paid foreign income tax the taxpayer shall be allowed a tax credit of an amount equal to the lesser of -

a) the foreign income tax paid or
b) the Pakistan tax payable in respect of income

(2) For the purpose of clause (b) of sub-section (1) the Pakistan tax payable in respect of foreign source income derived by a taxpayer in a tax year shall be computed by applying an average rate of Pakistan income tax applicable to the taxpayer for the year against the tax payers net foreign source income for the year.

(3) Where in a tax year, a tax payer has foreign income under more than one head of income this section shall apply separately to each head of income.
(4) For the purposes of sub-section (3) the income derived by the taxpayer from carrying on a business shall be treated as separate head of income.

(5) The tax credit allowed under this section shall be applied in accordance with sub-section 3 of section 4.

(6) Any tax credit or part of tax credit allowed under this section for a tax year i.e. not credited under sub-section 3 of section 4 shall not be refunded, carried back to the preceding tax year or carried forward to the following tax year.

(7) A credit shall be allowed under this section only if the foreign income tax is paid within two years after the end of tax year in which the foreign income to which the tax relates was derived by the resident taxpayer.

(8) In this section,-

"average rate of Pakistan income tax" in relation to a taxpayer for a tax year, means the percentage that the Pakistani income tax (before allowing of the tax credit under this section) is of the taxable income of the taxpayer for the year;
"foreign income tax" includes a foreign withholding tax; and
"net foreign source income" in relation to a taxpayer for a tax year, means the total foreign source income of the taxpayer charged to the tax in the year, as reduced by any deductions allowed to the taxpayer under this Ordinance for the year that-

a) related exclusively to the derivation of the foreign source income ;and

b) are reasonably related to the derivation of foreign source income in accordance with sub-section (1) of section 67 and any rules made for the purposes of that section.

104. Foreign losses:

(1) 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.

(2) If the total deductible expenditures referred to in sub-section (1) exceed the total foreign source income for a tax year chargeable to tax under a head of income (hereinafter referred to as a "foreign losses"), 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.
(3) Where a taxpayer has a foreign loss carried forward for more than one year, the loss for the earliest year shall be set off first.

(4) Section 67 shall apply for the purposes of this section on the basis that-

a) income from carrying on a speculation business is a separate head of income ; and

b) foreign source income chargeable under a head of income (including the head specified in clause (a)) shall be a separate head of income.

105. Taxation of a permanent establishment in Pakistan of a non-resident person:

1) The following principles shall apply to in determining the income of a permanent establishment in Pakistan of a non-resident person chargeable to tax under the head "Income from Business", namely:-

a) The profit of the permanent establishment shall be computed on the basis that it is distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the non-resident person of which it is a permanent establishment;

b) Subject to this Ordinance, there shall be allowed as deductions any expenses incurred for the purposes of the business activities of the permanent establishment including executive and administrative expenses so incurred, whether in Pakistan or elsewhere;

c) No deduction shall be for amount paid or payable by the permanent establishment to its head office or to another permanent establishment of the non-resident person (other than towards reimbursement of actual expenses incurred by the non-resident person to third parties) by way of;

(i) royalties, fees or other similar payments for the use of any tangible or intangible asset by the permanent establishment;

(ii) compensation for any services including management services performed for the permanent establishment; or

(iii) profit on debt on moneys lent to the permanent establishment, except in connection with a banking business; and

d) no account shall be taken in the determination of the income of a permanent establishment of amounts charged by the permanent establishment to the head office or to another permanent establishment of the non-resident person (other than towards reimbursement of actual expenses incurred by the permanent establishment to third parties) by way of;

(i) royalties, fees or other similar payments for the use of any tangible or intangible asset;

(ii) compensation for any services including management services performed by the permanent establishment; or

(iii) profit on debt on moneys lent by the permanent establishment, except in connection with a banking business.

2) No deduction shall be allowed in computing the income of a permanent establishment in Pakistan of a non-resident person chargeable to tax under the head "Income from Business" for a tax year for head office expenditure in excess of the

amount as bears to the turnover of the permanent establishment in Pakistan the same proportion as the non-resident's total head office expenditure bears to its worldwide turnover.

3) In this section, "head office expenditure" means any executive or general administration expenditure incurred by the non-resident person outside Pakistan for the purposes of the business of the Pakistan permanent establishment of the person, including-

a) any rent, local rates and taxes excluding any foreign income tax, current repairs, or insurance against risks of damage or destruction outside Pakistan.

b) Any salary paid to an employee employed by the head office outside Pakistan.

c) Any traveling expenditures of such employees; and

d) Any other expenditure which may be prescribed.

4) 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

a) any profit paid or payable by the non-resident person on debt to finance the operations of the permanent establishment; or

b) any insurance premium paid or payable by the non-resident person in respect of such debt.

Unlike, the repealed Ordinance a very exhaustive definition of Permanent Establishment has been provided in sub-section 41 of definition section 2 of the Ordinance. This section is also reproduced below:

2(41) : "permanent establishment" in relation to a person, means a place of business through which the business of the person is wholly or partly carried on, and includes-

(a) a place of management, branch, office, factory or workshop,(premises for soliciting orders, warehouse, permanent sales exhibition or sales outlet) other than a liaison office except where the office engages in the negotiation of contracts (other than contracts of purchase);

(b) a mine, oil or gas well, quarry or any other place of extraction of natural resources;

(c) a building site, a construction, assembly or installation project or supervisory activities connected with such site or project;

(d) the furnishing of services, including consultancy services, by any person through employees or other personnel engaged by the person for such purpose.

(e) a person acting in Pakistan on behalf of the person (hereinafter referred to as the "agent" other than an agent of independent status acting in the ordinary course of business as such, if the agent-

(i) has and habitually exercises an authority to conclude contracts on behalf of the other person;

(ii) has no such authority, but habitually maintains a stock-in-trade or other merchandise from which the agent regularly delivers goods or merchandise on behalf of the other person; or

(f) any substantial equipment installed, or other asset or property capable of activity giving rise to income."

Non-residents are taxable in Pakistan on their Pakistani source of income as defined in sections 101 to 105 reproduced above. If they are assessable under normal laws, their income is computed under sections ____ to ____ depending upon the head of income in the ambit of which their income falls. Before I discuss as to the taxability and exemptions of incomes under various heads, let me first explain which incomes of the Non-Residents fall under the presumptive tax regime. Under the provisions of sub-section 3 of section 15 of the Income Tax Ordinance, 2001, every prescribed person making payment to a non-resident person in respect of -

a) a turnkey contract
b) a contract or sub-contract for design, construct in or supply of plant, equipment under a power project
c) a contract or sub-contract under a construct in assembly or installation project in Pakistan including a contract for the supervisory activities in relation to such project ; and
d) any other contract for contract or services rendered other than a contract to which section 152 applies (which is the section dealing with with-holding tax on payments made to non-residents) shall withhold tax at the following rates:

i) Incase of turnkey contract at the rate of 8%. Incase of (b) on hydel project or transmission line project at the rate of 5% o other power projects at the rate of 4%. In case of (c) and (d) 6% where the value of contract exceeds 30 million rupees and 5% where the value of contract is less than 30 million rupees.

Under the provisions of sub-section 7 of section 153 read with section 169, the deduction of tax on the above payments to non-residents becomes the final tax liability and therefore fall under presumptive tax regime and the non-resident is not required to file any tax return but just a statement in lieu of return under section 115(4) of the Ordinance. However, the Non-Resident will only fall under the presumptive tax regime if he opts for presumptive tax regime by furnishing an option in writing within three months of the commencement of tax year and such declaration shall remain in force for a period of three years.

It will therefore, be seen that the non-resident has the option to be assessed either under the presumptive tax regime or under Normal Law and this option shall be

exercised after________ the profitability or otherwise of the project and also weighing all other relevant factors.

Under section 5 of the Income Tax Ordinance, 2001 the dividend received by any person including a non-resident person (but excluding a public limited company, an insurance company) is taxable at a flat rate of 10% on the gross amount of dividend.

Under section 6 of the Income Tax Ordinance, 2001, Royalty, Technical Services are taxable at the rate of 15% on the gross payment. Under section 7 of the I.Tax Ord.2001 tax on shipping and aircraft income of the non-resident person shall be taxable at the rate of 8% and 3% of the gross amount received or receivable for the shipping business and air transport business respectively. These incomes also fall within the presumptive Tax regime. But as already pointed out the provisions of the avoidance of double taxation agreement executed between Pakistan andnon-resident countries shall prevail and if these agreements provide exemptions to the above income or provide a lower rate of withholding tax the same shall be applicable instead of the rates prescribed in the I.Tax Ord.

The non-residents are entitled to certain other exemptions and lower withholding rates. Under section 50 foreign source income of an individual, who is a resident individual, solely by reason of his employment and who is present in Pakistan for a period or periods not exceeding three years shall be exempt from tax under the I.Tax Ord.2001. Subject to different conditions certain profits on debts are exempt in respect of loan made to the non-resident persons and certain salaries payable to certain non-residents working for various institutions are also exempt.

Under the I.Tax Ord.2001, the concept of thin capitalization has also been introduced in the Income Tax law of Pakistan. This section has been introduced mainly to encourage the foreign companies to invest in the equity of a company instead of advancing its loans. Section 106 which deals with this concept, provides subject to certain conditions that a foreign company other than a financial institution, which has a foreign debt to a foreign equity ratio in excess of three to one in any time during a tax year, shall not be allowed a deduction for the profit on debt paid by the company in that year on that part of debt which exceeds the three to one ratio. These were just a few of the incentives and provisions

which have been provided in the I.Tax Ord.2001, which is based on the government's commitment "voluntary compliance backed by strong audit". In this ordinance it has been provided that all returns filed u/s 114, including returns filed by the non-residents, of this ordinance shall be converted into assessment order on the date of their filing and only a certain percentage of the cases shall be selected for total audit. On the basis of these provisions, the foreign company and persons who wish to do make investment and do business in Pakistan require a lot of tax planning. Before ending my submissions on this subject I would like to refer to two other relevant sections. Section 152 provides that subject to certain exceptions, any person making any payment chargeable to tax under the provisions of this ordinance to a non-resident is required to deduct tax on such payments at the rate of 30% of the gross amount. However, the Commissioner has been provided with the discretion of deciding whether an amount is chargeable to tax or not and only after obtaining Commissioner's approval can a payment be made to a non-resident without deduction of tax u/s 152. The Commissioner is also empowered

to issue an exemption certificate or a lower withholding certificate to the person who is required to deduct tax from the payment of non-resident.

The Second section which I would like to refer is section 206-A, which has been incorporated vide Finance Ordinance, 2003 and deals with advance ruling. Under this section a non-resident is entitled to seek an advance ruling from the CBR on an interpretation of a particular section or the rate of tax applicable to him by stating the relevant facts. This section will play a great part in boosting a foreign investment in Pakistan by letting the non-resident know in advance their liability under the Income Tax Laws of Pakistan.

Avoidance of Double Taxation Agreement between Pakistan and AOTCA Countries:

(i) The States levy taxes on incomes which has arisen or accrued abroad, in cases of their residents.
(ii) The States do not waive or surrender their right to tax a person on the income which has arisen or accrued in their jurisdiction by virtue of the location of the source.
(iii) A person is deemed simultaneously to be resident by the two states, in one by virtue of his stay and in the other by virtue of any other criterion such as the source of income, or when the source rule overlaps because two states finds the same transaction to be within their territory.
(iv) Certain States tax worldwide income of their citizens, irrespective of their being residents of either states.

Double taxation agreements between two countries, therefore, aim at eliminating or mitigating the instance of double taxation. Or where such treaties are not in existence, countries have been avoiding taxing the same income twice through their unilateral action. In some cases specially for non-resident persons, unilateral tax relief is provided for doubly tax income. For developing countries such treaties have further importance as they facilitate attracting foreign investment. Thus, the agreements between the two countries to ensure that the persons are not taxed twice over, once in one country and again in another, on the same income, have normally been embodied in an agreement called avoidance of double taxation agreement. Such agreements are given statutory force in each country. They override to any other enactment. Even the parliament itself cannot alter the wording of double taxation agreement without the consent of both the parties.

As already pointed section 107 of the Income Tax Ordinance 2001 empowers the Federal Government to execute Avoidance of Double

Taxation Agreements with other countries and Pakistan has executed Avoidance of Double Taxation Agreements with many countries including thirteen countries who are members of AOTCA.

The main objective of an Avoidance of Double Taxation Agreement is to determine which of the two signatories to the agreement who are both claimants to tax the income may subject the Income to their taxes. The Avoidance of Double Taxation Agreement are based on various models which have been developed during the years. Before I discuss the various model agreements I would like to point out that currently

there is a well established pattern of Taxation of various types of Incomes and most of the tax agreement contain provisions to the following facts:

Income from the business is taxed.

(a) only in the home country, if the business undertaking carries on no activity in the host country:

(b) only in the host country, if there is a fixed place of business i.e., permanent establishment and to the extent it is attributable to other place;

(c) in both the countries (depending on whether the home country exempts the foreign profit or grants a credit)

- Income from immovable property arising to a non-resident is taxed primarily in the country of its own location.
- Income from movable property such as dividends, interest or royalty are primarily taxed in the home country, but the host country may impose a reduced tax.
- Income from personal exertion such as director's fees, service fees, pensions, remunerations, is taxed according to various rules with varying solutions.

The following model agreements form the basis of the Avoidance of Double Taxation Agreements between various countries

a) OECD model
b) ANDEAN model
c) UN model
d) US model

The main difference between the ANDEAN model and the OECD model is that the ANDEAN model is based on the source country principal while the OECD model recognizes the priority of the country to tax income. The basic concept of the OECD model is oppose to the principle of source and recognizes the right to tax income and gain to the country where the tax payer is resident. The ANDEAN model therefore, seeks to resolve the basic cause of international double taxation while locating the source in one country to the other but never in both the countries, where the OECD models resolve by dividing the tax take between the two countries. Thus, the OECD models recognizes and the ANDEAN model ignores the sauce doctrine that what is sauce for the goose and sauce for the gander.

That UN model is intended to serve the developing countries and was published by UN in 1980. This model has greater tax rights to the country where the income arises by providing the higher rates of withholding taxes on various heads of income and by allowing countries to retain most of the taxing powers available under the domestic tax laws for foreign businesses operating in the country. All the double taxation agreement entered by Pakistan with the member countries of AOTCA except the double taxation agreement between Japan and Sri Lanka are based on UN model and generally the

taxed of this agreement consist of around 7 chapters and 29 to 30 articles. A model agreement is detailed below:

¨ Article I : General scope.
¨ Article 2 : Taxes covered.
¨ Article 3 : General definitions.
¨ Article 4 : Resident.
¨ Article 5 : Permanent Establishment.
¨ Article 6 : Income of immovable property.
¨ Article 7 : Business profits.
¨ Article 8 : Shipping and Transport.
¨ Article 9 : Associated Enterprises.
¨ Article 10 : Dividends.
¨ Article 11 : Interest.
¨ Article 12 : Royalties.
¨ Article 13 : Capital gains.
¨ Article 14 : Independent Personal Services.
¨ Article 15 : Dependent Personal Services.
¨ Article 16 : Directors' Fees and remuneration on top levels managerial officials.
¨ Article 17 : Income earned by artistes and athletes.
¨ Article 18 : Pension and Social Security Payments.
¨ Article 19 : Remuneration and pension of government functions.
¨ Article 20 : Payments received by students.
¨ Article 21 : Professors, teachers and research scholars.
¨ Article 22 : Other income.
¨ Article 23 : Methods of elimination of double taxation.
¨ Article 24 : Non-discrimination.
¨ Article 25 : Mutual agreement procedure for resolving uncertainties and difference of opinion.
¨ Article 26 : Exchange of information.
¨ Article 27 : Diplomatic and consular activities.
¨ Article 28 : Entry into force.
¨ Article 29 : Termination.

The avoidance of double taxation which Japan and Sri Lanka is based on OECD model and does not include an article dealing with the taxability of capital gains and fee for technical services. It will therefore be presumed that capital gains and fee for technical services will be included in the industrial and business profits. However, in case of a US Company M/s. Motorala incorporated in USA , when the plea was taken that since the taxability of capital gains was not provided in the avoidance of double taxation between Pakistan and USA therefore, it became a part of business profits and could be taxed in Pakistan only if the US enterprises had a permanent establishment in Pakistan. The ITAT refuse to accept the plea and held that in accordance with sub-section 2 of article

(ii) of double taxation agreement b/w Pakistan and USA is completely paramateria with sub-section 2 of article (ii) of double taxation agreement b/w Pakistan and Japan and is reproduced below:

"In the application of the provisions of the present Convention by either the contracting State, any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the law of that contracting state relating to the tax."

Since the term capital gain has not been defined in the avoidance of double taxation agreement it shall have the meaning which it has under the tax laws of Pakistan and it accordingly taxable in Pakistan. The above sub-section is reproduced below for the sake of convenience.

Under article 7 of avoidance of double taxation agreement b/w Pakistan and Japan is exempt from tax if the japanese corporation receiving such royalty does have not a permanent establishment in Pakistan. However, in all other avoidance of double taxation agreement b/w Pakistan and aotca countries there is no exemption of royalty in Pakistan and if the recipient is the beneficial owner of such royalties a maximum rate of tax has been fixed beyond which no tax can be levied.

Under article 6 of avoidance of double taxation agreement between Pakistan and Japan, if a japanese corporation being a public company or a group of public companies owned not less than one third of the voting share of a Pakistani company engaged in an industrial undertaking. Such companies were entitled to a reduction of one anna in a rupee in respect of their tax in their dividend. On this the Tribunals of Pakistan have given conflicting decisions. One divisional bench has held that the rebate of 6.25% will be directly deducted from the rate of tax, whereas the other divisional bench has held that rate of tax on dividend shall be reduced by 6.25% of the rate of tax giving rise to the following situations:

A:

Prescribed rate on dividend	10%
Less : Rebate	6.25%
Rate of tax payable on dividend	3.25%

B:

Prescribed rate on dividend	10%
Less : Rebate (6.25% of the tax on dividend)	6.25%
Rate of tax payable on dividend	3.25%

After the above submissions I would now resort to discussing the interpretation of the provisions of Double Taxation Treaties.

Double taxation treaties have a dual nature on the one hand they are international agreements entered into between states to regulate the exercise of their fiscal jurisdiction; on the other hand they become part of the domestic law of each of the states. A treaty being a part of the domestic legislation the approach of many countries would be to adopt a strict construction.

Further a treaty generally offers an exemption to the taxpayer and therefore it is arguable that the exemption should be strictly construed. The burden is on the taxpayer to show that he or she fails within the exact terms of the exemption

Such agreements have to be interpreted in order to apply them to different cases of possible double taxation. The basis of interpretation of such international agreements may be slightly different from the interpretation applicable to domestic laws. The objects in interpreting such agreements is to avoid any conflict with international obligation of the state.

The problem of the correct approach to interpreting tax treaties is discussed by Dr. Raoul Lens, the General Reporter in the International Fiscal Association's 1960 Report on the interpretation of double taxation Convention.

"International agreement for the avoidance of double taxation are bilateral treaties and thus belong to the law of nations in the same way as any other political or economic treaty. If the meaning of a treaty provision is not clear then the problem will be solved in the first place by applying the usual public law. However, double taxation agreement have a purpose substantially different from that of normal fiscal legislation and to avoid the simultaneous taxation in both countries."

In interpreting fiscal statues as well as other laws, great emphasis is laid on the natural meaning of the language used without straining the meaning or interpreting it in an unnatural manner. It is generally held that the object of interpretation of a statute is to give effect to the intention of the legislature. The tax laws have to be considered as a whole and it has to be ensured that the intention of the legilstaure should not be defeated. For interpreting a statute the object of the legislation has to be kept in view. A particular law was to be considered as a whole and words used had to be given the intended meaning.

In IRC vs. Exxen corporation (56 T.C. 237) Gouldng J. depared from the plain meaning of words as specifically defined in the convention in order to give effect to terms used. He explained his approach as follows:

" In coming to this conclusion I bear in mind that the words of the convention are not those of a regular parliamentary draughtsman but a text agreed on by negotiation between the two contracting governments. Although I am thus constrained to be violence to the language of the convention, I see no reason to inflict a deeper would than necessary. In other words, I prefer to depart from the plain

meaning of language only in the second sentence of article XV and I accept the consequence (strange though it is) that similar words mean different things in the sentences."

In the case of Union Taxes Petroleum Corp. vs/ Critchly (1988 STC 691) Harman J. affirmed the words of Coulding J. and added:

"I consider that I should bear in mind that this double tax agreement is an agreement. It is not a taxing statute, although is an agreement about how taxes should be

imposed. On that basis, in my judgement this agreement should be constructed as ut re magis valeat quam pereat, as should all agreement. The fact that the parties are high contracting parties to use an old description, does not change the way in whch the courts should approach the construction of any agreement."

Just as the statutes have some purposes or object, agreements between the countries also have certain prupose. The purpose can be gathered from the agreement itself, from its preamble and the total tenor of the agreement. As tax treaties are meant to allocate tax claims equally between the contracting states, the tax authorities as well as the courts have to comply with the provisions of the treaty consistently. An interpretation which is most likely to be accepted by both contracting states, should always be preferred. In drafting the tax treaties several terms are defined in a manner which is acceptable to the two parties. Wherever, such definition is not given, a particular term may be interpreted having regard to the meaning given to it in the domestic laws. In such matters, therefore, both the international and domestic law have to be reconciled. The object and purpose of double taxation convention is:

1. To restrict the substantive tax law of contracting states reciprocally and;

2. To avoid cases of double taxation, while interpreting an agreement one has to keep in view the other related documents like protocols, notes and letters exchanged at the time the treaty is signed.

In January 1980 the United Nations Vienna Convention on the Tax Treaties of May 23, 1969, came into effect. To a great extent the convention codified income tax norms and customary international law. Such agreements are notified before their implementation. The Vienna convention contains general rules and they have resolved some uncertainties in international practice.

The tax agreements are in the nature of special provisions and they are not altered by subsequent law unless it expressly contradict their provisions. Bing special rules they override the domestic tax laws on the basis of the doctrine of generalia specialibus non derogant. This principle is attraction in case of conflict between a special and general statutes. It has been held by the supreme court of India in the case of Shahzada Nand and Sons : 60 ITR 392, that the eneral and special rules occupy the same filed. However in case of conflict the special provision must prevail as held by the Supreme Court in the case of Union of India vs. India Fisheries (P) Limited.: 57 ITR 33.

As the purpose of the agreements is to avoid any conflict, the approach for interpretation should always be harmonious interpretation of tax agreements. Where an interpretation is possible which promotes harmony and agreement it should be preferred to an interpretation which creates disharmony and disagreement. Even after such interpretation if a conflict remains, it has to be removed only by diplomatic means or by legislation. However, in all such interpretations the language has to go along with the intention and in case of conflict the language must be given its natural meaning. It is presumed that in the agreements the intention has been given in a clear manner and, therefore, there can not be an attempt at interpreting the provisions of the agreements in an official manner.

An important principle of interpretation of an agreement is to read the agreement as a whole. That would avoid any conflict in one part of the agreement with the other parts of the agreement. While interpreting the tax agreements, inconsistencies and collision have to be avoided and persuasive value should be attached to the decision of the foreign courts as well. However, the domestic courts continue to have their independent judgment even if it has to be against the decision of the foreign courts. The decision of the foreign court would be entitled to the same respect which the decision of any other domestic court would attract. The agreements between two states do not result in the application of tax laws of one state by the other. Rules of double taxation agreements are, therefore, "rules of limitation of law". A tax obligation exceeds in accordance with the domestic law of the state, but the same is defined and restricted by the tax agreements. In the domain of taxation, each state applies its own domestic laws subject to the limitation put by the agreements. Such limitation may be by giving credit to the tax paid in the other state or to waive the claim in its favour. They are called 'exemption' method or 'credit' method.

Where the expression is not defined in an agreement, controversy can arise in relation to the agreement if it is interpreted differently under the domestic laws of the contracting states. If the agreement uses the same which are used also in the substantive laws of the contracting states the controversy may become steeper. The conflict between the domestic laws of the two concerns can be resolved through various concepts. The concept of domestic law provides that each state qualifies the agreement terms according to the requirements of its own domestic laws. The argument against this concept is that it disregards the foreign law and may result in a conflict. The other concept is the concept of source country qualification according to which a term has to be interpreted in accordance with the laws in force in that state. These concepts are, however, not sufficient to resolve the conflict. Rules are only aids to construction and one must look to all the relevant circumstances and decide as to which rule should be applied in the circumstances of the case. The context is very important. The words cannot be read in isolation and their content is derived from their context. The reconciliation the conflicting legal system should be attempted under mutual agreement clause.

The courts in Pakistan have also been involved in interpreting the definition of royalty and determining its exemption.

One of the leading case decided on this issue has been decided by Honourable High Court of Sindh in the case of

M/s. Glaxo Laboraties Limited
V/s.
Commissioner of Income Tax Karachi
(1991) 63 Tax 100.

In this case Mr.Justice Saleem Akhter discussed the definition of royalty as given in the agreement for avoidance of double taxation between U.K. and Pakistan and held that payment made to M/s. Glaxo Laborites Pakistan Limited fell within the definition of royalty and was thus exempt from tax.

The courts may be aided by the use of "travaux preparratoires" in the interpretation of international conventions in general. With regard to double taxation agreements, in Sun Life Assurance Co. of Canada Vs. Pearson (1986) S.T.C. 335) Vinelott J. stated that the commentaries to the O.E.C.D. Model "can and indeed must be referred to as a guide to the interpretation of the Treat" The commentaries have also been referred to as an aid to interpretation in the United States (US V.A.L. Burbank & Co. Ltd. 525 F 2d 9 (2d Cir 1975) Switzerland, Germany and Belgium.

In forthergil Vs. Monarch Airlines Ltd. (1981 A.C. 251) the House of Lords give some guidance as to when "travaux preparatoires" may be consulted. Lord Wilberforce thought that they should be admissible only on tow conditions. First, that the material involved was public and accessible, and second, that it 'clearly and indisputable' pointed to definite legislative intention. The majority view of the house of lords in this case was' travaux preparatoires' are admissible. This view has been affirmed in another case decided in 1985 - Gatoil International Inc. V. Arkwright Boston manufacturers Insurance Co. (1985 A.C. 255) .

For the efficient and fair application of tax agreements, attempt of the courts world over should be to interpret its provisions consistently avoiding collision. Lord Scarman said in Fothergill Vs. Monarch Airlines "The decisions of the superior court, or the opinion of a court of cassation, will carry great weight "In Canada, decision, of the United States Tax Courts have been applied (see No. 630 V.M.N.R. 59 D.T.C. 300) as has an interpretation issued by the Dutch Ministry of Finance (Hunter Douglas Ltd. V.M.N.R. 79 D.T.C 5340). One rare example of the citation of a civil law country's decision in a common law country was a reference to a decision of the Bundesfinanzhof in a New Zealand case. (Commissioner of Inland revenue Vs. Unived Dominions Trust Ltd. (1973) 1, N.Z.T.C. 61, 028).

The issue remains what approach should courts take to the interpretation of double taxation agreements ?

In Canada, the Courts have at times suggested a different approach to the interpretation of taxation treaties from the interpretation of domestic tax legislation.

"The accepted principle appears to be that a taxing Act must be construed against either the crown or the person sought to be charged, with prefect strictness-so far as the intention of Parliament is discoverable. Where a tax convention is involved, however, the situation is different and a liberal interpretation is usual, in the interests of the comity of nations. Tax conventions are negotiated primarily to remedy a subject's tax poison by the avoidance of double tax taxation rather than to make it more burdensome.

Similarly, in New Zealand the Courts have held that they should take a broad approach to the interpretation of double taxation agreements:

"We are not to adopt a narrow interpretation but interpret having regard to the broad intention of the framers as they emerge from tax text.

The Australian Courts appear to have adopted a literal approach to the interpretation of

double taxation agreements, consistent with the approach of interpreting the agreement as part od domestic law without regard to its character as a bilateral treaty.

The situation of France is somewhat different from common law countries since courts may only interpret a treaty if its meaning is clear. In all other cases Ministry of Foreign Affairs is the competent authority for issuing interpretations which are binding upon the courts. Thus much of the discussion on treat interpretation by the courts cannot apply in France.

In the United Sates the "rules of construction used by United States Courts in interpreting treaties as domestic law are essentially the same as those used by the courts in interpreting statutory law" Particular features of the United States approach to interpreting tax treaties is the reliance placed upon committee treaties of the congressional committee (before whom the treaty has been discussed) and upon the technical Memorandum prepared by the United States Treasury. This Memorandum is prepared after the treaty is concluded on the basis of noted during the negotiations and the preparatory material.

In U.S.A. Vs. A.L. Burkbank the Second Circuit court of Appeal sanctioned a broad approach to he interpretation of tax treaties:

"Moreover it is well understood that treaties are to be broadly construed to enable the intent of the treaty to be enforced"

The case referred to the Commentaries to the OECD Model as an aid to interpretation, and looked at the purpose of the treaty to prevent fiscal evasion as a guide to interpreting the exchange of information provision.

It is worth pointing out briefly, however, that the regular recourse to committee reports and the Technical Memorandum had been doubted recently in the Supreme Court by Scalia and Kennedy JJ. In US Vs. Stuart.

While the issue whether that Technical Memorandum should prevail if it contradicted the clear words of the treaty did not have to be decided in that case, nevertheless Scalia J. had the following comments:

" Of course, no one can be opposed to giving effect to the intent of the Treaty parties'. The critical question, however, is whether that is more reliably and predictably achieved by a rule of construction which credits, when it is clear, the contracting sovereigns carefully framed and solemnly ratified expression of those intentions and expectations, or rather one which sets judges in various jurisdictions at large to ignore that clear expression and discern a ''genuine'' contrary intent elsewhere. To ask that question is to answer it."

An he added further :

" Using pre-ratification Senate materials, it may be said, is rather like determining the meaning of a bilateral contract between two corporations on the basis of what the Board of directors of one of them thought it meant when authorizing the Chief

Executive Officer to conclude it. The question before us in a treaty case in what the two or more sovereigns agreed to, rather than what a single one of them, or the legislature of a single one of them, thought it agreed to. And to answer that question accurately, it can reasonably be said, whatever extra-rextual materials are consulted must be materials that reflect the mutual agreement (for example the negotiating history) rather than a unilateral understanding."

There are a large number of cases in India in respect of double taxation cases arising from the Double Taxation Avoidance Agreements with Pakistan. A few of those cases are as under :-

(1) CIT Vs . Carew & Co. Ltd. (120 ITR 540 SC)
(2) CIT Vs . Mahalaxmi Sugar Mills Ltd. (160 ITR 920 SC).
(3) State Bank of India Vs . ITI (57 ITR 235 Cal).
(4) Cement Agencies Ltd. Vs . CIT (146 ITR 136 Bom).
(5) CIT Vs . Soorajmull Nagramull (130 ITR 136 Cal).

The subject of " Taxation of Non-Resident and Double Taxation Agreement" is a very vast & wide subject and if I had tried to cover every aspect of this subject in this paper, a treaties running into hundreds of pages would have resulted and it was not possible for me to conduct such painstaking research. I have however tried to briefly highlight the salient and important element of this subject.

I hope this paper with all its inadequacies may prove to be of some benefit to you.

Thank you very much all of you, it had been a great experience to be able to communicate with you.