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Recent Developments in International Taxation

Pakistan

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Overview

The Islamic Republic of Pakistan ('Pakistan') is a federal republic, comprising the provinces of Balochistan, Khyber Pakhtunkhwa, Punjab and Sindh; the federal capital, that is, the Islamabad Capital Territory (ICT); and such states and territories as are included in Pakistan through accession or otherwise. The country is governed by a written constitution.[1] The constitution contains a Federal Legislative List (FLL) that provides for the matters on which Parliament enjoys exclusive legislative authority. All residual matters fall within the domain of the provincial assemblies. The tax structure in Pakistan can therefore be divided into two categories: federal taxes and provincial taxes.

Entries No 43–53 of the FLL are tax entries and include taxes such as income tax, customs and excise duty, and sales tax on goods (all federal taxes). The provincial assemblies, on the other hand, possess legislative competence on taxes such as the sales tax on services and property tax (provincial taxes).

The following are the important federal taxing statutes:

- Income Tax Ordinance, 2001 (ITO);
- Customs Act, 1969 (the '1969 Act');
- Sales Tax Act, 1990 (the '1990 Act'); and
- Federal Excise Act, 2005 (the '2005 Act').

Services tax for the ICT is governed by the federal statute, that is, the Islamabad Capital Territory (Tax on Services) Ordinance, 2001 (the 'ICT Sales Tax Ordinance'). Administrative oversight of ICT services tax is carried out by the Federal Board of Revenue (FBR).[2]

The FBR is an autonomous body responsible for implementing and collecting taxes under the aforesaid statutes.

Provincial services tax is governed and implemented under the following legislation:

- the Punjab[3] Sales Tax on Services Act, 2012 (the 'Punjab Sales Tax Act');
- the Sindh[4] Sales Tax on Services Act, 2011 (the 'Sindh Sales Tax Act');
- the Khyber[5] Pakhtunkhwa Sales Tax on Services Act, 2022 (the 'KP Sales Tax Act'); and
- the Balochistan[6] Sales Tax on Services Act, 2015 (the 'Balochistan Sales Tax Act').

The federal and provincial legislatures enact a new statute each year called the Finance Act, which comes into effect from 1 July of that year (the start of the fiscal year), through which amendments are made to, inter alia, the aforesaid taxing statutes. The latest enactment in this regard is the Finance Act 2023, which came into force on 1 July 2023.

Pakistan has ratified the Convention on Mutual Administrative Assistance in Tax Matters and is part of the Multilateral Competent Authority Agreement for Automatic Exchange of Financial Account Information, implementing the Common Reporting Standard. Additionally, Pakistan is a signatory to the Multilateral Competent Authority Agreement for the automatic exchange of country-by-country (CbC) reports and actively participates in the Inclusive Framework on Base Erosion and Profit Shifting (BEPS), overseeing the Organisation for Economic Co-operation and Development (OECD)/G20 BEPS Action Plan's implementation.

[1] The Constitution of the Islamic Republic of Pakistan (last amended in 2018) (Constitution).
[2] See www.fbr.gov.pk accessed 12 September 2024.
[3] Punjab Revenue Authority: https://e.pra.punjab.gov.pk/ accessed 12 September 2024.
[4] Sindh Revenue Board: www.srb.gos.pk accessed 12 September 2024.
[5] Khyber Pakhtunkhwa Revenue Authority: https://kpra.gov.pk accessed 12 September 2024.
[6] Balochistan Revenue Authority: https://bra.gob.pk accessed 12 September 2024.

Income tax

Income for the purposes of tax is broadly categorised under five headings: (1) income from salary; (2) income from property; (3) income from business, (4) capital gains; and (5) income from other sources.

Corporate tax rules

A company is deemed a resident of Pakistan if incorporated under Pakistani law or if its control/management occurs wholly within Pakistan. Similarly, an association of persons is considered a resident if its affairs are controlled and management is located wholly or partly in Pakistan during the tax year.

Companies are individually taxed, with distinctions among small companies, banking companies and others. Specialised corporate income tax rules apply to sectors like oil, natural gas production, mineral exploration, banking, insurance and charitable organisations, while a minimum tax is mandated for resident companies and permanent establishments (PEs) of non-resident companies under specific conditions

Non-resident corporations in Pakistan are taxed on income and capital gains from Pakistan sources, as outlined in section 101 of the Income Tax Ordinance. This includes business income related to a PE in Pakistan, sales of similar goods, other relevant business activities, any business connection and the disposal of assets in Pakistan, even if the transaction occurs outside the country.

Under the ITO, a 'PE' for a non-resident includes physical locations like offices, factories, mines and virtual business presence through electronic transactions. It encompasses places where contracts are negotiated; agricultural properties; and sites or projects lasting over 90 days. Services provided through employees, agents with contracting authority, substantial equipment and cohesive business operations also qualify. The definition excludes liaison offices engaging in certain commercial, trading or industrial activity. A liaison office is one that doesn't derive income in Pakistan and is funded externally, provided it's not involved in specified commercial activities, and FBR specifies criteria for its classification.

Pakistan's standard tax year runs from 1 July to 30 June, and any deviation from this requires approval from the Commissioner of Inland Revenue. Notably, the FBR designates specific year-end dates for insurance companies (31 December) and certain other industries (30 September).

Corporate income in Pakistan is categorised under four headings: income from property, business, capital gains and other sources. Each heading follows distinct deductibility rules, generally permitting deductions for business-related expenditure. Non-deductible expenses include fines, penalties, personal and excessive entertainment costs. The term 'profit on debt' is employed instead of 'interest' in the taxation context.

Income exempt from federal tax in Pakistan includes agricultural income (taxed by provinces); profit from domestic power projects; Pakistan-source income protected by double tax treaties; income from contractors, consultants or experts on local projects; and profit on debt and capital gains from government-approved debt for non-resident banking companies under a sovereign agreement.

Corporate taxation includes group treatment options where companies can choose to be taxed as a single fiscal unit. This group taxation is available for locally incorporated companies under the Companies Act 2017, allowing intercorporate dividends within the group to be exempt from income tax. Group relief further permits a subsidiary to surrender assessed losses to its holding company or another subsidiary, subject to conditions like continued ownership and limitations on loss utilisation. The definition of a group involves locally incorporated holding and subsidiary companies within a wholly owned group, offering tax benefits under specified conditions.

Intercorporate dividends

Dividends from a resident company to another are taxed at 15 per cent (30 per cent for non-Active Taxpayer List entities). Intercompany dividends within a fiscal unit are exempt. Independent Power Purchasers' dividends and those from qualified bagasse and biomass-based cogeneration power projects have a 7.5 per cent tax rate. A 25 per cent rate applies to dividends when the paying company hasn't paid tax due to exemptions, and a 35 per cent rate for special purpose vehicles, exempt for real estate investment trusts (REITs). Tax is withheld at source, and excess withholding can be adjusted for non-Active Taxpayers List (ATL) entities.

Special tax zones

Special tax regimes in Pakistan include Export Processing Zones (EPZs), Special Economic Zones (SEZs) and Special Technology Zones (STZs).

- EPZs offer duty-free imports; exemption from national regulations, capital and profit expatriation; and no sales tax on input goods. Industrial exports from EPZs face a final one per cent withholding tax.
- SEZs grant customs duties and taxes exemptions for capital goods, and a ten-year income tax holiday for zone enterprises and developers.
- STZs provide tax concessions for designated developers and enterprises, including a ten-year exemption from various taxes and duties. Qualifying persons in STZs are exempt from minimum tax provisions for ten years.

Double taxation

Residents with foreign-source income that is subject to tax under the ITO are provided a credit equal to the lesser of the foreign income tax paid or the Pakistan tax payable. The credit is granted if the foreign tax is paid within two years of the relevant tax year.

Treaties for avoiding double taxation apply, providing relief under the ITO, determining Pakistan-source income for non-residents, and exchanging information.

Pakistan follows the convention that a tax treaty can only reduce, not increase, the tax burden, with the OECD model influencing its treaty interpretations.

Withholding tax

Internal withholding taxes in Pakistan involve resident companies withholding 15 per cent tax on profit on debt payments to non-bank entities. Prescribed persons making payments for services, goods, or contract execution face withholding tax. For services, rates vary, such as four per cent for specific services. Sales of goods attract a 1.5–5.5 per cent withholding tax, and contract execution incurs a 7.5 per cent to ten per cent withholding.

Income from immovable property is taxed at 15 per cent of gross rent. Export proceeds face a one per cent withholding tax. Advance tax, based on the previous year's results, is payable quarterly.

Penalties apply for non-payment or concealment of income. The statute of limitations allows authorities to amend returns within five years.

Corporate taxes

The standard corporate income tax rate in Pakistan is 29 per cent. However, a 'super tax' is applicable to high-earning individuals at varying rates based on income levels, ranging from one per cent to ten per cent. The super tax covers various sources of income, including profit on debt, dividend, capital gains, brokerage and commission. From 1 July 2023, the super tax was included in the requirements for advance tax payments. It may be noted that there were constitutional challenges to the super tax for tax year 2022, leading to a Supreme Court order capping the rate at four per cent pending a decision on its constitutionality.

In the context of minimum tax in Pakistan, resident companies and PEs of non-resident companies face a minimum tax rate of 1.25 per cent of turnover if the calculated tax payable is lower than this percentage. Different sectors, such as certain parts of the poultry industry, motorcycle dealers, oil refineries and oil marketing companies, have specific minimum tax rates ranging from 0.75 per cent to 0.25 per cent of turnover. Any excess minimum tax over the corporate income tax liability can be carried forward for up to three tax years.

Additionally, under the alternative corporate tax (ACT) regime, companies calculate their tax liability based on either the standard corporate income tax or the ACT at a rate of 17 per cent of accounting income, with any excess carried forward for up to ten years. The ACT regime excludes certain sectors like banks, insurance companies, and the petroleum and mineral exploration sectors.

Small companies registered post-1 July 2005 in Pakistan pay a reduced 20 per cent tax for the 2023 tax year, meeting criteria like a capital limit of INR 50m, up to 250 employees and an annual turnover below INR 250m. Small and medium-sized enterprises (SMEs) in goods production with a turnover of up to INR 250m choose between standard tax rates or a gross turnover-based optional regime, with exemptions from minimum tax and withholding tax on sales over INR 75,000. Online marketplaces also benefit from reduced rates.

Pursuant to recent legislation, the Federal Government can levy a maximum 50 per cent additional tax on those benefitting from economic factors like international price fluctuations or currency differences, leading to windfall income. Through SRO dated 21 November 2023, the banking companies have been notified to be the specified sector for the purpose of application of windfall tax, attracting income tax at the rate of 40 per cent.

Capital gains

In Pakistan, capital gains are taxed based on the type of property and holding period. Capital losses can offset gains, with a carry-forward period of up to six years. The tax rates for capital gains on securities vary, with exemptions for certain holding periods. Immovable property sales incur tax based on the holding duration. Corporate capital gains involve specific definitions and computation rules, with tax-neutral treatment for mergers and specific conditions for asset transfers. Losses from business operations can be offset against taxable income, with carry-forward periods and special considerations for certain industries. Tax rules apply to losses after changes in ownership, allowing adjustments and carry-forwards.

Tax withholding on non-residents

Corporate withholding taxes on non-resident corporations involve specific rates for different types of payments. For dividends, the general withholding tax rate is 15 per cent, with variations based on specific conditions and entities. Interest payments to non-resident corporations are subject to a ten per cent withholding tax rate. Royalties attract a 15 per cent withholding tax, and various services provided by non-resident companies have distinct withholding tax rates, such as 15 per cent for technical services and ten per cent for offshore digital services.

Additionally, other withholding taxes apply to categories like rent, sale of goods and contract execution, each with a specific rate.

The criteria for tax residency in Pakistan for individuals are based on presence, employment and citizenship.

Tax rates

Individuals in Pakistan face progressive tax rates based on their taxable income. Currently, for those whose salary constitutes over 75 per cent of their taxable income, rates range from zero per cent for income up to INR 600,000 to 35 per cent for amounts exceeding INR 6m. Director's fees are subject to a 20 per cent non-final withholding tax. Other individuals and associations of persons have varying rates, starting from zero per cent for income up to INR 600,000 and reaching 35 per cent for amounts exceeding INR 6m. Those with an annual turnover of INR 100m or more are subject to minimum tax requirements. Annual returns must be filed by 30 September, and electronic filing is encouraged, with specific mandates for certain income levels and turnover. Advance payments are required for individuals with non-salary taxable income exceeding INR 1m.

Dividends from domestic corporations face varying tax rates, including 7.5 per cent for specific dividends from Independent Power Producers, 15 per cent for mutual funds and real estate investment trusts (REITs), 35 per cent for special purpose vehicle dividends (zero per cent for REIT investors) and 25 per cent for dividends when the paying company hasn't paid tax due to exemptions or losses. The tax, withheld by the company, is generally final for those in the ATL. Dividends from foreign corporations are taxed at the same rates, with a credit available for foreign tax paid, up to the Pakistan tax payable, subject to applicable tax treaties.

Resident individuals receiving profit on debt up to INR 5m face a 15 per cent withholding tax. Amounts exceeding INR 5m are taxed under standard rates. Residents investing in government debt through a Foreign Currency Value Account (FCVA) enjoy a reduced ten per cent withholding tax. Non-resident withholding tax is ten per cent, with exemptions for certain accounts. Foreign interest received by resident individuals from foreign corporations is taxed similarly to domestic interest, with a credit available for foreign tax paid, up to the Pakistan tax payable, under applicable tax treaties.

Royalties paid to resident individuals are taxed as ordinary income. Rents paid to residents are taxed on a gross basis, with specified categories deducting tax based on gross rent amounts. For non-residents, royalty payments face a 15 per cent withholding tax, adjustable against the final tax liability. The withholding tax rates and amounts for rents paid to non-resident individuals mirror those for resident individuals.

Transfer pricing and anti-avoidance

Pakistan's transfer pricing policies empower the Commissioner of Inland Revenue to allocate income between

associates for controlled transactions, ensuring compliance with the arm's length standard. Permissible pricing methods include the comparable uncontrolled price, resale price, cost plus and profit split methods. No specific penalties for improper pricing are outlined. Although Pakistan lacks an Advance Pricing Agreement regime, non-resident taxpayers can seek advance rulings. The documentation requirements, including master files, local files and CbC reports, align with OECD/G20 BEPS project recommendations. Failure to comply with documentation requirements may incur penalties, with different penalties for record maintenance, non-compliance and failure by financial institutions to furnish information or CbC reports.

The Commissioner of Inland Revenue is empowered to recharacterise transactions, disregard those lacking economic substance and treat places of business as PEs. The thin capitalisation rules restrict interest deductions for foreign-controlled companies, incorporating a 3:1 debt-to-equity ratio and a fixed ratio test. Controlled foreign company (CFC) rules include the inclusion of CFC income in a resident's taxable income, considering factors like capital ownership, taxation and business activities. Income attribution follows a prorating method, with exemptions based on ownership percentages and *de minimis* thresholds.

Customs duty

The Customs Act, 1969 outlines duties on goods in Pakistan. Customs duties are applied to imported goods; those transshipped or transported between customs stations; and those moved in bond between stations. Customs duties are prescribed in the First Schedule or under other laws. The government may impose regulatory duties, not exceeding 100 per cent of the determined value, on specified goods. An additional customs duty, not exceeding 35 per cent, may be levied on specific imported goods. The cumulative incidence of customs duties under various sections should not exceed rates agreed on in multilateral trade agreements. These duties are in addition to other applicable duties and are effective from the specified day, regardless of the publication date.

For imported goods, the transaction value, that is, the price actually paid or payable, is the primary basis. Adjustments are made, including transport, handling, insurance and additional costs incurred by the importer. Royalties, licence fees and the value of subsequent proceeds accruing to the seller are also considered.

If the buyer and seller are related, the transaction value is accepted if it closely approximates certain test values. If not, alternative methods, including the transaction value of identical or similar goods, deductive value and computed value, are employed. A fallback method may be applied if none of the previous methods yield a result. The section also addresses the determination of customs value for exported goods, considering market sale conditions, additional costs and intellectual property rights.

The Customs Act emphasises the authority of customs officers to access business premises for audit purposes, and clarifies terms like 'identical goods', 'similar goods' and 'goods of the same class or kind'. The section stresses the right of customs officers to verify information and outlines procedures for cases where the relationship between the buyer and seller may influence the price.

The law also grants the Director of Customs Valuation the authority to determine the customs value of imported or exported goods. This can be initiated by the director, or in response to a reference from any person or a customs officer. The determination follows the methods outlined in section 25. The customs value established through this process becomes the applicable value for assessing the relevant goods. However, if the value declared in a goods declaration or invoice is higher than the determined value, the declared higher value takes precedence. Once determined, the customs value remains applicable unless revised or rescinded by the competent authority.

Sales tax on goods

The Sales Tax Act 1990 is the primary legislation governing sales tax in Pakistan, with its principles implemented through the Sales Tax Rules 2006 and Sales Tax Special Procedure Rules 2007. The FBR oversees administrative aspects of federal sales tax, being an autonomous body responsible for implementing federal fiscal statutes and tax collection.

Sales tax is imposed on the value of taxable supplies conducted by a registered entity. A taxable supply is any supply of taxable goods made by an importer, manufacturer, wholesaler, distributor or retailer, other than exempt goods. It

encompasses both domestic transactions and imported goods, regardless of their final destination within Pakistan.

Federal sales tax rates include a standard rate of 18 per cent, reduced rates ranging from one per cent to 12 per cent, enhanced rates, zero rates and exemptions. Special rates apply to specific products, and an additional three per cent tax is imposed on sales to unregistered persons. There's also a one per cent tax on supplies to non-registered purchasers. Provincial sales tax rates vary across services, with a maximum rate of 19.5 per cent.

The Sales Tax Act defines a person broadly, encompassing individuals, associations, companies, governments and international entities. Mandatory registration for federal sales tax is required for those involved in taxable supplies, falling under specific categories such as manufacturers, retailers, importers, wholesalers, exporters seeking refunds, service providers and those mandated by federal or provincial laws. Taxable activity encompasses economic endeavours, excluding employee services to employers or personal/recreational pursuits. The FBR holds authority for compulsory registration if eligible entities fail to apply voluntarily under the Sales Tax Act.

Imported goods are generally subject to sales tax, unless specifically exempted. Explicit exemptions are detailed in section 13 and Sixth Schedule to the Sales Tax Act 1990. Various exemptions apply to imports, including those not available locally, imports into free zones and imports for governmental or diplomatic purposes. Exempted items include goods imported by United Nations agencies, diplomats and diplomatic missions; certain imports by charitable hospitals; materials for Gwadar Port; and machinery for authorised financial services providers. Importers should seek advice to determine eligibility for these exemptions due to their detailed requirements.

Bonded warehousing is available for manufacturer-exporters in Pakistan, allowing storage of non-perishable goods for six months and perishable goods for one month. An extension is possible by prepaying a surcharge on duty and taxes. Sales tax applies on the goods' removal from the warehouse into free circulation.

Businesses in the Gwadar Free Zone enjoy a 23-year sales tax exemption, as per section 100B of the Sixth Schedule. Enterprises in specified STZs may be eligible for the sales tax exemption under the STZ Authority Act, 2021. The Sixth Schedule also provides exemptions for machinery, equipment and materials imported for exclusive use within the Export Processing Zone or for making exports from the zone, and goods imported for warehousing in the Export Processing Zone by its investors. Under section 7 of the Sales Tax Act in Pakistan, registered persons can deduct input tax (sales tax on supplies to them) during the tax period for taxable supplies made or to be made, subject to certain conditions. Input tax includes provincial services tax on services rendered to the registered person.

Taxpayers can claim a credit for adjustable input tax up to 90 per cent of output tax collected, except for fixed assets or capital goods. The excess can be carried forward. However, certain restrictions apply, and a registered person cannot reclaim input tax on supplies, such as goods or services used for non-taxable purposes, fake invoices and undeclared sales. The board can specify additional restrictions.

Section 73 of the Sales Tax Act states that no input tax deduction is generally allowed for supplies of a value greater than INR 50,000 paid by non-banking methods. Documentary requirements for claiming a refund or credit include a tax invoice, goods declaration for imported goods and a treasury challan for goods purchased at auction.

Specific rules apply to locally produced electric vehicles, limiting the input sales tax claimed to not exceed the output sales charged on the sale, with no carry-forward or refund allowed.

Federal excise duty

Excise duties are imposed under section 3 of the Excise Act on goods produced or manufactured in Pakistan, goods imported into Pakistan, certain goods brought from non-tariff areas to tariff areas and services provided in Pakistan. The duty rate is generally 15 per cent *ad valorem*, except for goods and services specified in the First Schedule. For imported goods, the duty is collected in the same manner and time as customs duty.

The Federal Government has the authority to specify goods or services for excise duty, and the duty may be levied based on production capacity or on a fixed basis. Additionally, a further duty of two per cent may be charged on excisable goods and services if supplied to an unregistered person.

The liability to pay duty depends on the origin and nature of the goods or services, including the manufacturer for domestically produced goods, the importer for imported goods, the service provider for services in Pakistan and the

person bringing goods from non-tariff to tariff areas.

For goods specified in the Fourth Schedule, a minimum production is determined based on input consumption, and if it exceeds actual supplies, duty is discharged accordingly.

Provincial sales tax on services

Taxable services under provincial sales tax acts are typically those listed in the second schedule to the relevant act, provided by a registered entity from its registered office or business location in the respective province in the course of an economic activity. These services commonly involve the transportation of goods or passengers, banking, construction, shipping, telecoms, advertising, professional services, outsourced business services, event organisation and temporary or contract employment, as well as hotel accommodation and catering.

Under provincial sales tax acts, individuals are typically obligated to register for services tax if they provide taxable services from an office or business location within the province. In some situations, registration is also required if the service recipient resides in the province.

While provincial sales tax rules lack detailed regulations on the time of supply, they generally stipulate that if a service is rendered over time with periodic payments, they are considered as distinct services, each corresponding to the part of the service linked to the respective payment.

In the Province of Sindh, services related to the renting, letting, subletting, leasing, sub-leasing, licensing or similar arrangements of immovable property for business or commerce are typically subject to sales tax on services. Taxable services under provincial sales tax acts encompass construction services, along with the services provided by developers, architects, dealers and interior decorators.

In Balochistan, the rates range from 15 per cent to 19.5 per cent under the Second Schedule to the Balochistan Sales Tax Act. Islamabad generally imposes a 16 per cent tax rate, with specific rates of 15 per cent for call centre services and five per cent for certain information technology services as per the Schedule to the Islamabad Capital Territory (Tax on Services) Ordinance, 2001. In Khyber Pakhtunkhwa, the sales tax rate on services falls between five per cent and 19.5 per cent under the Second Schedule to The Khyber Pakhtunkhwa Finance Act. The Punjab province applies sales tax rates ranging from four per cent to 19.5 per cent under the Second Schedule to the Punjab Sales Tax Act. Sindh imposes sales tax rates between 13 per cent and 19.5 per cent under the Second Schedule to the Sindh Sales Tax Act.

Taxpayers in Pakistan can claim provincial sales taxes as input tax, following regulations outlined in specific provincial sales tax acts, such as section 16 of the Punjab Sales Tax Act and Balochistan Sales Tax Act, and section 15 of the Sindh Sales Tax Act. Input tax credits reduce the amount of output tax owed to the provincial government. Adjustments are generally allowed for invoices up to six months old, but not permitted for missing or incorrect invoices or if output tax hasn't been paid to the relevant tax authority. Certain services, like capital construction or entertainment, are excluded from input tax adjustments. Input tax credits are typically not granted for services subject to reduced rates. Section 16C of the Punjab Sales Tax Act limits adjusting input tax to 80 per cent of output tax in a tax period, unless the tax authority provides an exception. Refunds for excess credit amounts are allowed under specific circumstances, such as errors or tax adjustments, and are processed yearly in the month following the financial year's end.

The Government of Khyber Pakhtunkhwa has imposed tax at the rate of two per cent on the value of goods imported into the province, as Infrastructure Development Cess, with effect from 23 February 2024.