Basic principles of taxation

A non-resident is taxable on his Pakistan-sourced income.

Federal Government has entered into an agreement with the government of various foreign countries for the avoidance of double taxation (Double taxation treaties)

Where under a tax treaty the extent of Pakistan sourced income is to be dealt with in a different manner that that provided for in the Ordinance, the provision of the tax treaty will apply

A non-resident person would generally conduct business in Pakistan through a permanent establishment.

Taxable income of permanent establishment is computed by and large under the same rules and principles as those applicable to computation of income in case of resident taxpayers.

When income of non-resident is considered Pakistan Source

Since non-resident is taxable in respect of Pakistan source income only therefore it is important to determine when a particular income of non-resident is Pakistan source. A non-resident can earn following sources of incomes:

(i). Business income including rendering of independent services
(ii). Royalty
(iii). Fee for technical services
(iv). Profit on debt
(v). Fee for offshore digital services
(vi). Dividend
(vii). Insurance premium
(viii). Capital gain
(ix). Salary and pension
(x). Income from Property
(xi). Any other income

Business income when considered Pakistan source

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

(i). A permanent establishment of non-resident in Pakistan

(ii). Sales in Pakistan of goods merchandise of the same or similar kind as those effected by the non-resident person through permanent establishment in Pakistan

(iii). 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

(iv). Any business connection in Pakistan

(v). Import of goods whether or not the title to the goods passes outside Pakistan if the import is part of an overall arrangement for the supply of goods, installation, construction, assembly, commission, guarantee or supervisory activities and all or principal activities are undertaken or performed either by associates of the persons supplying the goods or by its permanent establishment whether or not the goods are imported in the name of the person, associate of the person or any other person.

Where the business income of a non-resident person comprises the rendering of independent services (including professional services and services of entertainers and sports persons), the Pakistan-source business income of the person shall include (in addition to any amount treated as Pakistan-source as above) any remuneration derived by the person where the remuneration is paid by a resident person or borne by a permanent establishment in Pakistan of a non-resident person.

Taxability of Construction contract (Section 152(1B), Clause 41 Part Iv 2ND Schedule)

Definition: Construction contract with reference to non-resident

With reference to non-resident contractors, a construction contract will include the following:

(i). A contract or sub-contract for construction, assembly or installation project
(ii). A contract or sub-contract for supply of supervisory activities in relation to a construction, assembly or installation project
(iii). A contract for services in relation to a construction contract
(iv). A contract for advertisement services rendered by TV Satellite Channels

Payment to non-resident with no PE in Pakistan

Income of non-resident person from construction contract is either taxable on the basis of net taxable income (NTR) or under the presumptive mode of taxation (PTR) at the option of the taxpayer

Where a non-resident contractor selects to pay tax under presumptive mode, he is required to opt such option.

Where non-resident person does not opt for final tax regime, his taxable income will be computed on net income basis. In that scenario, income will be computed, on percentage of completion basis in case of long term contract and contract revenue – allowable expenses in case of short term contract.

Payment to PE

Income will be assessed under the normal tax regime in this case.

Withholding tax (Section 152)

Payment to non-resident with no PE in Pakistan

Payment for construction services are subject to withholding tax @ 7% for filer and 10% in case of sportsperson. In case income of Non-resident person is assessed under normal tax regime, then upon satisfaction of Commissioner he is entitled to obtain exemption certificate from withholding of tax.

Payment to PE

When construction services are rendered through PE, tax will be withheld from payment @ 7% in case of filer provided payments are made by prescribed persons as defined in section 153 of the Income Tax Ordinance, 2001.

In case payment is received by PE from any person other than prescribed, tax will not be withheld from payments on approval of the Commissioner.

Through Finance Act, 2015, payment to a sportsperson has also been taxed under the ambit of execution of contract by PE on which the rate of withholding tax is 10% of the gross amount payable.

Royalty income when considered Pakistan source

Definition: Royalty

Means consideration, received lump sum or periodically, for

- the use of, or right to use any patent, invention, design or model, secret formula or process, trademark or other like property or right.
- the use of, or right to use any copyright of a literary, artistic or scientific work.

- the receipt of, or right to receive, any visual images or sounds, or both, transmitted by satellite, cable, or similar technology in connection with television, radio or internet broadcasting
- the supply of any technical, industrial, commercial or scientific knowledge, experience or skill;
- the use of or right to use any industrial, commercial or scientific equipment;[and]
- the disposal of any property or right referred above

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Royalty when considered Pakistan source

Royalty shall be Pakistan source if it is

Paid by a resident person. However it will not be Pakistan source, if paid by resident person in respect of any right, property or information used, or services utilized for the purpose of a business carried on by the resident outside Pakistan through a Permanent establishment.

When royalty is paid by non-resident person it will be considered Pakistan-sourced if related expenditure is borne by a permanent Establishment in Pakistan of a non-resident person.

Taxability of royalty (Section 6, Rule 18)

The manner in which royalty income of a non-resident person is taxed will depend on whether or not the property or right giving rise to royalty is effectively connected with PE in Pakistan of the non-resident person.

Royalty not effectively connected to a PE

Where royalty is not connected to PE of the non-resident person, the gross amount of Pakistan source royalty shall be charged to tax @ of 15% as separate block. Such tax shall be final tax on the amount of royalty. (Section 6, 8, & Part I 1st Schedule).

Royalty connected to a PE

Where property or right giving rise to royalty is effectively connected with PE in

Pakistan of the non-resident person, the following principles will apply:

The taxable income of royalty for a tax year will be arrived at after deducting expenditure on account of the following from the gross amount:

- Expenses incurred in Pakistan to earn such income
- Expenses incurred outside Pakistan to earn such royalty income not exceeding 10% of the gross amount of royalty.

The taxable amount arrived at above will be charged to tax as per the applicable rates and resultant tax liability will be reduced by the amount of tax withheld at source.

Withholding tax (Section 152)

Payment to non-resident with no PE in Pakistan

Where property or right giving rise to royalty is not effectively connected with PE of non-resident person, tax is withheld @ 15%

Payment to PE

When property or right giving rise to royalty is effectively connected with PE in Pakistan, tax will be withheld from royalty payment @ 8% in case of filer and 14% in case of non-filer provided payments are made by prescribed persons ad defined in section 153 of the Income Tax Ordinance, 2001.

In case payment is received by PE from any person other than prescribed, tax will not be withheld from payments on approval of the Commissioner.

Tax withheld from payment is adjustable against final tax liability of PE.

Fee for technical services when considered Pakistan source

Definition: Fee for Technical Services:

Any consideration, whether periodical or lump sum, for the rendering of any managerial, technical or consultancy services including the services of technical or other personnel, but does not include:

(i). Consideration for services rendered in relation to a construction, assembly, or like project undertaken by the recipient; or

(ii). Consideration which would be the income of the recipient chargeable under the head salary

When considered Pakistan source (Section 101)

Fee for technical services shall be Pakistan source if it is

Paid by a resident person. However, if such services relate to any business carried on by the resident person outside Pakistan through a permanent establishment, the fee will not be considered Pakistan source.

When fee for technical services is paid by non-resident person it will be considered Pakistan-sourced if related expenditure is borne by a permanent establishment in Pakistan of a non-resident person.

Taxability of Fee for technical services (Section 6, Rule 19)

The manner in which income of a non-resident person from technical services (other than those relating to construction) is taxed will depend on whether these services are rendered through a PE in Pakistan or otherwise.

Services rendered without having a PE

Where technical services are rendered by non-resident not having a PE in Pakistan, the gross amount of fee for technical services shall be charged to tax @ of 15% and the general principles given earlier in royalty section shall apply.

Services rendered through a PE

Where services are rendered through a PE, the non-resident person can select to be taxed on either of the following two modes of taxation

(i). Pay tax at 15% on the gross amount of fee. Where this option is exercised, a written declaration is required to be filed with the Commissioner within 15 days of commencement of the contract. Such option once filed will remain operative till the completion of the contract. Where this option is exercised, tax deducted at source will be treated as final tax.

(ii). Pay tax on net income basis by calculating net taxable income for a year after deduction of the following:

(a). Expenditure incurred in Pakistan to earn such income
(b). Expenditure incurred outside Pakistan not exceeding 10% of the gross amount of fee

Withholding tax (Section 152)

Payment to non-resident with no PE in Pakistan

Payment for technical services (other than those relating to construction services) are subject to withholding tax @ 15%

Payment to PE

When technical services are rendered through PE, tax will be withheld from payment @ 8% in case of filer and 14% in case of non-filer provided payments are made by prescribed persons as defined in section 153 of the Income Tax Ordinance, 2001.

In case payment is received by PE from any person other than prescribed, tax will not be withheld from payments on approval of the Commissioner.

Tax withheld from payment is adjustable against final tax liability of PE.

Profit on debt when considered Pakistan source

Profit on debt shall be Pakistan-source income if it is:

(i). 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
(ii). borne by a permanent establishment in Pakistan of a non-resident person

Taxability of profit on debt in case of non-resident

Income of the non-resident will be taxable under the normal tax regime. Lower rate will be applicable in case of double taxation treaty.

However, tax shall be deducted @ 10% on profit on debt from debt instruments, Government securities including treasury bills and Pakistan Investment Bonds, payable to a non-resident person having no permanent establishment in Pakistan and the investments are exclusively made through a Special Rupee Convertible Account maintained with a Bank in Pakistan. Tax deducted @ 10% will be final tax.

Withholding tax (Section 152)

Payment for profit on debt are subject to withholding of tax @ 20%. However as per clause 5A Part II of the Second Schedule, rate of withholding tax on profit on debt payable to a non-resident person having no permanent establishment in Pakistan, shall be 10% of the gross amount paid.

Exemption from profit on debt under the Second Schedule

Following payments of profit on debt to non-resident is exempt for tax as per Second Schedule:

(i) Private loan to be utilized on such project in Pakistan as may be approved by the Federal Government for the purposes of this clause, having regard to the rate of profit and the terms of repayment of the loan and the nature of project on which it is to be utilized (Clause 72 Part I).
(ii) Interest payable on a loan in foreign exchange against export letter of credit which is used exclusively for export of goods manufactured in Pakistan. (Clause 72 Part I)
(iii) Any profit on debt derived from foreign currency accounts held with authorised banks in Pakistan, or certificate of investment issued by investment banks in accordance with Foreign Currency Accounts Scheme introduced by the State Bank of Pakistan, **by citizens of Pakistan and foreign nationals residing abroad**, foreign association of persons, companies registered and operating abroad and foreign nationals residing in Pakistan. (Clause 78 Part I)
(iv) Any profit on debt derived from a rupee account held with a scheduled bank in Pakistan by a citizen of Pakistan residing abroad, where the deposits in the said account are made exclusively from foreign exchange remitted into the said account. (Clause 79 Part I)

(v) Any profit received by a non-resident person on a security issued by a resident person shall be exempt from tax under this Ordinance where (Sec-46)

(a) the persons are not associates;
(b) the security was widely issued by the resident person outside Pakistan for the purposes of raising a loan outside Pakistan for use in a business carried on by the person in Pakistan;
(c) the profit was paid outside Pakistan; and
(d) the security is approved by the Board for the purposes of this section.

Fee for offshore digital services

Definition: Fee for offshore digital services means:

consideration for providing or rendering services by a non-resident person for

(i). online advertising including digital advertising space, designing, creating, hosting or maintenance of websites, digital or cyber space for websites,

(ii). advertising, e-mails, online computing, blogs, online content and online data, providing any facility or service for uploading, storing or distribution of digital content including digital text, digital audio or digital video,

(iii). online collection or processing of data related to users in Pakistan,

(iv). any facility for online sale of goods or services or any other online facility

When considered Pakistan source (Section 101)

A fee for offshore digital services shall be Pakistan- source income, if it is:

(i). paid by a resident person, except where the fee is payable in respect of services utilised in a business carried on by the resident outside Pakistan through a permanent establishment; or
(ii). borne by a permanent establishment in Pakistan of a non-resident person.

Withholding tax (Section 152)

Every banking company or financial institution remitting outside Pakistan an amount of fee for offshore digital services to a non-resident person on behalf of resident or PE of non-resident in Pakistan shall deduct tax @ 5% which will constitute final tax liability of the non-resident.

Dividend

A dividend shall be Pakistan-source income if it is paid by a resident company or it is after tax remittance of branch of foreign company (other than petroleum, exploration and production company company) operating in Pakistan.

Withholding tax (Section 152)

Dividend payment to non-resident will be subject to withholding of tax @ 15% which will constitute final tax liability of the non-resident.

Insurance premium

Insurance premium paid to non-resident will be Pakistan source if paid by resident person. Further any amount paid on account of insurance or re-insurance premium by an insurance company to an overseas insurance or re-insurance company shall be deemed to be Pakistan source income.

Withholding tax (Section 152)

Insurance premium to non-resident will be subject to withholding tax @ 5% which will constitute final tax liability of the non-resident.

Payment for foreign produced commercial films and advertisement

Every person responsible for making payment directly or through an agent or intermediary to a non-resident person for foreign produced commercial for advertisement on any television channel or any other media shall deduct tax at the rate of twenty percent from the gross amount paid.

The tax deductible shall be final tax on the income of non-resident person arising out of such payment.

Similarly payment for advertisement services to a medial person relying from outside Pakistan is subject to 10% withholding tax which constitutes final tax liability of the non-resident.

Shipping and Air transport income (Section 7)

In case of shipping and air transport income of the non- resident is taxable as a separate block.

Tax is imposed at the rates specified below on every non-resident person carrying on the business of operating ships or aircraft as the owner or charter thereof in respect of gross amount received or receivable

(i). For the carriage of passengers, livestock, mail or goods embarked (on board) in Pakistan; and

(ii). For the carriage of passengers, livestock, mail or goods embarked (on board) outside Pakistan

The rate of tax imposed shall be

(i). in the case of shipping income, 8% of the gross amount received or receivable
(ii). in the case of air transport income, 3% of the gross amount received or receivable.

Other payments

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

Withholding tax (Section 152)

In case of other payments rate of withholding tax is 20%. However following are certain payments from which tax shall not be deducted @ 20% but the rate of tax deduction shall apply as applicable in case of resident person

(i). Salary
(ii). Supply of goods
(iii). Services including transport services
(iv). Execution of contract including sportspersons
(v). Dividend
(vi). Prizes on prize bonds, crossword puzzle, lottery, winning on quizzes
(vii). Commission
(viii). With the written approval of the Commissioner that is taxable to a PE in Pakistan of the non-resident person
(ix). That is payable by a person who is liable to pay tax on the amount as representative of the non-resident person

Payment without deduction of tax

Where a person intends to make a payment to a non-resident person without tax deduction on the plea that such income is not chargeable to tax, then he shall furnish a notice to the Commissioner before making payment setting out:

(i). Name and address of the non-resident and
(ii). Nature and amount of the payment

The Commissioner shall within 30 days pass an order accepting or rejecting the application..

Tax shall not be deducted nor is any order from Commissioner required in the following cases:

(i). Import of goods where the title passes outside Pakistan and is supported by import documents except where supply is made in connection with overall arrangement for commission, guarantee or supervisory activities and all or principal activities are undertaken or performed either by associates of the person supplying the goods or its PE

(ii). Educational and medical expenses remitted in accordance with the regulations of State Bank of Pakistan.

Permanent establishment-Definition (Sec 2(41))

In relation to a person, means a fixed place of business through which the business of the person is wholly or partly carried on, and includes:

(i). a place of management, branch, office, factory or workshop
(ii). 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)
(iii). a mine, oil or gas well, quarry or any other place of extraction of natural resources
(iv). an agricultural, pastoral or forestry property
(v). a building site, a construction, assembly or installation project or supervisory activities connected with such site or project if it continues for a period or periods of more than 90 days in a 12 months period.
(vi). furnishing of services, including consultancy services by any person through employees or other persons engaged for this purpose
(vii). a person acting in Pakistan on behalf of the person (agent) other than an agent of independent status acting in the ordinary course of business if the agent

(a). has and habitually exercises an authority to conclude contracts on behalf of non-resident person or has habitually plays the principal role leading to the conclusion of contracts (whether goods or services)
(b). 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

(viii). Any substantial equipment installed, or other asset or property capable of activity giving rise to income.
(ix). A fixed place of business that is used or maintained by a person if the person or an associate of a person carries on business at that place and business carried on constitute complementary functions that are part of a cohesive business operations.
Cohesive business operation include an overall arrangement for the supply of goods, installation, construction, assembly, commission, guarantees or supervisory activities and supply of goods whether or not the title to the goods passes outside Pakistan.

Definitions "Liaison office" (Sec 2(41))

A liaison office is excluded from the definition of permanent establishment except where such office engages in negotiation of contracts barring contract of purchases. The determination of whether or not a place of business or entity constitutes liaison office is therefore pivotal for establishing the existence of permanent establishment in Pakistan of non-resident. The term liaison office is defined as:

liaison office means a place of business acting for the principal, head office or any entity of which it is a part, and

(a). its activities do not result in deriving income in Pakistan; and
(b). Maintains itself out of any amount remitted from outside Pakistan received through normal banking channels.

***Explanation*:** It is clarified that

(i). a place of business shall not be treated as liaison office if it engages in -

(a). commercial activities;
(b). trading or industrial activities; or
(c). the negotiation and conclusion of contracts

(ii). the activities shall be treated to be commercial activities, if these include

(a). providing after sales services for goods or services; or
(b). marketing or promoting pharmaceutical and medical products or services;
(iii). subject to clause (i), a place of business shall be treated as a liaison office, if it undertakes activities of

(a). an exploratory or preparatory nature, to investigate the possibilities of trading with, or in, Pakistan;
(b). exploring the possibility of joint collaboration and export promotion;
(c). promoting products where such products are yet to be supplied to, or sold in, Pakistan;
(d). promoting technical and financial collaborations between its principal and taxpayers in Pakistan; or
(e). provision of technical advice and assistance.

Some illustrative instances of non-resident, having Pakistan source business are:

Maintaining of branch office in Pakistan for sale of goods/transacting other business

Appointing an agent in Pakistan for a systematic and regular purchase of raw material or for sale of the non-resident's goods or for other business purpose

A factory where the raw material purchased locally is worked into a form suitable for export abroad.

Taxation of permanent establishment in Pakistan of a non-resident person (Sec 105)

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

To be treated as separate person

Permanent Establishment of a non-resident person shall be treated as a distinct and separate person, engaged in same or similar activities, under the same or similar conditions and dealing wholly independently as against the principle that a non-resident and its Permanent Establishment is one and the same person.

Note: Any Pakistan source royalty, fee for technical services, fee for offshore digital services received connected with Permanent establishment in Pakistan of the non-resident person shall be treated as income from business attributable to the permanent establishment in Pakistan of the person.

Admissibility of expenses

All expenses including executive and administrative expenses whether incurred in Pakistan or elsewhere for the purpose of business activities of the Permanent Establishment are allowed as deductions in computing income chargeable to tax under the head Income from Business.

Inadmissibility of certain expenses payable to head office

There are disallowances of certain expenses paid or payable by the Permanent Establishment to its head office or to another permanent establishment of the non-resident person (other than that towards reimbursement of actual expenses incurred by the non-resident person to third parties). Those expenses are:

(i). Royalty, fee or other similar payments for the use of any tangible & intangible assets by the Permanent Establishment
(ii). Compensation for any services including management service performed for the Permanent Establishment
(iii). Profit on debt on moneys lent to the Permanent Establishment except in connection with a banking business

Inadmissibility of certain incomes charged to head office

There are disallowances of certain items of income in the hands of Permanent Establishment charged to the head office or to another permanent establishment of the non-resident person (other than that towards reimbursement of actual expenses incurred by the Permanent Establishment to third parties). Those items are:

(i). Royalty, fee or other similar payments for the use of any tangible & intangible assets
(ii). Compensation for any services including management service performed by the Permanent Establishment
(iii). Profit on debt on moneys lent by the Permanent Establishment except in connection with a banking business

Head office expenses

Allocation of head office expenditures to the Permanent Establishment incurred for and on behalf of Permanent Establishment are allowable as to the lower of the following amounts:

(a) Actual expenses as allocated by the head office; and

(b) Allowable head office expense calculated in the manner prescribed below:

$$\frac{\text{Turnover of Permanent Establishment in Pakistan x Total Head Office expenditure}}{\text{Worldwide turnover}}$$

Head office expenditure means any executive or general administration expenses incurred by the non-resident person outside Pakistan for the purpose of business of the Pakistan permanent establishment of the person including

(a). Any salary paid to an employee employed by the head office outside Pakistan
(b). Any travelling expenditure of such employee
(c). Any rent, local rates and taxes excluding any foreign income tax, repairs, or insurance outside Pakistan
(d). Any other expenditure which may be prescribed

Inadmissibility of certain expenses

Following expenses incurred by the head office / non-resident person for the purpose of Permanent Establishment shall not be allowed as a deduction in computing income chargeable to tax under the head Income from Business

(a) Profit on debt incurred by the non-resident person on debt to finance the operations of the Permanent Establishment
(b) Insurance premium paid or payable by the non-resident person in respect of such debt.

Withholding tax (Section 152)

Nature of payment	Rate	Tax regime
Receipt on account of sale of goods by PE of non-resident	4/4.5% for filer	Adjustable
Receipt on account of rendering of services by PE of non-resident	8/10%	Minimum tax
Receipt on account of Execution of contract by PE of non-resident	7%	Final

Thin Capitalization (Sec-106)

Thin capitalization is a situation where in a foreign controlled resident company (FCRC) has a very lesser amount of capital as compared to its debts.

FCRC means a resident company in which 50% or more of the underlying ownership is held by a non-resident person either alone or together with any associates

Any profit on foreign debt incurred by Foreign Controlled Resident Company in excess of 3:1 foreign debts to foreign equity ratio at any time during the year shall not be allowed as tax expense.

This above provisions do not apply to

(i). A financial institution
(ii). A banking company

(iii). A branch of a foreign company operating in Pakistan

Foreign Debt

Foreign Debt in relation to FCRC means the highest amount at any time in a tax year of the sum of the following:

(i). Foreign Debt outstanding to Foreign Controller or non-resident associate of foreign controller

(ii). Foreign Debt outstanding to any non-associate where that non-associate has a balance outstanding of a similar amount of debt owed to foreign controller.

However only such debt will be considered part of the foreign debt if the profit on such debt is paid in either of the following manner:

Profit on debt is paid without deduction of tax Or

Taxed at rate lower than the corporate rate applicable on assessment of foreign controller or its associates.

Foreign Equity

Foreign Equity means the aggregate at the beginning of the tax year of the following:

(i). Paid-up value of shares held by foreign controller or a non-resident associate of the foreign controller at beginning of the tax year.

(ii). Proportionate share of acc. Profits, share premium, and revaluation surplus as it would be entitled to FC in the event of the company being wound up

(iii). As reduced by any debt obligation owed by foreign controller or non-resident associate of foreign controller to foreign controlled resident company and proportionate share of accumulated losses if any.