TAXING LIKE THE 2020s, GOVERNING LIKE 1990s

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The discourse pertaining to the persistent fiscal challenges faced by Pakistan has become increasingly salient, underscoring a notable intensification in recent years. A primary challenge within this context is the country's limited and underutilised tax base. Although the principal focus of debate has been the reform of the domestic tax system, numerous aspects have been neglected. A crucial dimension of our overarching tax base pertains to the international taxation framework, which often receives insufficient emphasis during the policy formulation and related discussions. The international tax base arises from the interaction between the tax system of Pakistan and other countries, and from Pakistan's perspective, is marred by revenue leakages. These leakages manifest through mechanisms such as profit shifting via abusive transfer pricing practices, base erosion payments such as royalties, management and other charges. Other distortions to the tax base associated with international tax systems include stashing of assets overseas by Pakistanis through various means including sophisticated corporate or trust s tructures. Digital business models have also been exploited to allow foreign firms to conduct business in Pakistan without maintaining a physical presence (and possibly without paying taxes), a phenomenon that is exacerbated by the rapid evolution of the digital economy.

What contributes to these distortions to Pakistan's tax base the most is the lax tax framework, dearth of information exchanges and inability to enforce the tax reform agenda due to covenants of superior arrangements such as tax and investment treaties. But the fundamental question in this debate remains: how to legitimately claim this intervening tax base and enforce it successfull? This has partially been attempted by placing tax liabilities on Pakistani consumers, for instance, through imposing taxes at the import stage (for physical goods) or taxation at the time of remitting the payments to foreign companies for their services, particularly. This approach has limited benefit since it will likely displace the incidence of tax on domestic consumers (businesses or the end consumers), as it will increase the cost of doing business for consumers in Pakistan, and foreign firms will continue to receive their dues, net of taxes. This article examines Pakistan's approach, and the instruments used to address erosion of its global tax base and highlights the need to restructure these interventions.

Pakistan has traditionally used bilateral tax treaties for avoidance of double taxation and prevention of fiscal evasion ("tax treaties" or "DTTs") to address the allocation of taxing rights with other countries. However, various other instruments are now available as a result of adopting several international tax standards, especially during the last decade. These include measures based on the OECD/G20-led BEPS reform, transparency standards, and proposals from various other international forums. Pakistan's approach to following these international standards is reactionary in general in response to the external institutions' push to adopt these reforms; however, there is limited room for customisation of these global standards to domestic needs. While the adopted standards support achieving tax policy objectives, the domestic context, such as the large proportion of the informal economy, low compliance, and excessive reliance on withholding taxes, are some areas which retort robust implementation of these standards. A succinct analysis of the standards employed by Pakistan to address distortions in the international tax base is elaborated in the subsequent sections.

Pakistan has a robust DTT network consisting of 68 bilateral agreements. The primary objectives of Pakistan's DTT policy are to attract Foreign Direct Investment (FDI), set clear rules for income allocation, and prevent instances of double taxation. Although these treaties are widely recognized as beneficial, there are concerns regarding their misuse that may lead to Base Erosion and Profit Shifting (BEPS) within the tax system. Key challenges in Pakistan's DTT practices include a lack of reciprocity in distributing taxing rights, issues with source state taxation, the abuse of treaty provisions and treaty shopping. Research indicates that the tax treaties established by Pakistan have not sufficiently safeguarded the country's taxing rights[1]. Furthermore, the tax advantages provided to foreign companies through these treaties have contributed to the decline of local industries[2]. A positive step in this regard is to declare the supremacy of tax treaty subservient to the anti-avoidance rules contained in domestic tax code. Additionally, ensuring the maintenance of source and market taxing rights within the new model tax treaty and policy framework represents a significant policy advancement by FBR, although this initiative will apply to future treaties only.

Pakistan has introduced several international tax measures based on the work of OECD (Inclusive Framework for BEPS established by G-20 and OECD) and international tax guidelines in its tax code. However, it faces challenges in effectively implementing these reforms due to the supremacy of the DTTs it has signed over the domestic laws. Consequently, unless a tax treaty is amended/renegotiated, the amendments to domestic tax law in key areas will not create an effective taxing right or generate additional revenue for the country. To illustrate the issue, consider an MNC that does not have a physical presence in Pakistan but can engage with Pakistani consumers by providing services digitally and hence profit from market due to its virtual business model. To tax this kind of activity, Pakistan has introduced domestic tax measures based on the concept of a virtual permanent establishment, SEP and withholding taxes. However, neither of these concepts is typically included in Pakistan's DTTs. The principles outlined in these treaties for taxing income are primarily based on physical presence (called permanent establishment – "PE"). As a result of this overriding effect, our tax authorities cannot successfully apply domestic laws to tax the income of foreign companies operating in Pakistani market.

In the international tax ecosystem, renegotiating treaties to reallocate taxing rights constitutes a multifaceted challenge that necessitates a long-term strategic approach and is fundamentally bilateral in nature.

The second important instrument to counter base erosion is transfer pricing rules. These rules require associated businesses to conduct transactions at arm's length prices rather than controlled prices influenced by tax considerations. In simple terms, intra-group transactions should not be priced to

1. Shabir, J. (2023) "Tax Policy: A Review of Pakistan's Tax Treaties and Recommendations for Actions," Pakistan Institute of Development Economics, Islamabad: PIDE. https://file-thesis.pide.org.pk/pdf/ms-management-sciences-2020-jawad-shabir--tax-policy-a-review-of-pakistans-tax-treaties-and-recommendations-for-actions.pdf.)
2. Ahmed, M. A. (2020) "UN MTC Article 8: Was the Source Rule Surrender on Article 8 a Blunder? The Case Study of Pakistan, INTERTAX, Volume 48, Issue 1, 2020 Kluwer Law International BV, Netherlands

minimize the group's tax liabilities. For instance, a multinational corporation (MNC) may charge its subsidiary in Pakistan a royalty for using specific intellectual property, based on a percentage of the subsidiary's revenue. This arrangement allows the subsidiary to reduce its taxable profit, as royalty payments are tax-deductible. To comply with transfer pricing rules, the royalty charge must be justified by comparing it to similar transactions among independent entities, taking into account performed functions, utilized resources, risk assessment, and the market rate for the royalty. This process adheres to the arm's length principle in controlled transactions, promoting fairness and compliance in pricing. If the transaction doesn't meet the arm's length principle, the tax authority may reject or adjust the royalty deductions made by the subsidiary based on their analysis.

Transfer pricing rules have been provided under domestic tax law and in DTTs for a long time. However, enforcement and compliance levels in this policy area are below par. This is because the practice of examining transfer pricing has not been robust due to long-practised presumptive/final tax regimes. A final tax regime calculates a firm's tax liability by applying a fixed percentage of the receipts of business while disregarding the bottom-line profits of business operating results for tax computation. Moreover, the tax authority faces capacity constraints regarding robust transfer pricing examinations, which include the availability of or access to a public data repository of open market prices to be used as a benchmark, trained subject matter specialists in the tax authority, and a lack of specialization in transfer pricing enforcement and knowledge management.

Abuse of transfer pricing regulations by MNCs negatively impacts Pakistan's tax revenue base[3] .Changes in the legal and administrative regime can reduce the extent of tax evasion, including by issuing detailed guidelines for taxpayers and introducing safe harbour provisions/benchmarks. Once basic practices have been established, the Advance Pricing Agreement (APA) framework can also be established, reducing the need for monitoring.

The CbCR-enabled[4] taxpayer data presents an opportunity to tackle tax evasion driven by transfer pricing. Trying to achieve effective reforms in this area would be futile without first strengthening institutional capacity to implement targeted enforcement strategies. This involves enhancing institutional resources and collaborating with multilateral partners to access technical training, technology, and data resources. Establishing a dedicated and empowered Transfer Pricing (TP) Unit is vital for institutionalizing best practices. This TP Unit should adopt a "center of excellence" model rather than function as a traditional tax office. Additionally, Pakistani law permits the tax administration to engage third-party auditors, which highlights the potential for outsourcing TP audits to address the capacity gaps within the Federal Board of Revenue (FBR).

The most recent tool for addressing the distortions to tax base is the mechanism for the bilateral and multilateral exchange of taxpayer information, especially regarding offshore assets. A robust exchange of information (EOI) is essential in international taxation, as it compiles taxpayer data held by various authorities across multiple countries, which is critical for accurately assessing taxes on cross-border transactions. It enhances tax certainty and transparency.

Pakistan has recently made reforms to its EOI framework in response to public demand for closer examination of the offshore wealth held by Pakistani citizens. Previously, conventional EOI under bilateral tax treaties was inadequate, prompting Pakistan to engage with the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes. Consequently, it signed the Convention on Mutual Administrative Assistance in Tax Matters (MAAC) in 2016 and the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (CRS MCAA) in 2017. To facilitate compliance with the CRS MCAA, Pakistan has significantly updated its domestic laws and established dedicated Automatic Exchange of Information (AEOI) zones within major taxpayer offices. As a result, Pakistan has developed a robust EOI practice. However, the information obtained through Country-by-Country Reporting (CbCR) is not fully leveraged, primarily due to a lack of focus on transfer pricing practices, representing a missed opportunity.

3. Pakistan loses PKR 200 billion (US$ 720 million) annually to abusive transfer pricing by MNCs. (Haq, I., and Bukhari, H. (2020))."Tax Reforms in Pakistan: Historic & Critical View," Pakistan Institute of Development Economics, Islamabad: PIDE. http://www.pide.org.pk.
4. Country-by-country Reporting requirement as part of Transfer Pricing Documentation requirement introduced by implementing the BEPS Action 13 by signing the Country-by-Country Reporting Multilateral Competent Authority Agreement (CbCR MCAA) on 21st June 2017.

Pakistan's nascent but growing digital economy presents a unique tax challenge: how to effectively tax the revenue generated from cross-border digital services while ensuring a fair and sustainable system. While the overall economy itself is fast becoming digital, the lack of effective legal framework for accurately taxing digital economy transactions also has consequences for Pakistan's global tax base. The first step taken by FBR to tackle this challenge was the imposition of a final withholding tax on inbound digital services. Subsequently, the concepts of virtual PE and a nexus-based significant economic presence (SEP) rule have been added to the tax code. While Pakistan has a well-established framework for handling non-resident taxation through withholding taxes, implementing virtual PE and SEP rules requires careful consideration, as it is a new intervention. The principle of virtual PE, which deems a foreign company to have a taxable presence in Pakistan based on its digital activities, needs careful scrutiny. Not every service received in Pakistan should automatically translate into a (virtual) PE. Implementing a threshold-based approach, defining specific criteria for establishing a virtual PE, would mitigate the risk of overreach and ensure fairness. This threshold should be determined based on a cost-benefit analysis, which considers factors like the volume of transactions, revenue generated, and the extent of engagement with Pakistani consumers.

Similarly, the SEP rule, which establishes a taxable presence based on significant economic activity of foreign businesses within Pakistan, demands a robust framework. Determining the precise threshold for SEP requires careful analysis, considering the specific nature of digital services and their impact on the Pakistani market. A nuanced approach that considers quantitative and qualitative factors will be crucial to ensure a balanced application of the rule, but such an approach remains a missing link.

Further, analysing the incidence of tax is crucial, particularly in the case of withholding taxes. The current system raises concerns about its ultimate burden and the increase in the cost of doing business. The "net of tax" arrangements often result in Pakistani consumers bearing the tax burden. This potential for regressive taxation necessitates a thorough review of the tax structure, exploring options like shifting the burden to foreign digital companies. Lastly, all initiatives to tax the digital economy encounter challenges due to Pakistan's extensive tax treaty network, which hinders the successful application of withholding tax on digital services.

The solution lies in broader multilateral frameworks. In this regard, the Pillar One reforms proposed by the OECD should be explored to create a fairer, more equitable, and reliable system for distributing taxing rights in a globalised digital economy. Pillar One focuses on reallocating the taxing rights to market jurisdictions, which are primarily expected to be developing countries. Areas such as the number of in-scope MNCs and the tax base potential should be analysed in this exploration. The impact of forfeiting domestic taxes in relation to the potential presented by Pillar One also requires careful assessment.

In summary, Pakistan faces the challenge of losing its tax base linked to cross-border business transactions. To address international tax evasion, the country has developed a toolkit based on specific international standards it has adopted. However, these standards have not effectively closed the loopholes in the current tax system. Enforcement remains weak in certain areas, such as transfer pricing, owing to capacity constraints within the tax administration. In other areas, like enforcement based on EOI, institutional practices have been established but the revenue generated has been modest[5], focusing primarily on easily accessible opportunities instead of comprehensive solutions.

Moreover, existing tax treaties create hurdles for taxing digital business models, restricting enforcement to scenarios where these treaties do not apply. It is advisable to address these issues at international forums, such as the United Nations or the OECD, as unilateral reform is not an ideal policy option.

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5. FBR tells SC: Rs.880m recovered from people holding foreign accounts, properties. Business Recorder. Online: https://www.brecorder.com/news/40335804/fbr-tells-sc-rs880m-recovered-from-people-holding-foreign-accounts-properties