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IMPACT OF PAKISTAN'S NOTIFICATION FOR ENTRY INTO FORCE OF OECD'S MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BEPS

IN BRIEF

Double Tax Treaties (DTTs) entered into by Pakistan with 66 countries, are expected to change, subject to certain reciprocal actions by the respective treaty partners, following the entry into force of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI") on April 1, 2021 through a notification/ S.R.O 405(I)/2021 dated April 1, 2021 (SRO 405) issued by the Federal Government (https://download1.fbr.gov.pk/SROs/202142164212305MLIFATE.pdf). The MLI will bring about important changes to the DTTs covered by the MLI, including **new preamble, anti-treaty abuse measures** as well as more **stringent rules on dividends, capital gains, and definition of permanent establishment**. On the other hand, the MLI seeks to improve the dispute resolution and provide for **corresponding adjustments** in case of **Transfer Pricing primary adjustments**, therefore **easing compliance burden**. In light of these changes, taxpayers should carefully consider the practical impact of the MLI in their business transactions.

IN DETAIL

MULTILATERAL CONVENTION

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI") is one of the outcomes of the **OECD's BEPS project**, aiming to tackle **tax planning strategies artificially resulting in lower or overall, no corporate income tax being paid**. The MLI will significantly change the global network of DTTs from 95 countries that have signed to it, modifying more than 1680 tax treaties.

The MLI was developed under BEPS Action 15 and encompasses recommendations for:

BEPS reference	Description	MLI reference
Action 2	Hybrid mismatches	Articles 3 to 5
Action 6	Tax treaty abuse	Articles 6 to 11
Action 7	Permanent Establishments	Articles 12 to 15
Action 14	Dispute Resolution	Articles 16 to 26

There are certain MLI provisions that MLI signatory territories are required to apply **(minimum standards)** unless, they will meet those minimum standards in alternative ways, whereas some provisions are optional (**signatories reserve the right not to apply those articles**). As part of ratification process, Pakistan has notified its position and reservations on each article of MLI in Annexure B of SRO 405.

The range of materials published by the OECD to help interpret the MLI can be found at the following link. (https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm)

Pakistan's Position

Covered Tax Agreements

Following the MLI's entry into force, in case of Pakistan, 66 DTTs as notified are covered by the MLI (Covered Tax Agreements – CTAs), which are going to be automatically updated on respective dates. The DTTs notified as CTAs are those entered by Pakistan and: Austria, Azerbaijan, Bahrain, Bangladesh, Belarus, Belgium, Bosnia & Herzegovina, Brunei Darussalam, Bulgaria, Canada, China, Czech Republic, Denmark, Egypt, Finland, France, Germany, Hong Kong, Hungary, Indonesia, Iran, Ireland, Italy, Japan, Jordan, Kazakhstan, Kuwait, Kyrgyz Republic, Lebanon, Libyan Arab Jamahuriya, Malaysia, Malta, Mauritius, Morocco, Nepal, Netherlands, Nigeria, Norway, Oman, Philippines, Poland, Portuguese Republic, Qatar, Republic of South Korea, Romania, Saudi Arabia, Serbia, Singapore, South Africa, Spain, Sri-Lanka, Sweden, Switzerland, Syria, Tajikistan, Thailand, Tunisia, Turkey, Turkmenistan, UAE, UK, Ukraine, USA, Uzbekistan, Vietnam & Yemen.

Amendments

MLI's entry into force implies significant changes in the Pakistani CTAs, including a new preamble, more stringent anti-abuse rules, change in the definition of Permanent Establishments, as well as improved dispute resolution. These are briefly explained as under (for further details, please refer the **Annexure** to this Note).

New Preamble

The new preamble found in Article 6 of the MLI, provides for required wording to be incorporated into CTAs and clarifies the intent of the treaty. As a result of MLI, the intention of the CTAs is "to further develop their economic relationships and to enhance their co-operation in tax matters". This change is intended to impact treaty interpretation and access to treaty benefits.

Anti-Avoidance Measures To Restrict Treaty Benefits

New anti-avoidance measures in the form of a simplified Limitation on Benefits (LOB) have been adopted by Pakistan, however, general anti-avoidance regime in the form of a Principal Purpose Test (PPT) may apply by default. This measure, restricts access to treaty benefits in case of transactions, where obtaining that benefit would be one of the principal purposes of any arrangement or transaction, unless it is established that granting a treaty benefit in those circumstances would be in accordance with the object and purpose of the relevant provisions of the CTA. The practical application of this article will bring significant challenges, and therefore calls for careful consideration especially keeping in view the 2018 amendments made in Pakistan tax law (sections 107 & 109 of the Income Tax Ordinance, 2001) whereby the overriding provisions of DTTs were made subservient to general anti-avoidance provisions and the tax authorities were additionally empowered to disregard entities set up with no economic or commercial substance or with one of the main purpose of tax avoidance including by way of treaty abuse.

Additional Rules On Dividends & Capital Gains

Additional rules on dividends and capital gains are provided in Articles 8 and 9 of the MLI, qualifying dividends which can be granted treaty benefits after a cooling off period of 365 days to be computed in the manner prescribed in the MLI, as well as determination of allocation rules in case of certain capital gains.

Commissionaire Structures As Permanent Establishments

An important addition relates to inclusion of commissionaire structures as Permanent Establishments. Until now, these structures have generally not been considered to constitute a permanent establishment, therefore do not create a taxable presence in Pakistan. As a result of MLI, this is expected to change, therefore, a detailed analysis on whether certain structures fall within the definition of permanent establishment is advisable. The amendments through MLI in particular address fragmentation of cohesive business operations, for which amendments in domestic law were so far considered as not applicable to non- residents covered under DTTs.

Dispute Resolution & Transfer Pricing Adjustments

Additional rules will also be introduced regarding dispute resolution and corresponding transfer pricing adjustments, which tend to reduce compliance burden for taxpayers. Hence taxpayers should consider whether they could benefit from these updates.

Entry Into Force

The MLI in Pakistan has entered into force on April 1, 2021.

Entry Into Effect

The effective date of the applicability for each of the Pakistan's CTA will be determined subject to the notification of CTA by both jurisdictions and deposit of instrument of ratification by the other contracting jurisdiction. There are **different dates** for applicability of amendments for the purpose of **withholding taxes** and for **other taxes**, hence, it is advisable to carefully consider the respective provisions after seeking a professional opinion in case of specific transactions.

MLI Matching Database

OECD has developed MLI Matching Database (https://www.oecd.org/tax/treaties/mli-matching-database.htm) to project the manner in which the MLI modifies a specific tax treaty covered by the MLI by matching information from Signatories' MLI Positions as a mismatch may occur where one of the Parties to the CTA has notified an existing article but the other has not, or that the parties to the CTA have made a different notification with respect to existing articles in their MLI positions.

Takeaway

The above presents a summary of the main changes to be introduced. The main takeaway is that MLI has **entered into force** in Pakistan on **April 1, 2021** and that it will bring **additional practical challenges, increased uncertainty, more controversy** and **dispute resolution**, especially in terms of **anti-abuse measures**, but will also bring **additional benefits**. Hence, taxpayers should become aware and carefully consider which aspects of the MLI will affect their business activity.

How AFF Can Help

We can help you navigate these challenges on anti-abuse measures, PE status and dispute resolution, thereby preserving the value of your business. Our key strength is the wealth of experience, and best experts in the field of international taxation. For a deeper discussion of how these issues might affect your business, please contact your relevant tax team within AFF.

ANNEXURE

SNAPSHOT OF PAKISTAN'S POSITION ON MLI

Snapshot of Pakistan's position on MLI provisions and the possible effect on Pakistan's CTAs:

MLI Provision	Brief Description	Pakistan's position	Possible effect on Pakistan's CTAs
Article 1: Scope of the Convention	Modifies all CTAs.	General Article	-
Article 2: Interpretation of Terms	Defines CTAs.	Adopted with respect to 66 CTAs notified to be covered by MLI	Covered CTAs for which the instrument of ratification has been deposited and for which the Convention is in force.
Article 3: Transparent entities	Provisions to neutralise effects and hybrid mismatch arrangements.	Not Adopted.	No effect - Provision of CTAs apply if explicit exemption is provided to fiscally transparent entities.
Article 4: Dual resident entities	Determination of resident jurisdiction by Mutual Agreement Procedure (MAP) for a person other than an individual who is resident of more than one contracting jurisdiction to determine the resident status having regard to its effective place of management, place where it is incorporated or otherwise constituted and any other relevant factors.	Adopted - Pakistan has notified 66 CTAs which already contain the tie breaker rule that is a place of effective management to determine residency.	Can amend CTAs to the extent that the other party has not made a reservation wholly or partly.
Article 5: Application of methods for elimination of double taxation	Provisions to address problems arising from the inclusion of exemption method in tax treaties with respect to items of income that are not taxed in the state of source.	Adopted - Opted for Option C (tax credit method based on Article 23 B of OECD Model Convention) in terms of para 6. This option will also apply in cases of notified CTAs (Saudi Arabia and Poland) where exemption is provided.	Option C will apply with respect to the residents of Pakistan irrespective of the options selected by the CTA partner.
Article 6: Purpose of a CTA	Contains provisions on preamble language for the tax treaties to be modified: **(i) Article 6(1)** - Intending to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions).	Adopted - Article 6(1) applies to all 66 CTAs as a default. Additional Preamble language in Article 6(3) applies subject to notification by contracting parties.	Preamble language of all 66 CTAs include language of Article 6(1). Additional preamble language of Article 6(3) to be only included where the contracting jurisdictions chose to apply and have made notification with respect to the CTAs.

MLI Provision	Brief Description	Pakistan's position	Possible effect on Pakistan's CTAs
	The text described in paragraph 1 shall be included in a CTA in place of or in the absence of preamble language. **Additional Text:** **(ii) Article 6(3)** - Desiring to further develop their economic relationship and to enhance their co-operation in tax matters.		
Article 7: Prevention of treaty abuse	(i) Principal Purpose test (PPT) rule is a default - a benefit under the CTA shall not be granted in respect of an item of income or capital if it is reasonable to conclude having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the CTA. (ii) PPT supplemented with a simplified limitation on benefits (LOB) provision.	Adopted - Pakistan opted for simplified LOB provision. However, PPT will apply as a default check.	PPT rule will apply to all CTAs. Simplified LOB to apply only if the other party has also opted for it.
Article 8: Dividend Transfer Transaction	Exemption of limitation on tax rate on dividend subject to minimum shareholding requirement shall apply only if the ownership conditions are met throughout a period of 365 days (cooling-off period). The minimum holding period shall apply in place of or in the absence of a minimum holding period in provisions of a CTA.	Adopted - Pakistan has notified 36 CTAs that do not contain provision relating to the requirement of minimum holding period to avail reduced rate taxation on dividend.	Can amend CTAs to the extent that the other party has not made a reservation wholly or partly.
Article 9: Capital gains from alienation of shares or interests of entities deriving their values principally from immovable properties	Capital gains arising from alienation of shares or other rights that derive their value principally from immovable property may be taxed in the country in which the immovable property is located only if shares derived more than a certain part of their value from immovable property (real property) at any time during 365 days preceding the time of alienation [Article 9(1)]. In addition, the above provisions are applicable in case of gain from comparable interests in a partnership or trust if at any time during the 365 days preceding the alienation, the comparable interest derived more than 50% of their value directly or indirectly from real property situated in a contracting jurisdiction [Article 9(4)].	Adopted - Pakistan has. opted for the provision in Article 9(4). Notified 32 CTAs that contain provision described in Article 9(1).	Can amend CTAs based on Article 9(1) to the extent that the other party has not made a reservation wholly or partly. Article 9(4) will apply only if the other party has also opted for the same.

MLI Provision	Brief Description	Pakistan's position	Possible effect on Pakistan's CTAs
Article 10: Anti-abuse rule for Permanent Establishment (PE) in third country	Tax treaty benefit not to apply to any item of income on which the tax rate in the third jurisdiction in which an exempt PE is located, is less than 60% of tax that would be imposed in the country of residence.	Adopted	Can amend CTAs to the extent that the other party has not made a reservation wholly or partly.
Article 11: Application of tax agreement to restrict a party's right to tax its own resident	CTA shall not affect taxation by a contracting jurisdiction of its resident, except with respect to the benefits granted under the provisions of the CTA. This shall apply in place of or in the absence of provisions of a CTA stating that the CTA would not affect the taxation by a contracting jurisdiction of its residents.	Adopted - Pakistan has notified that the CTA with Belgium already contains a provision in Article 27(3) in respect of a company which is resident of Belgium.	Can amend CTAs to the extent that the other party has not reserved wholly or partly.
Article 12: Artificial avoidance of PE status through Commissionaire arrangements and similar strategies	Expanding the scope of dependent agency PE and meaning of independent agent.	Adopted - Pakistan has notified 66 CTAs that contain provisions relating to definition of dependent and independent agents.	Can amend CTAs to the extent that the other party has not reserved wholly or partly.
Article 13: Artificial avoidance of PE status through the specific activity exemptions	- A party may choose to apply Option A (in paragraph 2) or Option B (in paragraph 3). - Option A ensures that all activities (specifically listed in CTAs that do not constitute PE whether because of being preparatory or auxiliary character, maintenance of fixed place of business solely for the purpose of carrying any activity or combination of activities) of fixed place of business are of preparatory or auxiliary character in order to qualify as an exemption to establishing a fixed place PE. - Option B allows the contracting Jurisdiction to preserve the existing exemption for certain specified activities. - Article 13(4) addresses fragmentation of activities between closely related enterprises i.e., specific activity exemptions being preparatory and auxiliary do not apply to a fixed place of business in case of a cohesive business operation. Regardless of options A or B, paragraph 4 of Article 13 shall apply to provisions of a CTA (as may be modified by paragraph 2 or 3) that list specific activities that are deemed not to constitute a permanent establishment even if the activity is carried on through a fixed place of business (or provisions of a CTA that operate in a comparable manner).	Adopted - Option A Adopted the optional provision in Article 13(4).	Can amend only if the tax treaty partner has opted for Option A.

MLI Provision	Brief Description	Pakistan's position	Possible effect on Pakistan's CTAs
Article 14: Splitting-up of contracts	Anti-fragmentation provisions to avoid a situation in which the splitting-up of contract is used as a potential strategy for the artificial avoidance of PE status by abuse of PE exceptions. Paragraph 1 shall apply in place of or in the absence of provisions of a CTA to the extent that such provisions address the division of contracts into multiple parts to avoid the application of a time period or periods in relation to the existence of a PE for specific projects or activities [Article 14(2)].	Adopted - Pakistan has notified CTA [Article 22(3)] with Denmark and Ireland which contain the provision described in Article 14(2).	Can amend CTAs to the extent that the other party has not reserved wholly or partly.
Article 15: Definition of closely related persons	Relevant for Articles 12, 13 and 14.	Adopted	Applies to CTAs if any of the Articles 12, 13 or 14 apply
Article 16: MAP	Where a person considers that the actions of one or both of the contracting jurisdictions result or will result for that person in taxation not in accordance with provisions of the CTA, that person may, irrespective of the remedies provided by domestic law of those contracting jurisdictions, present the case to competent authority of either contracting jurisdiction. The case must be presented within 3 years from first notification of action resulting in taxation not in accordance with provisions of the CTA.	Adopted without any reservations.	Can amend CTAs to the extent that the other party has not reserved wholly or partly.
Article 17: Corresponding adjustments	Article 17 is based on Article 9(2) of the OECD model convention and requires compensatory or corresponding adjustment if there is double taxation arising from transfer pricing adjustments.	Adopted - Pakistan has notified 50 CTAs that already contain provision that requires a Contracting Jurisdiction to make an appropriate adjustment to amount of tax charged therein on profits of an enterprise of that Contracting Jurisdiction where other Contracting Jurisdiction includes those profits in the profits of an enterprise of other Contracting Jurisdiction and taxes those profits accordingly, and profits so included are profits which would have accrued to enterprise of other Contracting Jurisdiction if conditions made between the two enterprises had been those which would have been made between independent enterprises.	Can amend CTAs to the extent that the other party has not reserved wholly or partly.

MLI Provision	Brief Description	Pakistan's position	Possible effect on Pakistan's CTAs
Articles 18 to 26: Arbitration	Articles 18 to 26 deal with mandatory arbitration and issues such as appointment of arbitrators, confidentiality of arbitration proceedings, and resolution of a case prior to the conclusion of arbitration, type of arbitration process, etc.	Not adopted	No effect
Articles 27 to 35: Final provisions	Part VII deals with procedural provisions, such as signature, ratification, reservations, notifications, date of entry into force, date of effect, etc., to make the MLI provisions operational.	Procedural articles	Pakistan has chosen to substitute "taxable period" for "calendar year" as far as entry into effect for taxes withheld at source [Articles 35(1) & 35(5) for existing and new CTAs respectively].

APPLICATION OF MLI

FIVE STEPS FOR APPLICATION OF MLI:

Step 1 - Entry into force of the MLI: Verify if the MLI has entered into force

Is the MLI in force for both Contracting Jurisdictions to the tax agreement? (Are both Contracting Jurisdictions Parties to the MLI?)

No - MLI does not apply.
Yes - MLI could apply to the CTA.

Step 2 - Covered Tax Agreement: Verify if the tax agreement is a CTA

Do both Contracting Jurisdictions list the tax agreement in their MLI positions as an agreement to be covered by the MLI?

No - MLI does not apply.
Yes - MLI can apply to the CTA.

Step 3 - Reservations and choice of optional provisions: Identify which MLI provisions apply

Reservations: Does either Contracting Jurisdiction to the Covered Tax Agreement make a reservation on the application of a provision of the MLI?

No - MLI Article could apply and modify CTA.
Yes - The MLI provision for which the reservation is made does not apply and does not modify the CTA.

Optional provisions: Do both Contracting Jurisdictions to the Covered Tax Agreement choose to apply an optional provision of the MLI?

No - The optional provision does not apply.
Yes - The MLI provision for which the reservation is made does not apply and does not modify the CTA.

Step 4 - Notifications of existing provisions: Identify which existing provisions are modified

To ensure clarity and transparency about the application, the MLI requires Parties to notify existing provisions to be modified by the MLI provision. In addition, each Article contains provisions describing details on how the applicable MLI provisions modify a Covered Tax Agreement (compatibility clauses). The effect of notifications depends on the type of compatibility clause which could provide that the MLI provision applies “in place of”, “applies to” or “modifies”, “in the absence of”, or “in place of or in the absence of”.

Step 5 - Entry into effect of the MLI: Verify if the MLI provisions have effect

The MLI provisions will generally have effect in the Contracting Jurisdictions with respect to a Covered Tax Agreement at different moment with respect to taxes withheld at source and with respect to all other taxes levied by a Contracting Jurisdiction.