GOVERNMENT OF PAKISTAN
(REVENUE DIVISION)
FEDERAL BOARD OF REVENUE
[INLAND REVENUE WING]
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Circular No. 4 of 2012
(Income Tax)

Subject: **ADEQUATE UTILIZATION OF 'EXCHANGE OF INFORMATION' ARTICLE CONTAINED IN THE AVOIDANCE OF DOUBLE TAXATION AGREEMENTS – INSTRUCTIONS REGARDING**

It has been observed that field formations while dealing with cases of fiscal fraud or evasion involving non-resident taxpayers or resident taxpayers having overseas fiscal connections/dealings generally adopt an unenthusiastic and laid-back attitude leading to substantial revenue loss for the national exchequer. The main reason for such sub-optimal taxation is lack of information about these taxpayers' economic activities in overseas jurisdictions. This lack of access to relevant information by the field officers is reinforced by the geographical distance and incapacity to enforce domestic tax laws in the foreign territories. In order to overcome these problems an extensive global network of Avoidance of Double Taxation Agreements has been put in place so that the interests of all contracting parties are adequately safeguarded.

2. Pakistan is also an important part of this global network having signed 62 such agreements with other countries with 12 more being in the pipeline. All of these full scope agreements contain a specific provision (generally Article 26) to address the issue of exchange of information between treaty partners. The Article, in principle, states that the contracting states shall exchange all such information as is necessary to carrying out the provisions of the agreements or those of the domestic laws of the contracting states concerning taxes covered by the agreements in so far as taxation there-under is not contrary to the agreements. The only exclusions from the ambit of Article 26 are: -

(a) The information for the collection of which a country has to undertake administrative measures those are at variance with its laws.
(b) The information, which is not obtainable under the normal course of a country's administrative practices.
(c) The information that would amount to a disclosure of any trade, business, industrial, commercial, or professional secret or trade process.
(d) The information the disclosure of which would be contrary to a country's public policy.

3. This enabling provision is frequently resorted to by the states to abate tax evasion, optimize revenue collection, and raise the deterrence level in order to impact the potential tax evasion ploys. However, unfortunately this is not true in the case of Pakistan as we are always at the giving-end of information exchange particularly to countries having larger segments of immigrant Pakistanis. Over the past few years field formations have approached FBR in merely four cases, and even in those cases references had not been properly drawn up to delineate clearly the parameters of the information required, its scope, use, and the purpose. This only led to either refusal or delay in receipt of information from the treaty partners. It is, therefore, of paramount importance that not only the field officers make full use of the provision of information exchange in all cases having substantial revenue potential, but also that they are skilled and trained to draw up the information exchange references properly.

4. Article 26 has equal utility at the time of enforcing domestic tax laws as well as implementing the double taxation agreements. A suggestive but by no means exhaustive list of scenarios in which exchange of information with other countries may be useful is as under: -

(A) <u>Domestic Tax Laws</u>

i) A person in State A supplies goods to an independent person in State B. State A wishes to know from State B what price the person in State B paid for the goods for purposes of correct application of the provisions of its domestic laws.

ii) A person in State A sells goods through a person in State C (possibly a low-tax country) to a person in State B. The persons may or may not be associated. There is no convention between State A and State C, nor between State B and State C. Under the treaty between State A and State B, State A, with a view to ensuring the correct application of the provisions of its domestic laws to the profits made by the person situated in its territory, asks State B what price the person in State B paid for the goods.

iii) State A, for the purpose of taxing a person situated in its territory, asks State B, under the treaty between State A and State B, for information about the prices charged by a person in State B, or a group of persons in State B with which the person in State A has no business contacts in order to enable it to check the prices charged by the person in State A by direct comparison (e.g. prices charged by a person or a group of persons in a dominant position).

iv) A person resident in State A earns passive incomes like dividend, interest, and royalty or the incomes for which his physical presence is not imperative, and the income earned is either exempted for one reason or the other or gets taxed in State B at a reduced rate, and the proper implementation of its own tax laws, State A approaches State B with the request to exchange precise and relevant information.

(B) Double Taxation Agreements

i) When applying articles relating to passive incomes, State A where the beneficiary is resident asks State B where the payer is resident, for information concerning the amount of income transmitted.

ii) Conversely, in order to grant the exemption provided for in the treaty, State B asks State A whether the recipient of the amounts is in fact a resident of the last-mentioned State and (is) the beneficial owner of the income.

iii) Similarly, exchange of information may be required to properly allocate the taxable profits between associated persons in different States or the adjustment of the profits shown in the accounts of a permanent establishment in one State and in the accounts of the head office in the other State or in the accounts of another permanent establishment in another State.

5. Thus, whereas on the one hand there is serious need to properly identify the cases and the scenarios in which information exchange provisions are invoked; on the other, the necessity to appropriately craft the exchange of information references is extensively underscored. While drawing up exchange of information references, it must be borne in mind that the onus is on the requesting state to convince the other state that the information sought is within the parameters of its obligations under the treaty, and that there is a potential of fiscal fraud, and that it is imperative to cooperate to checkmate fraud against the state authorities. In this regard, the following indicative set of guidelines may be of help and kept in view: -

i) The references should include all relevant background information that will enable the foreign tax authority to understand both the nature of investigation and what is to be established from the inquiries, information which is assumed by the auditor as opposed to information, which is factual. Where the facts are complex, charts showing interrelationships between entities, transfers of funds, etc. should be provided as an attachment. The years under investigation should also be clearly mentioned in the subject.

ii) All names and addresses pertaining to the foreign entities should be provided. Where individuals are involved, the year of birth should also be given, if known. Other information which could assist the foreign tax authority in identifying the foreign client should also be provided. If available, identification numbers and corporation numbers could prove invaluable in extracting quick and correct information.

iii) Where reference is made to sections of the national tax laws or other technical terms, an explanation of the section or the term

should be given, bearing in mind that the foreign tax authority will not be familiar with such legislation.

iv) In order to make full and effective use of the information sought, time limitations as contained in the law must also be borne in mind, and all such cases be dealt with on priority as the average time of exchange of information between tax authorities ranges between 3 months to a year.

v) An important angle of information exchange is its economics. Preferably maximum projected revenue – in case the information sought vindicates the audit assumptions – needs to be meticulously worked out for purposes of analysis and clarity; but in no case the possibility of receipt of information contrary to audit assumptions should breed fear and prove discouragement to undertake the very process of information exchange.

6. In recent years, a new mechanism of 'simultaneous audit' has been developed under the framework of Article 26, and frequently practised by various forward-looking tax administrations. Simultaneous audit signifies coordinated but independent tax examination of related taxpayers in two or more different states by exchanging background information, pre-audit assumptions, in-audit tips, and the eventual audit reports. Another similar mechanism developed under the umbrella of Article 26 is allowing tax experts of another State having both interest and locus to sit as observers when the authorities conduct their own tax audit. Thus, contingent upon the revenue returns projected requests for simultaneous audit of enterprises having multiple permanent establishments and / or associated enterprises (subsidiaries) may also be looked into by the Board on case-to-case basis.

7. This is also to be accentuated that our field formations never take pains to voluntarily transmit information that may be of use and value to our partner tax administrations. This by all means is obligatory upon us to pass information to the tax authorities concerned in situations where: (i) the non-resident person has been paid an amount debited to the accounts of a resident taxpayer and the aforementioned person is not chargeable to tax in Pakistan; (ii) the non-resident person has been taxed at a reduced tax rate under the provisions of the applicable agreement; and (iii) the non-resident person has been wholly exempted due to any provision of law. These kinds of gestures

are extremely important within the context of international good behavior as well as to further improve the image of the country as having very responsible, transparent, and efficient government structures. Such voluntary transmittals would also help improve the image of the tax department by discouraging the international operators to take us for a ride.

8. It is, therefore, of utmost importance that the field formations particularly those dealing with audit are confident, skillful and determined in dealing with cases involving international fiscal transactions, and approach FBR as and when required with a view to seek information from treaty partner countries for cognizance and proper taxation.

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