Industry letter on amendment made to the Pakistan domestic tax law definition of permanent establishment ('PE')

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16 February 2024

To
Mr. Malik Amjed Zubair Tiwana
Chairman, Federal Board of Revenue (FBR),
Government of Pakistan

On behalf of the Asia Internet Coalition (AIC) and its members, we are writing in relation to the amendment made to the Pakistan domestic tax law definition of permanent establishment ('PE') to include a virtual presence. The amendment, which was introduced in the 2023 Finance Bill and was effective July 1, 2023 and amended the definition of PE by removing the word 'fixed' and introducing a clause regarding 'virtual PE'. This amendment means that any business conducting transactions through the internet or any other electronic medium, regardless of whether a physical presence exists, could be considered to have a virtual PE.

AIC is an industry association comprising leading internet and technology companies. We seek to promote technology and policy issues in the Asia Pacific region, and we are fully committed to the cause of a safe and open internet.

In our view, the amendments made to the PE definition are not aligned with international best practices and could do more harm than good to the Pakistan economy. We are generally concerned about the wider impacts the Pakistan virtual PE amendment may have on foreign investment and the risk of retaliatory measures from other countries, including the United States, which could result in long term negative consequences for the growth of the country's technology sector. Moreover, research shows that these types of taxes are typically passed onto consumers which can arguably perpetuate production inefficiencies by targeting business input (e.g. advertising expenses) that are important for small businesses.

In the event the removal of the amendment to the PE definition is not viable, we put forth for your kind consideration certain suggestions in relation to the PE provisions, to ensure they are aligned with international practices.

1. Directions to be issued to tax officers to apply treaty benefits.

We request that guidance is provided by FBR to tax officials concerning tax treaty benefits. While the Supreme Court of Pakistan has consistently held that double tax treaties override the Income Tax Ordinance, Pakistan's tax department persists in applying the Tax Ordinance's definition of nexus over the definitions provided in treaties. Accordingly, in practice, even for companies which are tax treaty protected, the tax officers do not often provide benefit of no taxability, going against agreed treaty positions with contracting jurisdictions.

The tax treaties between Pakistan and over 60 other countries, including the United States and the United Kingdom, define "permanent establishment" as requiring a fixed place of business in Pakistan for nonresident enterprises to be subject to taxation. A fixed place of business typically refers to physical locations like management offices, branches, or factories. In both treaties, a nonresident enterprise will not have a permanent establishment unless it operates through a "fixed place of business" established in Pakistan. [1]

Given that nonresident entities providing digital services to Pakistani users usually lack a physical presence in Pakistan, they generally aren't subject to Pakistani taxation on profits from these services, provided they don't maintain a fixed place of business in the country. This arrangement reflects the principle that taxation is typically applied where physical presence or significant business activities occur, and it addresses the unique challenges of taxing digital services provided remotely across borders.

We suggest that directions or guidance are issued to Pakistan tax officers to apply tax treaty benefits, in line with the position held by the Supreme Court of Pakistan and in line with agreed double tax treaties in force. This guidance will make it easier for business to have certainty over the tax implications of their Pakistan business activities and will lower costs of doing business by reducing filing positions challenged by local Pakistan tax officers.

2. Sufficient lead time for application of the updated PE definition

We express our concerns about the implementation of the new tax regulations, specifically regarding the Permanent Establishment (PE) definition and its impact on businesses operating in Pakistan, especially those based outside the country. We kindly ask the government to allow businesses sufficient time to effectively implement these new tax provisions. The changes to the PE definition have significant implications for non-resident businesses looking to operate in Pakistan, whether through virtual means or temporary physical presence. E-commerce platforms and digital businesses, in particular, require adequate time to thoroughly understand the new laws and regulations and assess their implications for their services. They need to identify necessary modifications and ensure compliance with the regulations outlined in the notification. Implementing these changes requires businesses to restructure their operations to accommodate the new laws. This involves adjusting internal systems to comply with the new obligations, updating processes for submitting revised tax returns, and accurately calculating any tax liabilities resulting from the revised PE rules. We stress that these adjustments cannot be rushed and require careful planning and consideration. Therefore, we urge the government to provide a reasonable transition period for businesses to adapt to the new tax provisions effectively.

[1] Both treaties also provide that a dependent person which has and habitually exercises the authority to conclude contracts in the name of the nonresident creates a deemed permanent establishment of that nonresident. We will refer only to the "fixed place of business" permanent establishment in this letter, on the assumption that the "dependent agent permanent establishment" PE does not exist in the particular case.

It is recommended to provide at least 6 to 12 months to non-resident suppliers to comply. This will allow non-resident taxpayers to make the appropriate legal, operational and technical changes. The amendment went into effect immediately which is not a good practice. We strongly suggest that the enforcement date of the updated PE definition is deferred to the next financial year (i.e. Financial Year 2024-25). Providing sufficient lead time will minimize the risk of non-compliance and maximize revenue for the government. We also recommend that interest and penalty consequences are waived during this time.

3. Introduce a threshold exemption

We recommend establishing a registration threshold. We note that currently no de-minimis threshold applies to the PE definition under Pakistan law, for either applicability or compliance with the rules. This means that for businesses with a temporary or low virtual presence in Pakistan, including small businesses, business start-ups, or businesses testing the Pakistan market, will have to comply with onerous compliance obligations. These businesses will be required to register for income tax in Pakistan, file income tax returns, advancing taxes – even if the quantum of revenue and tax due is minimal. This imposes a huge compliance burden on taxpayers as well as a large administration burden on FBR. These businesses and FBR will end up spending more on the compliance of those entities, than the revenue that is received.

We strongly recommend a minimum revenue threshold is introduced into the Pakistan PE law to ensure that small businesses are not within scope. In this regard, we recommend an annual minimum threshold exemption of PKR 1M to be the minimally appropriate threshold which is the same level as the simplified business regime under the Sales Tax law.

This would not only ensure compliance costs are balanced with the revenue to be collected, but also ensure Pakistan aligns with international standards. Other countries that have introduced similar taxes over recent years included a minimum revenue threshold. For example, India's Equalisation Levy provides for an INR 20M (approx. USD 250,000) annual turnover threshold before the levy is applied. In Nepal, the DST is only applicable if the annual transactions pertaining to the electronic services do not exceed NPR 2 Million (approx. USD 16,500).

Should you have any questions or need clarification on any of the recommendations, please do not hesitate to contact our Secretariat Mr. Sarthak Luthra at Secretariat@aicasia.org or at +65 8739 1490.

Thank you

Sincerely,
Jeff Paine
Managing Director
Asia Internet Coalition (AIC)