# Taxation of Foreign Rental Income

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# Agenda

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# Taxation of Rental Income in Pakistan

# Taxation of Rental Income in Pakistan

- Taxed under the separate head of “Income from Property”
- Charging section 15 under ITO
- Deductions against chargeable rent are provided separately under section 15A
- Withholding on rent applicable under section 155
- Taxed on accrual basis

## Rent Defined:

“ ‘rent’ means any amount received or receivable by the **owner of land or a building** as consideration for the **use or occupation of**, or the right to use or occupy, the **land or building**, and **includes any forfeited deposit** paid under a contract for the sale of land or a building.”

[s 15(2) ITO]

## Exclusions:

i. lease of a building together with plant and machinery
ii. provision of amenities, utilities or any other service with the renting of the building
iii. sub-lease of land or building

# Taxation of Rental Income in Pakistan

## When tax treaty provisions become relevant?

| | | |
|---|---|---|
| Owner of immovable property | – | Resident of one Contracting State |
| Immovable property | – | Situated in the other Contracting State |

Both States may impose taxes under their local laws on the basis of either of the following:

i. **Residency –** Qualifies as resident of country as per local tax law or as per tie-breaker rule in Article 4 of DTT if resident in both countries

ii. **Source / Situs –** Where income generating source or economic activity is situated or more closely related to

# Taxation of Rental Income in Pakistan

## Pakistan-sourced rental income

"Rental income shall be Pakistan-source income if it is derived from the **lease of immovable property in Pakistan** whether improved or not, or from any **other interest in or over immovable property**, including a right to explore for, or exploit, natural resources in Pakistan."

[s 101(9) ITO]

## Taxation of resident and non-resident person

A Pakistan resident is taxable for his world over income.

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

[s 11 ITO]

# 2

## Tax Treaties in Action

# Tax Treaties in Action

## Relevance of OECD Model

- Bilateral treaties are typically based on a particular edition of the OECD Model Tax Convention as a starting point.
- Specific edition on which the treaty is based is not always publicly disclosed in the treaty text itself.
- Treaties are often influenced by the **most recent OECD Model available at the time of negotiation**.

## History of Pakistan's Tax Treaties with UAE and UK

| | **UAE** | **UK** |
|---|---|---|
| Signed by governments on: | 7th February, 1993 | 24th November, 1986 |
| Entry into force in Pakistan for income derived on or after: | 1st July, 1994 | 1st July, 1988 |
| Latest available OECD model available at the time of negotiation: | **1992** Model Tax Convention | **1977** Model Tax Convention |

# Tax Treaties in Action

## History of Article 6 of the OECD Model

| | |
|---|---|
| **1963** edition: | "1. Income from immovable property may be taxed in the Contracting State in which such property is situated." |
| **1977** edition: | "1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State." |
| No further changes since. Latest **2017 edition reads same**. | |

**Fundamental principle** has remained largely consistent across editions — **allowing the source state to tax** the income derived from such property.

# Tax Treaties in Action

## Pakistan-UAE DTT

“Article 6

**Income From Immovable Property**

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.”

## Pakistan-UK DTT

“Article 6

**Income From Immovable Property**

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.”

## OECD Model 1977

“Article 6

**Income From Immovable Property**

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.”

# 3

## Judgments of ATIR on Foreign Rental Income

# ATIR Judgments on Foreign Rental Income

## ATIR Lahore – decision dated 10.9.22 [Arshad Gulzar]

- **Favourable** judgment for taxpayer.
- ATIR held that Rental income from Dubai is not taxable in Pakistan for a Pakistan resident in terms of Article 6 of DTT.

## ATIR Islamabad – decision dated 7.11.22 [Naseer Ali Khan]

- **Adverse** judgment for taxpayer.
- ATIR held that UAE does not have exclusive rights to tax rental income from Dubai property.

## ATIR Lahore – decision dated 23.10.2024 [M Jahangir Muggo]

- **Favourable** judgment for taxpayer.
- ATIR scrutinized the DTT with UAE and UK and held that the taxing rights for rental income were exclusive only to source countries.

# ATIR Judgments on Foreign Rental Income

## Case 1 – ATIR Lahore – decision dated 10.9.22 [Arshad Gulzar]

- Words “may be taxed” is meant to allow taxation by the state where property is located, not to provide an option for both states to tax the same income.
- Word “may” is to be contextually interpreted. The phrase "may be taxed" in Article 6.1 should therefore be understood in the context of the **treaty’s object and purpose** which is **avoid double taxation**.
- Supreme Court has held that where the use of word “may” concerns public interest it is to be read as “must”.
- Absence of “may also be taxed” paragraph in Article 6 confirm that source country / UAE has exclusive taxing rights, as opposed to shared taxing rights for dividend (Article 10) and interest income (Article 11).

- On the basis of above, ATIR concluded that Pakistan being a country of residence is expressly precluded from taxing the rental income from property situated in UAE. Taxing rights are exclusive to UAE.

# ATIR Judgments on Foreign Rental Income

## Case 2 – ATIR Islamabad – decision dated 7.11.22 [Naseer Ali Khan]

- Words “may be taxed” is meant to allow taxation by the state where property is located, but not to restrict the rights of the country of residence to tax such income.
- The DTT uses the phrase “shall be taxed only” where it intends to restrict the taxing rights only to a particular state. For example, Article 14 relating to Capital Gains.
- Under the scheme of Model Tax Convention, the words "may be taxed" and "may also be taxed" gives simultaneous taxing rights to the State of the Source.
- Domestic law supports the taxation of foreign property income of a resident person and the DTT does not override this inherent right unless explicitly stated.

- On the basis of above, the Tribunal concluded that the phrase "may be taxed" in the DTT does not grant exclusive taxing rights to the UAE, and Pakistan retains the right to tax the rental income.

# ATIR Judgments on Foreign Rental Income

## Case 3 – ATIR Lahore – decision dated 23.10.2024 [M Jahangir Muggo]

- Mainly the same reasoning as Case 1, but a more detailed judgment.
- Supreme Court's decision in case of Snamprogetti BV discussed.
- If two conflicting decisions exist then the earlier one is to be followed.

- Hence, exclusive taxing rights of UAE and UK were confirmed with respect to Rental income as well as Capital gains.

# 4

# International Commentary and Case Laws

# International Commentary and Case Laws

## Supreme Court’s Interpretation Framework on Double Tax Treaties

- DTTs require a different interpretation than local tax law.
- Aim is to determine the mutual understanding among two or more contracting states. It should be interpreted to implement the terms of such agreement rather than interpreting the same in a unilateral manner.
- Interpretation of DTTs require taking into consideration the international tax language and terminology and placing reliance on legal decisions and practices in other countries, where appropriate, because these materials form part of the legal context.
- Model treaties developed by OECD and UN to provide standard frameworks of guidance for treaty negotiation, and official commentaries thereon, are of high persuasive value.
- Tax treaties tend to be less precise and require a broad purposive “substance over form” interpretation. Therefore, they are often interpreted more liberally than domestic law in the context of their object and purpose.

[2023 SCMR 1055 Snamprogetti BV]

# International Commentary and Case Laws

**Substantive Provisions of DTT** take one of the following three forms:

i. **the state of source may tax without limit.** e.g. income from immovable property situated in that state, and business profits derived from PE there.

ii. **the state of source may tax up to a maximum / ceiling.** e.g. dividends from companies resident in that state, and interest derived from there.

iii. **the state of source may not tax.** Here, the state of residence of the taxpayer alone has taxing rights. e.g. business profits where there is no PE in the state of source, and royalties derived from there, certain capital gains.

**In linguistic terms:**

Provisions which take the (i) or (ii) forms above generally employ permissive terminology: the income "may be taxed..”  or “may also be taxed...”

Provisions which take the third form employ mandatory terminology: the income "shall be taxable only..”

# International Commentary and Case Laws

## Exclusive right is available only to Country of Residence

As a rule, the exclusive right to tax is conferred only on the State of residence. Further, where taxing rights are available with both States, the State of residence eliminates double taxation by allowing a tax credit.

[Para 19 OECD commentary]

## Elimination of double taxation

- All of the substantive Articles must be considered along with Article 23 which sets out the methods for the elimination of double taxation by providing Foreign Tax Credit.
- This Article is **addressed to the state of residence** of the taxpayer and determines how that state will relieve from double taxation if the substantive Article is in either the (i) or (ii) form.

# International Commentary and Case Laws

## OECD Commentary on Article 6

"Paragraph 1 gives the right to tax income from immovable property to the State of source, that is, the State in which the property producing such income is situated. This is due to the fact that there is always a very close economic connection between the source of this income and the State of source."

[Para 1 OECD commentary]

"It should be noted in this connection that the right to tax of the State of source has priority over the right to tax of the other State."

[Para 4 OECD commentary]

Thus, the state of the situs is not granted the exclusive right to tax, the state of residence may also tax the income, and relief from double taxation is provided under Article 23.

[Sweet and Maxwell on DTTs]

# International Commentary and Case Laws

## Klaus Vogel Commentary

“When looked at in isolation, Article 6 OECD and UN MC **leaves both the right of the residence State and the right of the situs State** (i.e., ‘the other Contracting State', being the State in which the immovable property is physically situated) to apply their domestic, tax laws unaffected ('may be taxed' instead of 'is taxable only’).”

“Once integrated into the application of the Method Article (Article 23 OECD and UN MC, see Article 23 at m.no, 10), however, the words 'may be taxed' in Article 6 OECD and UN MC result in a **ban (Article 23A(1) OECD and UN MC) on taxation by the residence State**, or at least in a **duty of this State to credit pertaining taxes levied by the situs State** in accordance with Article 6 OECD and UN MC (Article 23B() OECD and UN MC).”

[Para 2-4, Art 6, Klaus Vogel on DTTs]

Klaus Vogel comments that state of situs has the primary taxing right. But the right of residence state is not precluded, rather it is bound to give credit of taxes paid to the state of situs.

# International Commentary and Case Laws

## International Case Laws on Article 6 paragraph 1

**Decision of the Bundesfinanzhof of January 22, 1980, VIII. R. 134/78 (1980) BStB1, II, 447 discussed in (1981) E.T. 89**

Concerned the taxation of a Spanish flat owned by German residents: the treaty with Spain permitted Spain to tax such property, Germany also had power to tax the deemed rental (i.e. an imputed rent for the enjoyment of the right to use property) with credit for Spanish tax. Since Spain did not tax the flat, there was no credit to be granted and the imputed rent was taxable entirely in Germany.

# International Commentary and Case Laws

## Purpose of Double Taxation Conventions

> *"The taxpayer hopes the treaty will prevent the double taxation of his income; the tax gatherer hopes the treaty will prevent fiscal evasion; and the politician just hopes."* [1]

From the governmental point of view, most comprehensive treaties have at least these twin purposes of avoiding double taxation and preventing fiscal evasion.

More recent narrative tends to refer to the basic purposes of tax conventions as including not only the elimination of double taxation, but also the **prevention of double non-taxation**.

*1 A. McKie at the 22nd Tax Conference of the Canadian Tax Foundation, quoted by P. Gravelle, "Tax Treaties: Concepts, Objectives and Types" (1988) Bull. I.B.F.D. 522.*

# International Commentary and Case Laws

## Whether double taxation is a prerequisite to obtain DTT benefit?

There may be situations where a taxpayer faces no taxation in one state, yet still seeks the protection of the convention against taxation in the other state. If he is entitled to this protection, the result will be double non-taxation.

Despite statements that the purposes of conventions include the avoidance of double non-taxation, the **view of most courts is that potential double taxation is not a pre-requisite.**

i. The issue was faced in Canada in **Estate of Michael Hausmann v R.**

   The deceased had been entitled to a pension from Belgium which was not taxed in that country. His estate sought to confirm that the pension was not taxable under the convention between Canada and Belgium since that convention allocated the right to tax such payments solely to the country of source. If this was correct, the pension would not be taxable anywhere. Estate's arguments were accepted.

# International Commentary and Case Laws

ii. Similar point was made by Federal Court in Australia in **Lamesa Holdings v Commissioner**.

iii. In **Re Schneider SA** the taxpayer company sought successfully to rely upon the provisions of the double taxation convention between France and Switzerland as a defence against a charge to tax under the French CFC rules. One argument was that the company faced no danger of double taxation since these provisions contained a tax credit mechanism which ensured that no double taxation would arise: the Administrative Court of Appeal of Paris <u>held that the company might rely upon the convention even though there was no danger of double taxation</u>.

iv. Similar issue arose in a decision of the **Netherlands Hoge Raad** and was decided in the like manner.

# International Commentary and Case Laws

v. **Indian decision against the taxpayer – Indian Authority for Advanced Rulings in case of Re Pereira.**

India had concluded a double taxation convention with the United Arab Emirates, a state which did not impose tax on individuals. Mr. Pereira—who resided in the UAE—sought a ruling that he was entitled to the benefit of the convention with regard to income derived from India and capital gains on assets situated there. It was concluded as follows:

"If a taxpayer pays tax or is liable to pay tax under the laws in force in one country alone, he cannot claim any relief from a non-existent burden of double taxation under the Double Taxation Avoidance Agreement. The Double Taxation Avoidance Agreement is meant only for the benefit of taxpayers who are liable to pay tax twice on the same income."

# 5

# Foreign Capital Gains Tax

# Foreign Capital Gains Tax

## Capital Gains from Immovable Property

Two types of gains relate to immovable property:

i. Gains from the alienation of such property [Article 13(1) OECD model]

ii. Gains from the alienation of shares deriving more than 50 per cent of their value from such property [Article 13(4) OECD model]

## Capital Gains from disposal of shares

iii. Other than those referred in ii above [Article 13(5) OECD model]

# Foreign Capital Gains Tax

## (i) Disposal of Immovable Property

### Pakistan-UAE DTT

"Article 14(1)

**Capital Gains**

1. Gains derived by a resident of a Contracting State from the alienation of immovable property, referred to in Article 6, and situated in the other Contracting State may be taxed in that other State.

### Pakistan-UK DTT

"Article 14(1)

**Capital Gains**

Subject to the provisions of paragraph 2 of this Article, capital gains which arise in a Contracting State may be taxed by that State in accordance with the provisions of its domestic law.

### OECD Model

"Article 13(1)

**Capital Gains**

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

# Foreign Capital Gains Tax

## (ii) Disposal of shares deriving value from Immovable Property

### Pakistan-UAE DTT

No equivalent paragraph, hence will be taxable as per paragraph 4 which pertains to shares

“Article 14(4)

**Capital Gains**

4. Gains from the alienation of any property other than that mentioned in paragraph 1, 2 and 3 shall be taxable only in the Contracting State of which the alienator is a resident.

### Pakistan-UK DTT

No equivalent paragraph, hence will be taxable as per paragraph 1

“Article 14(1)

**Capital Gains**

1. Subject to the provisions of paragraph 2 of this Article, capital gains which arise in a Contracting State may be taxed by that State in accordance with the provisions of its domestic law.

### OECD Model

“Article 13(4)

**Capital Gains**

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

# Foreign Capital Gains Tax

## (iii) Disposal of shares

### Pakistan-UAE DTT

Article 14(4)

**Capital Gains**

4. Gains from the alienation of any property other than that mentioned in paragraph 1, 2 and 3 shall be taxable only in the Contracting State of which the alienator is a resident.

### Pakistan-UK DTT

No equivalent paragraph, hence will be taxable as per paragraph 1

"Article 14(1)

**Capital Gains**

1. Subject to the provisions of paragraph 2 of this Article, capital gains which arise in a Contracting State may be taxed by that State in accordance with the provisions of its domestic law.

### OECD Model

"Article 13(5)

**Capital Gains**

5. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

# 6 Concluding Remarks

# Thank you