SUPREME COURT OF PAKISTAN
(Appellate Jurisdiction)

Bench-I:
Mr. Justice Umar Ata Bandial, CJ
Mr. Justice Syed Mansoor Ali Shah
Mr. Justice Munib Akhtar

Civil Petitions No.3286 to 3289 of 2017
(Against the consolidated judgment of Islamabad High Court, Islamabad dated 15.06.2017, passed in ITR Nos.160 of 2016, etc.)

Snamprogetti Engineering B.V. thr. its Special Attorney *(in all cases)*

..... Petitioner

Versus

Commissioner of Inland Revenue Zone-II, L.T.U, Islamabad, etc.
(In all cases)

....Respondents

For the petitioner: Mr. Makhdoom Ali Khan, Sr. ASC.
(In all cases) Syed Rifaqat Hussain Shah, AOR.

For the respondents: Mr. Babar Bilal, ASC.
(In all cases) a/w Shahid Soomro, Commissioner (Legal)

Date of hearing: 02.08.2022

JUDGMENT

Syed Mansoor Ali Shah, J.- Snamprogetti Engineering B.V. **("petitioner")**, a company incorporated in the Netherlands, entered into an engineering contract dated 14.03.2007 **("contract")** with Engro Chemicals Pakistan Limited **("local company")**, a company incorporated in Pakistan, to provide "engineering services[1]" for the plants[2] and for the procurement of spare parts[3] regarding the project i.e., construction of a fertilizer complex at Daharki, District Ghotki, Pakistan. The petitioner was a non-resident company under the Income Tax Ordinance, 2001 **("Ordinance")**.[4] Clause 3.18 of the contract provided that notwithstanding anything to the contrary in the contract, the petitioner would not be responsible for the construction and the overall management activities of the project. Engineering services as agreed to between the parties in the contract were duly provided by the petitioner to the local company.

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[1] Engineering Contract between Engro Chemicals Pakistan Limited and Snamprogetti Engineering B.V. for Engineering Services for 2,194 MTPD Ammonia Plant and 3,835 MTPD Urea Plant, See Engineering Services and Work under clause 1.1 (Definitions).
[2] ibid, See clause 1.1 (definitions): individually each of the Urea Plants and Ammonia Plant and the Utility Plants.
[3] ibid, See Clause 2 (Scope of Work).
[4] ss 81 and 83.

2. The petitioner filed tax returns for tax years 2007, 2008 and 2009, declaring that the income arising from such engineering services was exempt from being taxed under the domestic tax regime of Pakistan. The tax returns were treated as assessment orders deemed to have been issued in terms of Section 120(1) of the Ordinance. The department took exception to the exemption claimed by the petitioner. Show cause notices were issued to the petitioner under Section 122(9) read with Section 122(5A) of the Ordinance. The Assessing Officer amended the assessment orders under Section 122(5A) of the Ordinance. Tax was consequently ordered to be charged on the income which had been declared exempt by the petitioner.

3. The petitioner assailed the said orders in appeal before the Commissioner (Appeals) and the latter set aside the orders passed by the Assessing Officer on the ground that the petitioner did not have a "permanent establishment" in Pakistan in the context of the 'Convention between the Kingdom of the Netherlands and the Islamic Republic of Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income' **("Convention")** so as to be amenable to the jurisdiction of domestic tax regime with regard to their business profits relating to such engineering services. The department successfully challenged the order of the Commissioner (Appeals) before the Appellate Tribunal Inland Revenue **("Tribunal")**. The tax references filed by the petitioner remained unsuccessful in the High Court. So, the petitioner seeks leave of this Court to appeal against the decision of the High Court.

4. The sole question that has come up for determination before us is whether the income derived by the petitioner from providing afore-referred engineering services to the local company is exempt from income tax in view of the Convention or is it liable to be taxed under normal tax regime of Pakistan.

5. We have heard the arguments of the learned counsel for the parties on the said question and have carefully gone through the record.

6. International taxation treaties aim to avoid and relieve double taxation through equitable (and acceptable) distribution of tax claims between the countries. The purpose of these treaties has significant relevance as to how their provisions are to be interpreted.[5]

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[5] *Crown Forest Industries Ltd v Canada* [1995] 2 SCR 802.

The reason is that the efficacy of such treaties depends on common and workable interpretation of the treaty terms.[6] Such an interpretation requires 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 the Organisation for Economic Co-operation and Development **("OECD")**[7] and the United Nations **("UN")**[8] to provide standard frameworks of guidance for treaty negotiation, and official commentaries thereon, are of high persuasive value in terms of defining the parameters of double taxation treaties and have world-wide recognition as basic documents of reference in the negotiation, application and interpretation of multilateral or bilateral tax conventions.[9] Most countries accept the common interpretation principles of the Vienna Convention on the Law of Treaties of 23rd May 1969 (**"VCLT"**) under customary international law, and thus the VCLT and not the domestic law of the contracting states, usually governs the interpretation of such treaties.

7. It is perhaps necessary to mention at the outset that international tax conventions or agreements or treaties are of a special nature and the role of a state (being party to such a bilateral agreement) is more of implementing the terms of such agreement rather than that of interpreting the same and that too in a unilateral manner. Treaty interpretation rules[10] differ from domestic tax rules for the following among other reasons:

(a) As international treaties, the VCLT governs double tax agreements. Therefore, their interpretation is based on the rules of interpretation under customary international law. As these principles and procedures of interpretation of agreements differ from rules applied to domestic legislation, an interpretation under the domestic law as a taxing statute may be misleading and unsuitable;

(b) Unlike the domestic law which contains highly technical legislative language relevant to a specific jurisdiction, tax treaties are based on the mutual understanding among two or more contracting states. Moreover, more than one language may be involved. They must be applied by the tax authorities and the courts in each contracting state in a

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[6] Klaus Vogel, 'Double Tax Treaties and Their Interpretation' 4 Int'l Tax & Bus. Law. 1, 4 (1986).
[7] OECD Model Tax Convention on Income and on Capital.
[8] United Nations Model Double Taxation Convention between Developed and Developing Countries.
[9] *Crown Forest Industries Ltd v Canada* [1995] 2 SCR 802.
[10] Roy Rohatgi, *Basic International Taxation* (Kluwer Law International Second Edition 2001). See also *Commissioner of Taxation v Lamesa Holdings BV* (1997) 77 FCR 597; *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* (2005) 142 FCR 134; *A.P.Moller v Taxation Officer of Income Tax* 2011 PTD 1460.

uniform way (common interpretation) that may differ from the domestic laws and practices in each state;

(c) Tax treaties are primarily relieving in nature and do not impose tax, while the domestic tax law seeks to impose tax in specific circumstances. A treaty specifies general taxing principles to avoid double taxation. Moreover, as the life of a treaty can be long it must be flexible enough to adapt to changes in the domestic law while continuing to reflect the original negotiated balance of obligations and concessions;

(d) 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.[11] On the other hand, in states that prefer a liberal, purposive interpretation of their domestic law, the interpretation of the tax treaties may be stricter under the statutes. In both cases, a neutral interpretation and common understanding requires the use of an international fiscal language, which may not be found in the domestic laws and may provide a definition quite independent from domestic laws;

(e) Treaty interpretation is a subject in itself and not merely an extension of statutory interpretation despite the fact that treaties may be enforceable only when made part of the domestic law under a statute in certain countries. Therefore, tax treaties should be kept as free as possible from the interpretation rules under domestic law, unless specified in the treaty itself.

8. The petitioner, being a tax resident of the Netherlands, is entitled to the benefits and concessions under the Convention in line with the provisions of Section 107 of the Ordinance. Under subsection 2(c) of Section 107 of the Ordinance, the taxability of the petitioner's income is to be determined under the provisions contained in the Convention which override the Ordinance. The Convention involved in the present case was signed and enforced by Pakistan and the Netherlands in 1982. Its Article 7 provides that the business profits of an enterprise of one of the states shall be taxable in the other state only if the enterprise maintains a permanent establishment in the latter state and only to the extent that the profits are attributable to the permanent establishment. The concept of permanent establishment is used in bilateral tax treaties to determine the right of a state to tax the profits of an enterprise of the other state. According to Klaus Vogel, an eminent academic in the field of international taxation and recognized as an authority on the interpretation of double taxation treaties, the permanent

[11] The Australian Tax Office defines the term "liberal" to refer to the rules of construction to be used in interpretation and not the scope of the provisions.

establishment threshold has been commonly used since 1920s in double taxation treaties to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates.[12]

9. The term 'permanent establishment' is dealt with under Article 5 of the Convention. The structure of this Article as per the OECD and UN Model Conventions has been explained in Klaus Vogel's treatise, which is regarded as the international gold standard on the law of tax treaties, as a multi-level structure and can be read from more than one starting point. Clause 1 of Article 5 of the Convention gives a general or classic definition of the term permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partly carried on. Clause 2 contains a non-exhaustive list of examples which could be regarded as permanent establishments. Clause 3 expressly provides that a building site, construction, installation, assembly project or supervisory activities constitute a permanent establishment only if they last more than six months. Clause 4 relates to services and provides that the furnishing of services would fall in the ambit of permanent establishment if activities of that nature continue for a period or periods aggregating more than four months within any twelve-month period. Clause 5 lists a number of business activities which are treated as exceptions to the general definition. Clauses 6 and 7 are deeming provisions referring to situations where an enterprise is deemed to have a permanent establishment in one of the states. And, clause 8 provides an instance that a company which is a resident of one of the states and controls or is controlled by a company which is a resident of the other state or which carries on business in the other state shall not of itself constitute either company a permanent establishment of the other.

10. The Assessing Officer while dealing with the question of permanent establishment was of the view that the petitioner's case was covered by clauses 3 and 4 of Article 5 of the Convention. He observed that the petitioner was not only engaged in providing the designing and engineering services but was also performing the construction work at the plant site and that the implementation of the contract was not possible without the physical presence of the petitioner in Pakistan. The decision of the Assessing Officer was set aside by the Commissioner (Appeals) and though the decision of the Commissioner (Appeals) was

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[12] OECD Model Commentary, art 7; Ekkehart Reimer & Alexander Rust (eds), *Klaus Vogel on Double Taxation Conventions* (Wolters Kluwer Fifth Edition 2022) art 5.

reversed by the Tribunal which was then maintained by the High Court as well, the latter two forums did not reinstate the Assessing Officer's observation about the petitioner's case being covered by Clause 3 of Article 5 of the Convention.

11. The contract reflects that the petitioner was hired for the provision of engineering services only. The scope of the petitioner's work consisted of providing engineering services for the plants as well as for the procurement of two years' spare parts. The petitioner's obligations mainly included: (i) carrying out the work exercising due skill, care and diligence in accordance with good and internationally acceptable engineering, design and procurement practices;[13] (ii) furnishing five sets of the final version of the engineering documents to the local company;[14] (iii) providing on an ongoing basis engineering data including computer files to the local company for review of the work being performed by the petitioner;[15] and (iv) witnessing at its own expense at the place of manufacture all such tests and inspections of the equipment and materials and other parts of work, as specified in the contract to ensure that they comply with the engineering developed by the petitioner on the basis of the desired standards.[16] It is expressly clarified in the contract that notwithstanding anything to the contrary, the petitioner shall not be responsible for the construction and the overall management activities of the project which shall be the exclusive responsibility of the local company.[17] The local company was to perform or cause to be performed the construction and erection activities for the implementation of the plants and be responsible for the management and administration of such activities and any associated cost and time schedule.[18] The local company was to use an expert and competent construction contractor and was required to ensure that construction would be performed according to acceptable standards.[19] All work excluded from the petitioner's work was the local company's responsibility to perform or cause to be performed.[20]

12. The burden of proving the fact that the petitioner had a permanent establishment in Pakistan and must, therefore, suffer tax from the business generated from such permanent establishment was

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[13] Engineering Contract between Engro and Snamprogetti, cl 3.1.
[14] ibid, cl 3.8.
[15] ibid.
[16] ibid, cl 3.10.
[17] ibid, cl 3.18.
[18] ibid, cl 4.6.
[19] ibid.
[20] ibid, cl 4.14.

initially on the department.[21] The above-referred recitals of the contract adequately show that the petitioner and the local company did not have a contractual relationship ascribing any building, construction, installation, assembly project or supervisory activities role to the former. Rather, the role of the petitioner was limited to providing services only. The Assessing Officer's view about the actual involvement of the petitioner in the construction activity is not supported by any material on record. Clause 3 of Article 5 of the Convention has, therefore, no relevance to the petitioner's case.

13. However, the petitioner's case may fit in the category identified under Clause 4 of Article 5 of the Convention if the petitioner had rendered services through its employees in Pakistan provided the services were rendered for a specified period.[22] Clause 4 of Article 5 of the Convention provides that permanent establishment shall "encompass the furnishing of services including consultancy services, by an enterprise through employees or other personnel, engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than four months within any twelve-month period." The view of the Assessing Officer about the impossibility of the implementation of the contract without the physical presence of the petitioner in Pakistan appears irrational and purely assumptive because he failed to take note of the fact that the employees/representatives of the petitioner admittedly stayed in Pakistan for 97 days only.

14. The High Court, the Tribunal and the Commissioner (Appeals) all reckoned that the case of the petitioner was covered by Clause 4 of Article 5 of the Convention. However, they used different approaches to calculate the period of four months, necessary for any activity of furnishing services to be categorized as a permanent establishment. The Commissioner (Appeals), in view of the admitted position that the employees/representatives of the petitioner stayed in Pakistan for 97 days only, came to the conclusion that the stay of the petitioner's employees/representatives in the country was less than four months in each year and, therefore, did not correspond with the profile of permanent establishment given in Clause 4 of Article 5 of the

[21] *Assistant Director of Income Tax v E-Funds IT Solution Inc.* (2018) 13 SCC 294.
[22] *DIT (International Taxation), Mumbai v Morgan Stanley and Co. Inc.* (2007) 7 SCC 1.

Convention. The Tribunal, however, reasoned that it was not the presence but the activity which mattered; that the whole project was indivisible and taxability of project execution must be taken in entirety; and that the entire period of implementation of the project which was far longer than the prescribed period of four months was to be counted. The High Court recognized that the obligations of the petitioner under the contract were in the nature of furnishing of services and the employees/representatives of the petitioner had indeed stayed in Pakistan for 97 days only. Yet the High Court observed that the furnishing of services described in the contract was not dependent on the number of visits by the employees/representatives of the petitioner or their physical presence at the site. What was relevant, the High Court observed, was the continuation of furnishing of services and the activities relating thereto within Pakistan for a period or periods aggregating more than four months within any twelve-month period. The High Court elaborated that the plants were constructed and commissioned at Daharki, District Ghotki, Pakistan while the engineering services were being rendered by the petitioner in relation thereto and the activities of that nature had definitely continued in Pakistan. The petitioner, therefore, was held to have a permanent establishment within the meaning of Clause 4 of Article 5 of the Convention.

15. We are unable to subscribe to the reasoning provided for calculating the time period by the Tribunal and the High Court. Rather, we believe that the Commissioner (Appeals) had taken a correct and logical approach to calculating the period of four months necessary for any activity of furnishing services to constitute a permanent establishment. The language used in Clause 4 of Article 5 of the Convention with respect to time period shows that there may be a number of periods, interspersed with breaks, during which services are furnished by an enterprise. If the aggregate of these periods crosses the threshold of four months within any twelve-month period, a permanent establishment will stand constituted. What could be the way to separate breaks from periods of activity other than counting the days of the actual physical presence of employees or other personnel engaged in furnishing services by an enterprise in the source country. We agree with the High Court that the engineering services for which the contract was executed were in relation to the construction and installation of fertilizer plants but we disagree with the High Court as regards the finding that the

obligations of the petitioner relating to furnishing of services were in respect of the construction of the plants at the site and continued for the entire period of the validity of the contract. We do not see that contracts covering activities other than engineering services were concluded with the petitioner or related persons. The nature of the work involved in engineering services and construction activity could not be said to be the same. It has not been shown that the same employees rendered engineering services and performed construction activities under different contracts. Nor has it been brought on record that engineering services and construction activities would have been covered by a single contract except for tax planning considerations.

16. The department has failed to bring on record any evidence satisfying the threshold requirement of Clause 4 of Article 5 of the Convention that the petitioner had furnished services within Pakistan through employees or other personnel for a period or periods aggregating more than four months within any twelve-month period. The furnishing of services as envisaged under the Convention does not, of itself, create a permanent establishment unless it continues for a period or periods aggregating more than four months within any twelve-month period.

17. The representatives of the petitioner admittedly stayed in Pakistan for 97 days only which falls short of the requirement of continuation of services for four months in each year and, therefore, the provision of engineering services by the petitioner could not be placed in the category of permanent establishment set out in Clause 4 of Article 5 of the Convention. The income derived by the petitioner from the provision of engineering services to the local company being not attributable to a permanent establishment located in Pakistan is not taxable in Pakistan as long as it is not covered by other Articles of the Convention that would allow such taxation. We, therefore, reach the conclusion that the petitioner is entitled to the exemption provided in the Convention, and the income derived by the petitioner from providing the afore-referred services to the local company is exempt from income tax in Pakistan because of not fulfilling the conditions necessary to constitute a permanent establishment as set out in Clause 4 of Article 5 of the Convention.

18. In view of the above answer to the question under consideration, we convert these petitions into appeals and allow the same: the impugned judgment of the High Court and order of the

Tribunal are set aside while that of the Commissioner (Appeals) is restored and the bank guarantee dated 14.02.2022 in the sum of Rs. 20 million furnished by the petitioner with the Deputy Registrar of this Court shall be returned to the petitioner.

19. Foregoing are the reasons for our short order dated 02.08.2022, which is reproduced here for convenience:-

> For reasons to be recorded later, these petitions are converted into appeals and allowed. The bank guarantee dated 14.02.2022 in the sum of Rs.20 million furnished by the petitioner with the Deputy Registrar of this Court shall be returned to the petitioner.

Chief Justice

Judge

Islamabad,
02nd August, 2022.
Approved for reporting
Sadaqat

Judge