IN THE SUPREME COURT OF PAKISTAN
(Appellate Jurisdiction)

Present: Mr. Justice Umar Ata Bandial, CJ
Mr. Justice Qazi Faez Isa
Mr. Justice Syed Mansoor Ali Shah

Civil Appeals No. 94 to 106/2008
(On appeal against the judgment dated 12.10.2007
passed by the High Court of Sindh, Karachi
in ITRAs No. 71/1997, 99/2006, 274/1997,
275 to 281/1998, 514 to 516/2006)

And

Civil Appeal No. 550/2011
(On appeal against the judgment dated 11.11.2010
passed by the High Court of Sindh, Karachi
in ITR No. 229/2005)

The Commissioner of Income Tax
(in all cases) ... Appellant

Versus

M/s. Inter Quest Informatics Services.
(in all cases) ... Respondent

For the Appellant: Ms. Misbah Gulnar Sharif, ASC
(in CAs 94 to 106/2008)

Ch. Akhtar Ali, AOR
(in CA 94/2008)

Sh. Mehmood Ahmed, AOR
(in CAs 95 to 106/2008)

Hafiz Ahsan Ahmad Khokhar, ASC
Raja Abdul Ghafoor, AOR
(in CA 550/2011)

For the Respondent: Mr. Makhdoom Ali Khan, Sr. ASC
(in all cases) Syed Rifaqat Hussain Shah, AOR
assisted by M/s Saad Hashmi and
Khawaja Aizaz Ahsan, Advocates

Date of Hearing: 07.09.2022

JUDGMENT

Qazi Faez Isa, J. The High Court of Sindh at Karachi decided fourteen income tax references which had been filed by the respondent respectively under section 136(1) of the Income Tax Ordinance, 1979 and section 133(1) of the Income Tax Ordinance, 2001 (‘**References**’, ‘**ITO 1979**’, ‘**ITO 2001**’ and collectively ‘**the Ordinances**’ respectively). A Divisional Bench of the High Court decided thirteen of these references though a common judgment dated 12 October 2007 and one was decided *vide* judgment dated 11 November 2010, which relied on its earlier judgment.

2. The respondent is a company incorporated in and having its principal place of business in the Netherlands. The respondent has no place of business in Pakistan. The respondent files its income tax returns in Pakistan under national tax number 14-11-069875-7 (‘**the Returns**’). The Returns have different headings and under the heading *Income Claimed to be Exempted and not Included in Total Income* the respondent sought exemption in respect of its receipts in respect of *Rental from Lease FLIC Software computer program* which it stated was *exempt under article 7 of the Agreement for Avoidance of Double Taxation between Pakistan and Netherlands*. However, the Income Tax Officer did not accept the respondent’s contention, and was of the opinion that, *such income constitute royalty and is assessable under Article 12-3(a) (b) of the Tax Treaty between Pakistan and Netherlands*, and called upon the respondent to explain why the same *may not be taxed as royalty income @ 15%*.

3. The Income Tax Officer sent notices to the respondent and in response the respondent stated that the said income was *business profits*, and thus exempt under Article 7 of the said tax treaty. And with regard to the contention of the Income Tax Officer that the income (exemption whereof was claimed) were royalties, which were not exempted under Article 12 of the treaty, the respondent straight away proceeded to explain what constitutes *royalties* without first explaining the nature of the receipts, what they were for, the agreement they were paid under and the particular item of its schedule and what it entailed:

> ‘3. The term ‘Royalty’ as defined in Article 12 of the Tax treaty is as follows:
>
> Payment of any kind received as consideration for the use of, or the right to use:
>
> i. a patent, trademark or tradename, secret formula or process design or model, or information concerning industrial, commercial or scientific experience;

ii. Industrial, commercial or scientific equipment, cinematograph films and tapes for television and broadcasting;'

'From the above extract, it is clear that the rentals paid for tapes and software by SSI are neither in the nature of patent, trademark, or tradename, secret process or formula, design or model, nor any equipment, films and tapes for television and broadcasting. The Article includes only tapes for television and broadcasting as Royalty. Had the intention been otherwise, the Article would have referred to all sorts of films or tapes. Consequently, the rentals do not come within the ambit of the above definition of "Royalties".'

'4. It is also important to note that software cannot be classified as goods. A similar issue came up for consideration before the Income Tax Appellate Tribunal (ITAT) in a case where the question was whether the software payments are subject to tax withholding under section 50(4) of the repealed 1979 Ordinance applicable on 'supply of goods'. The ITAT after considering the various definition of 'computer software' categorically held that by any definition or connotation of the term, it cannot be treated as "Goods".'

'5. Classification of Software payments

5.1 With regard to consideration for computer software, whether the payments are to be classified as 'Royalties' or 'Business Income' or 'Capital Gains' guidelines has to be taken from the Organisation for Economic Co-operation and Development (OECD) commentary on Article 12 of the Tax treaties, as amended in 2000 to refine the principles by which the classification issues of computer software transaction can be resolved.

5.2 We would inform you that the character of payments involving the transfer of computer software mainly depends on the nature of rights the transferee acquires under the particular arrangement regarding the use and exploitation of the programme. Since the software is not in the nature of goods as such the rights in computer programme are in the nature of intellectual property, which are normally protected in most of the countries under copyright laws.

5.3 Transfer of rights in relation to software occur in many different ways ranging from outright alienation of the entire rights in the copyright in a programme to the usage of a product which is subject to restrictions on the use to which it is put. A distinction should, however, be borne in mind between the copyright in the programme and software incorporating a copy of the copyright programme.

The transferee's rights normally, consist of partial or complete rights in:

a) The underlying copyright; or

b) copy of the programme (programme copy), whether or not such a copy is embodied in a tangible medium or provided electronically.'

'6. The payments made for the acquisition of partial rights in (a) above can be treated as Royalty, subject to the condition that the programme should be used in a manner that would, without such authorisation, constitute an infringement of copyright. The examples of such arrangement include:

license to reproduce and distribute to the public, software incorporating the copyrighted programme; or
modification and public display of programme.

In these kind of cases, it is apparent that the consideration would be for the right to use the copyright in the programme, which otherwise would be commercial exploitation i.e. under the copyright laws.'

'7. In other types of transactions covered in (b) above, the rights acquired in relation to the copyright are limited to the extent of enabling the user to operate the programme. This commonly happens in acquisition of a programme copy where the transferee is granted limited right to reproduce the programme e.g. to copy the programme on user's computer hard drive or for archival purpose. Such act is, of course, essential in utilizing the programme, therefore, rights in relation to the act of copying merely for enabling the operation of the programme by the user would not give rise to 'Royalty'. In such cases, the consideration received will retain the character of 'Business Income'.

We submit that all that the company had granted to SSI was the use of its software. Under the Agreement, SSI is not entitled to amend or to make any changes. The income from such activities cannot be treated as Royalty as payment of royalty would have entitled SSI to make amendments / changes in the software according to its specific circumstances. SSI was not given the back-up of the process or the formula used in these software. It was only entitled to apply the same in its business and to obtain the results computed on the basis of inbuilt formula. It is further submitted that had the software been given to SSI on royalty basis, then SSI would also have gained the back-up information and a right to make amendments or exploit the software i.e. to sub-let it to third parties.'

4. The Income Tax Officer did not accept the aforesaid contention/explanation of the respondent and maintained that the receipts

by the respondent were royalties under paragraph 3 (a) and (b) of Article 12 of the treaty between the two countries. Therefore, such receipts were liable to be taxed under paragraph 2 (a) and/or (b) of Article 12 at the rate of fifteen percent, and consequently, assessment orders were issued by the Income Tax Officer who called upon the respondent to pay income tax thereon.

5. The respondent challenged the assessment orders by filing appeals before the Commissioner of Income Tax (Appeals), but these appeals were dismissed and the assessment orders issued by the Income Tax Officer were maintained. The respondent then assailed the assessment orders and the Commissioner's appellate orders before the Income Tax Appellate Tribunal ('**the Tribunal**'), but without success. The Tribunal determined that the receipts of payments by the respondents constituted royalties in terms of paragraph 3 (a) and (b) of Article 12 of the treaty and liable to income tax at the rate of fifteen percent. The respondent then assailed the assessment orders, the appellate orders and the judgments of the Tribunal before the High Court by filing references, respectively under section 136(1) of ITO 1979 and section 133(1) of ITO 2001.

6. Two questions were formulated for consideration by the High Court. Firstly, whether the said payment receipts were business profits under Article 7 of the treaty and, secondly, whether the same constituted income from royalties under Article 12 of the treaty, and as such were not business profits under Article 7. The High Court decided the questions in favour of the respondent, and held that the amounts received by the respondent did not constitute royalties. The judgments of the High Court were assailed before this Court under Article 185(3) of the Constitution of the Islamic Republic of Pakistan ('**the Constitution**') and leave was granted.

7. Through this common judgment fourteen appeals, arising from the said fourteen cases, particulars whereof are as under, are being decided:

No	**Supreme Court**	**High Court**	**Filed under**	**Agreement**	**Assessment year/s**
1	CA 94/2008	ITR 71/1997	s. 136(1), Income Tax Ordinance, 1979	Not mentioned	1987-1988 1989-1990

2	CA 95/2008	ITR 99/2006	s. 136(1), Income Tax Ordinance, 1979	Not mentioned	1998-1999 1999-2000
3	CA 96/2008	ITA 274/1998	s. 136, Income Tax Ordinance, 1979	Not mentioned	1990-1991
4	CA 97/2008	ITA 275/1998	s. 136, Income Tax Ordinance, 1979	Not mentioned	1991-1992
5	CA 98/2008	ITA 276/1998	s. 136, Income Tax Ordinance, 1979	Not mentioned	1992-1993
6	CA 99/2008	ITA 277/1998	s. 136, Income Tax Ordinance, 1979	Not mentioned	1993-1994
7	CA 100/2008	ITA 278/1998	s. 136, Income Tax Ordinance, 1979	Not mentioned	1994-1995
8	CA 101/2008	ITA 279/1998	s. 136, Income Tax Ordinance, 1979	Not mentioned	1995-1996
9	CA 102/2008	ITA 280/1998	s. 136, Income Tax Ordinance, 1979	Not mentioned	1996-1997
10	CA 103/2008	ITA 281/1998	s. 136, Income Tax Ordinance, 1979	Not mentioned	1997-1998
11	CA 104/2008	ITRA 514/2006	s. 133, Income Tax Ordinance, 2001	1995	2001-2002
12	CA 105/2008	ITRA 515/2006	s. 133, Income Tax Ordinance, 2001	1995	2002-2003
13	CA 106/2008	ITRA 516/2006	s. 133, Income Tax Ordinance, 2001	1995	2003
14	CA 550/2011	ITR 229/2005	s. 136(1), Income Tax Ordinance, 1979	Not mentioned	2000-2001

8. 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' ('**the Convention**') commences by stating that:

> 'The Government of the Kingdom of the Netherlands and the Government of the Islamic Republic of Pakistan, desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, have agreed as follows.'

Article 12, which the appellant says is applicable and which the respondent says is not, is reproduced:

> 'ARTICLE 12
>
> ROYALTIES
>
> 1. Royalties arising in one of the States and paid to a resident of the other State may be taxed in that other State.
>
> 2. However, such royalties may also be taxed in the State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties the tax so charged shall not exceed:
>
> (a) 15 per cent of the gross amount of the payments referred to in paragraph 3(a);
>
> (b) 15 per cent of the gross amount of the payments referred to in paragraph 3(b);
>
> (c) 5 per cent of the gross amount of the payments referred to in paragraph 3(c).
>
> 3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use:
>
> (a) a patent, trademark or tradename, secret formula or process, design or model, or information concerning industrial, commercial or scientific experience;
>
> (b) industrial, commercial or scientific equipment, cinematograph films and tapes for television and broadcasting;
>
> (c) a copyright of a literary, artistic or scientific work, but excluding cinematograph films and tapes for television or broadcasting.
>
> 4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of one of the States, carries on business in the other State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent

> personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.
>
> 5. Royalties shall be deemed to arise in one of the States when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties, whether he is a resident of one of the States or not, has in one of the States a permanent establishment or a fixed base in connection with which the contract under which the royalties are paid was concluded, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.
>
> 6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each State, due regard being had to the other provisions of this Convention.'

9. Section 163 of ITO 1979 (section 107 of ITO 2001) attends to *agreements for the avoidance of double taxation and prevention of fiscal evasion* which the Government of Pakistan may enter with other countries. The Convention between the Netherlands and Pakistan was duly notified in Pakistan.[1] The appellant does not oppose the applicability of the Convention nor denies that the respondent has no permanent establishment in the territory of Pakistan. The appellant also does not dispute that the Convention excludes the respondent's *business profits* under Article 7 of the Convention. The respondent contends that the payments received by it from Schlumberger Seaco Inc. ('**SSI**') were in respect of permitting temporary use of FLIC tapes. The dispute is limited to whether the amounts received by the respondent, which the respondent claims to be exempt, constitute *royalties* as defined in paragraph 3 of Article 12 of the Convention.

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[1] Notification No. SRO 1245(I)/82 dated 12 December 1982.

10. The respondent and SSI had entered into an 'Agreement for Lease of FLIC Tapes' dated 1 February 1986 and a 'Software Rental Agreement' dated 1 January 1995 (respectively '**the 1986 Agreement**', '**the 1995 Agreement**' and collectively '**the Agreements**'). In the 1986 Agreement SSI is described as the *lessee* and in the 1995 Agreement it is described as the *customer*. The Returns filed by the respondent claimed that the said receipts were *business profits* and exempt from payment of income tax in Pakistan under Article 7 of the Convention. However, the appellant's case was that the receipts were *royalties* under Article 12 of the Convention and the respondent was liable to pay income tax thereon at the rate of fifteen percent.

11. The learned Judges of the High Court referred to, and relied upon, the 'Organization for Economic Co-operation and Development Model Convention' ('**OECD MC**'),[2] its Article 12 and its interpretation by 'Klaus Vogel on Double Taxation Conventions.'[3] However, Article 12 of the Convention was not based on the OECD MC but on the 'United Nations Model Double Taxation Convention between Developed and Developing Countries' ('**UN MC**'). Paragraphs 1, 2 and 3 of Article 12 of the UN MC are reproduced hereunder:

'**United Nations**
Model Double Taxation Convention
between Developed
and Developing Countries
2017 Update

Article 12

ROYALTIES

> 1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
>
> 2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ____ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the

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[2] As they were on 22 July 2010.
[3] Published by Walters Kluwer, 5th Edition Volume-I.

> Contracting States shall by mutual agreement settle the mode of application of this limitation.
>
> 3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.'

Therefore, if the High Court had to make a comparison it should have compared Article 12 of the Convention with Article 12 of the UN MC, and its interpretation by Klaus Vogel on Double Taxation Conventions, and not with Article 12 of the OECD MC.

12. The impugned Judgments of the High Court state - '*In the light of the above extracts it is clear that OECD which is the authority which has drafted the Double Taxation Agreements has in respect of Software Transactions categorized*… .'[4] However, Article 12 of the Convention, as can be seen from the reproduced text (above), adheres to the UN MC, and not to the OECD MC. The High Court therefore had incorrectly assumed the applicability of OECD MC. Not only did the learned Judges of the High Court err in considering the OECD MC and commenting thereon but they also did not consider the UN MC and its commentary.

13. The United Nations explained the scope of Article 12 of the UN MC in the *Commentary* issued by it which states that Article 12 of the UN MC makes an important departure from Article 12 of the OECD MC because royalties, under the UN MC, may be taxable in the source country as well as in the resident country. Article 12 of the OECD MC does not permit this. Relevant extract from the *Commentary* on Article 12 of the UN MC is reproduced hereunder:[5]

> 'B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 12
>
> *Paragraphs 1 and 2*

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[4] Common Judgment in thirteen cases (ITRs No. 71 of 1997 and 99 of 2006, ITAs No. 274 to 281 of 1998 and ITRAs No. 514 to 516 of 2006), paragraph 16.

[5] *United Nations* ***Model Double Taxation Convention*** *between Developed and Developing Countries*, 2017 Update, Department of Economic & Social Affairs, United Nations, New York, 2017, p. 296.

4. Paragraph 1 omits the word "only" found in the corresponding provision of the OECD Model Convention, which provides that "royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State". Paragraph 2 is an addition flowing logically from the premise underlying paragraph 1, which is that royalties may be taxable in the source country as well as the residence country. By providing for taxing rights in respect of royalties to be shared between the State of residence and the State of source, the United Nations Model Convention departs from the principle of exclusive residence State's right to tax provided in the OECD Model Convention. In this context, it should be noted that several member States of OECD have recorded reservations to the exclusive residence State taxation of royalties provided by Article 12 of the OECD Model Convention.'

14. We have examined the files of the High Court and the pleadings of the respondent (who was the applicant before the High Court). The respondent had filed the *Commentary* on Article 12 of the OECD MC, which was not applicable. The respondent also did not refer to the UN MC, on which the Convention was based. The *statement of facts* submitted by the respondent before the High Court cursorily rebutted the appellant's contention that, Article 12 of the Convention was applicable, and did so unconvincingly.

15. Klaus Vogel on Double Taxation Conventions discusses Article 12 of both model conventions. The OECD MC is referred to as 'No Source State Taxation' and the UN MC is referred to as 'Source State Taxation' and that OECD MC '*limits taxation to the beneficial owner's residence, thus excluding source taxation in the State of the payer.*' With regard to the Article 12 of the UN MC it states:

'2. **UN MC: Source State Taxation**

Article 12 UN MC consists of six paragraphs. Paragraph 1 assigns the residence State of the beneficial owner a **non-exclusive taxing right**. Paragraph 2 is unique and allows for limited source State taxation. Paragraph 3 contains a slightly extended definition of royalties. Paragraph 4 contains the PE [Permanent Establishment] proviso. Paragraph 5, also unique to the UN MC, includes source rules as a necessary addition to paragraph 2. The source State is the residence State of the payer or, perhaps, PE State in which the payment obligation was incurred or borne. Paragraph 6 adds the special arm's length clause for royalties.

> In a functional comparison of the UN MC to the OECD MC, paragraph 1 relates to paragraph 1 (**the beneficial owner's residence State taxation**), paragraph 3 UN MC relates to paragraph 2 OECD MC (**definition**), paragraph 4 UN MC relates to paragraph 3 OECD MC (**the PE proviso**) and paragraph 6 UN MC relates to paragraph 4 OECD MC (**arm's length rule**). Paragraphs 2 and 5 UN MC is unique to the UN MC, as they deal with the source State taxation that is not allowed under the OECD MC.'[6]

And, that the 'Legal Consequence' of Article 12 of the UN MC would be that:

> 'The royalty payment is subject to source taxation according to domestic law.'[7]

However, if taxed under the UN MC then the country of residence of the supplier must adjust the tax liability accordingly:

> '*b.* *UN MC: Shared Taxation*
>
> The UN MC provides for taxation by the **State of Residence of the payee**. The taxation right is not exclusive and is thus open for additional taxation in the source State (payer's residence) as provided for in Article 12(2) and (5) UN MC. However, the State of Residence is obliged to credit the source tax according to Article 23 UN MC.'[8]

16. Therefore, it would not really matter to the respondent if under Article 12 of the Convention it had to pay income tax at the rate of fifteen percent in Pakistan because the respondent could with the tax authority of the Netherlands claim adjustment of the amount paid in Pakistan. The Convention recognized that an entity resident in the Netherlands may be taxed in Pakistan under Article 12, and if it is taxed then the Netherlands will allow *deduction from the Netherlands tax so computed*. In other words the respondent would not be double taxed. In this regard the Convention specifically stipulates '*Elimination of Double Taxation*' in its Article 22 and paragraph 3 of Article 23, respectively reproduced hereunder:

'Elimination of Double Taxation

Article 22

> **Elimination of Double Taxation**
> 1. The Netherlands, when imposing tax on its residents, may include in the basis upon which such taxes are imposed the items of income which, according to the provisions of this Convention, may be taxed in Pakistan.

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[6] *Klaus Vogel on Double Taxation Conventions*, Fifth Edition, Volume I, p. 1125.
[7] Ibid., p. 1135.
[8] Ibid., p. 1133.

2. However, where a resident of Netherlands derives items of income which according to Article 6, Article 7, paragraph 5 of Article 10, paragraph 5 of Article 11, paragraph 4 of Article 12, paragraphs 1, 2 and 5 of Article 13, Article 14, paragraph 1 of Article 15, Article 16 and Article 19 of this Convention may be taxed in Pakistan and are included in the basis referred to in paragraph 1, the Netherlands shall exempt such items by allowing a reduction of its tax. This reduction shall be computed in conformity with the provisions of Netherlands law for the avoidance of double taxation. For that purpose the said items of income shall be deemed to be included in the total amount of the items of income which are exempt from Netherlands tax under those provisions.

3. Further, the Netherlands shall allow a deduction from the Netherlands tax so computed for the items of income which according to paragraph 2 of Article 10, paragraph 2 of Article 11, paragraph 2 of Article 12, Article 17 and paragraph 2 of Article 18 of this Convention may be taxed in Pakistan to the extent that these items are included in the basis referred to in paragraph 1. The amount of this deduction shall be equal to the tax paid in Pakistan on these items of income, but shall not exceed the amount of the reduction which would be allowed if the items of income so included were the sole items of income which are exempt from Netherlands tax under the provisions of Netherlands law for the avoidance of double taxation.

4. Where, by reason of special incentive measures designed to promote economic development in Pakistan, the Pakistan tax actually levied on interest arising in Pakistan, which may be taxed in Pakistan according to subparagraphs (a) and (b) of paragraph 2 of Article 11 or on royalties arising in Pakistan, which may be taxed in Pakistan according to subparagraph (a) of paragraph 2 of Article 12, is lower than the tax Pakistan may levy according to those provisions, then, for the purposes of paragraph 3, the tax paid in Pakistan on these items of income shall be deemed to be:

(a) with respect to interest to which subparagraph (a) of paragraph 2 of Article 11 applies: an amount equal to the amount of tax which Pakistan actually has levied thereon increased by twice the difference between this amount and 10 per cent of the gross amount of such interest;

(b) with respect to interest to which subparagraph (b) of paragraph 2 of Article 11 applies or royalties to which subparagraph (a) of paragraph 2 of Article 12 applies: 15 per cent of the gross amount of such interest or royalties.

5. In the case of Pakistan, subject to the provision of the laws of Pakistan regarding the allowance of a credit against

> Pakistan tax (which shall not affect the general principle hereof), the amount of Netherlands tax payable, under the laws of the Netherlands and in accordance with the provisions of this Convention, whether directly or by deduction, by a resident of Pakistan, in respect of income which is subject to tax both in Pakistan and in the Netherlands, shall, except in the case referred to in paragraph 6 of Article 13, be allowed as a credit against the Pakistan tax payable in respect of such income but in an amount not exceeding that proportion of Pakistan tax which such income bears to the entire income chargeable to Pakistan tax.
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> 6. Where a resident of one of the States derives gains which may be taxed in the other State in accordance with paragraph 6 of Article 13, that other State shall allow a deduction from its tax on such gains to an amount equal to the tax levied in the first-mentioned State on the said gains.'
>
> 'Special Provisions
>
> Article 23
>
> 3. Except where the provisions of paragraph 1 of Article 9, paragraph 7 of Article 11, or paragraph 6 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of one of the States to a resident of the other State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.'

17. Paragraphs 1 and 2 of Article 27 of the Convention stipulate that regulations may by mutual agreement be made with regard to the manner in which royalties are taxed, which are reproduced hereunder:

> 'Article 27
>
> **Regulations**
>
> 1. The competent authorities of the States shall by mutual agreement settle the mode of application of paragraph 2 of Article 10, of paragraphs 2 and 3 of Article 11 and paragraph 2 of Article 12.
>
> 2. The competent authorities of each of the States, in accordance with the practices of that State, may prescribe regulations necessary to carry out the other provisions of this Convention.'

18. The matter primarily affected the interest of the two contracting countries (the Netherlands and Pakistan) and whether Pakistan was entitled to tax the respondent on royalties earned by the respondent in Pakistan, under Article 12 of the Convention at the rate of fifteen percent.

Therefore, if the respondent was not taxed in Pakistan it may still be taxed in the Netherlands.

19. The learned Judges of the High Court also did not note that the respondent had an alternative remedy under Article 24 of the Convention, which it did not avail. Article 24 is reproduced hereunder:

> 'ARTICLE 24
>
> MUTUAL AGREEMENT PROCEDURE
>
> 1. Where a person considers that the actions of one or both of the States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the State of which he is a resident or, if his case comes under paragraph 1 of Article 23, to that of the State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.
>
> 2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the States.
>
> 3. The competent authorities of the States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.
>
> 4. The competent authorities of the States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.'

Article 24 of the Convention enabled the respondent to present its '*case to the competent authority*' of its own country, the Netherlands, which if it agreed with the respondent, could take up the matter with the *competent authority* of Pakistan. This the respondent could have done within three years, but the respondent did not present its case within three years, or at all. If the respondent had presented its case to the *competent authority* of the Netherlands and if such *competent authority* was of the opinion that the respondent's objection to taxation in Pakistan was *justified* it would have taken up the matter with the *competent authority* in Pakistan. The matter could also have been resolved between the countries by '*mutual agreement*'. It is possible that the respondent did not submit its case to the *competent authority* of the Netherlands because it may not have agreed with the respondent's contention, and then the respondent may not have been able to claim exemption.

20. If a treaty or convention provides for a dispute resolution mechanism it is, always, preferable to avail of it, and amicably resolve matters. If this had been done in these cases it would have helped the High Court, and this Court too, to understand the point of view of the *competent authority* of the Netherlands, and prevent the possible undermining of bilateral relations on account of a misunderstanding. This would be preferable as the exemption claimed in respect of the receipts had not been interpreted, resolved or decided earlier.

21. The respondent instead availed of the remedies provided under the Ordinances. However, three findings of fact were concurrently recorded against the respondent, respectively by the Income Tax Officer, the Commissioner (Appeals) and the Tribunal. Thereafter, the respondent approached the High Court under section 136(1) of ITO 1979 and section 136(1) of ITO 2001, the scope whereunder is restricted to the determination of '*any question of law*'. However, it had to be first factually ascertained what the receipts were for and whether the same constituted *royalties* as defined in paragraph 3 of Article 12 of the Convention. Thereafter, the determination of any question of law may have arisen. The High Court (under the Ordinances) is to decide questions of law, and must not attend to, let alone decide, factual disputes.

22. Admittedly, the respondent had earned the receipts in Pakistan. This Court in the case of *A. P. Moller v Commissioner of Income Tax*[9] had approved of the interpretation by the High Court[10] of another double taxation convention as under:

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[9] 2012 SCMR 557, p. 565A.
[10] *A. P. Moller v Taxation Officer of Income Tax*, 2011 PTD 1460, pp. 1499-1500.

> 'However, if two reasonable interpretations of Article 8(3) are possible, or if there is any doubt or ambiguity in its interpretation (especially in relation to the expression "profits derived from sources within the other Contracting State") that should be resolved in favour of Pakistan having the right to tax... It is a recognized interpretation that the "source State" is the State in which payment is made, and generally such State is regarded as entitled to tax such payments. Pakistan is clearly the "source State" in the facts and circumstances of the present case since payments are made here by the Pakistani buyers. Thus, the amounts received or receivable in Pakistan by the carriers are "profits derived from sources within" Pakistan and hence can be reasonably regarded as within the taxing right of this country as contemplated by Article 8(3).'

23. Since the matter was not properly enunciated in the impugned judgments by the High Court we have had to consider the submissions and pleadings of the respondent. In response to the notices issued by the Income Tax Officer the respondent stated that the payment receipts were '*rentals paid for tapes by SSI*' and were '*neither in the nature of a patent, trademark or tradename, secret formula or process, design or model, nor any equipment, films and tapes for television and broadcasting.*' However, the full definition of *royalties* in paragraph 3 (a) of Article 12 of the Convention included payments for '*information concerning industrial, commercial or scientific experience*', which the respondent did not negate.

24. The respondent also did not disclose under which of the two Agreements it had received payments. It also did not particularize the nature of the receipts nor stipulate the components/services which it had provided to SSI, and that the said receipts were not *royalties* under Article 12 of the Convention. When the benefit of an exemption is sought the person claiming it must clearly set out its case. The respondent had to establish that the receipts were not *royalties* and thus not liable to income tax under paragraph 2 of Article 12 of the Convention. If the respondent had initially made out a case for exemption then the taxing authority would have examined the documents/proof tendered to it and considered whether the exemption was correctly claimed. Instead, the High Court took it upon itself to determine the nature of the said receipts, and did so without having the benefit of requisite documents, material and information.

25. Only in one appeal, Civil Appeal No. 94/2008 pertaining to assessment years 1987-1988 and 1989-1990, the 1986 Agreement may have been relevant. The remaining thirteen appeals are in respect of assessment years 1998 and later years, which was long after the expiry of the 1986 Agreement, the duration of which was till 31 January 1990.

26. The High Court also did not adequately comprehend the facts. The FLIC tapes were mentioned in the 1986 Agreement. However, the impugned judgments refer to the 1995 Agreement which did not mention FLIC tapes. The High Court had proceeded on the basis of an incorrect premise. The 1986 Agreement's clause 3 stated that the duration of the 1986 Agreement was for four years, that is, till 31 January 1990. Under the 1986 Agreement the respondent would provide to the lessee/SSI software programs '*for use in oilfield data processing and log interpretation, including the software programs set out in Schedule I, together with the related FLIC/VAX Handbook.*' Schedule I of the 1986 Agreement is a '*List of Oil Well Interpretation Program Products*' spread over nine pages, and its Schedule 2 stipulates the '*Monthly Charge*' for their use - '*Price List for FLIC Tapes Lease by Module.*' The contents of the 1986 Agreement and the listed programs are technical and not self-evident, yet the High Court interpreted the same, while purportedly deciding questions of law. In our opinion the High Court should not have ventured into an area requiring specialized knowledge, which the learned Judges did not possess. In any event the respondent had not explained the technically complex nature of the Agreements before any forum, nor was the same explained to us. The High Court could not have undertaken a factual determination while exercising powers under section 136(1) of the ITO 1979 and section 133(1) of the ITO 2001 whereunder the High Court could only determine legal questions. Incidentally, there was no material before the High Court, nor was any placed even before this Court, which may have persuaded one to hold that the said receipts were exempt under Article 12 of the Convention.

27. The 1995 Agreement was signed on 1 January 1995, but (unlike the 1986 Agreement) does not stipulate its duration. It also does not mention the 1986 Agreement nor the FLIC tapes. Unlike the 1986 Agreement it has only one schedule, Schedule A, which does not have the same components as those mentioned in the two schedules to the 1986 Agreement. The

respondent never explained the nature of the Agreements. The 1986 Agreement and its two Schedules and the 1995 Agreement and its Schedule A, were technical in nature and required expert assistance to comprehend. The Income Tax Officer was of the opinion that payments received by the respondent were *royalties*. Therefore, to successfully controvert this it was incumbent upon the respondent to explain the nature of the receipts and what were they for. The respondent had every opportunity to offer the requisite information and explanation to the Income Tax Officer, to the Commissioner (Appeals) and then to the Tribunal, but it did not do so; these three forums were legally competent to determine facts. Instead, without establishing the necessary foundation of facts, the respondent proceeded to the High Court on untenable *questions of law*. It was unwarranted for the High Court to have delved into the nature of the receipts, and that too without the benefit of requisite facts and/or by misconstruing facts and by misapplying the OECD MC, its *Commentary* and interpretation, instead of applying the UN MC, its *Commentary* and interpretation.

28. The tax authorities had relied on the Convention and its Article 12, and had not accepted the respondent's contention that the said receipts were *business profits*. Therefore, the respondent should have explained the nature of the receipts and that they were not *royalties* in terms of Article 12 of the Convention. The respondent did not clearly set out its case and did not provide the following information, documents and facts or provided misleading information:

(1) The respondent did not explain what each Agreement dealt with, which was necessary in view of their technical nature and as the language used therein was not self-evident, particularly the terms mentioned in the schedules thereto;

(2) The respondent did not state that the 1986 Agreement, the duration of which was for four years, still subsisted, yet referred to FLIC tapes which were only mentioned therein (FLIC tapes were not mentioned in the 1995 Agreement);

(3) The respondent did not itemize the nature of the receipts and then on the basis thereof claim that they did not constitute *royalties* (under Article 12 of the Convention) and that the

same constituted *business profits* (under Article 7 of the Convention);

(4) The respondent in its reply to the notices sent by the Income Tax Officer did not deny certain components of *royalties* (mentioned in paragraph 3 of Article 12 of the Convention);

(5) The respondent did not specifically state under which Agreement it had received payment, and for what; and

(6) The respondent had relied upon Article 12 of the OECD MC, its *Commentary* and textbook explanation/interpretation thereof, and did so despite the fact that the Convention's Article 12 had applied Article 12 of the UN MC, and not Article 12 of the OECD MC.

There were also the following drawbacks and legal shortcomings in the respondent's case:

(1) The respondent did not present its case to the *competent authority* of its country (the Netherlands) under Article 24 of the Convention, and thus its point of view did not come forth and could not be considered;

(2) If the respondent had presented its case (as stated above) and if the *competent authority* of the Netherlands had supported the respondent's contention there was the possibility of the two countries resolving the matter and/or making regulation/s with regard thereto in terms of the Convention;

(3) That by foregoing (1) and (2) (above) a very technical matter came before the High Court, which the High Court proceeded to determine without having the requisite technical expertise and without being provided it; and

(4) The respondent had invoked the jurisdiction of the High Court under section 136(1) of the ITO 1979 and section 133(1) of the ITO 2001 which was restricted to questions of law, however, factual determination of whether the receipts constituted *royalties* was considered despite three forums concurrently deciding the same against the respondent.

29. The High Court erred with regard to the following:

(1) The High Court overlooked the fact that the High Court's jurisdiction under section 136(1) of the ITO 1979 and section 133(1) of the ITO 2001 was limited to considering and deciding questions of law, however, the instant cases were filed to overturn the factual determination made by three qualified forums which had determined that the receipts were not *royalties* in terms of Article 12 of the Convention;

(2) The High Court did not appreciate, as probably it was not explained to by the respondent, that there was no mention of FLIC tapes in the 1995 Agreement, and presumed that the receipts were payment for temporary use of FLIC tapes, which were only mentioned in the 1986 Agreement;

(3) The High Court proceeded on an incorrect assumption that Article 12 of the Convention was based on Article 12 of the OECD MC, whereas in fact it was based on Article 12 of the UN MC, whereunder *royalties* earned in Pakistan were taxable;

(4) The High Court did not consider the matter and the Convention holistically, including comprehensively considering Articles 7 and 12 thereof, and overlooked its Articles 22, 23 and 24;

(5) The High Court without setting out the nature of the receipts, let alone doing so in detail, assumed that they did not constitute *royalties* in terms of Article 12 of the Convention, and did so without analogizing the receipts against the definition of *royalties* in paragraph 3 (a) and (b) of Article 12 of the Convention;

(6) The High Court failed to appreciate that the Convention was a complete document, each term whereof had to be considered, and instead proceeded to interpret it in the light of precedents and textbook explanations of general terms (which were not so used in the Convention), and also did so without appreciating that the Convention's Article 12 was based on Article 12 of the UN MC and not on Article 12 of the OECD MC;

(7) The High Court also (apparently) failed to appreciate that if the respondent was taxed in Pakistan under paragraph 2 of Article 12 of the Convention its tax liability to such extent would have

been accordingly adjusted in the Netherlands, and the respondent would not have been double taxed;

(8) The High Court appears not to have considered that the receipts that were taxed were the respondent's earnings in Pakistan, and to have kept this under consideration when considering the applicability of Article 12 of the Convention; and

(9) The High Court did not abide by the recognized principle of interpretation that the State in which payment is made (under the Convention) is generally entitled to tax such payment, as was reiterated in the case of *A. P. Moller v Commissioner of Income Tax*.[11]

30. Therefore, the impugned Judgments of the High Court in all fourteen appeals are not sustainable nor are the reasons given by the High Court to set aside the assessment orders, the appellate orders and the Tribunal's judgments, which are accordingly restored. Consequently, these appeals are allowed by setting aside the impugned Judgments of the High Court with costs throughout.

Chief Justice

Judge

I have attached my dissenting note.
Judge

Islamabad,
_____ July 2023.

Announced in open Court on 8 September 2023.

Judge

Approved for Reporting

[11] 2012 SCMR 557.

Syed Mansoor Ali Shah, J.- I have read the judgment authored by my learned brother Qazi Faez Isa, J agreed to by the Hon'ble Chief Justice. However, with respect, I am unable to agree with the reasoning as well as the result arrived at by my learned brother. The question before us, as also stated in the leave granting order, is whether the income derived by the respondent non-resident Dutch company for the lease of certain software in Pakistan constitutes "royalties" or not. This precise question has also been aptly articulated in the majority judgment, which states: "The dispute is limited to whether the amounts received by the respondent, which the respondent claims to be exempt, constitute royalties as defined in paragraph 3 of Article 12 of the Convention." Once the majority judgment itself narrows down the dispute which is very much a question of law, to say that the High Court should not have addressed this question is perplexing. Then, without deciding this question, it is later reasoned in the majority judgment, "it would not really matter to the respondent if under Article 12 of the Convention it had to pay income tax at the rate of fifteen percent in Pakistan because the respondent could with the tax authority of the Netherlands claim adjustment of the amount paid in Pakistan" and "if the respondent was not taxed in Pakistan it may still be taxed in the Netherlands." I respectfully disagree from this view, as our duty is to decide the question based on law, not extraneous and utilitarian considerations in disregard of the law. Furthermore, the majority judgment holds, "the full definition of royalties in paragraph 3 (a) of Article 12 of the Convention included payments for 'information concerning industrial, commercial or scientific experience', which the respondent did not negate." On this also, I disagree and hold for the reasons given below that income derived by the respondent non-resident Dutch company does not fall in this category of payments either. And, thus, I set down my dissenting opinion.

2. The respondent, a company incorporated in the Netherlands and thus a non-resident for Pakistan income tax purposes, entered into an agreement to lease certain software programs called "FLIC tapes" developed by it for use in oilfield data processing and log interpretation to another company, in the name and style of Schlumberger Seaco Inc., the lessee, having a place of business in Pakistan. The rentals received in lieu of the lease of FLIC tapes (software programs) were claimed to be exempt from tax in Pakistan by the respondent under Article 7 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"**) in the tax returns filed for consecutive assessment years from 1987 to 2003. However, the tax department imposed tax on the income arising from the lease of FLIC tapes (software programs) by holding that said payments were in the nature of royalty receipts and thus liable to be taxed under Article 12(3)(a) and (b) of the Convention. The appeals filed by the respondent before the Commissioner Income Tax (Appeals) and the Income Tax Appellate Tribunal remained unsuccessful. However, the High Court held that the payments received by the respondent for leasing FLIC tapes (software programs) did not fall within the definition of income arising from royalties.

3. The respondent is a tax resident of the Netherlands and, therefore, taxation in the matter is governed under the Convention which by virtue of Section 107(2) of the Income Tax Ordinance 2001 (**"Ordinance"**) enjoys overriding effect.[1] Article 7 of the Convention 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. Article 12 of the Convention permits that royalties arising in one of the states and paid to a resident of the other state may be taxed up to a specified percentage in the former state. The respondent admittedly did not have a permanent establishment in Pakistan. The entire case, thus, revolves around the nature of the income arising from the lease of FLIC tapes (software programs): is it to be treated as income arising from royalties or income arising from business profits? If the answer to the question is found in the first part of the question i.e., the rentals for the lease of FLIC tapes are treated as income arising from royalties, the respondent's income may be subjected to tax up to a specified percentage as per income tax law of Pakistan. However, in case the second part of the question supplies the answer i.e., the income arising from the lease of FLIC tapes is treated as income arising from business profits, the respondent's income would not be amenable to the domestic income tax regime of Pakistan for the reason that it did not have a permanent establishment in the country.

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[1] Earlier, this aspect was dealt with by Section 163(2) of the Income Tax Ordinance 1979.

4. The term “royalties” is defined in paragraph 3 of Article 12 of the Convention as follows:

> 3. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use:
>
> a) a patent, trademark or tradename, secret formula or process, design or model, or information concerning industrial, commercial or scientific experience;
>
> b) industrial, commercial or scientific equipment, cinematograph films and tapes for television and broadcasting;
>
> c) a copyright of a literary, artistic or scientific work, but excluding cinematograph films and tapes for television or broadcasting.

It could be said that royalties, as per the Convention, are payments for the use of or the right to use certain types of property (intellectual property or equipment) or information concerning industrial, commercial or scientific experience. The income under contention in this case resulted from the rentals received in lieu of the lease of some software programs. The tax department has contended before us that the use of software by the lessee is the use of copyright and the income received by the respondent as consideration for such use is a royalty liable to be taxed under Article 12 of the Convention. The argument of the learned counsel for the respondent is that there is a distinction between the use of copyright and the use of copyright product and, therefore, Article 12 of the Convention is not applicable in the present case.

5. This Court in the recent case of *Snamprogetti Engineering B.V. v Commissioner of Inland Revenue*[2] underscored the unique nature of international tax treaties, their distinct interpretation framework, and the importance of achieving equitable outcomes in cross-border taxation through these treaties. It has been held that international tax treaties or conventions or agreements being of a unique nature need to be looked at through a different interpretive lens as compared to the one employed while interpreting domestic legislation. These agreements being international treaties are governed by the rules of interpretation of the Vienna Convention on the Law of Treaties. Tax treaties differ from domestic tax law in language, application, and purpose. Tax treaties are relieving in nature

[2] 2023 SCMR 1055.

and seek to avoid double taxation, while domestic tax law imposes tax in specific circumstances. Tax treaties require a broad purposive interpretation, and their interpretation may be more liberal than domestic law. Treaty interpretation is a separate subject from statutory interpretation, and tax treaties should be interpreted independently from domestic law. 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. As the primary purpose of tax treaties is to avoid and relieve double taxation through equitable and acceptable distribution of tax claims between the countries, it is important that the provisions of these treaties are interpreted in a common and workable manner, taking into account international tax language, legal decisions of other countries, model treaties[3], along with their commentaries, developed by the Organisation for Economic Co-operation and Development (**"OECD"**)[4] and the United Nations (**"UN"**)[5], and scholarly academic works where appropriate.

6. Coming back to the solitary question in hand i.e., whether the payments received by the repondent for leasing FLIC tapes (software programs) fall within the definition of income arising from royalities. It is noted that the character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. For a payment to constitute royalty under the Convention, it must fall at least in one of the three categories provided in Article 12(3) of the Convention. One can start by narrowing down the possibilities envisaged in Article 12(3) of the Convention. The agreement for the use of FLIC tapes (software programs) concluded between the respondent and the lessee on 1 February 1986 (**"Agreement"**)[6] did not involve payments made for the use of or the right to use any patent, trademark or tradename, design or model, or cinematograph films and tapes for television and broadcasting. The next issue is whether the Agreement involved payments made for the use of or the right to use any

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[3] Model treaties provide standard frameworks of guidance for treaty negotiation and 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.
[4] OECD Model Tax Convention on Income and on Capital.
[5] United Nations Model Double Taxation Convention between Developed and Developing Countries.
[6] After its expiry, another agreement titled 'Software Rental Agreement' was concluded between the respondent and the lessee.

industrial, commercial or scientific equipment. According to Klaus Vogel's highly acclaimed treatise on double taxation treaties, which is regarded as the international gold standard on the law of tax treaties, 'equipment' consists of tangible movable objects and since the software itself is only comprised of instructions and is pure intangible information, it is not covered by the equipment clause.[7] It follows that the Agreement also did not involve payments made for the use of or the right to use any industrial, commercial or scientific equipment.

7. As regards the remaining possibilities envisaged in Article 12(3) of the Convention, one is now left, insofar as the case before us is concerned, with the payments made for the use of or the right to use secret formula or process, information concerning industrial, commercial or scientific experience or a copyright of a literary, artistic or scientific work. A secret formula or process comprises all kinds of company secrets, also known as industrial or trade secrets. The key element here is secrecy. This information must be confidential, meaning it is not widely known or easily accessible to those who typically deal with such information. It should have commercial value because of its secrecy and should be actively protected by the person who rightfully controls it through reasonable efforts.[8] If we advert to the Agreement and have a look at the definition clause, we see that the term 'FLIC tapes' means the full set of the respondent's proprietary software programs developed for use in oilfield data processing and log interpretation, including the software programs set out in the schedule attached to the Agreement, together with the related FLIC/VAX Handbook. Notably, however, what is not included is "any other related documentation such as, but not limited to, source code listings, program specifications, system flow charts, logic diagrams, system manuals or other documentation underlying and supporting the FLIC tapes". The reason for this exclusion is the respondent's intention that users shall have no knowledge of how FLIC tapes operate.[9] It shows that the Agreement did not envisage supplying of information about the ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques. The transaction between the respondent and the

[7] Matthias Valta and Stella Langner, in Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions* (5th edn 2021) vol 1, art 12, paras 160-162, 173-174.
[8] ibid, paras 153-159.
[9] Agreement for Lease of FLIC Tapes, cl 1.

lessee cannot, therefore, be said to be a transfer of secret formulas or process behind the software.

8. Concerning the question of information regarding industrial, commercial or scientific experience which is also known as know-how, it is seen that it is legally unprotected, not-secret-but-undisclosed knowledge that has been attained through experience. Such experience knowledge must go beyond the pure technical progress; it is related to persons having gained the knowledge by their activities. Such experience cannot be obtained simply by using the goods and services that are produced with the knowledge. Experience-based knowledge extends beyond mere technical progress and is tied to individuals who have acquired it through their activities.[10] No such experience was shared between the parties under the Agreement. When know-how is shared, it cannot be taken back and its use cannot be prohibited. The transfer of the use cannot be distinguished from a transfer of full ownership.[11] However, we see that in this case, the lessee, on termination of the Agreement, and the lease granted under it, was bound to deliver up the FLIC tapes to the respondent together with all copies of any part of the FLIC tapes held or made by the lessee.[12] Moreover, know-how beyond software can only be the specific programming design and structure such as algorithms and not the program itself.[13] This means that the chance of the Agreement to involve payments for the use of or the right to use information concerning industrial, commercial or scientific experience is also eliminated.

9. Let us determine if the case falls under the last possibility: whether the payments were made to the respondent in consideration for the use of or the right to use a copyright of a literary, artistic or scientific work. Transfer of rights in relation to software occurs in many different ways ranging from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the use to which it is put. The Agreement reveals that the lessee was obliged not to modify or reproduce the FLIC tapes or any part thereof, except as required for use on its own computer.[14] The lessee specifically undertook not to

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[10] Matthias Valta and Stella Langner, in Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions* (5th edn 2021) vol 1, art 12, paras 163-168.
[11] ibid, para 85.
[12] Agreement for Lease of FLIC Tapes, cl 6(c).
[13] Matthias Valta and Stella Langner, in Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions* (5th edn 2021) vol 1, art 12, para 175.
[14] Agreement for Lease of FLIC Tapes, cl 3(a).

supply any of the FLIC tapes or any reproduction thereof to any other person, or to permit the use of any of the FLIC tapes by any third party, even its own subsidiary or related company.[15] The lessee undertook to keep absolutely secret and confidential at all times all knowledge and information in relation to the FLIC tapes (or any correction, update, improvement or modification thereto) supplied by the respondent to the lessee, and the lessee further agreed not to communicate or cause to be communicated any information or knowledge in relation to the FLIC tapes to any other person, firm or company and to use its best endeavours to protect the FLIC tapes from unauthorised disclosure.[16] The provisions of this confidentiality clause were to survive termination of the Agreement.[17] It follows that the arrangement between the respondent and the lessee did not contemplate any licence to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. Therefore, there wasn't any transfer of rights to use the program in a manner that would, without such licence, constitute an infringement of copyright. Nor was there any transfer of the full ownership of the rights in the FLIC tapes. The rights acquired by the lessee comprised of partial rights in the copy of the program.

10. Vogel explains that software is pure intangible information. The way this information is transmitted is of no relevance – it can be attained through a variety of media, be it data storages or transmission networks. It is expounded that the granted copyright, in most cases, is limited to the extent necessary for the operation and use of one copy or limited number of copies and the software and digital product usually may not be reproduced beyond the allowed number of copies, modified, resold or publicly displayed. In such a case, it is not the intellectual property of the software that is licenced or sold, rather, a product made with the use of intellectual property. Thus, income from the renting out of software is not covered by Article 12 but by Article 7 of the UN Model Convention (**"UN MC"**) and OECD Model Convention (**"OECD MC"**).[18] In view of this, what follows is that no copyrights were leased out to the lessee which merely acquired a program copy of FLIC tapes for its operations.

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[15] ibid.
[16] ibid, cl 8.
[17] ibid.
[18] Matthias Valta and Stella Langner, in Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions* (5th edn 2021) vol 1, art 12, para 174.

11. It has been held that the right to reproduce and the right to use computer software are distinct and separate rights.[19] Similarly, ownership of copyright in a work and ownership of the physical material in which the copyrighted work is embodied are two different things. A licence from a copyright owner where no proprietary interest is transferred to the licensee, such as where the core of the transaction is to authorize the end-user to have access to and make use of the licenced computer software product over which the licensee has no exclusive rights, does not amount to parting with any copyright. Copyright is an exclusive and negative right which restricts others from doing certain acts. The right to use a copyrighted product, granted through a non-exclusive and non-transferable licence, being restrictive in nature only allows for specific uses and should not be considered as a licence granting the enjoyment of all or any rights related to the copyright.[20]

12. More importantly in *Geoquest Systems B.V. Gevers Deynootweg v Director of Income Tax*[21], is a case on all fours with that before us. The facts and issues were much the same. The applicant was a company incorporated in the Netherlands. It was engaged in the business of supplying special-purpose computer software to be used in the exploration and production of mineral oils. The applicant sold certain software packages to the Oil and Natural Gas Corporation in India. The terms of the agreement between the applicant and the customer among other things provided that the applicant granted to the customer a right to use the software and its associate proprietary information, and the term 'use' was to be limited to the processing of information and the process of copying, recording or transcribing software. The licensed use of the software was to remain restricted to the processing or interpretation by the customer of geoscience, reservoir, and production-related data owned or licensed by the customer in connection with oil, gas, and other natural resource development ventures where the customer was active as an operator or partner. On termination of the license as per the terms of the agreement, the customer was bound to discontinue all uses of the software and return the software and proprietary information to the applicant including all copies. The question before the Authority for Advance Rulings was if the

[19] *SBI v Collector of Customs* 2000 (1) SCC 727.
[20] *Engineering Analysis Centre of Excellence Private Limited v The Commissioner of Income Tax* 2022 (3) SCC 321.
[21] (2010) 327 ITR 1 (AAR).

income coming from the supply of software could be taxable as a royalty in India. Article 12(1) and (2) of the Agreement for Avoidance of Double Taxation concluded between India and the Netherlands, like Article 12(1) and (2) of the Convention, provide that royalties arising in a state and paid to a resident of the other state may be taxed in the other state though such royalties may also be taxed in the state in which they arise according to the laws of that state up to a specified percentage of the gross amount of the royalties. The definition of royalties in the Agreement between India and the Netherlands is similar to that given in the OECD MC. The Revenue contended that the income derived by the applicant for the supply of software could be taxed as a royalty in India. However, the Authority for Advance Rulings held that the amount payable under the agreement to the applicant did not amount to royalty within the meaning of the Agreement for Avoidance of Double Taxation between India and the Netherlands. This view of the Authority for Advance Rulings was accorded express approval by the Supreme Court of India in *Engineering Analysis Centre of Excellence Private Limited v The Commissioner of Income Tax*.[22] For what has been discussed above, it is abundantly clear that the income derived by the respondent for the lease of FLIC tapes (software programs) does not constitute royalities within the meaning of Article 12(3) of the Convention.

13. The majority judgment has spent a great deal of time and effort to argue that the High Court incorrectly assumed the applicability of the OECD MC to the case though it should have considered the UN MC. The reason underlying this criticism as suggested in the majority judgment is that royalties under the UN MC may be taxed in the source country as well as in the resident country while the OECD MC does not permit taxation of royalties in the source country. However, nobody has argued before us that the Revenue could not tax royalties arising in Pakistan. The exception taken by the majority judgment to the view of the High Court would hold water if the High Court relying on the OECD MC Commentary had declared that the Revenue could not tax royalties arising in Pakistan. What was overlooked by the majority judgment, with respect, is that the issue is not about the taxing rights of Pakistan over royalties arising in the country. Rather, the dispute is whether the income derived by the respondent non-resident Dutch company for the lease of certain software in Pakistan

[22] 2022 (3) SCC 321.

constitutes royalty or not. And in order to understand the concept of royalties, reference could be made to the OECD and UN MCs commentaries and academic treatises. Let us have a look at the definition of royalties provided in the OECD MC and UN MC and see if and to what extent they are at variance with one another and with the definition provided in the Convention. Paragraph 2 of Article 12 of the OECD MC provides:

> The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Paragraph 3 of Article 12 of the UN MC provides:

> The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

One can see that the definition of royalties provided in the Convention is more or less similar to the one provided in the UN MC and is not very different from that provided in the OECD MC. In fact, the only material difference between the definition of royalties provided in the UN MC and OECD MC is that the latter excludes the payments received as consideration "for the use of, or the right to use, industrial, commercial or scientific equipment" from the definition of royalties. And this exclusion, as explained earlier, is not relevant to the dispute before us because software is not covered by the equipment clause. It may be emphasized that once we are able to eliminate the payments for the use of or the right to use any industrial, commercial or scientific equipment from the definition of royalties, there does not remain any real difference between the definition of royalties provided in the OECD MC and UN MC. Therefore, I am of the view that the reliance placed by the High Court on the OECD MC and its Commentary, in order to decipher the true nature of payments received by the respondent and to understand the concept of royalties in the context of double taxation makes no material difference to the adjduciation of the question in hand. Notably, the UN MC Commentary on paragraph 3 of Article 12 includes the entire extract of the OECD MC Commentary on the question whether payments received as consideration for computer software are to be classified as royalties or not.

14. The majority judgment without definitively addressing whether the amounts received by the respondent constitute royalties, instead embarks upon a discussion which was not in contention between the parties. Thus the remark that if the respondent was not taxed in Pakistan, it might still be subject to taxation in the Netherlands, in my view, is not a pertinent consideration for a court tasked with adjudicating a legal dispute. Once it is established that the income earned by the respondent non-resident Dutch company for leasing software in Pakistan does not qualify as royalty, delving into irrelevant factors serves no useful purpose. Furthermore, the majority asserts that the High Court's jurisdiction in this case was limited to addressing and deciding questions of law. It is worth noting that the sole point of contention between the parties revolved around whether the amounts received by the respondent constituted royalties or not, a matter which is a question of law squarely within the purview of the High Court.

15. The majority opinion also takes exception to the absence of any mention of FLIC tapes in the second agreement. I respectfully contend that this detail is inconsequential since both agreements pertain to the leasing or renting of software. The core question remains unaltered: do the payments received for the leasing or renting of software qualify as royalties? Moreover, the majority judgment suggests that the respondent had an alternative remedy under Article 24 of the Convention to present its case to the competent authority in its own country. It is said that if the competent authority in the respondent's country agreed, it could then take up the matter with the competent authority in Pakistan. Does this provision of the Convention preclude the respondent from pursuing a remedy available under the laws of Pakistan, or does it prevent this Court from adjudicating a question coming before it in its lawful jurisdiction? In my humble opinion, the answer to both these questions is a resounding 'no.'

16. The majority judgment has also relied on an earlier decision of this Court in the case of *A.P. Moller v Commissioner of Income Tax* 2012 SCMR 557 wherein this Court had approved the interpretation of the High

Court of Article 8 of Double Taxation Conventions between Pakistan and Denmark and Pakistan and France in the context of taxation rights between the contracting states concerning profits earned from shipping operations. The question was whether the freight charges received or receivable by the carriers from Pakistani buyers under FOB contracts for inbound cargo could be regarded as resulting in profits "from sources within" Pakistan. The High Court interpreting Article 8(3) held that profits earned by carriers on inbound cargo on account of freight charges received in Pakistan arise "from sources within" Pakistan and, therefore, within the taxing right of Pakistan as contemplated by Article 8(3). It is to be noted that the question before the Court in the said case neither related to business profits nor royalties but to shipping and air transport and, therefore, does not have any material bearing on the present case. This view of mine is accentuated by the fact that the High Court at the end of the paragraph which was quoted with approval by this Court cautions, "we may also note that we need to interpret and apply the expression 'profits derived from sources within the other Contracting State' only to the extent required for purposes of the present proceedings, and we do not regard the foregoing observations as necessarily exhaustive of the meaning of this expression."

17. For the above reasons, I agree with the submission of the respondent that there is distinction between the use of copyright and the use of copyright product. No copyrights were leased out to the lessee which merely acquired a program copy of FLIC tapes (software programs) for its operations. Further, the transaction of lease of FLIC tapes software programs between the respondent and the lessee did not involve payments made for the use of or the right to use secret formula or process, or information concerning industrial, commercial or scientific experience. Income resulting from the lease of FLIC tapes amounts to business profits and cannot be treated as income arising from royalties. Therefore, Article 12 of the Convention is not applicable to this case. I do not feel inclined to interfere with the judgment of the High Court. As a result, these appeals are dismissed.

Judge

Approved for reporting
Sadaqat

ORDER OF THE COURT

With a majority of two to one, Justice Syed Mansoor Ali Shah, J. dissenting, these appeals are allowed.

Chief Justice

Judge

Judge

Islamabad:
8 September 2023
Approved for Reporting