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Comments & Observation on Federal Budget 2021-22

General Comments:

The Budget Presented today [June 11, 2021] is one of the best documents presented in almost three decades as far as corrective measures in the taxation system are concerned. This does not reflect any ideal prescription has been made, however, there will be very few, knowing the taxation system of Pakistan who will deny that through this document may aberrations, distortions, errors and policy mistakes have been highlighted and wherever possible corrected.

These comments should be read in the context that over the time we have moved far away from taxes on a net income basis and have created maximum distortions and difficulties for the corporatized and organized sector. In this document substantial corrections in this field have been made.

The revised definition of 'smuggling' as the first point in this note. In case if the government is able to achieve some corrective measure in this direction then I am completely hopeful that Pakistan will enter into a newer paradigm of growth.

As a matter of caution provisions relating to the arrest of taxpayers and their subsequent proceedings be reexamined as the same may lead to unnecessary issues leading to harassment.

The Prime Minister and Finance Minister are to be complemented for the bold and corrective steps undertaken in this budget.

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Introduction

These comments and observations are limited to summary effects on the amendments made in the Income Tax Ordinance, 2001, Sales Tax Act, 1990, Federal Excise Duty 2005 and

Customs Act, 2001. Detailed notes on the economic effects will be released through separate notes. It has been endeavoured to make comments simple for non technical persons.

Tax Collection: Tax collection for the year 2021-2022 is estimated to be around Rs 5800 billion. This appears to be a figure on a higher side by around Rs 200 to 300 billion figure however it is important to observe and monitor that increase is not wholly reliant on volume and value of imports withholding taxes. The number of withholding taxes have increased to over 75 heads. These heads have to be reduced to not more than 15 heads which actually contribute over 95% of taxes. 12 heads have been deleted however there is a need to eliminate over 50 such heads.

Current Account Balance: In Pakistan current account balance has

a direct effect on the tax collection on account of heavy reliance of taxes at import stage [over 45 percent] therefore tax collection will have direct relation with that balance. As budgeted imports are expected to be around USD 55.6 billion, Exports 26.5 and Inward remittance of over 31 billion USD leading to a surplus of around 2 billion USD. The points to caution are:

- Avoiding unnecessary imports and extended efforts for import substitution;
- Reducing heavy reliance on home remittances; and
- Diversification of exports and further concentration on intangible exports.

Comments on specific important changes in customs, income tax and sales tax laws are as under:

CUSTOMS

Retail Sale of Smuggled Good

In the Finance Act, 2021 a minor but substantially very relevant change has been made in Section 2(s) of the Customs Act, 1969. Through this

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amendment 'Retailing' of the smuggled goods has been included in the definition of smuggling¹. In case if this provision is implemented in Pakistan in proper sense then whole paradigm of undocumented economy will change. Under the present regime a 'retailer' is not required to produce evidence to the effect that goods being sold have been legally imported in Pakistan. In case if the amendment as introduced is implemented, in its true spirit, then it would mean that such retailers will be required to produce evidence to the effect that goods being sold at retail level have been legally imported.

This is a very important and necessary step for curbing smuggling and promoting local industry. In short, this amendment if properly implemented will be the game changer for Pakistan's economy as everybody is aware that our shops and market are filled with smuggled goods. It is true that the right place to curb smuggling is at the import stage however keeping in view the ground realities all the supply chain have to be made accountable. Nothing right can emanate from a wrong. Accordingly, the contention that retailers should

not be questioned for the sale of smuggled products as they are available in the market, is a wrong argument. Government is to be complemented for this corrective measure.

INCOME TAX

Introduction of Real Self assessment Scheme:

Through Income Tax Ordinance, 2001 a real self assessment scheme was introduced by way of Section 120 of the Income Tax Ordinance, 2001. However, since inception Section 122(5A) was regularly, frequently and wrongly used to dilute the effective implementation of real self assessment scheme as envisaged in Section 120 of the Income Tax Ordinance 2001.

In practice, it was assumed that Section 122(5A) is applicable in all cases which in effect meant that the provisions of Section 62 of the repealed Ordinance were reinstated in every case and the concept of audit as envisaged was totally destroyed. This was a completely wrong and imprudent action. This led to continuation of harassment by the taxation officers and no effective benefit of self assessment procedure.

¹ Some typo corrections required.

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The abuse of Section 122(5A) matter was challenged before the Income Tax Appellate Tribunal in the case of Meezan Bank Limited where the full Bench of the Income Tax Appellate Tribunal provided guidelines for the application of 122(5A) of the Ordinance.

Through the amendment in Section 122(5A) by the Finance Act, 2021 the spirit of Section 122(5A) has been revived and under the amended position every return filed will be deemed to be assessed under Section 120 of the Income Tax Ordinance, 2001 and Section 122(5A) shall be applied only the cases where there is 'valid' reason for that amendment. What is valid is a subjective matter however it is heartening to note that the government, unlike the past practices, has adopted the spirit of decisions of the appellate authorities if the same is in favour of taxpayers. A correct action undertaken in 2001-2002 by way of introduction of a self assessment scheme has actually been implemented in 2021-2022.

Furthermore, time limitation for amending the assessment under this section has been substantially curtailed.

'Mens Rea' in Case of Concealment:

Concealment of income is a very serious crime under the taxation laws. There are severe penalties for concealment of income. This has become all the more important after the current changes on the matter of arrest of persons undertaking concealment. Nevertheless there is a universal rule of law that all inaccurate, underestimated or wrong or non disclosure of income does not constitute concealment of income unless it is proved that such an act was undertaken deliberately with an intention to fraud. This is called the principle of 'mens rea'. All the courts in Pakistan have always accepted this principle and in almost all cases though not specifically mentioned in the law, principles of mens rea have always been adopted. In the Finance Act, 2021 a special section has been introduced to ensure that the principle of mens rea is to be adopted in all cases.

Export of Services:

In the past export of services were heavily discriminated against export of goods. Pakistan having very high quality and volume of manpower is an ideal place for export of services.

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Through the Finance Act, 2021 a revolutionary step has been undertaken and almost all kinds of export of services have been brought in line with export of goods. All such exports will be subject to tax equal to 1% of proceeds as realised by the State Bank of Pakistan. A new Section 154A has been inserted for this purpose. An option has been provided to the exporter of services to be taxed on a net income basis.

The State Bank of Pakistan will be required to make rules for situations and positions where a certain portion of export proceeds are allowed to be retained outside Pakistan.

It is suggested tax should be on the amount of value of export and the same should not be related to proceeds realised.

The services included are:

- IT related services;
- Technical services;
- Royalties;
- Construction contracts; and
- Any other service.

Whilst drafting the aforesaid law two primary errors in the present

presumptive law relating to export of goods have been removed:

1. Return has to be filed alongwith all registrations;
2. Imputed tax concept has been laid down with means that exporters are actually accountable for profits earned on exports.

These measures should also be adopted for export services.

Business Bank Account

In Pakistan there are a very large number of bank accounts of business which are not declared in the taxation system. It is estimated that the number of such accounts are around 50 to 60 million whereas 10 to 20 million are declared in various forms in the tax returns. In one of the most important changes introduced in the budget the concept of a 'business bank account' has been introduced for the purpose of Income Tax laws. This is a step towards a right and relevant direction. It suggested that a proper road map be designed that fruitful results are achieved from this positive measure.

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Special Incentives for Construction Contracts:

Through Finance Act, 2020 special regime was introduced for the construction sector. The main feature of that regime were:

1. Fixed tax regime;
2. Immunity for source of investment for the builder and developers; and
3. Immunity for the source of investment for the first purchaser of such property.

This is a time bound scheme and date were invariably expiring within the year.

On account of huge success of the scheme by way of acceleration of construction and allied activities time limits which were expiring this year have been extended upto next year.

Set off of Losses-Property Income

Income from property was not adjustable against business losses if any. This restriction was against the

general principles of taxation. This error has been removed. Now income from property can be set off against income from property. This is a very substantial change to promote construction and property business. This is another case of removal of aberration.

Other correction measures have also been made in the property income.

Special Regime for Small & Medium Enterprise:

A special tax regime has been introduced for the taxation of Small & Medium Enterprise that has been defined in Section 2(59A) as:

1. Engaged in manufacturing; and
2. Having turnover during the year less than Rs 250 million.

These SMEs shall be taxed in accordance with the provisions of the 14th Schedule to the Ordinance. This effectively means that such enterprises will be absolved from many intricacies that are related to larger entities.

The rate of tax for SMEs has been substantially reduced from the

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general rate. SMEs have been provided the option to pay tax on net income or turnover basis. The reduced rates are:

1. If turnover does not exceed Rs 100 million 7.5 percent of net income;
2. If turnover exceeds Rs 100 million but does not exceed 250 million 15 percent of net income.
3. In case if the SME opts for a turnover tax basis the tax rate shall be . 25% or .5% of turnover for turnover upto Rs 100 and 250 million respectively.

This is a new experience and success of the same shall be determined by implementation. At present bulk of such manufacturers are outside the ambit of taxation regime.

14th Schedule will be required to be lined up with the Sales Tax Act, 1990. On an overall basis this is a good step.

Telecommunication being Industrial Undertaking:

After a campaign of over two decades finally telecommunication has been declared as an industrial undertaking. All telecommunication companies operating under Pakistan Telecommunication Authority have been declared as industrial undertaking for tax purposes.

Taxability of Gain on Disposal of Capital Gain:

A fundamental change has been made in the taxability of capital gain on disposal of immovable assets. Now on in the case of capital gain on disposal of immovable assets where the gain exceeds Rs 5 million the following principles will apply:

- Rate of tax will be those applicable to general capital gain tax. If this provision is read with the condition as laid down in the second condition as above then on the positive side it would mean exemption of tax after a holding period as well as reduction in rate in relation to holding period. This matter will be clarified;

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- Nevertheless the benefit of holding period as laid down in this section shall remain applicable. This means that there will be no taxability for a gain arising after a certain period;
- These provisions shall not be applicable for transactions in the nature of an adventure in the nature of trade

Taxability of Gifts: A concept of enquiry in case of gifts which are deemed to be undertaken to avoid tax has been introduced. It is important to note that through this amendment gifts which may result in tax avoidance have not been brought into tax. The right of the officer is limited to mitigate avoidance by invoking respective provisions. This means that gift transactions cannot be interposed to avoid tax. In other words there is no tax at the time of gift even though deemed to be questionable unless the next transaction is not undertaken.

Tax Credits:

Through this Budget these two kinds of tax credit as were available earlier has been reinstated. These are:

Investment in plant and machinery credit to the extent of 25% of the value of eligible investment. This is the replica of the old provision 107 of the repealed Income Tax Ordinance, 1979.

The second credit is for income from certain industries. The Industries included in the present stage are:

1. Coal mining in Sindh for power projects;
2. Startups as approved by Pakistan Software Export Board
3. Income from export of computer software or IT services. This is 100 percent credit against 1% tax under Section 154A. Section 154A, notwithstanding any provision of the State Bank of Pakistan does not require remittance of income to Pakistan.

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Foreign Advertising

A new withholding provision has been introduced whereby a 20% withholding will be made to a non-resident person for any foreign produced commercial or advertisement. This will be the final tax.

Exemption from Minimum Tax

Under the present regime, listed companies withholding made on supply of goods and execution of contract is not treated as minimum tax. As a very major amendment, this concession has been extended to all 'companies'. If this provision is read in its correct perspective then it transpires that through this amendment a very substantial aberration and distortion created in the law in the past has been removed and the system is being moved towards taxes on net income basis. In the author's opinion this is one of the most important changes introduced in the budget.

Arrest of Taxpayer on Concealment of Income & Subsequent Legal Proceeding

A completely new procedure has been introduced that deals with the 'arrest' of a defaulting tax payer and the legal procedure to be followed. This detailed subject cannot be discussed in this note however the following matter needs special consideration prior to implementation of this subject.

- The whole process of arrest emanates from the assertion that there is concealment of income. The important consideration in this matter will be the determination of the stage where it is decided that there is a 'concealment of income' as defined under the law. It will not be correct to assert the said position unless the matter passes through an independent stage of appeal at least to the level of Appellate Tribunal that operates under the Ministry of Law. In case if any other mode is adopted then it may be counter productive. It is therefore suggested that provisions relating to prosecution which exist in law for a long time be

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implemented prior to resorting to direct action of arrest and such measures.

- There will be a requirement to decide the scope of a special judicial system as prescribed now to deal with the person so arrested and regular legal proceedings as some pre-emptive conclusions and conflicts may arise.

Minimum Tax

Minimum Tax on turnover tax is a bad law. Tax should only be there once there is an income. Nevertheless the legacy is so strong that there is little space for the government to do away with that system in one stroke. It is heartening to note that the general rate of minimum tax on turnover which is 1.5% of turnover has been reduced to 1.25% of turnover. This is a commendable step in this time of constraint. Furthermore special reduced rates have been prescribed inter alia for the following:

Oil & gas marketing companies	.75%
PIA	.75%

Poultry	.75%
Oil Refineries	.50%
Motorcycles dealers	.50%
Pharma Distributors	.25%
Petroleum Agents	.25%
Rice mills and dealers	.25
Tier 1 Retailer of FMCG	.25%
E-Commerce	.25%
Used Vehicles	.25%
All others	1.25%

Capital Gain on Disposal of Listed Securities

At present capital gain on disposal of listed securities within twelve months is subject to tax at the rate of 15% of such gain. This gain is proposed to be reduced 12.5% from July 1, 2021.

Inter-corporate Dividend

In the budget the government has provided all kinds of benefits to listed companies however the

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mistake made in the recent Finance Act, 2021 whereby inter-corporate group dividends have been taxed has not been reinstated as expected in this document. It appears to be an omission. It is suggested that the same will be taken into consideration whilst finalizing the documents.

Deletion of 12 withholding taxes

Following provisions withholding taxes are proposed to be removed.

1. 153B Collection of tax on payment of royalty to residents.
2. 231A Collection of tax on cash withdrawal.
3. 231AA Collection of tax on banking instruments.
4. 236P Collection of tax on banking transactions other than through cash.
5. 236Y Collection of tax from persons remitting amounts abroad through credit or debit or prepaid cards.
6. 236B Collection of tax on domestic air travel.
7. 236L Collection of tax on international air travel.
8. 236V Collection of tax on extraction of minerals.
9. 233A Collection of tax from members by a stock exchange registered in Pakistan.
- 10.233AA Collection of tax on marginal financing by NCCPL.
- 11.234A Collection of tax from CNG stations
- 12.236HA Collection of tax on certain petroleum products

SALES TAX

Common Tax Identifier: From July 1, 2021 there will be common identification between Sales Tax Registration number and CNIC.

8B Concession for Public Companies: A provision was inserted in the Sales Tax law over a decade ago in order to avoid excess claim of input by way of Section 8B of the Sales Tax Ordinance, 1990. Under that law, input tax cannot be claimed during the tax period over

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and above 90 percent of the value of output tax. After a long period of over a decade a positive amendment in this law has been made and under the proposed amendment this provision will not be applicable for 'public listed companies'. Under the amended law now the provisions restricting for a time the input tax will not be applicable for companies listed on Pakistan Stock Exchange Limited. This is an extremely positive step. It is in line with general recommendation that more and more concession and facilitation be provided to listed companies in comparison to other entities. In the past policies were working in the reverse order.

Cottage Industry;

The amount of aggregate sale to qualify for that purpose has been increased from Rs 3 million to Rs 10 million.



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