



## **Federal tax revenues - receipt side: Resilience to documentation continues - II**

**By  
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There is a need for a national anti-smuggling drive with political consensus for people to discourage and disassociate from purchase, sale and trade in smuggled goods. The ultimate solution for proper documentation is automation of the system. There are two stages of automation in customs viz:

-- Automation of process for clearance; avoiding human intervention; and;

-- Automation, if possible, for applicable duty rate and valuation process. For various ulterior motives, including lack of proper understanding, both these aspects have unnecessarily been mixed up and inter-related. The ground work undertaken since 2002 for the first part has been derailed for various reasons. The correct step was to move forward from that level and to build up capacities for improvement in proper classification and valuation.

In addition to all these matters, it is to be appreciated that the 'Customs' and 'Inland Revenue' are two different subjects. 'Customs' is effectively a subject of trade regulation. In countries like us, it should effectively be used as an aid for promotion of local industry and facilitation. Thus as an out of box thinking, a separate board for 'Customs' like in India and many other countries can be explored. Furthermore, since almost all the activities are effectively undertaken at ports located in the south, therefore the new board may be headquartered in Karachi.

To conclude this aspect, it appears that no serious thought has been applied for the inherent problems in this field that can directly provide incremental growth in our economy. There is a dire need for serious concentration of efforts on this subject. We wonder whether or not the reference of strong lobbies by the Finance Minister relate to those operating in this segment of economy.

**FEDERAL EXCISE DUTY** Federal Excise Duty structure is to be fundamentally revamped with the introduction of the proposed Value Added Tax. There had been serious intrusion by the federation in the right of taxation of the provinces through this tax for 'Services' especially in the nature of telecommunication, travel, banking and insurance. In fact the present unsettled issue between the Province of Sindh and the Federation on value-added tax's implementation primarily relates to this subject only.

At the first stage, it has to be settled that Federal Excise Duty is effectively not enforceable on 'services' which is a provincial subject. Excise Duty is effectively a tax to curb consumption for undesirable and luxury goods and services like alcohol, cigarettes, gambling etc.

Unfortunately in our country such duty is levied even on item like cement etc also. This conceptual diversion is to be removed and if a certain industry is to be taxed for extra profit or margin, then same may be done through a different mechanism. Another distortion created by us is adjustment of FED against Sales Tax or VAT. As stated earlier, there is no need for such complications and duplications and a single stage excise with a lower rate may be introduced.

In the recent budget, we have found traditional adjustment in the FED rates, especially for cigarettes, which appears to be a revenue collection measure only. We have not found any analysis or detail on the subject of so-called 'Mardanwallahs', who are notoriously known for manufacturing cigarettes through unorganised sector.

**SALES TAX AND VAT** This budget was supposed to be focused on the introduction of the VAT. The implementation of the proposed VAT has been deferred to October 1, 2010. I personally support this extension on the ground that July 1, 2010 is not any sacrosanct date. This new regime is to be introduced with national political consensus, agreement with the major stakeholders and improvement in the requisite capabilities of the FBR.

There is a need to properly understand the proposed VAT regime and misperception and apprehensions, if any, be removed for implementation. I consider that a lot of such apprehensions are either politically motivated, represent the pressure tactics of various groups, or have arisen due to improper understanding of the facts. There are in principle, five (5) issues with reference to the VAT:

(a) Is it a new 'Tax'? (b) What is the issue between the Federation and Provinces (especially Sindh) with reference to Services? (c) Would the same result in increase tax incidence and resultantly 'inflation'? (d) Is the wholesale or retail trade sufficiently documented to implement this tax? (e) Whether or not 'zero-rating' for exports continue to remain

applicable to export oriented sector through which local consumption of such industries also remain outside the tax ambit?

It is unfortunate that the matter is being dragged to political debate without realising the underlying objectives and potentials. Accordingly, before answering the aforesaid questions, it is essential to understand that the rationale for introduction of the VAT is based on the premise that:

(a) Contribution of services sector in overall tax base is to be improved. At present consumption tax is effectively restricted to goods; (b) local consumption of export oriented sector be brought into tax net; Zero-rating for products rather than whole sector; and (c) all segments of business being wholesaler, distributors and big retailers be brought into tax net. This extension of documentation will ultimately lead to improvement in direct tax collection. Indirect taxes are in any way being recovered.

Introduction of the VAT is a transition. In the beginning, it would not result in any major incremental growth in tax collection (Rs 80 billion only), however, if properly implemented, it has the potential to 'plug' the holes in direct taxation from wholesale and retail trade and services sectors.

The effect of this analysis clearly reveals why the introduction of VAT is being so strongly opposed by the lobbies involved in trade sector. Nevertheless, this does not mean that we have an efficient tax collection mechanism that can effectively plug these holes. What we need is a concerted, well thought through process without any haste. This justifies the present delay for a quarter.

IS VAT A NEW TAX? Sales tax on 'value-added tax mode' and the present VAT Bill are the two names of the same product. When we study the proposed VAT, it is revealed that it is almost similar to 'puristic' General Sales Tax as was introduced in 1996. The sales tax system (in the VAT mode) has been defaced, especially with reference to zero-rating, exemptions and mode of collection of tax at retail prices at manufacturing stage for certain products (Third Schedule basis of taxation).

It is reiterated that the VAT in the proposed form is a legislation better than that prevalent at present. This justifies the introduction of the new law. Accordingly, the impression that it is a new tax has to be dispelled with.

PROVINCES' RIGHT OF TAXATION Constitutionally, there is no dispute that consumption tax on services is the right of the provinces. In the past, there has been intrusion in the right of provinces through the FED on services as referred earlier. Furthermore, provinces can opt not to surrender their right of taxation of services to federation. We all should 'honour' this provincial right.

In my view, this matter is being unnecessarily complicated. There is no ideal system of the VAT and every country, on account of its constitutional provisions, may implement consumption tax according to its own basis of distribution of taxes between the Federation and the provinces. Thus, if the province of Sindh requires separate 'accounting' for tax on certain services that should be honoured and accepted.

INCREASE IN TAX INCIDENCE The VAT implementation is being linked to increase in over all inflation levels. The VAT per se will not result in any increase in prices as the present rate of 16 percent and certain higher rates as applicable are being reduced to 15 percent across the board. Nevertheless, the issue of inflation is directly related to following two factors:

-- Whether or not withdrawal of exemptions will increase the price levels for the reason that many products are not subjected to tax at present.

-- Whether or not multiple stage taxation for wholesale and retailer would effectively be implementable, especially on account of substitution of Third Schedule [Tax at retail price is charged from the manufacturer].

Extension of the scope of the VAT may result in increase in the price for products or services, which are at present, outside the tax ambit. Whilst implementing the law, it has to be ensured that the product or services, which are used by the common man such as food, education, health services and medicines should not be taxed. With reference to inflationary impact of the VAT in our country, the biggest tragedy is that this issue is being raised by 'traders', being a main constraint in documentation of economy.

We cannot pass a judgement on the matter of increase in prices without involving people having no conflict of interest like independent economists and members of civil society. I consider that it is the responsibility of relevant

educational institutions and independent bodies, like the ICAP, ICMA, IBA, LUMS etc to provide independent technical input on the subject.

IS WHOLESALE AND RETAIL TRADE READY? Implementation of VAT necessitates documentation. Extension of VAT to wholesale and retail trade [having turnover exceeding 7.5 million] with the removal of the provision of the Third Schedule [as explained earlier] assumes completion of the trail from manufacturer to retailer. This is an important subject as at present, our trade sector is filled with products being:

-- Imports through the ATT;

-- Under-invoiced products; and

-- Products originating from unorganised undocumented manufacturing sector. There have to be serious simultaneous actions on all such matters if any incremental improvement is required for the implementation of multiple stage VAT.

There is another issue of 'Equalisation' of tax incidence. This refers to the disparity which arises on account of sale to persons being retailers below the threshold limit. This is particularly important in our economy as bulk of retailers fall outside the ambit of tax.

In order to resolve issue of equalisation, a proposal of a 'further tax' of 3 percent is being considered. In my opinion, this action is not recommended. This would result in a perception, which in that case would become a reality, that the tax rate is effectively being increased to 18 per cent. Furthermore, there could be 'leveraging' of further tax as happened in the past.

In this situation, it can be proposed that any other solution be explored for the same which includes an amendment to the effect that all supplies to all persons, other than retailers having turnover exceeding Rs 7.5 million per annum, will be deemed as final supplies equivalent to supply to consumer.

ZERO-RATED SECTOR The biggest distortion in the VAT system as introduced in 1996 is zero-rating for the export-oriented sector. As explained earlier, we have zero-rated the export oriented sector as against exports. This reflects a defeatist attitude and is equal to action, which was taken due on account of complete failure in managing the refund mechanism. I fully acknowledge for the fact that I was a member of this team that worked out the excess refund paid on export sector in 2005 [around Rs 40 billion of refunds were issued whereas collection was around Rs 20 billion only].

There is no second view on the matter that only 'exports' be 'zero-rated'. There is no case for zero-rating of local consumption of export-oriented sector. In other words, why should we assume that whole local textile be exempted from tax. Why local sale of 'carpets', being a luxury item, be zero-rated? However, can we ignore the other ground realities as explained in the following paragraphs?

Total exports of Pakistan are estimated to be around US \$20 billion. This would mean that around Rs 225 billion [US \$20 - 10% (being exporter's margin) x 15% x Rs 84] will be collected and would have to be refunded. The question is whether or not we have established an adequate system managing such refunds.

In case of any mismanagement, genuine exporters will suffer giving boost to fictitious export etc. There is financial impact of the subject also. It has to be ascertained whether or not export industry, at this stage, would be able to bear the finance cost for the timing differences.

In these circumstances, a prudent approach that would cover both the risks would be to introduce the VAT on export oriented sector at a lower rate ranging from 2.5 to 5 percent. To conclude this matter, it is my view that implementation of a broad-based integrated consumption tax is a step in right direction. This correct step from national benefit needs to be handled carefully, diligently in the forthcoming quarter with national consensus.

INTERIM ARRANGEMENT IN SALES TAX General rate of sales tax, till the introduction of the VAT as proposed, has been increased from 16 percent to 17 percent. This appears to be only a tax collection measure. There is a case for reduction of rate as being envisioned in the proposed VAT, therefore, the present action becomes totally unjustifiable.

This increase, which is temporary and is not expected to generate substantial revenue, is a step in the wrong direction. Such measures erode the confidence of the independent advisors and reflect the slackness of the tax

collectors for looking for the ways to increase collection by increasing the rate as against improvement in administration.

To sum up the budget recommendations with respect to indirect taxation, it can be concluded that:

- (a) The present major issue of protection to local industry by tariff regime has not been taken into account.
- (b) Issues of Afghan transit trade, under-invoicing and smuggling have not been taken up seriously.
- (c) Increase in sales tax rate is not justified being 'inflationary' in character.
- (d) Proper 'roadmap' for implementation of VAT is missing; and;
- (e) There is no policy change being a reflection that the bureaucracy is looking for easier choices for tax collection even at the cost of disturbing economic fundamentals.

Notwithstanding, the present omissions, it is expected that all such measures will be taken up seriously in the near future as an integrated fiscal policy requires coherent approach.

**DIRECT TAXATION (INCOME TAX)** Budget documents provide certain direction for direct taxation system, however, following fundamental pitfalls present in our tax system have not been handled, either as a measure of policy or lack of clarity on the subject:

- (a) Window for whitening of untaxed money by way of remittance from abroad which is the biggest ill for taxation system [as briefly explained earlier] has not been plugged. There seems to be strong vested interest for the same; and;
- (b) The tilt towards presumptive taxation has not been removed. The budget does not seem to provide any roadmap or will towards the elimination of indirect taxation in the guise of direct taxation. At present, presumptive tax covers almost all the major activities of Pakistan businesses being exports and all kinds of trade. If these major segments are taken out from taxation on net income basis then no meaningful improvement can happen for direct tax regime.

At the outset, it is stated unless the aforesaid two ills are cured, which inflict the economy like cancer; other prescription will have marginal effect. It appears that there are very strong lobbies in the corridors of powers who want the continuation of these policies. The other cause may be a sense of insecurity of the FBR and the government of Pakistan for the potential shortfall in revenue collection if these guaranteed measures of revenue collections are disturbed.

There could be a feeling that removal of exemption for foreign remittances would affect their flow in Pakistan. There is no empirical evidence for the same and it appears that the relevant lobbies who want continuation of this policy for having a window for whitening of untaxed wealth are very influential. Continuation of presumptive taxation for commercial imports and export is a completely wrong approach. Presumptive taxation, per se, leads to non-documentation. In the present circumstances, there is no case for taxation from exports on presumptive taxes.

The change required is zero-rating of income arising from exports which would result in documentation of transaction and availability of relevant benefits such as tax credit for Balancing, Modernisation and Replacement (BMR) and credit for investment in plant and machinery by way of accelerated depreciation. Continuation of this policy reflects that our system inherently promotes non-documentation even at the cost of organised entities in export sector.

**LEVEL-PLAYING FIELD FOR VARIOUS FORMS OF BUSINESS** Pakistan's fiscal policy has been designed in a very strange way whereby, by design or implication, it encourages business in non-corporate sectors for the reason that:

- Lower tax rates for individuals and partnership (association of persons) in business;
- Exemption from withholding for Individuals and AOP in business; and;
- No minimum tax on Individuals or AOP in business.

There has been a positive change in the recent budget in this field. There is a move to increase the tax rates for individuals and AOP in business. Furthermore, such persons, if having turnover over Rs 50 million in a year will be subject to minimum tax and withholding tax provisions.

This policy shift, which is a step in the right direction, should further be improved and we should look forward for the days when tax incidence for companies is lower than other forms of business to promote documentation and corporatization of businesses. There have to be certain corresponding measures to curb the tendency for division of business to avoid such provisions.

**TAX ON BANK WITHDRAWAL** I have the honour or dishonour of recommending the introduction of the provisions relating to withholding tax on cash withdrawals. I have no regret for the same, however, I reiterate that the purpose of recommending this provision was not tax collection but to unearth the person dealing in cash which are not within the tax ambit.

The tragedy is that the tax department has not used this effective measure to identify and then penalise and prosecute the persons dealing in cash not within the tax net. This shows clear lack of conviction and enforcement by the tax department. It has to be admitted that this provision does not meet the test of good legislation.

There has been a further addition and extension of the said provisions and all modes of withdrawal, excluding cheques, have been subject to adjustable tax withholding. This rationale of the provision has been explained in the aforesaid paragraph; however, as stated earlier this provision should not be used as a tax collection measure. Tax withholding on SDR and CDR has been included to avoid the use of such instrument as an effective negotiable instrument equivalent to currency.

**REINTRODUCTION OF TAX CREDIT FOR BMR** After a very long time, an effective measure has been introduced for the promotion of industrial sector. This provision effectively means that government will finance 10 percent of the cost of plant and machinery by way of tax credit for BMR. This is a need of the time.

This issue is, however, required to be read with reference to the matter of presumptive taxation on exports. On account of being subject to presumptive tax regime, the biggest and most vital sector of our economy, those engaged in exports would effectively not be able to avail the benefit of this productive measure.

This would be a tragedy. It is, therefore, suggested as above, that exports income should be taken out of presumptive tax regime and be zero-rated. This would promote documentation and allow the exporter to avail the benefit of an industrial promotion scheme of the government.

**TAX ON CAPITAL GAIN ON TRADE IN STOCK EXCHANGES** Through an amendment introduced on this subject a very reasonable step has been undertaken whereby long-term capital gains on sale of shares of listed companies have been exempted from tax for ever. Such time bound exemption, which was provided by way a clause in the Second Schedule has now been incorporated in the law.

Now we can emphatically state and plan that long-term capital gains on sale of shares are exempt from tax in Pakistan for ever. In my view, this would encourage people to distinguish between short and long term gains and discourage the tendencies to trade in shares.

Short-term gains have been taxed at the rate of 10 and 7.5 percent depending on the holding period. There are certain issues with regard to advance payment of tax on such gains and it is recommended that in the initial period, such procedures be made simple to the extent possible.

Since capital gains were exempted for a very long time, therefore, assets giving rise to such income, were also outside the ambit of documentation. It is considered that under the law, no enquiry for the source can be made for assets so accumulated upto June 30, 2010. In order to avoid ambiguity or difference of view, if any, on this matter, a specific provision for the same needed to be introduced.

There is a need to further refine the system for non-residents, who invest in foreign currencies to the effect that there is indexation of the cost of shares in foreign currencies so that effective taxation is for the gain on sale of shares and not the effective notional amount of exchange difference arising due to the change in exchange rate parity for Pakistani rupee.

In my opinion, this is a correct step and reflects a vision that all income should be subject to tax on net income basis. There is a need to gradually remove other presumptive taxation so that a level playing field is maintained for all sources and heads of income.

**TAXATION OF BANKING COMPANIES** Seventh Schedule of the Income Tax Ordinance, 2001 is one of the product not properly understood by many stakeholders. This is a model whereby the role of regulator being State Bank of Pakistan has been accepted and protracted litigation and subjectivity with reference to charge for irrecoverable advances has been removed. Under the Seventh Schedule provisions for irrecoverable advances are allowable as per the amount so certified under the Prudential Regulation of the State Bank of Pakistan.

This reasonable system was sabotaged by an undesired provision whereby a limit of 1% of total advance was placed for the amount to be allowed in any particular year. This ceiling was totally unjustified especially in relation to consumer loans and loans to Small and Medium sector. Through the Finance Bill as proposed in the budget this hardship has been removed and ceiling in respect of such advances has been increased to 5% of such advances.

This is a step in right direction. However there is a need to further examine the ceiling for 'Other Advances' and revise the same to 2% in the following years. What the FBR has to realise is that it is a timing difference only.

Another good step which was suggested earlier was the introduction of similar mode of allowability of irrecoverable advances for years prior to the introduction of the Seventh Schedule. Numerous litigations are pending at various levels on this matter and the only workable solution for future is the allowability of the charge for earlier years on the similar basis. Enabling provisions to this effect have to be introduced. To sum up this matter it is stated that this is a step in right direction and there should be a move towards further consolidation and confidence building.

**TAX ON OIL EXPLORATION COMPANIES** There are three major issues in dispute between the oil exploration companies and the Federal Board of Revenue. In order to settle the matter a very reasonable document was exchanged between Pakistan Petroleum Exploration and Production Companies Association [PPEPCA] and the FBR in the form of a memorandum of understanding. In that MoU a manner of settlement of all the disputes was laid down.

The implementation of MoU was delayed apparently on account of the fact that legality of the matter could have been challenged in the court of law. This is not a correct notion. I totally disagree with this contention, however, even if that contention is taken to be true the right approach is to incorporate the understanding exchanged in the MoU by way of 'explanation' or 'amendment' in the Ordinance.

The FBR, in a very reasonable manner, has introduced a provision relating to 'Decommissioning Cost' in the Income Tax Ordinance, 2001 in line with the MoU through the proposed Finance Bill. This is a credible approach. It is recommended that other two issues as agreed between the parties should also be introduced in the law. In this connection it has to be clearly appreciated that amendment and explanations in the law are always introduced if there is a consensus on certain matter between the parties.

Pending legal proceeding on the matter can not in any manner prohibit the government to introduce such provisions. It is my view that explanations and amendments are effectively introduced for this purpose and at that stage. It is therefore strongly recommended that this correct approach be further consolidated by way of incorporation of other provisions of MoU in the Ordinance.

To sum up the issues relating to direct taxation, it can be concluded that there is no policy direction for improvement, except taxability of trading capital gains. There are certain specific positive actions, however, on overall basis these measures proposed would fail to:

(a) Broaden the tax base; (b) disincentives trading business against manufacturing and to curtail the process of whitening of untaxed income; and (c) abolition of the cruse of presumptive taxation.

An overall analysis of such measures reveal that the Federal government seems to be afraid of taking on the strong lobbies involved in trading, which are subject to presumptive tax regime and unorganised and undocumented export sectors which are ever ready to leave the benefits available in the form of BMR credit at the cost of keeping themselves outside the documented tax regime.

On an overall basis, it appears that the proposal in the budget 2010-2011 from the receipt side is a 'Non-Event'. This is a status quo position. We would have to sit down again to decide whether or not we have the 'space' for this status quo. In my view, time is short and we would have to take some strong, non-traditional actions. We would require a national political consensus for such revolutionary incremental approach.  
(Concluded).

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Syed Shabbar Zaidi, "Federal tax revenues - receipt side: Resilience to documentation continues - II," Business Recorder. 11-06-2010.

**Keywords:** Economics and business, Tax, Taxes, Taxation, Tax policy, Tax revenue, Economy, Economists, Taxpayers, Ordinance, Trade, Budget, Exports, Income tax, Loan, Banks, FBR, VAT, GST