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Kind Regards,

Huzaima Bukhari
Editor

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Strengthening Value Added Tax to improve revenue efficiency abstract

by
*Bilal Hassan**

In Pakistan, general sale tax is necessarily a value added tax (VAT) and is an important source of revenue for the government for financing the budgets. Despite significant increase in VAT revenue over the years, practically it is not an efficient tax. In this article, the author discusses the discusses the revenue performance of VAT with a focus on collection efficiency, VAT efficiency, gross compliance ratio, etc. An attempt is also made to compare VAT efficiency indicators with those of similar economies. Important issues hindering VAT performance have also been discussed.

I. Introduction

1. Since its full-fledged implementation in 1998 to cover manufacturers, importers, distributers, wholesalers and retailers, the VAT has been the backbone of the tax revenue system in Pakistan.[1] However, during the recent years the revenue performance of this tax has significantly been decreased. For this reason, the government proposed to reform existing VAT system with a broad-based tax on sales and purchases on goods in all areas of Pakistan.[2] This paper evaluates the past and current performance of the VAT in Pakistan. It examines the underlying factors behind that performance and the VAT's current weaknesses. This paper argues for the improving VAT design and strengthening the VAT administration and provides specific measures that could be implemented for that purpose.

Table-1: Revenue Sources as Percent of Total Federal Tax Revenue (2003-2011)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Income Tax	31.6	30.2	29.4	29.4	37.2	36.5	36.4	37.4	36.4
Other Direct Taxes*	1.4	1.5	1.6	2.1	2.2	2.0	1.8	2.2	2.0
Customs	14.9	17.5	19.5	19.4	15.6	14.9	12.8	12.1	11.9
Excise	9.7	8.7	9.0	7.7	8.5	9.1	10.1	9.4	8.8

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[1] Although a General Sales Tax (GST) was first introduced in 1991 through enactment of General Sales Tax Act, 1990 it was only in 1996 when GST was converted into "modern" type of VAT. Its coverage was extended to importers in 1996 and to wholesalers and retailers in 1998.

[2] The government prepared General Sales Tax Bill 2010 but could not succeed to get it passed from the parliament due to stiff resistance from the key stakeholders.

VAT	42.4	42.1	40.4	41.3	36.5	37.4	38.9	38.9	40.7

*: Capital Value Tax, Wealth Tax, Corporate Asset Tax and Workers Welfare Fund

Source: Federal Board of Revenue Year Book 2010-11, MOF

2. Indeed, the VAT is in trouble in Pakistan, with declining collection efficiency during the period under reviewed. This problem stems from VAT base erosion because of ever-expanding exemptions, special regimes, multiplicity of rates and several other deviations from international best concepts and practices. Second reason may be the comprehensive administrative reforms initiated under the Tax Administration Reform Project (TARP) in the Federal Board of Revenue, Pakistan in 2004 and completed in 2011 with creation of Inland Revenue Service (IRS) for administration of inland taxes -income tax, sales tax[1] and excise duty.[2] Previously, sales tax and excise were administered by the Customs & Excise group, which was re-classified as Pakistan Customs Service. Change in VAT administration during the period 2003 to 2011 might created problems of tax compliance.

3. Improving performance of the VAT is an urgent concern for Pakistan, especially in the wake of persisted large fiscal deficits due to considerable shortfall in achievement of tax revenue targets. Lowering the marginal tax burden in the country is important, but it needs to be accompanied by a broadening the tax base, better compliance and better overall administrative capacity.

4. The paper is organized as: Section II evaluates the VAT trends and performance for the period 2003 to 2011. It provides an analysis of collection efficiency using various benchmarks and examines the changes in VAT collection composition (i.e., VAT on imports vis-a-vis VAT on domestic consumption). Section III aims at examining the selected issues regarding VAT design, focusing particularly on exemptions, concessions, rates etc. The last section gives concluding remarks.

II. The Revenue Performance of VAT (2003-2011)

5. VAT and Revenue. The quick spread of VAT around the world is due to the reason that it is likely to be a good revenue-raiser. Sometimes, the VAT has even been called as a "money machine".[3] However, its revenue performance is different in countries that have introduced a VAT. For instance, in Ukraine, VAT revenue relative to GDP and VAT's collection efficiency declined significantly from 1998 to 2004.[4] The reasons for VAT success and VAT failure lie in the VAT design and its administration. The initial VAT legislation in most of the developing countries is close to standard international VAT models but over time, however, the VAT

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[1] The terms sales tax and VAT have been used interchangeably in this paper implying the same meaning

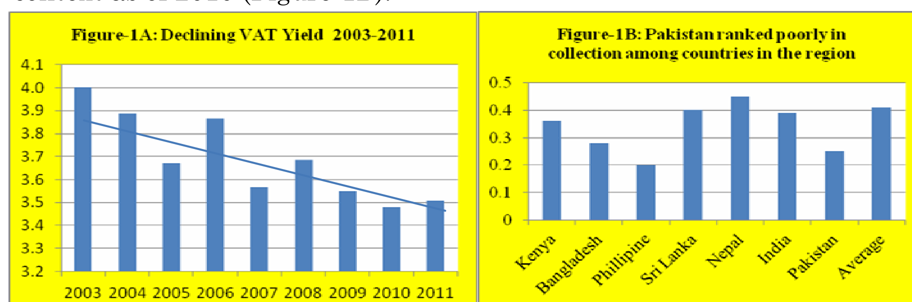
[2] See notification of the Establishment Division O.M.No.6/2/2009-C.P.II dated 12.09.2009.

[3] President's Advisory Panel (2006, 192)

[4] Bird, R.M. 2007. The VAT in Developing and Transitional Countries. P.58

structures become complex and tax expenditures increase significantly due to exemptions, exonerations, reduced rates, etc. The potential taxpayers find many ways to escape the taxation system by keeping themselves or their tax base abroad or remaining in the country but hiding in the shadow economy[1]. Or they exert pressure to make changes in tax law or its interpretation. Even they may seek forgiveness through amnesty laws or specific grants of relief if they found themselves trapped within the taxation system. Many or all of these processes play their role in erosion of the VAT base. In the literature, three related measures of VAT productivity include the VAT efficiency ratio, the C-efficiency ratio and the VAT gross compliance ratio[2].

6. Low and Declining VAT-GDP Ratio. As shown in Figure 1A, the revenue yield of VAT as a share of GDP declined more or less steadily since 2003. Such a prolonged decline in VAT yields is both unusual and disturbing. In general, VAT yields rise with both GDP growth and import growth. In Pakistan, however, although average GDP at market prices grew by 17 percent in the 2003-2011 period, VAT as a share of GDP actually fell by 12.5 percent. Collection Efficiency or C-Efficiency[3] is a better measure of VAT performance as it is closer to the theoretical VAT base. Using this measure, Pakistan ranked poorly in the international context as of 2010 (Figure-1B).



Source: Own calculations; data from FBR Year Book 2010-2011, MOF of selected countries, WDI and GDF 2010 (http://search.worldbank.org/data?).

7. VAT Efficiency and Gross Compliance Ratios. In principle, a VAT without exemptions, with a single rate, and full compliance must result in efficiency ratios of close to 100 percent (IMF 2010). But most of the VATs are not close to this goal. The VAT gross compliance measure should be closer than C-efficiency ratio and definitely closer than the VAT efficiency ratio. In addition use of single standard VAT rate to compute potential revenues ignore the existence of multiple rates, some lower than the standard rate and some higher. It also ignores exemptions and zero-

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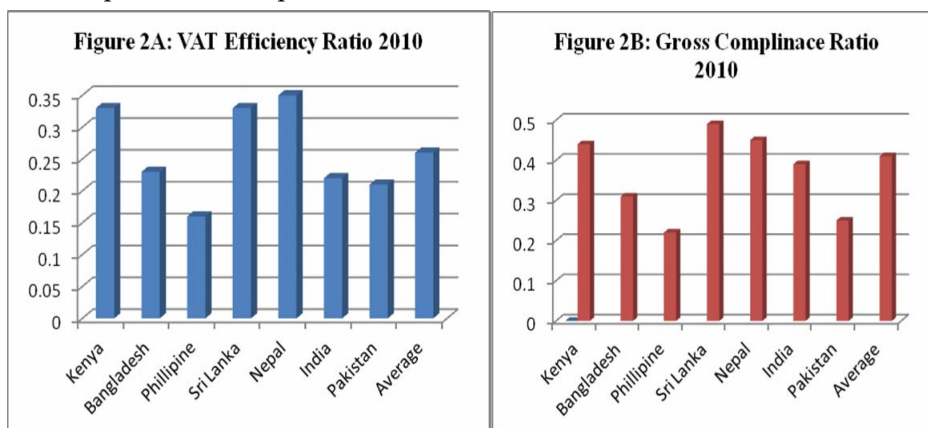
[1] ibid, 6. p.67

[2] For example, see Martinez-Vazquez, J., & Bird, R. M. (2010). Value-Added Tax: Onward and Upward?. International Studies Program. Working Paper 10-26.

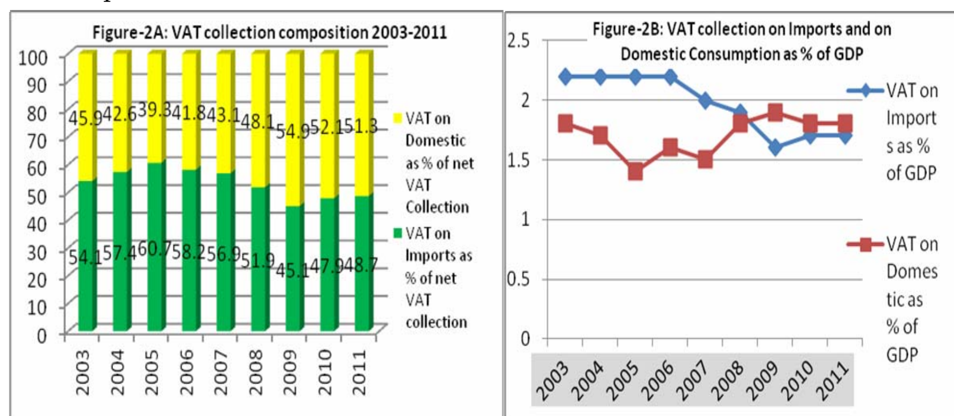
[3] VAT Collection Efficiency or C-Efficiency is the actual VAT collection as a ratio of final household consumption, divided by the standard rate of VAT in the country.

rating provisions. These ratios, thus, depends upon how broad the VAT base is and then how the actual revenue is realized through effective tax compliance and tax administration. Pakistan in terms of the Gross Compliance and VAT efficiency ratios ranks poorly among the selected countries (Figure 2A and 2B), which is indicative of the fact that both VAT base is eroded because of excessive exemptions, reduced rates as well as poor VAT compliance.



Source: Own calculations; data from FBR Year Book 2010-2011, MOF of selected countries, WDI and GDF 2010 (http://search.worldbank.org/data?).

8. VAT Collection Composition. In 2003, the collection of net domestic VAT was 46 percent of total VAT collection, while VAT on imports was 54 percent. By 2011, the relationship improves with net domestic VAT collection increased to 51 percent and VAT on imports as percent of total VAT collection dropped to 49 percent. Net VAT collection on domestic consumption as percent of GDP was extremely low, on an average 1.7 percent in the period 2003-2011. It was 1.8 percent in 2003 and fell to 1.5 percent in 2007 and on an average, remained stagnant to only 1.7 percent in the period 2008-2011.



9. Changes in the Economic Structure barely explain the declining trends in VAT collection. VAT does not tax either exports or investment. A rise in GDP attributable to either an export-driven expansion or an investment boom may therefore result in an initial decline rather than an increase in VAT revenue because an input credits (for exports and investment) may build up more quickly than output taxes. From 2003 to 2011, exports as percent of GDP have declined steadily (Table 2). The export-GDP ratio was highest (16.7%) in 2003 and was minimum (11.9%) in 2011. Similarly, though investment as percent of GDP increased from 16.9% in 2003 to 22.5% in 2007 but after that decreased and reached minimum level of 13.1%. Thus explanation for VAT's poor revenue performance cannot lie neither in exports nor in investment changes during the period under review.

Table-2: Exports & Investment as % of GDP

Year	Exports as % of GDP	Total Investment as % of GDP	VAT as % of GDP
2003	16.7	16.9	4.0
2004	15.7	16.6	3.9
2005	15.7	19.1	3.7
2006	15.2	22.1	3.9
2007	14.2	22.5	3.6
2008	12.8	22.1	3.7
2009	12.9	18.2	3.6
2010	13.6	15.4	3.5
2011	11.9	13.1	3.5

Source: *WDI and WDF 2010 extracted on 9 August 2012 from search. worldbank.org/data

** Economic Survey of Pakistan 2008-09 and 2010-11

This conclusion is especially strong because declining trends in issuance of refunds (Table 3). In particular, minimum refunds were issued during 2009 and 2010 about 0.21% and 0.19% of GDP, respectively. Whereas revenue as percent of GDP was lowest during these two years. On the whole, Pakistan's VAT performance cannot be explained by changes in economic structure.

Table-3: Refunds Issued

Year	Refunds (Rs. Millions)	Refunds as % of net VAT	Refunds as % of GDP
2003	43934	22.5	0.90
2004	52222	23.8	0.93
2005	54909	23.0	0.84
2006	32439	11.0	0.43

2007	37029	11.9	0.43
2008	28175	7.5	0.28
2009	26996	6.0	0.21
2010	28776	5.6	0.19
2011	50835	8.0	0.28

Source: FBR Year Book 2010-11

10. Changes in the VAT Structure partly explain the declining trends in VAT collection. Some of the decline in the VAT-GDP ratio during the period 2003 to 2011 may perhaps reflect base erosion in the form of increased exemptions, reduced rates, zero-rated etc. There is a long list of goods on which exemption of sales tax is available under section 13 of the Sales Tax Act, 1990, the Sixth Schedule of the Sales Tax Act, 1990. Other exemptions are available in various notifications called Statutory Regulatory Orders (SROs) issued by the government under section 13 from time to time. Zero-rating on goods other than exports causes base erosion. Zero rating has been practiced much more extensively in Pakistan over the years[1]. A number of goods besides exports are made zero-rated in Pakistan as mentioned in section 4 and the Fifth Schedule of the Sales Tax Act, 1990. Another reasons the reduced rates for some sectors of economy, which were inserted in the VAT system from time to time. For instance, VAT rates were reduced from 16% to 8% for sugar sector and from 21% to 19.5% for telecom sector during 2009-10.[2]

Base erosion due to excessive exemptions explaining the continued marked decline from 2008 onward is given in table 4. Changes in tax structure can, therefore, explain Pakistan's VAT performance trends.

Table-4: Estimated Revenue Loss due to exemptions

Major Sales Tax Exemptions	**2008**	**2009**	**2010**	**2011**
Fertilizers	9.2	8.2	8.797	9.138
Tractors	5.6	5.7	6.246	6.489
Pharmaceutical Products	2.3	3.1	3.754	5.505
Others**	0.5	0.5	8.612	12.63
Total	**17.6**	**17.5**	**27.409**	**33.762**
As % of GDP	0.17	0.14	0.18	0.19

Source: Economic Survey of Pakistan 2007-08 to 2010-11

11. Changes in the VAT administration partly explain for the poor performance of the VAT collection. The other explanation of the decline of the VAT in Pakistan lies in tax administration. No developing country starts with a good VAT administration; all have to

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[1] See Statutory Regulatory Orders such as 1125(I)/2011 available at www.fbr.gov.pk

[2] See FBR Quarterly Review April-June 2010.

grow one (Bird 2005). There may have been a significant deterioration in the efficiency of VAT administration because of administrative changes underwent during this period. Under the Tax Administration Reform Project (TARP) commenced in the Federal Board of Revenue in 2004, Inland Revenue Service (IRS) has been created to administer inland taxes -Income Tax, Sales Tax and Excise Duty.[1] The former Customs & Excise group, which was administering Customs Duty, Excise Duty and Sales Tax was re-classified as Pakistan Customs Service. The separate administration of sales tax from customs is internationally practiced. The growing private sector might has exploited the weaknesses of VAT administration during the reform period. VAT evasion, the size of the underground economy, and corruption are closely linked. With VAT, there are two ways to evade: by under reporting sales or by over reporting taxable purchases. A major form of VAT evasion: a firm creates a shell company and then shells inputs to itself at a false price that then serves as the basis for an input tax credit or refund claim. In Pakistan, a number of fictitious firms may have operated such frauds during the period under review, particularly during 2009 and 2010.

12. The July-March 2012 Period. VAT collection on imports registered substantial growth of 47.6 percent during the period as compared to same period of last fiscal year. The percent growth in VAT collection on domestic consumption stood at 18.9% during the same period. The overall VAT collection increased by 33.3 percent during the period as compared to the same period of last fiscal year. This increase in VAT collection is backed by the measures adopted by the organization administration against non-filers, short filers, filers of wrong input-output adjustment; increased sharing of information among different wings; and enhanced facilitation of taxpayers in the form of extensions in date of payment and filing of returns, keeping bank branches opened late hours, and guidance in e-filing.

III. The Underlying Problems of VAT System

13. The excessive exemptions have become hallmark. Exemptions of VAT are available under section 13 of the Sales Tax Act, 1990, the Sixth Schedule of the Sales Tax Act, 1990. Other exemptions are available in various notifications called Statutory Regulatory Orders (SROs) issued from time to time by the government under section 13 of the act. The exemptions have been extensively practiced in Pakistan over the last decade or so.

14. The increasing level of concessions proves to be deviation from true VAT base. The VAT regime contains a range of special concessions, which have been provided to simplify compliance obligations mainly in respect of input credits either due to difficulties taxpayers may face in obtaining invoices for purchases in an economy which has a large informal sector or the risk of fraudulent claims for input credits.

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[1] See notification of the Establishment Division O.M.No.6/2/2009-C.P.II dated 12.09.2009.

15. Zero-rating has been much practiced in Pakistan. Besides all exports except those made by land route to Afghanistan are zero-rated[1], other zero-rated supplies are mentioned in section 4 and the Fifth Schedule to the Sales Tax Act, 1990, which include supplies to diplomats, privileged persons and privileged organizations, supplies of raw materials to Export Processing Zones and supplies made against international tenders. Importantly, the facility of zero-rating has also been provided to every manufacturer, exporter, importer, and wholesaler but not retailer who is engaged in the five sectors -textile (including jute), carpets, leather, sports and surgical goods sectors.[2]

IV. Concluding Remarks

Presently, the country is facing wide budget deficits resulting in higher debt-to-GDP. It is, therefore, imperative to enhance revenues, particularly tax revenues since non-tax revenues could not be enhanced due to scarcity of natural resources in the country. Among tax revenues, VAT is a potential revenue source. It has been underutilized so far due to policy and enforcement issues. As a result, effective VAT rate is only 3.7 per cent as compared to standard VAT rate of 16% last year. Moreover, VAT is a business friendly tax and could be easily enhanced by standardizing its design, which aims at no or minimum exemptions, only exports are to be zero-rated, no special schemes, uniform tax rate, etc.

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[1] Zero rated goods are those goods on which the impact of tax paid is offset by subsequently allowing refund or input adjustment equivalent to the tax already paid. Zero rating is different from exemption in the sense that no tax is to be paid on the exempt goods whereas in case of zero rated goods not only that no sales tax is payable on supply but refund or input tax adjustment of tax already paid is allowed.

[2] See Statutory Regulatory Order . 1125(I)/2011 available at www.fbr.gov.pk

Germany

Germany lowers taxable pension threshold

The German Finance Ministry has confirmed a reduction in the taxable pension threshold, noting that in 2014 tax will be due on gross monthly pension income in excess of EUR1,225 (USD1,669) for single taxpayers (EUR2,450 for married couples).

This taxable amount is now EUR41 below the so-called standard pension (*Eckrente*) in Germany of EUR1,266, based on 45 insurance years and average earnings.

This is the first time that the taxable pension portion has fallen below the standard pension amount, and is as a result of provisions governing the taxation of pensions, fixed in 2005, which have progressively increased the taxable amount.

In 2005, the taxable pension portion was 50 percent of income. At the time, tax was therefore imposed on pensioners with gross monthly pensions above EUR1,599. The taxable pension portion now stands at 68 percent of income.

By 2040, pensions in Germany will be subject to taxation in full. – *Courtesy tax-news.com*

Ireland

Irish home renovation tax break 'Working'

Home building in Ireland last month grew at its fastest rate in almost nine years, prompting a politician to claim that the new Home Renovation Incentive (HRI) is "already working well for homeowners and builders at [a] local level."

Ulster Bank's latest Construction Purchasing Managers' Index shows that construction activity rose throughout 2013, with home building establishing itself as the strongest sub-sector. Firms remain optimistic that this improvement will be sustained throughout 2014, believing that "their industry has turned the corner following what has been a brutal downturn for the sector."

The HRI scheme was introduced to grant tax relief for homeowners having repair, renovation or improvement work done to their primary residence by qualifying contractors. The 13.5 percent income tax credit effectively nullifies VAT imposed on these contracts, which are subject to Ireland's reduced VAT rate of 13.5 percent.

The amount spent on qualifying works must exceed EUR4,405 (before VAT at 13.5 percent), with qualifying expenditure capped at EUR30,000 (before VAT). Therefore, the lowest tax credit amount is EUR595 (EUR4,405 at 13.5%) and the highest tax credit is EUR4,050 (EUR30,000 at 13.5%).

Carpets, furniture, white goods (such as fridges, dishwashers,) and services (such as architect's fees) that are subject to the headline 23 percent VAT rate do not qualify. Likewise, materials a homeowner buys such as paint, tiles, etc., are excluded.

Labour TD Eamon Maloney welcomed the figures, claiming that: "the new tax break in particular drove a jump in the number of home renovation projects."

According to Maloney, the aim is to "incentivize homeowners to spend money on their own home … and jumpstart activity in the building sector." This is clearly happening, he added, "with employment being generated for small-scale builders, carpenters, plumbers, and other workers."

Looking forward, Maloney hopes that "this positive news encourages more homeowners to avail of this smart and innovative measure, and that it continues to pay dividends for the construction sector, which has recorded its fourth straight month of growth." – *Courtesy tax-news.com*

Australia

ATO to fast track disaster-related refunds

The Australian Taxation Office (ATO) has pledged to fast track refunds for those directly affected by bushfires.

Tax Commissioner Chris Jordan explained that taxpayers will not need to apply for a deferral or a quick refund if their business or residential address is located in one of its identified affected postcodes.

For those in the Western Australia suburbs of Stoneville and Parkerville, the ATO has automatically deferred the lodgement and payment dates (excluding those for large pay-as-you-go withholders) for income tax returns and activity statements due between January and March. The new lodgement date is April 28, 2014.

The ATO will add further postcodes to its list as needed, and is encouraging taxpayers to check its website for updates. It will also

make arrangements on a case-by-case basis, as and when contacted by affected taxpayers.

Jordan said of the initiative: "We understand that for many people their tax affairs are the last thing on their minds right now. When people are ready, we will make sure they are supported in dealing with their tax obligations."

The ATO is also offering tax deductions to those donating to "bucket appeals" and other disaster relief funds this financial year. Deductions can be claimed without a receipt if the donation in question was AUD10 (USD8.82) or less. – *Courtesy tax-news.com*

January 11, 2014

Mr. Tariq Bajwa,
Chairman,
Federal Board of Revenue,
FBR Hosue,
Islamabad

Dear Sir,

Tax amnesty scheme for investment and non filers of tax returns

A meeting of the office bearers and members of the Karachi Tax Bar Association (KTBA), was held today at Bar Chambers, Regional Tax Office, Karachi, to discuss the issues arising from the SRO 1065(I)/2013 issued on 20.12.2013.

The following issues have come to light through the deliberations on the aforesaid SRO, which either require clarification or confirmation of our understanding:

1. <u>INVESTMETN IN GREENFILED PROJECTS</u>

Clause (86) of Part IV of the Second Schedule to the Income Tax Ordinance, 2001 (the Ordinance) introduced through the aforesaid SRO provides amnesty from any action under section 111 of the Ordinance to investments made in a Greenfield Industrial undertaking. It is our understanding that there is no requirement for investment in any particular area in Pakistan and as such industrial investment anywhere in Pakistan will be eligible for the benefit of the amnesty.

As per our understand **"Investment in Greenfield Industrial Undertaking"** means a new investment locally or through Foreign Direct Investment in all type of industrial undertaking whether newly setup or existing unit anywhere in Pakistan.

Clause (86) also provides that the amnesty would also apply to Investments made in-

(I) Construction Industry in corporate sector

(II) Low cost housing construction in the corporate sector

(III) Livestock development projects in the corporate sector

(IV) New captive power plants

(V) Mining and quarrying in Thar Coal, Balochistana and Khyber Pakhtunkhwa

It seems that Investments in sectors covered from (i) to (iii) will only be eligible if it is done through a Company registered under the Companies Ordinance, 1984 (Corporate Sector), whereas investments in the last two sectors mentioned above can be made through an individual or AOP. In our view investment in the last two sectors are most likely to occur through a corporate sector; whereas investment in Livestock, construction and low cost housing construction is likely to come through non corporate sector. We would suggest that Investments in all the above sectors should also be made open to all types of legal set up i.e. corporate or AOP or Individual.

2. ELIGIBILITY OF PERSONS HAVING INCOME COVERED UNDER FTR & SALARY INCOME TO AVAIL BENEFIT OF CLAUSE (87) & (88) OF PART IV OF THE SECOND SCHEDULE

The form of tax return for tax years 2008 to 2012 as per the SRO suggests that no tax credit is available to persons who avail this amnesty. However, there will be cases where a person may have derived income partly falling under NTR and partly under FTR or persons who only derived income that is covered under FTR on which tax has already been withheld/collected; but have not filed tax returns. Similarly salaries persons; who were liable to file tax returns in past years; but could not file return of income, although their due tax was withheld at source by the employer.

In the absence of facility to take tax credit; these persons will not be able to avail the benefit of above facility. **The Bar believes that the prime objective to grant amnesty to non-filers is to broaden the tax net and not just to collect tax. Therefore, it is strongly recommended that such persons may also be permitted to claim tax credit and file tax returns and avail the amnesty this will help in bringing such people in the tax net and increase the number of tax return filers.**

3. IMMUNITY TO A MINIMUM BENCHMARK OF BUSINESS CAPITAL FROM APPLICABILITY OF SECTION 111

In our view, the above scheme focus is primarily to broaden the tax net for persons having insignificant capital with the intention to provide another opportunity to those persons, who are inclined to conduct business in accordance with law.

Payment of this meager amount of tax would not generate any significant capital. Following is the example:–

Tax Year	Declared Income	Personal Expenditure	Gross Saving	Tax Payable	Net Saving
2008	300,000	300,000	NIL	22,500	[22,500]
2009	325,000	300,000	25,000	24,375	625
2010	350,000	300,000	50,000	26,250	23,750
2011	375,000	330,000	45,000	28,125	16,875
2012	420,000	360,000	60,000	21,000	39,000
TOTAL	**1,770,000**	**1,590,000**	**180,000**	**122,250**	**79,625**

However, we feel that ground reality may require revisit of above schemes. For example if a prospective person is conducting medium size business requiring minimum capital of Rs. 10 to 20 Million. If he files his return under this scheme for the last five years, generating equivalent amount of Capital would require such persons to pay tax at least 2.5 to 5.0 Million. Whereas in the present schemes, if someone who files return for the last five years, would not be able to generate any significant capital. In this regard it is noted that you have slashed the first tax slab for tax year 2012 from 7.5% to 5%, ***however it is suggested that a reasonable amount of progressive tax rebate may be announced for all the years against each tax slab for those tax payers who pay the tax more than Rs. 20,000/- or Rs. 25,000/-, whichever the category they fall.***

4. IMMUNITY FROM AUDIT/AMENDED ASSESSMENT PROCEEDINGS

The scheme currently grants immunity from tax audit U/s. 177 and U/s. 214C only whereas under the Ordinance, the Commissioner ahs the authority to amend the assessment without a detailed audit by using his powers U/s. 122(5A) of the Income Tax Ordinance, 2001. These powers are widely being used by the Tax Authorities. We therefore suggest that immunity from section 122(5A) of the Ordinance may also be extended under this scheme.

In the absence of immunity from all sorts of assessment/ amendments under the income tax, sales tax and federal excise acts, the scheme is unlikely to attract the large number of traders and small and medium size taxpayers. We,

therefore, suggest that immunity may be granted across the board under all the fiscal laws to make this scheme workable.

4. **Amnesty from action Under Sales Tax/FED laws.**

   In case a person desire to declare turnover exceeding 5 million for any past year, he will become liable to charge Sales tax on his turnover. Absence of amnesty from action under the Sales tax laws in past years will keep such persons away from availing this amnesty and regularizing their business. It is therefore suggested that to encourage such persons having turnover above 5 million, amnesty should be given against any action under sales tax and FED laws as well.

We trust that you will consider the above submission and issue necessary clarifications and where required make suitable additions/amendments to the scheme to achieve our common objective to increase the tax base.

Yours faithfully

Haider Ali Patel
President

Bajwa directs recovery of fake refunds

Chairman Federal Board of Revenue (FBR) Tariq Bajwa has directed officers of Inland Revenue Services (IRS) to ensure the recovery of refunds released against bogus/fake invoices, official sources told The News on Thursday.

The directives have been issued at a meeting of chief commissioners of tax offices, which was chaired by the chairman at Large Taxpayers Unit (LTU) Karachi.

The recovery of refunds released on fake invoices was stuck for the last two years as billions of rupees were given to the companies, which obtained sales tax registrations only for taking refunds.

The sources said that the three regional tax offices (RTOs) in Karachi had either blacklisted or de-registered those companies that were involved in such illegal practices but the tax offices had done nothing to recover the issued amount.

In June 2013, the RTO-II submitted a report about the tax fraud to the tune of Rs128 billion – both sales tax and income tax- to the

FBR. Since then, the senior tax officers were not taking any measure to recover the amount. Recently, the RTO-II unearthed another scam of nine billion rupees. However, no measure has been taken so far to recover the amount. The companies involved in the scam were only de-registered or blacklisted and the individuals responsible were not traceable.

The sources said the chairman at the meeting fretted over the slow progress of the recovery and directed the officials to ensure the recovery at any cost.

The sources said the chairman instructed the chief commissioners to deal the taxpayers with fairness to build their trust on FBR.

A day ago, Saeed Shafiq, former president of Karachi Chamber of Commerce and Industry at a meeting with the federal finance minister Ishaq Dar, complained that the chief commissioner RTO-II had not treated him with fairness while the lower staff was demanding bribe money for clearing refund claim process, which was stuck for last 30 months.

The finance minister referred the case to the FBR chairman. The sources said that the issue was resolved with the directives that any of the officials found in illegal practices would face disciplinary action. The sources said the tax officers have been directed to complete audit exercise on priority basis and ensure current and arrear demand.

Notably, the FBR was much behind the revenue collection target of Rs2,475 billion for the fiscal 2013/14 as it collected only Rs1,031 billion in July–December 2013.

The sources said the FBR chairman also issued directives for the disposal of the genuine refunds that were stuck for months and due to which business community was facing liquidity issues. – *Courtesy International The News*

Tax directory

On the directives of the government, the Federal Board of Revenue (FBR) will publish a tax directory of about all 0.7 million taxpayers on March 31, 2014.

In a country where ransom cases are on the rise, one fails to understand how the government can take such a foolish decision to make public the assets of the taxpayers, which if they land into the

wrong hands will be a weapon to kidnap taxpayers of good financial standing. – *Courtesy International The News*

Imported cars stuck at port

Thousands of imported used cars of 2009 model are stuck on Karachi port and waiting for the green signal from the government after the sudden withdrawal of a notification by the Federal Board of Revenue (FBR), said an auto expert.

The government allowed import of only 3-year old car, but in the beginning of 2013 through a notification it permitted the import of 2009-model car as well on heavy penalty. Consequently, overseas Pakistanis started sending such model cars to Pakistan, which were getting cleared after the payment of penalties to the customs.

However, by end of 2013, customs withdrew that notification, causing massive loss to Pakistani importers and making thousands of cars stuck on the port, said Javed Khan Niazi.

Chairman Pak-Japan Auto Association said though the FBR is a very professional organisation, yet it practiced really unprofessionally.

He said it is common all over the world that the government must inform stakeholders before releasing or withdrawing of any notification.

He added it happens only in Pakistan that a notification is issued and withdrawn on the spur of the moment.

Niazi condemns this act and demands the government to order the FBR to clear the cars, which were on the port at the time of the withdrawal of the notification.

He said a number of 2010 vehicles is also arriving Karachi. For which the bills of landing were made after December 2013. He added they could be cleared smoothly. – *Courtesy International The News*

Rs 10 billion TFC/Sukuk issue: Wapda seeks tax exemption

The Federal Board of Revenue has received a request from Water and Power Development Authority (Wapda) to amend the Exemption Schedule of the Income Tax Ordinance 2001 for tax exemption on issuance of Rs 10 billion TFC/Sukuk certificates for construction of Wapda hydropower projects. Sources told here on

Thursday that Wapda has repeatedly asked the FBR for implementation of the decision of the Economic Coordination Committee of the Cabinet.

The authority has again taken up the matter with the FBR seeking exemption under Part-I of the Second Schedule of the Income Tax Ordinance 2001. According to a communication of Wapda to the FBR, it is again requested to expedite the issue and necessary amendment may be made in the Income Tax Ordinance 2001 by replacing sub clause (xxvii) of clause (66) of Part-I of the second schedule as "WAPDA Third Sukuk Company Limited" and addition of new sub-clause may also be added as follows:

"WAPDA on issuance of ten (10) billion rupees TFC/SUKUK certificates for construction of WAPDA Hydropower projects," proposed amendment added. It is reiterated that till the issuance of above mentioned SRO, the compliance with the ECC's revised decision in case No ECC-48/05/2013 dated 26.02.2013 is pending on the part of Federal Board of Revenue.

Therefore, it is requested that the tax authorities should look into the matter personally and issue requisite amendment/SRO at earliest, as in compliance with the ECC's revised decision dated February 26, 2013, WAPDA Third Sukuk Company (for financing of Rs 10.00 billion to Neelum Jhelum Hydropower Project) has been registered on July 19, 2013 with Securities & Exchange Commission of Pakistan (SECP), Wapda added.

Through SRO.119, the Board had amended Second Schedule of the Income Tax Ordinance to grant tax exemption on issuance of TFC/Sukuk certificates for construction of Diamer-Bhasha Dam Projects. In the aforesaid Schedule, in Part I in clause (66), after sub-clause (xxvi), the following new sub-clause has been added, namely:- "(xxvii) WAPDA on issuance of twenty billion rupees TFCs/Sukuk certificates for construction of Diamer-Bhasha Dam Projects," the notification added. – *Courtesy Business Recorder*

Private aviation company found to be evading taxes

Federal Board of Revenue (FBR) has been dilatory in taking a firm action against one of the private aviation companies, which has committed tax evasion amounting to Rs 76.54 million; it was learnt here on Thursday. According to sources, this private jets company was involved in the evasion of Federal Excise Duty (FED), Sales

Tax (ST) and Income Tax (IT) for tax years 2007, 2008, 2009 and 2010.

They said that proceedings against the aforesaid company had been initiated by Anti-Evasion Cell (AEC) of Large Taxpayers Unit (LTU) Karachi on the complaint of private investigator Moin Mirza. They said that AEC-LTU had made a contravention case and issued a show cause notice to the taxpayer for evasion of FED, ST and IT that resulted in determination of tax liability of Rs 76.54 million.

"Although an order had been passed against the taxpayer on October, 2012, no recovery had been made so far. Instead of expediting the process of recovery, the authority has been dilatory in taking a firm action against the said private jets company," sources claimed. They said that the case had now been transferred from LTU, Karachi to Regional Tax Office (RTO), Karachi. This development has created problems in finding the complete relevant records of the company.

"Now the assessing officer is requesting the concerned RTO and registered person to provide the requisite record, but no such record has been received so far and the proceedings are still pending," sources said. Replying to a question, sources said that Federal Tax Ombudsman (FTO) had also issued orders for the recovery of evaded taxes but no efforts were visible in this regard, due to influential registered person/company. – *Courtesy Business Recorder*

Duty, tariff concessions: customs wing restructured

The Federal Board of Revenue has created a new position of Chief (Preferential Trade, Projects, Reforms & Automation) to exclusively deal with the issues such as concessionary rate of duties and tariff concessions under the Preferential Trade Agreements (PTAs). The FBR has issued an office order here Thursday on job description and work distribution in the restructured customs wing.

According to the FBR, in partial modification of the Office Order dated August 6, 2013, the job description of Chief (International Customs), Chief (Reforms & Automation), Secretary (Reforms & Projects) and Secretary (Automation) have been modified. FBR Chief (International Customs) would cover positions of Secretary (International Customs), Secretary (WTO/WCO and other

International Conventions) and Integrated Transit Trade Management System (ITTMs) Project.

Chief (Preferential Trade, Projects, Reforms & Automation) would cover four positions of Secretary (Preferential Trade), Secretary (Reforms & Projects), Secretary (Automation) and Secretary (Human Resource, Training & Welfare). Secretary (Reforms & Projects) would be responsible for co-ordination with SP&S Wing and field formations on all matter pertaining to Customs Reforms, monitor the progress of ITTMS and all customs-related infrastructure projects as well as prepare reports thereon, including matters pertaining to hardware requirements of field formations.

He would co-ordinate and implement all matters related to SECDIV project of Ministry of Foreign Affairs, co-ordinate the activities of National Trade Corridor Improvement Program (NTCIP) concerning customs and the trade facilitation committee of NTCIP. He would be responsible for co-ordinating all customs related matters related to Trade and Transport Facilitation Program (TTFP) as well as ITTMS, keep liaison with national organisations such as NTTFC, PIFFA and other for developing policies on trade facilitation, liaison with International Development Partners. He has also been directed to co-ordinate the meetings of Joint Working Groups, customs related consultancies procured through TARP and SP&S or any other Wing of FBR, co-ordinating and taking necessary action regarding the activities of customs related international aid projects and monitoring of progress regarding completion of customs related Projects under TARP within the specified deadlines.

Secretary (Automation) will closely work with the internal and external stakeholders to identify requirements for automation and modernisation of the existing business processes of all Customs formations. He would co-ordinate activities of Customs Automation of all field Collectorates and field offices; matter relating to computerisation in Customs, Interface, co-ordination and liaison with IMS Wing on all matters pertaining to automation of customs organisations and offices and carry out intensive consultation within the department to identify the capacity building requirements.

He would assist the Customs Wing in strengthening the linkages between various field/ support formations, compile "requirement for proposals" (RPF) documents for proposed development of

applications, in consultation with business users; co-ordinate printing of "User Manuals", brochures, guidelines, answer to FAQs and their dissemination to the concerned officers and monitor and evaluate the progress of automation and modernisation initiatives by conducting cost benefit assessment and getting feedback from all stakeholders.

Secretary (Reforms & Projects) would be responsible to co-ordinate/conduct "Business Testing" (alpha - versions) of business applications from time to time, monitor the rollout of new business applications and report progress to Member (Customs) on fortnightly basis through a comprehensive report, co-ordinate the plans for holding seminars/workshops for external stakeholders on changed business processes/automation, compile information to prepare periodic reports on the progress of various automation initiatives of the Customs departments and provide support, including procedural documentation and relevant reports to the field formations and other stakeholders.

FBR Secretary (Automation) will also co-ordinate, monitor and execute automation in Customs Wing of the FBR, in consultation with PRAL and under the direct supervision of Member (Customs). He would deal with all matters pertaining to automation of customs procedures including development and implementation of WeBOC and co-ordinating the finalisation of Customs Risk Management System (CRMS) and framing of relevant rules and SROs, monitoring of the automation process (One Customs & WeBOC) and firming up of any change in law and procedures to be notified upon finalization by the L&P Section, all matters related to Risk Management System of WeBOC and co-ordinate and establish liaison with Pakistan Revenue Automation Limited (PRAL) on all customs related matters.

Henceforth, Secretary (Reforms & Automation) shall be named as Secretary (Reforms & Projects), whereas Secretary (Information Technology) shall be re-designated as Secretary (Automation). Their job description shall remain, as aforesaid, it added. – *Courtesy Business Recorder*

S.R.O. 19(I)/2014, Islamabad, the 10th January, 2014.– In exercise of the powers conferred by Section 506B of the Companies Ordinance, 1984 (LVII of 1984), the Securities and Exchange Commission of Pakistan (the Commission) in continuation to SRO 831(I)/2012, dated July 5, 2012, is pleased to extend the deadline for seeking Commission's approval for dividends announced upto December 31, 2014:

Provided that a company in addition to the requirements of SRO 831(I)/2012 shall also produce evidence for publication of the requirement of CNIC from the shareholders in atleast one issue each of a daily newspaper in English language and a daily newspaper in Urdu language having circulation in the Province in which the stock exchange on which the company is listed is situated, along with the evidence of sending notices through registered post to all the shareholders who have not provided copy of their CNIC to company. The Commission while granting such relaxation shall direct the company to ensure compliance within a specific period as the Commission may deem appropriate.

2014 TRI 103 (H.C. Utk.)

HIGH COURT OF UTTARAKHAND AT NAINITAL

Barin Ghosh, CJ and
U.C. Dhyani, J.

Samsung Heavy Industries Co. Ltd.
v.
The Director of Income-tax -1 International Taxation, Delhi and another

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FACTS/HELD

Article 7 of DTAA: Even in a composite contract, Department cannot assess off-shore profits without showing how it is attributable to the permanent establishment

1. The assessee entered into a consortium contract with ONGC and L&T to carry the work of surveys, design, engineering, procurement, etc. It opened a project office in India for co-ordination and execution of the project. The assessee claimed that a portion of the work was carried out inside India and a portion was carried out outside India. It claimed that it had suffered a loss on the work done inside India and that income on the work done outside India was not assessable to tax in India. The AO held that 25% of the work done outside India had to be assessed in India. This was upheld in principle by the Tribunal (133 ITD 413 (Del)) on the ground that the contract was indivisible and that opening a project office in India was a condition precedent for the contract. It was held that the said project office constituted a "permanent establishment" under Article 5(1) of the India-Korea DTAA and that it covered the entire scope of work. As regards the percentage of income attributable to the PE, the Tribunal directed the AO to determine the extent of business activities carried on through the said project office. On appeal by the assessee to the High Court HELD reversing the Tribunal:

   Being a resident of Korea, the assessee is governed by the Income-tax laws as prevalent in Korea. Therefore, it has a

tax identity in Korea. In addition, the assessee has submitted to the jurisdiction of Indian taxing authorities by furnishing return of income and, thereby, acknowledged that it has also a tax identity in India. The question is, this identity is covered by which provision of the India-Korea DTAA. In terms of Article 7(1), the assessee will acquire its tax identity in India only when it carries on business in India through a permanent establishment situate in India. By submitting the return, the assessee has held out that it is carrying on business in India through a permanent establishment situated in India. In the circumstances, the contention of the assessee, whether the Project Office of the appellant opened at Mumbai can be, or cannot be said to be a permanent establishment within the meaning of the said DTAA is of no consequence. In terms of the DTAA, if an enterprise does not have a tax identity in India in the form of a permanent establishment, it has no obligation to either submit any tax return with, or pay any tax to India. The Indian Taxing Authority is not entitled to arbitrarily fix a part of the revenue to the permanent establishment of the assessee in India. The assessee held out that a part of the revenue was received by it for doing certain work in India. It did not contend that even those works were done by or through its Project Office at Mumbai. On the other hand, there is not even a finding that 25 per cent of the gross revenue of the assessee was attributable to the business carried out by the said Project Office. Neither the AO nor the Tribunal has made any effort to bring on record any evidence to justify the same. Tax liability cannot be fastened without establishing that the same is attributable to the tax identity or permanent establishment of the enterprise situate in India

Appeal allowed.

Income Tax Appeal No. 01 of 2012.

Decided on: 27th December, 2013.

Present at hearing: C.S. Aggarwal, Senior Advocate assisted by P.R. Mullick, Advocate, for Appellant. Hari Mohan Bhatia, Advocate, for Respondent.

JUDGMENT

Barin Ghosh, CJ.–

For the Assessment Year 2007-08 and in relation to previous year 2006-07, appellant, a foreign Company, filed its return of income on 21st August, 2007 showing nil income and claiming to have sustained loss. It was disclosed by the appellant that it has entered into a contract between O.N.G.C. on the one hand and Larsen & Toubro Limited and the appellant on the other hand as consortium partners executed on 28th February, 2006. It was indicated that under the contract, appellant received certain amount of money. It was held out that a part thereof was received in relation to inside India activities and, in respect thereof, it has incurred certain expenses and after deducting such expenses, it has earned a loss and, accordingly, earned no income taxable in India. The Assessing Officer, by its order dated 25th October, 2010 refused to accept some of the deductions as was claimed by the appellant and found on the disclosure made by the appellant that in addition to the sum of money shown to have been received, appellant has received other sums of monies under the contract and claimed that the same were in respect of outside India activities. The Assessing Officer held that 25 per cent of the revenues, thus received allegedly for outside India activities, should be brought within the taxing network of this country and passed an order accordingly. This order of the Assessing Officer has been confirmed by the Appellate Tribunal. Hence the present appeal.

2. Before filing the present appeal, appellant, on the garb of seeking rectification of mistake, made an attempt to have the order of the Tribunal reviewed by it, which the Tribunal has refused to do. In the present appeal, we are not concerned with the deductions as were claimed by the appellant and disallowed by the Assessing Officer. We are only concerned with bringing in of 25 per cent of the money received by the appellant under the contract, but in connection with allegedly outside India activities within the tax network of this country.

3. A short summarization of the facts, as above, would indicate two things, namely, that (i) the appellant has a tax identity in India and a tax identity outside India and, accordingly, (ii) its tax liability in India is required to be apportioned. What mechanism will be adopted to apportion the same has, however, not been provided in the Agreement for avoidance of double taxation of income and the prevention of fiscal evasion entered by the Union of India with the Republic of Korea.

4. In paragraph 1 of Article 7 of the said Agreement, it has been provided that profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. It, therefore, recognizes two tax identities of an enterprise. The said paragraph makes it clear that the profits of the enterprise may be

taxed in the other State only so much of the same which is attributable to that permanent establishment.

5. Paragraph 2 of Article 7 is as follows:–

> "Subject to the provisions of paragraph (3), where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

6. In the event, an enterprise having a tax identity in one Contracting State for having a permanent establishment there, and dealing wholly independently with its other tax entity situate in the other Contracting State, the profit attributable to the first tax identity will be profit which might be expected to be made.

7. Therefore, the said Agreement does not give any guidance to ascertain what income is attributable to which tax entity unless profit is generated by one tax entity dealing with the other tax entity.

8. In the instant case, appellant held out that a part of the money received by it was attributable to within India activities and the remaining on account of out of India activities. Appellant was not generating any revenue by dealing with either its Indian tax identity, or its Korean tax identity. It was generating revenue by dealing with O.N.G.C. under the said contract. It confessed that a part of such revenue was earned by it for having had carried out within India activities. It asserted and continues to assert that the remaining revenue was generated by carrying out out of India activities. There is no finding anywhere that the revenue earned and said to have been on account of out of India activity was earned, in fact, on account of within India activity.

9. Being a resident of Korea, appellant is governed by the Income-tax Laws applicable to the class of assessees as that of the appellant as prevalent in Korea. Therefore, it has a tax identity in Korea. In addition thereto, appellant has submitted to the jurisdiction of Indian Taxing Authorities by furnishing return of income and, thereby, acknowledged that it has also a tax identity in India. The question is, this identity is covered by which provision of the Agreement. In terms of paragraph 1 of Article 7, appellant will acquire its tax identity in India only when it carries on business in India through a permanent establishment situate in India. By submitting the return, appellant has held out that it is carrying on business in India through a permanent establishment

situated in India. In the circumstances, the contention of the appellant, whether the Project Office of the appellant opened at Mumbai can be, or cannot be said to be a permanent establishment within the meaning of the said Agreement is of no consequence. In terms of the said Agreement, as it appears to us, if an enterprise does not have a tax identity in India in the form of a permanent establishment, it has no obligation to either submit any tax return with, or pay any tax to India. The question still remains, whether it was right on the part of the Taxing Authority to assess income-tax liability of the appellant as was assessed in the instant case. In other words, can it be said that the Agreement permitted the Indian Taxing Authority to arbitrarily fix a part of the revenue to the permanent establishment of the appellant in India? As aforesaid, appellant held out that a part of the revenue was received by it for doing certain work in India. It did not contend that even those works were done by or through its Project Office at Mumbai. On the other hand, there is not even a finding that 25 per cent of the gross revenue of the appellant was attributable to the business carried out by the Project Office of the appellant. One has to read Article 5 of the Agreement in order to understand what a permanent establishment is, in terms whereof "permanent establishment" means a fixed place of business through which business of an enterprise is wholly or partly carried on. In the instant case, according to the revenue, the Project Office of the appellant in Mumbai is the "permanent establishment" of the appellant in India through which it carried on business during the relevant assessment year and 25 per cent of the gross receipt is attributable to the said business. Neither the Assessing Officer, nor the Tribunal has made any effort to bring on record any evidence to justify the same.

10. That being the situation, we allow the appeal, set aside the judgment and order under appeal as well as the assessment order in so far as the same relates to imposition of tax liability on the 25 per cent of the gross receipt upon the appellant in the circumstances mentioned above, and observe that the questions of law formulated by us, while admitting the appeal, have not, in fact, arisen on the facts and circumstances of the case, but the real question was, whether the tax liability could be fastened without establishing that the same is attributable to the tax identity or permanent establishment of the enterprise situate in India and the same, we think, is answered in the negative and in favour of the appellant.