Tax Review/Taxation

Daily Alert Services

Huzaima & Ikram
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Kind regards

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Punctured tax base

by

Huzaima Bukhari & Dr. Ikramul Haq

The Chairman of Federal Board of Revenue (FBR), while talking to Associated Press of Pakistan on 17 February 2012, conceded that "Pakistan has one of the lowest tax-to-GDP ratios in the world". After admitting this known fact, he made a totally fallacious assertion that "only 0.9 percent of the population of the country pays income tax". It is shocking that even the top man of apex revenue authority does not know the difference between a "taxpayer" and "return filer". We have mentioned time and again in these columns ['**The tax base**', *Business Recorder*, November 2, 2012 and '**Ailing tax system**', *Business Recorder*, November 16, 2012] that there are at least 40 million **income tax payers** in Pakistan but returns filers are pathetically low. Ali Arshad Hakeem said that during the year 2010-11, only 3.1 million National Tax Numbers (NTNs) were issued which constituted only 0.92 percent of population. He further revealed that "82 per cent of all sales tax and federal excise duty is paid by the top 100 companies". He made a deplorable disclosure that "only 269,770 individuals filed returns admitting any tax liability consistently from 2009-2011 while 3.1 percent of the government's total tax revenue is collected from the income tax on salaried individuals".

According to Chairman, "about 7.7 percent of the country workforce, approximately 4.5 million, earned enough money to pay the income tax during tax year 2011 when the minimum taxable income was Rs 300,000. However, out of 1,021,669 tax return filers in 2011, 394,169 paid income tax less than Rs 10,000", he added. Chairman FBR said that Pakistan's tax yield from individuals was extremely low compared to other countries and there had been continuous decline since early 2000—Pakistan ranks 23rd from the bottom of a list of 176 countries, whereas 4.7 percent of Indians contribute towards income tax and for Canada ratio is as high as 80 percent.

Ali Arshad Hakeem said that income tax collection from the individuals declined from 1.5 percent of GDP in 2000-2001 to less than one percent in 2010-11. He revealed that at present the ratio of individual return filers is only 0.5 of total population. In 2011, only 6,152 individuals showed personal income tax liability exceeding Rs. 5 million. If the figure for imports is excluded, since most of the goods are headed for other parts of the country, 37.8 percent of all taxes are collected from Karachi while 37.5 percent of all taxes are collected at the two sea port in the country. According to Chairman, "Rs. 650 billion is the cost of the exemptions from taxation granted in just last four years under various Statutory Regulatory Orders (SROs)".

Chairman FBR, in his analysis, overlooked the fact that an overwhelming majority of our population is paying income tax at source, though they earn much below the taxable threshold. In most of the cases, the tax withheld is the full and final discharge of liability and they are not required to file tax return as envisaged in section 115(4) of the Income Tax Ordinance, 2001. Since only a fraction of **income tax taxpayers** file returns or statements, a myth prevails that our income tax base is narrow. The fact is that in Pakistan millions pay income tax under various withholding provisions, but do not file returns or statements. **It is, therefore, wrong to say, as claimed by the Chairman FBR, that "only 0.9 percent of the population of the country pays income tax"**. The number of income taxpayers, in fact, is in millions. According to Pakistan Telecommunication Authority (PTA), there were 115 million mobile users as on 30 June 2011. A huge population, not less than 40 million (if we exclude multiple and inactive subscribers), paid 10% income tax for using this facility in tax 2011 (both pre-paid and post-paid connections), but only 513,044 individuals filed income tax returns. FBR did not bother to issue notices to those who paid substantial amount, say Rs. 30,000 or more.

Majority of the mobile users might not have taxable income yet they never bothered to claim the tax withheld as refund by filing tax returns—primarily because it would have cost more than the amount withheld. On the contrary, majority of the rich just pay a fraction of income tax on their colossal incomes—in 2011 as per admission of the Chairman FBR only 6,152 individuals in Pakistan filed tax returns showing taxable income exceeding Rs. 500,000! This confirms beyond any doubt the ineffectiveness and incompetence of FBR. Our tax base is not narrow as nearly 40 million persons are paying income tax at source, but the rich and mighty are not paying taxes on their actual incomes. Unfortunately, Chairman FBR did not speak the truth, failed to mention where the actual problem lies. He intends to give amnesty to the rich and mighty, non-compliant taxpayers rather than taking them to task. Our tax base is not narrow, but punctured—tax system protects the rich and mighty, tax revenue of billions was forgone through SROs, as admitted by the Chairman FBR.

If Pakistan has 10 million individuals having taxable income of Rs. 1.5 million (a very conservative estimate), total income tax collection from them should have been Rs. 3750 billion. If we add income tax collected from corporate bodies, other non-individual taxpayers and individuals having taxable income up to Rs. 1,000,000, the gross figure would be nearly Rs. 5000 billion. FBR collected only Rs. 716 billion as income tax in fiscal year 2011-12—it shows a whopping gap of Rs. 4984 billion in income tax alone.

FBR has been apologetic, specifically before the IMF and the World Bank, that total income taxpayers in Pakistan is less than 1.5 million in a population of 180 million. This is a blatant lie. The truth is that since July 1, 1992 all commercial electricity consumers (including about 5 million retail outlets in urban areas) are paying income tax whether their income is chargeable to tax or not. In 2007, this tax was converted into minimum tax, except for companies and from 2008 with the threshold of Rs. 20,000. Any business outlet receiving electricity bill of exceeding Rs. 20,000 is to pay 10% as advance income tax. The total number of commercial and industrial electricity consumers in Pakistan is more than 20 million. It means that during the tax year 2011, the total number of persons who paid income tax under section 235 of the Income Tax Ordinance, 2001 was not less than 20 million. The FBR in its ***Year Book 2010- 2011*** admitted that tax collection from telephone/mobile and electricity users during the financial year 2010-11 was Rs. 27.56 billion and Rs. 14.31 billion respectively. It is worthwhile to mention that total number of mobile and land-line telephone users, subjected to withholding tax, in this period was in excess of 40 million and yet FBR says that our tax base is narrow! In fact, FBR is hiding its own failure of not taxing the rich to whom concessions and exemptions worth billions of rupees were granted through innumerable SROs.

The above figures negate the claims made by FBR's chief that Pakistan's tax base is narrow. It is a great pity that FBR top man is spreading lies about Pakistanis. The poor people of this country are accused of not paying income tax; whereas the reality is that even a small shopkeeper in a village (whose annual total income is much below the minimum taxable limit of Rs. 400,000) is paying minimum income tax of Rs. 960 per annum. On the contrary, the absentee landlord of his village, who is earning millions by leasing his fruit orchards, is paying negligible amount, if at all, as agricultural income tax. This shows the real dilemma faced by Pakistan—the poor widow pays 10% income tax on meagre bank profit but rich property owner enjoys concessional rate of tax on enormous rental income.

Out of total population of Pakistan, according to *Economic Survey of Pakistan 2011-12*, 45% are below the age of 15 years (they are not income earners, hence cannot be taxpayers). The total labour force stands at 57.2 million, out of which 40 million is rural labour force. Reading all these facts together, the income tax paying population of Pakistan having taxable income during the tax year 2011 could not have been more than 25 million, yet over 40 million paid income tax as mobile users alone. Thus entire taxable population and even those who having below taxable incomes are already paying income tax at source, yet the FBR is engaged in a vicious propaganda that people of Pakistan are not paying income tax and that our tax base is narrow! Can FBR's Chief divulge to people how much tax was paid by the richest 1% of Pakistanis during the last 10 years? They accumulated collossal assets without paying due taxes.

FBR has failed to allot NTNs to all those who paid income tax under section 148,149,150,151,152,153, 153A, 154,155,156, 156A, 156B, 231A, 231AA, 231B, 233, 233A, 233AA, 234, 234A, 235, 236, 236A, 236B and 236C of the Income Tax Ordinance, 2001. Can FBR explain what prevented it to issue notices to the rich and mighty having taxable income to file tax returns under section 116 and/or tax statements under section 115(4) of the Income Tax Ordinance, 2001? Had the FBR done so by using data of banks, PTCL, WAPDA, DHAs, telecommunication companies, provincial excise departments—just to mention a few—we would have over 20 million income tax filers. For its incompetence, inefficiency, lethargy and inactions, FBR cannot blame others. FBR alone is responsible for the prevalent pathetic state of affairs. It is high time that FBR should put its own house in order, enforce tax laws and stop extending unprecedented exemptions and concessions to the rich and mighty segments of society. If Chairman is really sincere in his endeavours to increase tax-to-GDP ratio and number of return filers, he must take stringent action against the richest 0.2 million about whom he promised before the Senate Standing Committee on Finance that proposed amnesty schemes would not be extended. What has he done about them so far is not visible at all?

Comments on significant amendments in Sales Tax Special Procedures (Withholding) Rules, 2007 "STSPR"

Preamble:

STSPR was promulgated vide SRO 660(I)/2007 dated June 30, 2007. The afore-referred SRO was amended from time to time and a major change was brought recently vide SRO 98(I)/2013 dated February 14, 2013, to widened the ambit of withholding agent.

Scope:

This withholding Sales Tax ("ST") is applicable on all taxable goods as elaborated in section 2(39) of Sales Tax Act 1990 and service.

Purpose and Applicability:

The prime purpose of STSPR was to introduce withholding tax era in ST. Prior to the issuance of SRO 98(I)/2013; following categories were classified as withholding agents and were required to deduct withholding tax at the mentioned rates:

Withholding Agent	Rates in %		
	Registered Supplies (% of ST)	**Un-Registered Supplies (% of Invoice)**	**Advertisement Services (% of ST)**
Federal & Provincial Government	20%	13.80%	
Autonomous Bodies	20%	13.80%	
Public Sector Organization	20%	13.80%	
Taxpayers – LTU Jurisdiction registered for ST, IT and /or FED	6.25%		100%
Other Recipient of Advertisement Services			100%

- Invoice amount ***divided*** by 1.16 ***times*** 16% = 13.80%

Amendments vide SRO 98(I)/2013 and impacts:

The ambit of withholding tax regime is enlarged vide aforementioned SRO and consequently companies defined in *Section 80* of Income Tax Ordinance, 2001 and exporters (individuals and AOP also) are designated as withholding agents as well, ergo, update position of withholding agents and applicable rate of deduction is depicted as follow:

Withholding Agent	Rates in %		
	Registered Supplies (% of ST)	**Un-Registered Supplies (% of Invoice)**	**Advertisement Services (% of ST)**
Federal & Provincial Government	20%	13.80%	100%
Autonomous Bodies	20%	13.80%	100%
Public Sector Organization	20%	13.80%	100%
Companies as defined in Section 80 of Income Tax Ordinance, 2001, registered for ST, IT and/or FED	20%	0%	100%
Recipient of Advertisement Services	100%	0%	100%
Registered Exporters	20%	0%	100%

However, following registered supplies are not subject to ST withholding:

1. Electrical energy;
2. Natural gas;
3. Petroleum products as supplies by petroleum production and exploration companies, oil refineries and oil marketing companies;
4. Mild steel products;
5. Products made from sheets of iron or non-steel alloy, stainless steel or other alloy steel, such as pipes, almirahs, trunks etc.
6. Paper, in rolls or sheets;
7. Plastic products including pipes;
8. Vegetables ghee and cooking oil; and
9. Telecommunication services.

Furthermore, ST on advertisement services required to be paid in the Provinces Sindh and Punjab are also not falling within the purview of STSPR.

Significant Changes:

1. Rate of withholding ST with effective February 14, 2013; shall be uniform as portrayed in the aforesaid chart,

2. All companies and/or exporters are required to withhold ST,
3. Previously Individual and AOPs in LTU jurisdiction were required to withhold ST at 1%, are no more required to do the same, and
4. At present, ***sans clarification,*** commercially imported goods paying 3% minimum value addition ST will be subject to a further deduction of 20% and consequently may require claiming refund. – *Courtesy Naveed Zafar Ashfaq Jaffery & Co.*

ST, FED evasion: crackdown extended to sugar, other commodities

The FBR crackdown launched against textile sector has been extended to sugar and other evasion-prone commodities where massive sales tax and federal excise duty (FED) is evaded. Sources told here on Tuesday that the Federal Board of Revenue (FBR) has also launched an operation against the sugar mills involved in evasion of FED paid in sales tax mode.

The ongoing exercise against the textile sector has now been extended to the sugar mills across the country. Beside sugar mills, other items prone to evasion would also be brought into the scope of investigation. The enforcement drive against textile sector and 57 sugar mills would go side by side. This bold action has been approved by FBR Chairman Ali Arshad Hakim and now being enforced by FBR Member Inland Revenue Operations Raza Baqir. The FBR has also decided to invoke prosecution provisions of tax laws to take legal action against the sugar mills involved in tax evasion. Without any discrimination, legal action would be taken against sugar mills whosoever powerful group or lobby it belongs.

The FBR is well-aware of the implications of action against powerful sugar milers, but tax evaders would not be spared. If we can take bold step to take textile sector to task, the same treatment would be given to tax evaders in sugar sector, official said. In a major development on Tuesday, Lahore High Court (LHC) has vacated stay order of sugar mills. Resultantly, the FBR will now post tax officers at all sugar mills to check tax evasion and improve FED collection from this evasion prone sector. The level of evasion in the sugar sector is evident from the fact that a major dip has been witnessed in the payment of the FED by the sugar mills in 2012-13 when compared with 2011-12. Sugar mills have paid around Rs 5 billion as FED during July-January 2011-12 against Rs 3.4 billion in July-January 2012-13, reflecting a major decrease of 25 percent.

Primarily, the FBR would focus on stock-taking and actual production of sugar by deputation of tax officers at mills under Sales Tax Act and Federal Excise Act. The stock taking of mills would help in checking the gross discrepancies in the affairs of the sugar manufactures. The actual physical stocks of sugar would be checked with entries in accounts maintained by the mils. It has been found that the actual stock of the commodity is much more as compared concealed-entries in record and accounts. This has been deliberately done by certain mills to illegal remove huge quantity of sugar from factories without payment of taxes. In cases of major discrepancies in stock taking, the FBR will immediately prosecute such units with maximum punishments specified in the law. Another tool of evasion is that the sugar mills declare low recovery percentage to mis-declare actual production of the commodity with intent to evade taxes. The declaration of the 'low recovery percentage' is a method used by certain mills to conceal the actual production of sugar. – *Courtesy Business Recorder*

US and Isaf cargo: Customs Collector"s approval a must: FBR

The Federal Board of Revenue has made Collector of Customs approval mandatory for transportation of US military or Isaf transit cargo consignment by the bonded carriers in vehicles destined for Afghanistan. The FBR has amended the transshipment rules through an SRO.54(I)/2013 issued here on Tuesday.

According to the amended Customs Rules, for the transportation of US military or Isaf transit consignment by the bonded carrier in vehicles, prior permission shall be obtained from Collector, Model Customs Collectorate of Appraisement, Karachi for each trip after declaring and listing registration number, engine and chassis number, make, model and tare or weight of such vehicles with Customs and getting them inspected. The complete particulars of these vehicles shall be declared in the carrier manifest filed for each vehicle.

The rules further said that for the transportation of US military or Isaf transit cargo the restriction specified under sub-rule (7) of 328 shall not be applicable. Under sub-rule (7) of rule 328 of Customs

Rules, the registered vehicles of one bonded carrier shall not be allowed to be operated by another bonded carrier for the transshipment of cargo to upcountry Dry Ports. The said sub-rule would not be applicable on transportation of US military or Isaf transit cargo, sources added. – *Courtesy Business Recorder*

Suspension of work at AFU costs Rs 40 million loss to exchequer

Customs operations at Air Freight Unit (AFU) came to halt for two days, resulting in revenue loss to the tune of over Rs 40 million to the exchequer. During last two days, the city remained under the grip of tension as protesters, belonging to Shia sect, staged sit-ins at some 22 places in the city to show solidarity with Hazara community after Quetta carnage.

The life in the country's financial hub came to a halt as public transport remained thin, due to uncertain situation. Sources in the customs department told that no Goods Declaration were cleared in two days as no customs official managed to reach AFU because of highly tense situation at Malir area.

Resultantly, the country suffered huge loss in terms of revenue during last two days. According to official estimates, the country suffered a loss of over Rs 40 million in terms of customs duty and taxes only at AFU. They further said the customs department collects around Rs 20 million per day against some 350 GDs from AFU. But no revenue collection was witnessed because of sit-ins that crippled life in Karachi. – *Courtesy Business Recorder*

FBR grants approval for registration of FIRs: six textile units involved in bogus claims

The Federal Board of Revenue has granted approval for registration of FIRs against six textile units, of which four are in Karachi, under the national drive against bogus sales tax refund claims by the textile sector. Official sources told on Tuesday that the Directorate of Intelligence and Investigation Inland Revenue (IR) have obtained necessary approval from the Board for registering FIRs against bogus sales tax refund claimants.

The directorate of intelligence IR would register FIR against four units of Karachi, ie, Naveena Textile, NK Textile, MH Textile and Zeenat Impex. The FIRs would also be registered against two units falling within the jurisdiction of Faisalabad region. The units have massively misused SRO.283(I)2011. The name of the units is Five Industries Multan and Messer King Packages Multan. The agency has also obtained approval under Sales Tax Act 1990 for registration of FIR against one textile unit falling within jurisdiction of KP.

Official said that a number of FIRs and arrests are expected during the current week against the textile units involved in bogus sales tax refund and misuse of zero-rated SROs. During the on-going exercise against the textile sector, 23 units of Large Taxpayer Unit Lahore has caused revenue loss of Rs 522 million on account of inadmissible input tax adjustment on fake invoices.

The directorate of intelligence IR has unearthed different kinds of tax frauds committed by textile units across the country. In Punjab, majority of cases related to the violations of the SRO.283(I)2011 and SRO.1125(I)/2011. In Karachi, agency has unearthed cases of bogus sales tax refund by textile units. In KP, cases of 'missing trader fraud' have been detected where entire supply chain has misused zero-rated notifications etc. Refereeing to a major case of tax fraud in KP, official said that a textile unit of KP issued fake invoices of Rs 4 crore to a leading textile mill of Sindh. The KP-based unit claimed that it has conducted business transactions with the top unit in Sindh. When the agency verified the data from the textile mill in Sindh, the unit out rightly rejected any transaction with the KP based unit. This is height of lawlessness in the country that a fraudulent unit is issuing fake invoices in the name of a leading textile company without any fear. – *Courtesy Business Recorder*

Afghan cargo security: FBR takes fresh precautionary measures

The Federal Board of Revenue has taken fresh precautionary measures to ensure security of Afghan transit trade containers under the Afghanistan-Pakistan Transit Trade Rules, preventing misplacement of transit goods. In this regard, the FBR here on Tuesday amended the Afghanistan-Pakistan Transit Trade Rules through a notification.

According to the amended rules, the containers of transit cargo shall be loaded on trucks in such manner that their door sides shall be securely placed against the truck driver's cabin. Similar precautions shall be taken, to the possible extent, in case of containers of transit cargo transported by Pakistan Railways.

The officer allowing loading shall ensure that container is loaded on the authorised vehicle only. The goods shall be allowed to be moved in containers of international specification or in internationally acceptable and verifiable standard of sealable trucks, as specified under customs seal only, rules added. Following is the text of the notification issued here on Tuesday:

In exercise of the powers conferred by section 219 of the Customs Act, 1969 (IV of 1969), the Federal Board of Revenue is pleased to direct that the following further amendment shall be made in the Custom Rules, 2001, namely. In the aforesaid Rules, in rule 623, after sub-rule (3), the following new sub-rule shall be inserted, namely. "(3A) The containers of transit cargo shall be loaded on trucks in such manner that their door sides shall be securely placed against the truck driver's cabin. – *Courtesy Business Recorder*

Cigarette brands: withdrawal of middle-tier of FED slab proposed

Federal Board of Revenue (FBR) has proposed to withdraw middle tier of Federal Excise Duty (FED) slab on all cigarette brands, which is not only bringing negative impact on the legal tobacco trade, but also on revenue generation from cigarettes manufacturing sector.

The new taxation proposals are meant to generate additional revenues in the second half of current financial year - by bringing all cigarette brands falling in the middle tier to upper tier slab of duty under the Federal Excise Act - attracting 65 percent rate of duty. Consequently the price of pack of cigarette will also shoot up which will compel a larger number of people to opt for cheaper cigarettes, in cost and quality, sold illegally.

It is calculated that the intended proposal will increase most popular brands' retail price by 40 percent. The proposed tax increase is considered to be five times higher than the average disposable income growth for the last year. According to one estimates, if these proposals are approved and implemented, it will result into 20 percent decline in legal industry volume. Already government has been unable to recover billions of losses that illegal cigarette industry has inflicted on it.

The overall volume of illicit trade of cigarettes has reached 22 percent - inflicting a loss of more than 12 billion. There is a stark increase in the volume of illicit trade of cigarettes from 19 percent in 2010 to 22 percent in the current financial year. The sale of such cigarettes has also increased 65 percent. The smuggled foreign brands contribute a major share to the illicit cigarette industry. They are not only inflicting huge losses to the revenue generation but also violating fiscal and health laws. They comfortably evade multiple taxes which legitimate cigarette industry is liable to pay, such as; excise tax, customs duties and value added tax, while 1979 Ordinance compels the cigarette producers to abide by the health laws which also includes printing pictorial health warnings on the cigarette boxes. In case of violation, the accused is liable of two years of imprisonment.

The legal tobacco industry contributes 37 percent of the total Federal Excise Duty (FED) and 3.5 percent of the total FBR revenue. In the first three quarters of 2012 - the compliant tobacco industry contributed 48 billion rupees in various taxes to the national exchequer.

Massive production of counterfeit cigarettes is another form of illicit trade which poses serious dangers to health. They avoid all kinds of taxes, violate copyright laws and pose severe health risks. These are usually made in underground factories under unhygienic and dingy conditions while using contaminated tobacco leaves - with much higher level of nicotine and tar.

Tobacco products are one of the most heavily taxed consumer goods generating a hefty amount of revenues to the government. Unreasonable and ill-considered changes in the excise structure will take the revenue to the illicit sector, leaving the legal industry damaged. – *Courtesy Business Recorder*

FED in sales tax mode: LTU Islamabad issues recovery notices to telecom companies

Large Taxpayer Unit (LTU) Islamabad has issued recovery notices to telecom companies for collection of Federal Excise Duty (FED) in sales tax mode in addition to the provincial sales tax levied by the provinces of Punjab and Sindh, resulting in double taxation on telecom sector.

Sources told here on Tuesday that the Chief Financial officers of six telecom companies have made a collective presentation to the Ministry of Finance which has declared notices of LTU Islamabad as illegal and un-constitutional. They have also opined that such double taxation is against the 7th NFC Award and 18TH Amendment where only provinces can legislate and collect sales tax on service including (telecom services).

CFOs of the telecom companies have requested the Ministry of Finance to invite Chairmen Sindh Revenue Board and Punjab Revenue Authority (PRA) for resolution of the issue. According to the presentation of the six telecom companies duly signed by their CFOs, telecom companies have been served with recovery notices by Large Taxpayers Unit (LTU), Islamabad for charging and collection of Federal Excise Duty (FED) in sales tax mode under Federal Excise Act, 2005 as if it was sales tax under SRO 550(1)/2006 dated June 05, 2006 in addition to the provincial sales tax levied by the provinces of Punjab and Sindh.

The FED/Sales tax is charged and collected by the Federation on telecommunication services in sales tax mode, though after 18th Amendment and 7th NFC award the provinces now levy the same. In particular the province of Sindh through The Sindh Sales Tax on Services Act 2011 and subsequently Punjab through The Punjab Sales Tax on Services Act 2012 have also enacted their respective laws for the levy, charge and collection of sales tax (which replaced the FED to the extent of services provided) in Provinces of Sindh and Punjab.

However, the LTU Islamabad has demanded FED from July, 2012 to November, 2012 which is against the legal framework as enacted through 18th Amendment and 7th NEC award and thereby unconstitutional. If both FED and provincial sales lax are to be charged on rendering of telecommunications services, the aggregate charge would be 39 percent (FED of 19.5 percent + provincial sales tax of 19.5 percent) for services rendered in the provinces of Sindh and Punjab only, which we understand is unconstitutional in post 18th Amendment scenario. The federal government officials on a number of times expressed that after 18th Amendment, only provinces can legislate and collect sales tax on service (including the telecom services). In pursuance of this, FBR has clarified that the Federal Excise Duty (being collected in sales tax mode) have now been subject to sales tax by the provinces though their legislation with effect from, 1st July, 2011. The Federal Board of Revenue through a notification has withdrawn Federal Excise Duty on such services with effect from the same date ie 1st July, 2011 to avoid double taxation, FBR added.

Sources said that the incidence of related FED/ provincial sales tax, which is indirect tax levy, has already been passed on to the cellular mobile subscriber and any further demand of FED/Sales Tax on the same services would be unconstitutional and result in additional cost to the telecom operators, which would be highly detrimental to the business.

Based on the fact that the telecom companies have already collected and deposited FED/ provincial sales tax in the respective jurisdiction, CFOs of the telecom companies be allowed to present their case. They also requested to invite Chairman PRA and SRB for amicable resolution and avoid litigation thereon, CFOs of the telecom companies added. – *Courtesy Business Recorder*

2013 TRI 510 (H.C. Chd.)

HIGH COURT OF PUNJAB & HARYANA AT CHANDIGARH

Hemant Gupta, Ritu Bahri and Gurmeet Singh Sandhawalia, JJ.

The Commissioner of Income Tax, Patiala
v.
M/s Groz Beckert Asia Limited

FACTS/HELD

1. **Expenditure on corporate membership of club is revenue expenditure**
2. The assessee obtained corporate membership of the Golf Club on payment of Rs.6 lakhs. The AO disallowed the expenditure on the ground that it was capital expenditure. This was reversed by the CIT(A) & Tribunal which held that the expenditure was revenue in nature. The department filed an appeal to the High Court and relied on Majestic Auto Ltd where the High Court had held that expenditure on corporate membership is in the nature of capital expenditure. As the Bench was of the view that Majestic Auto was not the correct law, the issue was referred to the Full Bench. HELD by the Full Bench:

    In order to decide whether the expenditure is a revenue or a capital one has to look at the expenditure from a commercial point of view. Not every advantage of enduring nature constitutes capital expenditure. What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be disallowable. If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even though the advantage may endure for an indefinite future. On facts, the corporate membership was for a limited period of 5 years. It was obtained for running the business with a view to produce profit. Such membership does not bring into existence an asset or an advantage for the enduring benefit of the business. It is an expenditure incurred for the period of membership and is not long lasting. By subscribing to the membership of a club, no capital asset is created or comes into existence. By such membership, a privilege to use facilities of a club alone, are conferred on the assessee and that too for a limited period. Such expenses are for running the business with a view to produce the benefits to the assessee. Consequently, it cannot be treated as capital asset (Otis Elevator 195 ITR 682 (Bom), Engineers India 239 ITR 237 (Del), Gujarat State Export Corp 209 ITR 649 (Guj) followed; Framatone Connector OEN 294 ITR 559 (Ker) dissented from; Majestic Auto overruled)

Order accordingly.

ITA No. 366 of 2008.

Decided on: 24th January, 2013.

Present at hearing: Savita Saxena, Advocate, for Appellant. C.S. Aggarwal, Senior Advocate, with Radhika Suri, Advocate, for Respondent.

JUDGMENT

Hemant Gupta, J.–

1. A Division Bench of this Court vide its order dated 31.10.2012 referred the following Question No.5.1 to the Larger Bench in view of the doubt expressed about the correctness of the view of a Division Bench of this Court in ITA No.448 of 2007 titled "*Commissioner of Income Tax – I, Ludhiana vs. M/s Majestic Auto Limited, Ludhiana*" decided on 11.09.2008:

> "5.1 Whether on the facts and in the circumstances of the case, the ITAT was right in law in not sustaining the addition of Rs.6,16,945/- on account of corporate membership fee paid to Golf Club as a capital expenditure?"

2. The said question of law arises out of the fact that the assessee obtained corporate membership of Golf Club, Chandigarh on payment of Rs.6 lacs. Rs.16,945/- was paid towards services and facilities used during the relevant assessment year. The Assessing Officer declined such expenses for the reason that the same are personal expenses of the

Managing Director and other employees and, thus, added back to the income of the assessee. In appeal before the Commissioner of Income Tax (Appeals), the said disallowance was set aside holding that club membership is in the nature of an advantage in the commercial sense and not in the capital field. The Commissioner of Income Tax (Appeals) also considered the remand report dated 17.11.2005, wherein it was observed that the payment is for acquisition of Club Membership, therefore, it is a capital expenditure. The learned Income Tax Appellate Tribunal, Chandigarh Bench – A, (for short 'the Tribunal') affirmed the findings recorded by the Commissioner of Income Tax (Appeals) by observing to the following effect:

> "5. We have considered the rival submissions. Ostensibly, the membership of the club has been acquired by the assessee for the use of its personnel. The CIT(A) has accepted the plea of the assessee that the membership of club was obtained for business purposes in as much as it facilitated interaction with business associates etc. The decision of the CIT(A), in our view is in consonance with the judgment of the Hon'ble Bombay High Court in the case of Otis Elevator Company (I) Limited (supra). The plea of the Revenue that the membership of the club provides an enduring benefit and therefore the expenditure incurred is of capital nature, in our view, is unsustainable. No doubt, payment of membership fee results in obtaining of club membership for a period beyond the year of payment but the benefit remains in the revenue field and not in the capital field. Resultantly, the expenditure incurred on acquiring an enduring benefit in the revenue field is liable to be treated as a revenue expenditure. A gainful reference can be made to the judgment of the apex court in the case of Empire Jute Co. Ltd. 124 ITR 1 (SC) in this regard. Further, the Hon'ble High Court of Gujarat in the case of Gujarat State Export Corporation (supra) has held that the acquisition of club membership results in an advantage in the commercial sense and not in the capital field. On the basis of the aforesaid discussion, we do not find any justifiable reason to interfere with the decision of the CIT(A) on this issue. Accordingly, this ground of appeal of the Revenue is dismissed."

3. In *M/s Majestic Auto Limited's* case (supra), a Division Bench of this Court has dissented with the judgment of Bombay High Court in *OTIS Elevator Company (India) Limited vs. Commissioner of Income Tax* (1992) 195 ITR 682 and agreed with the judgment of Kerala High Court in *Framatone Connector OEN Limited Vs. Deputy Commissioner of Income Tax* (2006) 294 ITR 559 to hold that the expenditure of the assessee company on the corporate membership of the Delhi Golf Club was in the nature of capital expenditure as the same is properly attributable not to revenue but to capital. It is the said view with which

the Division Bench expressed reservation and referred the matter to the Larger Bench. In these circumstances, the matter is placed before this Bench.

4. Learned counsel for the Revenue relied upon the judgment of Kerala High Court in *Framatone Connector OEN Limited's* case (supra), to contend that the corporate membership is a capital expenditure. Such membership has long term advantage to the assessee and, therefore, such expenditure is to the capital field and not to the revenue field.

5. On the other hand, learned counsel for the assessee relied upon *Assam Bengal Cement Co. Ltd. vs. Commissioner of Income Tax, West Bengal* (1955) 27 ITR 34, *Empire Jute Co. Ltd. vs. Commissioner of Income Tax* 124 ITR 1, *Commissioner of Income Tax, Bombay City-I vs. Associated Cement Companies Ltd.* (1988) 172 ITR 257 (S.C), *Commissioner of Income Tax vs. Madras Auto Service (P) Ltd.* (1998) 233 ITR 468 apart from the judgments of Delhi High Court in *Commissioner of Income Tax vs. Engineers India Ltd.* (1999) 239 ITR 237 and of Bombay High Court in *Otis Elevator Co. (India) Ltd. vs. Commissioner of Income Tax* (1992) 195 ITR 682.

6. Having heard learned counsel for the parties, we find that the judgment of this court in *M/s Majestic Auto Limited's* case (supra) is not a correct law for the reasons recorded herein after.

7. Section 37 of the Income Tax Act, 1961 provides that "Any expenditure (not being expenditure of the nature described in Sections 30 to 36) and not being in the nature of capital expenditure or personal expenses of the assessee, laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head 'Profits and gains of business or profession". The expression 'capital expenditure' has been interpreted by the various judgments, starting from Assam Bengal Cement Co. Ltd. case (supra), wherein the Supreme Court approved the opinion of the Full Bench of Lahore High Court in *Benarsidas Jagannath* (1947) 15 ITR 185 and held that it is not easy to define the term 'capital expenditure' in the abstract or to lay down any general and satisfactory test to discriminate between a capital and a revenue expenditure. Some of the broad principles deduced were that, outlay is deemed to be capital when it is made for the initiation of a business, for extension of a business, or for a substantial replacement of equipment and; expenditure may be treated as properly attributable to capital when it is made not only once and for all, but with a view to bringing into existence as asset or an advantage for the enduring benefit of a trade. The expression 'enduring benefit' or 'of a permanent character' were introduced to make it clear that the asset or the right acquired must have enough durability to justify its being treated as a capital asset. The Court observed to the following effect:

> "This synthesis attempted by the Full Bench of the Lahore High Court truly enunciates the principles which emerge from the authorities. In cases where the expenditure is made for the initial outlay or for extension of a business or a substantial replacement of the equipment, there is no doubt that it is capital expenditure. A capital asset of the business is either acquired or extended or substantially replaced and that outlay whatever be its source whether it is drawn from the capital or the income of the concern is certainly in the nature of capital expenditure. The question however arises for consideration where expenditure is incurred while the business is going on and is not incurred either for extension of the business or for the substantial replacement of its equipment. Such expenditure can be looked at either from the point of view of what is acquired or from the point of view of what is the source from which the expenditure is incurred. If the expenditure is made for acquiring or bringing into existence an asset or advantage for the enduring benefit of the business it is properly attributable to capital and is of the nature of capital expenditure. If on the other hand it is made not for the purpose of bringing into existence any such asset or advantage but for running the business or working it with a view to produce the profits it is a revenue expenditure. If any such asset or advantage for the enduring benefit of the business is thus acquired or brought into existence it would be immaterial whether the source of the payment was the capital or the income of the concern or whether the payment was made once and for all or was made periodically. The aim and object of the expenditure would determine the character of the expenditure whether it is a capital expenditure or a revenue expenditure...."

8. The Court culled down the following tests to determine the nature of expenditure:

> "1. Outlay is deemed to be capital when it is made for the initiation of a business, for extension of a business, or for a substantial replacement of equipment: vide Lord Sands in IRC v. Granite City Steamship Co. (1927) 13 Tax Cases 1 at p. 14. In City of London Contract Corporation v. Styles (1887) 2 Tax Cases 239 at p. 243, Bowen L.J. observed as to the capital expenditure as follows:
>
> > You do not use it 'for the purpose of your concern, which means, for the purpose of carrying on your concern, but you use it to acquire the concern.
>
> 2. Expenditure may be treated as properly attributable to capital when it is made not only once and for all, but with a view to bringing into existence an asset or an advantage for the

> enduring benefit of a trade : vide Viscount Cave, L.C., in Atherton v. British Insulated & Helsby Cables Ltd. (1920) 10 Tax Cases 155. It what is got rid of by a lump sum payment is an annual business expense chargeable against revenue, the lump sum payment should equally be regarded as a business expense, but if the lump sum payment brings in a capital asset, then that puts the business on another footing altogether. Thus, if labour saving machinery was acquired, the cost of such acquisition cannot be deducted out of the profits by claiming that it relieves the annual labour bill, the business has acquired a new asset, that is, machinery.
>
> The expressions 'enduring benefit' or 'of a permanent character' were introduced to make it clear that the asset or the right acquired must have enough durability to justify its being treated as a capital asset.
>
> 3. Whether, for the purpose of the expenditure, any capital was withdrawn, or, in other words, whether the object of incurring the expenditure was to employ what was taken in as capital of the business. Again, it is to be seen whether the expenditure incurred was part of the fixed capital of the business or part of its circulating capital. Fixed capital is what the owner turns to profit by keeping it in his own possession. Circulating or floating capital is what he makes profit of by parting with it or letting it change masters. Circulating capital is capital which is turned over and in the process of being turned over yields profit or loss. Fixed capital, on the other hand, is not involved directly in that process and remains unaffected by it."

9. In *Empire Jute Co. Ltd.* case (supra), the Supreme Court was examining the consequences of a time agreement in which the Mills shall be entitled to work their looms. The agreement in question was transfer of allotment of hours of work per week, commonly referred to as sale of loom hours by one member to another. The question examined was; whether the sum paid by the assessee to purchase loom hours represents capital expenditure or revenue expenditure. It was observed that whether it is capital expenditure or revenue expenditure would have to be determined having regard to the nature of the transaction and other relevant factors. It was observed as under:

> "….There may be cases where expenditure, even if incurred for obtaining advantage of enduring benefit, may, none the less, be on revenue account and the test of enduring benefit may break down. It is not every advantage of enduring nature acquired by an assessee that brings the case within the principle laid down in this test. What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be

> disallowable on an application of this test. If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even though the advantage may endure for an indefinite future. The test of enduring benefit is, therefore, not a certain or conclusive test and it cannot be applied blindly and mechanically without regard to the particular facts and circumstances of a given case. But even if this test were applied in the present case, it does not yield a conclusion in favour of the revenue. Here, by purchase of loom hours no new asset has been created. There is no addition to or expansion of the profit-making apparatus of the assessee. The incomeearning machine remains what it was prior to the purchase of loom hours. The assessee is merely enabled to operate the profit making structure for a longer number of hours. And this advantage is clearly not of an enduring nature…."

10. In *Associated Cement Companies Ltd.* case (supra), the assessee under an agreement undertook to supply water and to put up a high tension electric transmission line as well as to supply electricity for the street lighting of a town. The assessee was to undertake and complete at its own cost the water supply scheme for the town involving laying of the main water pipelines. The Supreme Court negated the argument that the water pipelines were laid which could be regarded as capital assets; therefore, the expenditure could only be regarded as capital expenditure. It was observed as under:

> "….It is true that certain water supply lines did come to be laid as a result of the expenditure incurred, but the facts on record which we have referred to above, clearly show that these water pipelines on which the expenditure in question was incurred were not assets of the assessee, but assets of the Shahabad Municipality and hence it was not as if the expenditure resulted in bringing into existence any capital asset for the company. The only advantage derived by the assessee by incurring the expenditure was that it obtained an absolution or immunity, under normal conditions, from levy of certain municipal rates and taxes and charges…."

11. In *Madras Auto Service (P) Ltd.* case (supra), the Supreme Court observed that in order to decide; whether the expenditure is a revenue or a capital, one has to look at the expenditure from a commercial point of view. In the said case, the assessee had a lease of 39 years and also right to demolish the existing premises and construct a new building thereon to suit the purpose of their business. The lessee was not entitled to any

compensation whatsoever on account of its putting up new construction in the place of the old. It was held that the expenditure was made in order to secure a long lease of new and more suitable business premises at a lower rent. The saving in expenditure was a saving in revenue expenditure in the form of rent and that assessee did not get any capital asset by spending such amounts. Quoting from *Assam Bengal Cement Co. Ltd.* case (supra) and in respect of second test of "*any advantage of an enduring nature*", the Court held that by spending money on the construction of new building, the assessee did not acquire any capital asset. The only advantage by spending money was of a low rent. From the business point of view, the assessee got the benefit of reduced rent, which was a business advantage and has to be treated as revenue expenditure. After considering number of judgments, the Court concluded to the following effect:

> "All these cases have looked upon expenditure which did bring about some kind of an enduring benefit to the company as a revenue expenditure when the expenditure did not bring into existence any capital asset for the company. The asset which was created belonged to somebody else and the company derived an enduring business advantage by expending the amount. In all these cases, the expenses have been looked upon as having been made for the purpose of conducting the business of the assessee more profitably or more successfully. In the present case also, since the asset created by spending the said amounts did not belong to the assessee but the assessee got the business advantage of using modern premises at a low rent, thus saving considerably revenue expenditure for the next 39 years, both the Tribunal as well as the High Court have rightly come to the conclusion that the expenditure should be looked upon as revenue expenditure."

12. Applying the principles laid down in the aforesaid judgments, the Bombay High Court in *Otis Elevator Co. (India) Ltd.* case (supra) allowed the payment of club fee as a business expenditure. Similar view was taken by the Delhi High Court in a judgment reported as *Engineers India Ltd.* case (supra) in respect of membership fee of a club. Referring to the judgment in *Assam Bengal Cement Co. Ltd.* case (supra), it was observed that if expenditure is made for acquiring or bringing into existence an asset or advantage for the enduring benefit of the business, it is properly attributable to capital and is of the nature of capital expenditure. If, on the other hand, it is made only for running the business or working it with a view to produce the benefits, it is a revenue expenditure. It was held that payment of membership fee has to be allowed as revenue expenditure. The same view was followed later by Delhi High Court in *Commissioner of Income Tax vs. Nestle India Ltd.* (2008) 296 ITR 682 in respect of membership of a club and in *Commissioner of Income Tax vs.*

Samtel Color Ltd. (2010) 326 ITR 425, wherein the judgment of judgment of Kerala High Court in *Framatone Connector OEN Ltd.* case (supra) was dissented.

13. The Gujarat High Court in a judgment reported as *Gujarat State Export Corporation Limited vs. Commissioner of Income Tax* (1994) 209 ITR 649 examined the payment of fee to the Sports Club of Gujarat Limited. It was held that if expenditure is made for acquiring or bringing into existence an asset or advantage for the enduring benefit of the business, it is properly attributable to capital and is of the nature of capital expenditure. But if it is made for running the business or working it with a view to produce the profits, it is a revenue expenditure. The aim and object of the expenditure would determine the character of the expenditure whether it is a capital expenditure or a revenue expenditure. In view of the tests laid down, it was held that payment of entrance fee for becoming a member of the sports club cannot be termed as a capital expenditure.

14. The Kerala High Court in *Framatone Connector OEN Ltd.* Case (supra) has referred to a judgment rendered by the Supreme Court in *Punjab State Industrial Development Corporation Ltd. vs. Commissioner of Income Tax* (1997) 225 ITR 792 to return a finding that payment of membership, is a payment once and for all, resulting in an enduring benefit to the institution. None of the earlier judgments, referred to above, in respect of nature of capital expenditure were brought to the notice of the Court. The judgment in *Punjab State Industrial Development Corporation Ltd.* case (supra) is, in fact, in respect of expenses incurred for enhancement of capital. The assessee claimed such expenses as revenue expenditure. Since the expenses were incurred for expansion of capital base of the company, it was found to be directly related to capital expenditure. It was held that it would still retains the character of a capital expenditure. The said judgment is in respect of ancillary expenses incurred for expansion of capital. Therefore, the said case does not support the argument in respect of membership of a club.

15. In *M/s Majestic Auto Limited's* case (supra), this Court has followed the judgment of Kerala High Court in *Framatone Connector OEN Limited* case (supra) in preference to the judgment of Bombay High Court in *OTIS Elevator Company (India) Limited* case (supra). None of the judgments of Supreme Court, as mentioned above, were brought to the notice of the Bench.

16. In the present case, the nature of the expenditure incurred by the assessee cannot be said to be a capital expenditure. The second test culled down in *Assam Bengal Cement Co. Ltd.'s* case (supra) is that expenditure should bring into existence *an asset or an advantage for the enduring benefit of a trade*. In the present case, the corporate membership of Rs.6 lacs was for a limited period of 5 years. The corporate membership was obtained for running the business with a view to produce profit. Such

membership does not bring into existence an asset or an advantage for the enduring benefit of the business. It is an expenditure incurred for the period of membership and is not long lasting. By subscribing to the membership of a club, no capital asset is created or comes into existence. By such membership, a privilege to use facilities of a club alone, are conferred on the assessee and that too for a limited period. Such expenses are for running the business with a view to produce the benefits to the assessee. Consequently, it cannot be treated as capital asset. Therefore, the reasoning given by Delhi, Bombay and Gujarat High Courts in respect of members of Clubs is based upon correct enunciations of the principles of law as delineated above in the judgments of the Supreme Court.

17. In view of the above, we find that the judgment of this Court in *M/s Majestic Auto Limited's* case (supra) is not a correct interpretation of expression "capital expenditure". Consequently, the said judgment is overruled.

18. Having answered the question of law, in the manner above, the matter be placed before the appropriate Bench as per roster for decision on the other questions of law.