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Kind regards

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## Section 108 of income tax law: Application of ‘arm’s length principle’

by  
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In order to bring a transaction within the fold of section 108,1 the transaction must be an intra-group service and that too violating the arm's length principle. As regards the arm's length principle, it has been defined in paragraph I of Article 9 of the OECD Model Tax Convention. It provides:

“...Where conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly...” The said paragraph I is the foundation for comparability analysis because it introduces the need for:

- A comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether a re-writing of the accounts for the purposes of calculating tax liabilities of associated enterprises is authorized.
- A determination of the profits which would have accrued at arm's length, in order to determine the quantum of any re-writing of accounts.

Assuming that a disputed transaction was an intra-group service, it is the duty of assessing authority to identify the existence of some arrangements between the parties and to find out the nature of these arrangements. One has to determine what the said arrangements are, and the matter should be considered from the perspective of disputed transaction and from the perspective of the recipient of the goods or service. In this respect, relevant considerations include the value of the goods or service to the recipient and how much a comparable independent enterprise would be prepared to pay for like goods and service in comparable circumstances including the costs incurred by those involved in the transaction. For example, in respect of a financial service, rates offered by commercial banks are neither comparable rates akin to an independent enterprise nor these rates are independent as the same are controlled by the Central Bank and do include manifold considerations of

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the state's monetary policy compared to an independent transaction in the market.

**Further considerations to determine the existence of arm's length include the following:**

- (a) The matter should be considered both from the perspective of the seller and from the perspective of recipient of the goods or service, relevant consideration may be inclusion of the value of the goods or service to the recipient and for how much a comparable independent enterprise is prepared to sell the goods or service at a comparable value.
- (b) From the perspective of an independent enterprise offering goods and service, the seller in that market may or may not be willing or able to supply the goods or service at a price that an independent enterprise is prepared to pay. If the seller can supply the wanted goods or service within a range of prices that the independent enterprise is willing to pay, then a deal may be struck. From the point of view of the seller, a price below which it may not be possible to supply the goods or service including cost to it are relevant considerations to address, but these are not the only necessarily determinative of the outcome in every case.
- (c) There should be a consistency between the controlled and uncontrolled transactions in the categories of cost that are being compared.
- (d) In an arm's length transaction, an independent enterprise normally would seek to charge for goods or services in such a way as to generate profit, rather than providing the goods or services merely at cost. The economic alternatives available to the recipient of the service also need to be taken into account in determining the arm's length charge.
- (e) In determining whether the intra-group services represents the same value for money which is comparable with an independent enterprise becomes a relevant factor, and a comparison of functions and expected benefits becomes relevant factor for assessing comparability of the transactions.

Failing to define the considerations on the basis of which one challenges the disputed transaction not being at arm's length requires evidence and in absence thereof, such challenge will be illegal. It may be important to note here that where the burden of proof lies on the revenue, the tax payer is under no obligation to prove the correctness of its transaction or transfer pricing and it is incumbent upon the revenue to make a prima facie case showing that pricing is inconsistent with the arm's length principle and the taxpayer has failed to do so.

A transaction between associated persons does not become defective only due to the fact that transaction has taken place between the related or

associated parties. It is the availability of comparable evidence on the basis of which a doubt can be casted on such transactions. For example, rule 21 of the Income Tax Rules 2002 is linked with the CUP method, a method of determining transfer pricing. The said method is a reliable method where an independent enterprise sells the same product as is sold between two associated enterprises. For example, an independent enterprise sells unbranded Colombian coffee beans of a similar type, quality, and quantity as those sold between two associated enterprises, assuming that the controlled and uncontrolled transactions occur at about the same time, at the same stage in the production/distribution chain, and under similar conditions. If the only available uncontrolled transaction involved unbranded Brazilian coffee beans, it would be appropriate to inquire whether the difference in the coffee beans has a material effect on the price. For example, it could be asked whether the source of coffee beans commands a premium or requires a discount generally in the open market. Such information may be obtainable from commodity markets or may be deduced from dealer prices. If this difference does have a material effect on price, some adjustments would be appropriate. If a reasonably accurate adjustment cannot be made, the reliability of the CUP method would be reduced, and it might be necessary to select another less direct method instead.

From what was been stated above it is concluded that for invoking Section 108 which refers to the concept of transfer of pricing and is in fact anti-avoidance provision of the tax law, the revenue is required to establish that there was an avoidance of tax.

1. Section 108 reads: Transactions between associates.- (1) The Commissioner may, in respect of any transaction between persons who are associates, distribute, apportion or allocate income, deductions or tax credits between the persons as is necessary to reflect the income that the persons would have realised in an arm's length transaction. (2) In making any adjustment under sub-section (1), the Commissioner may determine the source of income and the nature of any payment or loss as revenue, capital or otherwise.

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**Annual turnover up to Rs five million: Income tax return form for retailers simplified**

The Federal Board Revenue has issued a simplified one-page income tax return form for the retailers having annual turnover upto Rs 5 million to encourage retail sector to voluntarily file their returns. In this connection, the FBR has issued SRO.727(I)/2012 to issue the draft of the new income tax return forms for individuals and Association of Persons (AOPs) for Tax Year 2012.

The FBR has given time period of 15 days to the stakeholders to submit their input on the proposed return forms. The FBR will notify the return forms in the official gazette taking into account viewpoint of stakeholders. The FBR has introduced IT-4 return form for retailers having annual turnover up to Rs 5 million, but not having any other taxable source of income. The retailers would only have to mention the opening stock, net sales during the year, closing stock, turnover tax payable and turnover tax Paid and other related information.

Sources told that the unique feature of the new return form is that the FBR for the first time issued a simplified return form for the retailers having annual turnover up to Rs 5 million. For small and medium retailers, the Board has issued a one-page return form which would improve compliance and encourage documentation. At present, the retailers are reluctant to come forward and file the income tax return forms.

Now, the retailers can easily fill the return form without seeking help of the tax officers, tax consultants, lawyers and chartered accountants. The retailers can themselves file the one-page returns without the help of the tax experts. This would encourage voluntarily return filing by the retails sector. In the presence of the simplified return form, the documentation of the retailers would be improved as it is very easy to fill the simplified returns form by the retailers, who are operating out of the tax net. – *Courtesy Business Recorder*

**Cases under FTR: KTBA for withdrawal of board's policy concession**

Karachi Tax Bar Association (KTBA) has expressed grave concern over the withdrawal of the board's policy concession for cases covered under Final Tax Regime (FTR). According to the letter issued to chairman Federal Board of Revenue (FBR), the

withdrawal of FBR policy concession for cases covered under FTR given vide FBR letter C.No 4936 ITP/2002 dated October, 5th 2009 was made without any consultation through the circular no.4(36)ITP/2002 dated April, 2 2012.

The association said that the cases of importers/ exporters, contractors etc are covered under section 153, where a person's earning income from dividends, interest income are covered under FTR and in these cases, tax is deducted at source by financial institutions and the same is final discharge of tax liability irrespective of the fact whether a tax payer has earned profit and/or suffered loss.

It further said the Bar had made representations to the board in 2009 when field tax offices attempted to select cases of exporters/importers etc which were covered by FTR for audit. The member direct tax (policy) after deliberations issued policy directions to the field offices that if the cases were covered under FTR, no audit should be conducted until any discrepancy was found.

Expressing concern over the issue, the association said that the withdrawal of FBR policy decision of October, 5 2009 without consultation could be counter productive and lead to unnecessary harassment and added that the said decision would not generate revenue but would cause to harass the taxpayers. The association also urged the chairman FBR to look into the matter and make suitable amendments to facilitate the taxpayers at maximum. –  
*Courtesy Business Recorder*

### **SRB seeks to enhance prowess through support**

Sindh Revenue Board (SRB) has asked the International Finance Corporation (IFC) World Bank group, to give technical and financial support in order to strengthen the functions of provincial sales-tax-collection-body, and a proposal in this regard had been moved to IFC authorities a few weeks back. The authorities of SRB had moved a proposal to the IFC on the offer which IFC gave during a meeting held at SRB head office on May 14, sources said.

A mission of IFC comprising Abdul Hakim N K Assad, Mohamed H Baider and Asfandyar Ali Khan had visited the SRB head office and held discussion with SRB authorities over possibility of identifying a project on administration of tax collection, on sales

tax on services future roadmap, and needs of the SRB and IFC, if any required in the matter of capacity building, sources said.

Former Chairman SRB Nazar Hussein Mehar apprised the mission about the background leading to the establishment of SRB, registration of taxpayers and collection matters, response of taxpayers, automation systems developed by SRB itself, future road map and needs of SRB.

The Mission enquired in detail about the registration process and the transfer of data, its current status. The Mission was informed that the SRB had a strong registration system which registered the persons by use of their National Tax Number (NTN) because all persons liable to be registered under the Sindh Sales Tax on Services Act 2011. They were also told that SRB and FBR had a mutual agreement to access each other's data, sources further informed.

The IFC mission had showed interest to help-out the SRB in future particularly in areas of tax collection - how to check sales tax on services evasion/avoidance, develop and support the capacity to monitor and track transactions, develop and support the capacity to conduct risk based audits, support for different IT solutions for administering tax collection by road mapping IT based needs and prioritising them for implementation in phases, sources told. In this connection, a high level official told that SRB had sent proposal to IFC but reply had not come yet. – *Courtesy Business Recorder*