

LECTURE ON INCOME FROM BUSINESS, SPECULATION BUSINESS AND DEDUCTIONS – GENERAL PRINCIPLES

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INCOME FROM BUSINESS (SEC. 18)

Scope:

- (1) The following incomes of a person for a tax year, other than income exempt from tax under this ordinance, shall be charged to tax under the head "Income from Business" –
- (a) The profits and gains of any business carried on by a person at any time in the year;
 - (b) any income derived by any trade professional or similar association from the sale of goods or provision of services to its members;
 - (c) Any income from hire or lease of tangible movable property.

INCOME FROM BUSINESS (SEC. 18)

Scope:

(d) The Fair Market Value of any benefit or perquisite whether convertible into money or not, derived by a person in the course of or by virtue of past, present or prospective business relationship.

Explanation.- For the purpose of this clause, it is declared that the word "benefit" includes any benefit derived by way of waiver of profit on debt or the debt itself under the State Bank of Pakistan, Banking Policy Department, Circular No. 29 of 2002 or in any other scheme issued by the State Bank of Pakistan.

(e) Any management fee derived by a management company including Modaraba Management Company.

INCOME FROM BUSINESS (SEC. 18)

Scope:

- (2) Any profit on debt derived by a person where the person's business is to derive such income shall be chargeable to tax under the head "Income from Business" and not under the head "Income from Other Sources".
- (3) Where a lessor, being a scheduled bank or an investment bank or a development finance institution or a Modaraba or a leasing company has leased out any asset, whether owned by it or not, to other person, any amount paid or payable by the said person in connection with the lease of said asset shall be treated as the income of the said lessor and shall be chargeable to tax under the head "Income from Business".
- (4) Any amount received by a banking company or a non-banking finance company, where such amount represents distribution by a mutual fund or a Private Equity and Venture Capital Fund out of its income from profit on debt, shall be chargeable to tax under the head "Income from Business" and not under the head "Income from Other Sources".

INCOME FROM BUSINESS (SEC. 18)

Scope:

The term “BUSINESS” has been defined in Section 2(10) of the Income Tax Ordinance, 2001 as follows –

(9) “business” includes any trade, commerce, manufacture, profession, vocation or **adventure** or concern in the nature of trade, commerce, manufacture, profession or vocation, but does not include employment.

INCOME FROM BUSINESS (SEC. 18)

Comments:

If any commercial activity which consists any one or all three of the following characteristics, it shall be considered as Income from Business.

- Intention.
- Systematic and organized course of activity.
- Continuity.

INCOME FROM BUSINESS (SEC. 18)

Intention:

The Intention has to be confirmed before deciding an income as "Income from Business". If a person carrying out any commercial activity with the intention of realizing gain, than it should be chargeable to tax under the head "Income from Business", if not, than should be chargeable to tax under any other appropriate head.

Case Law:

Major General (R) M. Jalaluddin V. Assistant Commissioner of Income Tax [2011 PTD 1377 (H.C.Kar.) = (2011) 104 TAX 67 (H.C.Kar.) = PTCL 2011 CL.901]

INCOME FROM BUSINESS (SEC. 18)

Systematic & Organised Course of Activity:

If any income is derived through systematic and organized course of activity than it should be chargeable to tax as "Income from Business". For example, Mr. X has setup an office for providing his services as a Real Estate Consultant, and charge a fixed percentage from his clients. In this case, the commission income earned by him would be chargeable under the head "Income from Business", even if he is doing so it as a part time.

On the other hand, Mr. Y does not have any office or any other organized setup, but intermediate two parties for any commercial activity and charges a fee for his services, than his income could be chargeable to tax under the head "Income from other sources"

INCOME FROM BUSINESS (SEC. 18)

Continuity:

If a person is continuously conducting any commercial activity for the purpose of realizing gain than the income realized from that activity should be charged under the Head "Income from Business".

Examples:

1. Mr. X buy motor vehicles on regular basis and immediately sell those vehicles without registering them on his name, in this case the gain realized on buying and selling of those motor vehicles should be chargeable to tax under the head "Income from Business"
2. On the Other hand, Mr. Y buy motor vehicles and register them on his name. and after using those vehicles in his personal capacity he sell those vehicles. In this case, the gain realized on buying and selling of such motor vehicles could be chargeable to tax under the Head "Capital Gains"

SPECULATION BUSINESS (SEC. 19)

Scope:

- (1) Where a person carries on a speculation business –
 - (a) That business shall be treated as distinct and separate from any other business carried on by the person;
 - (b) This part shall apply separately to the speculation business and the other business of the person;
 - (c) Section 67 of the Income Tax Ordinance, 2001 shall apply as if the profits and gains arising from a speculation business were a separate head of income;
 - (d) Any profits and gains arising from the speculation business for a tax year computed in accordance with this part shall be included in the person's income chargeable to tax under the head "Income from Business" for that year; and

SPECULATION BUSINESS (SEC. 19)

Scope:

(e) Any loss of the person arising from the speculation business sustained for a tax year computed in accordance with this Part shall be dealt with under section 58 of the Income Tax Ordinance, 2001.

(2) In this section, “speculation business” means any business in which a contract for the purchase and sale of any commodity (including [stocks] and shares) is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity, but does not include a business in which —

(a) a contract in respect of raw materials or merchandise is entered into by a person in the course of a manufacturing or mercantile business to guard against loss through future price fluctuations for the purpose of fulfilling the person’s other contracts for the actual delivery of the goods to be manufactured or merchandise to be sold;

SPECULATION BUSINESS (SEC. 19)

Scope:

(b) a contract in respect of stocks and shares is entered into by a dealer or investor therein to guard against loss in the person's holding of stocks and shares through price fluctuations; or

(c) a contract is entered into by a member of a forward market or stock exchange in the course of any transaction in the nature of jobbing [arbitrage] to guard against any loss which may arise in the ordinary course of the person's business as such member.

DEDUCTIONS IN COMPUTING INCOME CHARGEABLE UNDER THE HEAD INCOME FROM BUSINESS (SEC. 20)

(1) Subject to this Ordinance, in computing the income of a person chargeable to tax under the head —Income from Business for a tax year, a deduction shall be allowed for any expenditure incurred by the person in the year wholly and exclusively for the purposes of business.

(1A) Subject to this Ordinance, where animals which have been used for the purpose of the business or profession otherwise than as stock-in-trade and have died or become permanently useless for such purposes, the difference between the actual cost to the taxpayer of the animals and the amount, if any, realized in respect of the carcasses or animals.

DEDUCTIONS IN COMPUTING INCOME CHARGEABLE UNDER THE HEAD INCOME FROM BUSINESS (SEC. 20)

(2) Subject to this Ordinance, where the expenditure referred to in sub-section (1) is incurred in acquiring a depreciable asset or an intangible with a useful life of more than one year or is pre-commencement expenditure, the person must depreciate or amortize the expenditure in accordance with sections 22, 23, 24 and 25.

(3) Subject to this Ordinance, where any expenditure is incurred by an amalgamated company on legal and financial advisory services and other administrative cost relating to planning and implementation of amalgamation, a deduction shall be allowed for such expenditure.

DEDUCTIONS IN COMPUTING INCOME CHARGEABLE UNDER THE HEAD INCOME FROM BUSINESS (SEC. 20)

In a major departure from the RO the new law instead of enumerating various deductions in computing income from business, provides one general principle that "***deductions shall be allowed for any expenditure incurred by the person in the tax year wholly and exclusively for the purpose of business***" prior to 1.7.2004 it was to the extent to which the "***expenditure was incurred in deriving income*** from business chargeable to tax". By inserting sub-section (1A) through Finance Act, 2009 this departure is violated. This special deduction should have been entertained after section 31.

The omnibus clause in the RO – [section 23(1(xviii))] has now become the governing section for all kinds of expenses that are allowable for computing income from business. This will certainly include all kinds of expenses of revenue nature.

DEDUCTIONS IN COMPUTING INCOME CHARGEABLE UNDER THE HEAD INCOME FROM BUSINESS (SEC. 20)

The expression "*in deriving business income chargeable to tax*" has been replaced with "*wholly and exclusively*". The implication is simple as only those expenses will be allowed that are incurred **wholly and exclusively for business** under section 18 and 19. previously these were allowable only if incurred **in deriving income chargeable to tax**. The allowability of expenses was subjected resulting in come chargeable to tax that may not be the case owing to loss, lull in Business or any available exemption. Language employed by Mr. Lee Burns (The Australian tax teacher who was given the task of drafting the new income tax law for Pakistan) has been disapproved time and again by some unknown local experts and rightly so in this case. Apparently both the expressions "in deriving" and "wholly and exclusively" convey the same criterion but was the condition of **income chargeable to tax** a mischief of language or well-thought-for paradigm shift, is the real question. Certainly a great mistake has been timely rectified preventing taxation officers from playing havoc with taxpayers. The amendment will make all the existing case law relevant where the expression 'wholly and exclusively' (which does not mean necessarily) has been explained by the courts and historically too has a well-settled legal connotation in Indo-Pakistan tax statutes.

DEDUCTIONS IN COMPUTING INCOME CHARGEABLE UNDER THE HEAD INCOME FROM BUSINESS (SEC. 20)

Having considered the use of animals (other than stock in trade) in many businesses, the revenue authorities introduced sub-section (1A) for determining the quantum of expenses related to disposal of the carcasses of such animals.

Sub-section (2) says, that where expenditure mentioned in sub-section (1) is incurred in acquiring depreciable asset or an intangible with a useful life of more than one year or is pre-commencement expenditure, the same will be amortized in accordance with the section 22 to 25 of the Income Tax Ordinance, 2001.

DEDUCTIONS IN COMPUTING INCOME CHARGEABLE UNDER THE HEAD INCOME FROM BUSINESS (SEC. 20)

Case laws:

Commissioner of Income Tax, central Zone, Lahore v. Interhome Imperial International Ltd. [2001 PTD 1286 (H.C.Lah.) = (2001) 84 TAX 22 (H.C.Lah.)]

General Engineering Co. v. Income Tax Appellate Tribunal Lahore and others [2005 PTD 1861 (H.C.Lah.) = (2005) 92 TAX 111 (H.C.Lah.)]

DEDUCTIONS NOT ALLOWED (SEC. 21)

- (1) Except as otherwise provided in this Ordinance, no deduction shall be allowed in computing the income of a person under the head —Income from Business for —
 - (a) any cess, rate or tax paid or payable by the person in Pakistan or a foreign country that is levied on the profits or gains of the business or assessed as a percentage or otherwise on the basis of such profits or gains;
 - (b) any amount of tax deducted under Division III of Part V of Chapter X from an amount derived by the person;

DEDUCTIONS NOT ALLOWED (SEC. 21)

(c) any expenditure from which the person is required to deduct or collect tax under Part V of Chapter X or Chapter XII, unless the person has paid or deducted and paid the tax as required by Division IV of Part V of Chapter X:

Provided that disallowance in respect of purchases of raw materials and finished goods under this clause shall not exceed twenty per cent of purchases of raw materials and finished goods:

Provided further that recovery of any amount of tax under sections 161 or 162 shall be considered as tax paid.

DEDUCTIONS NOT ALLOWED (SEC. 21)

(d) any entertainment expenditure in excess of such limits or in violation of such conditions as may be prescribed;

(e) any contribution made by the person to a fund that is not a recognized provident fund , approved pension fund, approved superannuation fund or approved gratuity fund;

(f) any contribution made by the person to any provident or other fund established for the benefit of employees of the person, unless the person has made effective arrangements to secure that tax is deducted under section 149 from any payments made by the fund in respect of which the recipient is chargeable to tax under the head "Salary";

DEDUCTIONS NOT ALLOWED (SEC. 21)

(g) any fine or penalty paid or payable by the person for the violation of any law, rule or regulation;

(h) any personal expenditures incurred by the person;

(i) any amount carried to a reserve fund or capitalized in any way;

(j) any profit on debt, brokerage, commission, salary or other remuneration paid by an association of persons to a member of the association;

DEDUCTIONS NOT ALLOWED (SEC. 21)

(l) any expenditure for a transaction, paid or payable under a single account head which, in aggregate, exceeds fifty thousand rupees, made other than by a crossed cheque drawn on a bank or by crossed bank draft or crossed pay order or any other crossed banking instrument showing transfer of amount from the business bank account of the taxpayer:

Provided that online transfer of payment from the business account of the payer to the business account of payee as well as payments through credit card shall be treated as transactions through the banking channel, subject to the condition that such transactions are verifiable from the bank statements of the respective payer and the payee:

Provided further that this clause shall not apply in the case of:

DEDUCTIONS NOT ALLOWED (SEC. 21)

- (a) expenditures not exceeding ten thousand rupees;
- (b) expenditures on account of —
 - (i) utility bills;
 - (ii) freight charges;
 - (iii) travel fare;
 - (iv) postage; and
 - (v) payment of taxes, duties, fee, fines or any other statutory obligation;

DEDUCTIONS NOT ALLOWED (SEC. 21)

(m) any salary paid or payable exceeding fifteen thousand rupees per month other than by a crossed cheque or direct transfer of funds to the employee's bank account;

(n) except as provided in Division III of this Part, any expenditure paid or payable of a capital nature ; and

(o) any expenditure in respect of sales promotion, advertisement and publicity in excess of Ten per cent of turnover incurred by pharmaceutical manufacturers.

DEDUCTIONS NOT ALLOWED (SEC. 21)

a. Expenditures where withholding tax not deducted

Section 21(c) provided that expenditures on account of salary rent, brokerage or commission, payment to non-resident and payment for services or fee shall be not allowed as deduction in computing the chargeable income, if tax is not deducted and deposited (withholding tax) as required by various provisions of the Income Tax Ordinance, 2001.

DEDUCTIONS NOT ALLOWED (SEC. 21)

a. Expenditures where withholding tax not deducted

This provision is amended by Finance Act, 2016 to expand the scope of deductions not allowed to any expenditure, including purchases of raw materials and finished goods, instead of specified expenditures mentioned above, where (withholding tax) is not deducted and deposited as required by various provisions of Income Tax Ordinance, 2001.

However, in case of purchases of raw materials and finished goods without deduction and deposit of tax (withholding tax) the amount of deduction not allowed will not exceed 20% of the amount of purchase or raw materials and finished goods. It is also provided that tax not deducted and deposited, if otherwise recovered under various provisions of the Income Tax Ordinance, 2001 from the person who had to deduct and deposit or from the person from whom such tax was deductible, will be considered as tax deducted and paid in such a case this section will become inapplicable.

DEDUCTIONS NOT ALLOWED (SEC. 21)

Section 21(o) is inserted by Finance Act, 2016 that restricts the admissibility of any expenditure in respect of sales promotion, advertisement and publicity in excess of five percent of turnover of Pharmaceutical manufacturers.

Prior to 1st July 2004, any expenditure under a single account head exceeding Rs.50,000/- other than by a bank instrument was not allowable except single payment not exceeding Rs.5,000/-. This limit was later enhanced to Rs.10,000/-

Case Laws:

Commissioner Inland Revenue v. Sana Aluminium Industries (Pvt.) Ltd. [2014 PTD 1931 (H.C.Pesh.)]

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