

# Tax Review/Taxation

## Daily Alert Service

**Huzaima & Ikram**  
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This special email service from Monday to Friday, part of subscription package, is aimed at keeping you informed about tax and fiscal matters. It contains news, legislative changes, case-law, in-depth articles and analyses covering all areas of taxes at domestic and international level. On every Saturday evening, we email weekly compilation of the entire material. Every month, *Taxation* in printed form, is sent through post and digital version of *Tax Review International* is made available for download at [www.huzaimaikram.com](http://www.huzaimaikram.com).

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Kind Regards,

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## Concept paper on reverse charge mechanism

by  
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### **B**asic Principles of VAT

There are many differences in the way the value added taxes (VAT) are implemented around the world and across OECD countries (Pakistan is now signatory of OECD). Nevertheless, there are some common core features that can be described as follows:

- VAT is a tax on consumption paid ultimately by final consumers, however, collected by businesses.
- The system is based on tax collection in a staged process with successive businesses entitled to deduct input tax on purchases and account for output tax on sales. Each business in the supply chain takes part in the process of collecting the tax, remitting the proportion of tax corresponding to its margin i.e. on the difference between the VAT paid out to suppliers and the VAT charged to customers. In general, VAT impose the tax at all stages and normally allow immediate deduction of taxes on purchases by all but the final consumer.
- In principle, businesses should not bear the burden of the VAT itself and so there are mechanisms in place that allow for a refund or credit of the tax levied on transactions between businesses.
- Generally, VAT is not part of business decision or feasibility when the total sales are liable to VAT. However, in case sales are exempt from VAT, the respective VAT paid on purchases shall be the cost to the businesses.
- The application of VAT to international trade is based on the destination principle. This means that exports are free of VAT and imports are taxed on the same basis and at the same rate as local production. This destination principle is sanctioned by World Trade Organization rules.

### **Introduction of Reverse charge**

In many VAT systems that operate an invoice – credit method, the VAT on cross-border business-to-business supplies of services and intangibles are collected by the reverse charge mechanism. This is a tax mechanism that switches the liability to pay the tax from the supplier to the customer.

### **What is its scope?**

The reverse charge does not apply to supply of services where both the supplier and the customer belong to the same country. It only applies where services are supplied from one country by a supplier and are received by a service recipient of the other country.

**What is the effect of the reverse charge?**

If you can attribute the input tax due under the reverse charge to your taxable supplies/services (and so can reclaim it in full) then the reverse charge has no net cost to you. If you cannot (because, for example, you make exempt supplies/services) the effect is to make you pay VAT and that will be your cost.

**Reverse charge mechanism and its adjustment under Pakistan Sales Tax Federal and Provincial Laws.****1. Goods****1.1 Reverse charge Mechanism**

Sales tax on VAT mode is being collected at import stage on the taxable goods on the concept of reverse charge basis under section 3(3)(b) of the Sales Tax Act, 1990 [ST Act] in a manner that a person is liable to pay sales tax on the goods imported by him.

- 1.2 Adjustability of sales tax paid at the time of import of goods under reverse charge mechanism is allowed under section 2(14)(b) read with section 7 of the ST Act. However, sales tax paid on reverse charge under provincial laws cannot be adjusted under section 2(14)(d) read with section 7 of the ST Act due to the fact that FBR webportal is not accepting the similar NTN of buyer (i.e. service recipient) and supplier of goods.

**2.2 Services**

After 18<sup>th</sup> Amendment of the Constitution of Pakistan, services are made taxable under provincial domain.

**3. Sindh Sales Tax on Services Act, 2011. [SSTS Act].**

- 3.1 Under section 3(2) of the SSTS Act a service that is not provided by a registered person shall be treated as a taxable service if the service is listed in the Second Schedule to SSTS Act and is provided to resident person by a non-resident person in the course of economic activity. Here, for the sake of discussion we treat non-resident person as a person living outside Pakistan. Under section 9(2) of the SSTS Act, where a service is taxable by virtue of sub-section (2) of section 3 the liability to pay the tax shall be on the person receiving the services.

**3.2 Adjustability of sales tax under Reverse charge Mechanism**

The adjustability of sales tax is allowed in SSTS in a way that in case a person receiving or procuring taxable services from a non-resident service provider based in a country outside Pakistan paying standard rate of sales tax.

**4. Punjab Sales Tax on Services Act, 2012 [PSTS Act]**

- 4.1 Reverse charge mechanism is illustrated under section 4(5) of the PSTS Act where rendering of taxable service originates from outside Pakistan but is received or terminated in Punjab, the recipient of such service shall be liable to pay the sales tax to the PRA.

#### 4.2 Adjustability of sales tax paid on Reverse Charge Basis

Under Rule 6 of the Punjab Sales Tax on Services (Adjustment of Tax) Rules, 2012 no input tax adjustment is allowed which is paid under reverse charge mechanism inspite of paying standard rate of sales tax on services.

#### 5. KPK Finance Act, 2013 [KPK Act]

5.1 Reverse charge mechanism is illustrated under section 20(5) of the KPK Act where rendering of taxable service originates from outside Pakistan but is received or terminated in Khyber Pakhtunkhwa, the recipient of such service shall be liable to pay the sales tax to the KPK.

#### 5.2 Adjustability of sales tax paid on Reverse Charge Basis

Under Rule 49(2) of the KPK Draft Rules, no input tax adjustment is allowed which is paid under reverse charge mechanism inspite of paying standard rate of sales tax on services

#### 6. Baluchistan Sales Tax on Services Act, 2015 [BSTS Act]

6.1 Reverse charge Mechanism is illustrated under section 4(5) of the BSTS Act where rendering of taxable service originates from outside Pakistan but is received or terminated in Baluchistan the recipient of such service shall be liable to pay the sales tax to the BRA.

#### 6.2 Adjustability of sales tax paid on Reverse charge basis.

Adjustability of sales tax paid on Reverse charge basis is not expressly defined in the BSTS Act. However, since the Balochistan sales tax is taken on VAT mode, sales tax paid on reverse charge basis should be allowed.

Moreover, the BRA has almost adopted the SRB law and borrowed e-portal of SRB we understand that there would not be any problem in availing sales tax adjustment paid under Reverse charge Basis.

#### Conclusion and Recommendation

Sales tax paid under reverse charge basis is a valid input tax for adjustment under VAT mode as is being allowed in the case of acquisition of local taxable goods & services. Input tax on reverse charge mechanism is just like an input tax which is paid on import of goods and is allowed for adjustment.

Where the provincial sales tax laws do not allow adjustment against sales tax paid on reverse charge basis, the companies may firstly approach to the authorities to allow such input tax explaining the concept of VAT mode. On their denial, the companies may approach the High Court for legal remedy as was being done in the case when the FBR was not allowing input tax on the sales tax paid under provincial laws. Whereby, during the hearing before the High Court, Companies' lawyers pleaded that the sales tax under ST Act is taken on VAT mode and the sales tax paid under provincial laws is also under VAT mode and therefore, the input tax is the valid input tax for adjustment VAT mode. Consequently,

the High Court has given the order that the sales tax paid under provincial laws is allowed to the Companies. Now, the ST Act has also made necessary amendment in the section 2(14) of the ST Act allowing companies to take input tax paid under provincial laws. However, allowability of adjustment of sales tax paid on services under reserve charge mechanism against output under ST Act still needs to be settled either through dialogue with FBR or through Court.

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**One-window refund system can be introduced: FBR**

The Federal Board of Revenue (FBR) can introduce a simple one-window system for obtaining refunds by those persons, who are not liable to file returns, but paying higher rates of withholding tax being treated as 'non-filers'.

Speaking as a guest in 'Paisa Bolta Hai' of Aaj News with Anjum Ibrahim here on Sunday, FBR Member and Spokesman Dr Muhammad Iqbal said, "We would try to introduce some system to simplify process for obtaining refunds, by those who are not liable to file returns but pay higher rates of withholding tax on different transactions."

Under the law, everyone, who intends to obtain refund, has to file return electronically. Obviously, the law has been specified for those having taxable income, but the same law is applicable to everyone. This is also applicable to cases of pensioners and students for which they have to get electronic registration with the FBR. Ideally, there should be a system to issue refunds to them under one-window operation.

Tax lawyer Waheed Shahzad Butt suggested that the budget (2017-18) introduce a one-widow facility for those seeking refunds in cases where persons are not liable to file returns and pay taxes. If the FBR wanted to maintain a difference between the filers and non-filers for the payment of withholding tax, the FBR should simplify procedure for the payment of refunds to those not liable to file returns.

The persons, who are not liable to file returns, should not go through the cumbersome process of enrolment/registration electronically.

He said that the difference between filers and non-filers should be maintained to ensure payment of taxes by those doing businesses but not registered with the tax department. However, it is unjustified to collect withholding tax from those who are not obliged to file income tax returns like students, housewives and pensioners. The Commissioner concerned having jurisdiction over non-filers must be empowered by the FBR to issue exemption certificates to those paying higher rates of withholding taxes, but not liable to file returns. The exemption certificates be issued to avoid deduction of tax from those not liable to file returns.

The FBR is getting revenue from non-filers, but such persons have included the amount of withholding tax paid in their cost of doing

business. The FBR can easily collect data of non-filers from bank transactions where tax has been deducted as non-filers, Waheed Shahzad Butt added.

To a query, the FBR spokesman stated that two major policy initiatives have been implemented in the past. Firstly, real estate and stock exchanges were properly brought under the regime of capital gains tax. Secondly, higher rates of withholding tax have been collected from non-filers of income tax returns to increase their cost of doing business.

When asked why family unit cannot file return collectively, he said that every individual has to file return having taxable income under the law. In Pakistan, if all transactions are documented, it is easy to differentiate between the filers and non-filers.

About the Tax Directory of Parliamentarians, Dr Muhammad Iqbal said that the level of compliance has been improved following publication of tax directory of Parliamentarians every year. Since publication of tax directory, there is a substantial increase in contribution made by the Parliamentarians. The FBR is issuing Annual Tax Directories includes names of parliamentarians, corporations, Association of Persons (AoPs) and individuals. Tax Directory of Parliamentarians covers tax details of all Members of Senate of Pakistan and the National Assembly of Pakistan and the Provincial Assemblies. It is easy to pick non-filer Parliamentarians on the basis of filers mentioned in the tax directory, the FBR Member added. – *Courtesy Business Recorder*

### **Number of return filers up by 50 percent, ECC told**

The Economic Co-ordination Committee of the Cabinet was informed that there is 50 percent increase in the number of income tax return filers during the current fiscal year as compared to the same period of 2015-16. Sources told here on Saturday that the meeting of the ECC chaired by Finance Minister Ishaq Dar was submitted a proposal by the Federal Board of Revenue (FBR) for extension in date for reduced rate of 0.4 percent withholding tax on banking transactions for non-filers.

The ECC was further informed that through Finance Act 2015, a new section 236P was introduced in the Income Tax Ordinance 2001, whereby an adjustable advance income tax at the rate of 0.6 percent of the amount of transaction was levied which was to be collected by banking companies on all banking instruments and

other modes of transfer of funds through banks in case of persons who do not file income tax returns.

However, through the Income Tax (Amendment) Act 2016, the federal government was empowered to amend the rate of 0.6 percent on the recommendations of Economic Co-ordination Committee of the Cabinet. In exercise of these powers, the federal government reduced the rate from 0.6 percent to 0.3 percent up till 29-02-2016 and, subsequently, to 0.4 percent w.e.f. 1st March 2016 to 31st December, 2016, on the recommendations of ECC of the Cabinet. As recommendation of ECC of the Cabinet is mandatory, therefore it is proposed that the Economic Co-ordination Committee of the Cabinet may recommend to the federal government to extend the period of applicability of reduced rate of 0.4% to 31st March 2017 on banking transactions for non-filers under section 236P of the Income Tax Ordinance, 2001. Finance Minister Ishaq Dar has approved its submission to the ECC of the Cabinet, sources added. – *Courtesy Business Recorder*

### **FBR cuts ST on POL products**

The Federal Board of Revenue (FBR) has reduced sales tax on different petroleum products from January 1, 2017 including high speed diesel oil, kerosene and light diesel oil. According to an SRO.1180(I)/2016 issued by the FBR, sales tax on motor spirit remains unchanged at 14.5 percent.

Sales tax rate on kerosene has been reduced from two percent to zero percent from January 1. Sales tax on high speed diesel oil has been decreased from 31 to 25.5 percent, reflecting a decrease of 5.5 percent. – *Courtesy Business Recorder*

### **Inter-city movement of POL products: government data to be used to finalise GST formula**

The federal and provincial data pertaining to crude oil production/supplies, petroleum products and effective sales tax rate on POL products would be used to finalise an equitable mechanism or formula for sales tax collection on the services of inter-city transportation of POL products.

According to the letter of Member Tax Reforms Commission (TRC) Ashfaq Tola, who has been assigned to submit a comprehensive report on this issue, he sought data pertaining to 2015-16 and 2014-15 from the Ministry of Petroleum for finalisation of the



equitable mechanism or formula for sales tax collection on the services of inter-city transportation of petroleum (POL) products. The exercise is aimed at resolving issue between the Federal Board of Revenue (FBR) and provincial sales tax authorities regarding input tax adjustment on provincial sales tax on the services of inter-city transportation of POL products.

The letter of the member TRC has referred to a meeting held at the Ministry of Petroleum & Natural Resources to resolve the issue between the FBR and provincial sales tax authorities regarding input tax adjustment on provincial sales tax on the services of inter-city transportation of POL products. He was assigned to submit a comprehensive report on an equitable mechanism for collection of sales tax on services of inter-city transportation of petroleum products.

In this connection, information will be required for the last two years ie form July 2014 to June 2015 and from July 2015 to June 2016 preliminary: local crude oil production (in barrels) for each province; quantity of crude oil supplied to refineries within the province by each province (in barrels for each province); quantity of crude oil supplied to refineries outside the province by each province (in barrels) and quantity of petrol and diesel originated by each province from OMCs and supplied to each province and areas under Federation in following format (in litres).

Data also included average rent of Oil Tankers per litre with respect to supplies both within and inter-province for each province in the format as under (Oil Tankers Contractors' Association may be directed to provide this information): The member TRC has also sought data pertaining to the effective sales tax rate (after adjustment of input taxes) with respect to each provincial revenue authority/board and FBR for the last two years.  
– *Courtesy Business Recorder*

**S.R.O. 1180(I)/2016, Islamabad, the 31<sup>st</sup> December, 2016.**– In exercise of the powers conferred by clause (b) of sub-section (2) and sub-section (6) of section 3 of the Sales Tax Act, 1990, the Federal Government is pleased to direct that the following further amendment shall be made in its Notification No. S.R.O. 57(I)/2016, dated the 29<sup>th</sup> January, 2016, namely:–

In the aforesaid Notification, for the existing Table, the following shall be substituted, namely:–

“TABLE

<b>S. No.</b>	<b>Description</b>	<b>PCT heading</b>	<b>Rate</b>
(1)	(2)	(3)	(4)
1.	Motor spirit excluding HOBC	2710.1210	14.5% <i>ad valorem</i>
2.	Kerosene	2710.1911	0% <i>ad valorem</i>
3.	High speed diesel oil	2710.1931	25.5% <i>ad valorem</i>
4.	Light diesel oil	2710.1921	0% <i>ad valorem</i> .”