PBC's Comments on the Finance Bill 2016

The Pakistan Business Council on June 9th, 2016 submitted its formal position on the Finance Bill 2016 in a letter addressed to the Honorable Finance Minister Mr. Ishaq Dar. The PBC in its letter pointed out that the Budget was more of the same with no innovative thinking for increasing the tax base. Though PBC supported some of the measures for increasing investments in the industrial and agricultural sectors, it expressed its disappointed that certain measures had been recommended in the Finance Bill which will have severe repercussions for the competitiveness of Pakistani businesses. Some of these measures include the extension of Super Tax for one year, the proposal to disallow service taxes paid to the provinces, the proposal to withdraw exemption on the inter-corporate dividends, the proposal to increase the rate of tax on foreign contracts etc. The detailed letter is attached.

The Pakistan Business Council
FOSTERING ECONOMIC GROWTH
(A Company set up under Section 42 of the Companies Ordinance 1984)

Ehsan A. Malik
Chief Executive
8th Floor, Dawood Centre,
M. T. Khan Road,
Karachi-Pakistan.
PABX : 35630528-29
Fax : 3563 0530
e-mail: ehsan.malik@pbc.org.pk

9th June 2016

Mr. Muhammad Ishaq Dar
Federal Minister for Finance, Revenue, Economic Affairs, Statistics and Privatization
Government of Pakistan
Islamabad

Dear Honorable Minister,

Finance Bill 2016

The Pakistan Business Council (PBC) congratulates the government for delivering, under your economic leadership, the highest GDP growth in eight years; containing inflation to the lowest level in ten years; managing lending rates at a four-decade low; and achieving record foreign exchange reserves. With the decline in commodity prices globally, Pakistan is on the cusp of a unique opportunity. There is no better time than the present to make the critically needed structural reforms, and as mentioned in your post-budget speech, to create a national consensus on the economy. The PBC, through its National Economic Agenda (NEA) has also been advocating national consensus on economic policies to ensure consistent implementation by successive governments. As the voice of manufacturing and services businesses with large stakes in and long-term commitment to fostering economic growth, PBC would be delighted to provide a platform for political parties, academics and other stakeholders to come together to forge a common national economic agenda.

The measures proposed in your budget speech to boost value-added exports of goods and to help revive the agricultural sector are welcome. In addition the proposal for extension in tax credits for fresh investments in manufacturing sector are appreciated. However, opportunity to accelerate the documentation of the economy does not appear to have been fully availed. The consequence is a very evident and growing reliance on a narrow set of existing tax payers for funding the revenue side of the budget. The budget proposals to retain Super Tax; disallow full set off of group losses; tax inter-corporate dividends; enhance the tax rate on services executed abroad; disallow set off of GST paid to provinces; recover Alternate Corporate Tax in advance - all add to the burden of the existing tax payers. There are a number of other anomalies that need to be removed and suggestions to promote growth which we also outline.

Documentation of the economy and broadening the tax base:

The budget proposals to subject non-filers to further or higher rates of withholding taxes may meet short term cash flow objectives. However, there are no concrete proposals to widen the tax base. WHT on non-filers is tantamount to levying fines on motorists who repeatedly violate traffic rules but allowing them to continue to do so at will and without other consequence. It is pertinent to mention that withholding taxes are eventually passed on by non-filers to consumers and the formal sector, thus raising the cost of living and doing business. The PBC had pointed out to FBR the need to effectively mine the data of millions of tax deductions that the formal sector provides each month when acting as unpaid tax collectors. Furthermore until FBR's powers to inflict arbitrary audits and other measures bordering on harassment of existing tax payers are curbed, avoidance of withholding taxes alone will not provide incentive to non-filers to join the tax base. For the budget to be truly development oriented, the fundamental flaw of funding from a narrow tax base must be addressed boldly and urgently. Much has been made of the 60% increase in tax collected over three years. It would be enlightening to see how much of this came from broadening the tax base. Indeed that i.e. contributions made by new taxpayers should be the main KPI by which FBR's performance is judged henceforth.

In our proposal to the FBR, we had recommended that presumptive tax should not be treated as final liability but that it should be determined on the basis of assessement. We had also raised the critical need to strengthen the competiveness of domestic industry adversely impacted by smuggling, under-invoicing, dumping and the misuse of the Afghan transit treaty. In this context, the budget would have been a good opportunity to assure existing industry that it would not be impacted adversely by concessions proposed for SEZs under CPEC.

Denial of Input Tax relief:

A fundamental departure has been proposed in sales tax regime which is governed under the VAT Principle. The definition of Input tax has been proposed to be amended to exclude the Sales tax paid under respective Provincial laws. In economic sense, this would imply dual indirect taxation in the country as indirect taxes paid to Provinces shall not reduce the incidence of sales tax paid to Federation. It is suggested that the VAT principles should be completely adhered to. In addition to the above, input tax adjustment will not be available, if the supplier has not declared such supply in his return or has not paid tax due as per his return. This amendment effectively means that an eligible input tax shall become inadmissible for the buyer only for the reason that the supplier of goods has not declared such supply in his return of sales tax or has not paid the tax due. The validity of the aforesaid amendment needs to be examined with reference to the timing and relationship / control which a buyer could have on the conduct of supplier.

Tax on Services and Contracts executed abroad

Presently gross receipts from services rendered and construction contracts executed outside Pakistan are taxed at 1% of the amount remitted – this is the same rate which is applicable on remittances received against the export of goods. The budget proposes to increase this to 3.5%-4% for companies and 3.75%-5% for others. The manifold increase in tax on services is inconsistent with the widely recognized need to encourage the broad basing of exports. This should be reconsidered.

Group Taxation:

Through the Finance Bill 2016, the exemption for inter-corporate dividends in a group structure prescribed under section 59B is proposed to be abolished. Further, it has been proposed to add a restriction in section 59B whereby the surrender of losses will be restricted to the percentage holding of the holding company in the entity surrendering the losses.

The concept of Group Taxation and Group Relief was introduced on the basis of a detailed study carried out by a Task Force, constituted by the Chairman FBR, for the Review of Law relating to Holding Companies and included representatives of FBR, SECP, ICAP and PBC. The Task Force submitted its report in May 2007 and its recommendations were duly incorporated through Finance Act 2007 through amendments in section 59B. This was an important initiative for Pakistan's taxation system and economy, aimed at streamlining the group ownership structures and centralizing the complicated cross-company ownership to make the corporate sector internationally competitive.

One important feature of the section 59B is the elimination of incidence of double taxation on inter-corporate dividend. In the absence of exemption of tax on inter-corporate dividends, double or sometimes even triple taxation arises, i.e. the companies first pay tax on their profits and when inter-group dividends are distributed, these are taxed again in the hands of the receiving company and are further taxed on distribution to the shareholders of the parent company when distributed as dividends.

Another important feature further developed through section 59B is 'Group Relief' whereby the business loss of a group company is allowed to be surrendered for set-off against income of another company within the group subject to certain conditions. The idea is to revive the subsidiary company's business without giving any chance for trading in loss at the cost of state revenue. One of the major conditions for surrender of losses under group relief is the maintenance of substantial interest or control in the subsidiary company (55% to 75%) by the holding company. It is an internationally accepted principle that with control, an entity assumes the right to govern all the assets and liabilities of another entity in their entirety including losses. To impose a limitation on the right of the holding company to utilize such losses (based on holding percentage) would not only be economically unjust but would also be against the concept of group taxation under internationally accepted norms.

It is pertinent to mention that in the wake of these tax measures, the large industrial groups of the country have made considerable corporate structural changes and made huge investments creating new employment opportunities and significant contribution to the national exchequer in the last decade. As a result of such steps towards corporatization, new profitable companies have been enlisted on the country's stock exchanges boosting the country's image. The consolidation of corporate sector for emergence of financially and technically strong groups compatible with international corporations is the need of time so as to effectively play in the competitive environment of international market. The amendments proposed through the Finance Bill 2016 will hamper the confidence of these large industrial groups and discourage group formation as it will become economically more adverse compared to direct holding in companies. Further, these will cause a drastic change in the investment strategies of many major industrial groups and dis-incentivize investment due to dilution of profit from the holding company. Accordingly, we are of the view that proposed amendments in the Finance Bill be withdrawn.

WHT on Distributors of FMCG:

Distribution of fast moving consumer goods is high turnover and low margin business. The average gross margin of distributors ranges between 3%-8%. Whilst the budget proposes a reduction in WHT from 4% to 3.5% of gross sales, it still represents more than 50% of the distributors' gross margins and a very high multiple of their net margin. The FBR has already acknowledged the peculiar business dynamics of the FMCG distribution industry by reducing the rate of minimum tax to 80% of the WHT rate. Keeping in view the same rationale we suggest that the rate of WHT on FMCG distributors should be reduced to 80% of the basic rate of 4% i.e.to 0.8%.

Super Tax:

Through Finance Act 2015, Super Tax was imposed on i) banking companies; and ii) other taxpayers having income of Rs.500 million or above at the rate of 4% and 3% respectively for tax year 2015 only. The Finance Bill proposes to extend this levy for tax year 2016 as well. Further, it is now proposed that for the computation of income for the purpose of levy of super tax, depreciation and business loss shall not be taken in to account. This proposed change in the computation method will result in higher incidence of tax and also in depriving a taxpayer from the benefit of investing in the country. Whilst continuation of a one-time tax levied for a special purpose last year is in itself unjustified and if unchallenged will risk its perpetuation, denial of depreciation and offset of losses to large tax payers who already contribute substantially to the exchequer is inequitable. The PBC urges you to reconsider both.

Alternate Corporate Tax (ACT) for Computation of Advance Tax:

ACT on accounting profit of businesses that incur a net loss, post allowable depreciation, is in principle unjustified. The proposal to charge it in advance is untenable and should be reconsidered.

CPEC:

CPEC has the potential to transform Pakistan in numerous ways. However, its success is contingent on the readiness of Pakistan public and private sector to execute its obligations. One impediment is the capacity of existing domestic capital market to provide long term Rupee finance. PBC believes that an infrastructure investment bank established with government and multilateral assistance is required.

Real Estate:

Real Estate remains largely outside the formal sector and is used to hide wealth. Raising the rate of tax on transactions is a short-term cash flow measure. A more sustainable solution would be for the federation and provinces to jointly and simultaneously adjust valuations to realistic levels, whilst lowering the rates of tax. If also accompanied by a tax regime which encourages REITs and long term mortgage solutions for the middle class, the formalization of this large sector will accelerate. PBC notes the increase in tax deductible amount on housing loans proposed in the budget. Whilst this is a step in the right direction, the real constraint for development of mortgages is absence of 10+ years financing. PBC can work with the State Bank of Pakistan to outline possible solutions.

PBC members represent 10% of Pakistan's GDP, contribute 16% of tax revenues, generate 23% of exports and employ over 250,000. They belong to 13 manufacturing and services sectors and include MNCs from 11 countries, all with substantial on-ground investment. The PBC looks forward to engaging with you on fostering growth and to provide a platform to build national consensus on the economy.

Yours faithfully,

Ehsan Malik

Cc: Mr. Haroon Akhter, Special Advisor to the PM on Revenue
Chairman, Federal Board of Revenue