Basic Concepts of Income Tax

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Objective

The objective of this presentation is to:

- Develop an understanding of some fundamental principles of taxation;
- Discuss the dynamics of income tax law of Pakistan;
- Identify Person liable to tax and the extent of their taxability;
- Have an overview of tax year;
- Capture an overall structure of the Income Tax Ordinance, 2001;

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SOME BASIC CONCEPTS

Power to Tax

- Entry No. 47 and 48 of the Federal Legislature List as contained in Part I of the Fourth Schedule to the Constitution of Pakistan, 1973, empowers the Federal Government to impose tax on income and corporations respectively.

- Entry No. 49 of the said List also empowers the Federal Government to levy taxes on the sales and purchases of goods imported, exported, produced, manufactured or consumed in Pakistan.

Territorial Jurisdiction of Tax Laws

- The tax laws extends to whole of Pakistan. The territories of Pakistan under the Constitution means:
  - the four provinces viz Balochistan, KPK, Sindh, and Punjab;
  - the federal capital; and
  - such states or territories as are or may be included in the territories of Pakistan, by accession or otherwise.
- Respective areas of FATA and PATA now stand merged into Khyber Pakhtunkhwa & Balochistan. Such areas are now subject to the tax laws of Pakistan.
- Azad Jammu & Kashmir and Gilgit-Baltistan are currently autonomous regions. They have adopted the Income tax law of Pakistan with certain modifications.

Special Provisions of Law to Prevail Over General Provisions

- Where a law provides for a specific treatment in respect of a particular category of, say, income, person or class of persons, the same would prevail over the general provisions of the law.

Ordinance to Override Other Laws on Income Tax Matters

- Per section 3 read with section 54, the Income Tax Ordinance, 2001 has supremacy over all other laws in relation to Income tax matters.

Income- General Meaning

- All receipts by a person do not necessarily constitute 'income'.
- Generally income is the money received for work done or investment.
- Generally, income connotes a periodical monetary return, 'coming in' with certain regularity from a definite source.
- Generally, capital receipts are not taxable unless they are specifically provided in the tax law to be taxable.
- Conversely, revenue receipts are generally almost always taxable (being income), unless they are explicitly provided as not to be taxable.

Income- General Meaning (Contd.)

- Capital receipts generally arise out of Capital assets, e.g. disposal of a personal house, disposal of personal belongings, receipts without consideration etc.

- Certain capital receipts deemed as “income” for tax purposes include:

  - Golden handshake payment on cessation of employment.

  - Gain on disposal of capital assets, including jewellery, painting, immovable property including personal house, etc.

Income- General Meaning (Contd.)

- Certain revenue receipts which should otherwise be taxed but not taxed include:
  - Agricultural income.
  - Income of diplomats and foreign government officials.
  - Income of institutions like State Bank of Pakistan, Indus hospital, Shaukat Khanum hospital etc.

Expenditure - General Meaning

- The term ‘expenditure’ means ‘spending’ or ‘paying out or away’, i.e., something that goes out of the coffers of the taxpayer. It means something which is gone irretrievable.

- Expenditure, not being capital or personal expenditure, is an allowable deduction to the taxpayer in the tax year, provided that expenditure is incurred to earn income.

- Capital expenditure, in the nature of depreciable assets and intangibles, is allowed in the form of depreciation and amortization.

Income under the Ordinance

- As per Section 2(29) of the Ordinance, income has the following scope:
  - income as understood in normal parlance.
  - any amount chargeable to tax under the Ordinance.
  - any amount subject to collection or deduction of tax under the Ordinance as a final discharge of tax liability.
  - any amount “treated” as income under the Ordinance.
  - loss of income is also income.

Classes of Income Vs Heads of Income

- There are different classes of income, including:
  - salary (arising out of employment).
  - income from property (being rental income from immovable property).
  - royalty (on account of use of or right to use intellectual property).
  - profit on debt / interest (on funds lent to others).
  - dividend (from shares held by the investor).

Classes of Income Vs Heads of Income (Contd.)

- There are only five heads of income in which each of such class of income is to be classified. These heads are :
  - Salary.
  - Income from Property.
  - Income from Business.
  - Capital gains.
  - Income from Other Source.

Classes of Income Vs Heads of Income (Contd.)

- Categorization of a particular class of income into a particular head of income is dependent on the person who is deriving such income and therefore may differ from one person to another.

TAX AND ITS DYNAMICS

Tax [S:2(63)]

- The Ordinance levies a tax on income derived by a Person in a tax year

- The term "tax" means any tax imposed under the Ordinance. This includes:
  - Any penalty
  - Any fee
  - Any other charge; or
  - Any sum or amount

leviable / payable under the Ordinance.

Schemes of Taxation

- Broadly, there are two schemes of taxation:

  - **Normal Tax Regime** – whereby bottom line income, after allowing for all admissible deductions, are taxed at applicable rates.

  - **Final Tax Regime** – whereby tax is levied on the gross amount, without admissibility of any expense.

Income under the FTR is identified and specific with the result that all other income is taxable under the NTR. However, in certain cases, where the FTR applies, the tax payer has an option to apply NTR on fulfillment of certain conditions.

Normal Tax Regime - NTR

- Under the Normal Tax Regime, tax is imposed on the “taxable income” under various heads of income of a taxpayer by applying the rates as prescribed in the First Schedule.

- The computation of income and tax under NTR is governed by the provisions of sections 9, 10 and 11 of the Ordinance.

- For each head of income, there may be certain expenses which can be claimed as deduction. Moreover, against the tax liability under NTR, certain specified tax credits including credit of the amount of tax deducted from the taxpayer is available.

- Tax Payable / (Refundable) with Return = Tax - Tax Credits.

- Tax = Taxable Income x Rate of tax.

Taxable Income (S:9)

- Taxable income of a person for a tax year shall be the total income of the person for the year, excluding exempt income, reduced by the total of any deductible allowances allowed under the Ordinance for the year.
- Taxable Income = Total Income – Deductible Allowance - Exempt Income
- However, the total income cannot be reduced below zero by reason of any deductible allowances.

Total Income (S:10)

- The total income of a person for a tax year shall be the sum of:
  - Person's income under following heads of income:
    - Salary; (Sec. 12)
    - Income from Property; (Sec. 15)
    - Income from Business; (Sec. 18)
    - Capital Gains; (Sec. 37 and Sec. 37A)
    - Income from other sources; (Sec. 39)
  - Person's income exempt from tax under any of the provisions of the Ordinance.
- Total Income = Salary + Income from Property + Income from Business + Capital Gains + Income from Other Source + Exempt Income.

Deductible Allowance

- A deductible allowance represents an amount that directly reduces the total income to arrive at the taxable income for the year.

- Following deductible allowances are available in a tax year, to a taxpayer:
  - Zakat paid by the person.
  - Any amount paid to Worker's Welfare Fund by the person.
  - Any amount paid to Worker's Participation Fund by the person.
  - Tuition fee paid provided that the taxable income of the individual is less than one and half million rupees.
  - Deductible Allowance = Zakat + Workers' Welfare Fund + Workers' Profit Participation Fund + Tuition Fee

Tax Credits

- "Tax credits" represent amounts that reduce the tax liability for the year.

- Following tax credits are available under the Ordinance:
  - Foreign tax credit.
  - Tax credit on charitable donations.
  - Tax credit for contribution to an approved pension fund.
  - Tax credit for employment generation by manufacturers.
  - Tax credit for point of sale machine.

Tax Credits (Contd.)

- Tax credit for existing industrial undertakings.
- Tax credit for certain persons.
- Tax credit for specified industrial undertakings.
- Advance tax paid on quarterly basis.
- Withholding income tax.

Summary

- Tax Payable / (Refundable) with Return = Tax – Tax Credits
- Tax = Taxable Income x Rate of tax
- Taxable Income = Total Income – Deductible Allowance – Exempt Income
- Total Income = Salary + Income from Property + Income from Business + Capital Gains + Income from Other Source + Exempt Income
- Deductible Allowance = Zakat + Workers' Welfare Fund + Workers' Profit Participation Fund + Tuition Fee

Final Tax Regime – FTR

- Under section 4(5) of the Ordinance, amounts subject to tax under FTR are not to be included in the computation of "Taxable Income".
- Sections 8 and 169 of the Ordinance, being the governing sections prescribe the following distinct features of income governed under FTR:
  - Income falling under FTR shall not be chargeable to tax under any head of income. Therefore such Income does not constitute "Total Income" or " Taxable Income".
  - No deduction is allowable for any expenditure incurred in deriving the income falling under FTR i.e. income is taxable on gross basis.
  - The income shall not be reduced by any deductible allowance or any set off of losses.
  - The tax payable on the gross income shall not be reduced by any tax credits.

Final Tax Regime – FTR (Contd.)

- Examples of income that are subject to FTR include but are not limited to the following:
  - Dividend income earned by an individual shareholder.
  - Receipt on account of export of goods.
  - Royalty and Fee for Technical Services received by a non-resident person.
  - Prizes and winnings.

PERSON SUBJECT TO TAX

Persons Liable to Tax

- The Ordinance tends to tax the income derived by a person.
- Following are the main categories of persons:
  - Federal Government.
  - Foreign Government.
  - Political sub division of a foreign government.
  - International organization.
  - Individuals.
  - Association of Persons.
  - Companies.

Extent of Income Liable to Tax

- The extent of a person's income which is liable to tax is dependent on its residential status in Pakistan.
- A Resident person is liable to tax in Pakistan, both in respect of Pakistan source as well as foreign source income.
- Non-resident person is liable to tax in Pakistan only in respect of Pakistan source income.

- A resident person for a tax year is:
  - A resident individual
  - A resident company
  - A resident Association of persons
  - The Federal Government

Resident Individual (S:82)

- Residential status of an individual is based on number of days he is physically present in Pakistan during a tax year. Therefore, a foreigner can also be a resident person and a Pakistani national may become non resident for tax purposes.

- An individual shall be a resident individual if:
  - he is present in Pakistan for an aggregate period of 183 days or more in a tax year;
  - An individual who is an employee or official of the Federal Government or a Provincial Government posted abroad in a tax year is always considered as resident irrespective of his physical stay in Pakistan.
  - being a citizen of Pakistan is: i) not present in any other country for more than one hundred and eighty-two days during the tax year; or ii) who is not a resident taxpayer of any other country

Resident Company (S:83)

- A company shall be a resident company, if:
  - It is incorporated in Pakistan.
  - It is a Provincial Government or a Local Government.
  - A company shall also be a resident company, if the control and management of the affairs of the company is situated wholly in Pakistan at any time in the year, even if it is not incorporated in Pakistan.

Resident Association of Person (S:84)

- An association of person shall be resident in Pakistan if the control and management of the affairs of the association is situated wholly or partly in Pakistan at any time in the year.

TAX YEAR

Tax Year

- Income derived by a person in a tax year is taxable
- Normal tax year is from 01 July to 30 June
- Adopting any other 12 months period may be allowed which is called a special tax year
- The Government has prescribed special tax year for certain persons, including:
  - Insurance companies
  - Companies manufacturing sugar
  - All persons exporting rice
- Interim period between the normal tax year and the special tax year, or vice versa, is called the transitional tax year

OVERVIEW OF STRUCTURE OF INCOME TAX ORDINANCE, 2001

Structure of Income Tax Ordinance, 2001

- The Income Tax Ordinance, 2001 (the "Ordinance") comprises of 242 Sections and Fourteen Schedules
- The Ordinance is supported by Income Tax Rules, 2002
- Broadly these sections could be categorized into two categories, viz; Charging provisions, and Administrative provisions
- Charging sections generally lay the principle as to how the income is to be computed and taxed. Mainly these provisions are captured from section 4 to 113C of the Ordinance.

Structure of Income Tax Ordinance, 2001 (Contd.)

- Primarily these sections represent:
  - Charge of Tax (sections 4 - 8)
  - Tax on Taxable Income (sections 9 - 65E)
  - Common Rules in relation to income (sections 66 - 79)
  - Provisions Governing Persons (sections 80 - 98C)
  - Special Industries (sections 99 - 100E)
  - International (sections 101 - 107)
  - Anti-Avoidance (sections 108 -112)
  - Minimum Tax (sections 113, 113C)

Structure of Income Tax Ordinance, 2001 (Contd.)

- Administrative sections generally deal with the modus operandi of the charging provisions of the law. These provisions include:
  - Procedure (sections 114 - 206A)
  - Administration (sections 207 - 230I)
  - Transitional Advance Tax Provisions (sections 231 - 236)
  - Miscellaneous (sections 237 - 242)

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