BUSINESS INCOME: TAXATION & EXEMPTION, DEPRECIATION, AMORTIZATION, DEPRECIATION LOSSES & BUSINESS LOSSES

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TOPICS

- Business Income
- Tax Expenses
- Exemptions
- Set off and Carry forward of losses
- Deductible Allowances
- Tax Credits

Business Income

What is business?

- In common parlance, any commercial activity, occupation or trade is considered as a business.
- Under the income tax law, business includes trade, commerce, manufacture, profession or vocation
- Employment is not considered as a business
- Income from Business deals with two types of businesses:
    - Normal business
    - Speculation business – Considered separate and distinct

What constitutes “income from business”

- Profits and gains of any business carried on by a person at any time in a year
- Income derived by any trade, professional or similar association from the sale of goods or provision of services to its members
- Income from the hire or lease of tangible movable property;
- Fair market value of any benefit or perquisite derived by a person due to any past, present, or prospective business relationship
- Management fee derived by a management company (including a modaraba management company)

Income from Business – Special cases

Profit derived by a person whose business is to derive such income:

- Profit on debt derived by a person where the person's business is to derive such income is considered as **"Income from Business"** and not "Income from Other Sources".

Lease rentals received by lessor:

- Income from lease of assets, whether owned or not, is considered as "income from business" where the lessor is-
  - a scheduled bank
  - an investment bank
  - a development finance institution
  - a modaraba
  - a leasing company

Tax Expenses

Allowable deductions – Basic criteria

- Deduction against business income is allowed for-
  - An expenditure
  - incurred by a person in a tax year
  - **wholly and exclusively for the purpose of business**

- Expenditure incurred for:
  - acquisition of depreciable assets,
  - acquisition of an intangible asset
  - Pre-commencement expenditure

is to be depreciated / amortized in accordance with specific sections and is **not allowed as a straight deduction**.

Inadmissible deductions (Cont'd…)

- Any cess, rate or tax levied on the profits or gains of the business or assessed as a percentage of such profits or gains
- Tax deducted from an amount derived by the person (sections 149 to 158)
- Payment for an expenditure on which deduction / collection of tax was required, unless the person has paid OR deducted and paid the tax so required
- Commission paid **to a non-filer** for supply of products listed in Third Schedule of the Sales Tax Act, where commission exceeds 0.2% of gross amount of supplies
- Entertainment expenditure in excess of prescribed limits or in violation of prescribed conditions

Inadmissible deductions (Cont'd…)

- Contribution to non-approved / non-recognized retirement funds (provident fund, pension fund, superannuation fund or gratuity fund)
- 50% of the contribution made to approved retirement funds viz. gratuity fund, approved pension fund or superannuation fund
- Any fine or penalty paid or payable for the violation of any law, rule or regulation
- Any personal expenditure
- Amount capitalized / transferred to a reserve fund
- Profit on debt, brokerage, commission, salary or other remuneration paid by an AOP to a member of such AOP
- Any capital expenditure

Inadmissible deductions (Cont'd…)

- Salary paid exceeding **PKR 32,000 per month to an individual** other than by banking channel / digital mode
- Sales promotion, advertisement and publicity expense in excess of **10% of turnover** incurred by pharmaceutical manufacturers
- Expenditure for utility bills in excess of prescribed limits
- Expenditure attributable to sales made by an industrial undertaking to persons not registered for sales tax purposes (though required to be registered) computed in the **sales ratio**. Disallowance is restricted to 10% of total deduction
- Expenditure attributable to sales claimed by any person required to integrate point of sales with Board but fails to do so. Disallowance is restricted to 8% of total allowable deduction

Inadmissible deductions (Cont'd…)

- Payment made by a **non-corporate taxpayer,** otherwise through banking instrument / banking channel, where annual payment under a single account head in aggregate exceeds PKR 250,000.

- Verifiable online transfers from and to the business accounts as well as payments through credit cards are considered as transactions through banking channel.

- Payments excluded from applicability of Clause 21(l) are-
  - Expenditures not exceeding PKR 25,000
  - Expenditures on account of utility bills, freight charges, travel fare, postage and payment of taxes, duties, fee, fines or any other statutory obligation

Inadmissible deductions (Cont'd…)

- Payment made by **corporate taxpayers**, otherwise through digital means from declared bank account, where annual payment under a single account head in aggregate exceeds PKR 250,000

- Digital means refers to digital banking or online banking, where transactions are carried out over the internet.

- Exclusions from applicability of Clause 21(la) are similar to those prescribed under Clause 21(l)

- Effective date of applicability of Clause (la) has not been notified yet. Hence, provisions of Clause 21(l) would continue to apply in case of corporate taxpayers.

Depreciation – Section 22

- Depreciation deduction is allowable in respect of **depreciable assets** used in person's business in a tax year at the specified rates applied on the opening Written Down Value (WDV)

- WDV in the year of acquisition is the cost less initial allowance. For subsequent years, WDV is the cost less total depreciation deductions allowed including initial allowance

- Where an asset is used for earning **exempt income from business**, admissible depreciation is treated to be allowed in the years of exemption. Consequently, WDV after expiration of exemption period will be calculated after reducing total admissible depreciation deductions including initial allowance.

Conditions for claiming depreciation

- For claiming depreciation, following conditions are to be satisfied–
  - The asset is a depreciable asset
  - Ownership is of the person claiming deduction
  - Depreciable asset is used (wholly or partly) in person's business
- In case of partial use of depreciable asset, fair proportional amount of deprecation is allowed.
- Total deductions allowed restricted to the cost of the asset
- Cost allowable for depreciation in case of **passenger transport vehicle not plying for hire** is restricted to **PKR 7.5 million**. Sale proceeds upon disposal are also to be restricted in equal proportion.

What is depreciable asset?

- Depreciable asset means-
  - Tangible movable property, immovable property (other than unimproved land), or structural improvement to immovable property
  - Owned by the person
  - has normal useful life exceeding one year
  - is likely to lose value as a result of normal wear and tear, or obsolescence
  - is used wholly or partly **in deriving income from business chargeable to tax**
- Any asset for which entire cost has been allowed as a deduction under any other section is not a depreciable asset

Depreciation - Other rules

- Gain on disposal of a depreciable asset is treated as “income from business”. Similarly, loss on such disposal is allowable as a business expense

- Cost of immovable property/ structural improvement to immovable property shall not include cost of the land

- Where consideration received on disposal of immovable property exceeds its cost, consideration received shall be treated as the cost – **Recoupment of depreciation allowed as gain on disposal**

- In case of export of a depreciable asset, the cost will be treated as the consideration received.

Initial allowance – Section 23 (Cont'd…)

- Initial allowance is allowed as a deduction where an **eligible depreciable asset** is placed into service in Pakistan for the first time in a tax year

- Deduction is allowed on later of the following–
  - tax year in which the asset is used for business purposes for the first time in a tax year
  - tax year in which commercial production is commenced

- Initial allowance is presently calculated at 25% of the cost of the asset.

Initial allowance – Section 23

- Eligible depreciable asset means a depreciable asset other than-
  - Road transport vehicle not plying for hire (i.e. vehicle that cannot be hired by others for fare)
  - Furniture and fittings
  - Plant or machinery used previously in Pakistan (i.e. Second hand plant or machinery purchased from within Pakistan).
  - Plant or machinery, the entire cost of which has been allowed as a deduction under any other section in the year of acquisition
  - Immovable property or structural improvements

Amortization on intangibles – Section 24

- Amortization deduction is allowable in respect of cost of person's intangible asset that:
  - is wholly or partly used in deriving income from business chargeable to tax, and
  - has normal useful life exceeding one year
- Amortization is calculated based on the number of days the asset is used in a tax year
- Total deductions allowed restricted to the cost of the asset
- Intangible not having an ascertainable useful life shall be treated to have a normal useful life of **<u>25 years</u>**
- Definition of an intangible asset excludes self generated goodwill

Pre-commencement expenditure – Section 25

- Pre-commencement expenditure is not allowed as a straight deduction instead it shall be amortized on a straight-line basis at 20% i.e. amortized over a period of 5 years.
- "Pre-commencement expenditure" means any expenditure incurred before the commencement of a business **wholly and exclusively** to derive income chargeable to tax, including-
  - the cost of feasibility studies
  - construction of prototypes
  - trial production activities
- Expenditure incurred in acquiring land or allowed as depreciation / amortization is not a pre-commencement expenditure.

Bad debts – Section 29 (Cont'd…)

- Bad debts are allowed as a deduction subject to following conditions **<u>simultaneously</u>**-
  - amount of the debt was previously included in the person's income from business chargeable to tax
  - the debt is written off in the accounts of the person in the tax year; and
  - there are reasonable grounds to believe that the debt is irrecoverable
- The deduction allowed is restricted to the amount of debt written off in the accounts

Bad debts – Section 29

- Where bad debt is allowed and subsequently any amount in respect of such debt is received, following tax treatment applies-

Actual bad debt expense	A	25	25
Bad debt expense allowed	B	20	20
Amount already taxed	C = A – B	5	5
Amount recovered	D	10	3
Excess amount / (Shortfall)	E = D - C	5	(2)
Tax treatment		**Taxable**	**Deductible**

Exemptions under the Ordinance

Exemptions

Different exemptions / concessions have been provided in the Second Schedule, subject to any conditions prescribed therein. Such exemptions / concessions are categorized as under-

- Exemptions from total income – **Part I**
- Reduction in tax rates – **Part II**
- Reduction in tax liability – **Part III**
- Exemption from specific provisions of the Ordinance – **Part IV**

Exemption from total income – Part I

- **[57(3)] -** Income of following funds and institutions-
  - a provident fund to which the Provident Funds Act, 1925 applies
  - trustees on behalf of a recognized provident fund / approved superannuation fund / approved gratuity fund;
  - a benevolent fund or group insurance scheme approved by FBR
  - Service Fund
  - Employees Old Age Benefits Institution established under EOBI Act
  - any Unit, Station or Regimental Institute
  - any recognized Regimental Thrift and Savings Fund, the assets of which consist solely of deposits made by members and profits earned by investment thereof.

Exemption from total income – Part I

- a Pension Fund approved by the Securities and Exchange Commission of Pakistan under the Voluntary Pension System Rules, 2005
- any profit or gain or benefit derived by a pension fund manager from a pension Fund approved under the Voluntary Pension System Rules, 2005, on redemption of the seed capital invested in pension fund as specified in the Voluntary Pension System Rules, 2005
- International Irrigation Management Institute.
- Punjab Pension Fund established under the Punjab Pension Fund Act, 2007 and the trust established thereunder
- Sindh Province Pension Fund established under the Sindh Province Pension Fund Ordinance, 2002.

Exemption from total income – Part I

- Punjab General Provident Investment Fund established under the Punjab General Provident Investment Fund Act, 2009 and the trust established thereunder
- Khyber Pakhtunkhwa Retirement Benefits and Death Compensation Fund
- Khyber Pakhtunkhwa General Provident Investment Fund
- Khyber Pakhtunkhwa Pension Fund

- **(66)** - Income derived by institutions, foundations, societies, boards, trusts and funds specified in **Table I**
- **(66) -** Income derived by institutions, foundations, societies, boards, trusts and funds specified in **Table II** subject to section 100C

Exemption from total income – Part I

- **(99) -** Income derived by a Collective Investment Scheme or a REIT Scheme where at least 90% of the accounting income for the year is distributed amongst the unit or certificate holders or shareholders.
- **(103A) -** Income derived from inter-corporate dividend within group companies entitled to group taxation under section 59AA provided group return has been filed for the tax year.
- **(145A)** - Income which was not chargeable to tax prior to the commencement of the Constitution (Twenty-fifth Amendment) Act, 2018 of any individual domiciled or company and association of persons resident in the Tribal Area forming part of the Provinces of Khyber Pakhtunkhwa and Balochistan under the Constitution [from 01 June 2018 to 30 June 2024 (both days inclusive)].

Set off and carry forward of losses

Set off of losses – Section 56

- Where a person sustains a loss for **any tax year** under **any head of income**, it is entitled to set off such loss against income chargeable to tax **under any other head for the year**, **except salary income.**

- In case of loss under more than one head, **loss from business** shall be set off last.

- Loss not fully set off in a year shall not be allowed to be carried forward to the next tax year unless specifically provided in the Ordinance.

Carry forward of business loss – Section 57

- In case a business loss is not wholly set off in the year of its occurrence, remaining loss **shall be** carried forward to the following tax year (**maximum 6 tax years**) and set off **against business income only**.

- In case of multiple years' losses, loss of the earliest tax year shall be set off first.

- In case of a banking company, time limit for carry forward is 10 years

- In case of a resident company engaged in hotel business in Pakistan, time limit for carry forward is 8 years.

Carry forward of unabsorbed depreciation / Amortization – Section 57

- In case of loss arising due to unabsorbed depreciation / amortization in a year, such unabsorbed depreciation / amortization shall be carried forward to subsequent year (for an indefinite period) and is allowed to be set off against 50% of the person's balance business income for the following year (i.e. after first setting of any unutilized business loss)

- The above limit of 50% will not apply where taxable income for the year is **less than PKR 10 million**.

Carry forward of speculation business loss – Section 58

- Any loss for a tax year in respect of speculation business can only be set off against speculation business income for that year

- Unutilized speculation loss can be carried forward to the following tax year (maximum six years) and applied against speculation business income in that year

- In case of multiple years' losses, loss of the earliest tax year shall be set off first.

Carry forward of capital loss – Section 59

- Capital loss cannot be set off against any other head of income for the year **instead** shall be carried forward to the next tax year (maximum six years) and set off against chargeable capital gain for that year.

- In case of multiple years’ losses, loss of the earliest tax year shall be set off first.

Carry forward of capital loss on specified securities – Section 37A

- In case of a loss sustained on **specified securities under section 37A**, such loss can be set off only against capital gain on specified securities during the year and no loss shall be carried forward to the subsequent tax year.

- **As an exception**, where the above loss relates to tax year 2019 or onwards, such loss may be carried forward to the following tax year (maximum 3 years) and set off only against gain from disposal of specified securities under section 37A.

Deductible Allowances

Deductible allowances

- Deductible allowance means an allowance that is deductible from total income
- Any such allowance can neither create a taxable loss (i.e. deduction allowed can only reduce total income upto zero and not below) nor can be refunded

Zakat, WWF and WPPF – Sections 60, 60A & 60B

- Zakat paid under Zakat and Ushr Ordinance, 1980 can be claimed as a deductible allowance except Zakat already claimed as a deduction against profit on debt will not be considered for claiming deductible allowance.
- Zakat not able to be deducted in a year shall not be refunded, carried forward to a subsequent tax year, or carried back to a preceding tax year.
- Workers' Welfare Fund or Workers Participation Fund paid in a tax year under Federal law or any Provincial laws (after the eighteenth Constitutional amendment Act 2010) is claimable as a deductible allowance.
- WWF / WPPF paid by a trans-provincial establishment to a provincial authority is not claimable as a deductible allowance.

Tax Credits

Charitable donations - Section 61

- A tax credit is allowed in respect of any sum paid / any property given by a person in a tax year as donation, voluntary contribution or subscription to-

Institution	Condition
Any board of education or any university in Pakistan	Established by or under a Federal or a Provincial law
Any educational institution, hospital or relief fund	Established or run in Pakistan by • Federal Government • Provincial Government; or • Local Government
Any non-profit organization or any other person	Eligible for tax credit under section 100C
Entities, organizations and funds	Mentioned in the Thirteenth Schedule

Charitable donations - Section 61

- Credit allowed is computed as under:

(A/B) x C

Where:

- **A -** is the amount of tax assessed for the tax year before any tax credit;
- **B -** is the taxable income for the tax year; and
- **C -** is the lesser of:
  - total donation paid
  - 30% of the taxable income for the year – in case of an individual or AOP; **OR**
  - 20% of the taxable income for the year – in case of a company

Charitable donations - Section 61

- In case where donation is paid to an associate by a donor, the limit of taxable income provided in component C would be reduced by 50%

- Tax credit is only allowed subject to fulfilment of following conditions-
  - In case of donations in cash - Only if it is paid by a crossed cheque drawn on a bank
  - In case of donation in kind - Fair Market Value of the property determined at the time it is given

Tax Credit for employment generation by manufacturers – Section 64B

- A company formed for establishing and operating a new manufacturing unit
- Sets up a new manufacturing unit (treated to have been setup on the date on which the manufacturing unit is ready to go into production, whether trial production or commercial production)
- between the 01 July 2015 and 30 June 2019 (both days inclusive)
- Is allowed a tax credit for a period of **ten years**
- Tax credit is allowable at 2% of the tax payable for every fifty employees registered with EOBI or ESSI of Provincial Governments during the tax year
- Maximum tax credit is allowable upto 10% of the tax payable

Tax Credit for employment generation by manufacturers – Section 64B

- Tax credit under section 64B shall be allowable where all of the following conditions are met:

S.#	Condition	Description
(a)	company is incorporated and manufacturing unit is setup between	01 July 2015 and 30 June 2019 (both days inclusive)
(b)	No. of employees	50 employees in a tax year registered with EOBI & ESSI of Provincial Government
(c)	Manufacturing unit managed by	company formed for operating the said manufacturing unit and registered under the Companies Ordinance, 1984 and having its registered office in Pakistan
(d)	manufacturing unit is not established by	splitting up / reconstruction / reconstitution of an undertaking already in existence or by transfer of machinery or plant from an undertaking established in Pakistan at any time before 01 July 2015

Tax Credit for point of sale machine – Section 64D

- Any person integrating with FBR’s computerized system for real time reporting of sale or receipt, is entitled to tax credit in respect of the amount invested in purchase of point of sale (POS) machine.
- The tax credit for a tax year in which POS machine is **installed, integrated and configured** with FBR’s computerized system is the lesser of –
  - amount actually invested in purchase of POS machine;
  - PKR 150,000 per machine
- POS machine means a machine meant for processing and recording sale transactions for goods or services in an internet enabled environment.

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