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TAX PAK

NEWSLETTER BY TOLA ASSOCIATES

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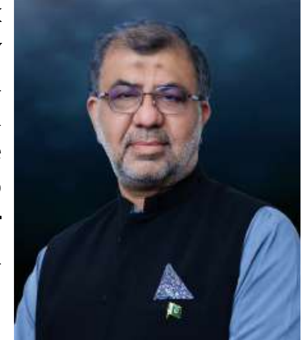

We are back yet again with our monthly issue of "Tax Pak". This the 25th Edition of this newsletter, and by now we hope we have been able to keep you updated with the recent developments in the Tax system of Pakistan. By the blessing of Allah Almighty, we keep on striving with dedication and devotion, to keep all our readers updated with regards to major developments and recent legislations passed and their effect on our tax system.

We have once again enlightened our readers with important developments, be it in the form of Statutory Regulatory Orders, Regulations passed, or a landmark case decided by an Honourable Court within the jurisdiction of Pakistan.

In this edition of Tax Pak, we have highlighted notifications issued by the Tax Regulatory Authorities and, to the best of our abilities, have tried clarifying them, in order to enable a layman, or a professional within the industry understand them better from a technical point of view.

Moreover, we have discussed an essential verdicts relating to Sales Tax which may aid in understanding and the applicability of the Sales Tax Laws.

Just like always we end our newsletter with an interesting topic of the month, which in this issue is "*Royalties*". Our commitment to educate our readers, with regards to international taxation, remains firm as we publish our 25th edition of this newsletter.

We are delighted to let our readers know through this forum, that we have decided to apprise them of the main economic indicators, and a detailed analysis of the balance of trade of Pakistan. The initiative came to fruition last month only, when we published two new monthly issues, namely; "*Pakonomics*" and "*Trade Pak*". The new additions are valuable in sense of their contribution towards understanding of economic developments and their impact on general consumers, business individuals as well as their salaried counterparts.

Readers are requested to visit our website www.tolaassociates.com or download our mobile apps from the links mentioned below to access our previously published monthly issues and other publications and stay updated of future notifications.

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Readers are also requested to circulate this e-copy within their circle, as our primary aim is to benefit the masses. Feedback is always welcomed.

Ashfaq Tola - FCA
Editor in Chief

1. NOTIFICATIONS/ CIRCULARS

1. SALES TAX PAYABLE BY WHOLESALERS/ DISTRIBUTORS OF PRODUCTS MANUFACTURED IN A&K AND SOLD IN PAKISTAN.

The FBR, vide Sale Tax General Order No. 107 of 2019, dated 21st November 2019, has issued a clarification pertaining to three different scenarios, in relation to the above, which is as follows:

Scenario A: If goods supplied in Pakistan are exempted from Sales Tax in AJK vide AJK Notification No. FD/Tax 1145-1245/95, dated 8.2.1995, then these are taxable in Pakistan, wherein it will be chargeable to Sales Tax in Pakistan by the dealers/distributors of such products on the value of supply or the printed Retail price. For e.g., the purchase price for the dealer is Rs 100 and sales price is Rs 110, the Sales Tax@ 17% will be charged by dealer on Rs 110 and will be deposited with the FBR.

Scenario B: If goods supplied in Pakistan are taxable in AJK, the Dealers and distributors of such products will then discharge their Sales Tax liability charged on the value addition of such products after adjustment of input tax paid in AJ&K in accordance with Section 7 read with section 2(14)(e) of the Sales Tax Act, 1990. In case of supply of products from AJ&K falling in the Third Schedule of the Sales Tax Act, 1990, on which sales tax is to be charged on retail price, the Manufacturer and the distributors/Dealers in Pakistan are required to charge the Sales Tax on retail price and discharge their liability to the FBR accordingly.

Scenario C: The Manufacturers of goods exempted in AJK establishes their own distribution, wholesale and retail establishment in Pakistan. These establishments will be treated as separate entities and hence be required to get sales tax registration. They will discharge their liability as per Scenario A.

2. DATE OF FILING INCOME TAX RETURNS AND STATEMENTS EXTENDED TILL 16 DECEMBER 2019.

The FBR, vide Circular No 16 of 2019, dated 29th November 2019, has extended the date of filing of Income tax returns/Statements for Tax Year 2019. The filing of return was initially due on 30th September 2019, which was extended to 30th November 2019 and now has been further extended to 16th December 2019. The abovementioned extension has been provided so that the FBR can achieve its targeted in lieu of Tax collection for the Year 2019.

The extension of filing of return for companies, falling under Special Tax Year category, is subject to the condition that that they had paid up to 95 percent of admitted tax liability on or before 30 September 2019.

3. VALUATION OF IMMOVEABLE PROPERTY – RAWALPINDI.

The FBR has issued SRO 1376 dated 13th November 2019, thereby amending SRO 843 dated 23rd July 2019 which related to value of immovable properties in Rawalpindi. Through the current SRO, FBR has bifurcated Gulberg Green (Serial no. 50) into Gulberg Green Residential (Serial no. 50) with Value of Residential property being Rs. 350,000 per Marla and Value of Commercial property being Rs. 2,500,000 per Marla and added Gulberg Greens Farmhouse (4 Kanal and above) (New Serial no. 51) with the Value of Residential property being Rs. 250,000 per Marla and Value of Commercial property being Rs. 2,500,000 per Marla.

4. AMENDMENT IN TWELFTH SCHEDULE (MINIMUM VALUE ADDITION) OF SALES TAX ACT, 1990 [“STA 1990”]

The FBR had inserted Twelfth Schedule in STA 1990 through the Finance Act 2019 to prescribe procedures and conditions for chargeability of minimum value

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addition tax at the stage of import. In the said Schedule, the FBR had also excluded some items from purview of minimum value addition tax. The FBR has, vide SRO 1321(I)/2019 dated 8th November 2019, also added the item in the Third Schedule to the exclusion list.

5. FEDERAL EXCISE DUTY LEVIABLE IN SALES TAX MODE ON THE GOODS SPECIFIED IN THE SECOND SCHEDULE OF FEDERAL EXCISE ACT, 2005 ("FEA 2005").

As per Section 7 of FEA 2005, the goods specified in the 2nd Schedule of FEA 2005 are chargeable to duty under the sales tax mode, such that the person producing such goods shall be entitled to deduct input tax paid during the tax period, from the duty of excise due from him on such goods in respect of that period. The Federal government has also been empowered to declare that any of the provisions of STA 1990 relating to the levy and of exemption from the sales tax, registration, book keeping and invoicing requirements, returns, offence and penalties, appeals and recovery of arrears shall be applicable in regard to similar matters in respect of the duty leviable under this Act.

The FBR vide SRO 1461(1)/2019 dated 27th November 2019 has declared that the following sections of STA shall apply to goods listed in Second Schedule of FEA:

a) Restriction on input tax – Section 8B
b) Tax Invoices – Section 23
c) Serial number 46, 49, 52, 52A, 71, 109, 134 and 147 in Table 1 of the Sixth Schedule pertaining to Imports or Supplies.
d) Serial number 3 and 4 of Table -2 of Sixth Schedule.

For e.g. Steel Billets listed in 2nd Schedule to FEA is chargeable to FED in Sales Tax mode, if imported as gift and relief consignments. In the event of a natural disaster or any other catastrophe (entry no. 49 of sixth schedule of sales tax), no FED will be charged at import stage and subsequent supply.

6. PRA OFFICE ORDER REGARDING ATTACHMENT OF BANK ACCOUNTS

The PRA, vide its Office Order no 06/2019 dated 11th November 2019, has directed that no officer of the Enforcement Wing shall proceed to attach any bank account without prior approval of the Chairperson of PRA, and all the officers must ensure strict compliance of the Punjab Sales Tax on Services Act, 2012 and Punjab Sales Tax on Services (Recovery) Rules, 2012. In this notification, a committee has also been formed, comprising of heads from various functions/ departments of PRA for review and recommendation of necessary amendments to Punjab Sales Tax on Services (Recovery) Rules, 2012 by 30th November 2019.

7. EXEMPTION OF PREPAID/POSTPAID CELLULAR TELEPHONE SERVICES INCLUDING INTERNET SERVICES IN SRB

The SRB has issued a Notification bearing No. SRB-3-4/34/2019, whereby, the SRB in order to give effect to Judgment passed by Hon'ble Supreme Court of Pakistan in the Human Rights Case no. 18877 of 2018, has retrospectively exempted the following, for the period mentioned hereinbelow:

Services provided or rendered by Cellular Mobile Phone Companies	Period during which the provision of services shall be exempt
1. Prepaid cellular telephone services and its related services including internet services.	**From 13.06.2018 to 24.04.2019**
2. Post-paid cellular telephone services and its related services including internet services.	**From 16.10.2018 to 24.04.2019**

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8. EXTENSION IN DATE OF ONLINE INTEGRATION OF TIER-1 RETAILERS.

Through the Finance Act 2019 (hereafter "FA 2019"), all Tier-1 retailers had been required to integrate their outlets with the Board's computerized system for the purposes of real time reporting of sales tax from such date and in such manner, as prescribed by the Board. Further, FA 2019 provided that incase a Tier-1 retailer does not integrate his retail outlet in the prescribed manner, during a tax period or a part thereof, the adjustable input tax for whole of that tax period shall be reduced by 15%. The FBR through SRO 1203(I)/2019 had made mandatory for Tier-1 Retailers to integrate with FBR to report real time sales to FBR by 1st December 2019. Now FBR through letter no. C.No. 2(1)/ ST&FE/Misc/2019/280683-R dated 4th December 2019 has further extended the date for integration 10 15th December 2019.

2. LHC- ISSUANCE OF SIM CARD IS NOT CHARGEABLE TO FEDERAL SALES TAX

In Pak Telecom Mobile Limited vs Federation of Pakistan & Others **[reported as W.P. No. 20727 of 2014, decided on 5.10.2017]**, the taxpayer was a Cellular Mobile Operator (hereafter "CMO") engaged in the business of providing telecommunication services. The issue that mandated this writ petition being filed in the Hon'ble High Court of Lahore (hereafter "LHC") was the amendment made in Sales Tax Act, 1990 (hereafter "STA 1990") through the Finance Act 2014, whereby Section 3B and the Ninth Schedule were introduced to bring a 'separate fixed tax regime' for the telecom sector, and fixed tax was charged on various items including SIM card and IMEI registration. Consequently, a notice was issued to Pakistan Telecom Mobile Limited (hereafter "PTM") by the department to pay Sales Tax on account of registration of IMEI and SIM to its customers.

PTM filed a Writ Petition before the LHC praying for Section 3(3B) and Ninth Schedule to be struck down as being unconstitutional, and submitting that since issuance of a SIM does not constitute a 'supply', no liability arose with regards to payment of Sales Tax. To substantiate their submission, it presented the relevant portion of a Cellular Service Agreement executed between PTM and its customer(s) to whom SIMs are 'supplied'. According to Clause 13(i) of the abovementioned agreement, all SIM Cards supplied to the customer shall remain the property of PTM. Since all SIMs supplied to customers remain the property of PTM, no question of a supply arises, and hence, no liability of payment of sales tax arises. Further, even if for the sake of argument if it was treated as a supply, it would at best be treated as a supply of 'services', which is in the Provincial domain after 18th Amendment to the Constitution, and not 'goods', hence the amendments made by FA 2014 are ultra vires the Constitution.

The LHC held that what a SIM card is, is ultimately a question of fact. Since the SIM card is not sold by the assessee to the subscribers, but is only a part of the services rendered by the service provider, the SIM card cannot be subjected/charged to sales tax separately. However, the LHC did not agree to strike down Section 3(3B) and Ninth Schedule, whereas, it only struck down serial no. 1 of Ninth Schedule which was in relation to SIM cards.

3. ECONOMIC INDICATORS

KARACHI INTER-BANK OFFERED RATE (ALSO KNOWN AS "KIBOR"): -

The 3-month, 6-month and 1-year KIBOR rate for the month of **October 2019** was 13.86%, 13.90% and 14.03% respectively, which subsequently declined in **November 2019** to 13.49%, 13.49% and 13.47% respectively.

TREASURY BILLS: -

The 3-month rate for the Treasury Bills for the month of **October 2019** was 13.72% which declined to 13.44%

during **November 2019**. Moreover, the 6-month rate for the month of **October 2019** was 13.89%, which declined to 13.30% during **November 2019**. The rate for 1 year for the month of **October 2019** was 13.92%, which declined to 13.03% in **November 2019**.

PSX 100 INDEX:

At the end of **October 2019**, the index closed at 32,254.32 points. Whereas, at the end of **November 2019** the index increased to 34,377.61 points indicating a growth of 6.17%.

RATE OF CRUDE OIL: -

The rate for Crude Oil in the Organization for Petroleum Exporting Countries basket, at the end of **October 2019** was $ 53.62 per barrel, whereas, the rate at end of **November 2019**, was $ 56.20 per barrel. The increase in price was 4.6%.

RATE OF GOLD: -

The rate of Gold per troy ounce in the month of **October 2019** was $1,489.00, whereas, the same saw an increase of about 1.7% for the month of **November 2019**, leading to a rise in price to $1,514.80.

OTHER KEY ECONOMIC INDICATORS: -

- The rate of Sugar at end of **October 2019** was 0.34 US$/KG which remained stagnant at 0.34 US$/KG in the month of **November 2019**.

- The rate of Palm Oil in the month of **October 2019** was 502.63 US$/MT which increased in the month of **November 2019**, by 11.76% to 569.62 US$/MT.

- The US$ parity to Chinese Yuan at the end of **October 2019** was 7.15 whereas in the month of **November 2019** it was 7.03 showing a decrease of 1.67%.

- The US$ parity to Indian rupee at the end of **October 2019** was 71.08 whereas in the month of **November 2019** it was 70.81.

- The US$ parity to Bangladesh Taka at the end of **October 2019** was 84.53 whereas it increased to 84.78 at the end of **November 2019**.

- The US$ parity to Pakistan Rupee at the end of **October 2019** was 156.90 which slightly decreased to 156.50 at end of **November 2019** by a mere 0.25%.

- The stock of currency in circulation was Rs. 5,385.171 billion as on **26th October 2019** which decreased by Rs. 670 billion up to Rs. 4,715.271 billion till **23rd November 2019**.

- The net Government-sector borrowings at end of 26th **October 2019** were Rs. 12,638.72 billion which decreased by Rs. 282.4 billion up to Rs. 12,356.32 billion by **23rd November 2019**. The net Government-sector borrowings were used for the purpose of budgetary support (Rs. 11,630.93 billion), commodity operations (Rs. 744.04 billion); and supported by others (Rs. -18.52 billion).

- The credit to the private sector, by **26th October 2019**, was Rs. 6,832.59 billion, which saw an increase to the tune of Rs. 102.63 billion, with the final figure standing at Rs. 6,950.47 billion as of **23rd November 2019**.

From next month onwards, our Key Economic Indicators section will be covered in our economic newsletter **"Pakonomics"**.

4. TOPIC OF THE MONTH

- ROYALTIES

A. PREAMBLE

Considering our trend and previous publications, consisting of Dividend and Profit on Debt, we will now

shed light on our next Topic, Royalties, so that our readers can buckle up against the pitfalls regarding the same. It may be noted, this is well in line with the basic ethos of this segment, which is, and has always been to educate professionals, as well as laymen, relating to different industries, on matters pertaining to International Taxation.

2. DEFINITION

Royalty is a payment made to an owner against the use of tangible and intangible assets including property, especially patents, copyrighted works, trademark, franchises and natural resources. Royalty is paid to the legal owner of the asset and is legally binding.

Payment of any kind in respect of motion picture films, films, tapes for radio broadcasting or television, and other payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work also comes within the scope of Royalty.

3. ROYALTY AS PER DOUBLE TAXATION AVOIDANCE AGREEMENT ("DTAA").

When the user of a patent or similar property is resident in one country (Country A) and pays royalty to the owner of the property who is resident in another country (Country B), the amount paid by the user is generally subject to withholding tax in his country, the source country (Country A). The source country tax is imposed on gross payments, with no allowance for any related expenses incurred by the owner.

4. TAXABILITY OF ROYALTY INCOME

As per Article 12.1 of the UN Model Convection, *"Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State"*.

ILLUSTRATION (AS PER THE MODEL UN CONVENTION)

Mr. Z, a Pakistani resident is in receipt of royalty from allowing the use of his copyrights in UAE. Accordingly, Pakistan may tax such income arising to Mr. Z by virtue of its power to tax the global income of residents. But this article does not stop UAE to levy taxes on such royalties if it is provided in the domestic laws of UAE. Hence in this case, if Mr. Z is liable to pay tax in both Pakistan and UAE, Pakistan shall allow credit for the taxes paid in UAE.

However, as we have already defined in our previous Topic of the month pertaining to Taxability of Dividend and Interest, the phrase may be taxed (as highlighted above) concludes that the taxability of royalty is not limited to the country of residence, which in our example is Pakistan but can also be taxed in the country of Source, i.e. Dubai. For the purposes of clarity, it may be noted that **the primary right** to tax the royalty fee lies with the country of residence with country of source holding additional right to tax the royalty income. What this basically means, is that the country of source is at liberty to tax the royalties, subject to a provision allowing the same in their domestic laws. However, the rate of tax agreed between two countries through bilateral negotiations, will override the rate provided for in the domestic laws of the source country.

5. TAXABILITY OF ROYALTY INCOME AS PER PAKISTAN (DTAA)

As per the DTAA agreement between Pakistan and several other countries, *"the royalty may be taxed in the Contracting State in which they arise, according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed _%(the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation".*

For example, as per the DTAA signed between **Pakistan and UAE**, the tax chargeable on the gross amount of

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royalty fee arising in either of the country is agreed to be **12 percent**. For **Pakistan and Saudi Arab**, the rate happens to be **10 percent**. For **China** the rate happens to be **12.5 percent**, whereas, for **Bangladesh**, the rate is **15 percent** of the gross amount.

6. ROYALTY PAYMENT IN CASE OF PERMANENT ESTABLISHMENT

As per Pakistan's DTAA with several other countries, the taxability of royalty illustrated in point 4 and 5 shall not apply in certain situations. This will be when the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base, or with business activities referred in paragraph 1 of Article 7 i.e. Business Profits in Pakistan's Double Tax treaties, (also discussed in one of our previous monthly issues). In such cases the provisions of Article 7 or Article 14 "Independent Personal Services" and in some treaties referred as Article 15, as the case may be, would apply accordingly.

ILLUSTRATION

Mr. Z is the owner of a company named XYZ Ltd. XYZ Ltd is into the business of software development services and they have developed a unique software which has been patented in the name of XYZ Ltd in Pakistan. XYZ Ltd and Mr. Z are Pakistani residents. They are having a branch in UAE which is being run by Mr. Z's brother Mr. A. Mr. Z on behalf of XYZ Ltd, receives royalty from Mr. A for the use of software which has been patented by XYZ.

In the above case, XYZ Ltd is the legal owner of the patent and Mr. Z is the beneficial owner. They have a branch in UAE which is being operated by Mr. A and it is said to have constituted a permanent establishment in UAE. Mr. Z on behalf of XYZ Ltd receives a royalty from Mr. A for the use of software developed by XYZ Ltd. Since there is a permanent establishment in UAE, as defined in our point number 7, this case is not covered in the Article of Royalty, hence its taxability will be adjudged by either Article 7 "Business Profits" or Article 14 "Independent Personal Services" and in some treaties referred as Article 15.

If the payer of royalty is a resident of the Contracting State, then royalty shall be deemed to arise in the Contracting State. Where a person has a Permanent Establishment or a fixed base in a country and in connection with such PE or the fixed base, royalty is incurred and such royalty is borne by such PE or fixed base, the royalty is deemed to arise in the country where the PE or fixed base is situated.

For example, a Pakistani company has a PE in Bangladesh and in connection with such PE, the Pakistani company has to pay royalty to another company in China, the royalty would be deemed to have arisen in Bangladesh instead of Pakistan and hence the provisions of China – Bangladesh DTAA would be applicable in this situation.

7. SPECIAL RELATIONSHIP

The term "Special Relationship" is highlighted when it comes to Taxability of Royalty fee in several DTAA's. The term Special Relationship when co-related with Royalty is defined in the treaties as below.

"Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention".

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The purpose of this definition is to restrict the applicability of the provisions concerning the taxation of royalties in cases, where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they been two parties who are unrelated or strangers to each other.

It further provides that in such a case the provisions of the article apply only to the fair value or market value of the royalty and that the excess part of the royalty would remain taxable according to the laws of the two Contracting States with due regard to the other provisions of Bilateral treaties with respect to DTAA.

Clarifying the taxability of the excess part paid in terms of Royalty with respect to special relationship, the exact nature of such excess should be determined according to the circumstances of each case, in order to actuate the category of income in which it should be classified for the purpose of assigning the provisions of the tax laws of the States concerned and the provisions of the applicable DTAA. According to the nature of payment, the head of taxation can be concluded.

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