TAX PAK

NEWSLETTER BY TOLA ASSOCIATES

TOLA ASSOCIATES
TAX & CORPORATE ADVISORS

DECEMBER
2020

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EDITORIAL NOTE

We are pleased to welcome our readers to yet another edition of our monthly newsletter. Adding to our rack, this happens to be 38th edition of this Newsletter. We look forward to keep striving and publish content to keep our readers abreast with the recent advancements in the Tax System of Pakistan. By the grace and blessing of Allah Almighty, we continue our dedication and devotion to help our readers achieve proficiency in the tax world by imparting our analysis regarding major major developments and recent legislations passed and their effect on our tax system.

Our readers seem to know the scheme of things regarding our newsletter but in order to educate people who have tagged along recently regarding the context of our newsletter, we start our newsletter with analysis on the notifications passed by the Tax regulatory bodies including FBR and SRB, etc. Going along, the mid-section of our newsletter comprises of brief analysis on the corporate notifications passed by the Securities and Exchange Commission of Pakistan "SECP" and our comments on a recent verdict passed by the Judiciary Body pertaining to tax. For this month, the Case Law section pertains to a verdict passed by the Sindh High Court on the matter of "Capital Gain on Disposal of Securities".

Lastly, we end our newsletter with our customary Topic of the Month, which for this month happens to be "Payment of Interes to Foreign Entities" which is set to clear the air regarding the concept of Profit on Foreign Debt / Thin Capitalization Rules and hence is also of importance to person(s) involved in 'cross border transactions".

All our readers are requested to visit our website www.tolaassociates.com, or download our mobile application from the links mentioned below, in order to access previously published editions of this monthly issue along with other publications, and to stay updated of future notifications.

1. https://goo.gl/QDM4ZM **(IOS)**
2. https://goo.gl/LFiWyx **(Android)**

Lastly, we request our readers to circulate this e-copy within their circle, as our primary aim is to benefit the masses. Feedback is always welcomed.

Happy New Year!

Ashfaq Tola - FCA
Editor in Chief

1. NOTIFICATIONS/ CIRCULARS

A. SIMPLIFIED INCOME TAX RETURN FOR MANUFACTURERS HAVING TURNOVER LESS THAN RS. 500 MILLION

The FBR has issued SRO 1316(I)/2020 dated 9th December 2020 whereby it has issued final draft for manufacturers having turnover less than Rs 500 million. However, the final date of filling of return was 8th December 2020 and has not yet extended which renders this new facilitation of FBR to small manufacturers fruitless.

B. DESIGNATED NON-FINANCIAL BUSINESS AND PROFESSIONS REGULATIONS – DNFBPS (REGULATORY POWERS AND FUNCTIONS) REGULATIONS, 2020

FBR has issued SRO 1319(I)/2020 dated 10th December 2020 whereby it has issued DNFBPs (Regulatory Powers and Functions) Regulations, 2020 as per power given under Section 6A of the Anti-Money Laundering Act, 2010.

The Section 6A was inserted in Anti-Money Laundering Act, 2010 through Anti-Money Laundering Act (Second Amendment) Act, 2020. It is pertinent to note that through Second Amendment Act, 2020 the following were designated as Regulatory Authorities for AML Act:

(i) SBP for any reporting entity licensed or regulated under any law administered by SBP;
(ii) SECP for any reporting entity licensed or regulated by SECP under any law administered by SECP; unless that entity is licensed by any other AML/CFT regulatory authority;
(iii) Federal Board of Revenue for Real Estate Agent, jewelers and for dealers in Precious Metals and Precious Stones Sectors. FBR shall also be an AML/CFT regulatory authority for Accountants that are not the members of ICAP and ICMAP;
(iv) National Savings (AML and CFT) Supervisory Board for National Savings Schemes;
(v) Pakistan Post (AML and CFT) Supervisory Board for Pakistan Post; and
(vi) Any other such regulatory authority as may be notified by the Federal Government notification in the Official Gazette

According to Section 6A, the Regulators shall exercise following powers:

(a) licensing or registration of reporting entities; (b) imposing any conditions to conduct any activities by reporting entities to prevent the offence of money laundering, predicate offence or financing of terrorism;
(b) imposing any conditions to conduct any activities by reporting entities to prevent the offence of money laundering, predicate offence or financing of terrorism;
(c) issuing regulations, directions and guidelines with respect to sections 7A to 7H of this Act;
(d) issuing regulations, directions and guidelines with respect to financing of proliferation obligations;
(e) providing feedback to reporting entities for the purpose of compliance with the requirements of sections 7A to 7H of this Act and as prescribed thereunder;
(f) monitoring and supervising, including conducting inspections, for the purpose of determining compliance with the requirements of sections 7A to 7H of this Act and any rules or regulations made thereunder and with the orders or regulations made thereunder that impose TFS obligations;
(g) compelling production of information relevant to monitoring compliance with the requirements of sections 7A to 7H of the Act and any orders, rules or regulations made thereunder that impose TFS obligations;
(h) impose sanctions, including monetary and administrative penalties to the extent and in the manner prescribed, upon their respective reporting entity, including its directors and senior management and officers, who violates any requirement in section 7A to7H and any rules or regulations made thereunder or those who fail to comply with the TFS regulations. Any person aggrieved by the imposition of sanctions under this clause may prefer an appeal in such manner and within such period to such authority as may be prescribed;
(i) maintaining statistics of the actions performed in respect of the functions and powers conferred by this Act, in order to report to the National Executive Committee and the General Committee as required; and

(j) exercising any other such powers and performing any other such functions that may be otherwise granted in any other applicable law.

As per DNFBPs (Regulatory Powers and Functions) Regulations, 2020 following designations have been made:

(a) Director General
(b) Directors
(c) Additional Directors
(d) Deputy Directors
(e) Assistant Directors
(f) Inland Revenue Audit Officers, Inland Revenue Officers, Superintendents and Deputy Superintendents Inland Revenue, Senior Auditors Inland Revenue, Inspectors Inland Revenue, and officers of Inland Revenue with any other designation.

These will exercise powers mentioned above and also given in SRO 924(I)/2020 dated 29th September 2020, FATF Non-Financial Business and Professions. The FBR has also provided separate tab in IRIS for registration as DNFBPs.

C. TAXPAYER PROFILE-RULES

Section 114A was inserted in Income Tax Ordinance, 2001 through Finance Act 2020, whereby it was made mandatory for following persons to update their profile on IRIS:

(a) Every person applying for registration under section 181;
(b) Every person deriving income chargeable to tax under the head "income from business";
(c) Every person whose income is subject to final taxation;
(d) Any non-profit organization as defined in clause (36) of section 2;
(e) Any trust or welfare institution; or
(f) Any other person prescribed by the Board.

The profile shall contain particulars of following:

(i) Bank accounts;
(ii) Utility connections;
(iii) Business premises including all manufacturing, storage or retail outlets operated or leased by the taxpayer;
(iv) Types of businesses; and
(v) Such other information as may be prescribed;

The taxpayers' profile was required to be furnished:

(a) On or before the 31st day of December, 2020 in case of a person registered under section 181 before the 30th day of September, 2020; and
(b) Within ninety days registration in case of a person not registered under section 181 before the 30th day of September, 2020.
(c) Taxpayer's profile shall be updated within ninety days of change in any of the relevant particulars of information.

Penalty was also imposed u/s 182 for not furnishing profile with a penalty of Rs. 2,500 for each day of default from the due date subject to a minimum penalty of Rs. 10,000.

However, the above was ineffective due to absence of Rules. Now, FBR has issued SRO 1341(I)/2020 dated 16th December 2020 whereby Draft Rule 34B is proposed to be in inserted in Income Tax Rules, 2002. As per Rules profile can be updated only electronically on IRIS.

The FBR has issued Circular no. 08 dated 30th December 2020, whereby it has extended the last date of furnishing of Taxpayer's Profile up to 31st March 2021.

D. DEDUCTION – PROFIT ON DEBT ON NON-RESIDENT RECIPIENTS

The FBR has issued Circular Letter no. C.No. 1(23) Secy(ITC) 2020/224253-R dated 9th December 2020, whereby it is clarified that in order to incentivize remittances by Pakistani Citizens residing abroad but holding Rupee Account with a Schedule Bank in Pakistan, profit on debt to the extent of deposit made exclusively from foreign exchange is exempt from tax under Clause 79 of Part-1 of Second Schedule of ITO.

Section 159(2) of ITO requires withholding agents to deduct full amount of tax in case the taxpayer fails to produce certificate from tax under section 159(1) of ITO. In case the taxpayer produces it, then bank being withholding agent, will comply with the certificate. To qualify for relief under this clause, the account holder is required to be Pakistan citizens living abroad and profit on debt may be in no way attributable to local deposit in same account.

E. CASH BACK TO CUSTOMERS

The FBR has issued SRO 1339(I)/2020 dated 16th December 2020, to prescribe rules for customers of Tier-1 Retailers who have integrated their retail outlets with FBR

computerized system. The procedure for claiming 5% of sales tax paid as cash back on eligible goods is as follows:

- To redeem cash online, the customer shall log on to the mobile application.
- Soon after log-on an independent FBR wallet account shall be created for each customer.
- Approved outlet shall also create an independent FBR wallet for each customer.
- An identical FBR wallet account shall be created for each point of sale by the approved outlet.
- The customer shall verify that the electronically generated invoice is verified, the system shall automatically calculate the 5% amount of the tax paid on the invoice.
- The customer shall transfer the amount determined into his FBR wallet account.
- The customer may redeem the earned amount within 1 month of his purchases accumulated in his FBR wallet account on any approved outlet who shall refund the amount accumulated in the wallet account of the customer after ensuring that the earned amount is transferred from the customer's wallet account to the approved outlets wallet account.
- The approval outlet shall adjust the amount so refunded to the customer which shall be automatically uploaded from the approved outlets' wallet account to the sales tax return of the approved outlet for the relevant tax period by auto adjusting the output liability.

F. SALES TAX RULES- PROCEDURE FOR E-AUDIT

The FBR has issued procedure for E-Audit u/s 25 and/or 72B of Sales Tax Act, 1990 vide SRO 1338(I)/2020 dated 16th December 2020. The Salient features are as follows:

- E-audit means the audit proceedings of registered person conducted through electronic means including video links, or any other facility as may be specified by the FBR.
- The concerned Commissioner Inland Revenue shall serve a notice under sub-section (1) of section 25 of the Act to the registered person specifying the reasons for selection of his case for audit
- The Commissioner Inland Revenue having jurisdiction shall assign the case to an Audit Officer to conduct e-audit.
- A registered person shall produce the record as required to be maintained under section 22 of the Act through IRIS or an electronic data carrier as notified by the Board.
- a registered person shall not be required to appear either personally or through authorized representative in connection with any proceedings under e-audit before the Audit Officer.
- However, a registered person may request for an opportunity of personal hearing through IRIS and such hearings shall be conducted, exclusively through video links from personal computer system or any of the nearest Tax Facilitation Centre situated at the premises of field formations.
- After considering all the information, documents, or evidence, if the Audit Officer finds no discrepancy and have no conclusive proof against registered person, he may close the audit in IRIS under intimation to the Commissioner Inland Revenue having jurisdiction.
- After completion of audit, examination of record and obtaining registered person's explanation on all the issues raised, if the Audit Officer does not agree with the declared version, he shall prepare an audit report, containing audit observations and finding. The Audit Officer shall forward the report to the Commissioner Inland Revenue having jurisdiction and also send **a copy of it to the registered person** through IRIS;
- The Commissioner Inland Revenue having jurisdiction shall assign the case to an Adjudicating officer to make an order for assessment of tax under section 11, including imposition of penalty and default surcharge in accordance with section 33 and 34 of the Act.
- On the basis of the audit report, the Adjudicating Officer shall issue a show cause notice through IRIS to the registered person.
- the Adjudicating Officer may, if considered necessary, after obtaining the registered person's explanation on all the issues raised in the audit report, pass an order under section 11 of the Act.

G. EXCLUSION OF FERTILIZER MANUFACTURERS FROM THE PREVIEW OF SECTION 73(4) OF THE SALES TAX ACT, 1990

Section 73 requires payment above certain threshold to be made through banking channel and within 180 days, otherwise input tax on purchases cannot be allowed. Through FA 2020, Sub section 4 was inserted whereby, a registered person shall not be entitled to deduct input tax (credit adjustment or deduction of input tax) which is

attributable to such taxable supplies exceeding, in aggregate, one hundred million rupees in financial year or ten million rupees in a month as are made to a certain person who is not a registered person under this Act. However, this conditions not applies to supplies made to:

(a) Federal/provincial/local Government departments authorities, etc. not engaged in making of taxable supplies;
(b) Foreign Missions, diplomats and privileged persons;
(c) all other persons not engaged in supply of taxable goods; and
(d) persons or classes of person **specified by the FBR through notification** in the official Gazette subject to such conditions and restrictions as may be specified therein.

Now as per power given to FBR above, it has excluded Registered persons engaged in manufacturing of fertilizer from application of Sub section 73(4) with effect from 1st July 2020, through SRO 1337(I)/2020 dated 16th December 2020, if following conditions are met:

- The registered persons shall provide following documents and details to the Board on or before the 15th day of January, 2021:
    a. Complete list of the dealers or distributors of their products including details of business name, address and NTNs;
    b. Complete list of buyers, other than dealers and distributors, including details of their names, residential addresses and CNICs;
    c. Copies of relevant dealership or distribution agreements, as the case may be;
    d. Details of all business bank account of the dealers, distributors or buyers along-with names and addresses of the relevant bank branches;
    e. Dealer or distributor-wise figures of sales made by the registered persons during the period 01.07.2019 to 30.06.20 and 01.07.2020 till date; and
    f. Any other document specially required by the Board for compulsory registration of dealers, distributors or buyers

H. STANDARD PROCEDURE FOR SANCTIONING OF MISSING AMOUNTS STUCK IN FASTER SYSTEM DUE TO SYSTEM ERRORS

The FBR has issued SOP for missing refunds vide Circular No. 03 of 2020 dated 07th December 2020. The FASTER system was introduced to process speedy refunds of zero-rated sector covered in repealed SRO 1125 of 2011. However, some malfunctions have been reported such as skipping of sales tax credits of various taxpayers.

The FBR has investigated the issues and found that the problem of missing amounts arises due to design of FASTER module as it works as follows:

(i) FASTER was programmed to pick **the least** of the three opening balances of carry forward of previous month from (a) Sales Tax Return; (b) Annexure-H and (c) the e-RPO generated
(ii) FASTER module's non-synchronization with STRIVE i.e. Serial 7a and 7b of the Sales Tax Return; and
(iii) Misapplication of Section 8B to certain exporters in FASTER module.

This causes problems with exporters as large amounts claimed are not reflected in their E-RPO. Now these have been resolved by FBR as under:

- The problem of opening balance has been resolved by de-linking the opening balance of Sales Tax Return and Annexure-H effectively and linking it to the previous e-RPO alone. This will also solve issue of misapplication of Section 8B on certain exporters
- In all cases wherein the missing amounts could be retrieved by the system, have already been communicated to taxpayers for re-filling after adequate modifications in the refund claims/sales tax return
- In all remaining cases, where taxpayer believes that a material amount of his refund claim has been unaccounted for, he may apply to the Deputy Commissioner who will examine the case and after due verification, will sanction the amount.

I. RECOGNITION OF PROVIDENT FUNDS AND APPROVALS OF GRATUITY FUNDS – VERIFICATIONS THROUGH IRIS-INSTRUCTION REGARDING

The FBR vide Circular No. 6(2) S(IR-Ops)/2020 dated 31st December 2020 on complaints on issuance of exemption certificates to provident funds/gratuity funds under Section 159/150/151 of the Income Tax Ordinance, 2001. It is noted that where recognition of funds was granted by Commissioner prior to tax year 2013, the Officers are refusing the request for exemption certificates and asking

the taxpayers to move fresh applications for recognition of the funds on the pretext that the fact of their approval is not available/evident in the FBR's system IRIS.

The FBR has directed field formations to issue exemption certificate for all funds who produce evidence of recognition under Income Tax Ordinance, 2001 and Income Tax Ordinance, 1979 without requirement of IRIS verification. However, verification of documents can be made subsequent to approval.

J. STANDARD OPERATING PROCEDURES FOR REGISTRATION OF NEW MANUFACTURERS FOR CONCESSIONARY TARIFF RATES ON SUPPLY OF ELECTRICITY AND GAS

The FBR has issued C.No. 1(I) ST-LP&E/ZR/2017/243658-R dated 30th December 2020 in light of decisions and directions of Economic Coordination Committee (ECC) of the Cabinet, whereby SOPs for enrollment of Registered under export-oriented sectors to qualify for concessionary regime of electricity, RLNG and Gas tariff. The salient features of SOP w.e.f. 1st January 2021 are as follows:

- For new registration of manufacturers, applicant may apply through their respective representative Association,
- The Association after verification of the particulars on the prescribed format, may forward the application along with its recommendations to the Export oriented Sector Registration Cell (ESRC) FBR.
- The ESCR shall verify and check the particulars, registration profile and forward case to Ministry of Commerce for allowing concessionary DISCOs/ Gas Companies.
- The newly enrolled taxpayers shall be entitled to avail concessionary tariff prospectively.
- The DISCOs/Gas Companies shall ensure that the taxpayers are active on FBR's (Sales Tax) Active Taxpayers List (ATL) as shared with DISCOs/Gas Companies each month before generating the monthly utility bill. In case the taxpayer is found non-active on the ATL, standard utility tariff shall apply on supply of utilities for the relevant period.
- Any taxpayer aspiring to avail concessionary utility rates and who is not registered with the respective sector Association, may approach the IR field formation concerned for verification of its business particulars and onward submission of report on the prescribed format to the ESRC within 15 days of the submission of the application.

2. CORPORATE NOTIFICATIONS / CIRCULARS

A. SRO 1340 (I)/2020 – CORPORATE INSURANCE AGENTS REGULATIONS 2020.

The SECP vide SRO 1340 dated 3 December 2020, issued regulations for all corporate insurance agents of life and non-life insurers, namely Corporate Insurance Agents Regulations, 2020.

The regulations will be applicable to all agreements entered on or after **July 1st, 2021** by the corporate insurance agents, whereas for the existing agency agreements in place, the corporate insurance agents have time till 1 July 2021 to make necessary amendments to those agreements according to the Corporate Insurance Agents Regulations, 2020.

B. SRO 1145(I)/2017- COMPANIES (DISTRIBUTION OF DIVIDEND) REGULATIONS, 2017 – UPDATED DEC 11, 2020.

The SECP vide SRO 1145 dated 6 November 2020, placed on the website on 11 December 2020 issued regulations in essence of distribution of dividends namely, Companies (Distribution of Dividends) Regulations, 2017.

The abovementioned regulations will not be applicable to those companies that have already announced cash dividends before **November 6th,2020**.

C. S.R.O.1385(I)/2020 AMENDMENT IN PUBLIC OFFERING (REGULATED SECURITIES ACTIVITIES LICENSING) REGULATIONS,2017.

The SECP vide SRO 1385 dated 23 December 2020 made amendments in the Public Offering (Regulated Securities Activities Licensing) Regulations, 2017, wherein provisions relating to Debt Securities Trustee were added into the regulations.

D. S.R.O.1384(I)/2020 AMENDMENTS IN DEBT SECURITIES TRUSTEES REGULATIONS, 2017.

The SECP vide SRO 1384 dated 23 December 2020 made amendments in the Debt Securities Trustees Regulations,

2017 wherein, substitutions regarding Companies Act 2017 were made in the places where Companies Ordinance, 1986 was previously applicable.

Furthermore, provisions presently applicable in terms of "Debt Securities regulations, 2017" were substituted by the provisions of "Structuring of Debt Securities Regulations, 2020" in the Debt Securities Trustees Regulations, 2017.

E. S.R.O. 1383(I)/2020 AMENDMENTS IN THE PUBLIC OFFERING REGULATIONS, 2017.

The SECP vide SRO 1383 dated 23 December 2020 made amendments in the Public Offering Regulations, 2017, wherein provisions related to Investment agency were added in the aforesaid, regulations.

F. S.R.O.1282(I)/2020 AMENDMENTS TO THE ASSOCIATIONS WITH CHARITABLE AND NOT FOR PROFIT OBJECTS.

The SECP vide SRO 1282 dated 23 December 2020 proposed draft amendments to the Associations with Charitable and Not for Profit Objects Regulations, 2018.

The proposed amendments pertain to the fee received by the Chief Executive officer and directors in terms of board meetings and disclosure of such fee in the financial statements of the Association.

The SECP has notified that any comments. Suggestions or objections regarding the proposed amendments will be taken into consideration if sent within **14 days** from the date of publication of this notification in the official gazette.

3. SINDH HIGH COURT [SHC] RESOLUTION OF CONFLICT BETWEEN SECTION 37A AND EIGHT SCHEDULE OF CAPITAL GAIN ON SECURITIES

The capital gain on the disposal of capital assets in a tax year is chargeable under the head capital gains. The capital assets covered under Section 37A are chargeable to tax on capital gain as per separate rates provided in Division VII of Part 1 of First Schedule of ITO. Before Finance Act 2016 the table consisted of rates for tax year 2015 and 2016 as per holding period of capital assets, however, separate rates were also provided in case of investment in debt securities, mutual fund or a collective investment scheme or a REIT scheme through proviso to main table. Through FA 2016, this table was **substituted** by another table with tax rates for Tax Year 2015 and 2016 maintained in new table whereas the reduced rates in case of investment in a mutual fund or a collective investment scheme or a REIT scheme were removed.

Different petitions were filed with two major petitions as under:

a) Amendment in FA 2016 proviso deletion also effects Tax Year 2016
b) Amendment in FA 2016 proviso deletion applies to Tax Year 2017 onwards

1. COMMON GROUNDS FOR BOTH CATEGORIES

1.1. Maintainability of Suit

The petitioner was of view that provisos have been deleted with table. However, department was of the view that provisos were remain intact and issued show cause notice which petitioner directly challenged in SHC. The FBR had also issued Circular no. 7 of 2016 whereby It was clarified that no change has been introduced in provisions in the Division VII of Part I of the First Schedule. Redemption of securities in a mutual fund, a collective investment scheme or REIT scheme shall continue to be taxed under second and third proviso read with sub-rule (1A) of Eight Schedule. Hence tax on redemption of securities under Mutual fund, collective investment scheme or REIT shall continue to be taxed at reduced rate under second and third proviso in Division VII of Part I of the First Schedule. The DR also maintained this position and argued that show cause notice cannot be challenged in Sindh High Court before going through all forums below it as per decision of Supreme Court in this regard. It also relied on SHC Judgement by Dr. Seema Irfan that a show-cause notice may not ordinarily be justiciable in writ jurisdiction; unless it is shown that the same suffers from lack of jurisdiction; amounts to an abuse of process; and/or is mala fide, unjust and/or prejudicial towards the recipient.

The SHC rules that Petition is maintainable as FBR has already issued its interpretation therefore it is deemed that Petitioner has already resort to statutory remedies available.

1.2. Proviso is deleted or intact

As discussed above, the main issue was that whether provisos were deleted or not. The department argued that the provisos were still intact by virtue of section 100B read with Rule 1(1A) of the Eighth Schedule which states as under:

> *"Provided that second and third proviso in Division VII of Part I of the First Schedule regarding capital gains arising on redemption of securities shall continue to apply".*

With regard to effect of substitution in Division VII, the SHC held that when legislature use the word substitute the plain meaning of it is to the replacement of entire provision as it has the effect of deleting the old provision and make the new provision operative. This is also augmented by the contrast of words used in substitution of Division VII vs Division VIII. The word used by legislature in Division VII was "for Division VII, the following shall be substituted "however in Division VIII, following words were used "in Division VII, for the table, the following shall be substituted". Which means Legislature intent was complete substitution in Division VII whereas in Division VIII substitution of only table was intended.

The SHC further held that section 37A of the Ordinance is the charging section whereas, Rule 1A of Eight Schedule is merely a collection mechanism. As per charging section capital gains shall be chargeable to tax at the rate specified in Division VII. While the statute appears to have deleted the relevant provisos completely, Rule 1A states that second and third proviso in Division VII regarding capital gains arising on redemption of securities shall continue to apply. There appears to be an inconsistency between the charging section and the collection mechanism, however, it is settled law that under such circumstances the charging section will apply.

The SHC further held that based on the binding ratio that fiscal statutes ought to be strictly construed and any doubts arising from the interpretation of a fiscal provision must be resolved in favor of the taxpayer, the substitution carried out in Division VII, vide the FA 2016, replaced the entire constituent thereof (which includes the provisos still being relied upon by Respondents) and not merely the tables therein and hence the view taken by Petitioners is correct and provisos stand deleted.

2. PETITION PRE-AMENDMENT – TAX YEAR 2016

The petitioner's case was that beneficial amendments apply retrospectively and since FA 2016 was applicable from 01.07.2016 and Return for tax year 2016 was filed after that date, hence it is applicable. The SHC held that as general rule amendments vide Finance Act apply prospectively and charging provisions apply prospectively unless legislature mentions it to apply retrospectively. However, collection provisions are retrospective unless the legislature expresses otherwise. Since the charging section 37A read with Division VII of Part1 is given preference over Eight Schedule, therefore provisos being intact in Eight Schedule cannot give any benefit to taxpayer to apply deletion of provisos retrospectively. It is also not in line with general rule of beneficial legislation which says that retrospective effect is to be given to lower the tax incidence, whereas no suffering of taxpayer was shown. If the principle of retrospective effect is given to all legislations of lowering tax rates, then entire scheme of revenue generation for specific periods may stand altered by subsequent legislation. Therefore, the petitioner plea that new table, post amendment (in absence of provisos), would also apply to tax year 2016, hence petition dismissed and SCN upheld.

3. PETITION POST AMENDMENT – TAX YEAR 2016 (I.E. FOR TAX YEAR 2017 AND 2019)

In this regard the FBR's position was that provisos are still intact for tax year 2017 and onwards with only table being replaced. The SHC observed that for FBR's position to be correct there should be an amendment vide subsequent finance acts or otherwise by legislature to reinsert the provisos under deliberation. The FBR has relied upon its own interpretation of law vide Circular 7, therefore SCN are found to be abused, unjust and prejudicial towards petitioner, therefore SCN have been quashed.

4. TOPIC OF THE MONTH

- PAYMENT OF INTEREST TO FOREIGN ENTITIES

➢ PREAMBLE

In our last segment of the Newsletter, we bring to your good self, our very own topic of the month "Rules of Thin Capitalization under Section 106 and 106A of the ITO, 2001". These Sections revolve around the concept of Profit on Foreign Debt / Thin Capitalization Rules. Taxpayers get confused while going through the concepts of Section 106 and 106A so we will try to ease out the difficulty of understanding and interpreting those sections in our topic as below.

A. CONCEPT

A company is declared to be thinly capitalized on the basis, if its level of debt greatly exceeds its equity capital i.e., its financing is mainly based on debt rather than equity capital. Such companies are also called highly geared companies.

A High level of gearing ratio is unfavorable to the creditors and Revenue Authorities. The creditors are concerned regarding the solvency risk of a company and Revenue Authorities are concerned regarding excessive interest claims by a company reducing their tax liability. The later will be our focus in this topic.

Generally, where country's corporate laws permit companies to be thinly capitalized, Tax Authorities in those countries often limit the amount that a company can claim as a tax deduction on interest.

The OECD issued initial draft in August 2012 "Thin Capitalization legislation: A Background Paper for Country Tax Administration" in which it mentioned that the manner in which a company is capitalized can have a significant effect on the amount of profit it reports, and thus the amount of tax it pays.

For this reason, country's tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in calculating the measure of a company's profit for tax purposes. Thin capitalization rules typically operate by means of one of two approaches:

a) determining a maximum amount of debt on which deductible interest payments are available; and
b) determining a maximum amount of interest that may be deducted by reference to the ratio of interest (paid or payable) to another variable

B.1 Limiting the amount of debt on which deductible interest payments may be made:

It has generally two approaches

B.1.1 The 'arm's length" approach: Under this approach, the maximum amount of allowable debt is the amount of debt that an independent lender would be willing to lend to the company i.e., the amount of debt that a borrower could borrow from an arm's length lender. This approach is difficult for tax administration to implement as it requires tax auditor to gain significant understanding and investigation of third-Party lending practices and this will require a degree of judgement to determine the proper treatment for each factual situation.

Transfer pricing rules apply to the rate of interest applied to its loans. The rate of interest is the price on loan and transfer pricing rules require that such price conforms to arm's length principle. The interest in excess of arm's length amount will be disallowed.

B.1.2 The "ratio" approach: Under this approach, the maximum amount of debt on which interest may be deducted for tax purposes is established by a pre-determined ratio, such as the ratio of debt to equity, revenue, fixed assets, etc. The ratio or ratios used **may or may not be intended to reflect an arm's length position.**

Section 106 of ITO is based on ratio approach and as per its provisions, any profit on debt incurred by a foreign controlled resident company (FCRC) or a branch of a foreign company operating in Pakistan in excess of 3:1 foreign debt to foreign equity ratio at any time during the year shall not be allowed as tax expense. This concept shall apply where FCRC is other than banking company or a financial institution AND where interest income of non-resident is exempt in Pakistan or taxable at a rate lower than normal corporate tax rates i.e., 29%.

Foreign Debt means the highest amount at any time in a tax year being sum of foreign debt outstanding to Foreign Controller (or any of its non-resident associate) and

Foreign Debt outstanding to any non-associate where that non-associate has a balance outstanding of a similar amount of debt owed to FC.

Foreign Equity means the aggregate at the beginning of the tax year of the following:

- Paid up value of shares held by FC
- Proportionate share of accumulated profits shares premium account and revaluation surplus as it would be entitled to FC in the event of the company being wound up.

It may be noted that this Section 106 is applicable on loan from **non-resident associates**.

The advantage of a ratio approach over arm's length approach is that it provides a great deal of certainty and reduces compliance costs to companies and taxing authorities. The rule is simple to implement and reduces the costs of tax authorities. However, fixed ratio approach does not necessarily reflect economic reality and does not take into account specific market situations and industries and may result in inconsistent treatment of members of MNCs in comparisons to independent companies.

B.2) Limiting amount of interest that may be deducted by reference to its ratio to another variable.

Another method is ratio approach that focuses on the amount of interest paid or payable in relation to the amount of income out which that interest is paid. This is sometimes referred to as an earnings stripping approach. The applicable ratio may be by reference to a ratio of the amount of interest to operating profit or a measure of cash flow (e.g., an interest to Earnings Before Income Tax, Depreciation and Amortization ratio (EBITDA) or Taxable income before depreciation and amortization.

This approach is incorporated in Section 106A of ITO. As per Section 106A, a portion of foreign profit on debt claimed by a foreign-controlled resident company (FCRC) (other than insurance or banking company) during a tax year, shall be disallowed according to following formula

Formula

B-(A+B) x 0.15

Where

A is the taxable income of a FCRC before depreciation and amortization; and

B is the foreign profit on debt claimed as deduction.

The disallowance under section 106A is restricted and is applicable if the total foreign profit on debt claimed as deduction is **Rs. 10 million** or more for tax year.

The effect of the above formula is that foreign profit on debt shall be disallowed which is in excess of 15% of taxable income before tax depreciation and amortization and foreign profit on debt.

Where in computing the taxable income for a tax year, full effect cannot be given to a deduction for foreign profit on debt, the excess shall be added to foreign profit on debt for the following 3 tax years i.e., excess profit on debt shall be c/f for 3 years to include in the foreign profit on debt. However, this carry forward is not available in Section 106. Where deduction of foreign profit on debt is disallowed under Section 106 (one method of Thin Capitalization Rule) and also under Section 106A (another method of thin capitalization rule), the disallowed amount shall be the higher of the disallowed amount under section 106A or 106. A broader definition of foreign profit on debt is provided in Section 106A, which means interest paid or payable to a non-resident or an associate of nonresident including:

(i) Interest on all forms of debt;
(ii) Payments made which are economically equivalent to interest;
(iii) Expenses incurred in connection with the raising of finance;
(iv) Payments under profit participating loans;
(v) Imputed interest on instruments such as convertible bonds and zero coupon bonds;
(vi) Amounts under alternative financing arrangements such as Islamic Finance;
(vii) The finance cost element of finance lease payments;
(viii) Capitalized interest included in the balance sheet value of related asset, or the amortization of capitalized interest;
(ix) Amounts measured by reference to a funding return under transfer pricing rules;

(x) Where applicable, notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;
(xi) Certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
(xii) Guarantee fees with respect to financing arrangements; and
(xiii) Arrangement fee and similar cost related to the borrowing funds.

It is in accordance with OECD paper in which third party lenders define interest to include all financing costs, regardless of whether it is legally defined as interest. The definition of interest typically includes premiums for options, discounts, finance lease payments, payments, and receipts under interest rate swaps.

It is worthwhile to mention that Section 106A is subjective of Arms' length Rules u/s 108, means if arm's length disallowance is higher than section 108 will be followed.

DISCLAIMER

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