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BUDGET RED-EYE 2016

KEY MEASURES

On the back of achieving stability in the Macro Economic Framework, the Budget Speech, perhaps rightly, began with claiming that the economy is on track with all macroeconomic indicators confirming good performance. The reference to setting up of such macroeconomic targets in the manifesto and achieving these in three years is again a justifiable claim based on the following:

- GDP growth of 4.71%; the highest in last 8 years. It was forcefully asserted that had there not been 28% losses in cotton crop, the GDP growth might have been higher by another 0.5%.

- Increase in per capita income from US$ 1,334 in 2012-13 to US$ 1,561 in 2015-16.

- Inflation at 2.82% during 2015-16; a 10 year record.

- 60% increase in tax collection in 3 years; with total tax collections expected to surpass Rupees 3 trillion.

- Tax to GDP ratio improving to 10.5%.

- Fiscal deficit, albeit including provincial surpluses, held at 4.3%.

- 40 year record low State Bank of Pakistan policy rate at 5.75%.

- Exchange rate held stable for 3 years which is currently at US$ 1= Rupees 104.70.

- Pakistan Stock Exchange Index at an all-time high, crossing 37000.

- And the indicator which the Finance Minister is most passionate about, Foreign Exchange Reserves at a record US$ 21.6 billion.

While, arguably, the above claims can be subjected to substantive micro critique encompassing data errors, unpaid circular debt, luck, declining oil and commodity prices, rather than policy, all of which the opposition is expected to raise, however, criticism for its own sake is an exercise in futility. All in all, it is acknowledged that the Government since it came to power has made strenuous efforts to stabilize the economy and deserves all credit for positively converting international and domestic views about the state of the Country's economy.

Going forward the Government has set even more challenging Medium Term Macroeconomic Targets to be achieved till 2018-19:

GDP growth	7%
Inflation	Single digit
Investment	21%
Fiscal deficit -clean	3.5%
Tax to GDP ratio	14%
Forex reserves	US$ 30 billion

The biggest obstacles to these rather ambitious targets are:

- declining exports with an ever increasing Trade deficit of US$ 20 billion in ten months;
- declining growth rate of workers remittances which at US$ 16 billion in ten months were instrumental in achieving economic stability;
- total national debt and liabilities at Rupees 22 trillion with national foreign debt surpassing US$ 69 billion; and
- very low investment rate of 15%.

In order to address impediments to development, the Government's three tier, out of the box, strategy is:

- to invest more in infrastructure development;
- provide incentives to the agricultural and industrial sector; and
- to focus on poverty alleviation.

Within infrastructure the Government proposes to increase the PSDP to Rupees 800 billion as compared with Rupees 661 billion this year with a focus on motorways and Gawadar. Railways got a special mention, with an allocation of Rupees 78 billion. Diamer Bhasha and Dasu Dams were also allocated funding, but considering the forecasts regarding water stress, this may not be enough. Surprisingly while CPEC was mentioned as a game changer, its share in the budget speech was less than minimal.

It is refreshing that the government is focusing attention on agriculture and industry, with incentives ranging from cheaper financing, zero rating in sales tax, subsiding electricity, technology upgrading fund, early payment of tax refunds and duty free imports. However most of these incentives have been carried forward from last year, and which apparently did not foster the desired results. Ultimately, industrial growth and increase in exports are the biggest challenge for Pakistan, and will require constant monitoring with perhaps direct public investment.

The flip side of the above incentives is the policy to increase regressive taxation to fund sectors represented by strong lobbies; reverse redistribution. The middle class paying for the rich class.

On the other hand, the Government's initiatives to alleviate poverty are applauded, especially in the case of BISP with a caveat that the program should eventually move towards encouraging self-sustainability within the targeted beneficiaries.

Improving macroeconomic stability was indeed a difficult task, the path to real development is tougher. The Government is moving in the right direction but will need to maintain a focused approach.

INCOME TAX

- The Bill proposes to give exemption from all income taxes, including on dividend, to specific Chinese companies and their contractors and subcontractors, domestic or otherwise, operating at Gawadar Port for a period of 23 years commencing from 6th February 2007. In addition it is proposed that businesses operating in the Gawadar Free Zone would also be given tax exemption for 23 years commencing from 1st July 2016. This exemption across the board may perhaps be detrimental to the objective of documenting the economy.

- Super Tax, levied for the tax year 2015 as a onetime tax, has now been extended and will be levied for tax year 2016 as well on the same basis; 4% on banking companies and 3% on other companies whose income exceeds Rupees 500 million. Further, it is proposed to exclude business losses and depreciation from the definition of income for the purposes of Super Tax. This particular amendment attempts to address the disputes arising in 2016 of adjusting brought forward business losses and unabsorbed depreciation for determining income subject to Super Tax. Furthermore, minimum tax under section 113 of the Ordinance will also apply in addition to Super Tax.

- The Bill proposes to introduce a separate tax regime for Developers of plots and Builders of residential, commercial and other buildings, whereby tax is proposed to be charged on the basis of geography and size of plot. The intent is perhaps to provide an incentive to the sector, since the maximum rate of tax for a 500 Sq. Yd. residential plot is proposed to be Rupees 35,000, notwithstanding the current price of property in prime urban areas. While there is a need to incentivize the Housing Sector, linking taxes with area will necessarily result in taxes being passed on to the ultimate buyers. Nonetheless, FBR will be making Rules for implementation of this regime.

- The Bill proposes to treat rental income in case of Individuals and Association of Persons as a separate block and to be taxed at rates ranging from 5% to 20%, with rentals below Rupees 200,000 to be exempt from tax.

- Where taxes have not been withheld by a payer, the bill now purposes to treat all such expenses as inadmissible in case of the payer. However, on a positive note the disallowance in the case of raw materials and finished goods is being caped at 20%, and in case such withholding taxes have already been recovered by the tax authorities, presumably from either the payer or the recipient, expenses will not be disallowed.

- The Bill proposes to restrict admissibility of expenses related to sales promotion, advertisement and publicity in case of pharmaceutical manufacturers to 5% of turnover.

- The benefit of group relief is proposed to be restricted to percentage of holding of the parent company in the subsidiary company. Presently, the subsidiary may surrender all its assessed losses to the parent company holding at least 75% shares in case of an unlisted company and 55% in case of a listed company. The exemption from inter-corporate dividend for companies exercising group relief is also being withdrawn.

- It is proposed to allow tax credit at average rate of tax on premiums paid for health insurance, upto Rupees 100,000 or 5% of income whichever is lower. This provision already exists for life insurance premium.

- It is also proposed to allow a deduction against income on account of children's education fees to parents earning upto Rupees 1 million in a year; restricted to lower of either 5% of the fee, 25% of income or at Rupees 60,000 per child. Ironically, the employer is not permitted to give this tax credit to an employee when withholding tax from salaries.

- Tax credit for employment generation proposed to be extended to industries set up by 30 June 2019, as it was set to expire on 30 June 2018. In addition, tax credit for balancing, modernization and replacement of plant and machinery is being extended to investments up to 30 June 2019; this credit was ending on 30 June 2016.Finally the exemption on income from export of software and IT enabled services also being extended to 2019 subject to the proviso that 80% of proceeds will be remitted through banking channels.

- The limit of 100% equity for claiming 100% tax credit in case of newly established industrial undertakings, including corporate dairy farms, is being rationalized with tax credit proportional to the amount of new equity, and the later reduced to at least 70% of the total capital of the undertaking. The time limit for admissibility of credit is also being increased to 30 June 2019.

- It is proposed to bring such Individuals and Association of Persons within the ambit of minimum tax at 1%, whose turnover in 2017 exceeds Rupees 10 million. Further, there will be no exemption from minimum tax in case of gross loss henceforth.

- The Bill proposes to treat payments made to print and electronic media for advertisement services under Presumptive Tax. Tax will be deductible at 1.5% for filers, 12% for non-filer companies and 15% for non-filer non-corporate entities. Non-filers will have the option to file a return and claim refund of excess tax paid, if any. In addition, payments to non-residents for foreign produced commercials or advertisements on television channels are proposed to be subjected to withholding tax at 20%. The intent perhaps is to protect domestic talent.

- Tax rate on income from services rendered and construction contracts executed outside Pakistan are being proposed to be increased from 1% to 50% of withholding rates applicable to resident persons for such services or contracts executed locally.

  Withholding Taxes:

  - Advance tax at 3% of the value of the vehicle to be collected from non-filer lessees.

  - Advance tax at 4% for general insurance and at 1% on life insurance on payment of insurance premium. In the case of life insurance, the amendment will apply to policies where premium exceeds Rupees 200,000.

  - Advance tax at 5% on the value of mineral extracted by a non-filer to be collected by relevant provincial authorities.

  - 3% advance tax on turnover to be paid by non-filers on filing of provincial sales tax returns.

  - Withholding tax on dividend for non-filers increased to 20% from 17.5%.

SALES TAX

- As in the case of Income tax, the Bill proposes to include material and equipment for construction and operation of Gawadar port, and free zone at Gawadar, imported by or supplied to specific Chinese companies operating in Gawadar, including their contractors and sub-contractors in the Sixth Schedule, Table 1, to the Sales Tax Act 1990. The intent is to provide exemption from Sales tax to the Chinese companies, including their domestic contractors and sub-contractors, for a period of 40 years. The proposal appears to be extremely generous, irrespective of the benefits that may or may not accrue to the nation because of CPEC.

- It is proposed that Businesses in the Gawadar Free Zone be also exempted under the Sixth Schedule for all supplies within the Gawadar Free Zone for 23 years. While the basis for the period of exemptions in income taxes and sales taxes for port and free zones is curious, nonetheless, perhaps the Government should consider a reduced rate for companies operating in Gawadar, rather than total exemption.

- The definition of “cottage industry” is being modified to include all manufacturers whose annual turnover from taxable supplies do not exceed ten million rupees; previously the turnover was restricted to five million rupees. This is a positive relief for cottage industry, however perhaps the Government should also amend the other condition relating to utility bills if the intent is to give real relief.

- Alarmingly the Government is moving to exclude provincial taxes from the definition of input tax. This will obviously increase the overall sales tax payable by registered persons and will have an inflationary impact, beyond being detrimental for entrepreneurship. In case the provinces move in the opposite direction and start disallowing federal taxes, it will be disastrous for honest businesses. The Government needs to simplify the sales tax regime rather than increase the workload of an already overburdened judiciary.

- The Bill proposes to empower the tax collector to recover taxes not withheld, from the withholding agent which was previously an oversight in the Act.

- Laptops, notebooks and personal computers are being exempted from sales tax, which is indeed a step in the right direction in the information age. On the other hand, sales taxes on medium priced and smart phones is being increased by Rupees 500 per unit. Perhaps this is an attempt to tax luxury.

- Fertilizers are currently taxed on retail prices at 17% which is now proposed to be kept at 5% of ex-factory price. This is in line with the Government’s policy to provide incentive to farmers.

FEDERAL EXCISE DUTY (FED)

- As in the case of Sales tax and Income tax, Chinese companies and their contractors, including domestic, working in Gawadar Port and the Gawadar Free Zone are being exempted from FED for 40 years and 23 years respectively. We reiterate, that while CPEC is being deemed a game changer, tax exemptions should be considered in a long term perspective for the economy.

- As usual bad news for smokers. The Government appears to continue with its drive to curtail smoking through increase in FED. However, the proposal this time is to increase FED in a piecemeal manner probably to water down the impact from illicit trade in cigarettes. Curiously, contrary to the strategy relating to mobile phones, FED on rich man's cigars has not been increased.

- The mechanism of levying tax on cement is proposed to be modified from 5% on retail price to Rupee 1 per Kilogram. This not only increases the amount of FED but also insulates the Government from downward movement in prices. This proposal will have an adverse impact on housing costs and consequently rentals. This will also adversely impact the poor man's inflation.

- The Bill proposes to exclude services which have been subjected to provincial levy of Sales tax from FED. This particular matter of charging of FED at the Federal level was in courts pursuant to the 18th Amendment, according to which taxation of services fall within the provincial domain. Unfortunately, the bill does not clarify whether the amendment will be effective retrospectively or not.

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This document contains significant highlights of the budget 2016.

The amendments in taxation laws are generally applicable from 01 July 2016, unless otherwise stated.