KPMG

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Budget Red-Eye 2018

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Key Measures

"*GDP continued to grow above 5% in each of the last two years reaching 5.79 percent highest in 13 years in the outgoing fiscal year FY2018 and 4 percent in each of the three preceding years. This achievement is remarkable as it has been accomplished in the face of global head winds" Pakistan Economic Survey 2017-18.*

Conversely, the Rupee exchange rate vis-à-vis the US dollar declined to Rs. 115.93 compared with Rs. 98.49 in May 2013; the exchange rate during March 2008 was Rs. 62.58. Eventually, a continuingly depreciating rupee could raise inflationary concerns.

Perhaps, the two sides of the picture summarized above, appropriately describes the state of the country's economy.

The domestic outlook is perceived to be, and indeed is, encouraging with increasing GDP growth, fundamentally led by the services sector; lower inflation at 3.78% compared to 4.16% last year; increased tax collection of Rs 3,900 billion, continuing low State Bank of Pakistan (SBP) policy rate of 6% and the PSX 100 index at a comfortable level of 45,562. Further, it is maintained that fiscal deficit will be restricted to 5.5 %; albeit this will be dependent on fiscal measures taken by the caretaker government to June 2018. Circular debt is currently estimated at Rs. 1,000 billion.

The external economy on the other hand portrays a completely different picture. Trade deficit for goods, services and primary income stands at US $ 29.7 billion for the nine month period July 2017 to March 2018. Workers' remittances are more or less stagnant when compared with last year at US$ 14.6 billion for the same nine month period. The current account deficit as a result has ballooned to US$ 12 billion, which perhaps is also a record. Consequently, the country's external debt and liabilities increased to US$ 88.89 billion at 31 December 2017; SBP has not updated data thereafter to date. A bigger concern is that net reserves with SBP have declined to US$ 10.9 billion; precariously under 3 month's imports.

The twin amnesty schemes recently announced by the Government, can therefore be better understood in the context of the twin deficits showcased above; fiscal and current account. Broadly foreign assets can, under the scheme, be "whitened" by paying a nominal 5% tax with a lower rate of 2% for remitting foreign monetary assets to Pakistan. The domestic amnesty allows accounting for undisclosed income and assets at 5% and liquid assets at 2%. The view is that the government is targeting upwards of US$ 2.5 billion from the foreign asset amnesty scheme and hopes to address the fiscal deficit through the domestic amnesty scheme. Albeit, at this point fate of the schemes remain uncertain, as these continue to be debated in the Parliament with rumor mongers having a heyday, predicting an imminent review by the Apex Court.

Simultaneously with the amnesty schemes, significant changes have been made in income tax rates, reducing the highest slab for individuals to 15%; the impact of this being estimated at Rs. 100 billion. While the stated intent for dropping tax rates for individuals is to provide tax relief to the middle class, perhaps, this rate reduction might even be a catalyst for the informal sector to come forward and become part of the documented economy. It might therefore be productive to revisit corporate and AOP taxation on similar lines. Nonethelss, without the amnesty, the likelihood of increased tax collection may reamin remote.

Additionally, a fundamental change has been made in the limitation period for undisclosed foreign assets, these can now be taxed in the tax year prior to the year of discovery. There is a risk that this change in law, minus the amnesty, is likely to be challenged in courts in relation to rights vested by existing limitations provisions.

Whether or not these amnesty schemes meet the objectives, and to what extent, remains to be seen. Meanwhile, irrespective of the growth, the ride appears to be bumpy going forward; the Government, nonetheless, remains refreshingly optimistic as evident from the key measures announced in the budget speech.

Reduction in sales tax on fertilizer to 2% and on agricultural machinery by 2%; setting up of

agricultural support fund; support for cinema industry in the form of reduced indirect taxes and reduction in direct taxes; buying busses for Karachi green line project; 100/100/100 program for child education; measures to address child stunting and malnutrition; increase in pensions and in house rent for public servants; establishment of 400 vocational training schools; investment in Gwadar, roads and dams; are all positive but rather ambitious steps just prior to the next election. And that is not all, across the board tax relief has been announced for individuals, companies, investors, brokers and REIT, with a reduction in withholding for non-filers as well. Remains to be seen whether or not the next government can continue with this exciting agenda.

While we have always been optimistic about Pakistan's economy, primarily because of the nation's inherent strengths, we have always flagged economic indicators that point towards a black swan. For the coming year, debt servicing costs and defense expenditure combined exceed net Federal receipts.

Income Tax

- Offshore Digital Services to be taxed at 5% under the Final Tax Regime.

- The definition of Permanent Establishment brought in line with OECD requirements and extended to include the concept of cohesive business operations.

- Presently banking companies and other persons are required to pay super tax at 4% and 3% respectively. These rates shall be reduced by 1% per anum until eliminated.

- A public company, other than scheduled bank and modarba is liable to pay tax on undistributed profits at the rate of 7.5% of its accounting profit before tax in case less than 40% of such profit is distributed as dividend. This rate is now being reduced from 7.5% to 5% and the requirement of 40% distribution is now being reduced to 20%. Furthermore, bonus shares shall no longer be treated as profit distributed for the purpose of this exclusion.

- Non recognition of gain or loss is being restricted to gifts from a relative only.

- Only 50% of business income of a tax year can be set off against unabsorbed tax depreciation and amortization brought forward from a previous year. This limit of 50% will not be applicable if the taxable income for the year is less than ten million Rupees.

- The threshold for calculation of rebate on investment in shares and insurance premium to be enhanced from Rs. 1.5 million to Rs. 2 million.

- The limit for tax credit for investments in plant and machinery, BMR and new industrial undertakings, under sections 65B, 65D and 65E extended till 2021.

- Non-Profit Organization, trusts and welfare institutions may claim 100% tax credit against income from investment in micro finance banks.

- Gain arising to a non-resident company from disposal or alienation outside Pakistan of an asset located in Pakistan will be treated as Pakistan source income and chargeable to tax at 15%.

- Tax authorities' powers to recharacterize income and deductions further enhanced to disregard corporate structures created as part of tax avoidance scheme.

- Income attributable to a controlled foreign company is to be included in the taxable income of a resident person for a tax year in case where capital or voting rights of the resident person is 10% or more and income of the controlled foreign company exceeds Rs 10 Million.

- Resident persons will be required to provide details for remittances in excess of Rs. 10 million in any tax year.

- The provision pertaining to unexplained income and asset are being amended as follows;

  - Addition towards income of a person on account of unexplained Pakistani asset or income will be made in the year to which the same relates.

  - Addition towards income of a person on account of unexplained offshore asset or income will be made in the immediately preceding tax year in which the same is discovered by the Commissioner.

- Resident individual taxpayers are required to file foreign income and asset statement in case where foreign income exceeds USD 10,000 or foreign asset exceeds USD 100,000 in

prescribed manner. Non filing of foreign income and asset statement to attract a penalty of 2% of the value of such income and assets.

- Non-filers will not be eligible for registration of vehicle and immovable property valuing in excess of Rs. 4 million.

- Tax Rates for individuals, recently reduced through an Income Tax Amendment Ordinance 2018, also included in the finance bill.

- Corporate tax rate reduced to 29% for tax year 2019. Thereafter, the rate will continue to reduce by 1% annually until 2023.

- Tax rate for AOP to be reduced from 35% to 30%.

- Property rates declared by FBR to be abolished, all transactions to be recorded at actuals. Adjustable tax at 1% to be collected from the buyer on the declared value; existing withholding provisions abolished. Such advance tax may be recovered in installment if the purchase price is being paid in installments. Additional stamp duty at 1% payable to the Provinces at the declared value. Finally FBR shall have the right to purchase any property transacted within 6 months at twice the declared price for 2018-19; 1.75 for 2019-20; and 1.5 for 2021.

- In order to settle dispute through ADRC, now its decision shall be binding on the aggrieved person as well as FBR. The ADRC will be required to pass the order within 120 days of its appointment. Further, the aggrieved person and FBR will be required to withdraw appeal, if filed. On failure of making a decision within 120 days, the appeal shall stand restored under specified procedure.

- Automatic selection of audit being abolished. In a positive move, registered persons will only be subjected to audit once in three years.

- Tax rate of advance tax for non-filer on banking transactions reduced from 0.6% to 0.4%.

- The amount required to be deposited to qualify for an automatic stay of demand reduced from 25% to 10%.

- Minimum limit for tax deduction on payments for goods enhanced from Rs. 25,000 to Rs. 75,000 and on services enhanced from Rs. 10,000 to Rs. 30,000.

- Rate of tax on dividend received from a rental REIT by a filer reduced from 12.5% to 7.5%.

- Bonus shares issued to mutual funds exempted from withholding tax.

- Tax on commission earned by member of stock exchanges of 0.02% made adjustable.

- Reduced minimum tax rate applicable to large trading houses extended to 2021.

- Domestic film makers tax liability reduced by 50% for a period of 5 years while foreign film makers producing in Pakistan to get a tax rebate of 50%.

- Income of Pakistan Mortgage Refinance Company PMRC exempted from tax. Additionally income on bonds issued by PMRC to be exempt from tax.

- Import of coal to pay tax at 4% for filer and 6% for non-filer, incase of manufacturer as well as commercial importers.

- Debit and Credit card transactions outside Pakistan to be subjected to advance tax at 1% for filer and 3% for non-filers.

- Tax for commercial importers changed to minimum taxation.

- Withholding tax rates for non-filers increased once again from 7% to 8% in case of companies and from 7.75% to 9% in case of other than companies in respect of sale of goods. For contracts the rates have been increased from 12% to 14% for companies and from 12.5% to 15% in other cases.

- Tax deducted on payment against services to permanent establishment of non-residents to be treated as minimum tax.

- Transfer pricing regulations and provision relating to geographical source of income made applicable to banking companies.

- Requirements for furnishing of information by banks have been modified by substituting online access with certain specific details relating to cash withdrawals.

Sales Tax

- "Further Tax" rate increased from 2% to 3%. The cost of doing business in the informal sector to be enhanced for nudging businesses towards registration under the Act.

- The rate of default surcharge on outstanding sales tax demand to be fixed at 12% per annum. Undoubtedly the continuing low KIBOR rate is the catalyst to replace the existing KIBOR plus 3% charge. Albeit, we believe that surcharge was previously rightly linked with the cost of borrowing in the country. The change however harmonizes the default surcharge rate for income tax.

- The tax collectors, specifically, the Chief Commissioner and his team, will no more be able to post officers at business premises without permission of FBR.

- In a positive move, registered persons will only be subjected to audit once in three years.

- In another positive action, orders for appeal effects, as well as cases where fresh assessments need to be issued, will have to be made within one year. The stated objective is to quantify actual demands to facilitate registered persons.

- In order to settle dispute through ADRC, now its decision shall be binding on the aggrieved person as well as FBR. The ADRC will be required to pass the order within 120 days of its appointment. Further, the aggrieved person and FBR will be required to withdraw appeal, if filed. On failure of making a decision within 120 days, the appeal shall stand restored under specified procedure.

- A person will now be entitled for automatic stay of demand on payment of 10% of tax payable instead of 25% presently required.

- Sales Tax on all kinds of fertilizers being reduced to 3%. Further, sales tax on natural gas used by fertilizer plants as feed stock is being reduced from 10% to 5%. LNG used as feed stock is being exempted.

- Sales Tax on furnace oil reduced from 20% to 17%.

- China State Construction Engineering Limited exempted from Sales Tax (and FED) on imported construction and related machinery not manufactured in Pakistan as well as material and goods, whether made in Pakistan or not, up to a limit of Rs 10.8 billion, for specified projects. Similar exemptions are proposed for the Chinese contractor for the Lahore based Orange Line Metro Train Project. Such blanket exemption may not be in the best interest of local businesses.

- Import of specified parts of personal computers and laptops imported by the manufacturers are being exempted from sales tax.

- Reduced rates of 12% to apply on import of LNG by Pakistan State Oil Limited and Pakistan LNG Limited and on supply of RLNG by these companies to Sui Northern Gas Pipelines Limited.

- Sales tax on cinematographic equipments reduced to 5%.

- The rate on steel sector increased to Rs. 13 per unit of electricity.

- The rate on finished articles of leather and textile sectors increased from 6% to 9%.

Federal Excise Duty

- Similar changes made in the Sales Tax are being made for FED in respect of ADRC, appeal effect, audit, default surcharge rates and the amount to be deposited for automatic stay. In summary, if the changes go through, ADRC decisions will be binding on taxpayers and the FBR; taxpayers will only be subjected to audit once in three years; default surcharge will be charged at 12% per annum; and the amount required to be deposited for an automatic stay will stand reduced to 10%.

- FED on certain categories of cigarettes to be increased by around 6%.

- FED on cement to be increased from Rs. 1.25 per kg to Rs. 1.50 per kg.

- Commission paid by SBP and its subsidiaries to National Bank of Pakistan or any other banking company for handling banking services of the Federal or the Provincial Governments as SBP agents to be exempted from FED.

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This document contains significant highlights of the budget 2018.

The amendments in taxation laws are generally applicable from 01 July 2018, unless otherwise stated. This document contains comments, which represent our interpretation of the legislation, and we recommend that while considering their application to any particular case, reference be made to the specific wordings of the relevant statutes.