TAXATION OF BUSINESS INCOME IN PAKISTAN------ PRINCIPLES AND TAX POLICY CONSIDERATIONS UNDERLYING INADMISSIBLE DEDUCTIONS REGIME.

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Contrary to the principle specific admissibility regime of Section 20; the Income tax Ordinance, 2001 contemplates u/s 21 an expenditure specific inadmissibility regime for the purposes of computing taxable income of a taxpayer under the head of "income from business". There are 13 types of specific expenditures which are not admissible as an expense against business income.

(2) The evaluation of the nature, style, manner, pre-qualifications and the set of circumstances covering the 13 types of specified expenditures are under written by concrete tax policy. The tax policy options are rooted in seven under lying principles:

(i) Tax is not a cost component for doing business.

(ii) Personal expenditure can not be claimed as a proxy expenditure against business income.

(iii) Taxes are tools to influence behavior of a taxpayer to make him more compliant to tax laws in particular and other laws of the land in general.

(iv) Business related entertainment expenditure must conform to the socio cultural norms of propriety.

(v) Taxes are an instrument for ensuring documentation of economy

(vi) A capital expenditure is not cost component for doing business unless specifically stated.

(vii) An Association of Persons and its members are not two distinct legal entities.

(3) The principle that tax is not a cost component for doing business is woven into provisions of sub-section (a) and (b) of Section 21. Section 21 stipulates that any type of tax whether we call it a cess, or rate or whether we call it tax in its ordinary sense can not be claimed as a business expense whatever and wherever paid i.e in Pakistan or in a foreign country. Likewise Section 21(b) dictates that any amount of tax deducted at source on payment on account of salaries, interest (profit on debt), payments to a non-resident, sale or supply of goods, charges or fee paid against rendering of services, executing of contract, payment to a non- resident media person, transfer of export proceeds to an exporter, on payment of rent or advance related to any property, on prizes and winnings, on payment of commission on petroleum products, withdrawal of balance sums under a pension fund scheme can not be claimed by a recipient as an expense against its business income.

(4) The principle that any personal expenditure can not be claimed as a proxy of business expenditure is covered in Section 21(h). Such like provisions are provided in the tax codes of almost all the income tax jurisdictions in the world. Violation on this score is treated as an extreme case of tax evasion. We can refer to the famous American case of Mrs. Leona Helmsley, the wife and heir of New York real estate tycoon Harry Helmsley, who was sentenced to 18 months on charges of three counts of tax evasion by the Internal Revenue Service (IRS) of USA on claiming as her hotel business expenses the sums which were actually incurred on her personal residence i.e. $ 1 million dance floor, $ 45000 silver clock and $ 130,000/- stereo equipment.

(5) Tax policy option to employ taxes as a tool for influencing the behavior of a taxpayer to make him compliant to tax laws in particular and other laws of the land in general is reflected in the provisions of Section 21(c) (e) (f) (g). A bare reading of Section 21(c) would show that it contemplates to heavily punish non-compliant behavior of a taxpayer in terms of his failure to discharge his statutory obligation to deduct tax at source at the time of making payment against prescribed transactions:

(i) payment of salaries to its employees.
(ii) payment of rent to its landlord
(iii) payment of brokerage or commission to its broker or agent
(iv) payment of professional charges/fees for rendering services
(v) payment of interest
(vi) payment to a non-resident.

Section 21(e) contemplates that where business sets up any provident fund, pension fund or a gratuity fund for welfare of its employees but such funds are not recognized by the concerned commissioner of Inland Revenue the whole of such contribution made by the employer would be an inadmissible expense. Section 21(f) is similar to section 21(c) in its tone and tenor. It is of wider import and covers any provident fund or any other fund that is established by business for the benefit of its employees. Any contribution made by a business towards such provident or any other beneficial fund would be hit by the mischief of section 21(f) in case the taxpayer/business enterprise fails to make effective arrangements for ensuring tax deduction at source at the moment any such sums is paid to an employee out of such funds which qualifies to be his taxable salary income. Section 21(g) stipulates that any fund or penalty paid or payable by a business for violation of any law, rule or regulation can not be claimed as a business expenses. This is a provision of wide amplitude and aims to discourage the violation of all other laws of the land. For example if any business is charged for theft of electricity and is subjected to any fine or penalty or both the amount of such fine or penalty can not be claimed as a business expense.

(6) The admissibility of entertainment has been qualified in terms of socio cultural propriety in Section 21(d) read with Rule 10 of Income Tax Rule 2002.The qualification of propriety is embedded in the concept of "entertainment" as defined in sub-rule 3 of Rule 10 of the Income Tax Rule 2002: "Entertainment" means the provision of meals, refreshments, and reasonable leisure facilities in accordance with the tradition of business and subject to overall norms of custom of business in Pakistan. Expressions like "reasonable leisure facilities, "tradition of business," and "over all norms and custom of business in Pakistan" are the limiting factors and can be better summed up as the expressions denoting "socio- cultural propriety". Rule 10 further stipulates that entertainment expenditure is admissible only when it is directly related to the person's business. It means that any expense incurred on a birth day party or a marriage party would not qualify under the head of entertainment for business purposes. Rule 10 also stipulates the location, the type of entertainees and the occasions of entertainment as under:-

(a) expenditure incurred outside Pakistan on entertainment in connection with business transactions or where such expenditure is allocated as head office expenditure;

(b) expenditure incurred in Pakistan on entertainment of foreign customers and suppliers;

(c) expenditure incurred on entertainment of customers and clients at the person's business premises;

(d) expenditure incurred on entertainment at a meeting of shareholders, agents, directors or employees; or

(e) expenditure incurred on entertainment at the opening of branches.

(7) According to some estimates almost 50% of the economy of Pakistan is undocumented and is a major source of tax evasion. In order to curb and contain the trends of cash economy the Income Tax law introduced the provisions of Section 21(1) and (m). Section 21(l) stipulates that any expenditure under a single account head which, in aggregate, exceeds Rs. 50,000/- must be paid by a banking channel. The scope of banking channel is sufficiently wide. It includes any payment under any single head of expenditure exceeding Rs. 50,000 by

(i) crossed bank draft

(ii) crossed cheque

(iii) crossed pay order

(iv) any other crossed banking instrument showing transfer of amount between the parties concerned

(v) on line transfer of payment

(vi) payment by credit card.

This provision however creates an exception in two ways. In the first category it shows that any expenditure under a single account head which does not exceed Rs. 10, 000/- can be paid in cash. It further stipulates that any payment on expenditure like utility bills, freight charges, fee, fines or payment of taxes, duties, can be paid in cash. The reason for such exception is self evident because the very nature and processing of such transactions is well documented in terms of capturing the credentials of the taxpayers and such documents emerge as traceable records in the hands of relevant tax authorities. Section 21(m) creates an exception and ordains that any sum of salary payment below Rs.15000 can be paid in cash. In respect of salary payments exceeding this threshold, the employer is obliged to make payment by a crossed cheque or transfer it to an employees bank account.

(8) The principle that a capital expenditure is not admissible as expenditure against business income is stated in Section 21(n) and (i). Although the law has not defined the expression "capital expenditure" but in the case reported as CIT V Luxmi Narayan Cotton Mills Ltd reported as 1960 PTD 855 it has been referred as the expenditure which is spent "once for all"; an expenditure with a view to bringing into existence an asset or advantage for continuing benefit of the trade (per Viscount L.C. in the British insulated and Halsbly Ltd case). However exception to this provision is provided in sections 22, 23, 23A, 23B, 24, 25, 26, 27, 28, 29, 29A 30 & 31 wherein the capital expenditure incurred in acquisition of the durable assets (tangible as well as intangible) are made admissible as a business expense on the basis of prescribed eligibility criteria. Likewise any amount carried to reserve fund or capitalized in any way can not be claimed as business expenditure within the dictates of section 21(i).

(9) The Principle that Association of Persons and its members (an individual natural person) are not two distinct legal entities but the same entity for the purposes of computing business income is reflected in Section 21(g). This provision stipulates that an Association of Person can not claim any payments made by way of interest, brokerage, commission, salary or any other remuneration to an individual member. Any such claim would be disallowed and added back to the income of an Association of Persons or vice verse.

The above discussed evaluation of the inadmissibility regime of Section 21 of the Income Tax Ordinance, 2001 incorporates a host of tax policy options in order to secure the tax base, promote the documentation of economy and discourage an erratic behavior of a taxpayer that tends to violate the tax laws or other laws of the land.