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**Income Taxation in Pakistan**

By

Abdur Rab



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INCOME TAXATION IN PAKISTAN

By

Abdur Rab<sup>\*\*</sup>

\* The author is Research Economist at the Pakistan Institute of Development Economics. He has received the encouragement to attempt a study of Pakistan's income tax system, of which the present survey is the beginning, from Stephen R. Lewis (Jr.), formerly Research Advisor at the Institute and now Assistant Professor, Harvard University. He had the benefit of helpful suggestions from Lewis, and from Bruce Glassburner, Senior Research Advisor, Keith B. Griffin, Fellow at Magdalen College, Oxford and Research Advisor at the Institute during Summer 1965 and Joseph J. Stern, Research Advisor, which considerably improved the presentation of the survey. None is responsible for any mistakes except the author himself.

## INCOME TAXATION IN PAKISTAN

### 1. INTRODUCTION

There is in Pakistan at present no up-to-date, precise, simple and comprehensive statement of the income tax system. What is available does not lend itself to easy analytical treatment by an economist interested in the problems of taxation in underdeveloped countries. For this reason, and as a necessary introduction to additional research work in this area, a survey of Pakistan's income tax system is attempted here.

Such a survey would be useful for a number of reasons.

a) Pakistan has inherited and developed a very elaborate and intricate body of income tax laws which needs to be analysed and presented in a systematic form.

b) About one fifth of the central government tax revenue comes from income taxes. Moreover, income taxes are by far the most important of the direct taxes levied in Pakistan. No meaningful analysis of the overall tax system is possible without giving full consideration to the income taxes.

c) Pakistan is one of the few underdeveloped countries which has a long experience in income taxation, the first income taxes having been levied in 1860. The current law is based on the Income Tax Act of 1922 of British India. It would be interesting to see how the British-influenced income taxes have fared in the relatively short history of a newly established nation.<sup>1/</sup>

d) There are important problems of analytical interest that are posed by the Pakistan income tax system. First, as indicated by the Taxation Enquiry Committee

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<sup>1/</sup> Having remained under British rule for about two centuries, India gained independence and was partitioned into two sovereign states, India and Pakistan in August, 1947.



appointed in 1957 by the Government of Pakistan, income taxes have poor coverage of income-earners probably less than one percent [7, pp. 31, 37]. It is desirable to have a closer examination of this coverage and to trace the actual and likely changes that occur with economic development. Second, it would be useful to know who pays income taxes in Pakistan. This could be a study of incidence by occupational groups as well as by income classes with the available data, although there are some gaps in the available information. A further incidence analysis that can be carried out with the available information on both income taxes and other taxes is an inter-industry as well as inter-sectoral tax burden analysis. Third, one might ask: what role is being played by these direct taxes in Pakistan as a revenue-raising instrument? How responsive to economic development or to changes in the underlying economic base are the revenues from these taxes? One can attach primary importance to this question in view of the desirability to develop such instruments as are best capable of raising domestic resources for economic development as economic growth proceeds. Other questions that might be asked are: what prospects do income taxes have in becoming a major revenue instrument in the near future as the economy passes through a phase of intensive economic development? A study of the income tax system would assume an added significance if one foresees a larger role for this tax in the coming years, which is the likely possibility. It might also be asked: how effective and efficient is the income tax administration here? In a meeting of the Karachi Chamber of Commerce and Industry held on April 24, 1965, the Finance Minister remarked that if tax evasion could be avoided, there would be no need of additional tax measures for the Third Five Year Plan (which began July 1965). This seems to point to the large revenue potential of the existing income taxes in particular since these are

the more important of the direct taxes where tax evasion is presumably most rampant. There is also a need to carefully scrutinize the statutory rate structures of these taxes falling on both personal and corporate incomes, the effective rates and the aspects of vertical and horizontal equities, the system of exemptions and the associated structure of incentives and disincentives, and similar other aspects of the tax system. The writer hopes subsequently to analyze several of these problems.

The survey is organized in the following manner. General features of the income tax system covering the taxation of both personal and corporation incomes will be noted first. The two major divisions of the system, namely, the taxation of personal income and corporation income will then be separately described. All this will be presented in terms of the 1965-66<sup>1/</sup> legal framework. This will be followed by a brief history of the evolution of the system containing a statement of the major changes in the tax law during the lifetime of Pakistan. Unless otherwise indicated, the basic sources for the survey are the Income Tax Act of 1922, as amended from time to time [ 11,12,16 ] and the annual Finance Acts as contained in the Budgets of the Central Government [ 15 ].

## 2. GENERAL FEATURES

### 2.1. Tax Authority and Revenue Allocation.

Income taxes are levied by the central government. There is however, an arrangement to remit part of the revenue collection to the provincial governments. Different arrangements were adopted from time to time in the past.<sup>2/</sup> The present arrangement was adopted very recently on the basis of the recommendations of a Finance Commission appointed by the Government of Pakistan. According to this, each province would receive 65 percent of the collections of "income tax" which can be attributed to it as its contribution. The provinces have no share, however, in the collections from "super tax" which is

<sup>1/</sup> Fiscal years in Pakistan are split calendar years which run from July 1 of the previous year to June 30 of the following year. Until April 1, 1959, they ran from April 1 to March 31.

<sup>2/</sup> For these arrangements see [ 7, pp.11-13 ].

also an income tax now being levied on corporations and a few other taxable entities.

## 2.2. Income Taxes and Taxable Groups.

2.2.1. Until 1959-60, Pakistan used to have as many as three kinds of income taxes: a standard levy called "income tax" (which we will designate as normal income tax), a "super tax" and a "business profits tax". The "business profits tax" was introduced shortly before independence replacing in a way a pre-independence imposition called "excess profits tax". The latter tax was abolished in 1946, the former in 1959. However, collections from these taxes continued to be made even after they had been abolished and these collections were on assessments relating only to the incomes of earlier years when the taxes had been in force. At present the normal income tax and super tax are levied. These taxes derive from the basic income tax legislation of 1922, as amended and supplemented by the annual finance acts which establish the current rates of taxes and fix certain exemptions including rebates.<sup>1/</sup>

The "business profits tax" was levied on the profit incomes of trade, commercial and manufacturing activities with the exception of income of life insurance companies. With minor exceptions, the profits were determined in the same manner as for the purposes of the other income taxes. However, a special "abatment" or deduction was allowed to determine the net taxable profits to be assessed at the existing tax rate. The abatment was usually Rs.100,000 or an amount equivalent to 6 percent of the capital cost, whichever was greater. The tax was applied at a flat rate of  $16\frac{2}{3}$  percent. With respect to new industrial enterprises established after independence and coming up to a certain size of operation, a part of the profits equivalent to 5 percent of the capital cost which was exempt for purposes of "income tax" was

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<sup>1/</sup> In this survey, the terms "exemptions", "deductions" and "rebate" are used in the following senses. "Exemption" is used in a general sense to cover every case of income which goes untaxed in any form. "Deduction" is used to mean any amount which is deducted from receipts to arrive at net taxable income assessable at the going tax rates. In this sense, a deduction may be an expense item like business deduction, or it may be an income item which is a particular case of income exemption. "Rebate" has been officially used in the context of income taxation to mean either of two things. First, it means exemption of part of income at the going tax rates where the rebate bears the same proportion (cont: p.5).

also exempt from the business profits tax. Beginning in April 1951, all such new industrial enterprises became completely exempt from this tax for the first five years of their operation. As a result the incidence of the tax has remained very partial since then. In 1959 the tax was completely withdrawn.

2.2.2. The broad assessable groups specifically identified by the law for income tax purposes include individuals, firms, corporations, and other associations of persons. Firms that are partnerships can be "registered" with the income tax authorities, and when so registered, the individual partners of a firm are made liable to pay income tax on their individual share of profits added to their other incomes while the firm itself is made liable to pay super tax on its total profits. In the case of unregistered firms, tax is levied on the firm itself and only on exceptional occasions are the individual partners of a non-registered partnership made liable. Corporations make a distinct group by themselves as they are subject to a set of income tax rates separate from the one applying to the remaining groups.

### 2.3. Residence Status as a Liability Criterion

2.3.1. It is not nationality but residence of the tax-payer, which determines his income tax liability in Pakistan. Three grades of residence status are distinguished for individuals while two are maintained for corporations, firms or other associations of persons. The former can be (i) "resident" in Pakistan, (ii) "resident but not ordinarily resident", and (iii) "non-resident". The latter can be either "resident" or "non-resident". The difference in tax liability or taxable incomes of the tax payers, which is created by the residence status lies only in respect of foreign incomes and not in respect of domestic incomes of the taxpayers. All taxpayers have to pay taxes on their incomes that have or are deemed to have arisen, accrued, or been received in Pakistan. Non-residents do not have to pay taxes on the part of their incomes that has not so arisen, accrued, or been

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(from pre-page) to total gross tax liability without the rebate, as the exempt income does to the total income without the exemption. The net tax liability after the rebate is payable. In the second sense, the rebate implies a reduction in the rate of tax at which tax is payable.

received in Pakistan. Residents are taxed on their total incomes. Individuals who are resident but not ordinarily resident are not taxed on all of their foreign incomes. Only that part of their foreign incomes is taxed which arises from a business controlled in Pakistan.

The income tax liabilities of non-residents except corporations may differ in another way from those of their resident counterparts. They are liable to pay income tax on their Pakistan income at the "maximum rate", that is at the rate of 30 percent or the rate at which a resident would pay on the same amount of income, whichever is the higher. Or, alternatively they may choose to be taxed as residents and pay tax on their Pakistan income at the rate applicable to their total income, an option given on the first assessment, which once exercised becomes binding on all future assessments.

#### 2.3.2. How is the residence status of a taxpayer determined?

An individual is considered resident in Pakistan for any tax assessment year if he:

- i) has been in Pakistan in that year for an aggregate period amounting to at least 182 days, or
- ii) has maintained a residential house for at least 182 days and has been in Pakistan at any time during that year or
- iii) has stayed in Pakistan for at least 365 days during the four years preceding the assessment year and has been in Pakistan for any time during that year except on a casual visit.

An individual is resident but not ordinarily resident in Pakistan in any year if he has not been resident in Pakistan in nine out of the ten years preceding that year, or if he has not stayed in Pakistan for more than two years during the seven preceding years. Partnerships or other associations of persons except corporations are resident in Pakistan unless the control and management of their affairs are wholly situated abroad, whereas incorporated companies are resident only if the control and management of their affairs are wholly situated within Pakistan.

#### 2.4. Avoidance of Double Taxation

Pakistan has agreements with several countries such as India, the United Kingdom, the United States, West Germany, Switzerland, Japan and Sweden to avoid double taxation of the incomes of the resident tax-payers. In cases involving countries with which no such agreements exist, Pakistan affords unilateral relief up to the full amount of the foreign tax or the Pakistan tax, whichever is lower.

#### 2.5. Taxable Income Common to both Personal and Corporation Income Taxation

The income tax law does not define "income" as such. However, the concept of income used for tax purposes broadly conforms to the usually accepted notion of income as found in economic text books. Tax is levied on incomes from several specifically mentioned sources: (i) salaries; (ii) interest on securities; (iii) income from property; (iv) profits of a business, profession, or vocation; and (v) income from other sources. The last group includes such incomes as dividends, interest on bank deposits, ground rent on non-agricultural land, rents or royalties from the lease of mining, fisheries, forests, and similar property, and commissions and fees of various types.

However, several kinds of income remain completely exempt under the Pakistan tax law. These are noted below.

##### 2.5.1. Incomes Totally Exempt. (a) Farm Incomes.

By far the most important kind of income in Pakistan, agricultural income, is not touched by the income tax law. Agricultural income is left under the tax jurisdiction of the provincial governments.

"Agricultural income" is defined to include incomes derived from land cultivated or used for agriculture, or from processing of agricultural goods ordinarily employed by a farmer. What constitutes agricultural income or non-agricultural income is not always explicit and has partly depended on custom and past court

interpretations in specific cases. Income from certain processes such as the gathering of forest products and fishing is not considered agricultural income. Income from dairy farming becomes agricultural income when the cattle are pastured but it is not agricultural income when they are wholly stall-fed. Agricultural income includes rent received from agricultural land, and buildings, remunerations for work done on land, and dividends on investments in agriculture. A major part of the income from the processing of tea on tea plantations, roughly sixty percent, is agricultural income while the rest is regarded as non-agricultural income.

(b) Casual Incomes. Casual and non-recurring incomes which do not arise out of any business, profession, vocation or occupation get exempted from income tax unless these receipts are by way of addition to other taxable income of an assessee. Incomes earned from lottery winnings, gambling or betting are included in this category.

(c) Transfer Receipts. Transfer receipts as such are not considered as taxable income. However, the subsequent flows of income received on the gifts of assets have become considered as taxable income beginning 1964-65.

(d) Trust Incomes. Incomes of charitable and religious institutions applied solely to charitable or religious purposes for the general public are exempt. These institutions may derive incomes from voluntary contributions, from property held under trust, or from business carried on as a subsidiary occupation by themselves or on their behalf by others. Income received in trust for certain provident funds is also exempt.

(e) Incomes of Local Authorities. Income of local authorities such as municipalities are exempt insofar as they are earned within the area of their jurisdictional limits. Thus



incomes from a business or supply of services such as electricity supply extending beyond the local authority's jurisdictional limits are taxable.

There still remain a variety of other exempted incomes which will be noted in the appropriate context of personal and corporation taxes.

2.5.2. Taxable Income of Business.<sup>1/</sup> Business income is the main category of income which is assessed either to personal income tax or corporation income tax depending on the organization of the business. Unlike personal incomes where no expense items are recognized, the characteristic of business income is that it is determined after deduction of certain expenses from gross business receipts. Business expenses constitute a large category of total business receipts and are open to abuse for tax purposes.

Whereas general accounting and economic principles essentially underlie the determination of business net income, there are significant departures from this procedure in determining business net income for tax purposes. The tax law allows as deductions all the operating expenses which are strictly business expenses incurred during the accounting and tax assessment year. It also allows some items such as fees to business directors, bonus payments which may not be strictly business expenses, and it permits a liberal deduction that can be charged to depreciation. Moreover, some expense items which are not items of operating cost but items of capital expenditure also may be allowed as deductions from current income. The tax law, while it lays down some general principles to permit business deductions, also takes care to enumerate most of these deductions. Major types of these deductions may be listed as follows:

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<sup>1/</sup> The description here ignores the special types of business such as life insurance and various fields of oil and mineral extraction where special procedures are adopted for determining taxable income.



Business Deductions. Current or operating costs of business allowed as deductible items for income tax purposes include (i) depreciation and obsolescence charges, (ii) payments to labour, (iii) bonus payments, (iv) brokerage and commission charges, (v) fees and remunerations to the managing agents and directors, (vi) advertizing outlays, (vii) auditing and legal charges, (viii) travelling and entertainment expenses to a "reasonable" extent if incurred in the course of business, (ix) material costs, (x) rent payments on hired business premises, (xi) interest payments on borrowed funds (excluding certain interest payments to non-residents if no tax is paid on this interest income behalf of the non-resident lenders), (xii) charges on insurance covering risk of damage of destruction of fixed capital assets of business including inventories, (xiii) repair charges, (xiv) bad and doubtful debts written off, and (xv) current expenses incurred for boarding, conveyance, health services, education and other welfare for the employees insofar as the employees are not charged for the services rendered.

There are two items of capital expenditure which need not be recovered gradually through depreciation, but are allowed full deductions from current profits to determine net taxable profits. These are : (1) expenditure on scientific research related to business including payments to educational institutions for such purposes, and (2) expenditure incurred on the construction of schools and hospitals for the business employees.<sup>1/</sup> Investment in human capital including expenditure incurred on the training of Pakistani citizens abroad in connection with a scheme approved by the Government is also treated as current business deduction.

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<sup>1/</sup> While returns from such expenditure are unlikely to be limited to just one year, part of it may nevertheless be in the nature of current expense.

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<sup>1/</sup> The description here ignores the special types of business such as life insurance and various fields of oil and mineral extraction where special procedures are adopted for determining taxable income.

Deductions to Property Income. Deductions allowed to income from house property are similar to business deductions and cover (i) repair charges, subject to a maximum of one-sixth of the gross income which is normally the annual rental value of such property, (ii) rent payments on land taken on lease on which the property stands, (iii) interest payments on borrowed funds used for the construction of such buildings, (iv) payments on insurance of property, (v) rent collection charges and legal charges to a maximum of six percent of the gross income, and (vi) allowance for vacancies of houses or for unrealized rent. Income from buildings used for business purposes is exempt since it is deducted from gross business profits to arrive at net business profits.

#### 2.6. Tax Treatment of Depreciation

Depreciation allowances are allowed to physical capital assets owned by the assessee. These assets cover buildings, machinery, plant, motor cars and vans, furniture, and office equipment (typewriters, calculators, etc.) utilized for the business activity during the assessment year. Buildings include those used for housing employees where the quarters are provided rent-free. Depreciation is not allowable on stocks and stores.

A declining balance method of calculating depreciation is used. This is a kind of accelerated depreciation used in many countries.<sup>1/</sup> The valuation of assets adopted for purposes of statutory depreciation is the original cost of acquisition less depreciation allowances previously accorded. This is called the "written-down value". The statutory depreciation accorded may not have any relation to what is actually written off in the assessee's accounts.

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<sup>1/</sup> The declining balance method has come into wide use in European countries and has recently been brought into use in the United States.

If current profits are not sufficient to have the full amount of current admissible depreciation allowances/realized, it is permissible to carry forward for realization against profits of future years for an indefinite period of time the unrealized part of the allowance.

Several statutory allowances on account of depreciation are provided as an avowed policy of encouraging productive activities using physical capital. There are normal, initial, additional, and extra-shift allowances which can be simultaneously enjoyed by a firm under certain circumstances. The initial and additional allowances are intended to be temporary tax incentive measures. The additional allowances cease to apply to plant and machinery installed after June 30, 1965. However, these allowances will still continue to be available for sometime on the plant and machinery which were installed earlier than July 1965 but not so early as to enable them to have the allowances for a complete period of five years. The initial allowances are officially declared to be available up to June 30, 1970, the end of the Third Five Year Plan period.

The initial allowances are granted to buildings, plant and machinery not previously used in Pakistan, and office equipment. Plant and machinery previously used in Pakistan, motor vehicles other than those plying for hire, and furniture and fittings are not entitled to these allowances. The initial allowances are once-and-for-all allowances available in the first year of commercial production or in the year of installation of the assets whichever is later. However, the unabsorbed allowances can be carried forward into future years for an indefinite period of time.

The additional allowances are available on plant and

machinery and other assets, except buildings, and except motor vehicles other than those plying on hire. They are available for the first five years of use of these assets.

The additional allowances are provided at the same rates as those specified for the normal allowances. The rates of normal and initial depreciation allowances by major type of assets are as tabulated below:

Table 1.  
RATES OF DEPRECIATION ALLOWANCES

| Asset                                  | (Percentages of written-down value) |                 |                    |
|--|-------------------------------------|-----------------|--------------------|
|  | Normal Allowances Range             | Average         | Initial Allowances |
| Buildings other than factory buildings | 2.5 - 7.5                           | 5               | 15 <sup>a</sup>    |
| Factory buildings                      | 5 - 15                              | 10              | 15                 |
| Machinery and plant                    | 2.5 - 40 <sup>b</sup>               | 10              | 25 <sup>c</sup>    |
| Motor cars                             | -                                   | 20 <sup>d</sup> | None <sup>e</sup>  |
| Motor lorries and buses                | -                                   | 25              | None <sup>e</sup>  |
| Furniture and fittings                 | 6 - 9 <sup>f</sup>                  | 6               | None               |
| Office equipment                       | -                                   | 15              | 25                 |

- a) The rate is 10 on buildings other than industrial and commercial buildings. The rate is 25 on residential buildings constructed to house industrial labour with monthly wages below Rs. 400.
- b) Rates below 7 apply to very few cases.
- c) The rate is 40 on ships.
- d) Cars with value per car exceeding Rs. 40,000 are not eligible for depreciation allowance in respect of the excess value.
- e) Motor vehicles plying on hire are entitled to the initial allowance at the rate of 25 percent. and the 9
- f) There are no rates between 6 and 9/percent rate applies only to furniture and fittings used in hotels and boarding houses.

It should be noted that the initial and additional allowances are not available to all enterprises. Since new undertakings in approved lines of industry are granted complete tax exemption for a certain period, a tax holiday, these undertakings cannot take advantage of these allowances when their tax holiday ends.

Extra-shift allowances are provided to plant and machinery used in multiple shifts. On double-shift use, these allowances are 50 percent of the normal allowances, and on triple-shift use, 100 percent. If plant and machinery are not used for a complete year, the admissible depreciation allowances are determined according to the portion of the year for which plant and machinery have been utilized.

These various allowances enable most of the capital cost to be recovered within the first few years.

Where plant, machinery and buildings are scrapped, obsolescence allowance is provided to the full extent of the written-down value less the scrap value. Where, however, the scrap value or the sale value exceeds the written-down value, the difference between the sale value and the written-down value is treated in a special way. This difference up to the full extent of the depreciation allowances already received is treated as regular income subject to income tax. If this difference exceeds the amount of the previously received depreciation allowances, such excess receipts are treated as capital gains subject to capital gains tax.

#### 2.7. Loss Offset Provisions

Losses from business, profession or vocation are allowed to be offset against current incomes from all sources, and where they are not fully realized in this manner, they can be carried over to a maximum period of six years - to be offset against only

machinery and other assets, except buildings, and except motor vehicles other than those plying on hire. They are available for the first five years of use of these assets.

The additional allowances are provided at the same rates as those specified for the normal allowances. The rates of normal and initial depreciation allowances by major type of assets are as tabulated below:

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| Motor cars                             | -                                   | 20 <sup>d</sup> | None <sup>e</sup>  |
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| Furniture and fittings                 | 6 - 9 <sup>f</sup>                  | 6               | None               |
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the incomes from the same business, profession or vocation. Losses from "speculative transactions" are not allowed to be offset against incomes from other sources but only against future profits from the same source. The time limit for the carry-forward of losses does not apply to depreciation allowances which, as already noted, can be carried forward indefinitely.

#### 2.8. Exclusion for Local Taxes

Business and property incomes are subject to some provincial and local taxes such as land revenue, property taxes and other local rates. The income tax law allows these taxes to be excluded from incomes to arrive at the net taxable incomes. The principle adopted for allowing exclusion to these taxes is that they must not relate to the incomes or profits of the taxpaying unit concerned.

#### 2.9. Special Tax Treatment of Capital Gains

Capital gains are treated differently from other taxable incomes under the income tax law. Capital gains are taxed more lightly than the other forms of income.

For income tax purposes, capital gains do not include gains which arise in the exchange of immovable property. The latter kind of gains are subject to provincial taxation. The main category of assets on which capital gains or losses are deemed to arise are equity shares.

Liability for income tax on capital gains varies with the period of time for which the assets are held by the assessee. When the holding period is six months or less, capital gains are treated as normal income and hence liable to the same income taxes as other income. Capital gains qualify for special treatment



in case the assets are held for a period exceeding six months. If the holding period lies between six months and five years, the tax is levied in the following manner: For individuals, two-thirds of the capital gains, subject to a minimum of Rs.10,000, are exempt and the balance is to be added to the other income of the taxpayer and assessed at the appropriate income tax rate. For corporations and registered firms, capital gains are taxed at a reduced rate of 20 per cent. If the holding period is more than five years, the respective rates of tax as applied to individuals and corporations (including registered firms) are reduced to one-half of the rates as applicable in the above case.

A somewhat different treatment is accorded to stock exchange dealers. The minimum holding period which enables them to get the tax advantage of capital gains is one year instead of six months. This provision has been introduced in 1965-66.

Capital losses can be offset only against capital gains and they can be carried forward for offset purposes for six years, as in the case of other business losses.

### 3. TAXATION OF PERSONAL INCOME

#### 3.1. The Tax-paying Unit

Personal income tax rates are applied to the incomes of individuals, partners of registered firms, unregistered firms, and certain associations of persons which are not assessed at the company tax rates. Tax payers are required to disclose their incomes from all sources even when their incomes from a particular source such as salary or interest on securities are subject to taxes that are withheld at the source.

In a progressive system of personal income taxation such as exists in Pakistan and other countries, some analytical significance attaches to the concept of "tax-paying unit of a family" used for taxation purposes, for the tax liability of a person, or of a family may depend on the particular concept used. In Pakistan<sup>1/</sup> the earning members of a family constitute separate tax-paying units and they are assessed separately according to their respective earnings. Some exception is made with regard to joint Hindu families when the family as a whole is the tax-paying unit and the total family income is assessed at the appropriate rate.

The concept of the tax-paying unit used in Pakistan has some side implications. All the admissible personal exemptions, allowances, and rebates are available to the tax-paying unit and not to the family as such, or to the individual members of a family as such unless they appear as separate tax-paying units. Thus a family can have the advantage of one, two, or three times the various admissible personal allowances, depending on the

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<sup>1/</sup> Tax-paying units under personal income taxation in a few developed countries are as follows. In the United Kingdom, the family is treated as the tax-paying unit where the incomes of all the members of the family are pooled to be assessed at the appropriate rate. In the United States husband and wife are separate tax-paying units with their total incomes equally split for assessment. In Canada husband and wife are separate units with their incomes assessed according to their respective earnings. In France a family constitutes several units depending on its size and appropriate rates are applied to the incomes equally split among them.

number of the tax-paying income-earners of the family. The size of the family is no consideration for the extent of allowances admitted to a family. A married person receives virtually the same tax treatment as an unmarried person.

### 3.2. Taxable Personal Income : Exemptions

3.2.1. Personal Incomes Completely Exempt. Certain types of non-assessable personal income, aside from the general types of non-assessable income already noted, include interest income from post office savings deposits and from investment in National Development Certificates floated by the Government, incomes of certain foreign officials working in Pakistan, and certain lump-sum receipts such as receipts from provident funds, from superannuation funds, and from insurance policies, unemployment compensations, and receipts in commutation of annuities or pensions. Other lump sum receipts such as gratuities, deferred annuities and commutations of pensions in compromise or reduction of salary are not exempt. Pensions, royalties from mining leases or patent licenses have usually been considered taxable income. With regard to pensions, however, the government has, with effect from 1965-66, granted complete exemption for persons over sixty-five years of age.

3.2.2 Personal Exemptions. a) Basic Personal Exemption Limit. Personal incomes not exceeding a certain minimum limit are completely exempt from income tax. This limit at present stands at Rs. 6000. However, once incomes reach the taxable range, the total income, without the deduction for this basic exemption, becomes taxable. Thus a person with an annual income of Rs. 6001 is to be assessed at some rate on this whole income less the permissible deductions while the person with one rupee less goes untouched.

b) Personal Allowance. A straight personal deduction of Rs. 2000 is allowed on the income of every tax-paying income-earner.

c) Earned Income Relief. Differential tax treatments are accorded to "earned incomes" and "unearned incomes"<sup>1/</sup> and to salary incomes and non-salary earned incomes. Earned incomes are entitled to special deductions. A tax payer with non-salary earned incomes receives a deduction of 20 per cent of such incomes, subject to a maximum of Rs. 4000. Salary earners receive a deduction equivalent to 25 percent of salary up to an income level of Rs. 20,000, plus 20 per cent of the excess of their incomes over Rs. 20,000, the total deduction so arrived at being subject to a maximum of Rs. 6000.

### 3.2.3. Exemption for Charity.

Donations to educational institutions, hospitals, calamity relief funds, or any other institutions established for charitable and religious purposes are tax-exempt up to a limited extent. At present tax payers can donate tax-free up to a maximum of 20 percent of their incomes. Until 1965-66, the exemption limit on this account had been 10 percent of income.

As a consequence of the September 1965 war and continuing conflict with India, the Government of Pakistan has felt it necessary to raise additional resources to meet the defence needs of the country. Among other measures, an appeal has been made for liberal contributions to the National Defence Fund. By a post-budget declaration in late 1965, a tax incentive has been offered to the contributions to the Defence Fund. Such contributions, in full amount and without being limited in relation to the total incomes of the tax payers, will be exempted from income tax (including super tax where relevant).

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<sup>1/</sup> "Earned income" means income derived from personal exertion, such as income from business, salary, etc; while "unearned income" is income without such exertion, such as rent, interest and dividend incomes.

3.2.4. Exemptions to Encourage Personal Saving. Exemption to certain interest incomes, noted above, are in the direction of encouraging personal saving. There are other interest incomes which are similarly exempt. Interest on government securities held by or on behalf of the railways and chiefs and princes of Pakistan is also exempt. Beginning 1964-65, the government has extended a partial exemption to interest incomes accruing on savings deposits in commercial banks. Such interest income is exempt up to a maximum of Rs. 500. With regard to the securities issued by the provincial government it should be noted that the provincial government is liable to pay tax on the interest income which is paid tax-free to the security holders.

In addition to these incentives, the tax law allows exemption to other forms of saving when the total portion of income exempted in this way under certain circumstances amounts to 30 percent of income, or Rs. 15,000, whichever is lower. Savings that are eligible for purposes of this exemption are:

- a) contributions (both employer's and employee's) to "recognized" provident funds;
- b) premia paid for the life insurance of the assessee or his/her spouse;
- c) investments in the new share floatation of government-approved "public"<sup>1/</sup> industrial and insurance companies;
- d) investments in Post Office Savings Certificates, NIT (National Investment (UNIT) Trust) - a government-sponsored mutual fund established in late 1962 - Certificates and other

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<sup>1/</sup>For the meaning of "public", see supra in the context of corporation taxation. It should be worth noting here, however, that "public" as used here does not necessarily imply "government-owned" or "government-sponsored".

- government securities or bonds; and
- e) investments in shares of the two PIDC'S - East and West Pakistan Industrial Development Corporations (government-sponsored corporations engaged in industrial development).

This group of exemptions also includes expenditure incurred on the purchase of books of professional or technical nature or of general utility. The general exemption limit for all these partially exempted items is 20 percent of income or Rs.12,000 whichever is lower. While subject to the same aggregate exemption limit of Rs. 12,000, premia on life insurance can get exemption up to 30 percent of the assessee's income. The 30 percent exemption is also available where 10 percent is invested on life insurance and 20 percent in other investments. With effect from 1965-66 an additional amount of Rs. 3,000 can be exempted in case of investments in NIT Certificates and any other investments which may be notified by the government from time to time. In the case of persons over forty-five years of age and those who are non-insurable, the special exemption of 10 per cent of total income admissible for life insurance can be received through investments in other fields. Investments in new share capital of industrial companies which are approved by the Government are eligible for this exemption for a transitional period only. The 1965-66 budget prescribes this period to end on June 30, 1970.

3.2.5 Children's Education Allowance. The law extends some exemption to lower-income tax-payers on account of the education expenses defrayed on their children. Educational expenses of school-going children between the age of 5 to 21 years can be deducted up to a maximum of Rs. 900 from the incomes of assesseees who have incomes below Rs. 25,000.

3.2.6. Special Allowances. Perquisites received in addition to regular salaries, such as, conveyance allowance, entertainment allowance and free housing accommodation are entitled to some special exemptions. Conveyance allowance is tax-exempt up to Rs. 2,400. Entertainment allowance is exempt up to Rs. 3,000 or 10 percent of basic salary, whichever is higher. House rent allowance in cash payments is fully taxable but freely provided housing accommodation is taxable only to the extent of either the rental value or 10 percent (12.5 percent in case of furnished accommodation) of the assessee's total income, whichever is lower. Thus if the rental value of a freely provided accommodation exceeds 10 or 12.5 percent of an assessee's income, this excess of his income goes untaxed. Some special allowances received by army personnel and some other minor allowance items, and certain special types of pensions are also exempt.

3.2.7. Dividend Exclusion. Persons whose income consists at least partly of dividend income can have a further portion of their income exempted or excluded from income tax. Dividend receipts out of corporate profits subject to normal corporation income taxes are exempt from personal income tax to the extent of Rs. 3,000. The exclusion limit has been raised from Rs. 2,000 by the 1965-66 budget. Dividends are sometimes received out of capital gains of corporations, which are not subject to the normal corporation income taxes. This special-kind dividend income is completely excluded at the personal level.

The principle adopted for taxation of dividend income at the shareholder level is that this income is taxable at the shareholder level only when it was subject to tax at the corporation level also. Thus dividend income received from profits of tax-holiday<sup>1/</sup> industries or from corporate profits which

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<sup>1/</sup> For the meaning of "tax-holiday", see the section on corporation income taxation.

are tax exempt are also tax exempt for the shareholders.

3.2.8. Exemptions to Property Owners. In Pakistan income from property, whether in kind from owner-occupied houses-where the imputed rental value is assessed - or in the form of actual rent payments realized from the tenants is taxable income. Property here virtually means house property or "buildings and lands appurtenant thereto". However, various special exemptions, some on a temporary basis, are available to individuals having income from houses.

House owners receive two kinds of exemption in respect of their income from own-occupied houses. First, the first Rs.4,800 of this income is exempt. Second, regardless of the amount of real income enjoyed by an individual from his own-occupied house, the tax law considers the income from this source as equivalent to not more than 10 percent of his total income. Thus income enjoyed in house accommodation by the assessee in excess of 10 percent of his total income goes exempted.

A further exemption is extended to income from newly built houses as a matter of announced policy to encourage construction of residential buildings. This exemption is available to income from buildings constructed within a specified time period which is scheduled to expire on June 30, 1970. For individuals the exempted part of the income amounts to the first Rs. 6,000 of the rental value from such houses. This exemption can be realized by an assessee for five years. Prior to 1965-66, it could be realized for three instead of five years.

3.2.9. Concessions to Persons with Income from Literary and Artistic Work. Remunerations received during a year by a person, other than a professional writer, journalist or artist, for occasional literary or artistic work are tax-exempt to the extent of the first Rs. 1,000. The incomes of authors, except royalties,



qualify for complete exemption if they relate to such work of a "creative nature" as may be approved by the income tax authorities. Lump sum incomes earned on pieces of work involving more than a year are allowed to be spread over up to three years for tax purposes.

3.2.10. Exemptions as Export Incentives. For the first time an export-incentive feature was incorporated in the income tax law by the Finance Act, 1963. This may be a rare example of incentive provided through direct taxation.

The exemptions provided are in the form of a tax rebate. Individual exporters who are not manufacturers receive a tax rebate in respect of their export earnings to the extent of 10 percent of the tax attributable to export sales at the normal income tax rates. Exporters, being manufacturers themselves, receive tax rebates on export sales if export sales exceed 10 percent of their total sales. The rebate is 10 percent of the tax attributable to export sales if export sales fall between 10 percent and 20 percent of the total sales, 15 percent in case of export sales between 20 and 30 percent, and 20 percent where export sales exceed 30 percent of the total sales. These concessions, however, do not apply to the traditional exports of tea, raw cotton, raw jute and jute manufactures.

With effect from 1964-65, the government has extended a similar concession to income remittances by Pakistani professional and consulting firms and enterprises working or operating abroad. The concession is a tax rebate of 15 percent of the total tax liability in respect of such remittances.

3.2.11. Exemptions for Foreign Technicians. As an announced policy of encouraging the import of foreign skills and technical knowledge, the law permits, complete income tax exemption to

incomes of foreign technicians and teachers for certain periods of time. Foreign technicians enjoy the exemption for three years, and foreign teachers, for two years. A foreign technician can earn income tax-free for five years when his employing agency pays income tax on his behalf.

3.2.12. Exemption to the Foreign Lender. Interest income earned by foreign lenders on government approved loans to Pakistani enterprises is also exempt from income tax, an incentive provided to lending by foreigners.

3.2.13. Concluding Remarks. To all these exemptions must be added general deductions and exemptions available to both personal and corporate incomes. The total picture that emerges shows that a substantial amount of personal income is exempted by the Pakistan income tax law, thereby eroding the effective tax base into a very narrow one.

### 3.3. The Rate Structure.

As is to be expected of the personal income tax system of any country where such a system has been introduced, Pakistan, in line with the British tradition, has maintained a progressive system of personal income taxation. Pakistan had very high marginal rates in the earlier years. The highest marginal rates have been modified in the recent past and modified further in 1965-66. Before 1959 two sets of rates, normal income tax rates and super tax rates, were superimposed on each other, the super tax rates starting at a fairly high income point. Since 1959 a simplified and integrated rate structure has been maintained. The tax rates are applied to the net taxable incomes that are determined after the deduction of the various admissible exemptions as outlined above.

The tax liability in each individual case is determined through the application of a "slab" system where marginal tax

rates are applied to some successive slabs of one's taxable income rather than one rate being applied to the whole income. In Table 2 the 1965-66 schedule of personal income tax rates is reproduced.

Table 2. RATES OF PERSONAL INCOME TAX

| Slab of taxable income (Rs.)   | Total income at the end of the slab (Rs.) | Tax rate applying to the slab of income (percent) |
|--------------------------------|---|---|
| On first 1,000                 | 1,000                                     | Absolute amount of Rs.25                          |
| On next: 1,000                 | 2,000                                     | 2   |
| 2,000                          | 4,000                                     | 10  |
| 2,500                          | 6,500                                     | 15  |
| 3,500                          | 10,000                                    | 20  |
| 10,000                         | 20,000                                    | 25  |
| 10,000                         | 30,000                                    | 35  |
| 10,000                         | 40,000                                    | 50  |
| 20,000                         | 60,000                                    | 60  |
| On the balance of total income | -   | 70  |

In order to get a rough idea of the average statutory rates applying to different levels of taxable income and some additional insight into the progressiveness of the tax, we have worked out the amounts of total taxable income at the end of each slab and the average rates applying to them. The income levels, except for the top level, are thus so chosen that flat marginal rates apply to the various income intervals. The results are shown in Table. 3.

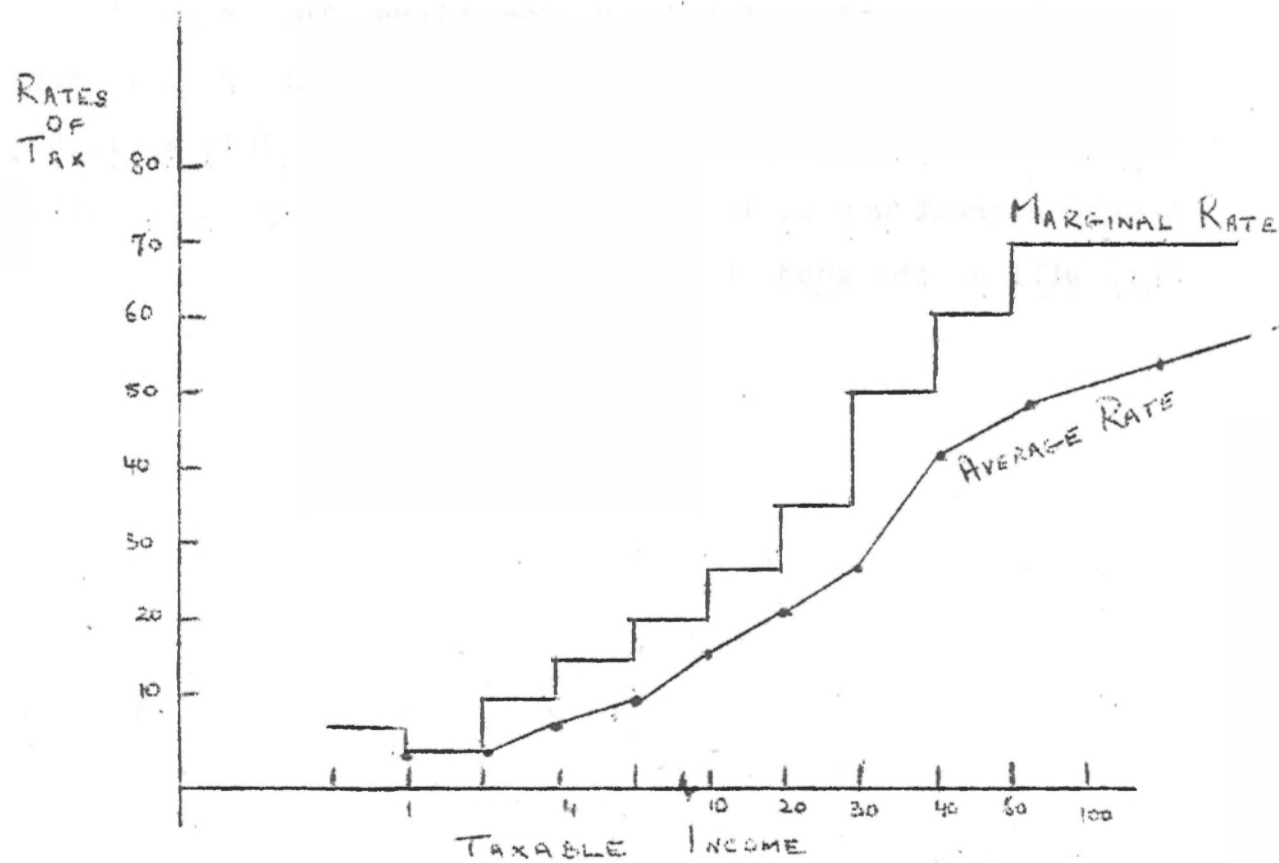
Table 3: AVERAGE RATES OF TAX AT SPECIFIED LEVELS OF TAXABLE INCOME.

| Taxable income (Rs.) | Tax rate (percent) |
|----------------------|--------------------|
| 1,000                | 2.5                |
| 2,000                | 2.25 <sup>1/</sup> |
| 4,000                | 6.13               |
| 6,500                | 9.54               |
| 10,000               | 13.2               |
| 20,000               | 19.1               |
| 30,000               | 24.4               |
| 40,000               | 30.8               |
| 60,000               | 40.53              |
| 100,000              | 52.32              |

1/ The rate is lower than on the income of Rs. 1,000 because of a higher rate on the first Rs. 1,000 and a lower rate on the next Rs. 1,000. Cf. Table 2.

A clearer picture emerges when one looks at the marginal and average rates together after combining the two tables. This is shown in Chart 1. As it appears from the

Chart 1. AVE. AND MARGINAL RATES OF PERSONAL INCOME TAXATION.



chart, the present rate structure of personal income tax in Pakistan is not steeply progressive except for the taxable incomes upto Rs. 10,000. The average rate asymptotically approaches the top marginal rate of 70 percent as one's taxable income rises above Rs. 60,000. There is a big spread between the marginal rate and the average rate except for the very low and extremely high taxable incomes. At the taxable income level of Rs. 30,000 where the marginal rate is 50 percent, the average rate is only about 24.5 percent, at Rs. 40,000 of taxable income where the marginal rate is 60 percent, the average rate is only about 31 percent; and at the income level of Rs. 60,000 where the top marginal rate of 70 percent starts, the average rate is only about 40.5 percent. The average tax rate does not reach the fifty percent mark until the taxable income reaches about Rs. 90,000. Taxes at the sixty percent average rate would be paid by extremely wealthy people in Pakistan with taxable incomes near two hundred thousand rupees.

Note that this does not give a complete idea of the progressivity of Pakistan's personal income tax. The tax rates relate to taxable incomes and not to personal incomes before the deduction of various exemptions. The scale of progression would be modified if one worked out the effective tax rates as related to gross taxable incomes. This would be a more correct way of looking at the "progressivity" question. This will be the subject of a later analysis.

#### 4. TAXATION OF CORPORATE INCOME

This survey considers a corporation to be synonymous with what constitutes a "company" for income tax purposes in Pakistan. "Company" tax rates are also applied to taxable incomes, if any, of local authorities and of certain special cases where income tax is to be charged the maximum rate. The tax law also allows co-operatives to be assessed either at the personal income tax rates or at "company" tax rates according to their option. Corporation income taxes<sup>1/</sup> include taxes on all these entities, which are levied at the "company" rates.

##### 4.1. The Definition of a "Company"

Any two or more persons (shareholders) can form a "company". Two or more persons holding shares jointly are treated as a single person. The present legal definition of a "company" for income tax purposes was adopted in 1957. A "Company" is defined as (i) any organisation registered in Pakistan under the Companies Act, 1913 [16], or (ii) an organization formed in pursuance of an act of Parliament; and is defined to include (iii) a provincial government; and (iv) any foreign association, whether incorporated or not, which is declared to be a company by the income tax authority.

##### 4.2. Distinction between Private and Public Companies

The tax law maintains an important distinction between private and public companies. The tendency has been to give a more favourable tax treatment to public companies.

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<sup>1/</sup> Corporations face two kinds of income tax levies: "income tax" and super tax. The super tax alone on "companies" is sometimes mentioned as "Corporation tax". Such a use of a term can be misleading. Corporation income taxes under discussion here include both the so-called "income tax" and the super tax levied on corporations.

A sharply restrictive definition of a "public company" was adopted in 1963 embodying the Government's policy objective of spreading the control and ownership of these companies. A company may become a public company when at least forty per cent of its shares are held by the government, or when shares representing at least half of its total voting power are held by not less than twenty persons exclusive of specified relatives. The 1965-66 budget further specifies that the shares held by foreign companies are not to be included in determining whether a company is a public one.

A company remains a private company so long as it does not meet the above-mentioned requirements. One special restriction imposed on a private company is that it cannot have more than fifty persons on the roll of its shareholders while, as already noted, the minimum required number of members is only two.

#### 4.3. Taxable Income of Corporations

In certain ways the gross taxable income of an incorporated company may differ from the gross taxable income of an unincorporated firm. The differences lie chiefly in the matter of treatment of two special groups of corporate incomes or funds: intercorporate dividend income and "bonus shares". Both these items of corporate income or fund are treated as separate categories of taxable income, like capital gains, subject to lenient tax treatments. Bonus shares are a corporate fund, treated as income, out of a company's accumulated reserves, which are declared in the form of bonus or additional shares for the company's shareholders. In determining the net income after the deduction of allowable (business) expenses, a further departure from the general practice is made in the case of

corporations. In order to put a curb on the tendency of companies to provide lavish perquisites and other benefits in addition to regular salary payments to their directors and other employees, the tax law, with effect from July 1963, allows these special remunerations as deduction from corporate incomes to the limited extent of 75 per cent of regular salary or Rs. 30,000 in each individual case, whichever is lower. This restriction does not apply to foreign technicians whose incomes are tax-exempt.

Corporations are not eligible to receive most of the tax exemptions available to persons or firms assessed at personal income tax rates. Corporations are, however, entitled to special types of exemptions on various considerations. Most of these exemptions are by way of rebates for super tax in the form of reductions in the rate of super tax. The special exemptions available to corporations are noted below.

4.3.1. Exemption for Charity. Corporations receive an exemption for charity similar to the one received by those assessed at personal income tax rates. There is, however, one very important difference in the extent of the exemption available to corporations. Corporations can get 20 per cent of their incomes exempted from normal income tax, not from super tax. However, according to a (late 1965) declaration, the contributions to the National Defence Fund will be totally exempt from both normal income tax and super tax.

4.3.2. Tax Holiday for Industrial Corporations.

A major tax concession is the corporate income tax holiday provided to new "approved" industrial under-takings. The tax holiday includes complete exemption of profits from income tax for a certain initial period, which began applying to the profits of industrial enterprises established after April 1959, and from 1960 became applicable also to the profits earned in new identifiable industrial units or processes in old enterprises. The concession is designed to be a temporary incentive to new



industrial units in the current phase of Pakistan's economic development. It is also a major tax incentive offered foreign companies for investment in Pakistan. The concession will, unless there is a legal extension of the period of applicability of the provision, cease on June 30, 1970, which means that this concession will be available only to industrial units established before that date. Concessions may extend for a certain period beyond this date for going concerns, but will not be available to industrial units set up after this date.

A differential set of tax holidays is provided to influence the regional location of industrial enterprises. Applying to industrial undertakings established prior to July 1964, tax holiday periods amount to four years, six years and eight years depending on the geographical areas in which the industries are located. The differentials are in favour of the industrially more backward regions of Pakistan. The regions are: (i) those eligible for the four-year holiday namely, the built-up metropolitan areas in West Pakistan, namely, Karachi, Lahore, Rawalpindi, Lyallpur, Gujranwala, Multan, Nowshera, Mardan, Jhelum, Sialkot, Sukkur and Hyderabad; (ii) those eligible for the six-year holiday namely, the cities of Dacca, Narayanganj, Chittagong and Khulna and the areas within a radius of ten miles of the municipal limits of these cities in East Pakistan, and the remaining parts of West Pakistan after excluding the areas eligible for the four-year and eight-year holidays; (iii) those eligible for the eight-year holiday, namely, all of East Pakistan except the areas mentioned in (ii) and certain underdeveloped areas in the north-west part of West Pakistan. The budget of 1964-65 revised the set of holidays into two, four and six years respectively in place of four, six and eight years leaving their

distribution unchanged. This new set of holidays applies to industrial units being installed after June 1964.

For industries to be approved for the tax holiday privilege, a major stress was laid upon the requirement that they should be based primarily on indigenous raw materials. This condition was relaxed during 1964-65 to considerably enlarge the scope of the industries eligible for tax-holiday. Industrial corporations can take advantage of the tax holiday privilege after satisfying a number of conditions which at present are the following:-

i) The industry should be a primary user of indigenous raw materials. Or it should be one requiring special technical knowledge or large risks or one that has appreciable export potential or contribution to agricultural development.

ii) The industrial corporation should have a minimum paid-up capital of Rs. 50,000.

iii) It should be ready to reinvest at least sixty per cent of its profits in the same business or in other industries which are found listed in the Industrial Investment Schedules issued by the Government from time to time.

4.3.3. Rebates of Super Tax. Incorporated companies or units of an individual company that do not enjoy complete income tax exemption by way of the tax holiday provision can receive partial but substantial exemption by way of rebates of super tax on various counts. The rebates are available in the form of reductions in the super tax rate. An exemption in the form of a certain rate reduction necessarily denotes exemption of a higher percentage of income than the absolute figure of drop in the tax rate so long as the tax rate to start with is not one hundred per cent amounting to confiscation of all income. Thus where corporate income is subject to an aggregate pre-rebate tax rate of 50 per cent, a reduction in the tax rate by 5 per cent, would imply exemption of 10 per cent of income at the pre-rebate tax rate of 50 per cent. At a rebate

rate of 10 per cent, 20 per cent of income gets exempted at the pre-rebate tax rate of 50 per cent. The lower the pre-rebate tax rate, the higher the percentage of income that can get exempted at the before-rebate tax rate even though the rebate rate is the same. The following rebates are available to corporations at present.

(i) Rebate to Smaller Companies. A rebate of 5 per cent is provided to smaller companies with incomes up to Rs.50,000 in the case of non-industrial companies and with incomes up to Rs.100,000 in the case of industrial companies. The income limits were raised from Rs.25,000 and Rs.50,000 respectively during the present budget year 1965-66.

(ii) Rebate for Exports. Manufacturing companies which directly export their goods abroad receive the same rebates on their export sales as individual firms: 10 per cent when export sales lie between 10 and 20 per cent of their total sales, 15 per cent with export sales between 20 and 30 per cent, and 20 per cent with exports exceeding 30 per cent. An exporting company that does not itself manufacture the exportables would receive a rebate of 15 per cent on export sales, as against 10 per cent received by individual exporters. These concessions do not apply to the same traditional exports as were mentioned in the context of personal taxation. As in the case of individuals, corporations can also have a rebate of 15 per cent on income received from abroad.

(iii) Rebate to Public Corporations. A company would receive a special rebate of 10 per cent if it is a public company as defined earlier. This tax differential between public and private companies was raised from a rebate of 5 per cent in the 1965-66 budget to provide further incentive to the formation of public companies. By a post-budget

post budget declaration in late 1965, a rebate of 5 percent has been made available to private companies which undertake to convert themselves into public companies by June 30, 1970.

(iv) Rebate to Companies Declaring Dividends in Pakistan.

A rebate of 10 percent is available to companies declaring dividends in Pakistan.

4.3.4. Special Concessions to Particular Industries.

Special tax concessions are extended to mining companies and housing estates or companies engaged in the construction of residential buildings.

Concessions to Mining Companies. A wide range of mineral extraction activities are approved by the government for special tax treatment. Mining industries are divided into two groups which receive somewhat different treatments. One group consists of industries engaged in the exploration and production of petroleum oil and natural gas. The remaining mineral deposits comprise the other group.

The concessions provided to the first group provide for an equal division of the profits between the government and the undertaking companies. The concessions allowed are (i) complete loss offset privilege in case of unsuccessful exploratory activities, (ii) allowing as current deduction all expenditure incurred prior to the commencement of commercial production excluding expenditure on acquiring physical assets, (iii) full cost offset privilege if admissible current deductions exceed gross receipts from sale, and (iv) a depletion allowance at the rate of 15 percent of gross receipts representing the "well-head" value of the production, subject to a maximum of 50 percent of the gross income.

Other mining industries which are in the second group can take advantage of the tax holiday provisions or instead choose to enjoy a number of other concessions. These concessions are (i) carry-forward provision for pre-production expenditure up to a maximum period of ten years of commercial production, (ii) treatment of all expenditure including expenditure on physical assets as current cost deduction, (iii) a depletion allowance to the extent of 15 per cent of the total income or 50 per cent of the capital employed, whichever is less, subject to the condition that such allowance would be credited to a reserve account to be utilized for the development and expansion of such undertaking, and (iv) if the mineral in question is also "refined" or "concentrated" in Pakistan, exemption from income tax of the profits of such refining undertakings up to 5 per cent of the capital employed over the first five years of commercial production. In addition, beginning 1964-65, these second group mining companies receive an additional concession, viz., a tax rebate of 10 per cent.

Concessions to Housing Estates. A six-year tax holiday is provided to companies engaged in the construction of buildings. The concession was first introduced and applied to buildings erected after June 30, 1961, and is scheduled to expire after June 30, 1970. The tax holiday is available to a company that has a housing estate composed of either at least one hundred ordinary housing units with monthly rental values varying between maximums of Rs. 25 and Rs. 75 according to accommodation specifications, or at least twenty five bungalows or flats with annual rental values not exceeding 7.5 per cent of the total cost or Rs. 500 per month, whichever is less.

Besides these tax concessions to mining industries and housing estates, some concessions are also given to life insurance companies and certain development institutions.

#### 4.4. Rates of Corporation Income Taxes

The basic aggregate tax rate at which corporate incomes excluding certain types of incomes are presently assessed is 60 per cent, of which 30 per cent represents the normal income tax rate and 30 percent is the super tax rate. The special types of corporate incomes which are assessable at different rates include capital gains, dividend income received from other corporations and bonus shares. We have already looked at the way capital gains of corporations are assessed. Intercorporate dividend incomes are assessed at the rate of 15 per cent where the assessee or the receiving corporation is a public company and at the rate of 20 per cent where the assessee is a private company. Bonus shares, as defined previously, are assessable at the rate of 12.5 percent. Bonus shares of a company issued during its tax holiday period were tax-exempt until 1964-65.

A local authority is assessed at an aggregate rate of 42.5 per cent, of which 30 per cent is the normal income tax rate and 12.5 per cent the super tax rate.

Because of one or another of the various rebates of super tax allowed, a company is virtually assessed at a considerably lower rate than the basic rate. The aggregate rate is 50 per cent in the case of companies which do not declare dividends outside Pakistan and this rate is slashed down to 40 per cent for such companies as are at the same time public companies.

5. OTHER SPECIAL TREATMENT AREAS: REGISTERED FIRM

In addition to corporations proper and taxable entities that are assessed at the personal income tax rates, there are certain special taxable entities, the most important of which is the registered firm. As mentioned already, the registered firm by itself is not subject to the normal income tax rates. The partners of a registered firm are individually responsible for income tax payments on their shares of profits from this firm. The firm, however, is made liable to pay super tax on its total income. A graduated rate structure on a slab basis is applied - which is as follows.

Table 4

| Slab of taxable income (Rs.)   | Total income at the end of the slab | Super tax rate applying to the slab of income (percent) |
|--------------------------------|-------------------------------------|---|
| On first 12,000                | 12,000                              | Zero  |
| On next: 18,000                | 30,000                              | 5   |
| 30,000                         | 60,000                              | 10  |
| 40,000                         | 100,000                             | 20  |
| On the balance of total income | -                                   | 30  |

"Siraj"

## 6. HISTORICAL BACKGROUND OF THE INCOME TAX SYSTEM

We have outlined above the present income tax system of Pakistan. The present system is the culmination of numerous historical changes in the tax law. Since we will concern ourselves with income taxation during the post-independence period, we present below a historical survey of the system covering this period. In this survey, mainly those aspects of the tax law will be covered which principally differed from the present system. However, certain aspects of very recent origin and others which have experienced no change have already been mentioned. These latter aspects will not be repeated here unless it is thought necessary to do so to maintain the link to the present.

### 6.1. General Features

6.1.1. Business Deductions. In the matter of business deductions for income tax purposes certain differences in the tax treatment were periodically introduced. These are as follows.

(1) The business profits tax, the additional levy which had been in force during 1947-1959, was, except in the last year 1958-59, treated as a business deduction in determining taxable income for the normal income and super taxes.

(2) The expenditure incurred by business on the training of Pakistani citizens abroad in connection with a scheme approved by the Government began to be treated as a business expense with effect from the assessment year 1952-53.

(3) Capital expenditure incurred on scientific research related to business became a current deductible expense with effect from the assessment year 1954-55. Previously such expenditure could be spread over a period of five years for deduction purposes.

(4) Capital expenditure incurred by business on the construction and maintenance of educational institutions and hospitals for the business employees began to be allowed as a current deduction from the assessment year 1954-55.



(5) During the earlier years, that is, before 1955-56, the initial depreciation allowance was not taken into account to determine the written-down value of depreciable assets for purposes of calculating depreciation allowances for the subsequent periods, except for the last period when the terminal allowance was to be determined. From 1955-56 the initial depreciation allowance became deductible from the acquisition cost of capital to determine all subsequent written-down value of capital. With effect from the same time the rate of the allowance in the case of machinery and plant was brought from 20 percent up to the present rate of 25 percent. The presently available initial allowance in the case of residential buildings constructed for industrial labourers was introduced in 1954-55.

During 1962-63 a non-deductible development allowance was granted to industrial enterprises not covered by the tax holiday, in substitution for the initial and additional depreciation allowances. The new allowance was made admissible on plant and machinery installed after June 1962 at the rate of 20 percent of the cost of such plant and machinery. This allowance, which enabled industrial profits to go tax exempt up to 120 percent of the capital cost of plant and machinery, was however, discontinued from the very next year.

6.1.2. Tax Treatment of Capital Gains. Capital gains were subject to tax during the first two years after independence. During this period capital gains were assessed in the following way. In the case of individuals and non-corporate firms, capital gains were subject to a graduated tax with gains not exceeding Rs.15,000 completely exempted. Tax rates varying from 6.25 percent to 31.25 percent were applied to capital gains exceeding Rs.15,000. The bottom rate was applied to gains between Rs.15,000 and Rs.50,000 and the top rate to gains exceeding Rs.1,000,000. In the case of corporations, capital gains were assessed at the corporate income tax rate, which was then 31.25 percent.

Capital gains remained tax-exempt during the next fourteen years, 1949-50 through 1962-63. When their taxation was resumed in 1963-64, capital gains became assessable in the following way. In the case of corporations and registered firms, the tax was payable at a rate of 20 percent. In other cases, an amount, equivalent to two-thirds of the capital gains (but subject to a minimum of Rs. 10,000), was exempt and the balance was required to be added to the other incomes of the taxpayer and assessed at the appropriate personal income tax rate. This system of assessment was changed to the present system in the following year.

## 6.2. Taxation of Personal Income

The nature and extent of various personal exemptions varied from time to time thereby affecting personal incomes assessed for income tax purposes. The year 1959 marks an important dividing line in the matter of treatment of various exemptions in two substantial ways. First, before the fiscal year 1959-60, individuals were subject to two rate structures under normal income tax and super tax; beginning 1959-60, they became subject to a combined rate structure. Second, before 1959-60, most exemptions applied to the normal income tax only, and were given in the form of rebates. Since 1959-60, all exempt incomes except the basic personal exemption limit have been treated as deductions from total income, and the rate of tax has been applied to the net income after the deductions.

6.2.1. Basic Personal Exemption Limit. The personal tax exemption limit has undergone several changes in the past and was gradually raised after independence. Before independence, the limit usually stood at Rs.2,000. At independence, it was fixed at Rs.2,500. Thereafter it was increased to Rs.3,000 in 1949-50, Rs.3,600 in 1952-53, Rs.4,200 in 1954-55, Rs.5,000 in 1957-58 and to the present level of Rs.6,000 in 1959-60. The exemption has never been treated as a deduction from total income (i.e. in the case of income larger than the limit itself) to determine net income for assessment at the prevailing tax rate. The limit served only to demarcate income-earners with incomes below and above the limit

and to exempt the former group of earners altogether.

6.2.2. Personal Allowance. The presently available straight personal deduction of Rs.2,000 was introduced in 1958-59. In 1959-60 when the whole basis of assessment of personal incomes was recast, the personal deduction began to look like a tax-exempt slab of income as found in earlier rate structure.<sup>1/</sup>

6.2.3. Earned Income Relief. A portion of earned income of individuals has always (beginning 1945) been tax-exempt. Before 1959-60, it was exempt from normal income tax, but not from super tax. However, during the earlier years upto 1949-50, earned incomes were assessed at lower super tax rates than unearned incomes. Before 1959-60, exempt earned income was allowed to be deducted from total income to determine the net income and the corresponding normal income tax rate, but it was not a deduction from total income in determining super tax. Also before 1958-59, exempt earned income was the only deduction made available to personal incomes. Throughout the period beginning from the time of independence right upto the assessment year 1962-63, exempt earned income amounted to 20 percent of total earned income, subject to a maximum of Rs.4,000. The amount of the exemption was raised in 1963-64 for that part of of earned income which consisted of salary income only and the resulting exemption procedure continues up to the present.

6.2.4. Exemption for Charity. The provision for a limited exemption for approved charitable donations can be traced back to 1952-53. Before 1959-60 personal donations were exempt both from normal income tax and super tax, to the extent of 10 percent of total income, but subject to the qualification that small donations up to Rs.250 and very big donations exceeding Rs.100,000 were both excluded from the exemption privilege. There was also the provision that the tax rebate on account of the exemption would not in any case exceed half the amount of donations. The ten-percent limit was

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<sup>1/</sup> See supra, Table 5. ... percentage

relaxable in special cases of donations such as contributions to the Quaid-e-Azam Memorial Fund. In 1959-60, while the same percentage limit was retained, the upper absolute limit was withdrawn and the charitable contributions became a straight deductible item from total income. Small donations also became eligible for deduction. In order to provide further tax inducement to charity, this year's (1965-66) budget has doubled the percentage limit for charitable deduction.

6.2.5. Exemptions to Encourage Personal Saving. Before 1951-52, personal savings to the maximum extent of one-sixth of total income or Rs. 6,000, whichever was the lower, were entitled to normal income tax, but not super tax, rebates. However, the forms of personal savings recognized for purposes of the tax exemption consisted only in the contributions to recognised provident and old-age funds and the premium payments on life insurance policies. In 1951-52, the purchase of shares of domestic public companies began to receive tax exemption on a limited scale.<sup>1/</sup> The exemption in this particular case was from both normal income tax and super tax, whereas the other forms of savings continued to be (partially) exempt from normal income tax alone. In 1951-52, 25 percent of personal investment in such shares, subject to a maximum of 10 percent of the total income of the investor was tax-exempt. The year following, the entire amount of investment on the purchase of the specified shares, subject only to the same percentage limit of total income, became tax-exempt. Beginning in 1953-54, the savings exemption limit for this particular form of savings was raised from 10 percent of total income to 20 percent of the first Rs.100,000 of income plus 10 percent of the remainder of total income. In the same year, exemption was extended to another new form of savings, namely, purchase of Government securities and Post Office Savings Certificates but this extension was limited to small income-earners with incomes not above Rs.25,000. For this group of tax-payers, the savings exemption limit for the aggregate of investments in the purchase of company shares, Government Securities, and Post Office Savings Certificates was fixed at 20 percent of total income. Savings in other forms, namely, contributions to

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<sup>1/</sup> For those companies engaged in approved industrial undertakings.

provident funds and life insurance policies, continued, (until 1954-55) to be tax exempt to the maximum extent of savings of Rs.6,000 or one-sixth of income, whichever, was lower. In 1954-55, the exemption limit for these savings was pushed to the level of 20 percent of income or Rs.8,000, whichever was lower. Until 1959-60, savings in these particular forms received exemption from only the normal income tax, but not from the super tax.

In 1959-60, the exemption for personal investment in Government Securities and Post Office Savings Certificates was extended to all tax payers. Savings of all kinds eligible for tax exemption became subject to an aggregate tax-exempt limit of 20 percent of total income or Rs.8,000 whichever was lower. Furthermore, exempt savings began to be treated as deductions from income. In 1960-61, the absolute limit was raised to Rs.12,000 while the same percentage limit was maintained. In 1961-62, the percentage limit was raised to thirty percent. However, the additional ten percent of income now eligible for exemption could be utilized for exemption purposes only by investing in life insurance. In 1963-64, more areas of personal investment were included in the tax-exempt category. The present exemption procedure for personal savings embodies further changes which were introduced by the 1965-66 budget.

6.2.6 Children's Education Allowance. Tax-payers with incomes below Rs.25,000 began to receive a tax rebate from 1956-57, and an income deduction from 1959-60, for their children's educational expenses. The portion of income entitled to the rebate or deduction was limited to Rs.200 of the educational expenses per child, subject to a maximum of Rs.600. In 1963-64, the amount of the exempt income for this purpose was increased to Rs.300 per child up to a maximum of Rs.900. The present procedure, as adopted by the 1964-65 budget, allows the maximum deduction of Rs.900, irrespective of the number of children.

6.2.7 Special Allowances. The special limited exemptions relating to entertainment and conveyance allowances and free housing accommodation, which are allowed at present, were introduced in 1961-62. Until 1961-62, all perquisites in cash were included in taxable

income, and those in kind except free housing accommodation were excluded from taxable income. However, most of the freely-provided services have continued to remain tax-exempt in the same manner.

6.2.8 Exemption for Dividend Income. Until 1960-61, full credit was provided to dividend recipients for the normal income but not the super tax, paid at the corporate level. The individual taxpayer was liable to pay tax, both normal income tax and super tax before 1959-60, on his dividend income at the rate applying to his total income. However, for the purpose of calculating the individual's tax liability, his dividend income included the normal income tax already paid by the corporation on his share of the dividend. In 1960-61, the tax credit system was replaced by a system of limited dividend exclusion whereby the shareholders could get dividend income up to Rs.1,000 deducted from total income. In 1962-63, the deduction was increased to Rs.1,000 plus 20 percent of the remaining dividend income. The following year, the percentage provision was withdrawn and the dividend exclusion was fixed at Rs.2,000. The exemption limit was raised to the present figure of Rs.3,000 by the 1965-66 budget. It should be noted that whenever dividends have been exempt from either normal income tax or super tax at the corporate level, they have been similarly exempt at the personal level also.

6.2.9 Exemptions to Property Owners. Legal income from owner-occupied houses has throughout been deemed not to exceed 10 percent of the total income of a house-owner and as such income from his occupied houses, which is actually in excess of 10 percent of his total income, has always gone tax-exempt. From the legally recognized income from owner-occupied houses, a further sum has been exempted since 1959-60. The exempted sum allowed as a deduction from total income was Rs.2,400. In 1962-63, the sum was increased to Rs.4,600, but from this time on, the amount deductible was gross, not net, annual letting value of owner-occupied houses. There was no exemption in the case of income from let-out houses except for income from newly constructed houses.

In the case of newly constructed houses, income from build-



dings constructed during the period April 1946 through March 1948 enjoyed complete tax exemption for two years after the completion of the construction. The two-year tax holiday was provided again to income from buildings constructed after March 1951. In the case of buildings erected in the period April 1957 through June 1961, the tax holiday was, however, confined to small buildings with an annual letting value of not more than Rs.3,000. For constructions completed after June 1961, the tax holiday period was increased to three years and the scope of the exemption was widened to buildings with annual letting value up to Rs.6,000. The tax holiday period was further increased to five years in 1965-66.

6.2.10 Exemptions to Foreign Technicians. Foreign technicians employed in specified industries have enjoyed complete income tax exemption for the first two years of their employment since 1956-57. Foreign teachers began to receive the same tax advantage beginning in 1960-61. The tax holiday period continued to be two years for the foreign teachers, whereas it was raised to three years in 1964-65 in the case of foreign technicians.

6.2.11 Rates of Personal Income Tax. As already noted, before 1959-60 personal incomes were assessed according to two separate schedules of tax rates following from two kinds of income tax imposition, a normal income tax and a super tax. In 1959-60, the dual basis of income tax assessment was replaced by a single rate structure. The slab system under which marginal tax rates are applied to slabs of income has been maintained since pre-independence time. In order to see how personal income tax rates have changed historically, the rate schedules of 1947-48 and later years have been related to comparable slabs of taxable income, and the results are recorded in Table 5. For the earlier years (before 1959-60) the normal income tax and super tax rates were combined into integrated rate schedules. Before one may draw any conclusions about the historical behaviour of the tax rates, it should be noted that the concept of taxable income adopted for rate purposes was radically different in the two periods before and after 1959-60. After 1959-60, the income

TABLE 5.

PERSONAL INCOME TAX RATES: 1947-48 to 1965-66

| Slab of taxable income $\sqrt{}$ | Total income at the end of the slab (Rs.) | (1)   | (2)   | (3)   | (4)   | (5)   | (6)   | (7)   | (8)   | (9)   | (10)           |
|----------------------------------|---|-------|-------|-------|-------|-------|-------|-------|-------|-------|----------------|
| On first 1,000                   | 1,000                                     | zero  | zero  | zero  | zero  | zero  | zero  | zero  | zero  | zero  | On first 1,000 |
| On next: 500                     | 1,500                                     | zero  | 6.25  | 6.25  | 6.25  | 4.69  | 4.69  | zero  | zero  | zero  | 500            |
| 2,000                            | 4,000                                     | 6.25  | 6.25  | 6.25  | 6.25  | 4.69  | 4.69  | zero  | zero  | zero  | 2,000          |
| 1,000                            | 5,000                                     | 6.25  | 6.25  | 6.25  | 6.25  | 4.69  | 4.69  | 6.25  | 6.25  | 6.25  | 1,000          |
| 1,000                            | 6,000                                     | 12.50 | 12.50 | 12.50 | 12.50 | 10.94 | 9.37  | 6.25  | 6.25  | 6.25  | 1,000          |
| 500                              | 6,500                                     | 12.50 | 12.50 | 12.50 | 12.50 | 10.94 | 9.37  | 12.50 | 12.50 | 12.50 | 500            |
| 3,500                            | 10,000                                    | 12.50 | 12.50 | 12.50 | 12.50 | 10.94 | 9.37  | 12.50 | 12.50 | 12.50 | 3,500          |
| 5,000                            | 15,000                                    | 21.87 | 21.87 | 21.87 | 21.87 | 18.75 | 18.75 | 18.75 | 18.75 | 18.75 | 5,000          |
| 5,000                            | 20,000                                    | 31.25 | 31.25 | 31.25 | 31.25 | 28.12 | 28.12 | 28.12 | 28.12 | 28.12 | 5,000          |
| 5,000                            | 25,000                                    | 31.25 | 31.25 | 31.25 | 31.25 | 31.25 | 31.25 | 31.25 | 31.25 | 31.25 | 5,000          |
| 5,000                            | 30,000                                    | 50.00 | 50.00 | 50.00 | 50.00 | 45.31 | 45.31 | 45.31 | 45.31 | 45.31 | 5,000          |
| 5,000                            | 35,000                                    | 53.12 | 53.12 | 53.12 | 53.12 | 46.87 | 46.87 | 46.87 | 46.87 | 46.87 | 5,000          |

Contd:



| (1)                  | (2)     | (3)   | (4)   | (5)   | (6)   | (7)   | (8) | (9) | (10) |
|----------------------|---------|-------|-------|-------|-------|-------|-----|-----|------|
| 5,000                | 40,000  | 56.25 | 53.12 | 50.00 | 50.00 | 50.00 | 50  | 50  | 50   |
| 5,000                | 45,000  | 56.25 | 53.12 | 50.00 | 50.00 | 50.00 | 65  | 65  | 60   |
| 10,000               | 55,000  | 62.50 | 56.25 | 53.12 | 53.12 | 53.12 | 65  | 65  | 60   |
| 5,000                | 60,000  | 68.75 | 65.62 | 56.25 | 56.25 | 62.50 | 65  | 65  | 60   |
| 5,000                | 65,000  | 68.75 | 65.62 | 56.25 | 56.25 | 62.50 | 75  | 75  | 70   |
| 5,000                | 70,000  | 75.00 | 65.62 | 56.25 | 56.25 | 62.50 | 75  | 75  | 70   |
| 5,000                | 75,000  | 75.00 | 71.87 | 59.37 | 59.37 | 68.75 | 80  | 75  | 70   |
| 10,000               | 85,000  | 81.25 | 71.87 | 59.37 | 59.37 | 68.75 | 80  | 75  | 70   |
| 5,000                | 90,000  | 81.25 | 75.00 | 62.50 | 62.50 | 75.00 | 80  | 75  | 70   |
| 10,000               | 100,000 | 87.50 | 75.00 | 62.50 | 62.50 | 75.00 | 80  | 75  | 70   |
| 5,000                | 105,000 | 87.50 | 78.12 | 68.75 | 68.75 | 81.25 | 80  | 75  | 70   |
| 15,000               | 120,000 | 93.15 | 78.12 | 68.75 | 68.75 | 81.25 | 80  | 75  | 70   |
| 30,000               | 150,000 | 96.87 | 78.12 | 68.75 | 68.75 | 81.25 | 80  | 75  | 70   |
| 100,000              | 250,000 | 96.87 | 81.25 | 71.87 | 71.87 | 87.50 | 80  | 75  | 70   |
| Balance<br>of income | -       | 96.87 | 87.50 | 78.12 | 78.12 | 87.50 | 80  | 75  | 70   |

Note: Before 1959-60 the tax rates originally given in units of annas per unit of a rupee were converted into percentage.

1/ Taxable income did not mean the same thing over the entire period. See the text.

2/ During these years at high levels of income, that is when incomes exceeded Rs.25,000 earned incomes were assessed at slightly lower rates.

for rate purposes was net taxable income after the deduction of numerous personal exemptions. Before 1959-60, only one item of personal exemption, namely that portion of earned income exempted under earned income relief, was deducted from personal income, and that to determine the normal income tax only. From Table 5, one can easily separate the normal income tax rates and super tax rates from the combined rates, as in force from 1947-48 to 1958-59. The super-tax rates always began to operate whenever a person's income exceeded Rs.25,000 and before the top marginal rate of normal income tax began to operate. The slab rates applying to incomes upto Rs.25,000 were thus normal income tax rates. The top slab rate of normal income tax which remained constant at 31.25 per cent over the period was added to the super tax rates for higher incomes.

There is a further qualification to the rates reproduced in Table 5. There was an additional provision, except for 1959-60, that the rates would be effective subject to the condition that the total tax liability in any individual case would bear a certain relation to the excess of the assessed income over the income pertaining to the basic exemption limit. Before 1959-60, it was provided that the total tax liability would not exceed half the excess of total <sup>assessed</sup> income over the basic exemption limit income.<sup>1/</sup> After 1959-60, the provision was that the total liability would not exceed the full amount of such excess income.

This provision afforded tax relief in marginal cases where persons in the immediate range of taxable income were adversely affected by the tax rates in relation to those who were immediately below the taxable range. In the 1959-60 and 1960-61 rate structure, the top marginal rate was 80 per cent. The effective application of this rate was subject to a legal provision that the total tax liability would not exceed 75 per cent of the total assessed income.

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1/ The basic exemption limit should not be confused with the tax-exempt slab of income of the rate structures of these earlier years. The exempt slab was just a graduation device applying to incomes exceeding the basic exemption limit.

### 6.3. Taxation of Corporation Income

6.3.1. Legal Definitions of Taxable Entities. Before 1955-56, foreign companies or associations of persons could remain excluded from group of legally recognized "companies" for tax purposes. From 1955-56 on, any foreign association which was declared by the Central Board of Revenue<sup>1/</sup> to be a company became a company for income tax purposes. In 1956-57, provincial governments were made liable to income tax as companies with respect to incomes the earning of which was not confined to their territorial jurisdictions. From 1957-58 on, corporate bodies formed in pursuance of Acts of Parliament also began to be treated as companies.

Important changes took place in the legal definition of public, as distinguished from private, companies. Until April 1950, a company could call itself a public company if its shares carryin, not less than 25 per cent of the total voting strength were allotted to the public. From April 1950, companies could become recognized as public companies only by distributing their shares to the public which represented more than 50 per cent of the voting power. The present definition of public companies, as adopted in 1963-64, further requires that more than 50 per cent of the voting power should be controlled by not less than 20 persons (shareholders) exclusive of specified relatives.

6.3.2. Exemption for Charity. Beginning in 1952-53 when recognized charitable spendings first became eligible for a limited tax exemption, companies, like individuals, began to receive such an exemption. Out of the numerous exemptions available to individuals, the exemption for charity was the only one common to both individuals and companies. In the

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<sup>1/</sup> The Central Board of Revenue is the highest authority on matters of central government taxation in Pakistan.

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case of companies, however, the tax exemption for charity was available only for the normal income tax, not for the super tax. Until 1961-62, the tax-exempt income for charity was upto a maximum of 5 per cent of the company's total income. The tax-exempt limit for charity was raised to 10 per cent of income in 1961-62 and raised again to the present 20 per cent in 1965-66.

6.3.3. Exemption for Industry. Before the major tax concession in the form of a tax holiday to new industrial enterprises was introduced in 1959-60, profits from new enterprises in approved lines of industry enjoyed a limited exemption. A portion of an enterprise's income equivalent to 5 per cent of the capital cost was exempted from both income tax and super tax for a period of five years, beginning from the time commercial production commenced in the enterprise. The concession was granted initially to enterprises employing more than fifty persons and using mechanical power. In 1955-56 the concession was extended to smaller units in special lines of industry, which either employed ten or more persons and used power, or employed twenty or more persons and did not use power. Manufacturing industry was the main beneficiary of this extended concession.

The above limited exemption ceased to apply <sup>to</sup> industries which were established after March 1958. A new tax holiday concession came into effect for industrial enterprises which began to be established after March 1959. The period of the tax holiday was set at two years beginning from the time of commercial production. The enterprises eligible for the tax holiday were those which used mainly domestic raw materials, reinvested (in the same enterprises) at least 60 per cent of their profits, and had a minimum paid-up capital of Rs. 200,000. Beginning in 1960-61, the tax holiday period was increased to six years for East Pakistan and some backward

regions of West Pakistan, and to four years for the rest of West Pakistan. The condition that an industry seeking a tax holiday must use mainly or entirely domestic raw materials was relaxed in special cases. Moreover, it was no longer necessary to reinvest in the same enterprise to take advantage of the holiday provision; it was necessary, however, to reinvest in lines of industry approved by the Government.

In 1961-62, the whole country was, for purposes of the tax holiday, divided into three geographic areas as previously noted under description of the present system. Corresponding to these areas, tax holidays of the duration of four, six and eight years began to be allowed. The minimum limit of share capital of a corporate enterprise, required for the tax holiday privilege, was reduced from Rs.200,000 to Rs.50,000. Mining enterprises were given the option to receive the benefits of the tax holiday provision in lieu of the five-year limited exemption of profits, whereby the portion of profit equivalent to 5 per cent of the capital cost was exempted. The present set of tax holiday periods, namely, two, four and six years, corresponding to the same geographic areas, began applying to industrial units which were initiated after June 1964. In 1964-65, the condition relating to the use of raw materials was further relaxed.

6.3.4 Rebates of Super Tax. (1) Rebate to Small Companies. Small companies with income below Rs.25,000 per annum received a more favourable tax treatment beginning from 1957-58, when super tax rates were raised for the bigger companies. The extent of the implicit rebate to the smaller companies was one anna in the rupee or 6.25 per cent.<sup>1/</sup> In 1959-60, an explicit rebate of 5 per cent was substituted for the implicit rebate. At the same time the rebate was extended to companies having income upto Rs. 200,000. How-

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<sup>1/</sup> For meaning of "a rebate of 'certain' percent"  
See infra, 4.3.3.

ever, during the following three years (1960-63), smaller companies did not receive any special rebate. The rebate of 5 per cent was reintroduced in 1963-64 and its availability was restricted to incorporated firms having income upto Rs. 25,000. In 1964-65, the rebate was extended to industrial firms with income upto Rs.50,000, while for the non-industrial firms the criterion remained Rs.25,000. The income limits for the rebate were doubled for both categories by the 1965-66 budget.

(2) Rebate to Public Companies. In 1950-51, a tax distinction was introduced between public and private companies in the case of foreign companies only. Public companies were taxed at a rate lower by a rate of 6.25 per cent than private companies. The same distinction was extended to domestic companies in 1958-59. The distinction was withdrawn in 1959-60 for all companies, but reintroduced in 1963-64 when the special rebate for public companies was fixed at 5 per cent. The concession was doubled by the 1965-66 budget.

(3) Rebate to Companies declaring Dividends in Pakistan. Beginning in 1950-51, a rebate was provided to companies which made effective arrangements for the declaration of their dividends in Pakistan; the rebate amounted to two annas in the rupee or 12.5 percent. In 1958-59, the rebate rate was reduced to 6.25 percent. It was reduced again, to 5 percent, the following year. With effect from July 1960, the rebate was raised to 10 per cent which has been effective till at present.

(4) Rebate to Retained Profits. During the early years, 1947-48 through 1954-55, an implicit rebate was given to the retained profits of companies. An additional super tax at progressive rates was levied on distributed profits which exceeded 30 percent of total profits and at the same time exceeded an amount equivalent to 5 per cent of the capital



of the company. The additional super tax applied only to domestic public companies. The rates of this additional super tax were: three annas in the rupee or 18.75 percent when distributed profit exceeded 30 percent but were not more than 40 percent of the total income; 31.25 percent when distributed income exceeded 40 percent, but did not exceed 50 percent of the total income; and 43.75 percent when distributed income exceeded 50 per cent. In 1955-56, this system of implicit rebate to retained profits was replaced by an explicit rebate of 6.25 percent (flat rate). The rebate was withdrawn in 1959-60 and since then no rebate has existed for retained profits.

(5) Rebate to Selected Industrial Companies. A special tax exemption was temporarily available for a certain group of industrial enterprises which were not eligible to receive the tax holiday benefit. A tax distinction was created in 1959-60 between companies which set up industrial enterprises after independence and all other companies. A rebate of 5 percent was granted to the former group of companies on income from post-independence industrial concerns. This tax distinction remained in operation for four years and it was withdrawn in July 1963.

6.3.5 Special Concessions to Mining Industries. Beginning in 1961-62, new mining enterprises became entitled to the tax holiday privileges; until then they had a limited tax exemption for five years which was an exemption of income equivalent to 5 percent of capital. The presently available depletion allowance of 15 percent for non-tax-holiday industries was introduced in 1962-63. An additional rebate of 10 percent was introduced in 1964-65.

6.3.6. Compulsory Dividend Declaration Requirement for Private Companies. There is a provision of the income tax law the enforcement of which requires private companies, as defined earlier, to distribute at least sixty percent of their after-tax incomes as dividends. When a private company fails to

distribute upto the sixty-percent requirement, the income tax authority will assess the shareholders according to the presumption that the company's undistributed profits also have been distributed to them. The sixty-percent requirement is replaced by a hundred-percent requirement when the company's accumulated reserves of undistributed profits exceed the paid-up capital including either the loan capital (being the property of the shareholders) or the actual cost of the company's fixed assets, whichever of these is greater.

This provision is applied as a measure to discourage the tendency of tax-avoidance on the part of shareholders of private companies. It has remained in force from 1947-48 through 1958-59. However, as its application was a hindrance to reinvestment as well, beginning in 1958-59, the provision ceased to apply to private companies with respect to their industrial enterprises established after independence and which reinvested their undistributed profits in the same enterprises. During the two years, 1959-60 and 1960-61, the application of the provision was suspended for all private companies. Beginning in 1961-62, the provision was enforced again. By a recent post-budget (late 1965) declaration, the Government has decided to keep the application of the provision in abeyance for the Third Five Year Plan period which ends on June 30, 1970.

6.3.7 Rates of Corporation Income Tax. The various rates of normal income tax and super tax which have been in force since 1947-48 are given in Table 6 below. The rates mentioned here are those which would have become effective if no rebates had

TABLE 6

|              | RATES OF CORPORATION INCOME TAX |                          |                           |         |                                       |
|--------------|---------------------------------|--------------------------|---------------------------|---------|---------------------------------------|
|              | 1947-48<br>and<br>1949-50       | 1950-51<br>to<br>1956-57 | 1957-58<br>and<br>1958-59 | 1959-60 | (Percent)<br>1960-61<br>to<br>1965-66 |
| "Income tax" | 31.25                           | 31.25                    | 31.25                     | 30.00   | 30.00                                 |
| Super Tax    | 12.50                           | 25.00                    | 31.25                     | 35.00   | 30.00                                 |
| Total        | 43.75                           | 56.25                    | 62.50                     | 65.00   | 60.00                                 |



TABLE 7  
RATES OF SUPER TAX ON REGISTERED FIRMS

| Slab of Taxable income ( Rs. ) |                   | Total income at the end of the slab | (Percent)           |         |                         |   |                    |
|--------------------------------|-------------------|-------------------------------------|---------------------|---------|-------------------------|---|--------------------|
|                                |                   |                                     | 1955-56 and 1956-57 | 1957-58 | 1959-60 through 1965-66 | 1958-59                                       |                    |
| On first                       | 12,000            | 12,000                              | zero                | zero    | zero                    | Where total income does not exceed Rs. 25,000 | 6.25 <sup>1/</sup> |
| On next:                       | 13,000            | 25,000                              | zero                | zero    | 5.00                    |   |                    |
|                                | 5,000             | 30,000                              | 6.25                | 6.25    | 5.00                    | Where total income does not exceed Rs. 60,000 | 9.37               |
|                                | 30,000            | 60,000                              | 6.25                | 6.25    | 10.00                   |   |                    |
|                                | 40,000            | 100,000                             | 6.25                | 9.37    | 20.00                   | Where total income exceeds Rs. 60,000         | 12.50              |
|                                | Balance of income | -                                   | 6.25                | 9.37    | 30.00                   |   |                    |

<sup>1/</sup> The rate is zero on first Rs. 10,000 or 15,000 of income if the number of partners is two or more respectively.

been available. The bonus shares of companies became taxable in 1958-59 at a rate of 12.5 percent. Intercorporate dividend income became assessable at a reduced rate of 15 to 20 percent in 1959-60.

#### 6.4. Special Tax Treatment Areas

Registered partnerships, local authorities and co-operatives have been assessed in special ways. Registered partnerships became subject to a super tax levy in 1955-56. No normal income tax was levied on registered firms as such; the normal tax was payable by the partners as part of their individual incomes. The super tax levied on registered firms was a graduated tax. The super tax rates which were in force after 1955-56 are tabulated in Table 7. Except for 1958-59 when the basis of assessment was quite different from that in other years, the rates were arranged according to common slabs of income. Local government authorities have all along been subject to normal income tax at the rate applicable for corporations and in addition they have been subject to a super tax at a concessional rate of 12.5 percent. Until 1960-61, co-operatives were assessed at personal income tax rates, and in addition they were subject to a super tax at the rate of 12.5 per cent with the first Rs.25,000 of their income exempted. In 1960-61, co-operatives were given the option of being taxed at the rates applicable to companies or at personal rates, whichever treatment was more beneficial to them. Co-operatives engaged in cottage industries or established for providing agricultural and rural credit were exempted completely from income taxation.

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