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# ISSUES IN PAKISTAN'S DIRECT TAXES: AN EXAMINATION OF THE RECENT PROBLEMS IN THE INCOME TAX ORDINANCE, 2001

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## ABSTRACT
*Pakistan is amongst the countries with reliance on indirect taxes more than the direct taxes, as far as the revenue collection from tax is concerned. Being a law dynamic in nature, income tax law in Pakistan undergoes several changes in a tax year; some proving to be useful while others problematic. In either case, there are some flaws exposed due to reliance of each statutory provision over the others. As of the tax year 2022, there are several problems including tax on deemed income, super tax, active taxpayers list, recharacterization of income, withholding taxes, presumptive taxation and some procedural aspects. This paper tends to examine the legal aspects all of these problems with reference to their relevant provisions of law and also aims at providing pragmatic solutions and recommendations that may be adopted for a better system of direct taxes in Pakistan.*
**Keywords:** direct taxes, deemed income, active taxpayer, MTR, PTR, audit, amendment of assessments, unexplained income or assets, intra-vires doctrine, tax reforms.

## INTRODUCTION
As of the data provided by the Federal Board of Revenue (FBR) in for financial year 2019-20, direct taxes have contributed only to the extent of Rs. 1,523,445 out of the total revenue of Rs. 3,997,408 in all federal taxes (Strategic Planning Reforms & Statistic Wing, FBR, 2021). This constitutes only 38.11 percent of the total revenue collected. In developed countries direct taxes contribute to two-thirds of the tax revenues (Thaçi & Gërxhaliu, 2018). The reason for low yielding of revenue through direct taxes in Pakistan is twofold, one of law and other of policy. Being concerned primarily with the legal problems faced by direct taxation in Pakistan, this paper gives hereby a synopsis of these major hurdles in direct taxes in light of provisions of Income Tax Ordinance, 2001.

## ISSUES OF DIRECT TAXES AS IN INCOME TAX ORDINANE, 2001
### 1. Tax on Deemed Income (Section 7E)
Introduced by the Finance Act of 2022, Section 7E imposes a tax equivalent to five percent of fair market value of a capital asset on a resident person in lieu of holding an immovable property subject to certain

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exclusions. Tax on Capital Assets, under the guise of Capital Gains, was already dealt under Sections 37 and 38 in accordance with the rates specified in Division VII of Part I of the First Schedule of the Income Tax Ordinance 2001. Slab rates on the capital gains arising out of disposal of immovable properties were also categorically stipulated. Yet, not in consistency with the provisions already prevalent, Section 7E has tended to impose taxes on capital assets.

Section 7E and Section 37 both, in text, apply on "holding" of a capital asset. But the purposive reading of Section 7E suggests that rather than holding, it applies on "owning" of an immovable property. Furthermore, the whole idea of income tax is to tax the increase/decrease or the gains in income, whereas Section 7E operates on a pretext, assumption and a supposition of "deemed" income. By taxing an immovable property despite the fact that the gains or income derived from it are being taxed separately under other provisions, Section 7E operates contrary to the spirit of income tax. Thus, the tax on deemed income, rather than a tax on income becomes a tax on wealth. Another blatantly grey area in taxing 'owning' of an immovable property is about the future implications in relation to the property, whether there is still a tax to be paid by taxpayer on the gains while disposing off the property or he is relieved of such tax liabilities incurred?

The constitutional validity of the provision is also questionable. Section 7E; in contrast to the limit of taxation on immovable property put forth by the Entry 50 of the Federal Legislative List in the Fourth Schedule of the Constitution of Pakistan, 1973 which bars the levy of federal taxes on immovable property, is a federal tax on an immovable property of a resident person, which is beyond the powers of federal legislature and is exclusively a domain of the provincial legislature. Thus, the only tax federal government is competent to impose is a tax on capital "gains" of capital assets, not the capital "assets" themselves, as far as immovable properties are concerned. Courts have still validated the enactment for the time being based upon legislative novelty (Business Recorder, 2022), as the doctrine of pith and substance deems any legislative enactment as valid unless declared invalid (Pakistan International Freight of Forwarders Association vs Province of Sindh, 2017). But it is yet too early to determine the exact future implications of a jurisprudentially immature provision of law like Section 7E which still under-development.

### 2. Super Tax (Section 4B & 4C)

Pakistan inherited a taxation system of 1860 from the Britishers. This system had embedded a law called Super Tax Act of 1917, modified later by Super Tax Act of 1920, which was later consolidated with Income Tax Act of 1922 (Bukhari & Haq). Since then, the colonial Super Tax culture has drastically been reduced. However, the governments have been using this special kind of tax imposed on certain high earning persons from time to time and for some specific purposes and urgencies. In the present Income Tax law, 4B and 4C are the heirs of the law of 1920. Section 4B was first inserted by the Finance Act of 2015, aiming at collection of tax for the purposes of creation of additional funds for rehabilitation of temporarily displaced persons. However, the provision continues till the day. The rate of tax has now been reduced to nullity, but only for the companies other than the banking companies. The 'temporary' character of the provision has been made permanent by the realization that for the past five tax years since 2018, the rate of super tax on banking companies has been kept at a constant of four percent.

Section 4C, on the other hand, is a progressive tax for high earning persons earning a certain income (defined itself by the section) which is more than Rs. 150 million. This provision was introduced by Finance Act of 2022. It applies even higher super tax rates for persons engaged, partly or wholly, in a category of businesses including airlines, automobiles, beverages, cement, chemicals, pharmaceuticals and so on. Progressive taxation on high earning persons is indeed a step in conformity with Adam Smith's proportionality and equity principles of taxation. But since Super Tax is imposed in addition to the normal tax liability, the overall tax liability of certain high earning persons may become significantly high. As a consequence, the larger business persons, in order to elude super tax, would be compelled to split up businesses for reducing their liabilities on this account.

### 3. Withholding Income Taxes

In developing countries like Pakistan, inefficiencies in tax policies often lead to broadening of tax base by the means of greater reliance on withholding income taxes and imposition of measures like minimum tax regime (Best, Brockmeyer, Kleven, Spinnewijn, & Waseem , 2015). Withholding taxes in Pakistan contribute to almost 41 percent of the total revenue from direct taxes (Federal Board of Revenue, n.d.).

Deduction or collection made in advance for the purposes of withholding tax can be an adjustable as well as a non-adjustable payment of tax. When a tax withheld is treated to be a final tax by the statute, it falls in the Final Tax Regime (FTR), whereby its character is one of a non-adjustable nature. Such provisions include, wholly or partly, Sections 101A(8), 101A(9), 151(1)(b), 152(1), 152(1BA), 152(1C), 152(1D), 152(1DA), 152(1DB), 152(1DC), 152(1DD), 152(2), 153(1)(a), 152(1)(b), 153(2), 154(1), 154(3), 154(3A), 154(3B), 154(3C), 154A, 156, 156A, 235(1A), 236A and 236C(1). Withholding tax is adjustable when it is fundamentally treated to be:

i. a withholding tax, levied to be adjustable under provisions including 149, 152(2), 155, 231B, 234, 235(1), 236, 236A, 236C, 236G, 236H, 236K and 236Y.
ii. in Minimum Tax Regime (MTR) levied, wholly or partly, under provisions including 148, 151(1A), 152(1A), 152(1AA), 152(1AAA), 152(2A), 153(1)(a), 153(1)(b), 153(1)(c), 233, 236C and 236CA.

Thus, most off the withholding tax provisions deal with the final discharge of tax liability, which falls outside the ambit of the Normal Tax Regime (NTR). Adjustable withholding taxes are the discharge of a taxpayer's liability in the NTR. But the scope of withholding taxes is so broad that it includes and incorporates almost every person, every business, every sector and most of the notable transactions. Consequentially, the advance tax already collected or deducted as withholding tax of taxpayers before the end of a tax year often exceeds their regular liability under NTR, especially for the low earning businesses or sectors. Hence, the only way out for such businesses or sectors is to claim refunds, adjustments or carry-forwards in the subsequent tax years. In the subsequent tax years, further withholding taxes are added and the carry forward amounts keep piling up to an extent where the adjustments of the subsequent years become even greater than the previous ones. As a result, a despondent taxpayer undergoes padding of expenses, availing false benefits of several provisions and exemptions. This whole exercise, in the broader spectrum, promotes evasive activities and avoidance.

Another significant drawback of withholding taxes is that they are in addition to other taxes. Moreover, most of the withholding taxes apply on transactions, so they are based upon a 'presumption' of income. When a person engages in a transaction, the consideration of the transaction is treated to be an income by the way of a legal fiction, while actually it is not (Elahi Cotton Mills Ltd. and others v. Federation of Pakistan, 1997). Time and time again, this fiction has been called in to question in Pakistan. But it has always been upheld, for this legal fiction has resulted in to high yields of tax revenues, it has been solidified over the course of time. Now, it is entrenched so deep within the direct tax systems that majority of the provisions of withholding taxes are unimaginable without a presumption of income. Ergo, withholding income tax in Pakistan, whether it be adjustable or otherwise, cannot be regarded as a good tax, for it is far too inferior to the criteria of a good tax, i.e., one that is based on fairness, adequacy, simplicity, transparency and administrative ease.

### 4. Active Taxpayer List (ATL)

In order to promote the tax culture in Pakistan, the concept of Active Taxpayer List was introduced. Persons who furnish their returns and pay taxes in a tax year are displayed on FBR's website as active taxpayers who enjoy certain benefits like reduction in withholding taxes, reduced rates of taxes on sale/purchase of immovable/movable properties, etc. Nevertheless, it is ironic to observe that one of the very first definitions of the income tax statute is of 'Active Taxpayer List', yet nowhere in the Ordinance has an 'Active Taxpayer' been defined. However, this undefined term has its definitional foundations resting in the Sales Tax Act, 1990, even for the purposes of Income Tax. It is quite possible that the term has deliberately been left undefined to overcome the procedural and technical incongruities arising out of practice.

Practically observing, there are some problems that comes into existence. A person mentioned in the active taxpayer list is always an active tax payer, but an active taxpayer is not necessarily on FBR's active taxpayer list (Jamil, 2022). The record of FBR's online portals lacks real-time upgradation to active taxpayers list. This is because the entry in the active taxpayer list, rather than being dependent on FBR's Iris portal, Web Based One Customs (WEBOC) or any other online entry database, depends on manual entry by the income tax officials. Ergo, during the time between furnishing or submission of an income tax return under Section 114 and the time of upgradation of the list by an official, an active taxpayer by definition of the statute might not actually be an active taxpayer for the time not being updated over the list. During such time, such person not being updated on the list, if intends to undergo a transaction or any activity where he may avail the benefits reserved for an active taxpayer, shall not be able to do so.

## 5. Intra Vires Doctrine – A Direction or a Mandate?

The Ordinance confers several powers upon the Commissioner Inland Revenue. In fact, most of the procedural provisions from Section 114 to Section 242 are, either directly or indirectly, concerned with the powers of Commissioner or the Board thereof. The Commissioner or the department are bound to act within the authority and powers given to him by law, hence they cannot act ultra-vires and the use of their powers must be intra-vires (Azee Securities (Pvt.) Ltd. v. Federation of Pakistan, 2019). Some of these provisions confer discretionary powers to the Commissioner while others are related to mandatory powers. But amongst all of these provisions, the provisions being more practically operational yet problematic are of audit, amendment to assessments, unexplained income or assets and anti-avoidance measures enshrined within Sections 177, 122, 111 and Chapter VIII of the Ordinance, respectively.

When a taxpayer furnishes the return of income under section 114, it is a deemed assessment order as if issued by the Commissioner to the taxpayer within the meanings of Section 120(1)(b) after it is furnished. On a realization of a bona fide or a mala fide mistake or an omission in assessment of the taxpayer by the Commissioner, there exist two modes of amendment to that assessment. One is by the way of Section 111 while other is through Section 177. In either of these modes, amendment is made by the procedure envisioned in Section 122. The consequences of the amendment may be several. Sometimes a taxpayer shall have to pay or adjust a differential liability incurred. Otherwise, the department adopts coercive means as provided by Part X and XI of Chapter X of the Ordinance, making the affirmations of the presence of a possible 'avoidance' at the end of taxpayer in accordance with the Chapter VIII of the Ordinance.

The problem arises at the part of the department when mandatory provisions are construed as directory and directory provisions are used as excuses for acting beyond the permissible ambit prescribed by law. Similarly, when disabling provisions are construed as enabling by the taxpayer and enabling provisions are used to avail an undue benefit to the taxpayer for lowering the tax liability. For example, for purposes of Recharacterisation of income and deductions, the powers of a commissioner are limited to the extent of "transactions" and "entities". But in practice, these powers are construed by the department to the extent of Recharacterisation of "regimes", i.e., the persons falling under one regime are recharacterized to be assessed and audited in another regime of income tax for aims of greater yield of revenues, which is far beyond the statutory powers of the Commissioner. Furthermore, at times, the Commissioner construes a "may" as a "shall" and a "shall" as a "may" to his own advantage or to an unjustified advantage for the department.

These questionable interpretations and constructions are often contended by the taxpayers before the Courts. Owing to different facts and circumstances, many of these contentions have resulted in judgements against the departments for violation of the intra-vires doctrine. The instances of compliance to the doctrine have also been recorded in the judgements but they are few and far between. At some instances, the entire course of procedure adopted by the Commissioners has been considered nullity in the eye of law by the courts (Azee Securities (Pvt.) Ltd. v. Federation of Pakistan, 2019). At others, Courts have looked for the protection of Statutes and have not declared the whole of the departmental activities as nullity (Haroon-ur-Rashid v. Lahore Development Authority etc, 2016). Most of the times in cases involving Rectification of mistakes, the Courts have tended to uphold the departmental exercises as intra-vires for not involving a blatant error in law (C.I.R. Legal Division, LTU, Lahore v. Messrs Service Industries Limited, Lahore, 2011). The abuses of power by the Commissioners can only be averted with an interpretation of statute in close coherence to the judgements of Courts.

## SUGGESTIONS AND RECOMMENDATIONS

Suggestions for any legal reforms, unlike an egg and chicken equation, are not as simple as they seem. In a bird's eye view, there are two approaches towards the solutions to the problems identified herein. One is bringing the problematic provisions of law in conformity with the other provisions. Other is where the law is in conformity but there is a misapprehension in practice leading to a misuse. In the later case, the misapprehensions leading to misuse can be rooted out through policy considerations.

As far as the matter of Section 7E is concerned, the only way out is if the Courts interpret this article in the light of Doctrine of Aspect of Legislation. This principle has not yet developed its jurisprudence in Pakistan, however several legislative issues of taxation in India have been settled through this doctrine. While testing a provision on legislative competence, there can be several matters where legislative competence may fall within the domains of two different legislatures, and if so, these are the Courts that need to settle the degree and extent of legislative competence in the best interests of law (Federation of Hotel & Restaurant Association of India v. Union of India, 1989). While testing 7E on coherence with the statute, the only solution is either to bring Section 7E in conformity with Section 37 or not having it at all. To bring 7E in conformity with Section 37, the subject matter of 7E should be changed from capital asset to a capital gain tax, which may also be termed as an additional capital gain tax. For not having it at all, a subsequent amendment in the next Finance Bill may also be proposed, which is quite likely to be a possibility.

Super tax, if enacted for a time being and then repealed, cannot be regarded as a bad tax. However, the prolonged use of this type of tax for the purposes it is not actually meant for makes it a bad tax. Therefore, the only solution against Section 4B is to repeal the provision, for it is of no use in the circumstances prevalent. Moreover, the progressive but coercive approach of Section 4C is proving to be fatal for bigger enterprises. The consequence, if 4C remains in effect, would be further splitting up of businesses till a point there would be only a few bigger enterprises operational to their entirety. Therefore, an amendment should be introduced in the subsequent Finance Bill to charge a tax at the same rate for every person falling beyond certain limits, but not as high as ten percent as given by the Division IIB of Part I of First Schedule.

To unencumber the hindrances in mechanism of upgradation of an active taxpayer to the Active Taxpayer List, one of the best possible solutions can be an automated system for upgradation of the list instead of a manual entry system. Active taxpayer list on the website of FBR should receive real-time upgradation from other online portals like Iris and WEBOC. In this way, an active tax payer would actually be an active tax payer without any technical and infrastructural delays.

Considering the issue of withholding tax as elaborated, an eminent solution could be restricting the withholding tax base, keeping the withholding tax net at a constant. The primary subjects forming the base should be shifted from individuals, small businesses/AOP's/companies and small & medium enterprises to Multi-National Corporations (MNC's), medium sized businesses and larger taxpayer units. In this way, the onus of upholding the targeted revenues could be shifted towards high income persons rather than being on the shoulders of average income generating persons. One of the attributes of a good taxation is that its compliance is voluntary, not compulsory. Withholding provisions of the statute, which require compulsory compliance, should be reduced to a bare minimum where the principal source of revenues is through voluntary compliance. In the past years, especially in the Finance Act of 2019, several provision falling under FTR have been amended to make them a domain of MTR. Amendments of a nature alike are required to me made; initially to make more non-adjustable taxes adjustable and ultimately to eradicate compulsion of compliance.

For the issues of questionable constructions and interpretations leading to several incongruities including breach of authority, as forementioned, one of the most amicable reforms at the hour could be bringing the departmental practices in harmony with the judgements of the higher courts. Regular record of judgements, translated into their simpler versions, should be made accessible to every official of the

Federal Board of Revenue. The procedural and substantive misapprehensions should be clarified from these judgments. The rules and laws regulating direct taxation should be understood by the officials as interpreted by the judicial bodies. The whole idea of litigation is the restoration of the status quo. What if the departmental practices are so precisely accurate that they do not create an unrest to the status quo in the first place?

## CONCLUSION

Pakistan's direct taxes are encumbered with a lot of hindrances to their fair and equitable execution and implementation. The problems identified by this paper can be categorized in two classes; those relating to substantive foundations of law and those provided by law as departmental procedures. Substantive difficulties can gradually be unhindered by gradual and transitional jurisprudential development over the course of years. However, departmental procedures can only be complied with through administrative reformative measures, for even the substantive provisions owe their practical embodiment to machinery provisions. As the charity begins at home, the step foremost to the reformation is administrative willingness to submit to law. Only then, shall a substantive transition of a considerable magnitude be conceivable. Thereafter, the substance and procedure shall undergo a simultaneously synchronized advancement, eventuating in a consequent improvement of direct taxes in Pakistan.

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