

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Advanced Taxation

Examiners' comments and Suggested answers

Certified Finance and Accounting Professional (CFAP) – Summer 2017

Examinations

Overall General Comments:

- 28% candidates passed as compared to 25% in the previous attempt.
- Most of the candidates had poor understanding of Provincial Sales Tax laws, non-revenue objectives of taxation and allocation of expenses among various streams of revenue under the Income Tax Ordinance, 2001.

Question-wise comments:

Question 1

General comments:

51% candidates secured passing marks in this question.

Common errors:

- Contrary to the requirement of computing head wise income and total income, only taxable income was computed.
- The effect of sales tax on electric motors was ignored.
- Monetary award from Governor of Sindh was treated as exempt from tax.
- Service charges on tax withheld from suppliers were ignored. It should have been deducted in arriving at the business income, as it was included in profit before taxation, and should have been added to tax payable for the year.
- Profit paid on securities issued in China was treated as inadmissible due to non-deduction of withholding tax. Whereas u/s 46 of the Ordinance, no tax was required to be deducted in the given situation.

Suggested answer:

Bismil Limited (BL)
Computation of Total Income, Taxable Income and Income Tax Liability
For the tax year 2017

Income from Business:	Rupees
Profit before taxation	25,000,000
Add/(Less): Inadmissible expenses/(income)	
Withholding tax on sale of electric motors (15,000,000/0.96 x 4%)	625,000
Sales tax on sale of electric motors (15,000,000/0.96 x 17/117)	(2,270,299)
Sale of a product to an associated company	(50,000)
Fee paid on account of financial due diligence – capital exp.	900,000
Loss on disposal of machine	5,000
Penalty on short payment of tax	150,000
Entertainment expenses	385,000
Training expenses – Pakistani citizen	-
Profit on debt	-
Monetary award by President- Exempt	(1,000,000)
Monetary award by Sindh Governor – taxable	(300,000)
Service charges on tax withhold from suppliers	(500,000)
Dividend received from a subsidiary – FTR separate block	(120,000)
Total business income for the year	A 22,824,701
Exempt income:	
Monetary award by President – Exempt	B 1,000,000
Income from other source / FTR income:	
Gross value of dividend	120,000
Monetary award by Sindh Governor – taxable	300,000
	C 420,000
Total income for the year	(A+B+C) 24,244,701
Less: Exempt income/FTR income	
Monetary award by President – Exempt	(1,000,000)
Gross value of dividend-FTR	(120,000)
	(1,120,000)
Taxable income for the year under NTR	23,124,701
Computation of net tax liability:	
Tax on taxable income [23,124,701 @ 31%]	7,168,657
Tax on dividend -FTR [120,000 @ 12.5%]	15,000
Gross tax payable	7,183,657
Less: Tax deduction at source:	
Advance tax paid u/s 147	(5,300,000)
Advance tax paid u/s 153(1) (adjustable tax)	(625,000)
	(5,925,000)
	1,258,657
Add: Service charges payable to the Federal Government	500,000
Net tax payable	1,758,657

Question 2

General comments:

29% candidates secured passing marks in this question.

Part (a)(i)

Common errors:

- The allowable limit of 5% of turnover was computed on the targeted turnover rather than the actual turnover.
- The admissible expense was considered to be 1/5th of the total expenditure.
- The entire amount was declared allowable subject to meeting of certain conditions.

Suggested answer:

Alpine Pharmaceuticals Limited would be allowed 5% of the turnover as deductible expenditure. Therefore, in this case it would be allowed to deduct Rs. 1,070,000 in computing income from business. $(20,000,000 \times 107\% \times 5\%)$

Part (a)(ii)

Common errors:

- Opening equity was incorrectly computed.
- Closing equity instead of the opening equity was considered for the computation of share in foreign equity.

Suggested answer:

Thin capitalization:

Calculation of deductible amount of interest on debt:

	Rs. in million
Total equity at the beginning of the year:	
Net assets at the year-end (350 – 190)	160
Less: After tax profit for the year	(120)
Equity at the beginning of the year	40
Foreign equity- share of Big Inc. $(0.85 \times 40 \text{ million})$	34

Foreign debt eligible for thin capitalization: (interest exempt from tax-2nd Sch.Cl.72)

Thin capitalization ratio = Foreign debt ÷ Foreign equity ÷ 3

Thin capitalization ratio for SPL = 113 million ÷ 34 million ÷ 3 = 1.10784

Deductible interest for the tax year:

On Big Inc. loan = $7,500,000 \div 1.10784$	Rs. 6,769,931
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Therefore total interest on debt allowable for tax purposes under the provisions of Income Tax Ordinance, 2001 is Rs. 6,769,931.

Part (a)(iii)

Common errors:

Generally the candidates did not realise that it was not a Pakistan source income and therefore not subject to withholding tax.

Suggested answer:

Withholding tax is required to be deducted from Pakistan source income. In this case income of the China based company is not Pakistan source as the items were purchased from their website in China (it does not matter whether payment was transferred from Pakistan). Therefore, the entire amount of Rs. 300,000 will be deductible.

Part (a)(iv)

Common errors:

- The entire amount was considered as inadmissible because of non-deduction of withholding tax whereas only 20% of the purchase amount is disallowed on failure to deduct withhold tax.
- Only the issue of payment through banking channel was discussed without offering any comments with regard to non-deduction of withholding tax from the payment.

Suggested answer:

In order to claim the purchase of raw material of Rs. 700,000 as deductible, NL was required to deduct withholding tax of Rs. 28,000 from the payment made to DL. NL's failure to withhold tax from the payment has resulted in disallowance of 20% of the amount of purchase of raw materials.

However, since the payment against purchase of raw material under single account head, in aggregate, exceeded the basic threshold of Rs. 50,000, NL was required to pay the amount through banking channel by way of either crossed banking instrument or online transfer of funds or through credit card showing transfer of funds from NL's business bank account to DL's business bank account. Contrary to this, NL made online transfer of payment from their business bank account into DL's director's personal bank account. In view of above, the entire amount of Rs. 700,000 would be disallowed.

Part (b)

Common errors:

- The term is used with respect to the pledge of securities only. In many cases it was used in general terms also.
- Tax treatment was missing in most of the cases.

Suggested answer:

Pledge call transaction:

When a borrower defaults in payment to the lender, and securities were pledged as collateral, the lender is entitled to transfer such securities from the account of the person in default to his own account.

Tax treatment:

When the securities are transferred from the account of person in default to the lender's account, such transfer will be treated as disposal for tax purposes. The system price (day-end price) will be taken as deemed consideration for the purpose of computation of capital gain and tax thereon. Since no proceeds will be due to the person in default, thus, NCCPL may not be able to collect tax from such person. However, NCCPL shall report such capital gain and the amount of tax, if any, in the statements.

Part (c)

Common errors:

Only one or two methods were correctly mentioned instead of the required four methods.

Suggested answer:

Arms's length standard:

Commissioner may apply the following methods for the purposes of determining an arm's length result:

- (i) the comparable uncontrolled price method;
- (ii) the resale price method;
- (iii) the cost plus method; or
- (iv) the profit split method.

Question 3

General comments:

18% candidates secured passing marks in this question.

Common errors:

Part (a)

- Franchise was incorrectly considered to be a trademark, a brand name, an outlet with franchiser's name, an agreement, etc.
- Candidates were confused between a franchiser and a franchisee.
- While explaining the term franchiser, students ignored that it also includes any associate of a franchiser.

Suggested answer:

Franchise:

Franchise means an authority given by franchiser under which the franchisee is contractually or otherwise granted any right to produce, manufacture, sell or trade in or do any other business activity in respect of goods or to provide service or to undertake any process identified with franchiser against a fee or consideration including royalty or technical fee, whether or not a trade mark, service mark, trade name, logo, brand name or any such representation or symbol, as the case may be, is involved.

Franchiser:

Means any person who enters into franchise and includes any associate of franchiser who enters into franchise on his behalf.

Part (b)

Common errors:

- Candidates failed to comprehend that a valid proof of Payment of goods purchased including the amount of duty and the proof of receiving the price of goods sold including excise duty are the pre-requisites for the adjustment of excise duty.
- The second condition about declaration of input goods in the return of the supplier was also ignored by most of the candidates.

Suggested answer:

Adjustment of duties of excise:

Adjustment of excise duty on input goods shall be admissible only if:

- a person registered under the Federal Excise Act holds a valid proof to the effect that he has paid the price of goods purchased by him including the amount of duty and received the price of goods sold by him including the amount of duty through banking channels including online payment whether through credit card or otherwise.
- the supplier of input goods has declared such supply in his return and he has paid amount of tax due as indicated in his return.

Part (c)

Common errors:

- It was mentioned that duty drawback is allowed by the Federal Government instead of the FBR.
- Candidates used guesswork and failed to highlight the key aspects such as the following:
 - that the FBR is the authority which notifies the grant of duty drawback.
 - that the rate of duty drawback and the conditions attached thereto are also specified by the FBR.

- Answers were based on Section 62 of the Sales Tax Act, 1990 “Drawback allowable on re-export” instead of section 5(2) of the Federal Excise Act, 2005.

Suggested answers:

Duty drawback:

The Board may, by notification in the official Gazette, grant drawback of duty paid on any goods used in the manufacture of any goods manufactured in and exported out of Pakistan, or shipped as provisions or stores for consumption on board a ship or aircraft proceeding to a destination outside Pakistan, at such rate or rates and subject to such conditions and limitations as may be specified in the notification.

Question 4

General comments:

56% candidates secured passing marks in this question.

Common errors:

- Allocation of common expenses was either totally ignored or the entire expenses were allocated to income under NTR.
- Fee for technical services derived in Doha and revenue from online services fell within the ambit of export of services and were therefore exempt from tax. These were wrongly treated as FTR income. Many candidates also treated these receipts as normal income.
- Rent of office premises was considered as inadmissible because of non-deduction of tax, whereas, in case of rent, withholding tax is required to be deducted only when the amount of rent exceeds Rs. 1.5 million per annum.
- Vehicle was capitalized at its market value instead of residual value.
- Withholding tax on retainer ship services was subject to minimum tax. This aspect was mostly ignored.

Suggested answer:

RM Associates (RMA)
Computation of taxable income and net tax liability
Tax year 2017

				Rupees
	Retainership fee	Fee for technical services	*Other fees	Total
Scheme of taxation:	NTR/min.tax	Exempt	Exempt	
Net revenue	19,710,000	6,210,000	10,580,000	36,500,000
<i>Sales ratio</i>	<i>54%</i>	<i>17%</i>	<i>29%</i>	<i>100%</i>
Less: common expenses (W-1)	(8,608,263)	(2,710,010)	(4,622,960)	(15,941,233)
Total income	11,101,737	3,499,990	5,957,040	20,558,767
Taxable income	11,101,737	-	-	11,101,737
Tax on first Rs. 6,000,000				1,319,500
Tax on balance [(Rs. 11,101,737 – 6,000,000) × 35%]				1,785,608
				3,105,108
Less: Paid u/s 152				(105,800)
Paid u/s 153				(1,379,700)
Total tax payable for tax year				1,619,608
Test of minimum tax on retainership income:				
Retainership income				11,101,737
Total tax on retainership income				3,105,108
Withholding tax deducted from gross retainership fee				1,379,700
Since the normal tax under NTR is higher than the withholding tax deducted from gross receipt, normal tax would be payable. However, the withholding tax can be claimed as tax credit.				

W-1: Determination of common expenses	Rupees
Total expenses	25,150,000
Less: Inadmissible expenses:	
Salaries paid to partners [(290,000 × 12)+(355,000 × 12)]	(7,740,000)
Rent of premises	-
Accounting depreciation / amortization	(1,680,000)
Software expense – to be capitalized	(650,000)
Interest on finance lease	(135,000)
Withholding tax on retainership fee - included in other charges	(1,379,700)
Withholding tax on on-line services - included in other charges	(105,800)
Add: Admissible expenses:	
Tax depreciation on assets:	
Leased vehicle (950,000 × 15%)	142,500
Furniture and fixture (1,700,000 × 15%)	255,000
Computers and laptops (840,000 × 30%)	252,000
Tax amortization–software(5,000,000÷5+650,000÷10x181/365)	1,032,233
Lease rentals	800,000
Common expenses	15,941,233

***Explanation:**

An amount of Rs. 10,580,000 received from clients in Iran and Afghanistan on account of provision of on-line services falls within the ambit of export of '*IT enabled services*' under clause 133 of Part I of the Second Schedule to the Ordinance. It is therefore, exempt from tax. Consequently, withholding tax at the rate of 1% deducted from export proceeds is refundable.

Question 5

General comments:

36% candidates secured passing marks in this question.

Common errors:

- Input tax on packing material of textile products was treated as admissible.
- Input tax was claimed on raw material purchased from cottage industry whereas supplies by cottage industry are exempt from sales tax.
- Candidates failed to comprehend that:
 - Gift vouchers being in the nature of actionable claims are not subject to output tax.
 - Where, by reason of any misconstruction, any tax has not been levied, the amount of tax shall be recovered as tax fraction. Therefore, output tax on Promotional give-away was to be calculated as a tax fraction.
 - Supply of lubricants is subject to 17% output tax.
 - Goods destroyed by fire and subsequently compensated by an insurance company do not constitute supply. Sales tax paid on the goods destroyed by fire is therefore not refundable or adjustable.

Suggested answer:

Pasdar Limited (PL)
Computation of Net Sales Tax Liability
For the tax period May 2017

SALES TAX CREDIT (INPUT TAX)	Taxable Value	Sales Tax Rate	Amount of Sales Tax
Raw material from registered suppliers	4,710,000	17%	800,700
Packing material for textile products	850,000	inadmissible	-
Raw material from cottage industries	1,500,000	exempt	-
Import of finished goods	4,200,000	17%	714,000
Value addition		3%	126,000
Import of tyres for own consumption	800,000	inadmissible	-
Overhauling services	3,000,000	inadmissible	-
Purchase of taxable activity from GE	10,500,000	0%	0
Sindh sales tax on franchise fee			50,000
Punjab sales tax on franchise fee		inadmissible	-
Federal excise duty on franchise fee		inadmissible	-
Input tax on goods destroyed by fire			(325,000)
Input Tax for the month			1,365,700
SALES TAX DEBIT (OUTPUT TAX)			
Taxable supplies to registered persons	2,800,000	17%	476,000
Supply of electric iron	500,000	Exempt	-
Supply of goods to Local Govt.	2,700,000	17%	459,000
Taxable supplies to un-registered persons	1,560,000	17%	265,200
Supply of 2 nd hand worn clothing to un-registered persons	200,000	5	10,000
Claim against fire	2,750,000	-	-
Gift vouchers – actionable claims	450,000	-	-
Set off of loan	1,100,000	17%	187,000
Promotional give-away	235,000	17/117	34,145
Supply of lubricants	2,350,000	17%	399,500
Output tax for the month			1,830,845

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Less: WHT on supplies to registered persons (476,000/10)	(47,600)
WHT on taxable supplies to Local Govt.- not applicable	-
Debit for the month	1,783,245
Sales tax withheld from registered supplier (800,700 × 1/5)	160,140
Sales tax withheld from registered supplier on packing material (850,000 × 17% x 1/5)	28,900
Sales tax withheld from cottage industries- Rules not applicable as not liable to be registered	-
Further tax on supplies to un-registered person in March 2017 [480,000 × 2%]	9,600
Further tax on supplies to unregistered person assuming liable to be registered	31,200
Further tax on supplies of worn clothing to un-registered persons- exempt	0
Admissible credit (lower of 1,365,700 or 90% of 1,830,845 = 1,647,761)	(1,365,700)
Sales tax payable	647,385

Question 6

General comments:

16% candidates secured passing marks in this question.

Common errors:

- The areas in which the tax revenue is spent were specified which was totally irrelevant.
- Cannons of taxation were discussed which was not required.
- The fact that only the 'non-revenue objectives' of taxation had been asked was mostly ignored and the candidates gave objectives related to revenue generation also.

Suggested answer:

Non-revenue objectives

- To strengthen anaemic enterprises by granting them tax exemptions or other conditions or incentives for growth;
- To protect local industries against foreign competition by increasing local import taxes;
- As a bargaining tool in trade negotiations with other countries;
- To counter the effects of inflation or depression;
- To reduce inequalities in the distribution of wealth;
- To promote science and invention, finance educational activities or maintain and improve the efficiency of local forces;
- To implement laws which eliminate discrimination among various elements in the markets/businesses.

Question 7

General comments:

Only 9% candidates secured passing marks in this question.

Common errors:

Part (a)

- Companies registered under Companies Ordinance, 1984 were mentioned instead of companies as defined in the Income Tax Ordinance, 2001.

- Besides Federal and Provincial Governments, Local Governments were also included.
- Corporations established by Federal and Provincial Governments were mentioned.

Suggested answer:

Withholding agents:

Following are the withholding agents under the Sales Tax Special Procedure (Withholding) Rules, 2007:

- (i) federal and provincial government departments;
- (ii) autonomous bodies;
- (iii) public sector organizations;
- (iv) companies as defined in the Income Tax Ordinance, 2001 (XLIX of 2001), which are registered for sales tax, federal excise duty or income tax;
- (v) recipients of service of advertisement, who are registered for sales tax;
- (vi) persons registered as exporters.

Part (b)(i) and (ii)

Various types of mistakes were witnessed. Candidates are advised to seek guidance from the suggested answer and co-relate it with the relevant provisions to obtain a sound understanding of the law.

Suggested answer:

- (b)(i) Sixty days, one hundred and twenty days, Additional Commissioner Inland Revenue, Board, nine months.
- (b)(ii) A taxable supply, the first charge on the assets, transferee of business.

Part (b)(iii)

Deductible amount of tax was computed at 1% of Rs. 500,000 instead of working it out on the basis of gross value of taxable supply i.e. $1/117$ of Rs. 500,000.

Suggested answer:

$$500,000 \times 1 \div 117 = 4,274.$$

Part (c)

Very poor performance was witnessed in this part pertaining to Provincial Sales Tax on services. Candidates are advised to seek guidance from the suggested answer.

Suggested answer:

Application of principle of origin and reverse charge: (Punjab/ Balochistan/ Khyber Pakhtunkhwa) [Note: Any one of the three is required]

- (i) Where a person is providing taxable services in a Province other than the Punjab/ Balochistan/ Khyber Pakhtunkhwa but the recipient of such services is resident of the Punjab/ Balochistan/ Khyber Pakhtunkhwa or is otherwise availing such services in the Punjab/ Balochistan/ Khyber Pakhtunkhwa and has charged tax accordingly, the person providing such services shall pay the amount of tax so charged to the Government.
- (ii) Where the recipient of a taxable service is a person registered under the Act, he shall deduct the whole amount of tax in respect of the service received and pay the same with the Government.
- (iii) Where a person is providing taxable services in more than one Province or territory in Pakistan including the Punjab/ Balochistan/ Khyber Pakhtunkhwa, such person shall be liable to pay tax to the Government to the extent the tax is charged from a person resident in the Punjab/ Balochistan/ Khyber Pakhtunkhwa or from a person who is otherwise availing such services in the Punjab/ Balochistan/ Khyber Pakhtunkhwa.
- (iv) Where rendering of a taxable service originates from the Punjab/ Balochistan/ Khyber Pakhtunkhwa but terminates outside Pakistan, such person shall be required to pay tax on such service to the Government.
- (v) Where a taxable service originates from outside Pakistan but is received or terminates in the Punjab/ Balochistan/ Khyber Pakhtunkhwa, the recipient of such service shall be liable to pay the tax to the Government.
- (vi) The person who are required to pay the tax to the Government in terms of sub-sections (i), (ii), (iii), (iv) and (v) shall be liable to registration for the purpose of this Act.
- (vii) All questions or disputes relating to the application of the principle of origin given in this section shall be resolved in terms of the already recorded understanding between the Federal Government and the Provincial Governments on the implementation of reformed General Sales Tax: provided that pendency of any such question or dispute shall not absolve the concerned person from his obligation to deposit the tax.
- (viii) The provisions relating to origin and reverse charge shall apply notwithstanding any other provision of this Act or the rules and the Government may specify special procedure to regulate the provisions of this section.

(THE END)