RRI&A

STUDY OF EXISTING INCOME TAX REGIME FOR SMALL & MEDIUM ENTERPRISES

Summary of Key Findings & Recommendations

Research, Regulatory Insight & Advocacy Assistance for SMEs (RRI&A)

Small and Medium Enterprises Development Authority (SMEDA)

SMEDA

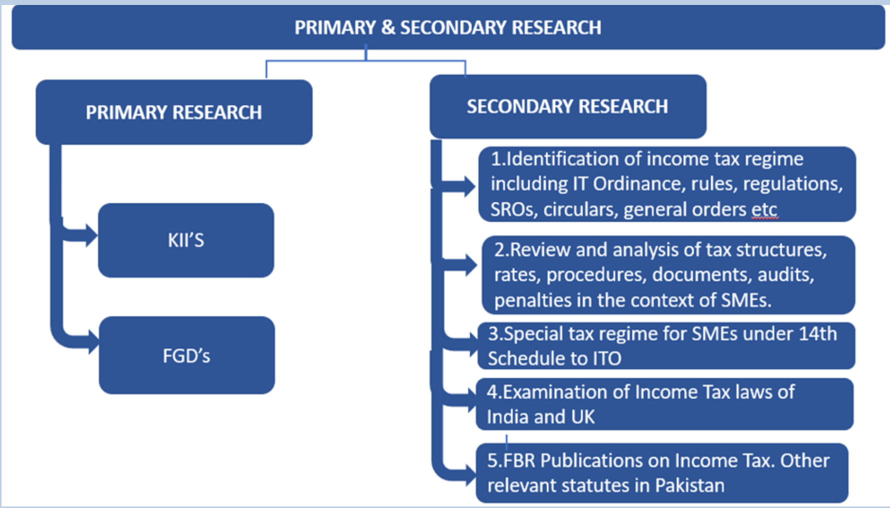
Why the Study

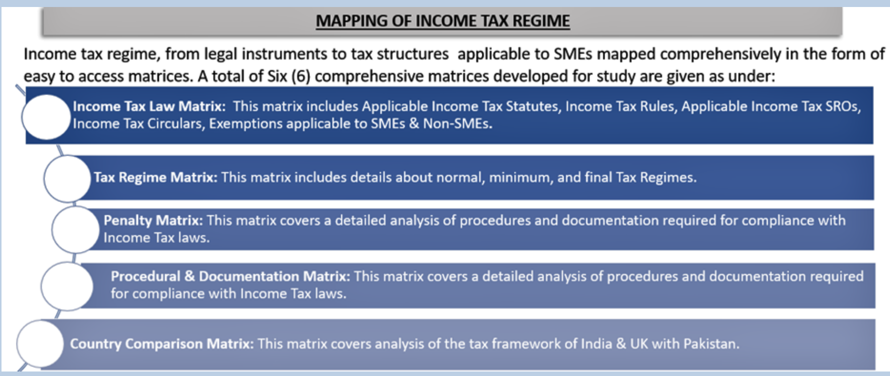
- Identify the entire substantive and procedural regulatory framework applicable to SMEs.
- Know and understand the tax structure and the challenges being faced by SMEs to comply with the requirements of Applicable Income Tax framework and how to mitigate the challenges.
- Examine the effect of rates of income tax applicable with reference to business structures i.e. company partnership, limited liability partnership and sole proprietors.
- Assess the impact, if any, of the Applicable Income Tax Regime on cost of doing business of an enterprise.
- Analyze the efficacy of the Special Income Tax Regime applicable to manufacturing SMEs under 14th Schedule to the Income Tax Ordinance.
- Evaluate the benefits and or growth prospects for SMEs to become tax payers.

Objectives

- Design and propose SME focused but informed Policy, Advocacy, and Support Initiatives for consideration of the government of Pakistan and other relevant stakeholders for an improved yet inclusive income tax environment for SMEs.
- Propose reforms in Applicable Income Tax Framework to bring ease of compliance for existing and potential SMEs.
- Balance / remove distortions of income tax rates for sole proprietors, partnership firms, limited liability partnerships and companies as SMEs.
- Improve and upscale the special income tax regime for SMEs as notified under 14th schedule of the Income Tax Ordinance, 2001.
- Build capacity and create awareness of benefits of being a tax payers

Execution Methodology





A Current Income Tax Regime (AITF)

Findings

- Income tax framework consists of a complex system of substantive and procedural legislation. There are 242 sections of Income Tax Ordinance, 232 clauses of the Income Tax Rules 2002, 908 Statutory Regulatory Orders, and 757 Circulars in vogue. Out of these instruments, approximately 237 sections of the ITO, 232 clauses of Income Tax Rules, 180 SROs and 160 Circulars are directly related to SMEs.

- A maximum of 16 documents are involved at the stage of registration for Income Tax. Although, there are no legal fees associated with registration, the process involves an estimated out-of-pocket cost of around Rs. 20,000 and takes approximately two weeks to complete.

- A Company shall be a withholding agent in all cases; however, an Individual and AOP shall be Withholding Agent only when they have an annual turnover of Rs. 100 million or above in any of the preceding tax years. Accordingly, small companies having turnover of less than Rs. 100 million may be at a disadvantage against similarly placed AOPs and individuals.

- The Income tax framework itself is a complex mix of multi-tiered incidences of taxation including normal income tax, advance tax, withholding tax, minimum tax, corporate tax and final tax.

- An SME taxpayer must comply with approximately 50 procedures within a given tax year which is challenging apart from being costly,

- An SME taxpayer has to file 8 withholding statements i.e., 4 quarterly withholding statements, 2 biannual withholding statements and 2 annual withholding statements apart from an annual income tax return. Biannual and annual statements are mere repetitions.,

- Given the existence of largely informal enterprises, deduction of WHT does not remain possible for registered SME taxpayers. Therefore, the taxpayer SMEs, unwillingly, look for alternate ways to avoid loosing their vendors / suppliers, which usually include adding an additional cost of non-filer's WHT e.g. 9% for goods in the product cost and getting an invoice. Alternatively, they may procure the material or services and do not record it. This becomes a necessary evil since the regulator, instead of capturing the vendor and or suppliers, penalizes the registered taxpaying SMEs which are unable to produce the documents of WHT collection from the vendors.

- Enterprises which are required to be registered but keep themselves unregistered due to inherent loopholes in the tax structure and or FBR's inefficiencies such as payment of tax at the double rate and go scot free. This has the effect of discouraging registered taxpayer SMEs.

- Given the complexity of the income tax structure, SMEs have to engage a tax expert, which adds an annual average cost of Rs.0.45 million excluding the cost of litigation, where more technical resources may be required against a hefty amount.

- There are almost 24 incidents of business enterprises where the deduction or collection of the advance tax is to be done by SME taxpayers. Almost 13 events include collection of tax on utility bills, imports, purchase, or transfer of vehicles etc. For the rest of almost 11 incidents, all withholding agents are required to deduct and deposit the tax with the FBR on payments made for local purchase of goods and services, collection of tax on salaries paid to employees etc.

- Currently, all business enterprises, whether SME or Non-SME, are required to pay at least 90% of their estimated tax liability as advance tax under section 147 of the Income Tax Ordinance in Quarterly installments. In case of non-compliance 12% of default surcharge is levied.

- There is an apparent disparity of taxation between different business structures. Sole proprietors and AOPs are taxed at varied rates according to their annual income which may go up to 35%. However, registered small and medium companies and limited liability partnerships are taxed at a fixed rate of 21% and 29% respectively, irrespective of their income. Apart from taxation of their enterprises, income drawn by the shareholders / directors / partners out of their corporate entities is taxed separately, which is not the case with owners / partners of Sole proprietors and AOPs. This disparity of tax rates has unintended but ominous consequences of discouraging the corporatization of SME businesses.

- Most of the SMEs perceived the WHT tax rate to be high. They also suggested an alternate rate. 60% of the SMEs were of the view that if the rate is fixed as 1-2% for the filer, and 9% for the non-filer, it will help to bring more suppliers into the tax net.

- An SME taxpayer has to file 8 withholding statements i.e., 4 quarterly withholding statements, 2 biannual withholding statements and 2 annual withholding statements apart from an annual income tax return. Biannual and annual statements are mere repetitions.,

- The Income Tax Ordinance specifies around 35 penalties and surcharges, ranging from Rs.1000 to Rs. 1 million. There are 35 penalties under section 182 which applies on approximately 50 events, out of which approximately 32 are fixed penalties, 3 are progressive and 15 are both fixed and progressive. Fixed types of penalties are applicable on all types of taxpayers regardless of their size including SMEs.

- Random external audits by the tax authorities is one of the biggest challenges for the taxpayer SMEs. The attitude of the tax authority toward the SMEs is like they have caught a suspect who has to be charged as a criminal for tax evasion, non-compliance, hiding records, etc.

- The Income Tax Ordinance does not provide any specific incentive in the form of tax credits or exemptions for newly set up SME enterprises. Although enterprises set up in the special economic zones are exempt from payment of income tax for a period of 5-10 years; however, no such exemption is available for investments in small industrial estates.
- The applicable income tax regime has not been designed in a manner to bring about an enabling environment for growth of SMEs per se. Therefore, most of the SMEs do not willingly register under the Income Tax regime; rather, they get themselves registered due to the fear of tax authorities as well as to avoid double rates of income tax.

Recommendations

- Withholding tax for small and medium enterprises should be based on revenue threshold rather than their legal structure i.e., AOP, Company, or Individual.
- FBR may introduce an online module for SMEs to help them comply with withholding tax requirements. This could take the form of a system that automatically generates withholding statements for the quarter, which could then be updated by the taxpayer if necessary.
- A carefully structure exemption from the responsibility of withholding tax may be provided for SMEs with turnover of up to Rs. 250 million on the basis of a real time turnover monitoring module.
- A system of incentives and support including reduced rates of withholding taxes, minimal penalties for unintended omissions / non-compliance may be introduced by the FBR for SME withholding agents to encourage improved compliance of withholding tax regime as well as for increased tax base.
- SMEs should be provided relaxation in major penalties in relation to incidents like withholding of advance tax (filing of statements and deduction of the tax at applicable rates) thus exempting or reducing penalties by 25%.
- Exemption from income tax for a specific period may be provided for SMEs startups irrespective of their nature of business. Further, SMEs making investments in small industrial estates established by the federal and or provincial governments should also be provided exemption from income tax for a specific period.
- For improved compliance and increased taxation, a sustained and structured awareness campaign, physical as well as online, may be designed and implemented jointly by the FBR and SMEDA.

B Issues and Challenges in Special Income Tax Regime for SMEs

Findings

- Eligible SME taxpayers under the Special Income Tax Regime (STR) under section 100E, read with Schedule 14 of the ITO, are likely to have an average benefit of 37% to 68% of the amount of tax (depending upon the category they choose) in a given tax year than they would have to pay before the promulgation of the STR.
- Eligible SME taxpayer exporters under the STR are likely to have an average benefit of 50% to 75% (depending upon the category they chose) in a given tax year than they would have to pay before the promulgation of the STR.
- Definition of Small and Medium Enterprises under section 2(59-A) is not aligned with the National definition of SMEs.
- The STR eliminated the minimum tax treatment for payments related to goods to facilitate business operations of SME taxpayers.
- Small companies as defined under the ITO, despite facing similar challenges as other SMEs, are not able to avail the benefits under the 14th schedule for no obvious reason.
- Taxpayers opting for the FTR, have no relaxation in withholding tax rates. The situation is likely to result in higher tied up funds of eligible SMEs, with the FBR, as against the SMEs not opting for the STR.
- No audit for SMEs opting for FTR while 5% of the SMEs opting for NTR are subject to selection of audit on the risk based parametric computer ballot if its tax to turnover ratio is below the tax rates specified.
- SMEs in general, are not cognizant of the advantages provided by the special tax regime under the14th schedule.

Recommendations

- Definition of Small and Medium Enterprises under section 2(59-A) may be amended in accordance with the national definition of SMEs.
- Scope of the Applicability of the STR may be enhanced by increasing the threshold of SMEs to Rs. 800 million in line with the national SME definition to extend thereto the benefits of reduced rates of taxation, lesser and easy compliance requirements.
- Applicability of the STR be extended to the Small companies to provide a level playing field to the corporate sector SMEs.
- The process for the refund of tied up funds may be automated, like that of the Sales Tax system of refund for exporters to help the SMEs in overcoming their cash flow problems. Till the time the process is automated, it is proposed to reduce withholding tax rates for SMEs up to the maximum rates applicable for the Companies in Pakistan.
- FBR and SMEDA may jointly and or severally organize an ongoing robust awareness campaign through electronic, print and social media about the STR indicating the benefits available under the scheme.

C Impact of IT on Cost of Doing Business of Enterprises

Findings

- Withholding tax results in high tied-up of funds of SMEs. Since the refund process is extremely slow, therefore, SMEs are often compelled to seek fresh loans to fulfill their cashflow requirements, which results incurring additional financing costs by them.
- About 80%-87% of unregistered taxpayers are not willing to pay their withholding taxes and consequently businesses either have to assume the full liability and pay 25% to 100% of the withholding taxes on behalf of their unregistered suppliers in order to remain compliant or somehow adjust such amount in their cost of sales, which ultimately raises their cost of doing business.
- SMEs having revenue ranging from Rs. 100 million -800 have to incur per annum indirect cost ranging from Rs. 200,000-450,000 and Rs. 300,000 to Rs. 600, 000 respectively in relation to hiring a dedicated resource, compliance, audit, penalties.

Recommendations

- The process for the refund of tied up funds may be automated, like that of the Sales Tax system of exports to help SMEs in overcoming their cash flow problems. Till the time the process is automated, it is proposed to reduce withholding tax rates for SMEs up to the maximum rates applicable for the Companies in Pakistan.
- Definition of Small and Medium Enterprises under section 2(59-A) may be amended in accordance with the national definition of SMEs. This will have the effect of extending the applicability of the specialized taxation for SMEs under the 14th schedule. As a result, the majority of the SMEs will be able to get relief from stringent provisions of audit, minimum taxation, etc. which will also help in reducing their cost of doing business.

D Key determinants of Tax Evasion

Findings

- The general preference for cash transactions in the economy contributes both to the cause and effect of tax evasion, as it results in a lack of documentation. Many unregistered and registered small and medium enterprises (SMEs) prefer to make and receive payments in cash to avoid taxation.
- It is important to note that in Pakistan, Non-Filer Taxpayers have emerged as a distinct category of taxation. The legal provision to impose a double rate of taxation on non-filers / unregistered persons without requiring them to get registered, file tax returns / wealth statements, and face compliance notices and penalties thereof has the likely effect of encouraging the deliberate tax evasion by such persons in respect of their dealings where no tax is withheld on their account.
- Given the existence of largely informal enterprises, deduction of WHT does not remain possible for registered SME taxpayers. Therefore, the taxpayer SMEs, unwillingly, look for alternate ways to avoid loosing their vendors / suppliers including payments to fake vendors on which withholding is not applicable or non-recording of procurements. Hence, some of the SMEs, unwillingly, have to become part of the tax evasion.
- SME Taxpayers consider tax laws as complex and challenging to understand. This complexity results in creating confusion and errors in tax compliance, which leads to intentional or unintentional tax evasion.

Recommendations

- Encouraging greater use of electronic payment methods and promoting the benefits of tax compliance can help shift the preference away from cash transactions, towards greater transparency in financial transactions, thus discouraging tax evasion in the economy.
- The category of Non-Filer Taxpayers should be eliminated to prevent taxpayers from not registering and avoid taxation and compliance obligations.
- The government should develop targeted tax education and awareness campaigns specifically for SMEs to help them understand their tax obligations, the benefits of being SME taxpayer and the consequences of non-compliance.
- To reduce evasion, the government may offer incentives for compliant behavior, such as tax credits or lesser penalties, and acknowledge and reward taxpayers who adhere to the regulations.

E Country Comparison for SMEs

Findings

- Tax is withheld at source. However, no requirement for filing of withholding statements separately in UK.
- In India, the number of withholding statements to be submitted to the relevant authority is 5 (i.e., only Quarterly and annual statements are required to be filed in India) as compared to Pakistan i.e. 8.
- In Pakistan, corporate income tax rate is 29% for all companies while it is 20% for small companies. In India as well as the UK corporate tax is slab / revenue based.
- In India and UK progressive taxation is followed. India's tax rates vary according to different slabs ranging from 15%-25% whereas for UK it ranges from 19-25%.
- While India treats withholding tax and minimum tax differently, Pakistan considers withholding tax as a minimum tax. The United Kingdom on other hand deducts tax at source and has no such concepts.
- Unlike Pakistan, no separate income taxation regime for SMEs exists in the UK and India with lesser tax rates and compliance requirements. However, tax laws of both UK and India do prescribe some incentives for SMEs in tax rates.

Recommendations

- Like the UK, Pakistan may also introduce 'Pay as you earn' system and help its SME sector to save costs related to withholding responsibilities by using data available with existing Management Information system of FBR.
- Like in India, Introducing tax rates for normal companies based on revenue/profit slabs to will have the effect of encourage more businesses to become taxpayers as well as encourage corporatization.
- Like the UK, Pakistan may also introduce specific incentive schemes with reduced Tax rates or Tax Credits on R&D, new investments etc.

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