



Fundamental Flaws in Pakistan's Taxation System

The writer has contributed this article exclusively for the current issue of CMA Journal

Prime Minister of Pakistan, Mr. Shahbaz Sharif, has stated that Pakistan will sink if the taxation system and power sector are not substantially reformed. This may be a revelation for some people; however, for the author, this has been a subject of concern for over three decades. In the following paragraph, the author will elaborate on the relationship between the accounting systems of businesses and taxation, and how this relationship has been intentionally or unintentionally destroyed in Pakistan by incorrect tax policies.

There are only two taxes in the modern taxation system: consumption tax and income tax. Consumption tax is generally termed as Value Added Tax. This tax is easy to levy and collect; however, it is more of a revenue collection measure than a step toward equitable distribution of wealth. Equitable distribution of wealth is the objective of every civilization. No civilization can sustain itself without equitable distribution of wealth. The objective of equitable distribution of wealth can only be achieved through a proper income tax system. Income is not an absolute term; it means receipts/sale proceeds less expenses. This determination cannot be made unless there is proper documentation, commonly referred to as accounting.

There may be varied bases for maintaining the accounts; however, the ultimate objective is to determine an income or loss during a particular period as decided by the individual. Thus, documentation and accounting are essential for determining income/loss. Income tax is levied on income; therefore, if a proper income tax system is to be introduced, there must be a proper underlying system of documentation leading to the fair determination of income. This is a universal principle that cannot be disturbed. If any other basis is adopted, it may be facilitative to the taxpayer and tax administrator, but it can never ensure that proper tax is being collected on income.

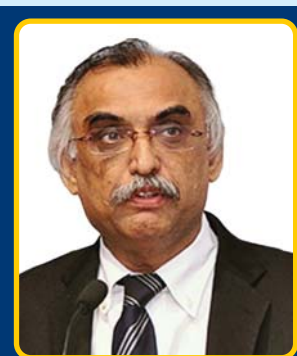
All tax systems, therefore, require that income tax determination is based on accounting income determined by the taxpayer. There may be certain

variations between financial accounting practices and the income determined for tax purposes; however, in substance, income tax is always payable on income determined after taking into account all receipts/sale proceeds and deducting expenses during the period.

It is very unfortunate for Pakistan that, in the past 40 years, two or three incorrect tax policy measures have been undertaken, which have divorced income tax collection from income determination. In other words, after these aberrations, it is possible that income for tax purposes is completely different from the actual income realized by that person. This aberration essentially means that the country has moved away from an equitable tax system, as the ultimate objective of proper income distribution is not being achieved. In addition to other problems of tax administration, this has created disharmony in society, with a growing perception that the incidence of tax is not distributed equitably, resulting in an increase in the concentration of wealth and the gap between rich and poor.

For common understanding, three vital mistakes in tax policies that destroyed the tax system have been identified. These are the 'Incorrect Self-Assessment Scheme,' the 'Presumptive Tax System,' and the coinage of the term 'Non-filer.' These systems, in combination, have destroyed the basic core of tax culture in Pakistan. Over time, after realizing the facts on the ground, the first two mistakes have been corrected; however, the third mistake is worsening year by year.

During the dictatorial period of General Zia Ul Haq, the economic managers at the time, in order to support the martial law government, designed a fundamentally flawed self-assessment scheme.



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This was introduced in the late seventies. Under that scheme, taxpayers were given the choice to be immune from any kind of examination or inquiry if their voluntarily paid tax liability exceeded a certain percentage over the previous year. This meant that the basic and primary link between actual income and tax incidence was broken. The process of determining accurate results became futile, and most small and medium-sized businesses stopped maintaining proper books of accounts, as they were not required by any regulators. This was a blunder. Through this measure, the Martial Law government ensured a certain guaranteed collection of tax.

Accordingly, it can easily be assumed that from the 1980s until the new Income Tax Ordinance, 2001 was introduced, almost all tax schemes for tax assessment provided that there would be no 'audit' or 'inquiry' of accounts maintained if the tax liability for the year exceeded a certain percentage over the previous year. This meant that for two decades, there was no requirement to maintain books of accounts for all businesses other than companies by any regulator. Beyond the tax aspect, this was a significant disincentive for the corporatization and consolidation of businesses, as it was always easier and more suitable to maintain businesses in the non-corporate sector.

In 1990, the biggest bombshell on the taxation system was dropped with the introduction of a useless scheme called the 'Presumptive Tax' system. Under this system, a certain percentage of tax withholding or tax collection, which had no relation to actual income or loss, was considered as income tax liability. As is apparent from this simple definition, even the basic requirement of a sum of income shown as self-assessed income was removed from the system, and a notional or illusory sum was treated as the discharge of income tax liability. This was against any principle of accounting, taxation, and law. However, the biggest tragedy for the nation is that our highest judicial body declared that such an absurd system of income tax liability payment was constitutionally valid.

This horrendous system was validated in the Elahi Cotton Mills Limited case by the Supreme Court of Pakistan. After the introduction and validation of the presumptive taxation system, the relationship between documentation, accounting, and taxation was completely severed.

The defect in the system was further exacerbated by the fact that this presumptive system of taxation was made applicable to a large number of companies, mainly importers. This meant that after the introduction of the presumptive taxation system, there was no effective income tax in Pakistan. A sum collected or withheld at source, being an indirect tax in every common and

economic sense, was being treated as income tax. It is good that this aberration was substantially corrected by the Finance Act, 2019; however, it is a fact that even today, in 2024, there is likely no importer who has been paying tax on a net income basis more than the amount collected at the import stage. So, a presumptive tax system still prevails in practice.

In the early 2000s, the term 'Non-filer' was coined. It is actually a crime to coin such terms. A Non-filer is a person who is required to file a tax return but does not file it. It means that a person is a 'thief'; however, they are called an 'actor.' This term was coined to save people who had earned income from sources that were not explainable and who spent such amounts for consumption or other purposes where documentation is essential. So what the government did was ask them to pay an additional sum while making such a transaction without disclosing their tax identity. For example, in the case of a person acquiring a property, a tax collection, say at the rate of 5%, is made from the purchaser. The law provides that if the purchaser does not want to file a return of income, though required, then the transaction can be validly made if the person is designated as a 'Non-filer' and a legal payment of 10% is made. This means that the identity of the person making the purchases will not be known to the tax department, even though the property purchased is worth billions.

The author is unable to understand the reason why a person making a purchase above a certain amount during a period is mandatorily required to file a return of income. The return of tax is not effectively a return of income; it is effectively a return of tax showing that all economic transactions, though not necessarily resulting in income, are accounted for. This is, in essence, a wealth statement. However, in our law, by coining and promoting the term 'Non-filer,' this primary concept has been undermined.

These three mistakes are so substantial and have persisted for such a long time that it has virtually become a culture in Pakistan to seek to discharge tax liability without maintaining documentation and accounts. This is not sustainable. There is no shortcut to achieving the desired goal of equitable income taxation. The country has no choice in this matter; however, it must be remembered that it will take a reasonable amount of time for society to adopt the correct approach, which is entirely different from what has been practiced in the past.

About the Author: The author is a former Chairman of the Federal Board of Revenue and has an extensive background in the field of accounting and taxation. He also served as Territory Senior Partner at A. F. Ferguson & Co. and was President of the Institute of Chartered Accountants of Pakistan (ICAP) in 2006 and the South Asian Federation of Accountants (SAFA) in 2008.