FBR Quarterly Review

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A Review of Resource Mobilization Efforts of
Federal Board of Revenue

FEDERAL BOARD OF REVENUE
Fiscal Research and Statistics Wing
Government of Pakistan
Constitution Avenue
Islamabad - Pakistan

Contact:
Editor: Mumtaz Haider Rizvi
Member, Fiscal Research & Statistics
Fiscal Research and Statistics Wing
Federal Board of Revenue
e-mail: memberfrs@FBR.gov.pk
Phone: (051)-920-4436
Fax: (051)-921-9211
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Fiscal Research and Statistics Wing
Federal Board of Revenue

Research Team

1. Mumtaz Haider Rizvi
   Member, Fiscal Research and Statistics

2. Robina Ather Ahmed
   Chief (FR&S)

3. Shafiq Mohammad
   Secretary (FR&S)

4. Umar Wahid
   Secretary (FR&S-I)

5. Mir Ahmed Khan
   Second Secretary (FR&S-I)

6. Naeem Ahmed
   Second Secretary (FR&S-II)

7. Waseem Hayat Bajwa
   Second Secretary (FR&S)

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Abbreviations

AoPs	Association of Persons
ATT	Air Travel Tax
BPR	Business Process Reengineering
CD	Customs Duties
CFY	Current Fiscal Year
CoD	Collection on Demand
DT	Direct Taxes
FBR	Federal Board of Revenue
FED	Federal Excise Duties
FY	Fiscal Year
GST	General Sales Tax
LTU	Large Tax Payers' Unit
MCC	Model Customs Collectorate
NFS	Non-Fund Services
NTN	National Tax Number
PCT	Pakistan Customs Tariff
PFY	Previous Fiscal Year
Q2CFY	Quarter 1 Current Fiscal Year
Q2PFY	Quarter 1 Previous Fiscal Year
RTO	Regional Tax Office
ST(D)	Sales Tax Domestic
ST(M)	Sales Tax Import
STARR	Sales Tax Automated Refund Repository
TARP	Tax Administration Reform Project
USAS	Universal Self-Assessment Scheme
VP	Voluntary Payments
WHT	Withholding Taxes
WLT	White List of Taxpayers

Foreword

The current issue of FBR Quarterly Review includes detailed revenue analysis of federal taxes for the 2nd quarter and first half of current financial year. Revenue figures for the second quarter (October-December) have always been of key significance; because analysis of revenue up to December sets the pace for the remaining financial year. This synopsis also identifies slack areas of revenue and enables the Board to focus on the ultimate revenue targets.

The issue contains articles on “Strengthening the audit / examination system of tax in Pakistan” and “Acknowledging the Compliant Taxpayers”. The articles highlight the importance of an effective audit system and link it with the success of prevailing system of USAS. In this regard, audit system of Japan has been analyzed to draw relevant lessons to improve our system.

Efforts of the team of Fiscal Research and Statistics Wing in bringing out the publication are commendable.

(Ahmad Waqar)
Secretary Revenue Division/Chairman, FBR

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FBR Tax Collection:
An Analysis of 2nd Quarter Revenue Outturn[1]

The Economy

There has been no let down in the ongoing global economic recession, and has continued to further shrivel the economies of both developed and developing countries in the recent months. The world trade has plummeted to the lowest level during the last eighty years; after the economic depression of 1920s. This economic meltdown and trade slump has cast immense negative repercussions on the already fragile economies of the developing countries. Thus, Pakistan is also bearing the brunt of this current global economic crisis further aggravating the economic problems of Pakistan. Its exports, the major source of foreign exchange earning, have been battered badly during the current financial year. The major reason behind this decline is the deteriorating demand all over the world. Resultantly, the countries like Pakistan who largely depend on the policies of export-led growth and development are under immense pressure.

On the other hand political turmoil and law and order situation during first 6 months of the CFY did not allow the business activities to flourish and grow at the desired level. The confidence of both local and foreign investors has not yet been restored fully. Nevertheless, it is heartening to note that despite the severe crisis the half yearly revenue targets have been met by about 100 percent. But in the backdrop of prevailing circumstances, the prognosis for achieving the remaining six monthly revenue targets would remain bleak, unless and until we create an environment conducive to the investors. This can be done by diffusing political tensions, improving law and order situation and by ensuring the uninterrupted power supply to industrial sectors and businesses. It is also time to revisit the export policies in order to strengthen the export oriented sectors being the backbone of our economy.

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[1] The Research Team of Fiscal Research Wing of FBR has carried out the analysis.

FBR Revenue Collection vis-à-vis Target

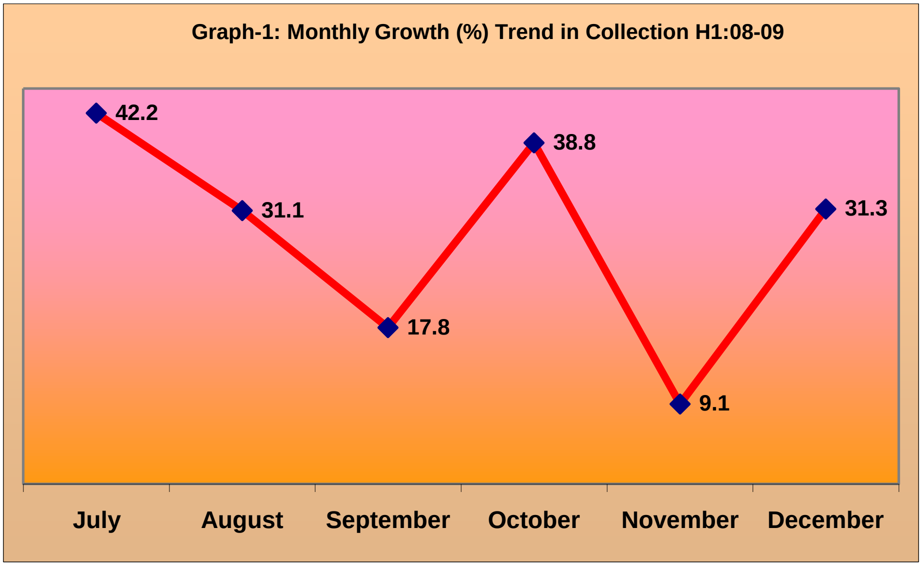
The upward revised revenue target of Rs.1300 billion for fiscal year 2008-09 is challenging amid severe local and global economic crisis. To achieve the huge revenue target extraordinary efforts would be required. In response to the revenue target, FBR has collected Rs. 589.1 billion and Rs. 553.8 billion in gross and net terms, respectively during first half of FY: 08-09. The growth in gross and net collection has been 25.5% and 27.3% respectively (Table 1). During the same period refund payments had increased by 2.6%. The six monthly target of Rs. 555.0 billion has been achieved to the extent of 99.8%. Keeping in view the deteriorating national and international economic conditions this performance is satisfactory. However, there will be more pressure in the second half of current fiscal year to collect the remaining balance of Rs.746 billion which is about 58% of total revenue target.

Table 1: Month-wise Comparative Net Revenue Collection

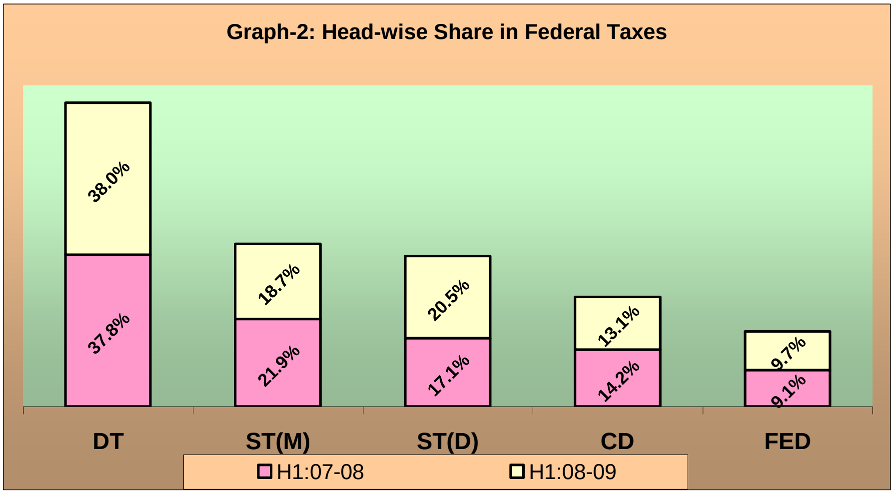
(Rs. Million)

Months	FY 08-09	FY 07-08	Difference	
			Absolute	Percentage
July	72,462	50,941	21,521	42.2
August	78,815	60,139	18,676	31.1
September	110,813	94,056	16,757	17.8
October	92,182	66,388	25,794	38.9
November	74,809	68,543	6,266	9.1
December	124,752	95,009	29,743	31.1
July-December	**553,833**	**435,076**	**118,757**	**27.3**

The monthly growth trend in collection during the first half of the year has been volatile. It has varied between 42.2% in July to 9.1% in November and then it picked up again in December and grew by around 31% (Graph-1). The average growth during H1 of CFY has been 28.3%, which is less than the required growth of 29% to meet the full year target.



The tax-wise details reveal that the direct and indirect taxes grew by 27.8% and 27.0% respectively during H1:08-09. Among indirect taxes sales tax (import), sales tax domestic, customs and FED grew by 9.1%, 52.8%, 18% and 35.5% respectively. The contribution of direct taxes during H1: 08-09 has marginally increased from 37.8% to 38.0% in the H1: 07-08 (Graph-2). A notable change has been witnessed in ST(M) and ST(D). The share of ST(M) in federal taxes has declined by 3.1% whereas, the share of ST(D) has increased by 3.4%. The reason for this shift is change in policy of zero rating of POL products (major source of revenue) at import stage and levy of sales tax at domestic level.



Though the revised target for first half of CFY has almost been achieved, but to achieve the overall target for the second half of CFY as depicted in the table below appear to be an uphill task particularly for direct taxes at 319.7 billion and sales tax (D) at 189.5 billion.

Table 2: Net Collection vis-à-vis Targets for H1: 2008-09

(Rs. Billion)

Tax Heads	Target	Collection	Difference	Balance Amount to be collected in H2:08-09	Remaining Balance as % of total Target
Direct Taxes	210.0	210.3	0.3	319.7	60.3
Sales Tax(D)	131.2	103.7	-27.5	189.5	64.6
Sales Tax (M)	91.8	113.4	21.6	92.4	44.9
FED	49.0	53.6	4.6	65.4	55.0
Customs	73.0	72.8	-0.2	79.2	52.1
Half Year	**555.0**	**553.8**	**-1.2**	**746.2**	**57.4**

The Refund/ Rebate Payments

Overall refund payments grew by 2.6% during H1:08-09, nonetheless, as a result of the introduction of zero-rating regime in GST and the adoption of a policy of speedy disposal of refunds and transparency in the system, a substantial decline has been witnessed in ST(D) refund payments, which has been the major source of refund payments. In absolute terms Rs. 1,338 million lesser amount has been paid in ST(D), which is around 9% lower than the previous year refund payments. Similarly, in the customs more than 10% decline has been registered in refund/rebate payments during the same period. However, in direct taxes Rs.16.3 billion refunds have been paid during H1:08-09 against Rs.13.4 billion in the corresponding period last year revealing a growth of 21.2%.

Detailed Analysis of Individual Taxes

The half-yearly revenue performance has been satisfactory. The overall revenue target has been achieved to the extent of 99.8%. Major shortfall has been witnessed in the collection of ST(D) which has been compensated by the excess collection from ST(M). The targets of DT and FED have been achieved more than 100%, whereas collection of customs fell short only by 0.3% during first half of CFY.

***Direct Taxes*:** The gross and net collection of direct taxes during H1: 08-09 has been Rs. 226.6 billion and Rs. 210 billion, indicating a growth of 27.3% and 27.8% respectively. The performance when viewed with the last year has shown better results, and thus could be argued that the direct taxes are getting close to the envisaged targets for the year under consideration. Within various components of direct taxes, major increase and growth has been encountered in collection on demand. The other two components comprising of voluntary payments and withholding taxes have also shown better results when compared with the similar period last year.

Components of Income & Corporate Taxes

Collection on Demand (COD): Although COD has become a minor component over the years after the shift towards self assessment system but it will remain of paramount importance as it is the only component which reflects the departmental efforts to recover arrear payments and raise current demand by analyzing the documents (returns and annexes) filed by the taxpayers. The share of COD, in total income tax collection has improved from 6.6% during H1: 07-08 to 13.4% in H1: 08-09. Within the COD, the share of current demand and arrear demand was around 71% and 29%, as against 58% and 42% respectively in the previous year. The collection from current demand reached Rs. 21.3 billion in H1:08-09 against Rs.6.5 billion in H1:07-08, whereas in the head of arrear demand Rs. 8.6 billion against 4.8 billion have been accrued . The healthy collection and better growth, particularly, from the current demand is an indicator to gear up our efforts to educate the taxpayers about the advantages of effectively using the prevalent facility of self-assessment. The possibility of inadmissible deductions appears to be the case. Thus, there is a clear case for targeted audit of the submitted declarations. Regarding arrear collection the percentage growth of 71.5% against previous year's 135% is suggestive of a renewed strategy and more efforts in this regard.

Voluntary Payments (VP): This component includes payments with return and advances. In net terms, Rs. 79.8 billion have been generated during H1: 08-09 as compared to Rs. 67.5 billion in the corresponding period last year. Thus, 18.2% increase has been witnessed in collection from this important component. It may be recalled that after the introduction of USAS, the share of VP in gross collection has kept on rising and during H1: 06-07 it reached 55.5%, but in the last two years there has been a reverse trend whereby during H1: 07-08 it has declined to only 39.5% and presently in H1:08-09, it has further dipped to 35.8%. A detailed analysis of this component reveals some development and the payments with return have registered an increase by 102.8% against a decline of 87% in the corresponding period last year. In nominal terms, an amount of Rs.12.5 billion against Rs. 6.2 billion collected in H1: 08-09, and consequently its share in total VP has also increased to 16% from 9% in the previous year. The second component of VP, i.e., advance payments has also shown better result with a growth of 9.7% against only 2.3% during the previous year and during H1: 08-09 Rs.67.3 billion were collected against Rs. 61.3 billion in H1: 07-08. (Table 3)

Though in the period under review, there has been a better trend of collection from this component as compared to last year, but by keeping in mind the target of current year the collection does not seem to be in consonance with target. In a system of USAS, this component should have an increasing trend as we witnessed up to 06-07, but on the contrary it is a decreasing trend as observed during the last two years. As VP is the primary indicator reflecting the success and failure of the prevalent system of USAS, the department need to review this aspect comprehensively so as to evolve an appropriate strategy to make the USAS successful.

Table 3: Voluntary Payments (VP): A Comparison

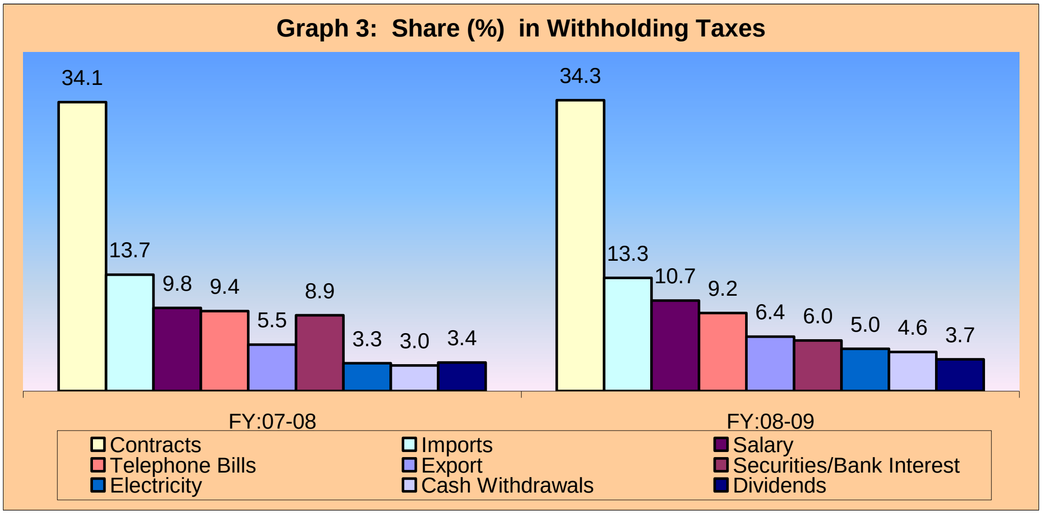
(Rs. Million)

Heads	H1: 08-09	H1: 07-08	Growth (%)	Share (%) in Total VP	
				H1: 08-09	H1: 07-08
With Return	12,515.1	6,171.3	102.8	15.7	9.1
Advance Tax	67,266.5	61,345.4	9.7	84.3	90.9
Total VP	**79,781.6**	**67,516.7**	**18.2**	**100**	**100**

Withholding Taxes (WHT): Withholding tax is the third important component of income tax. During H1: 08-09 tax receipts worth Rs. 112.7 billion have been collected against Rs. 92.1 billion in the corresponding period of last year entailing a significant growth of 22.4%. The share of WHT in gross income tax collection has declined during the current period and stands at 50.6% against 54% in H1: 07-08.

The major revenue spinners as far as WHT is concerned are: contracts and supplies, imports, salary, telephone, securities, exports, electricity, cash withdrawals and dividends.

The major heads, mentioned in Table 4, contribute 93.2% of total the WHT collection. Their respective shares are shown in Graph 3. The major share of WHT comes from contracts and supplies (34.3%), which are followed by trade related deductions 19.7% [imports (13.3%) and exports (6.4%)], salaries (10.7%) and Telephone bills (9.2%) and so on.



A healthy performance in receipts on account of contracts, telephone use, salary payments, electricity bills, cash withdrawals and dividend has been witnessed during H1: 08-09. On the other hand, there has been a decline in WHT on imports and exports which appears to be inconsistent with 14.1% and 3.8% growth in imports and exports respectively during H1: 08-09. Finally, 86% increase in deductions on cash withdrawal vindicates the assertion that the undocumented economy requires special tax treatment.

Table 4 Half-Yearly Collection from Major Revenue Spinners Related to Withholding Taxes

(Rs. Million)

Collection Heads	H1: 08-09	H1: 07-08	Difference (Absolute)	Growth	Share in WHT H1: 08-09
Contracts	38,662.7	31,375.5	7287.2	23.2	34.3
Imports	15,046.6	12,640.7	2,405.9	19.0	13.3
Salary	12,041.7	9,030.0	3,011.7	33.4	10.7
Telephone Bills	10,355.6	8,679.8	1,675.8	19.3	9.2
Export	7,209.5	5,022.7	2,186.8	43.5	6.4
Securities/Bank Interest	6,713.1	8,238.5	-1,525.4	-18.5	6.0
Electricity	5,597.4	3,009.0	2,588.4	86.0	5.0
Cash Withdrawals	5,186.2	2,789.9	2,396.3	85.9	4.6
Dividends	4,195.9	3,105.4	1,090.5	35.1	3.7
Sub-Total (9 major items)	105,008.7	83,891.5	21,117.2	25.2	93.2
Share in Total WHT	93.2%	91.1%			
Other WHT	7,707.6	8,167.4	-459.8	-5.6	6.8
Total WHT	**112,716.3**	**92,058.9**	**20,657.4**	22.4	100
Share in Gross I. Tax	50.6	54.0%			

Analysis of Income Tax Returns: The number of Income Tax Returns and statements received during H1:08-09 as compared to the corresponding period last year are higher by 412,272 indicating a growth of about 23%. But negative growth of 7% in the number of returns received during this period has been observed, the statements have increased by 43.1% (Table 5). Also the total tax received has registered an increase of 87%.

Table 5: Income Tax Returns Vs Collection 2008-09 and 2007-08

	H1: 08-09		H1: 07-08		Growth (%)	
	No. of Returns Received	Tax Paid	No. of Returns Received	Tax Paid	No. of Returns Received	Tax Paid
Returns						
Corporate Cases	17,430	6584.9	16,063	5,325.60	8.5	23.6
AOPs	25,103	96.5	24,876	103.5	0.9	-6.8
Salaried Individuals	126,453	160.2	94,078	79.2	34.4	102.3
Non-Salaried Individuals	508,456	3,064.10	589,651	1,336.20	-13.7	129.3
Sub Total Returns	677,442	9,906	724,668	6,845	-6.5	44.7
Statements						
Salary certificates/statements	18,464	4.4	64,266	14.2	-71.3	-69.0
No of employees in the statement	1,385,303		900,179		53.9	
Importers	20,698	0.2	15,385	0.6	34.5	-66.7
Exporters	9,679	0	8,569	1	12.9	-100.0
Retailers up to 5m turnover	44,925	32.5	33,725	88.8	30.2	-63.4
Above 5m turnover	2119	6.8	2,292	2.5	-7.6	172.0
Contractors/ Suppliers	37,908	3.6	31,190	6.2	21.54	-41.9
Others	18,023	3157	18,110	54.1	-0.5	5735.5
Sub Total Statements	1,537,119	3,205	1,073,716	167	43.2	1814.3
Total	**2,214,561**	**13,110**	**1,798,384**	**7,012**	**23.1**	**87.0**

<u>Return Analysis of corporate entities</u>

To ascertain the potential growth vis-à-vis the department efforts with regard to the 'Returns' a gap analysis of corporate returns received up to December 08-09 has been done.

Table 6: Number of Corporate Returns and Payment with returns

	2008-09	2007-08	Change (%)
Returns filed	17,430	16,063	8.5
Payments With Returns (Rs Million)	6584.9	5,325.6	23.6

The above table clearly shows that the number of corporate returns filed during the period H1 08-09 has registered a growth of 8.5 %. Now to analyze the potential of increasing the compliance of corporate sector, it is better to review the SECP data, which is depicted below in Table 7. The given data not only reveals poor compliance of only 34% on part of the corporate taxpayers, but also leave a viable room for the department to broaden the tax base and improve collection by nabbing 33,552 corporate non- filers as registered with SECP.

Table 7: Comparison with the SECP data of registered corporate entities

	Nos
Corporate entities registered with SECP as on 30-06-2008	50,952
Corporate returns received as on 31-12-2008	17,430
% age of compliance	34%
Deficiency in compliance	33,552 66%

Source: Director MIS – SECP, Islamabad

By analyzing the returns received from the corporate sector during H1: 08-09, the data (Table -8) give us another gloomy picture. Out of the total returns filed only 24% have declared income and 76% are without any contribution to the federal revenue. The trend in the corporate sector to declare income has registered a growth of 9.4%.

Table 8- Analysis of Corporate return data w.r.t Income, Loss or Nil

	2008-09	2007-08	Growth %
No of cases declared income	4,201 (24.1%)	3,841 (23.9%)	9.4
No of cases declared Loss	2,480 (14.2%)	2,625 (16.34%)	-5.5
No of cases declared NIL	10,749 (61.7%)	9,597 (59.7%)	12.0

A further in depth analysis of the corporate entities sector would provide a comprehensive picture to ascertain and pinpoint the non compliant sectors so as to devise a strategy accordingly. From the given table it is well evident that of the top 20 corporate entities except for five sectors, the compliance level in submitting the returns is less than 50%.

Table 9: Percentage of compliance – Top 20 corporate entities

	Sector	Coys Reg. with SECP	Filer of Returns	% age of Compliance
1	Tobacco & Tobacco Products	82	19	23.17
2	Autos	391	271	69.31
3	Hotel / Restaurants	405	108	26.67
4	Iron & Steel	406	233	57.39
5	Chemical	1092	314	28.75
6	Pharmaceuticals	939	413	43.98
7	Banking	449	524	116.70
8	Electronics & allied	561	226	40.29
9	POL (Marketing & Refinery)	686	180	26.24
10	Food Products	1453	739	50.86
11	Paper & board	491	213	43.38
12	Fertilizers	57	25	43.86
13	Beverages	150	43	28.67
14	Services (Consultancy, Security & Others)	5400	7,257	134.39
15	Sugar & allied	159	72	45.28
16	Power (Hydal, Thermal & generation coys)	397	156	39.29
17	Telecom	759	148	19.50
18	Textile	3744	1,624	43.38
19	Cement	105	39	37.14
20	Others	33,226	4,826	14.52
	Total	50,952	17,430	34.21

The sector wise analysis of corporate case with respect to the declaration of income and loss (Table 10) is also quite dismal as the percentage of cases declaring income in all the listed major 20 corporate entities are less than 50% and majority of the companies are either declaring loss or nil income. The question here is how a company is surviving over the years by continuously declaring losses? This aspect must be probed in by conducting a detailed field audit.

Table 10 – Income / Loss Analysis – Top 20 Corporate entities

	Sector	Total No	Cases with Income		Loss Declared	NIL Income
			No	%		
1	Tobacco & Products	19	9	47.4	3	7
2	Autos	271	122	45.0	54	95
3	Hotel	108	42	38.9	21	45
4	Iron & Steel	233	95	40.8	36	102
5	Chemical	314	114	36.3	51	149
6	Pesticides	37	17	45.9	4	16
7	Pharmaceuticals	413	143	34.6	56	214
8	Banking	524	161	30.7	86	277
9	Electronics	226	81	35.8	38	107
10	POL	180	61	33.9	35	84
11	Food Products	739	208	28.1	132	399
12	Paper	213	65	30.5	40	108
13	Fertilizers	25	6	24.0	4	15
14	Beverages	43	12	27.9	12	19
15	Services	7,257	1,906	26.3	898	4,453
16	Sugar	72	7	9.7	32	33
17	Power	156	25	16.0	34	97
18	Telecom	148	30	20.3	28	90
19	Textile	1,624	252	15.5	350	1022
20	Cement	39	5	12.8	20	14
	Others	4789	840	17.5	546	3403
	Total	17,430	4,201		2,480	10,749

As far as the contribution of revenue is concerned (Table11), top five sectors contribute 80 % of the total revenue received with the corporate returns. Owing to this uneven composition and reliance on few entities of corporate sector is not at all promising for the overall health of the economy, thus a detailed analysis and probe is reiterated to get the maximum revenue from the rest of the non compliant entities of corporate sector. As far as the growth is concerned the telecom, chemical and POL sectors have shown healthy trends of growth as compared to the previous year.

Table 11 – Contribution towards revenue - top 20 corporate entities

	Sector	Total Tax Paid (Rs. in Million)		% age Share in 08-09	Growth (%)
		2008-09	2007-08		
1	POL	79,227.8	53,361.6	43.30	48.5
2	Banking	40,800.2	35,345.7	22.30	15.4
3	Services	15,725.8	17,884.5	8.59	-12.1
4	Autos	5,918.5	6,061.1	3.23	-2.4
5	Telecom	5,063.9	1,697.9	2.77	198.2
6	Food Products	3,884.3	3,280.1	2.12	18.4
7	Fertilizers	3,760.0	3,646.9	2.06	3.1
8	Power	3,152.0	2,715.3	1.72	16.1
9	Pharmaceuticals	3,127.8	3,158.7	1.71	-1.0
10	Textile	3,091.6	2,566.7	1.69	20.4
11	Chemical	1,955.4	1,063.3	1.07	83.9
12	Tobacco	1,627.1	1,689.3	0.89	-3.7
13	Iron and Steel	1,576.9	2,354.3	0.86	-33.0
14	Electronic	1484.5	1,107.6	0.81	34.0
15	Beverages	1,101.5	903.2	0.60	22.0
16	Paper	889.5	955.1	0.49	-6.9
17	Sugar	685.6	707	0.37	-3.0
18	Cement	593.5	619.1	0.32	-4.1
19	Hotel	424.2	517.5	0.23	-18.0
20	Other	8,875.7	7,408.5	4.85	19.8
	Total	**182,966.0**	**147,043.4**		**24.4**

Sales Tax:

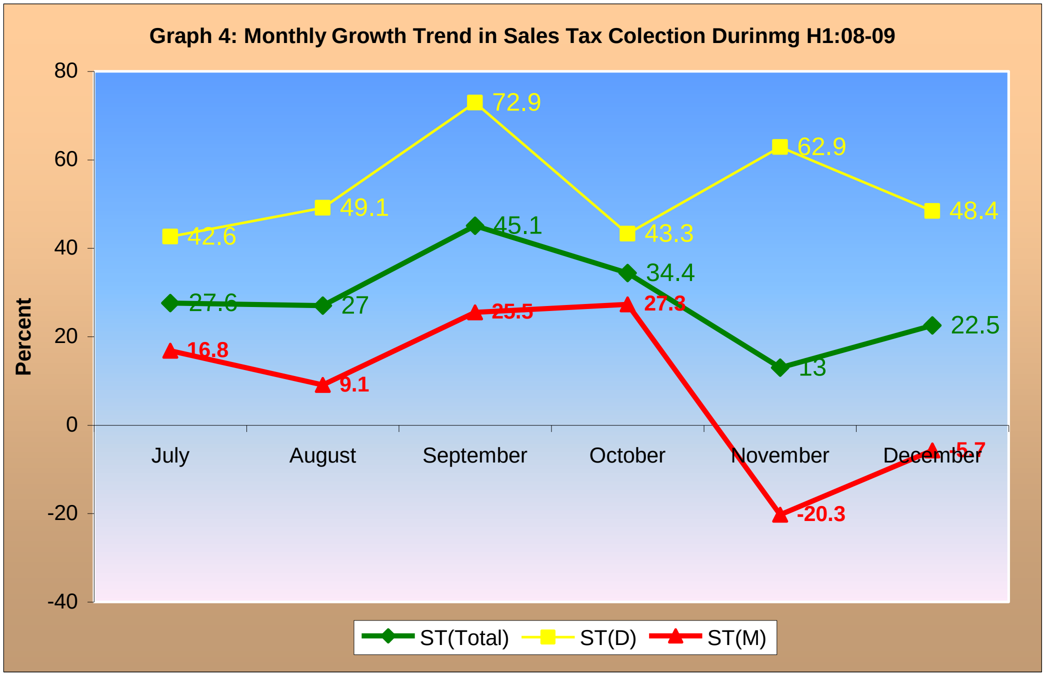
The total gross and net collection stood at Rs.231 billion and 217.2 billion respectively during July-December 2008. The gross and net revenues grew by 25.2% and 28.3% respectively. The refund payments declined by around 9% during the same period as Rs. 13.7 billion were paid against Rs.15 billion in the corresponding period last year.

Table 12: Collection of Sales Tax during H1:2008-09

(Rs. Million)

Tax-Head	Net Collection		Growth	
	H1:08-09	H1:07-08	Absolute	%
Sales Tax Imports	103,731	95,070	8,661	9.1
Sales Tax Domestic	113,448	74,246	39,202	52.8
Sales Tax (Total)	**217,179**	**169,316**	**47,863**	**28.3**

Overall monthly collection has grown with the average of 28.3% during first half of CFY. In respect of ST(D) and ST(M) the average growth remained 53.2% and 8.8% during the same period. The monthly growth trend has been shown in the Graph 4.



During first half of CFY the revised target in respect of sales tax total, ST(D) and ST(M) has been achieved to the extent of 96.3%, 107.7% and 86.3% respectively. Shortfall occurred at the import stage has been largely compensated by the sales tax domestic collection and resultantly overall shortfall has been reduced to 3.7%.

***Sales Tax (Domestic) Collection and Major Revenue Spinners*:**

The share of major ten commodities has touched 92% in H1: CFY from 85% in the corresponding period last year, thus enhancing further the vulnerability of sales tax domestic revenues. A notable shift has been witnessed in the POL products whose share has gone up from 20.8% to 48.2% (Table 13). Contrary to this, the share of remaining nine major items has declined during the same period. The changing composition, increasing concentration on fewer items needs attention from the concerned quarters.

Table 13: Gross Collection of GST (Domestic) from Major Revenue Spinners

(Rs. Million)

Commodities/Items	Net Collection			Share (%)	
	H1:08-09	H1:07-08	Growth (%)	H1:08-09	H1:07-08
POL Products	54,716	15,440	254.4	48.2	20.8
Telecom Services	23,368	21,809	7.1	20.6	29.4
Natural Gas	7,487	5,966	25.5	6.6	8.0
Sugar	4,504	5,007	-10.0	4.0	6.7
Cigarettes	4,011	3,964	1.2	3.5	5.3
Services	2,878	2,975	-3.3	2.5	4.0
Electrical Energy	2,842	902	215.1	2.5	1.2
Beverages	2,011	2,136	-5.9	1.8	2.9
Tea	1,569	1,332	17.8	1.4	1.8
Cement	1,334	1,724	-22.6	1.2	2.3
Major Ten Commodities	**104,720**	**63,328**	**65.4**	**92.3**	**85.3**
Share(%) of ten Major	***92***	***85***			
Other	8,728	10,918	-20.1	7.7	14.7
All Commodities	**113,448**	**74,246**	**52.8**	**100**	**100**

The performance of the major commodities has been mixed. Four commodities out of ten registered negative growth in the collection during H1: CFY. On the other hand the collection from POL Products, telecom, natural gas, cigarettes, electrical energy and tea recorded a positive growth. The collection from telecom, one of the key revenue generator and emerging sector, grew only by 7.1%. The possible explanation for this meager growth could be the increased rate from 15% to 21% announced in the budget 2008-09. Another important source of ST(D) revenue is the cigarettes, but surprisingly collection from this head increased only by 1.2%. Despite increase in the retail price of cigarettes and improved collection of federal excise collection, there is a question mark on low growth in the collection of sales tax from cigarettes. A significant growth in the collection from electrical energy is visible, which is due to the lesser refund payments made during July-December 2008 as compared to corresponding period last year. It is encouraging that the ST(D) collection from tea stood at Rs. 1.6 billion and exhibited around 18% growth over the collection of previous year.

Major refund seekers during H1:08-09 were the POL, natural gas, electrical energy, cement and food products (Table 14).

Table 14: Major Refund Payments

(Rs. Million)

Commodities	ST(D) Refunds		
	H1:08-09	**H1:07-08**	**Growth (%)**
Electrical Energy	444	2,980	-85.1
POL Products including LPG	951	2,710	-64.9
Natural Gas	2,579	2,121	21.6
Cement	476	10	4660.0
Food Products	102	60	70.0
Major Five Commodities	**4,450**	**7,821**	**-43.1**

The refund payments to cement sector has jumped from only Rs.10 million to Rs. 476 million, whereas during the same period Rs. 102 million were paid to food products against Rs. 60 million in the first half of previous fiscal year. The refund payments need a detailed analysis to ensure potential net revenues.

Sales Tax Collection on Imports

During July-December, 2008, sales tax on import contributed 18.7% in the indirect taxes and 30.2% in total taxes. The share of sales tax on imports in total sales tax has come down significantly from 56% in the first half of 2007-08 to 47% in July-

December, 2008. The collection of sales tax on imports grew by only 9.1% against growth in the value of imports by 42.4%. The wide gap between the growths of imports and sales tax imports is mainly attributable to zero rating of crude oil on 30th November, 2007 vide SRO No.1164 (I)/2007.

Major Revenue Spinners of Sales Tax on Imports

Ten major revenue spinners contributed around 81% of the total sales tax import collection during July-December 2008-09 (Table 15). Petroleum sector is the top revenue generation source of sales tax imports by contributing 2/5th of the collection of sales tax on imports. The tax collection of petroleum products yielded only 7.1% growth during July-December, 2008. Despite higher international prices of POL in the early months of CFY and depreciation of rupees, the growth in the collection of sales tax on imports could not pick up strongly. Actually, zero rating of crude oil as mentioned earlier has largely affected the collection of petroleum products in particular and sales tax imports in general. In absolute, a loss of Rs. 17.3 billion during July-December 2008-09 has been recorded due to this measure.

Edible oil is the second highest source of sales tax imports with 8.5% share in total S(TM). The collection of sales tax on imports from edible oils recorded a strong growth of 32.8% due to 35% growth recorded in the value of imports. Major reason behind this growth was the higher prices of edible oils in the early months of CFY. As far as the collection of plastic is concerned, the collection grew by 21.2% mainly due to 17% growth in the value of imports. Like customs duty, the auto sector has also exhibited decline in the collection of sales tax imports by 10% due to reduced demand. The remaining major items except electrical machinery and oilseeds reflected double digit growth in the collection due to increased imports.

The collection of electrical machinery (CH:85) has declined by 5.4% mainly attributable to lesser collection from telephone equipments, electrical transformers and transmission equipment. On the other hand, a considerable reduction of 35.6% in the sales tax collection from oilseeds has been mainly due to 40% fall in the import of rape/colza seeds.

Table 15: Net Sales Tax (M) from Ten Major Chapters during July-December: 08-09

(Rs. Million)

PCT Head	Commodity	H1: 08-09	H1: 07-08	Growth (%)	Share (%)
27	POL Products	43,028	40,222	7.0	41.5
15	Edible Oil/Ghee	8,792	6,618	32.8	8.5
39	Plastic and Articles	7,997	6,597	21.2	7.7
87	Vehicles and Auto Parts	5,834	6,483	-10.0	5.6
72	Iron & Steel	5,835	4,965	17.5	5.6
84	Mechanical Machinery	3,465	2,966	16.8	3.3
85	Electrical Machinery	3,028	3,202	-5.4	2.9
29	Organic Chemicals	2,860	2,220	28.8	2.8
48	Paper & Paperboard	2,773	2,228	24.5	2.7
12	Oil Seeds & Misc. Grains	1,204	1,871	-35.6	1.2
	Sub Total	84816	77372	1.0	81.7
	Others	18972	17742	6.9	18.3
	Gross	103,788	95,114	9.1	100.0
	Refund	56	44	27.3	
	Net	103,732	95,070	9.1	

Customs Duties: Despite the emergence of sales tax and direct taxes as leading sources of tax revenues, the customs duties still contribute 15% of the total tax collection of FBR. This performance is significant when viewed in the context of large scale tariff reduction over the last two decades.

The value of total import and dutiable imports has exhibited remarkably higher growths of 42.4% and 37.2% respectively during July-December, 2008. This huge growth is attributable to excessive depreciation of rupees viz a viz dollar and extremely higher petroleum prices. The gross and net collection from CD during H1:08-09 has been Rs. 77.9 billion and Rs. 72.8 billion, respectively while Rs. 5.2 billion has been paid back as refund/ rebates. Similarly, the gross and net collection has reflected growths of 15.6% and 18% during H1:08-09. The difference between these growths has been due to saving of Rs. 625 million in the payments of refund/rebates. Interestingly, the dichotomy of growth of customs duty reveals that collection grew by 31.7% in the Q1:08-09 while 5.9% in the Q2:08-09. Main factor behind this scenario has been the huge growth in the collection of CD from POL products in first quarter and decline in the second quarter mainly due to impact of international prices. As far as the revised target of customs duty for July-December, is concerned, it has been missed by 0.3%.

Customs Duty from Major Revenue Spinners July-December 2008-09

It is evident from Table 16 that 79% of the customs duties have been emanated from only 15 major commodities grouped in PCT Chapters. Moreover, only 5 commodities contributed 3/5th of the collection i.e. Petroleum (CH:27), automobile (CH:87), machinery (CH:84-85) and edible oil (15). It reveals the vulnerability and concentration of generation of revenues from customs. All the major spinners except vehicles and edible oils have exhibited considerable positive growth.

Due to world wide rise in the prices of petroleum products in the early months of fiscal year 2008-09 has partly resulted in 72.6% growth in the collection of customs during July-December, 2008-09. This phenomenal growth has been achieved despite reduction of HSD tariff rate from 10% to 7.5% w.e.f. 04.09.2008. Therefore, petroleum has emerged as the top revenue source of customs duties during July-December, 2008-09. Its contribution in overall customs duties has also gone up from 10.8% in July-December 2007-08 to 16.2% during 2008-09. The collection from auto sector has reflected a decline of 20.8% in CD mainly due to lesser imports by 11.2%. The main factor behind this decline has been 24.4% drop in the dutiable imports of motor vehicles (87.03) reflecting 27% decrease in the collection of customs duties.

A growth of 25.3% in the dutiable import of electrical machinery has yielded 21.4% growth in the CD. The growth is attributable to Rs.800 million additional collection from mobile phones due to bringing it into duty net. Moreover, huge growth in the import of electrical generating sets has resulted higher growth in the collection. Similarly, a massive growth in the import of mechanical machinery by

53.5% has resulted in improvement of its collection by 39.7%. Main drivers of this growth in the collection of CD have been in mechanical appliances, laboratory equipments, centrifuges, valves, engines and pumps due to their strong growth in the imports.

The growth in the collection of customs duty from plastic i.e. 16.8% is in line with 16.5% growth in the dutiable imports. As far as the collection of iron and steel is concerned, growth of only 10% in the iron and steel (CH:72) and 94.3% in the articles of iron and steel (CH:73) reveals that probably domestic industry, especially, Pakistan Steel Mills have not properly functioned and dependence for articles of iron and steel has been visible. Similarly, this transformation has improved CD collection from iron and steel articles more vigorously. The remaining items of major spinners have enhanced their collection due to substantial growths in imports and dutiable imports.

Table 16: Major Revenue Spinners of Customs Duties July-December

PCT Chap	***Tariff Description***	***Collection of Customs Duties (Rs. Million)***			***Contribution in Customs Duties (%)***	
		H1:08-09	***H1:07-08***	***Growth (%)***	***H1:08-09***	***H1:07-08***
27	POL Products	12,590	7,293	72.6	16.2	10.8
87	Vehicles	9,821	12,403	-20.8	12.6	18.4
85	Electrical Machinery	7,269	5,990	21.4	9.3	8.9
15	Edible oil and Waxes	7,212	8,441	-14.6	9.3	12.5
84	Mechanical Machinery	6,929	4,960	39.7	8.9	7.4
39	Plastic Resins, etc.	3,396	2,907	16.8	4.4	4.3
72	Iron and Steel	2,882	2,686	7.3	3.7	4.0
48	Paper and Paperboard	2,339	2,059	13.6	3.0	3.1
29	Organic Chemicals	1,782	1,527	16.7	2.3	2.3
73	Articles of Iron & Steel	1,465	1,053	39.2	1.9	1.6
32	Dyes, Paints etc.	1,164	896	29.9	1.5	1.3
9	Coffee and Tea etc.	1,160	786	47.6	1.5	1.2
34	Soap and Detergents	1,142	726	57.3	1.5	1.1
33	Perfumery & Cosmetics	1,119	633	76.8	1.4	0.9
69	Ceramic Products	1,090	613	77.9	1.4	0.9
Sub-total		*61,362*	*52,973*	*15.8*	*78.7*	*78.5*
Others		*16,570*	*14,470*	*14.5*	*21.3*	*21.5*
Gross		*77,932*	*67,442*	*15.6*	*100.0*	*100.0*
Refund/Rebate		*5,173*	*5,798*	*-10.8*		
Grand Total		*72,759*	*61,644*	*18.0*		

Federal Excise: The collection from federal excise duties has registered a growth of 35.5% during H1: 08-09. The net revenue stood at Rs. 53.6 billion against Rs. 39.5 billion during the corresponding period last year. Nonetheless, one point needs to be clarified for drawing meaningful conclusion. Due to procedural change adopted from July 2007, the filing of excise return was tied with GST return. Consequently, there was only a meager FED collection in July 2007. Resultantly, a huge growth i.e. 340.4% in collection appears when July 2008 revenue is compared with July 2007 (Table 17).

Table 17: A Comparative Analysis of FED Collection

(Rs. Million)

Months / Quarters	H1: 08-09	H1: 07-08	Difference	
			Absolute	%
July	8,187	1,859	6,328	340.4
August	8,940	6,555	2,385	36.4
September	8,334	7,462	872	11.7
Quarter 1	**25,461**	**15,876**	**9,585**	**60.4**
October	10,604	7,548	3,056	40.5
November	8,549	8,304	245	3.0
December	8,944	7,793	1151	14.8
Quarter 2	**28,097**	**23,645**	**4,452**	**18.8**
Total[2]	**53,558**	**39,521**	**14,037**	**35.5**

Barring the month of July, growth in other months has shown inconsistency. Maximum growth of 40.5% has been recorded in October, followed by August (36.4%), December (14.8%) and September (11.7%), whereas in November, it grew only by 3%.

The commodity-wise collection of major revenue spinners provides a comparison between H1: 08-09 against H1: 07-08 (Table 18). The share of six major items including services has been around 91% during this period. A detailed analysis confirms that except natural gas all other major items have recorded a double-digit

[2] It is pertinent to mention that actual growth in the FED collection is less than the growth depicted in the table. For apple to apple comparison, the collection of July is excluded and then growth would stand at 17% during first half of CFY.

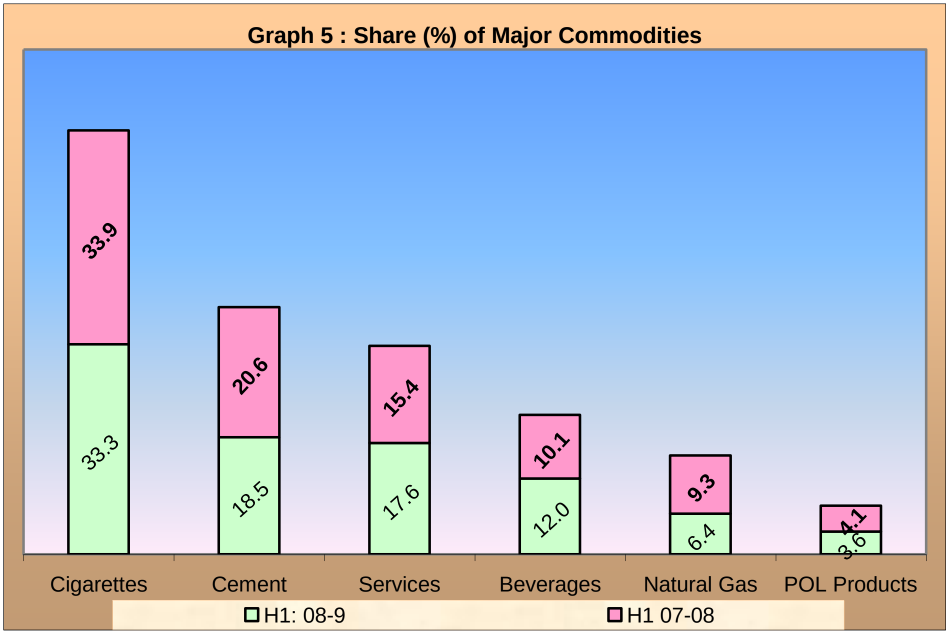
growth. The collection from beverages grew by 67.2%, followed by services (60.6%), cigarettes (37.7%) and cement (26.2%) during July-December 2008.

Table 18:FED Collection from Major Commodities H1:08-09 and H1:07-08

(Rs. Million)

Commodities	Collection		Difference	
	H1: 08-9	H1: 07-08	Absolute	Percent
Cigarettes	15,468	11,235	4,234	37.7
Cement	8,616	6,828	1,788	26.2
Natural Gas	2,978	3,070	-93	-3.0
POL Products	1,663	1,371	292	21.3
Beverages	5,583	3,339	2,243	67.2
Services	8,198	5,104	3,094	60.6
Sub Total	**42,505**	**30,948**	**11,557**	**37.3**
Others	3,952	1,646	2,307	140.2
Domestic Total	**46,457**	**33,141**	**13,316**	**40.2**
Imports Total	7,101	6,380	722	11.3
Grand Total	**53,558**	**39,521**	**14,038**	**35.5**

During last couple of years due to the levy of FED on services, one percent SED and FED on Cars a declining trend in the share of major items has been witnessed (Graph 5). Consequently, there is a decline in the shares of other revenue heads like cigarettes, cement, natural gas and POL products. Indeed it is a healthy sign as it indicates the expansion in the base of FED. It is expected that with the passage of time, the dependence on fewer items will be reduced further.



Collection from FED Services: The share of revenue from services has increased significantly during last two years. The international air travel (IAT), Non-fund services (NFS) and insurance have gained prominent position in the overall FED collection. The share of this new head has increased from 7% in H1: 06-07 to 17.6% in H1: 08-09 in the domestically collected FED revenue. Within services around 64% of collection is realized from ATT, followed by insurance (19%), NFS (16%) and franchise (1%). In absolute terms, Rs. 8.2 billion have been collected during H1: 08-09 against Rs. 5.1 billion in the corresponding period last year (Table 19).

Table 19: FED Services a Comparison

(Rs. Million)

Services	H1: 08-09	H1: 07-08	Difference	
			Absolute	Percent
Air Travel Tax (ATT)	5,229	3,462	1,768	51.1
Non-Fund Services	1,346	604	742	122.9
Insurance	1,530	918	612	66.6
Franchise	93	120	-28	-22.9
Total	**8,198**	**5,104**	**3,093**	**60.6**

Performance of one-percent SED: The one-percent SED was introduced at the time of budget FY: 07-08, at domestic and import stages. It has also become an important source of FED revenue. Its share has increased from 9.5% in H1: 07-08 to 12.2% during H1: 08-09.

Further details reveal, during H1: 08-09, Rs. 6.5 billion have been collected against Rs. 4.1 billion in the corresponding period last year (Table 20). Like the previous year, the collection from SED at import stage has been relatively encouraging and collection from SED domestic has still not taken the pace and shared 39% in total SED collection. The improved collection of SED from imports is also attributed to depreciation of rupee.

Table 20: 1% SED Target Vs Collection

(Rs. Million)

Heads	Collection		Achievement	
	H1: 08-9	H1: 07-08	Absolute	Percent
1% SED Domestic	2,540	1,315	1,225	93.2
1% SED Imports	3,981	2,834	1,146	40.4
Total SED	**6,521**	**4,149**	**2,371**	**57.1**

In the federal budget FY: 2008-09, 5% FED on the import and locally manufactured motorcars with engine capacity exceeding 850cc was levied. The projected revenue for current fiscal year from this head was Rs. 3000 million. During first six months of CFY Rs. 1,139 million has been collected. The realized amount is 38% of yearly projected revenue. Further bifurcation reveals that a major chunk of Rs. 927 million has been collected at domestic level, whereas Rs. 211 million were collected at the import stage. Nevertheless, it is not a healthy performance but, it has been observed that in the beginning normally there are enforcement issues whenever a new levy is introduced. It is also pertinent to mention here that the FED on cars would be elastic in nature as it is the luxury item and the lower than expected revenue in the recent economic crisis has confirmed the same. Indeed the overall economic slowdown and depression has affected the revenue from this head as well. However, it is again asserted that through better efforts and monitoring the FED revenue can be enhanced.

Concluding Remarks

In the backdrop of global economic meltdown and deteriorating law and order conditions in the country, the achievement of the revenue targets for the current year appeared to be an uphill task. Till the end of first half of CFY, the performance of FBR is satisfactory as it remained in line with the desired targets. For the next half of CFY, the major burden is on the two core taxes i.e. income and sales tax as they have to collect Rs.602 billion, which is 81% of the remaining target at Rs.746 billion. So, the administration of these two taxes must revitalize their strategy to achieve the desired target. In this regard, the major thrust should be on plugging the loopholes by extensive audits of withholding agents, corporate cases and other potential revenue cases pertaining to sales tax. A concerted and planned effort coupled with a strong will could help the FBR to even achieve this uphill task.

II

STRENGTHENING AUDIT & EXAMINATION SYSTEM OF TAX

By: Waseem Bajwa (Second Secretary FR&S)

1. Introduction

In the modern taxation system, self assessment has become an important tool not only for effective tax administration but also for facilitating the taxpayers to declare their taxable share at their own. The success of this system in the developed countries has also attracted the attention of developing countries to adopt this system. The strength and viability of this system depends primarily on two aspects, one is the proper education and guidance to the taxpayers to make compliance voluntarily thus declaring their results properly and other is the effective and comprehensive examination / audit system to create deterrence for the taxpayers. Without prejudice to the above, an effective examination system also put an appropriate check on tax evasion thus acts as an important device for the success of self assessment system.

In Pakistan the universal self assessment scheme (USAS) is in a nascent stage and has not attained the requisite maturity because of the two controlling factors mentioned above being non systematic and incoherent. The purpose of this paper is to focus on the second aspect i.e. the examination system so as to identify the loopholes in the new taxation system comprising of self assessment regarding the examination / audit procedures. Here, the major emphasis has been laid on the general policy areas as regarding methods and techniques FBR has already developed an extensive document in the form of National Audit Manual. Further, an effort has also been made to draw some lessons from the Japanese examination system relevant to the indigenous requirements of Pakistan.

2. Tax Audit Selection and Examination flow in Pakistan

Despite the revamping of the system, the core function of examination / Audit has not yet been brought up to the requisite standard of performance or delivery. After the adoption of USAS, an effective examination system is pivotal to achieve desired results of revenue maximization, but in Pakistan it is not only poorly developed but also limited in scope. So to have a fair idea, a brief overview of the prevailing examination system with regard to its procedure and functionality has been stated below to weigh its pros and cons in the light of Japanese tax examination system which is quite developed and extensive in scope.

2.1 Tax Audit Selection

In Pakistan all returns are filed under Universal Self Assessment System. Due date for filing of income tax returns for persons other than companies is September 30 whereas for corporate taxpayers due date is December 31. All returns are filed under section 114 of Income Tax Ordinance 2001 and accepted under section 120 of the Income Tax Ordinance 2001 according to which assessment is deemed to have been completed immediately when the taxpayers file their returns. After due date for filing of returns, the data of all the returns filed are entered in central data entry center located at Islamabad. At the same time notices are also issued to the defaulters who have not filed their returns within statutory deadlines.

Since all returns filed are accepted under Self Assessment System, therefore, to raise any additional assessment on a taxpayer its return can only be amended under section 122 of the Income Tax Ordinance on the basis of definite information in the possession of the tax authorities. The return selected for audit is ultimately amended under section 122 if some material evidence of concealment of income is found by the department.

Taxpayers are selected and the audit proceedings are carried out under section 177 of the Income Tax Ordinance 2001. In Pakistan primary objective of tax audit is to create deterrence, improve and encourage compliance to the tax laws on voluntary basis i.e. promoting self assessment system. Treating audit as source of revenue collection is secondary objective. Under the provisions of section 177(1) Federal Board of Revenue is empowered to specify some criteria for selection of any taxpayer for audit of its tax affairs. It can also keep this criterion confidential. The Commissioner Audit then conducts the detailed audit of these taxpayers who fulfill the criterion as announced by the CBR. The criteria by the CBR may differ every year having due consideration to the growth of a specific business sector, industry parameters, standard accounting results or ratios of a business activity, historical performance and track record regarding declaration of true particulars of income of a certain trade, some threshold of declared income, loss or turnover etc.

At the same time under section 177(4) the Commissioner (Audit) can also select a taxpayer for audit having regard to:

(a) The person's history of compliance or non-compliance;

(b) The amount of tax payable by the person;

(c) The class of business conducted by the person; and

(d) Any other matter which in the opinion of Commissioner is material for determination of correct income

2.2 Preparatory Examination

After the taxpayers are selected on the lines discussed above. Audit Officers are required to conduct a desk audit of all the material and documents available with the tax office. The entire desk audit is done manually whereby the business returns are scrutinized by the examiners / audit officers. They give consideration to all the important areas of a taxpayer's business, available documents, history of compliance to tax laws, financial statements and personal life which can be useful in determination of his correct income.

2.3 Tax Audit / Examination

On the basis of the above mentioned preparatory examination, selection of the taxpayer for audit is completed and an audit plan is chalked out. The taxpayer is formally informed of the fact and the reasons for which he has been selected for audit. After the formal intimation is served upon the taxpayer he is requested to extend his cooperation in order to complete the audit activity at the earliest and smoothly. He is also required to produce his accounts and records and other details of his assets, expenditures and liabilities. In some cases his business premises is also visited in order to collect information related to the nature and extent of the taxpayer's business but after approval by the Commissioner audit under section 175 of the Income Tax Ordinance, 2001. As such, the field audit is not compulsory in Pakistan and is optional depending upon the maliciousness of the case.

2.4 Third party enquiry

Along with obtaining of information directly from the taxpayer, information possessed by the tax authorities is also cross matched with the information available with third parties related to the taxpayer. This is done under the provisions of section 176 of the Income Tax Ordinance 2001. This may include verification of the list of creditors, bank accounts, expenditures incurred, investments and other related personal information related to tax matters. Then, during the course of audit if Commissioner Audit feels that he needs an assistance of some expert or valuer in order to ascertain the correct value of some asset or to understand the true nature of a complicated transaction, he can also seek assistance of some expert or valuer under the law.

2.5 Settlement of tax account (Amended Assessment / Correction or Determination)

Soon after the completion of audit proceedings the audit officer makes a detailed audit report and the same is submitted to the Commissioner Audit. If it is found as a result of audit that the taxpayer has not declared particulars of his total income in accordance to the law, then a written show cause notice under section 122(9) is issued to him conveying him the intention of the tax authorities to amend his return under section 122(1) on the basis of the grounds specified in that notice. In case the reply is not satisfactory, the return is amended and additional assessment is raised upon the taxpayer. Taxpayer can also amend his return suomoto even during the course of proceedings if he feels that he has made some omission in declaring true particulars of his income and can file a revised return under section 122(3) of the Income Tax Ordinance, 2001. In case of non-compliance on part of the taxpayer, the Audit Officer has discretion under section 121 of the Income Tax Ordinance, 2001 to make a best judgment assessment on the basis of available record, history of the tax payer, prevailing nature of business and comparative analysis of similar business, thus determining the income of the taxpayer accordingly.

2.6 Tax Payment

If some additional assessment is raised against the taxpayer as a result of audit proceedings the demand notice under section 137 of the income tax ordinance is served upon him and he is required to pay that demand with a time period specified or 30 days which can be the maximum. In case of default he is charged with additional taxes and penalties both. The last resort can also be the coercive action ranging from the arrest of the delinquent taxpayer to freezing his bank accounts and auction of his immovable properties.

2.7 Penalties

The major penalty related to the audit proceedings is u/s 184 ‘penalty for concealment of income’, stipulating the imposition of such penalty equal to the amount of tax the person sought to evade by concealment of income.

The following tables reveal the data regarding audit in Pakistan

Table 1: Audit Cases u/s 177 of corporate entities - 2007-2008

Audit Cases for Disposal	Amendment u/s 122(5)	%age of cases amended	Demand created (millions)
6,600	688	10.4	10,008

Source: Monthly performance reports of all the field units for the period ending June 30th, 2008

Table 2: Audit Cases u/s 177 of non-corporate entities - 2007-2008

Audit Cases for Disposal	Amendment u/s 122(5)	%age of cases amended	Demand created (millions)
15,593	1,640	10.5	1,813

Source: Monthly performance reports of all the field units for the period ending June 30th, 2008

The above data reveals that not only the cases selected for audit are on the lower side but also the disposal of these cases is quite discouraging and dismal.

3. Tax Audit Selection and Examination flow in Japan

In Japan the examination has been broadly categorized into two major types.

3.1 Compulsory Examination:

In pursuance of the National Tax Violations Control Law, the criminal investigations are conducted on a compulsory basis.

3.2 Tax Examination:

The tax examinations are conducted on a voluntary basis through questioning and inspection in accordance to the tax laws.

3.2.1 General and Special Examinations

Generally, there are three examination groups in accordance to the types of taxation i.e. individual, property and corporation taxation groups. The examinations are conducted by each group in terms of general and special examinations. In this regard, for general examination, the examination is only done by one examiner in 3 to 7 days, whereas the special examination is conducted by examiners ranging from 2 to 10 in 10 to 20 days.

3.2.2 Focusing Examination:

The examiners in a short span of three days analyze the tax declaration on the basis of materials and information and seek clarification thereto with respect to the business conditions.

3.2.3 Comprehensive Examination:

From 2000 onwards, the comprehensive examination started and mainly responsible for the cross-functional examination of individual and corporate taxes, usually done by 2 to 10 examiners in 20 days.

3.3 Selection of Target Corporations

It involves three major steps; the first is the inspection of documents submitted by the taxpayer in the light of available information with the tax authorities. Then, on the basis of this preliminary inspection the corporations with questionable points are listed for examination on the basis of the type. After that, the chief examiner delegates these examinations to the examiners at the lower level by adequately explaining them the points of examination. Regarding selection of corporations for audit, the chief examiner assesses the necessity for examination on the basis of available data and information. It primarily includes the economic conditions of the respective industry, business category and location, data of past examinations, contents of return, information available with KSK, transaction data, media information and personal life style of the taxpayer.

3.4 Preparatory Examination:

After checking the reasons of selection, the examiners closely analyze the returns, the documents attached and other relevant materials. After that the taxpayers and their tax agents are informed in advance by telephone or other means about the date and hour of field examination. Sometimes advance notice is not given depending on the importance and type of the case and the same is decided after thoroughly weighing the need for such an examination without an advance notice.

3.5 Field Examination:

The field examination is concluded in different stages involving examination by inquiry, current state examination, inquiry to the trading partner of the taxpayer and finally by mission report. In the mission report, the examiners explain to the chief examiners about the examination plan and then obtain their consent in this regard.

In the course of field examinations, effective use of data from several sources in evaluating credibility of the corporation's books and documents and uncovering false accounting thereby to efficiently arrive at its correct tax base. Then field examinations are also used for updating the data base and gathering information that may be helpful for other examinations such as backdoor trade, disguised transactions and shift of investments.

3.6 Recommendation of Amended Return:

When some discrepancies and errors are found in the returns after examination, the examiner explain the errors and amount of additional tax. In addition to this the legal effects of the amended return are also explained and it is recommended that the return may be amended. In case of no errors, the written notification of "Tax Examination Findings" is issued to the taxpayer.

3.7 Correction, Determination and Amended Return:

If the taxpayer does not agree or cooperate with the examiners' recommendation regarding amended return, then the District Director of the tax office makes the correction and sends a notice of "Correction or Determination" to the taxpayer. Also, if the taxpayer does not cooperate regarding submitting of accounts, details etc pertaining to the examination then the District Director may estimate the income of the taxpayer based upon reasonable calculations and accordingly makes the correction of the return.

3.8 Penalties and Additional Taxes:

Penalties pertaining to examination are as under:

i. A penalty for understatement is imposed when the amended return is
filed after submission of return within the due date or when the District Director of the Tax office makes a correction because of deficient tax payment. It is imposed @ 10% of the tax amount.

ii. Fraud penalty is imposed when the taxpayer disguises or hides fact.
It will be equivalent to 35% of the increased tax amount or 40% of the amount of tax paid or to be paid.

The following data reveals about the examination / audit conducted in various cases by the National Tax Agency Japan:

Table3: Examination for Self-assessed Income Tax – 2006

	No. of Cases (Thousands)	Total Understated Income		Total Additional Tax Revenue Collected	
		(Million Yen)	Understated income/case (Thousand yen)	(Million Yen)	Addl. Tax revenue/case (Thousand yen)
Field Examinations	63	533,700	8,460	99,500	1,580
Focusing	183	328,100	1,800	15,300	80
Brief Contact	549	54,800	100	9,500	20
Total	795	916,600		124,300	

Source: National Tax Agency Report, 2008

Notes: - Field Examination involve both specific and general examinations of malicious cases Focusing refers to the short-term examination to grasp the understated income 'Brief Contact' refers to the correction of tax return errors by speaking with the taxpayer on telephone or by asking the taxpayer to visit the tax office.

Table 4: Examination for withholding Income Tax - 2006

Number of Cases Examined (Thousands)	Number of Illegal cases discovered (Thousands)	Total Additional Tax Revenue Collected (Million Yen)
202	56	63,500

Source: National Tax Agency Report, 2008

Table 5: Field Examinations for Corporation Tax – 2006

No. of Cases (Thousands)	Total Understated Income		Total Additional Tax Revenue Collected (Million Yen)
	(Million Yen)	Understated income / case (Thousand yen)	
147	1,724,700	11,762	440,220

Source: National Tax Agency Report, 2008

Table 6: Criminal Investigations - 2007

No. of Cases Conducted	No. of Cases Closed	Total Tax Evasion		Total Tax Evasion in Prosecuted cases	
		(Million Yen)	Tax Evasion / case (million yen)	(Million Yen)	Tax evasion / Prosecuted case (Million yen)
220	218	35,300	162	30,900	195

Source: National Tax Agency Report, 2008

The above data clearly reveals major revenue generated through effective implementation of their audit plan. By comparing the data of Japan with Pakistan, it can be clearly deduced that Pakistan is far behind not only in selection of cases for audit but also its disposal and revenue generation.

4. Identification of Issues and Recommendations in the Audit System of Pakistan

The audit / examination system of Pakistan is still in the nascent stage as the present system started with the change in the tax system to universal self assessment scheme in 2003. Though the audit procedure has been clearly defined in the law, but has not been effective due to the inadequate policy, administrative and implementation problems, the issues confronted and the probable solutions in the light of Japanese examination / audit system are dilated as under:

4.1 Requirement of a Uniform Audit / Examination Policy at FBR

Though the new system of audit has been implemented since 2003, but every year the Federal Board Revenue (FBR) comes up with new policy and parameters for the selection of cases pertaining to individual and corporation tax for examination / audit. As a result of this inconsistent policy, there has been a chaos and distrust among the taxpayers and confusion among the tax officers at the field level. So, every year the audit procedure is disrupted by a number of litigations on part of the taxpayers in the higher courts regarding the selection of cases for audit. Another problem is that the audit policy is highly centralized and also not in conformity with the Income Tax Ordinance, 2001.

This issue can be dealt with by devising a uniform policy in the broader context, thereby dilating the procedures already mentioned in the Ordinance and its appropriate implementation mechanism. The selection criteria should be devolved to the lower tiers like Regional Tax Offices in the case of individuals and small corporations and Large Taxpayers Unit in the case of large corporations. This selection criteria should be at two tiers i.e. one at the FBR level whereby a uniform criteria may be set for general selection throughout the country and other at the field level at RTO or LTU level. The general selection criteria may include sales ranking, industry type; losses declared and claim of continuous refunds for the last three to four years. The field level criteria may involve actual situation, historical basis of the case and definite information from the data source.

4.2 Constraint on the powers of Examiners / Auditors:

It is very strange though the examiners have been legally equipped to conduct a thorough examination in accordance to the Ordinance, but are handicapped due to the political pressures and also have not been given full liberty to conduct audit administratively. The field examination is limited and very poorly organized, so the examinations conducted are not thorough and lacking depth, thus the cursory examinations mainly do not come up with adequate results.

In the first instance, the examiners should be completely independent of any political or administrative pressures in their line of duty. One way is by incorporating a non-interference clause in the statute by any outsiders in the work of an examiner. Then, the examination should be in detail and depth as done by NTA (National Tax Agency, Japan) whereby they simultaneously raid all the business premises, residence and other related places of taxpayer after a proper inquiry and verification.

4.3 Time period to complete audit not specified

As such there is no specified time to complete an audit and usually depends on the officer incharge and the supervising officer. In this regard lesson should be learned from the Japanese system where there are time limitations for all the audits whether of individuals or corporations. Then every year an approximate or rough number of taxpayers to be audited should be communicated to the field offices. Thereby every Regional Tax office or Large Taxpayer Unit should chalk out an audit plan in advance on the basis of examinations and number of officers available for examination. In this way an estimate number of days can be calculated for one audit, but depending on the case if it is a malicious case then extra days may be given to that case. Then cases should be assigned to the examiners on the basis of their time availability and capacity to complete the examination.

4.4 Emphasis on field examination :

The usual procedure adopted in Pakistan for examination and audit of the taxpayers is that the taxpayer or the authorized representative normally comes to the tax office with his books of accounts and records in response to the notice of audit. In this system the taxpayer normally does not present his actual business position and also the tax officer or examiner by sitting in the office cannot evaluate judiciously the results of business for the examination purposes.

The appropriate solution is to conduct a field examination of every case selected for audit by visiting the business premises as done in Japan, because by actually visiting the business and the related places the examiner is in a best position to evaluate the declared results.

4.5 Inadequate data of the Taxpayers

The Federal Board of Revenue does not have the requisite data and information of the taxpayers. Though efforts in this regard have been started, but still it is not enough to draw some reliable conclusions about tax evasions by different taxpayers.

The FBR has collaboration with a software company Pakistan Revenue Automated Limited (PRAL), on the pattern of KSK in Japan, but has not been able to achieve the targets as envisaged. In this regard the supervision and monitoring pertaining to data collection, its relevancy and dissemination should be in the hands of FBR officers / officials and PRAL should assist only in the technical expertise. One of the important aspects in this regard is the identification of the sources of information. Then dissemination and collection of information from the identified sources and organizations should be given a legislative / statutory cover as done by NTA where there are 40 statutory information sources relating to income tax. Then reliance may be made on the non statutory sources of information as in the case of NTA, which involve following methods / ways:

a) *Collection at the time of information day*: Whereby every tax office designates a certain day in the year called the information day on which further sources of information could be identified and accordingly information is collected.

b) Assigning tax officials as *information specialists* to various tax offices to identify sources of information and ways of collection.

c) *General collection*: Through this method on a routine basis information may be collected from various corporations and owners of firms about their suppliers and customers involving sales, purchases, material costs, expenses, advertisement etc. So, an independent and reliable data base is essential similar to KSK in Japan to strengthen the examination / audit system, by first identifying the sources and then devising a mechanism for its collection, sorting, storing and dissemination to the examiners.

4.6 <u>Strengthening the Intelligence & Investigation department of FBR:</u>

The Intelligence and Investigation Department of FBR is a subordinate department of FBR working independently and mainly concerned with the internal audit. It is a check on the officers with respect to any malpractices or corrupt practices and also suggests further examination of the cases by identifying loopholes in the previous examined case or not selected for examination. This department can also be utilized for identification of information sources, collection and dissemination to the examiners for proper and good examinations. Further it can also identify the malicious case on basis of its information to the audit wing of the respective field office.

4.7 <u>Absence of Examiners / auditors at the local tax level</u>:

This is one of the major deficiencies in the prevalent system as with the centralization of powers from the field offices to Regional Tax Offices the essence and utility of field audit has been completely eroded. The officers conducting examination at the Regional Tax Office level are usually far enough from the business premises to gather the requisite information and repute of the business of the taxpayer. For instance, how do you expect an officer sitting at RTO Peshawar to conduct audit of a business at D.I. Khan about 200 km away and arrive at factual results which may also stand the test of appeal. There are number of other examples in almost all the 13 RTOs operating in Pakistan.

In this regard, every TFC should have an audit function to get the desired results and make the system successful. Again an important lesson can be drawn from Japan, where there are 520 local tax offices and despite having a documented economy, every local office has an independent audit function. Despite the fact that the tax compliance ratio of Japan is far better than Pakistan, they have given due consideration to this important function by incorporating it at the local level. The stance is to create deterrence and have primary information and data of the taxpayers with in the local jurisdiction of the tax office being in close proximity to them. To start with, some model TFCs should be developed in major RTOs having vast territorial jurisdiction with examiners / Audit officers posted there and if it is result oriented then the same may be replicated to all other RTOs.

4.8 Professional Capacity:

Professional Capacity of the allied and the support staff need to be improved through trainings. In this regard the FBR has already started an intensive program of training for the officers and the officials whereby they are being trained with the techniques of examination, information technology with reference to tax and legal aspects of tax. These training should be a regular feature and could be more result oriented if made incentive based, like accelerated promotions and awards in the form of annual increments in the pay etc.

4.9 Separate Tax Criminal Investigation Department (TCID)

A separate TCID should be established to detect tax frauds with respect to highly malicious cases. This may be started as a pilot project at one LTU for corporations and one RTO for individual income tax to create deterrence for the taxpayers. This can be further strengthened by establishing a liaison with the Intelligence & investigation department regarding provision of information and identification of malicious cases. This department should exclusively deal with the fraudulent cases and should have quasi judicial powers drawn from the Criminal Procedure Code of Pakistan. Another viable option would be divesting the powers of FIA (Federal Investigation Agency) pertaining to economic and tax crimes and transferring it to the tax authorities. Even in FIA or earlier in NAB (National Accountability Bureau), these functions have been performed by the tax officers being deputed there for a certain period. When it will be an allied department of FBR, not only the performance would improve but also the compliance level of taxpayers would increase manifolds. It is not a novel idea the practice has been in vogue in Japan and other developing countries. When the tax evaders will be given exemplary punishments by the tax department itself, it would not only serve lesson to the others to refrain from such practices, but would also act as an effective deterrent for the tax department.

4.10 <u>Comprehensive Examination / Audit:</u>

In the present changed scenario, another major change brought is the integration of Sales Tax and Income Tax functions. Prior to this these two taxes were working independently having all their functions and procedures separate from one another. The intention of collocation was to merge the functions on one hand and facilitate the taxpayers on the other. But the first aspect has not yet been achieved, and still the administration of both the taxes is working separately at the field formation level.

As far as improving the examination system, both these taxes should be merged with regard to a joint examination as done by NTA. In the beginning one officer each from the respective taxes should be assigned a joint examination of the taxpayer. Later these should be merged completely and a comprehensive examination should be conducted of both the taxes by one officer or one team if it is a big and malicious case.

4.11 <u>Fostering the practice of proper documentation among taxpayers:</u>

One of the main problems in Pakistan which also hinder the smooth audit and examination procedure is the lack of documentation particularly in the case of individuals and also pertain to the firms and small corporations. It implies that an incomplete and inaccurate data is provided by the taxpayer with poor record keeping.

One solution by drawing a lesson from the Japanese tax system is the introduction of system similar to the Blue return system, thereby granting some concessions and privileges to the taxpayers so as to improve the documentation.

Conclusion:

Although detailed working and procedures have been identified in the 'National Audit Manual' to reform the audit / examination system of Federal Board of Revenue, but it requires implementation in its true spirit to yield the desired results. Further by incorporating the above mentioned recommendations which are not part of the 'National Audit Plan', the audit / examination system of Federal Board of Revenue may be further strengthened. Last but not the least, by having an effective enforcement of rigorous penalties particularly in the fraudulent cases the delinquents and tax evaders could be deterred appropriately.

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III

ACKNOWLEDGING THE COMPLIANT TAXPAYERS

By: Waseem Bajwa and Mir Ahmad Khan 2nd Secretaries FRS

Documentation on the part of the taxpayers and existence of reliable data base with the federal revenue authority have been identified as the two predominant instruments to enforce effective tax compliance in the countries operating under the Universal Self Assessment system. In this regard, by acknowledging the compliant taxpayers through some tangible measures would be a positive step to strengthen the on going process of documentation, thus leading to a better tax to GDP ratio. The same system has been in vogue in Japan in the form of Blue Return System. In Japanese tax system, they have categorized returns into blue and white, whereby Blue Return category involves compliant taxpayers, thus enjoying certain incentives and privileges by virtue of their compliance and white category is otherwise.

It is a well established fact that merit based incentive system always improves performance of an organization. Nonetheless, the concept of preparing a separate list of compliant taxpayers is a debatable and sensitive issue keeping in view various constraints in Pakistan. It warrants careful but judicious understanding of pitfalls in its implementation. The government requires adequate tax revenue generation for its current and developmental expenditure but not at the cost of business deterioration.

In the past, certain efforts have been made to discourage the non-compliant sector of tax as well. For instance, the further tax with varying rate of 1-3% was levied from 1998 to 2004-05. The rationale behind this tax was to raise the cost of business for the informal sector i.e. generally non compliant and to protect the genuine taxpayers in the organized sector. The levy was abolished in the Budget 2004-05 on the plea to bring uniformity of sales tax rates. On the other hand, an effort was made in the past to provide some incentives to the genuine taxpayers by issuing them with NTN cards, but no substantial outcome gained. Similarly, an increased rate on withholding tax had been imposed for those not registered with the tax department.

In this paper an attempt has been made to formulate basic policy guidelines for the compliant taxpayers by incorporating some of relevant aspects of Blue Return System of Japan conforming to our indigenous requirements. So accordingly the various parameters and implementation procedures of the proposed compliant list of taxpayers for Pakistan have been evaluated as under:

1. Parameters

The basic aim is the identification and documentation of the list of compliant taxpayers. Thus, the emphasis here should be on the credibility of taxpayers with respect to various parameters as discussed below:

1.1. Regular Sales Tax Return Filer – a sales threshold should be given e.g. more than 1 million etc. and no short payment for the last three years.

1.2. Regular Income Tax Return Filer – with no short document, submitting return in prescribed time, for the last three years.

1.3. Regular Withholding Statement Filer – only applicable to the withholding agent with proper tax deduction as per law and depositing the deductions within the prescribed time. In this list, the taxpayers whose income have been subjected to withholding tax and paying more than Rs.25,000/- tax in a financial year should also be included in the WLT

1.4. Importers and Exporters - only applicable to the importer, exporters or the clearing agents falling solely in the jurisdiction of customs department, having a clear history of 3 years, not involving in any mis-declaration.

As far as the validity of compliant taxpayers is concerned, it should be valid for the whole financial year, subject to any audit where mis-declaration or fraudulent practice discovered.

2. Implementation & Enforcement

This is the most important and the crucial part, as poor implementation & enforcement mechanisms always lead to the failure of even a very well planned system. The old method of 'Carrot and Stick' has to be employed to get the desired results, whereby stringently penalizing the non-compliant taxpayers and giving incentives to the compliant taxpayers.

The following measures can be helpful to bring desired outcome;

2.1 Creation of a reliable database

In order to have an effective check and appropriate monitoring of the taxpayers, a central and reliable database center should be established. In this regard lesson may be drawn from the Japanese KSK system, which is a central database system connecting all the 12 Regional Tax Bureaus and 520 local tax offices in Japan. It is not only maintaining a reliable data base but also updating it regularly. This data is used by tax officials for the accomplishment of their various functions like audit, enforcement, monitoring and confirming status of blue return etc. There is a need to gear up efforts to create an appropriate and reliable data by synchronizing the systems of PRAL and MOHASIL having a similar functioning and objective as of the KSK system in Japan.

2.2 Incentives to the Taxpayers

To acknowledge the compliant taxpayers and have an increased percentage of voluntary compliance, following incentives and privileges may be given to the taxpayers in a phased and systematic manner depending on the category of the taxpayers as mentioned above in the parameters. So accordingly, a general and specific incentive list has been proposed as under:

2.3 Specific Incentives

The specific incentives pertain to each category separately, thus given as under category-wise:

a) Regular Sales Tax Return Filer:

In this category the taxpayer coming in the mentioned parameters and included in WLT may be given the following incentives:

i. Sales tax input credit
ii. Bidders for contracts suppliers to Government departments and Public limited companies
iii. Refund to be given on priority basis within the stipulated time
iv. Availing of Bank loan over a certain limit i.e. Rs.10 million etc.
v. Only the purchases made from the compliant taxpayers to be treated as an admissible expense

b) Regular Income Tax Return Filer:

In addition to the incentives as mentioned above from ii to v, following additional incentives may also be given:

i. Allowed to carry forward and back the losses of three years
ii. Special depreciation deductions may be allowed
iii. Special tax credits for individuals and AOPs.

c) Importers and Exporters:

The importers, exporters, clearing and shipping agents coming in this category should only be allowed to use the green channel facility under CARE.

2.4 General Incentives

In addition to the above mentioned specific incentives, some general incentives should be given to all the WLT particularly the withholding agents and the taxpayers who are paying more than Rs.25,000/- withholding tax in a financial year. These include the following:

i. Preferential treatment on travel abroad, for instance issuance of ticket & reservation of seats on priority, facility of VIP lounge etc
ii. Preferential treatment in getting government services like Issuance of NIC, Passport etc
iii. Preferential treatment in obtaining fresh connections of basic public utilities like electricity, telephone, mobile, water, gas etc.
iv. Concessional rates in 3-5 star hotels

Then to discourage the Non-Compliant taxpayers, they should be subjected to higher rates of taxes. In addition to higher rates they should also be subjected to additional taxes and penalties for submitting short documents or improper documentation.

2.5 Education of taxpayers by involving private sector

Public awareness and education of taxpayers is of pivotal importance to make this scheme successful. In addition to the departmental efforts, private sector may also be encouraged to participate in this regard actively. In Japan the private sector is assisting the National Tax Agency of Japan with the help of Blue Return Associations. At present, there are 3800 Blue Return Associations with membership of more than 1 million taxpayers operating. These associations are helping the taxpayers to prepare and submit the required documents for tax purposes by emphasizing the importance and benefits of blue returns. Similarly in Pakistan, various Tax Bar Associations can play an important role to strengthen this system of compliant taxpayers in Pakistan.

Box-1: ***A Case of acknowledging the complaint tax payers***

Uganda Revenue Authority (URA) has exempted about 800 business institutions and organizations, which have kept a clean track record in meeting their dues of paying a 6 percent withholding tax.

URA explains that the beauty of this system for those taxpayers, who are complying, is that they are given a chance to have a smooth cash flow, which at the end of the day helps them earn more as the entire payment is not affected.

It has also been intimated to the exempted taxpayers that their exemption may be revoked at anytime if their compliance status falls below the standard requirement.

Similarly, in Sri Lanka the department of Inland Revenue is issuing taxpayers privilege cards to the taxpayers paying more than 0.5 million Sri Lankan Rupees. By virtue of this card, these taxpayers get preferential treatment at airports, customs and banks.

3. Administration & Management

A system could not attain the desired results if marred by poor administration and management. In this regard, the present setup of Directorate of Research and Statistics (DR&S) may be utilized by upgrading it to a level of Directorate General (Directorate General Research, Statistics and Compliant Taxpayers' wing). The proposed organizational setup is given at Annexure-A.

Among the other important aspects, the legislation part is crucial. Proper legislation would help in the effective implementation and enforcement of list of compliant taxpayers.

4. Common Tax Identifier (CTI)

At present FBR lacks an appropriate mechanism to find common taxpayers across all federal taxes. Several abortive attempts have been made but without any tangible outcome. In the absence of CTI, it has been difficult to navigate across the taxes. National Tax Number (NTN) can be used as a CTI. For this purpose, there is a need to verify and match all the NTNs across various taxes. The CTI will be very helpful in determining compliant taxpayers.

Conclusion

The idea of compliant taxpayers is quite good but we should think of the matter in the tax culture of our country. The big question is the determination of genuineness of taxpayers to qualify for the incentives in the light of unreliable database. A package of incentives would be good idea as far as acknowledging the compliant taxpayers in recognition of their proper contribution to the national exchequer. Further as a deterrent, a well organized system of penalties and audit would be quite helpful to increase the level of compliance and discourage the informal sector. Moreover, the efforts of using NTN in all the taxes as common identifier would help in gauging the particular taxpayer's contribution across the taxes. The work on preparing the list of compliant taxpayers can only be started after ascertaining the authenticity of information available with the FBR as the data base requires large scale cleaning. This is a must otherwise it would be just like leaping in the dark. Unreliable information can lead to disruption of business activities. The criteria of only filing of return would not be good indicator of genuineness of a taxpayer. We need to further ferret out details of the taxpayers like trends in his declaration of income/loss, nil payment, actual payments, gap between the due and actual payments, arrears position, litigation, etc.

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Annexure-A

ORGANIZATIONAL SET UP OF DIRECTORATE GENERAL OF RESEARCH, STATISTICS AND WHITE LIST TAXPAYERS