Candid WITH P@SHA

Impact of Tax Credit System on the IT Industry

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Declared by many a major setback in the growth of the IT sector, the recent Tax credit regime introduced by the Government of Pakistan has now officially replaced the Income Tax exemption on IT & ITES exports from March 22nd, 2021. The exemption was previously valid till June 2025 and its sudden substitution with the tax regime 3 and a half years prior to its due date has not been received well by the members of the industry.

To dive deeper into how this development will affect the sector, Pakistan Software Houses Association for IT & ITES (P@SHA) organized an informative Candid with P@SHA webinar on April 12th, 2021 under the moderation of **Shahzad Shahid, CEO TPS Worldwide & CEC Member P@SHA**.

The experts invited to speak on this panel were as follows.

- **Sadia Nazeer - Partner Tax, KPMG Taseer Hadi & Co.**
- **Sharif uddin Khilji - CEO Khilji & Co.**
- **Naseer Akhtar - CEO InfoTech & Member, PM IT TaskForce**

Based on the government's understanding with the International Monetary Fund (IMF), it has been decided that exemption previously provided to some of the industries will be withdrawn. One such industry is the IT & ITES sector which has shown tremendous potential for growth in recent years. This abrupt decision came as a surprise to the relevant stakeholders, including the Ministry of IT & Telecom as well as P@SHA, since they were not engaged in the decision making process.

How does the Tax Credit Regime work?

Contrary to popular belief, the new Tax Credit Regime that has replaced the exemption does at present offer relaxation on taxes. It became effective immediately through a Presidential Ordinance on March 22nd, 2021. However, it comes with a list of requirements that need to be met thoroughly for any company to be eligible for this relaxation. Any non-compliance will result in disqualification from 100% tax credit.

The tax credit regime requires compliance on the following aspects:

- Quarterly tax withholding statement are filed. The company applying for tax credit should be 100% withholding compliant w.r.t all expenses; procurement, rent, subscriptions and salaries etc.
- Annual Income tax returns are filed.
- Sales tax returns are filed - an unnecessary condition since sales tax is exempted on the export of IT services.
- 80% of the foreign receipts should be brought back to the country.

What are the ambiguities in the new Tax Credit regime?

While most companies have been fulfilling these conditions in the past as well, startups and freelancers which were previously not obligated to fulfill any such conditions will now also have to be fully compliant. With the regime being completely novel to the industry, there are drafting errors in it which can create strong chances of difference of interpretation within individuals and companies, leading to barriers in achieving 100% tax credit.

One such error is the declaration that a person who is involved in export will be able to receive this tax credit, which can create confusion for the beneficiaries whether they will be eligible or not if they are involved in both exports and domestic business.

To make matters worse, the affectees have not been given sufficient time to create strategies or prepare themselves for this transition. Instead of making the new regime a part of statute at the beginning of the upcoming fiscal year, it has been implemented from March 22nd, 2021 which has resulted in different opinions on how the returns will be filed:

- The tax applicable on the date of filing the returns should be the creditable amount.
- Income should be bifurcated into two periods; from July 1st 2020 till March 22nd, 2021 (period of unconditional exemption) and then from March 22nd, 2021 to June 31st, 2021 for which income should be computed separately along with its credit, subjected to compliance with the conditions mentioned previously.

Another sector to which the tax credit regime has been previously introduced to is the Non Profit Organizations (NPOs). In typical fashion, the financial statements for most NPOs reflect either net operating loss or at best, break-even. It is feared that the same will happen to the IT sector with companies having back offices in Pakistan only sending bare minimum amount to cover the expenses, which will have catastrophic effects on the sector's export revenue growth.

What is the tax liability incase of non-compliance?

If a company is not able to avail tax credit, they will be liable to pay as per the normal taxable regime which is applicable on either 29% of taxable income OR 17% of accounting income OR 1.5% of gross revenue, whichever is higher.

What is the impact on Cost of Doing Business?

For larger companies that have already been meeting the requirements for the tax credit regime, the impact on cost of doing business could be negligible in the beginning but will be significant for startups and SMEs. However, with the expectation of higher frequency of notices and litigations under the new regime, it is possible that the ease of doing business will also reduce for the bigger firms in the long run.

How Sales Tax registration comes into play?

Based on the companies' locations, they will have to get registered with the relevant (Federal or Provincial) tax authorities and file annual sales tax returns to be eligible for tax credit. For companies with offices in more than one province, there are still ambiguities in the regime and it is likely that registration with more than one tax authorities will be required to be compliant.

What will be its impact on Freelancers?

Previously, any export income falling in the definition of IT & ITES was exempted which included freelancers working in the sector as well. According to the new regime, freelancers are also candidates for 100% tax credit, provided they fulfill the requirements.

Given the circumstances, It is very important for all stakeholder business entities to be compliant with all the conditions put forward under the tax credit regime to avoid any legal notices and continue working smoothly during the financial year.

Information Technology has been the fastest growing industry with more than 40% growth in comparison to last year without receiving any special incentives from the government. According to the estimates, the average yield of a worker in traditional industries is around $600 per annum whereas the average yield of a knowledge-worker in the IT/ITES industry is more than $25,000 per annum. Despite its potential, the sector has been discriminated from the other goods-based industries and is the only one to have its tax exemption on exports withdrawn - a serious obstruction in the way of Pakistan becoming a knowledge economy.

Watch this session on YouTube **here**.
You can also watch it on Facebook **here**.