Allama Iqbal Open University AIOU BS ADC solved Assignment NO 1 Autumn 2024 Code 5445 Business Taxation

Q.1

With reference to Income Tax Ordinance 2001, explain the following concepts and their taxation treatment: (20)
i.Agricultural income
ii.Exempt income

Ans:

i. Agricultural Income under Income Tax Ordinance 2001

Definition of Agricultural Income

Agricultural income, as defined under Section 2(1) of the Income Tax Ordinance 2001, refers to income derived from agricultural activities such as farming, livestock, poultry, and other related agricultural activities. The ordinance specifies that agricultural income includes:

- **Income from land** used for agricultural purposes, such as cultivation, horticulture, and dairy farming.

- **Income from livestock** such as cows, buffaloes, goats, sheep, and poultry.
- **Income from horticulture** (i.e., cultivation of fruits, vegetables, flowers, etc.).

The Income Tax Ordinance emphasizes that agricultural income does not include income derived from any business activity conducted on agricultural land. For instance, if a business operates on agricultural land (like a factory or processing unit), any income generated from that business is not considered agricultural income.

Taxation Treatment of Agricultural Income

Agricultural income is **exempt from income tax** under Section 10 of the Income Tax Ordinance 2001. This means that individuals whose total income consists solely of agricultural income are not required to pay income tax. The government encourages agriculture as a critical sector of the economy and provides this exemption to ensure farmers and agricultural producers remain financially supported.

However, there are specific conditions under which agricultural income might lose its exemption. For instance:

- If the agricultural income exceeds a certain threshold, it may become subject to tax, especially if combined with non-agricultural income.
- If a taxpayer derives income from both agricultural and non-agricultural sources, only the agricultural part might be exempt up to the prescribed limits, while the non-agricultural income is taxable.

In practice, many farmers benefit from this exemption, which contributes to their financial relief and encourages investment in the agricultural sector.

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ii. Exempt Income under Income Tax Ordinance 2001

Definition of Exempt Income

Exempt income refers to income that is entirely or partially free from tax under specific provisions of the Income Tax Ordinance 2001. The ordinance outlines several types of income that are not subject to taxation due to their nature or the purpose they serve, such as supporting specific sectors like agriculture, charities, and social welfare. Section 2(29) of the Income Tax Ordinance 2001 defines exempt income as follows:

Categories of Exempt Income

1. Agricultural Income

As already discussed, agricultural income is fully exempt from taxation.

2. Gifts and Inheritances

Gifts and inheritances received from family members, relatives, or others are exempt from income tax. This applies to monetary gifts, properties, and assets received as part of inheritance.

3. Capital Gains from Sale of Certain Assets

- **Capital gains from the sale of immovable property**, such as agricultural land or personal residences, are exempt from tax under specific conditions.

- For instance, when an individual sells their primary residence after holding it for a certain period, the capital gains are exempt from taxation.

4. Foreign Income

- **Foreign source income** like foreign salaries, dividends, interest, or royalties are generally exempt from taxation, particularly if there are treaties between Pakistan and the other country.
- Income arising from countries that Pakistan has double taxation agreements with is not taxed to avoid double taxation.

5. Public Assistance and Relief Funds

- Donations made to **welfare funds, relief funds, or charity organizations** are exempt from income tax.
- The government encourages charitable activities by ensuring that donors receive tax benefits.

6. Pensions and Gratuities

- **Pensions and gratuities** received from employment or retirement are exempt up to a certain limit as specified by the government.
- This aims to support individuals after their retirement without imposing additional tax burdens.

7. Dividends from Resident Companies

- Dividends distributed by **resident companies** to shareholders are often exempt from tax, especially when shareholders are individuals receiving the dividends from non-corporate sources.

8. Income of Educational Institutions and Religious Organizations

- Certain **educational institutions and religious organizations** are exempt from income tax, provided they meet the specific criteria outlined under the ordinance.
- This encourages the establishment of institutions that contribute to the betterment of society.

Importance of Exempt Income

Exempt income plays a critical role in promoting specific sectors and reducing the tax burden on certain individuals and entities. Below are some key points highlighting the importance of exempt income:

1. **Encourages Agricultural Development**
    - By exempting agricultural income, the government supports farmers and the agricultural sector, which is a significant part of the economy.
    - This reduces the financial burden on farmers and helps in the growth of agriculture, which in turn boosts rural development.
2. **Promotes Social Welfare**
    - Exemptions on donations and contributions to welfare funds encourage philanthropic activities.
    - It ensures that more resources are allocated to social causes like education, healthcare, and relief funds, reducing the financial burden on organizations working for social welfare.

3. **Reduction in Tax Complexity and Burden**
    - Exempt income reduces the complexity of tax calculations, particularly for individuals and businesses involved in sectors that contribute to the economy in vital ways, such as agriculture and charitable work.
    - It helps streamline taxation, ensuring that individuals who are earning low or moderate-income levels aren't burdened unnecessarily.
4. **Attracting Foreign Investment and Skills**
    - Exempt income provisions related to foreign income encourage foreign investment and talent by ensuring income from international sources remains untaxed.
    - This encourages foreign professionals and companies to work or invest in Pakistan.

Challenges in Managing Exempt Income

While exempt income has several advantages, there are challenges in its administration:

1. **Difficulty in Enforcement**
    - Ensuring compliance with the rules related to exempt income, particularly in areas such as agricultural exemptions or charitable contributions, can be challenging due to documentation and verification issues.

2. **Potential for Abuse**
   - Some individuals or organizations may misuse the provisions by claiming exemptions for income that doesn't strictly meet the criteria.
   - For example, falsely classifying non-agricultural income as agricultural income or over-claiming deductions under charitable exemptions.
3. **Monitoring and Verification Costs**
   - The government incurs costs to monitor and verify the legitimacy of claims for exempt income, particularly in sectors like agriculture, donations, and foreign income.
4. **Changing Economic Landscape**
   - The criteria for exempt income may need to be updated regularly due to changing economic conditions, which could result in disputes or confusion regarding what constitutes exempt income.

Conclusion

Under the Income Tax Ordinance 2001, agricultural income and several other categories of income are exempt from taxation. These provisions play a vital role in supporting specific sectors of the economy, promoting social welfare, and reducing the tax burden on individuals and entities. However, administering exempt income can pose challenges, including ensuring compliance, preventing misuse, and verifying claims. Proper understanding and implementation of these provisions are essential for ensuring fairness and efficiency in the tax system.

Q.2

Explain the concept of income from business and its taxation treatment as per the provisions of the Income Tax Ordinance 2001.

Ans:

Concept of Income from Business

The term **income from business** refers to the profit generated from carrying out commercial, industrial, or professional activities that involve the production, sale, or exchange of goods and services. It is one of the primary sources of income under the Income Tax Ordinance 2001.

According to the Ordinance, **income from business** is defined as any income derived from trade, commerce, manufacture, or any other activity that a person engages in with the intention of making a profit. This includes income from both sole proprietorships and corporate entities. The key criteria for income from business are that the activity must be carried out regularly and systematically with a motive to earn a profit.

Taxation Treatment of Business Income under Income Tax Ordinance 2001

The taxation treatment of business income under the Income Tax Ordinance 2001 is primarily governed by **Part I of the First Schedule** of the Ordinance.

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1. Taxable Income from Business

The Income Tax Ordinance 2001 taxes **business income** on the principle of **comprehensive income**, which means all profits derived from business activities are subject to taxation unless specifically exempt under certain provisions.

- **Business income includes**:
  - Sales and trading profits.
  - Income from manufacturing.
  - Profits from professional services (such as doctors, engineers, accountants, lawyers, etc.).
  - Rental income (if derived from business premises).
- **Income from business is computed on the basis of the accounting method** chosen by the taxpayer (usually the cash or accrual method).
- **Income is calculated after accounting for allowable expenses** such as:
  - Cost of goods sold (COGS).
  - Administrative and operating expenses.
  - Depreciation on fixed assets.
  - Salaries and wages.
  - Rent and utilities.

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2. Computation of Taxable Business Income

To determine taxable income from business, the following steps are taken under the Income Tax Ordinance 2001:

- **Gross Business Income**:
  This includes all revenue generated from business operations such as sales, services, and other income sources.

- **Allowable Deductions**:
  Expenses that are directly related to earning business income are deducted from the gross income. These deductions include:

  - Cost of goods sold (COGS).
  - Operating expenses (e.g., salaries, rent, utilities, and insurance).
  - Depreciation on business assets.
  - Interest on loans taken for business purposes.
- **Taxable Business Income**:
  After deducting allowable expenses, the remaining amount is the taxable business income, which is subject to the applicable tax rate.

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3. Tax Rates on Business Income

The Income Tax Ordinance 2001 specifies tax rates applicable to different categories of business income:

- **Tax Rates for Individuals and Sole Proprietors**:
  The tax rates vary based on the income brackets:
  - For individuals earning less than Rs. 600,000 per year, the income is taxed at a lower rate.
  - For income between Rs. 600,001 to Rs. 1,200,000, a higher rate applies.
  - For income exceeding Rs. 1,200,000, higher tax rates are applied.
- **Corporate Tax Rates**:
  For companies, corporate tax rates are structured at a flat rate. For instance:
  - Listed companies are taxed at **29%**.
  - Unlisted companies are taxed at **29%**.
  - Certain sectors may be taxed at reduced rates under specific conditions (e.g., agriculture, small and medium enterprises, etc.).

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4. Deductions and Allowable Expenses

The Income Tax Ordinance 2001 allows taxpayers to deduct certain expenses while computing business income. These expenses must be:

- **Directly related** to business operations.
- **Reasonable and necessary** for generating income.

Some common **allowable expenses** include:

- **Cost of Goods Sold (COGS)**: The cost of inventory or raw materials used to produce goods or services.
- **Salaries and Wages**: Payments made to employees.

- **Rent and Utilities**: Expenses for business premises and utilities.
- **Depreciation**: Cost of wear and tear on fixed assets like machinery, vehicles, and buildings.
- **Interest on Loans**: Interest paid on loans acquired for business purposes.
- **Travel and Business Entertainment**: Reasonable expenses incurred during business travel and entertainment.

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5. Taxable vs. Exempt Income from Business

Certain types of income from business may be subject to special tax treatment or exemptions:

- **Exempt Income**:
  - Agricultural income.
  - Capital gains from the sale of assets (e.g., immovable property) under specific conditions.
  - Dividends and certain profits from the sale of shares.
- **Taxable Income**:
  - All other forms of business income not expressly exempt under the law are taxable.

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6. Advance Tax and Filing Requirements

Businesses are required to pay **advance tax** under certain conditions:

- For businesses with taxable income exceeding Rs. 3 million, advance tax payments must be made in quarterly installments.

- Tax returns must be filed annually, declaring business income, deductions, and applicable tax liabilities.

Conclusion

Under the Income Tax Ordinance 2001, **income from business** is broadly defined and subjected to taxation unless explicitly exempt under the ordinance. The computation of taxable income involves deducting allowable expenses from the gross revenue. Tax rates vary for individuals, sole proprietors, and companies. Understanding the tax treatment of business income is essential for compliance and effective tax planning for businesses and entrepreneurs.

Q.3

Calculate the tax liability of Mr.Sahir, a salaried person, from the following records:

Ans;

Step-by-Step Calculation

We will apply the Income Tax Ordinance 2001 to calculate Mr. Sahir's tax liability based on the provided details.

Step 1: Basic Salary and House Rent Allowance (HRA)

- **Basic Salary**: Rs. 42,000 per month × 12 months = Rs. 42,000 × 12 = Rs. 504,000
- **House Rent Allowance (HRA)**: Rs. 5,000 per month × 12 months = Rs. 60,000

Step 2: Overtime and Medical Allowance

- **Overtime**: Rs. 60,000 (fully taxable)
- **Medical Allowance**: Rs. 4,000 per month × 12 months = Rs. 48,000

Step 3: Conveyance Facility

- **Cost of Vehicle Provided**: Rs. 900,000
- **Standard Deduction**: 10% of the cost of the vehicle (per Income Tax Ordinance 2001) = Rs. 90,000

Step 4: Reimbursement of Medical Expenses

- **Reimbursement of Medical Expenses**: Rs. 7,000 (fully taxable as per Income Tax Ordinance)

Step 5: Provident Fund Contribution

- **Provident Fund Contribution**: Rs. 6,000 (deductible under the relevant section of the Income Tax Ordinance)

Step 6: Zakat Paid

- **Zakat Paid**: Rs. 2,000 (deductible under certain conditions)

Step 7: Shares of BC Ltd. Purchased in IPO

- **Shares Purchased in IPO**: Rs. 19,000 (exempt from tax under Section 62 of the Income Tax Ordinance)

Step 8: Donation to a Hospital

- **Donation to a Hospital**: Rs. 2,000 (deductible under specific provisions of the Ordinance)

Step 9: Taxable Income Calculation

Now, we compute the taxable income by adding up all the taxable components and subtracting the allowable deductions:

- **Gross Salary** = Rs. 504,000 (Basic) + Rs. 60,000 (HRA) + Rs. 60,000 (Overtime) + Rs. 48,000 (Medical Allowance) = Rs. 672,000

- **Less: Allowable Deductions**

    - Standard deduction on vehicle = Rs. 90,000
    - Reimbursement of Medical = Rs. 7,000
    - Provident Fund Contribution = Rs. 6,000
    - Zakat Paid = Rs. 2,000
    - Donation to hospital = Rs. 2,000
- **Total Deductions** = Rs. 107,000
- **Net Taxable Income** = Rs. 672,000 - Rs. 107,000 = Rs. 565,000

Step 10: Calculation of Tax Liability

- **Taxable Income**: Rs. 565,000
- **Tax Rate for Individuals** (as per the Income Tax Ordinance 2001): 15% on the first Rs. 600,000 and 20% on the remaining.
- **Tax on First Rs. 600,000**: 15% of Rs. 600,000 = Rs. 90,000
- **Tax on Remaining Rs. 65,000**: 20% of Rs. 65,000 = Rs. 13,000
- **Total Tax Liability** = Rs. 90,000 + Rs. 13,000 = Rs. 103,000

Final Tax Liability of Mr. Sahir

Mr. Sahir’s total tax liability for the year is **Rs. 103,000**.

Q.4

What is the concept of taxpayer? Explain in detail with reference to the Income Tax ordinance 2001.

Ans;

Concept of a Taxpayer

A **taxpayer** is any individual, entity, or organization that is obligated under law to pay taxes to the government. In the context of the **Income Tax Ordinance 2001**, the term "taxpayer" is defined broadly to include various categories of individuals and entities subject to tax obligations.

The primary responsibility of a taxpayer is to report taxable income, pay the due tax amount, and comply with the provisions outlined in the Income Tax Ordinance 2001.

Definitions and Key Provisions from Income Tax Ordinance 2001

The Income Tax Ordinance 2001 governs the taxation system in Pakistan. It provides a comprehensive framework defining who qualifies as a taxpayer, the scope of their responsibilities, and the types of taxes they are liable to pay.

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1. Categories of Taxpayers under Income Tax Ordinance 2001

The Income Tax Ordinance 2001 categorizes taxpayers into several broad groups:

- **Individuals**:
  These are natural persons who earn income from various sources such as salaries, businesses, investments, etc.
  Example: Mr. A, a salaried employee, is considered a taxpayer under this category if his taxable income exceeds the minimum threshold.

- **Association of Persons (AOPs)**:
  This includes partnerships, joint ventures, and similar groups formed to conduct business. Each member of the AOP is liable to pay tax on their share of income.
  Example: A partnership firm formed by three individuals is considered an AOP and each member has a tax liability on their share of income.

- **Companies**:
  Companies are corporate entities that are taxed separately from their owners.
  Example: A private limited company like XYZ Ltd. is treated as a taxpayer and is liable to pay corporate tax under the Income Tax Ordinance 2001.

- **Trusts**:
  Trusts established for charitable, religious, or other exempt purposes are treated as separate taxpayers.

Example: A hospital trust set up to provide medical care may be treated as a taxpayer if its income exceeds exempt limits.

- **Federal and Provincial Government**:
  Government organizations and agencies, while they may not pay corporate tax, are considered taxpayers under different sections for reporting purposes.

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2. Definition of Income under Income Tax Ordinance 2001

Under Section 2(29) of the Income Tax Ordinance 2001, **income** is broadly defined as any amount derived, whether directly or indirectly, from a variety of sources such as:

- **Salary**: Wages, bonuses, overtime, and other benefits received by employees.
- **Business Income**: Income from trade, commerce, manufacturing, or any other profession.
- **Investment Income**: Income from dividends, interest, rental income, capital gains, etc.
- **Agricultural Income**: Income from agriculture-related activities as defined under the ordinance.
- **Pensions and Annuities**: Income from retirement benefits.
- **Capital Gains**: Profit from the sale of assets such as property, shares, or investments.

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3. Responsibilities of Taxpayers under Income Tax Ordinance 2001

Taxpayers are required to fulfill certain obligations under the Income Tax Ordinance 2001, which include:

- **Filing Income Tax Returns**:
  Taxpayers are required to file their income tax returns annually. The return should include details of income, deductions, and any tax payable.

  - For individuals, the due date for filing tax returns is typically by September 30 of the following tax year.
  - Companies must file returns by the due date mentioned in the Ordinance.
- **Payment of Taxes**:
  Taxpayers are obligated to pay the tax due on their income as per the specified tax rates under the Ordinance.
  Example: A salaried individual with taxable income of Rs. 600,000 is required to pay tax on the income above the exemption threshold.

- **Keeping Records and Documents**:
  Taxpayers must maintain proper records of all income, expenditures, and transactions, as these may be required during audits.

  - This includes maintaining receipts, invoices, and documentation of expenses and deductions.
- **Compliance with Advance Tax Provisions**:
  Certain categories of taxpayers, like businesses or individuals earning higher income, are required to pay advance tax installments on estimated annual income.

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4. Exemptions and Exclusions for Taxpayers under the Ordinance

The Income Tax Ordinance 2001 also specifies certain **exemptions** from taxation:

- **Agricultural Income**: Income from agriculture is generally exempt from income tax under Section 2(1)(b) of the Ordinance.
- **Certain Types of Dividends**: Dividends from public companies are subject to withholding tax but may be exempt in certain cases.
- **Capital Gains from Certain Assets**: The capital gains from assets like immovable property are exempt under certain conditions.

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5. Penalties for Non-Compliance

Taxpayers who fail to fulfill their tax obligations under the Income Tax Ordinance 2001 may face penalties, including:

- **Late Filing of Returns**: Failing to file a return by the due date can lead to fines and interest on unpaid taxes.
- **Late Payment of Taxes**: Failure to pay the due tax amount can result in interest and penalties.
- **Failure to Maintain Records**: Inadequate or incomplete records may result in additional tax liabilities and penalties.

Conclusion

The concept of a taxpayer under the Income Tax Ordinance 2001 is broad and covers individuals, companies, associations, trusts, and government entities. Taxpayers have a responsibility to file returns, pay taxes, and maintain proper records to comply with tax laws. Understanding the rights and obligations of taxpayers is essential to ensure compliance and avoid penalties under the ordinance.

Q.5

Differentiate between the statement of final tax and the income tax return? Who is required to file the income tax return under the Income Tax Ordinance 2001?

Ans;

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1. Statement of Final Tax

The **Statement of Final Tax** is a simplified method of taxation applied to specific categories of taxpayers, especially individuals and businesses that meet certain conditions. It allows taxpayers to pay tax on a final basis without filing a full income tax return.

- **Nature**:
  The statement of final tax calculates tax liability based on

fixed or specific income sources, such as salary, capital gains, or certain business activities, without considering other sources or deductions.

- **Applicability**:
  Taxpayers whose income falls under certain presumptive taxation schemes or fixed-rate tax slabs, like salaried individuals, businesses, or those dealing with specific sources like capital gains, may opt for final taxation.
- **Key Features**:
  - Tax is deducted at source (TDS) by the payer.
  - Final tax is paid on the basis of fixed tax rates.
  - No need to file detailed returns or maintain extensive records.
  - Commonly applied to small business owners, freelancers, or salaried individuals with fixed incomes.

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2. Income Tax Return

The **Income Tax Return** is a detailed declaration of all sources of income, deductions, and tax calculations that a taxpayer submits to the tax authority. It provides a comprehensive picture of a taxpayer's financial position and liabilities.

- **Nature**:
  The income tax return requires taxpayers to report all types of income, deductions, and any allowable exemptions. The taxpayer computes their total taxable income and applies the relevant tax rates to calculate tax liability.
- **Applicability**:
  It applies to all categories of taxpayers, including salaried

individuals, businesses, companies, and trusts. Individuals not eligible for final taxation or those with multiple income sources must file detailed returns.

- **Key Features**:
  - Covers all sources of income, such as salary, business, capital gains, and others.
  - Deductions, exemptions, and credits are claimed.
  - Detailed record-keeping is required for accurate reporting.
  - Necessary for assessing total income, calculating tax liability, and claiming refunds.

Key Differences Between Statement of Final Tax and Income Tax Return

Aspect	Statement of Final Tax	Income Tax Return
Definition	A simplified tax mechanism for specific income sources.	A detailed declaration covering all income and deductions.
Applicability	Applicable to salaried individuals, businesses under presumptive taxation, and specific income sources like capital gains.	Applicable to all individuals, businesses, companies, and trusts.
Nature of Tax	Tax is deducted at source (TDS) with a fixed tax rate.	Tax calculated based on total income and applicable tax rates.

Record-keeping	No detailed record-keeping required.	Requires detailed record-keeping and documentation.
Claiming Deductions	Not applicable; tax is final.	Applicable; deductions, exemptions, and tax credits can be claimed.
Reporting	No need to file full income tax return.	Must file comprehensive tax return.
Tax Refund	Not applicable in most cases.	Taxpayers can claim refunds if tax paid exceeds liability.

Who is Required to File Income Tax Return under Income Tax Ordinance 2001?

Under the Income Tax Ordinance 2001, **every individual, business entity, company, or trust** that meets specific criteria is required to file an income tax return.

1. **Individuals (Salaried and Non-Salaried)**:
    - Individuals earning income above the minimum exemption limit (Rs. 600,000 for individuals) are required to file tax returns.
    - This includes salaried individuals who earn salary, allowances, and other taxable incomes like investments or business income.
2. **Companies and Corporations**:

    - All corporate entities, including private limited companies, public companies, etc., are mandated to file income tax returns.
3. **Partnerships and Association of Persons (AOPs)**:
    - Businesses structured as partnerships or AOPs must file income tax returns, especially if their income exceeds the minimum threshold.
4. **Trusts and Non-Profit Organizations**:
    - Trusts formed for charitable, religious, or other exempt purposes are required to file returns if they have taxable income.
5. **Foreign Nationals and Non-Residents**:
    - Non-resident individuals earning income from Pakistan are also required to file tax returns.
6. **High-Income Individuals and Businesses**:
    - Individuals and businesses with significant income sources such as capital gains, rental income, etc., must file detailed tax returns.

Conclusion

The **Statement of Final Tax** simplifies taxation for specific categories, particularly individuals or businesses with fixed income or specific sources of income, requiring minimal record-keeping. In contrast, the **Income Tax Return** is comprehensive and mandatory for all categories of taxpayers, ensuring proper reporting, claiming deductions, and calculating tax liabilities accurately as per the Income Tax Ordinance 2001.