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The Akhtar & Hasan *letter*

We wish all our readers Eid Mubarak

Tax credit on life insurance premiums

The Finance Act, 2011, replaced S.62 of the Income Tax Ordinance, 2001, with a new S.62.

Old S.62 allowed a tax credit only on new investments in a listed public company. Under definition (47) in S.2, this includes "a unit trust whose units are widely available to the public".

Under new S.62, tax credit would be allowed on either new investments as before or on "any life insurance premium paid on a policy to a life insurance company registered [by the SECP], provided the resident person is taxable either on 'salary' or 'income from business' ".

As before, the tax credit will be at the rate of income tax before the credit.

Limit raised
Holding period increased for investment in shares and unit trusts

The previous limit on the annual amount eligible for tax credit was 10% of taxable income, or Rs 300,000, whichever is less. 10% has been raised to 15%, and Rs 300,000 to Rs 500,000.

In respect of investment in shares and unit trusts, previously if the investment was realised within 12 months, the tax credit would be recovered. This period has been extended to 36 months.

No "holding period" has been prescribed for the life policy under which the premiums were paid.

Points which arise under new S.62

(a) Do the words either / or mean that investment in new shares or unit trusts, and life insurance premiums, are mutually exclusive? Suppose a tax payer makes a new investment of 10% in new shares or unit trusts. Can he use the balance of 5% for life premiums?

(b) On a plain reading, premiums paid on existing policies would be eligible.

Expert advice should be obtained.

Pakistan's life insurance business has done well without the tax relief

Under the doctrine of 'fiscal neutrality", tax reliefs on investment in Defence Savings Certificates, new shares, unit trusts and life insurance were withdrawn from 1 Jul 1991. In return, tax rates for individuals were reduced.

Despite the withdrawal of tax relief, the life insurance business has done well. In recent years, the growth of New Business has been 25% per annum compound, or more.

The industry learned to sell life insurance on its merits as a means of family protection and long term saving. The protection content of the policy mix of the industry as a whole, is high compared with the investment content.

Possible adverse effect of new tax credit

Experience in India and other countries shows that tax relief on life insurance policies was mis-used to sell investment products with a thin "wrapper" of life insurance. The life insurance protection may be only 1% of the investment.

Protection is life insurance's Unique Sales Proposition

Pakistan's life insurance industry should continue to emphasise protection, and not design policies with low, or token, life cover. The SECP may have to issue guidelines on the minimum protection content of life policies. We hope these will protect the present high protection content.

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With-holding tax @ 6% of gross will be minimum tax on corporate bodies which provide services: new "Tax Risk"

The Finance Act, 2011, has a new S.153 dealing with with-holding tax. Under Proviso (b) to S. 153(3), tax deducted in respect of " rendering of or providing of services" shall be a minimum tax for everybody, including companies. The rate of with-holding tax on services is 6%.

We quote an abridged extract from Ernst & Young Ford Rhodes Sidat Hyder's Budget Briefing 2011, with their kind permission:

"This amendment will cause a huge obligation in terms of tax incidence on corporate entities rendering services. To bring them into the minimum tax regime [at 6% of gross] is not rational taxation.".

A new risk has been created, namely "Tax Risk". The Sum at Risk is 6% of gross. The Table shows the Level 1 Tax Risk.

<u>Level 1 Tax Risk</u>

Case	Net Profit	Level 1 Tax risk
A	Break even, or loss	Equity (capital + reserves) depleted or wiped out by Sum at Risk
B	Up to 6% of gross	Equity depleted or wiped out by "Sum at Risk *minus* net profit"
C	6% of gross	Effective tax rate 100%
D	10% of gross	Effective tax rate 60%
E	17.14 % or more of gross	Effective tax rate 35%, as for other corporate entities

Net profit of 17.14% is perhaps rarely achieved

<u>Level 2 Tax Risk</u>: Suppose the company plans to increase business. This will increase the Sum at Risk @ 6% of gross. Expansion usually means higher expenses incurred up front. Suppose there is a loss, or a small profit. Then the increased Sum at Risk will have a bigger impact in Cases A and B shown in the Table.

Faced with these Tax Risks, no sensible person would start a new company to provide services.

Existing companies will face a hard task to ensure the growth of shareholders' equity, and indeed to prevent its depletion or exhaustion. The Level 2 Risk will put a damper on expansion plans.

IAS 19 amended on 16 Jun 2011

The amended International Accounting Standard 19 on Employee Benefits introduces important changes. These will take effect on 1 Jan 2013, or such other date as may be notified by the SECP. They will affect Defined Benefit schemes.

The corridor to recognise actuarial gains and losses will be scrapped. Gains and losses must be recognised immediately as lump sums.

Those lump sums will not be passed through P & L. They will be recognised in "Other Comprehensive Income".

The expected return on assets will be the same as the discount rate.

Many additional disclosures will be required.

Sage advice on money management

Never ask of money spent,
Where the spender thinks it went,
Nobody was ever meant,
To remember or invent,
What he did with every cent.

(Robert Frost)