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An FDI-friendly tax regime

The World Bank placed Pakistan among lower-middle-income countries based on its gross national income (GNI) per capita of $1,580 in 2018.

A low GNI per capita is the major obstruction to human development. The country's value on the human development index (HDI) was 0.562, which was less than the average HDI value of 0.645 for countries in the medium human development group. It was also less than the average of 0.638 for South Asian countries.

A low value on the HDI shows large gaps in human development that must be bridged on an urgent basis — something that requires substantial investment.

A huge investment is needed to improve infrastructure in different sectors, including oil and gas, power, telecommunication, transportation, construction, textile, trade, financial services, water and sanitation, education and health.

Importantly, the investment-to-GDP ratio of 15 per cent in Pakistan is considerably lower than around 30pc prevailing in China, India and South Korea.

Among other factors, the tax regime has a major role in attracting investment, especially foreign direct investment (FDI). It is empirically established that the tax regime is important for attracting efficiency-seeking FDI. The tax policy plays a significant role in attracting FDI. A well-structured corporate tax policy plays a crucial role in persuading businesses to start investing. The rate of return on investment depends on the corporate tax rate. Businesses generally invest in countries where they expect the highest rate of return on investment.

The government has recently adopted a foreign investment–friendly regime that allows non-residents to invest in government securities

Keeping the significance of FDI in view, the government has recently adopted an FDI-friendly regime that allows non-residents to invest in debt securities and government securities through special convertible rupee accounts maintained with banks in Pakistan.

The tax payment system has been amended entirely through the Tax Law (Second Amend-ment) Ordinance 2019 enacted on Dec 26 last year. Now every banking company or financial institution maintaining a special convertible rupee account of a non-resident company with no permanent establishment in Pakistan is obliged to deduct final tax at the rate of 10pc from capital gains arising on the disposal of debt instruments and government securities, including treasury bills and Pakistan investment bonds.

Importantly, there will be no restriction on the repatriation of funds from special convertible rupee accounts, which incentivises investment in the local debt market by non-resident investors.

Furthermore, the tax regime has significantly been amended to encourage investment in the local debt market. For example, the enhanced rate of withholding tax for persons not on the active taxpayers' list will not be applicable to capital gains and profit on debt earned by non-resident companies.

Similarly, special convertible rupee accounts being maintained by non-resident companies having no permanent establishment in Pakistan will be exempted from the collection of advance tax on banking transactions. No such benefit will be available in case they withdraw cash from such accounts.

Also, a non-resident company will not be required to pay advance tax in respect of capital gains. Additionally, requirements concerning filing the statement of final taxation and registration will be applicable to a non-resident company solely by reason of capital gains or profit on debt earned from investments in debt and government securities.

The introduction of the tax-friendly regime for non-resident companies aiming to attract FDI is a significant step in the right direction. Developments in the regional tax regimes, especially in India, might have a triggering impact on the introduction of tax amendments concerning non-resident companies.

The Indian government has adopted a number of tax-related measures to attract investment. With effect from 2019-20, the corporate tax rate on the income of domestic companies has been reduced to 22pc provided that such companies will not avail any exemption or incentive. It is even less than the tax rate of 23pc prescribed for small companies in Pakistan for 2019-20. The effective tax rate is 25.17pc inclusive of surcharge and cess, which is almost three percentage points less than the corporate tax rate of 28pc for 2019-20.

Additionally, Indian domestic companies are not required to pay the minimum alternate tax. Corporations in Pakistan are subject to minimum tax as well as super tax that banking companies will continue to pay.

In India, new domestic manufacturing companies commencing production on or before March 31, 2023, but incorporated after Oct 1, 2019, pay income tax at 15pc subject to the condition that they will not avail any exemption or incentive under the tax law. The effective tax rate is 17.01pc inclusive of surcharge and cess. Further, such companies are not obliged to pay alternate minimum tax.