

WITHHOLDINGIZATION OF TAXATION SYSTEM: BENEFICIAL OR NOT?

Amer Shakeel

(This document is unedited author's version submitted to RASTA)

INTRODUCTION

Tax is a compulsory payment by the people to the government which is ultimately used for the common interest and welfare of the public of the country and running the expenses to carry out the government functions. Tax is considered as the largest financial source for the developments work like public service, poverty relief and to establish physical and social infrastructure that leads towards long term growth of a country. However, since long time, many developing countries like Pakistan have been facing a great challenge in generating revenues from tax.

Withholding tax (WHT), also called a retention tax, is an act of deduction or collection of tax at source, which has generally been in the nature of an advance tax payment. Withholding tax is a tax system in which the payer withholds a portion of a payment and remitted directly to the government. Its common example is tax deducted from the salary of employee by the employer. After the deduction, employer will deposit this tax into the national treasury in the name of the employee. This tax system is used by many countries around the world, including developing countries. WHT creates several advantages and disadvantages to the governments and tax payers. WHT system has the benefit of reducing the cost of tax collection and enhancing the government's cash flow and budgetary management because of the advance collection of taxes.

In this research project, analysis was made about the current state of the withholding taxation system, its benefits, related problems and criticism on this system. Policy recommendations were also given to improve the withholding taxation system in Pakistan.

METHODOLOGY

Required data were collected from the different reports published by FBR, finance division, research institutions and other departments. For the collection of additional data which is not publicly available, a direct request was made to the FBR and in response to that, FBR provided us most of the requested data officially. Discussions were also made with the tax professionals, taxpayers and businessmen to identify the effects of WHT system.

COLLECTION OF INCOME TAX IN PAKISTAN

Following Table shows the total income tax collected, income tax collected through WHT system, income tax paid by the taxpayers with the income tax return, quarterly advance tax (collectively they are called voluntary payments) and income tax paid on demands generated by the FBR officials through assessments and audit.

Table Amount of Voluntary Tax Payments and Payment on Demand (Amount in Million)

Years	Gross Income Tax Collected (A)	Withholding Income Tax (B)	Income Tax Paid with Annual Return (C)	Quarterly Advance Income Tax (D)	Total Voluntary Payments (B+C+D)	Income Tax Paid on Demand by FBR

2011	629,102	357,836	11,852	184,213	553,902	72,182
2012	811,893	420,457	14,968	222,398	657,823	130,054
2013	776,009	436,088	14,770	230,150	681,008	89,427
2014	918,863	571,667	13,761	248,837	834,265	80,582
2015	1,084,472	691,181	17,915	269,693	978,789	115,495
2016	1,242,195	803,116	38,462	302,358	1,143,936	87,884
2017	1,373,697	944,068	45,394	325,112	1,314,574	92,819
2018	1,577,441	1,046,917	131,216	335,791	1,513,924	102,905
2019	1,509,788	960,239	117,830	344,334	1,422,403	102,648
2020	1,570,820	1,091,737	60,674	350,664	1,503,135	60,807
2021	1,802,417	1,237,338	54,091	413,664	1,705,092	80,143
2022	2,269,800	1,534,400	78,534	586,880	2,199,814	101,095

KEY FINDINGS

Following are the key findings of the research project with respect to the benefits, criticism and recommendations to improve the system of withholding taxation in Pakistan.

BENEFITS OF WITHHOLDING TAXATION SYSTEM

Following are some major benefits associated with the WHT system.

- It is easy to collect income tax through this system because it is collected and deposited in treasury when transactions are generated. In a country like Pakistan which has limited resources, it is difficult to cover every type of income and to assess it and impose required income tax on it, this system is very useful.
- For taxpayers, it is easy to pay required tax conveniently. For example, salaried persons pay total tax due on their salary through deduction at source from the monthly salary payment. Through this system income tax burden of the tax payer spread over the year in easy small instalments.
- WHTs reduce the cost of collection of income tax because its collection totally depends on the withholding agents. They collect the tax while doing specified transactions and deposit in the national treasury. No direct collection cost of FBR involved in this procedure.
- Government gets the money promptly and throughout the year through this system. Because the major portion of the income tax is collected through this system. In this way, WHTs improve the cash flow management of the government.
- Tax avoidance and evasion is not possible for those transactions covered under WHT system. Withholding agents are responsible for the collection/deduction of this tax and they cannot avoid it because of the penalties imposed by the income tax law.

CRITICISM ON WITHHOLDING TAXATION SYSTEM

There is a strong criticism on the scope and application on the WHT system. Over reliance on this system always creates problems in the collection of income tax. Here is the summary of some critics on this system.

- Our income tax system is based on progressive tax rates for individuals and AoPs but through this system the tax is collected/deducted with the same rate irrespective of taxable income of the taxpayers.
- Sometime WHT becomes a reason for undocumented transactions. People prefer to do transactions in cash to avoid the WHT imposed on these transactions.
- There are many types of WHTs which are applied on the taxpayers' expenses rather than incomes. For example, WHT collected on internet services, purchase and sale of property, etc. If you are selling the property even on loss, you have to pay WHT on that transaction. In the case of purchase of property, it is completely unjustified.
- It increases taxflation in the country, for example, someone imports an item and pays WHT on it then he will add all types of taxes paid on these imports in the price of the items and shifts its burden to the end consumer.
- WHTs are deducted/collected from the payments but not deposited in the national treasury by withholding agents and it is a common practice in our country. Therefore, some times, it becomes the additional source of income for the withholding agents.
- In some cases, it leads to double implementation of the income tax on an amount. For example, if you earn income from dividend or salary etc., income tax will be deducted from these payments. Afterwards you buy a car from a company, again you are required to pay income tax on this transaction.
- WHTs collection/deduction in case of loss is also a problem for taxpayers. For example, the tax deducted from the payment for execution of contracts, you are required to pay this tax even you are suffering from a loss in that contract.
- Over reliance on the withholdingization is a major cause of narrow tax base. As long as our country will achieve targets for revenue by simply changing WHTs provisions, no sincere efforts will be made by the tax authorities for broadening the tax base.
- Tax administration hide their inefficiency by collecting major portion of income tax through WHTs. FBR uses WHTs collection in measuring its performance against the tax targets.
- Due to continuous increase in WHT rates, existing tax payers are suffering from extra tax burden. It has become the practice of the government to increase the rates of indirect taxes and WHTs to attain the tax targets.

KEY POLICY RECOMMENDATIONS

In the light of the analysis made by using available data on WHT system, we present the following recommendations to make it convenient and suitable for economy and business environment.

- Reliance on the WHTs should be reduced, because it is partially an indirect tax in the form of direct tax. Over reliance on WHTs affects the collection of income tax. In almost every

budget government changes the tax rates of WHTs and indirect taxes to meet the target of tax collection.

- Currently almost more than eighty types of transactions are included in the WHT regime. This number should be reduced to top 15 items which contribute almost 95% of the total WHT collection.
- Claiming of the adjustments of WHTs should be based on system generated figures. For example, income tax deducted from salary is written in the IRIS manually, it should be automatically inserted by the FBR system in the annual tax return of the individual.
- Because of many problems of the adjustments of WHTs, it is recommended by the tax professionals' bodies that this system should be replaced with the monthly advance tax system for the listed companies.
- There are no sincere efforts have been made by FBR to include more persons in tax net. New taxpayers should be brought in the net through the use of NADRA databases, data analytics and digitalization. In Pakistan, according to different estimates, tax gap is about 70% of the actual tax receipt. Its basic reason is reliance on the indirect taxes and WHTs, and absence of fruitful efforts for broadening the tax net.
- There are many items which are actually expenses of the consumers not incomes like purchase of motor vehicles, cash withdrawals from bank, cellular and internet services etc. All these items should be eliminated from the list of WHTs.
- Through this system FBR has obtained huge data regarding the persons who are non-filer but spending money on valuable purchases like property, motor vehicles, international air tickets etc. But still FBR is ineffective in the inclusion of these persons in tax net.

CONCLUSION

Higher dependence on the WHT depicts the failure of tax collection system. Our study suggests that we should reduce the dependence on the WHT system for the collection of income tax. There are many other problems associated with WHT regime which cause short collection and deposit of WHTs. In this project these problems are analyzed and suitable solutions are recommended.

We cannot eliminate WHT regime from our current taxation system. It will create problems in tax collection because still major portion of our economy is undocumented and out of tax net. In every budget, only changes are announced in WHTs and normal tax rates to increase the income tax collection. Now this practice should be avoided and strict steps should be taken to add more people in the tax net. Similar to the practices of many other countries, few items like salaries, profit on debt, dividend and royalty etc. should only be included in the list of WHT regime.

It is not possible to implement reforms in WHT regime and in overall taxation system without the strong institutional reforms in FBR. According to professionals, its only solution is to establish a National Tax Authority (NTA) to deal with all types of taxes in Pakistan. This is the only solution of the revenue problems of Pakistan and moving towards a just and equitable taxation system.