

TAXATION OF

RELEVANT TO ACCA QUALIFICATION PAPER F6 (PKN)

This article covers the key topic of capital gains. Question 3 of the Paper F6 (PKN) examination, worth 20 marks, will be on capital gains.

Easy marks can be earned in this question, as the provisions under the Income Tax Ordinance, 2001 (Ordinance), relating to capital gains, are neither numerous nor complicated, and are common to all persons chargeable under the Ordinance. An individual, an unincorporated body, a company, the Federal Government and a foreign government are all treated as a person for the purpose of the Ordinance.

NO SEPARATE TAX FOR CAPITAL GAINS

There is no separate capital gains tax. A gain under the income heading 'Capital Gains' forms part of the total income of a person. The total income of a person reduced by deductible allowances is the taxable income, which is chargeable to tax at the rate applicable to the person. Capital gains which are exempt from tax are not included in the total income.

WHEN DO CAPITAL GAINS ARISE?

Capital gains can only arise on the 'disposal' of a 'capital asset'. In other words, the tax provisions relating to capital gains do not apply unless the gain has arisen from the disposal of a capital asset.

A loss on the disposal of a capital asset, with certain exceptions, is deductible when computing the amount chargeable to tax. These exceptions are discussed in a subsequent paragraph.

CAPITAL ASSET

What is a capital asset?

The term 'capital asset' is broadly defined to mean property of any kind held by a person, whether or not connected with business. The definition is very wide, and the courts have held that capital assets include foreign currency, shares in a company, a business undertaking, a partner's share in a firm, and the right to exploit a piece of land. However, five categories of assets have expressly been excluded, under the Ordinance, from the definition of capital asset. Therefore, no gain or loss can be taken to arise on the disposal of these assets.

Assets not considered as capital assets

The following assets held by a person are expressly excluded from the definition of a capital asset:

- (i) Any stock-in-trade (except stocks and shares), consumable stores or raw materials, held for business purposes.

The exception refers to a situation where a person's stock-in-trade is represented by stocks and shares. In other words, stocks and shares held by a person as stock-in-trade is considered to be a capital asset. To illustrate: XYZ is a dealer in stocks and shares – the shares held by XYZ as stock-in-trade are considered a capital asset, and any gain or loss made on their disposal would be chargeable to tax as capital gains, unless the gain is exempt from tax.

- (ii) Any depreciable asset for which the person is entitled to a depreciation deduction when computing business income. To illustrate: a unit of machinery held for business purposes is entitled to a depreciation allowance when computing business income. Therefore, the machinery is not a capital asset.
- (iii) Any asset on which the person is entitled to an amortisation deduction when computing business income. To illustrate: intangibles such as patents, intellectual property or copyright are entitled to an amortisation deduction when computing business income, and are therefore not capital assets.

CAPITAL GAINS

(iv) Any immovable property.

To illustrate: land is immovable property and is therefore not a capital asset.

(v) Any movable asset held for personal use by the person or by any of the person's dependent family members.

However, the following movable assets (referred to as 'excluded assets'), though held for personal use, are treated as capital assets:

- paintings, sculptures, drawings or other works of art
- jewellery
- rare manuscripts, folios or books
- postage stamps or first day covers
- coins or medallions
- antiques

On the disposal of an excluded asset, a gain is treated as a capital gain, but a loss is not recognised as a loss and therefore is not deductible. To illustrate: a gain on the sale of jewellery held for personal use is a capital gain, but a loss is not recognised as a loss.

Shares acquired under an employee share scheme

Any share acquired under an employee share scheme ('Scheme') is a capital asset, and any gain on its disposal is chargeable to tax as a capital gain. A loss on the disposal of such a share is deductible.

However, a gain on the disposal of a right or option to acquire

shares under a Scheme is not chargeable to tax as a capital gain, but is chargeable under the heading 'Salary'. The value of a right or option to acquire shares under a Scheme granted to an employee is not chargeable to tax under the Ordinance.

DISPOSAL OF CAPITAL ASSETS

Modes of disposal

A person holding an asset is treated as having made a disposal when the person parts with the ownership of the asset. An asset is disposed of when the asset is sold, exchanged, transferred, distributed, cancelled, redeemed, relinquished, destroyed, lost, expired or surrendered.

When the asset of a deceased person is transmitted to an executor, or to a beneficiary by succession, or under a will, the transmission is treated as a disposal by the deceased at the time the asset is transmitted.

The use, by its owner, of a personal asset as a business asset is treated as a disposal of the personal asset. A personal asset is an asset held wholly for the personal use of the owner.

Modes of disposal where no gain or loss is recognised

Under the non-recognition rules, no gain or loss is taken to arise on the disposal of a capital asset if:

- the person acquiring the asset is resident for Pakistan tax purposes at the time of the acquisition, and

- the disposal of the asset is:
 - (i) between spouses under agreement to live apart
 - (ii) by reason of transmission of the asset to an executor or beneficiary on the death of a person
 - (iii) by reason of a gift by the owner of the asset
 - (iv) by reason of compulsory acquisition of the asset under any law, provided that the compensation received is reinvested by the owner of the asset in an asset of a like kind within one year of the disposal
 - (v) by a company to its shareholders on the liquidation of the company
 - (vi) by an association of persons to its members on dissolution of the association, provided the assets are distributed to the members in accordance to their interests in the capital of the association.

FAIR MARKET VALUE

The concept of fair market value (FMV) is often used when determining the cost of an asset, and also when determining any consideration received. The FMV of an asset at a particular time is the price which the asset would fetch on its disposal in the open market at that time. There can be a situation where the open market price of an asset is not available. In this situation,

THE TERM 'CAPITAL ASSET' IS BROADLY DEFINED TO MEAN PROPERTY OF ANY KIND HELD BY A PERSON, WHETHER OR NOT CONNECTED WITH BUSINESS. FIVE CATEGORIES OF ASSETS HAVE EXPRESSLY BEEN EXCLUDED, UNDER THE INCOME TAX ORDINANCE 2001, FROM THE DEFINITION OF CAPITAL ASSET.

the FMV is to be determined by the Commissioner. In all cases, the FMV of an asset is to be determined without regard to any restriction on the transfer of the asset or its convertibility to cash.

CONSIDERATION RECEIVED

Disposal of an asset

The consideration received on the disposal of an asset is the amount received plus the FMV of any consideration received in kind, or the FMV of the asset, whichever is the higher.

Assets lost or destroyed

When an asset is lost or destroyed by a person, the consideration received for the asset shall include any compensation, indemnity or damages received under an insurance policy, settlement or judicial decision.

Personal asset used for business use

The FMV of the personal asset on the date the asset is used for business is treated as the consideration received.

Disposal of two or more assets in a single transaction

Where the consideration received for each asset is not specified, the total amount received is apportioned among the assets disposed of, in proportion to the respective FMVs of each asset at the time of the transaction.

THE COST OF AN ASSET PRODUCED OR CONSTRUCTED BY A PERSON IS THE COST INCURRED IN PRODUCING OR CONSTRUCTING THE ASSET, AND ANY EXPENDITURE INCURRED IN ALTERING OR IMPROVING THE ASSET, PROVIDED THE EXPENDITURE HAS NOT BEEN ALLOWED AS A DEDUCTION.

Disposal of an asset in a non-arms length transaction

When a person disposes of an asset in a non-arms length transaction, the FMV of the asset at the time of the disposal is treated as the consideration received by the person.

COST OF ACQUISITION OF A CAPITAL ASSET

Asset purchased

The cost of an asset purchased by a person is the sum of:

- the consideration paid, including the FMV of any consideration in kind, and
- any expenditure incurred in acquiring the asset and in altering or improving the asset, provided the expenditure has not been allowed as a deduction.

Asset produced or constructed

The cost of an asset produced or constructed by a person is the cost incurred in producing or constructing the asset, and any expenditure incurred in altering or improving the asset, provided the expenditure has not been allowed as a deduction.

Shares acquired under an employee share scheme

The cost of shares acquired under an employee share scheme (Scheme) is the sum of:

- the amount, if any, paid by an employee for the grant of the right or option to acquire the shares
- the amount paid for acquiring the shares, and

- the amount chargeable to tax in the employee's income under the heading 'Salary'.

EXAMPLE 1

Under a Scheme, Mr Bee, an employee of XYZ Ltd, is granted the right to acquire 10,000 shares in XYZ Ltd at the exercise price of Rs. 10 per share. The Rs. 10 is inclusive of a consideration of Rs. 1 per share for the right to acquire the shares.

On 1 July 2007, Mr Bee accepts the offer for the right to acquire the 10,000 shares and makes a payment of Rs. 10,000 (Rs. 1 x 10,000) to the custodian of the Scheme.

On 1 September 2007, Mr Bee exercises the right to acquire the 10,000 shares and makes a payment of Rs. 90,000 (Rs. 9 x 10,000). Mr Bee has already paid Rs. 10,000 at the time of accepting the rights.

The 10,000 shares in XYZ Ltd are issued to Mr Bee on 1 September 2007, when the price quoted for one share in XYZ Ltd on the Karachi Stock Exchange is Rs. 50. The difference of Rs. 40 per share (Rs. 50 per share less the Rs. 10 per share paid by Mr Bee), equal to Rs. 400,000 (Rs. 40 x 10,000), is the salary income of Mr Bee chargeable to tax under the head 'Salary'.

The cost of the 10,000 shares in XYZ Ltd is Rs. 500,000. **Table 1** on **page 61** shows the make-up of Rs. 500,000.

THE GAIN ON THE DISPOSAL OF A CAPITAL ASSET IS THE DIFFERENCE BETWEEN THE CONSIDERATION RECEIVED ON THE DISPOSAL OF AN ASSET AND ITS COST. THE ENTIRE GAIN IS CHARGEABLE TO TAX AS CAPITAL GAINS, UNLESS THE ASSET HAS BEEN HELD FOR MORE THAN ONE YEAR.

TABLE 1: MAKE-UP OF COST OF THE 10,000 SHARES IN XYZ LTD

| | Rupees |
|--|----------------|
| Rs. 1 paid on accepting the right to acquire 10,000 shares (Rs. 1 x 10,000) | 10,000 |
| Rs. 9 paid on acquisition of 10,000 shares (Rs. 9 x 10,000) | 90,000 |
| Amount chargeable to tax as Mr Bee's salary income on the acquisition of 10,000 shares | <u>400,000</u> |
| | <u>500,000</u> |

Asset acquired where no consideration is payable

There is no consideration payable when an asset is acquired by a person:

- under a gift, bequest or will
- by succession, inheritance or devolution
- on the distribution of assets on the dissolution of an association of persons
- on the distribution of assets on the liquidation of a company.

In the above cases, the FMV of the asset on the date of its transfer or acquisition by the person is considered to be the cost of the asset.

EXAMPLE 2

Mr Dee inherited an original painting on the death of his father on 1 April, 1930. From the records available, it was determined that Mr Dee's father had bought the painting in an auction for Rs. 300,000 in 1920. Mr Dee had the painting valued by an expert a few days after his

father's death. The expert valued the painting at Rs. 1,000,000.

The cost of the painting for Mr Dee is Rs. 1,000,000, i.e. the FMV of the painting on the date of its acquisition by Mr Dee, and not the Rs. 300,000 paid for the painting by Mr Dee's father.

Asset acquired with a foreign currency loan

Where a person has acquired an asset with a loan denominated in a foreign currency (and repayable in foreign currency), if, before the loan is fully paid, there is an increase or decrease in the loan liability of the person (in terms of Pakistan rupees) due to a change in the rate of exchange, the amount by which the liability has increased or decreased (after taking into account any hedging agreement) will be added to or taken from the cost of the asset.

In other words, any loss caused by exchange rate fluctuations is to be added to the cost of the asset, whereas any gain reduces the cost of the asset.

Cash assistance for the acquisition of an asset

The cost of an asset has to be reduced by the amount of any grant, subsidy, rebate, commission or other assistance received or receivable by the person in respect of the acquisition of the asset, except to the extent to which the grant, subsidy, etc., is chargeable to tax under the Ordinance.

Asset acquired in a non-arms length transaction

As stated in an earlier paragraph, in a non-arms length transaction, the FMV of the asset at the time of its disposal is treated as the consideration received by the person disposing of the asset. The person acquiring the asset is treated as having a cost equal to the consideration received by the person disposing of the asset.

COMPUTING CAPITAL GAINS

Gain on the disposal of a capital asset

The gain is the difference between the consideration received on the disposal of an asset and its cost. The entire gain is chargeable to tax as capital gains, unless the asset has been held for more than one year. If the asset has been held for more than one year, 75% of the gain is chargeable to tax.

Loss on the disposal of a capital asset

The loss is the difference between the cost of an asset and the consideration received on its disposal.

Loss allowed as a deduction

When computing capital gains, a loss on the disposal of a capital asset is allowed as a deduction except where:

- a loss on the disposal of certain movable assets held for personal use (referred to earlier in this article as ‘excluded assets’) is not recognised as a loss and is therefore not deductible; such assets include jewellery, paintings, rare manuscripts, antiques, etc
- a loss on the disposal of a capital asset is made when a gain is not chargeable to tax; for example, a disposal of shares in a company listed on a recognised stock exchange in Pakistan is presently exempt from tax: a loss on the disposal of such shares is not deductible.

CARRY FORWARD OF CAPITAL LOSS

A loss under the income heading ‘Capital gains’ (referred to as a ‘capital loss’) cannot be set off against any other income heading when computing a person’s total income.

A capital loss can be carried forward and is available for set-off only against capital gains in a subsequent year.

A capital loss cannot be carried forward for more than six years immediately succeeding the tax year in which the loss was first computed. To illustrate: a person sustaining a capital loss in the income year ended 30 June 2002 can carry forward the loss up to the income year ended 30 June 2008 (tax year 2008). If all (or some) of the loss is not absorbed by then, the unabsorbed portion of the loss lapses and cannot be carried forward further.

If the loss carried forward includes losses of more than one year, the loss of the earliest tax year is set off first.

CAPITAL GAINS EXEMPT FROM TAX

Part I of the Second Schedule of the Ordinance

Part I relates to income (or classes of income) or persons (or classes of persons) which are exempt from tax, subject to the conditions and to the extent specified for each exemption. The following exemptions are relevant for examination purposes:

- ▣ Capital gains on the disposal of modaraba certificates or any instrument of redeemable capital listed on any stock exchange in Pakistan, or shares in a public company (as defined for Pakistan tax purposes) derived by a taxpayer; these are exempt from tax up to the tax year ending 30 June 2010.

A LOSS UNDER THE INCOME HEADING ‘CAPITAL GAINS’ (REFERRED TO AS A ‘CAPITAL LOSS’) CANNOT BE SET OFF AGAINST ANY OTHER INCOME HEADING WHEN COMPUTING A PERSON’S TOTAL INCOME. A CAPITAL LOSS CAN BE CARRIED FORWARD AND IS AVAILABLE FOR SET-OFF ONLY AGAINST CAPITAL GAINS IN A SUBSEQUENT YEAR.

- ▣ Capital gains on the disposal of shares in a public company (as defined for Pakistan tax purposes) derived by any foreign institutional investor, provided the foreign institutional investor is approved by the Federal Government for the purpose of this exemption.
- ▣ Capital gains on the disposal of a membership right held by a member of an existing stock exchange for the acquisition of shares and trading, or clearing rights acquired by such member in a new corporatised stock exchange in the course of corporatisation of an existing stock exchange.
- ▣ Capital gains on the disposal of a capital asset of the existing stock exchange to a new corporatised stock exchange, in the course of corporatisation of an existing stock exchange.

Limitation of exemption

The exemption from tax of any income, in the absence of a specific provision to the contrary, is limited to the original recipient of the exempt income and cannot be extended to any person receiving any payment out of that exempt income.

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