CHAPTER 1

SYSTEM OF TAXATION

Why governments tax, the canons and principles behind tax laws, the kinds of taxes, the main taxes in Pakistan and how income tax law developed. A theory chapter — learn the **lists** and the **matching of examples to concepts**.

CHAPTER ROADMAP

1 **Objectives of tax laws** — revenue · policy
2 **Basics of taxation laws** — canons · kinds
3 **Taxation laws of Pakistan** — direct · indirect
4 **History of tax laws** — 1860 → 2001

DEFINITION **Taxation** is the process by which the sovereign, through its **law-making body**, raises revenue to meet the expenses of government — under the authority of law, to promote the welfare and protection of its citizens.

1 OBJECTIVES OF TAX LAWS

revenue and non-revenue

1 REVENUE
Collect revenue to **run and administer** the Government.

2 POLICY TOOL
Use tax as a tool to **implement government policies**.

3 FAIR DISTRIBUTION OF WEALTH
Reduce **inequalities** in the distribution of wealth.

4 DEVELOPMENT
Exemptions and incentives to strengthen **weak enterprises**; promote science, invention and education.

5 PROTECTION
Raise import taxes to **protect local industries** against foreign competition.

6 TRADE & ECONOMY
A **bargaining tool** in trade negotiations; counter the effects of **inflation or depression**.

7 REMOVE DISCRIMINATION
Laws that eliminate discrimination among elements in the markets / businesses.

8 DISCOURAGE
Discourage certain **undesirable sectors and activities**.

Illustration — match the tax law to its objective:

Tax law / measure	Objective
Tax on salary income	Revenue collection
Amount transferred otherwise than through a banking channel deemed income	Documentation of the economy
Tax on moveable assets of taxpayers	Fair distribution of wealth
Higher taxes on import of luxury goods	Fewer unnecessary imports · balance of trade
Allowability of research and development expenditure	Promote research and development
Zero rating of exports	Promotion of exports
Tax credit on donations to approved institutions	Charity through recognised, regulated bodies
Tax credit on contribution to approved pension fund	Long-term savings, retirement planning
Tax incentives for IT and software activities	Promote the software industry

2 TAXES AS A MEANS FOR DEVELOPMENT

not just revenue

FREE / ECONOMIC ZONES
Tax incentives in underdeveloped areas attract industry, jobs and prosperity.

PROGRESSIVE RATES
Tax the **rich at higher rates**, low-income groups at lower rates.

HIGH DUTY ON LUXURY
Promotes the **local manufacturing** industry.

TAX CREDIT ON DONATIONS
Promotes **welfare activities**.

EXEMPTIONS TO CHARITIES
Charitable and educational institutions are exempt to promote their work.

AGRICULTURE EXEMPTION
Exemption promotes agriculture; agricultural income falls under the **provincial** framework.

3 CANONS OF TAXATION

Adam Smith · Wealth of Nations

EQUALITY
Payments **proportional to income**, applied equally.

CERTAINTY
Tax liability must be **clear and certain**.

CONVENIENCE
Collected at a **time and in a manner** convenient to the taxpayer.

ECONOMY
Cheap to collect; must not discourage business.

4 PRINCIPLES FOR LEVY OF TAX

three broad principles

BENEFIT PRINCIPLE
Taxed in proportion to the **benefits received** from government programmes.

ABILITY-TO-PAY
Related to income or wealth: those who can afford more pay more; the **rate can rise** with income.

EQUAL-DISTRIBUTION
A **fixed percentage**: who earns / spends more pays more tax, but **not a higher rate**.

5 KINDS OF TAXES

by how the rate behaves

PROPORTIONAL / FLAT
Same percentage for all. Example: flat **15% on dividend**.

REGRESSIVE
Takes a larger share of a **low income**; hits the poor harder. Example: **18% sales tax** on consumer goods.

PROGRESSIVE
Takes a larger share of a **high income**. Example: salary slabs rising **0% to 35%**.

6 CHARACTERISTICS OF TAX

seven features

1 ENFORCED CONTRIBUTION
Payment is **not voluntary**; it does not depend on the will of the taxpayer.

2 PAID IN MONEY
Through the **prescribed modes**; payment in kind is not accepted.

3 PROPORTIONAL, PROGRESSIVE OR REGRESSIVE
The rate structure may take any of the three forms.

4 ON INCOME, TRANSACTIONS OR PROPERTY
Taxes fall on acts, rights, privileges, income or property.

5 LEVIED BY THE STATE WITH JURISDICTION
Only persons, property or transactions **within its jurisdiction** are taxed.

6 LEVIED BY THE LAW-MAKING BODY
The law must first be **enacted by Parliament**.

7 FOR PUBLIC PURPOSES
Revenue for public services, and for wider economic and social aims.

7 PRINCIPLES OF A SOUND TAX SYSTEM

four principles

FISCAL ADEQUACY
Revenue sufficient for government spending and able to expand or contract.

EQUALITY
Based on the citizen's **ability to pay**.

ADMINISTRATIVE FEASIBILITY
Clear, enforceable by trained officials, convenient, not burdensome.

CONSISTENCY
Compatible with the **economic goals** of the government.

8 TAXES IN PAKISTAN

direct and indirect

Tax	Type	Key points
Income tax	Direct	Principal federal direct tax (ITO 2001). Five heads: **salary, property, business, capital gains, other sources**.
Capital Value Tax	Direct	Imposed on specified assets, transactions or rights; rate depends on the asset or transaction.
Customs duty	Indirect	Import and export duties; higher rates on luxury and less essential goods; **lower on plant, machinery and raw material**.
Federal Excise Duty	Indirect	Federal Excise Act, 2005; on value, quantity, retail price etc.; HS classification; **exports 0%** and duty paid is refundable.
Sales tax	Indirect	Importer pays on imports; registered person on taxable supplies; **input tax adjusted** against output tax; rate may differ from 18%. Services: federal or provincial law.

9 HISTORY OF TAX LAWS

1860 → 2001

Law	What to remember
Income Tax Act, 1860	First formal income tax; meant to end the budget deficit after 1857; **temporary, repealed in 1865**.
Income Tax Act, 1886	General income tax; **defined agricultural income**; stayed in force **32 years**.
Super Tax Act, 1917 · Act of 1918	Graduated super tax on income over Rs. 50,000; 1918 Act consolidated wartime amendments.
Income Tax Act, 1922	Consolidated the income tax and super tax Acts; in force till **30 June 1979**.
ITO, 1979	Effective 1 July 1979.
ITO, 2001	**Promulgated 13 September 2001**; effective **1 July 2002**.

10 EXAM FOCUS · MCQ TRAPS

what examiners test

1 Law first
A tax needs an **Act of Parliament**; an executive circular is not enough.

2 Money, not kind
Tax is paid **in money** through prescribed modes.

3 Three different lists
Canons: equality, certainty, convenience, economy. **Levy**: benefit, ability, equal-distribution. **Sound system**: fiscal adequacy…

4 Flat ≠ progressive
Flat = same rate; progressive = rising slabs; regressive = uniform tax that burdens the poor.

5 CVT is direct
Income tax and CVT are direct; customs, FED and sales tax are indirect.

6 FED on exports
Exports are **zero-rated**; duty paid is refundable.

7 Jurisdiction
No jurisdiction over the person or property, no tax.

8 Dates
ITO 2001: promulgated 13 Sep 2001, **effective 1 Jul 2002**; 1886 Act ran 32 years.

CLASSIFY IT · KIND OR PRINCIPLE?

1	Flat 15% tax on dividend	PROPORTIONAL
2	18% sales tax on consumer goods	REGRESSIVE
3	Salary slabs rising from 0% to 35%	PROGRESSIVE
4	Higher income, higher rate	ABILITY TO PAY
5	Same percentage for all; big spenders pay more rupees	EQUAL-DISTRIBUTION
6	Pay for the benefit you receive	BENEFIT
7	Rates and due dates clearly stated in the law	CERTAINTY
8	Tax deducted when salary is paid	CONVENIENCE

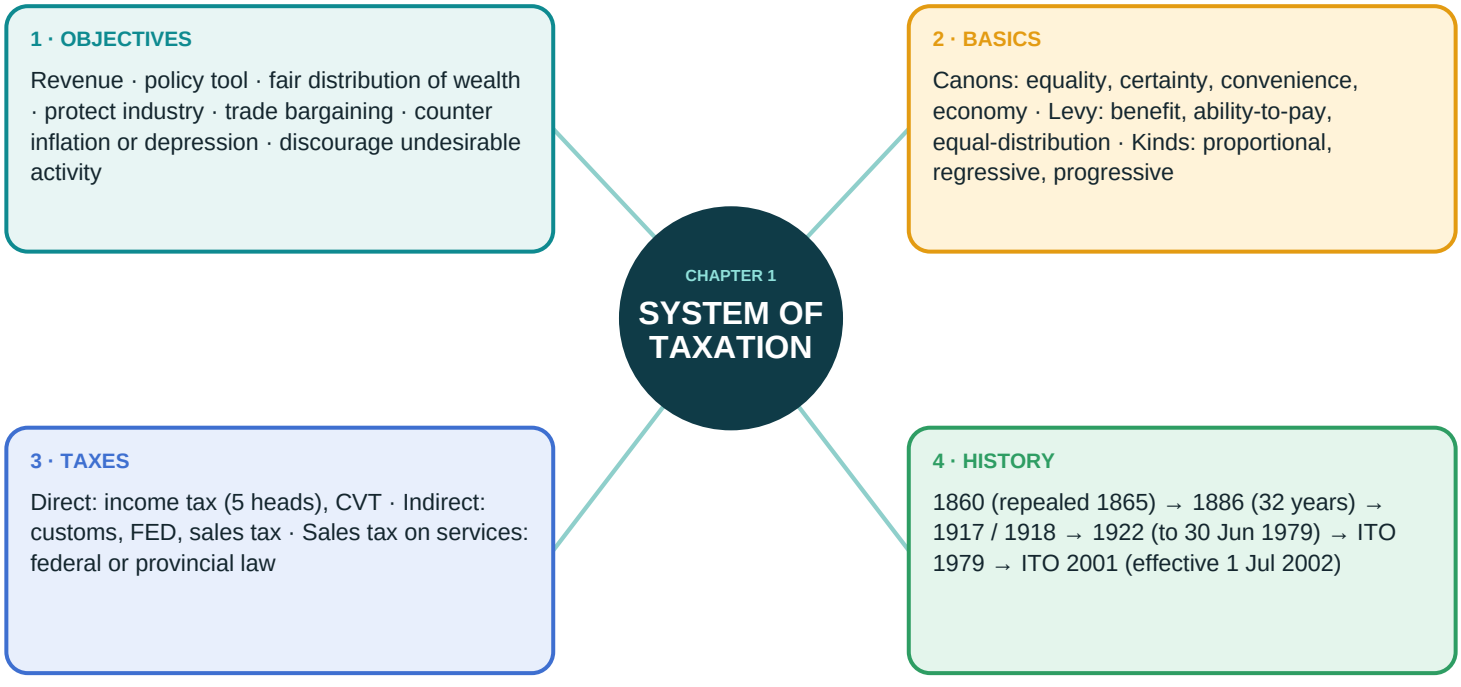
CLASSIFY IT · TYPE OR AIM?

1	Income tax	DIRECT
2	Capital Value Tax	DIRECT
3	Customs duty	INDIRECT
4	Federal Excise Duty	INDIRECT
5	Sales tax on goods	INDIRECT
6	Zero rating of exports	PROMOTE EXPORTS
7	Banking-channel deeming rule	DOCUMENTATION
8	Tax on moveable assets	WEALTH SHARING

LISTS TO KNOW

Canons	Levy	Direct	Indirect	ITO 2001
Equality · Certainty · Convenience · Economy	Benefit · Ability · Equal-distribution	Income tax · CVT	Customs · FED · Sales tax	Effective 1 July 2002

REVISION MAP



Objectives
Revenue plus policy aims.

Canons
Four: equal, certain, convenient, economic.

Kinds
Flat, regressive, progressive.

Taxes
Direct vs indirect.