HBL P@SHA
Pakistan IT Industry Association

Policy Jirga

Taxation, Regulations, & Policy Directives

https://www.pasha.org.pk

Introduction

Pakistan's IT sector has been a significant contributor to the country's economic growth, with a thriving ecosystem of startups, entrepreneurs, and professionals. However, the sector faces several taxation issues that threaten to undermine its progress. Pakistan's tax system is inherently complex, leading to high compliance costs and burdens for taxpayers, including those in the IT sector. The country ranks[1] 161st out of 190 economies for the "paying tax" indicator, underscoring the difficulty and complexity of complying with tax regulations.

Pakistan Ranks 161st out of 190 economies for the "paying tax" indicator

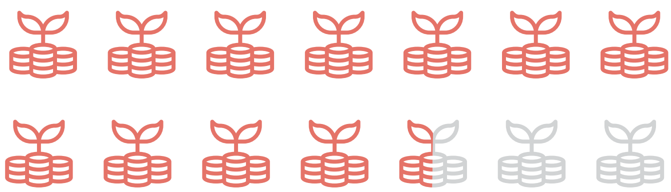
In the purview of this, **P@SHA** arranged a Policy roundtable "Policy Jirga - Taxation, Regulations, and Policy Directives" at ITCN Asia Lahore, 2024. The roundtable was attended by key stakeholders from the IT sector and important regulatory authorities including the State Bank of Pakistan, Federal Board of Revenue and Pakistan Telecommunication Authority. .

The recent budget for fiscal year 2024-2025 has imposed[2] higher income taxes on skilled salaried IT professionals, which could lead to a brain drain and negatively impact the industry's growth trajectory. Furthermore, the doubling of the General Sales Tax (GST) on IT hardware from **5%** to **10%** is expected to hinder digitization efforts and harm both consumers and the tech industry. The withdrawal of tax credits and incentives previously available to the IT sector, such as the 100% tax credit regime for software and IT-enabled services exports, has also raised concerns.

Potential of Pakistan's IT Industry

The IT industry is now Pakistan's largest services export sector, achieving a **88% trade surplus**[3]. This indicates the industry's competitiveness and ability to generate significant export revenues.

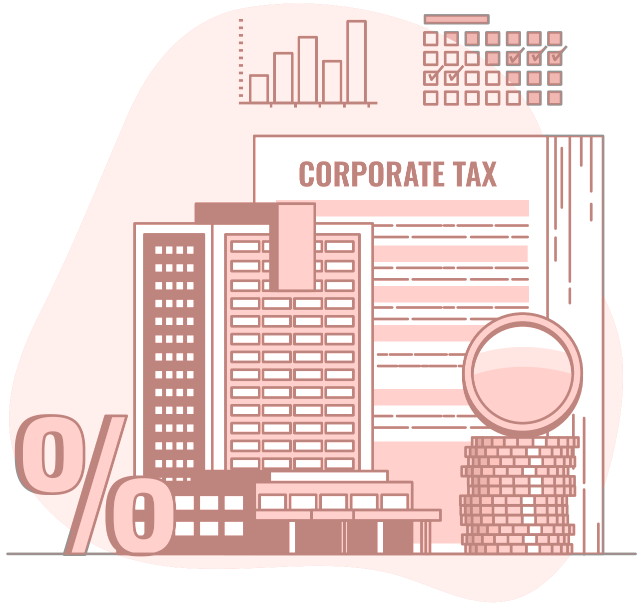
[1] https://karandaaz.com.pk/media-center/news-events/karandaaz-launches-report-state-business-taxation-pakistan-challenges-smes/
[2] https://profit.pakistantoday.com.pk/2024/06/16/new-taxes-threaten-it-sector-stability/
[3] https://www.finance.gov.pk/survey/chapters_23/15_Information_Technology.pdf



Pakistan's IT sector is **88% trade surplus**

The government has set its sights high, aiming to expand IT exports exponentially. The goal is to reach[4] $10-20 billion within the next five years, which is an ambitious 4-8 times increase from the current level of $3 billion.

To achieve this significant growth, several initiatives are planned. These include training a substantial workforce of 200,000 new IT professionals, supporting the growth of a freelance IT sector with 500,000 freelancers, and streamlining processes by improving payment processing and regulatory frameworks.



Regulatory Challenges:

Employment Taxation Issues

The panelists discussed the crucial distinction between employees and remote workers (self-classified freelancers) in Pakistan, emphasizing that misclassifying workers can lead to non-compliance and potential tax liabilities. Some of the key highlighted points were:

- The distinction between employees and remote workers is crucial in Pakistan. Misclassifying workers can lead to non-compliance and potential tax liabilities. Companies must ensure[5] that they correctly classify their foreign hires as employees to avoid legal risks and fines.
- Compliance with taxation regulations is essential for overseas employers. Failure to comply can result in legal risks, and damage to the company's reputation. It is recommended that companies consult with professional accountants or lawyers to ensure the legality and compliance of their operations in Pakistan.
- When hiring foreign workers, employers must deduct[6] personal income tax from their salaries as per the Federal Board of Revenue's requirements. This includes understanding the tax implications of foreign income and ensuring that the correct taxes are withheld and remitted.

[4] https://thediplomat.com/2023/11/adjusting-pakistans-tech-sector-priorities/
[5] https://workmotion.com/top-10-international-payroll-tax-mistakes-and-how-to-avoid-them/
[6] https://workmotion.com/top-10-international-payroll-tax-mistakes-and-how-to-avoid-them/

State Bank

Senior representatives from the State Bank of Pakistan, one of the key economic regulators of the industry, were invited to the roundtable discussion. Key points included:

Ease of doing business

Allow software exporters to retain 100% of their export earnings in Exporters' Special Foreign Currency Accounts (ESFCAs) with Authorized Dealers, up from the current 50%.

1. Identified Challenges

- Inadequate bank infrastructure.
- Delays in issuing debit cards.
- Challenges in equity investments abroad.

2. Urgent Requests to SBP

- Expedite the ESFCA process so more companies can avail the benefits of ESFCA.
- Exempt corporate debit cards from additional taxes.
- The issuance of corporate debit cards has not been fully implemented by Commercial Banks as per SBP circular dated February 23, 2024.

3. Highlighted Needs

- Increase retention limits to support IT companies' growth.
- Streamline payment processes for imports and IT services.
- Raise the annual expense limit for marketing offices abroad from USD 30,000 to USD 1 million.
- Allow fund transfers for business expansion to improve ESFCA functionality and ease business operations for Pakistani IT exporters.

4. Taxation Issues:

- The current policy imposes a 5% tax on corporate debit cards linked to ESFCAs for each transaction, in addition to the 0.25% Final Tax Regime (FTR) paid by IT companies on their export proceeds.
- It was proposed to exempt corporate debit card transactions from the additional 5% tax to avoid double taxation and promote the use of ESFCAs.

P@SHA's Advocacy Yields Results

The State Bank of Pakistan has approved amendments to the Policy for Equity Investment Abroad by Residents to facilitate Exporters, especially those in the IT sector. The revisions can be accessed in the provisions of Para 13(II)A of Chapter 20 of the Foreign Exchange Manual (FEM). These changes will help our tech companies grow their international presence and increase the country's exports.

Key updates include

- A new category of Equity Investment Abroad (EIA), specifically for export-oriented IT companies.
- No longer need prior bank designation for exporters utilizing funds from Exporters Special Foreign Currency Accounts (ESFCAs).
- IT exporters can now acquire interest (shareholding) in entities abroad.
- The previous restriction of establishing or acquiring only one entity per jurisdiction has been lifted.

The revisions can be accessed here: https://www.sbp.org.pk/epd/2024/FEC1-AnnexA.pdf

5% Tax on Corporate Debit Cards

Despite IT Companies Paying

0.25% Final Tax on Exports

Remote Workers' Taxation Proposal by P@SHA

The panelists discussed how employing remote workers under contracts versus freelancers affects tax dynamics and operational impacts on the IT sector.

Remote workers are employed under contracts, unlike freelancers who have consultancy agreements. The classification of these roles affects tax and operational dynamics.

Key Issues

Reclassification Trend

01

Senior employees in the IT sector are being reclassified as freelancers to benefit from lower tax rates, which could lead to:

- Reduced government tax revenue.
- Higher per capita productivity loss due to less investment in training and development.

Operational Impact

02

Foreign companies hiring remote employees from Pakistan benefit from lower costs. However, this results in:

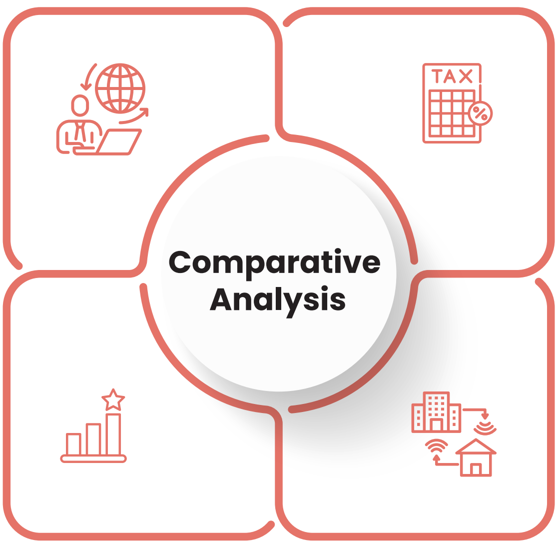
- Loss of senior employees for Pakistani entities.
- Pressure on Pakistani entities to increase salaries, impacting their operations.

Tax Avoidance

03

Remote employees often evade taxes through:

- Declaring salaries as family remittances.
- Maintaining undisclosed foreign bank accounts.
- Misclassifying income as export proceeds to benefit from lower tax rates.



Inflation Protection

Remote workers are protected from PKR depreciation by earning in foreign currencies.

Tax Rates

Corporate employees pay 5-35% in taxes, while remote workers pay significantly less, often only 1%.

Salary Levels

Remote workers earn substantially more compared to corporate employees due to the absence of intermediaries.

Flexibility

Remote workers have complete work-from-home flexibility, unlike corporate employees.

Potential Challenges

Government Revenue
Reduced tax rates might lower immediate tax revenue but could be offset by long-term benefits.

Discrimination Claims
Other sectors might perceive this as discriminatory, potentially leading to litigation against the government.

Enhancing IT Trade and Investment

Renegotiate FTAs like the one with China to remove[7] unfair advantages for imports and protect local IT industries.

Utilize existing[8] agreements like the Generalized System of Preferences (GSP) to reduce tariffs on IT imports from Pakistan.

Explore opportunities to expand[9] bilateral IT trade and investment cooperation with strategic partners.

Conclusion

Pakistan's IT sector faces a conflict between complex taxation structures and its significant potential for growth. While the industry boasts a trade surplus and ambitious export targets, recent tax regulations and the high cost of compliance threaten to stifle its progress.

The roundtable discussion highlighted the challenges of employee classification, tax evasion among remote workers, and the unattractiveness of corporate employment due to higher tax rates. P@SHA proposed solutions including tax rate adjustments and reduced business costs for the IT sector.

To truly harness the IT sector's potential, the government needs to find a balance between tax revenue generation and fostering a competitive environment. Streamlining regulations, addressing the remote workers (self-classified freelancers)-employee distinction, and offering tax incentives are crucial steps. Additionally, renegotiating trade agreements and utilizing existing programs can further fuel the IT industry's growth and position Pakistan as a strong competitor in the global market.

[7] https://www.brecorder.com/news/40217040
[8] https://www.brecorder.com/news/40217040
[9] https://www.sgs.com/en-sa/news/2023/07/import-substitution-advisory-creating-cluster-for-localization

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