Inequities in the Taxation of Mutual Funds

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In his budget speech the Finance Minister stated that distortions and inequities in the mutual fund industry and other corporate entities are proposed to be removed.

Through Finance Act 2014, the Government introduced following amendments in the Income Tax Ordinance, 2001 relating to mutual funds.

- Insertion of new proviso in clause 99 of Part 1 of Second Schedule to the Income Tax Ordinance, requiring mutual funds to distribute as cash dividend to unit holders at least ninety per cent of its income reduced by realized and unrealized capital gains to qualify for exemption from income tax; bonus distribution will not qualify for exemption.

- New definition of "Stock Fund" introduced that means a collective investment scheme or mutual fund which invests at least 70% of its investible funds in equity securities.

- For mutual funds, separate rates of tax on dividend have been prescribed for stock funds and funds other than stock funds. For stock funds, tax rate shall be 10% if dividend constitutes more than 50% of mutual funds' income and 12.5% if capital gains constitute more than 50% income of mutual fund.

- For all other categories of mutual funds, except stock funds, the rate of tax on dividend is fixed at 10%; however, for corporate investors the rate of tax on dividend is fixed at 25%.

- The holding period for exemption from capital gains tax has been increased from one to two years. If securities subjected to capital gains tax are disposed within one year after acquisition, the capital gains tax will be levied at 12.5% ; If these are disposed within two years the capital gains tax will be levied at 10% and if these are disposed after two years there will be no capital gains tax.

It is pertinent to highlight that there are many other distortions or inequities with respect to taxation of mutual funds. Through the amendments mentioned above, a few inequities have been removed, but other inequities were not addressed; also new inequities have been created. Before we examine the taxation of mutual funds and the inequities, it is necessary to examine the role of mutual funds in economy and principles governing taxation of mutual funds.

Role of Mutual Funds in Economy

A mutual fund is a mechanism for pooling resources by issuing units to the investors and investing funds in securities in accordance with the objectives disclosed in the respective offering documents. It offers an array of products like equity funds, income funds, cash funds and multiples of hybrid funds/ plans. By investing in mutual funds, investors' worries are taken care of by fund managers, who backed by a dedicated research team, handles the investment decisions based on the performance and prospects available in the market. Unlike fixed deposits, bonds and Government securities, mutual funds do not provide a guaranteed return. Their returns are directly related to performance of the underlying investment. Mutual funds' management company charge the service fee that is capped at 2% (3% for initial five years) by the Securities and Exchange Commission of Pakistan. Normally the Fund Management Companies charge 2% fee for equity funds and 1.5% and lower for fixed income and cash funds. Mutual funds also help small investors in risk diversification by investing in larger basket of securities and in different asset classes. In Pakistan mutual funds are well regulated and over a period of time the regulators' capacity to regulate has improved considerably.

Mutual funds have an important role in the development of the capital markets. In many countries, through mutual funds and pension funds, it has been possible to convert workers into individual owners of the country's capital and create a cultural atmosphere more consistent with free market and free country. Mutual funds help in improving corporate governance. A paper prepared at University of Delaware on Corporate Governance states that "monitoring influence of institutions is associated more with potentially active institutions (investment companies and pension fund managers who would be less sensitive to pressure from corporate management due to lack of potential business relations) than with potentially passive institutions (banks and insurance companies who would be more pressure sensitive)." Economic parameters, such as savings, capital market development, dispersal of corporate ownership and corporate governance are related to the development of mutual funds industry. In jurisdiction throughout the World legislators have provided competitive environment and level playing field to mutual funds to grow.

In Pakistan, the mutual fund industry has completed half century of its existence but has not been able to achieve the desired level of popularity/participation. This is depicted by the fact that there were only 244,362 mutual fund accounts with asset management companies on June 30, 2014 in a country whose population is over 180 million people and assets valuing Rs. 416 billion. Much of this is largely due to historically low savings rate in Pakistan and that in recent years has been on further decline due to lack of initiative on the part of the Government to promote savings.

Two principles govern the taxation of mutual funds. First, there is tax-neutrality principle that states that for investors, whether they invest directly in securities or through mutual funds it should be tax neutral. Second, there is a pass-through principle that states that mutual funds being pass-through entities are not subject to tax; investors to mutual funds are subject to income tax and capital gains tax.

Tax to be neutral whether investor invests direct in securities or through mutual fund.

Mutual Funds have been subjected to three types of taxes that an investor making direct investment in securities is not. These taxes are against the principle of tax neutrality. The impact of these taxes is on all categories of mutual funds and voluntary pension schemes but it is more severe on money market funds and other fixed income funds.

- **Workers Welfare Fund (WWF):** The Finance Act 2008 introduced an amendment, whereby the scope of WWF was extended to all establishments to which the West Pakistan Shops & Establishments Ordinance, 1971 applied. The FBR presumed that this amendment extended the applicability of the Ordinance so extensively that contributions could be claimed on saving schemes such as mutual funds and voluntary pension funds, as if these are commercial establishments. Mutual funds' management companies (AMC) have contended that AMC are establishments and subject to WWF and that mutual funds and voluntary pension funds, not being establishments could not be subject to WWF. Ministry of Labour and Manpower supports this view and MUFAP has a very clear clarifications issued by them that WWF is applicable on asset management companies but not on mutual funds. FBR has however persisted in having notices for WWF sent to mutual funds. Mutual funds and voluntary pension funds have filed a petition in the Honourable Sindh High Court against the imposition of WWF on mutual funds and pension funds that is pending since 30th June, 2010. Meanwhile the mutual funds and pension funds are providing for WWF and the return to investors is reduced by the provision.

- **Provincial Sales Tax:** The provincial sales tax levied from July 2011 is not tax neutral as this tax is not borne by investors directly investing in securities. As such this tax is against the principle governing taxation of mutual funds. As most of the AMC and funds are registered in the province of Sindh, the tax is paid in Sindh. The law governing Sindh Sales Tax enacted by Sindh Revenue Board (SRB) states that sales tax to be provided where business is registered. Meanwhile the Punjab Revenue Authority (PRA) came up with a law that states sales tax to be provided where business is provided. During last financial year, the Punjab Government also started demanding Sales Tax on strange plea that some unit holders are resident in Punjab and has demanded a share based on population of the provinces and not on percentage of unit holders. AMCs collectively through MUFAP were discussing with both PRA and SRB to resolve the matter amongst them but due to no positive action, AMCs had to obtain stay order from the Honourable Sindh High Court against the tax demanded by the PRA. If the Punjab Government had felt that they were entitled to a share in the Sales Tax, this matter could be settled between Punjab and Sindh Governments or the Council of Common Interest should determine the formula for each province rather than harassing the AMCs.

- **Federal Excise Duty:** Through Finance Act 2013, yet another tax was imposed on mutual funds and pension funds that are not paid by investors making direct investment in securities. However, this tax became controversial as imposing such tax on services is a provincial subject. After the 18th amendment to the Constitution through the Constitution (Eighteenth Amendment) Act, 2010, only the provinces can impose sales tax on services. FED on services is no different than sales tax on services since the taxable event is the same and as such Sales Tax and FED on Services are the identical tax. The Federation and the provinces cannot legislate on the same subjects except for criminal law, criminal procedure and evidence; therefore they cannot impose the same tax on services. Article 142 of the Constitution states that Majlis-e-Shoora (Parliament) shall have exclusive power to make laws with respect to any matter in the Federal Legislative List and a Provincial Assembly shall, and Majlis-e-Shoora (Parliament) shall not, have power to make laws with respect to any matter not enumerated in the Federal Legislative List.

  The Sindh Assembly raised objection on Federal Government imposing this tax and passed a resolution on June 24, 2013, calling any move aimed at amending the definition of sales tax on services in federal finance bill "unconstitutional". AMC have obtained stay order from the Sindh High Court against the imposition of FED. Meanwhile the mutual funds and pension funds are providing for FED and the return to investors is reduced by the provision.

Taxation of Mutual Funds in Pakistan – removing distortions and inequities through Finance Act 2014 and creating new distortions and inequities

1. Clause 99 of Part 1 of Second Schedule of Income Tax Ordinance recognizes the pass through status of the mutual funds. It provides that if mutual funds distribute 90% of its income as reduced by realized and un-realized capital gains, the mutual funds will be exempt from income tax. The amendment now introduced through Finance Act 2014 states that to qualify for exemption, only cash distribution will be considered. The amendment now introduced would mean that mutual funds will continue to be exempt from income tax. However, unit holders will be subject to tax on cash dividend. Prior to this amendment mutual funds used to distribute through issue of bonus units that was not subjected to income tax. Hence both mutual funds and investors were exempt

from income tax. In this way the distortion and inequities have been removed. The amendment in clause 99 of Part 1 of Second Schedule of the Income Tax Ordinance is the right move to remove inequities.

2. The amendments through Finance Act 2014 provide different rates of withholding tax on dividend to be distributed by stock funds. If dividend income constitutes minimum 50% of the income of the stock fund the tax on its dividend distribution shall be 10%. If however, capital gains constitute minimum 50% of the income of mutual fund then tax on its dividend distribution shall be 12.5%. The tax authorities have assumed that capital gains realized by mutual funds would be all short term and thus have proposed to tax the distribution at the highest capital gains tax rate. The arbitrary fixing of 10% and 12.5% rate has created inequities, as would appear from an example of the income distribution by a stock fund, as given below:

Source of Income of mutual funds	Amount	Tax Rate	Tax
Dividend	50,000	10%	5,000
Capital gains – over two years	50,000	Nil	Nil
Capital gains – over one years	50,000	10%	5,000
Capital gains – less than one year	50,000	12.5%	6,250
Aggregate Income	**200,000**	**8.125%**	**16,250**
Distribution by mutual fund	180,000		
Units outstanding	100,000		
Distribution per unit	Rs. 1.80		
% of capital gains in distribution	More than 50%		
Withholding Tax on distribution		**12.5%**	
Applicable tax rate for investor making direct investment in securities		**8.125%**	

The tax rate on dividend of stock funds should be determined for each stock fund based on composition of income earned by that fund and applicable tax rate on investor making direct investment in securities to ensure tax neutrality. It should not be arbitrarily fixed.

3. In open-end mutual funds investors enter and exit the fund throughout the financial year. A portion of offer price of units of mutual fund is to cover for income equalization. Recovery of income equalization from incoming unit holders is necessary because mutual funds pay equal amount of dividend, irrespective of the date of investment. When the investor is paid dividend after the end of the financial year, a portion represents refund of equalization payment. Under UK law and laws in other jurisdiction the amount of dividend that represents refund of equalization payment is not subjected to income tax. In these jurisdictions, equalization payment is deducted from cost of purchase for the purpose of determining capital gains, if the units are redeemed. Under Income Tax Ordinance, the entire dividend amount, including equalization is subject to income tax. This can be illustrated by following example of XYZ Cash Fund for financial year ended June 2015.

Particular	NAV (Rs,)	Income constituting NAV (Rs.)
NAV on July 1, 2014	10.00	Nil
NAV on April 1, 2015	10.80	0.80
NAV on June 2015	11.25	1.25
Dividend for the year ending June 30, 2015		1.15
NAV on July 1, 2015	10.10	Nil

Zaid, an investor invests in 100 units of XYZ cash fund on April 1, 2015 and pays Rs. 1,080 of which Rs. 80 is payment for income equalization. The tax inequity to Zaid is illustrated as under:

Particular	Dividend Income (Rs.)	Tax (Rs.)
Dividend on 100 units	115	11.50
Equalization payment by Zaid	80	Nil
Income to Zaid	35	11.50
Applicable tax rate for Zaid	32.85%	
Tax rate on dividend	10%	
Tax if income equalization is adjusted		Rs. 3.50

As is evident from above example, dividend of Rs.115 paid to Zaid includes refund of Rs. 80 paid by him. If adjustment is allowed in Income Tax Ordinance as in UK tax laws, Zaid will be taxed on net dividend after adjustment of income equalization i.e. on Rs.35/= only. The UK tax law also provides that income equalization is deducted from cost of investment for the purpose of capital gains tax. This can be, taking the above example, illustrated as under;

Particulars	Cost of investment (Rs.)	Capital gains tax (Rs.)
Payment made by Zaid for 100 units	1,080	
Income equalization	80	
Cost of investment	1,000	
Redemption of investment within one year	1,050	
Capital gains tax – rate 12.5%	50	6.25
Redemption of investment after one year	1,050	
Capital gains tax – rate 10%	50	5.00
Sale of investment after two years	1,050	
Capital gains tax – rate Nil	50	Nil

Summary and recommendations

The Finance Minister has claimed to have removed inequities in the taxation of mutual funds through Finance Act 2014. It would have been advisable if the tax authorities had consulted the SECP before any amendment in tax laws. The principle governing tax on mutual fund provides tax neutrality whether investor invests directly in securities or through the media of mutual funds. This no longer holds true and mutual funds' competitive position is affected as given below:

1. Mutual Funds and Voluntary Pension Funds are subjected to Workers Welfare Fund, provincial Sales Tax and Federal Excise Duty that an investor making direct investment in securities is not. It is proposed that these taxes be removed.
2. The tax rate on stock fund has been fixed on the assumption that there will not be any income from capital gains tax where securities are sold after holding for more than two years, where there the rate of capital gains tax is nil. It is proposed that the tax rate on dividend of equity rate should be worked out on the basis of composition of income of the stock fund and average rate of tax.
3. Payment made by unit holders on account of income equalization should not be taxed when the fund pays it back by to the unit holders in the form of dividend. However, income equalization payment may be adjusted against cost of acquisition of units of the open ended mutual funds.

The above inequities in taxation of mutual funds is impacting the competitiveness of mutual funds. It is expected that tax authorities will examine these in consultation with SECP and remove the anomalies.