

Capital gains tax

Investor concerns & our take

Ever since the KSE announced its has broadly agreed to a capital gains tax (CGT) framework with the Government, there has been a barrage of questions coming in from investors who seem confused on how the process would be implemented. We have therefore carried out a detailed study on the key questions brought forth, and following discussions with KSE officials and tax experts, have tried to come up with the required answers. Some of the questions include:

- How will the capital gain tax be implemented in Pakistan?
- Is the tax going to be deducted at source or charged on an annualized return basis?
- What will be the treatment for capital losses?
- What will be the treatment of the current holdings under this CGT structure?
- Will there be any change in the tax structure for banks?
- What will be the implementation deadline for Insurance companies (June or Dec)?
- Would mutual funds be liable to pay CGT?
- How will the bonus and right shares be treated under CGT?
- How has the CGT been implemented worldwide?
- What will be the tax policy for foreigners?
- What will be the impact of CGT's imposition on the government's tax base?
- What will be the effective purchase cost for determination of capital gains/losses?



JS Global Capital Limited

KSE-100 Index:
9,686.18

Market Cap:
Rs2,785bn
US\$32.7bn

Market PE:
8.3x (2010E)

Market Dividend Yield:
6.5% (2010E)

1-yr High/Low:
9,954.41/5,557.92

Market estimated free float:
25%

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JS Research's answers to investor queries:

- How will the capital gain tax be implemented in Pakistan?

Capital gain tax would be charged on all purchases made after July 1, 2010 under different slabs (see table). The tax rates will remain unchanged for 2 years i.e. until FY12. Effective FY13, there will be an annual rate increase of 2.5% for the less than 6 months category capped at 17.5%, while an annual increment of 0.5% for 6-12 months, capped at 10%.

Table: Capital gain tax

Less than 6 months	10%
6-12 months	7.5%
More than 12 months	NIL

Source: KSE

- Is the tax going to be deducted at source or charged on an annualized return basis?

Investors would need to file an annual return for capital gains/losses as the tax will not be deducted at source.

- What will be the treatment for capital losses?

In accordance with the current tax laws, capital losses can be adjusted against capital gains, while unabsorbed losses can be carried forward for a maximum period of 6 years.

Illustration: An investor earns capital gains of Rs2mn in FY11, while he incurs a capital loss of Rs3mn. As a result, the net loss for the year arrives at Rs1mn, which would be allowed to be carried forward, for offsetting against future capital gains for a maximum period of 6 years i.e. until FY17.

- What will be the treatment of the current holdings under this CGT structure?

Profit from disposal of holdings prior to July 1, 2010, would be exempt from tax, however, investors would need to clearly indicate such details in their tax returns.

- Will there be any change in the tax structure for banks?

There will be no change in the capital gains tax structure for banks.

- What will be the implementation deadline for Insurance companies (June or Dec)?

Though insurance companies have their financial year end in December, we understand that implementation of the CGT would be uniformly carried out, and hence be effective from July 1, 2010 for these institutions as well.

- Would mutual funds be liable to pay CGT?

Though details regarding the applicability for Mutual funds are still being processed, we understand that mutual funds would not be liable to pay CGT, and it would be charged only on the realized returns of unit holders.

- How will the bonus and right shares be treated under CGT?

Bonus shares do not form part of purchases; hence, they will be exempt from the calculation of CGT. Right shares though, are fresh purchases and thus gains on those would indeed be subjected to CGT.

- How has the CGT been implemented worldwide?

We have carried out a study on countries from three different continents to obtain an understanding of the CGT regulations enforced elsewhere. The following table illustrates the CGT mechanism in India, UK and Nigeria.

Table: International comparison

India

Short Term 10% Securities transaction tax (STT) of 0.125% on the total transaction value.
Long Term Nil However, for squaring off daily positions, a STT of 0.025% applies.

United Kingdom

The balance of overall gains (gains-costs-tax reliefs-losses) and Annual Exempt amount (£10,100 for 2009-10) is taxed at 18%.

Nigeria

Short Term 10% Withholding tax on transaction applies.
Long Term 10%

Source: JS Research

- What will be the tax policy for foreigners?

According to our discussions with KSE officials, one of the proposals under consideration is currency indexation for the calculation of capital gains for foreigners. This seems to be fair as depreciation of the Rupee versus the dollar in recent years place foreigners in a disadvantage state if indexation is not provided. That said, it remains unclear whether foreigners would need to submit tax returns or not, which we believe would be clear once the Budget and Finance Bill is announced.

- What will be the impact of CGT's imposition on the government's tax base?

According to our calculations, the incremental revenue from the imposition of Capital Gain tax is estimated at Rs35bn (0.25% of GDP). Our analysis is based on a market return assumption of 25% (last 10 years average return). While the amounts seems small in the context of the overall tax revenue, there remains room for an increase in this figure, as market capitalization rises going forward and new corporations come in for listing. For instance, CGT collection would have been 4-5 folds higher in 2005-2006 when daily traded value was Rs30bn as against the current Rs7bn. We have also run a scenario analysis to determine the quantum of CGT revenues at various market return expectations.

- What will be the effective purchase cost for determination of capital gain/losses?

The cost of the shares purchased would be inclusive of any brokerage fees charged, while withholding tax would be adjustable against the capital gain tax calculated.

Imposition of CGT: Is it healthy?

CGT is a tax charged on income and can be adjusted with the withholding tax upon the returns submission. We however, do not buy the idea that overall volumes would shrink as a result of the imposition of CGT as the local bourse transactions are currently recorded and can be identified through the UIN – a number assigned to each investor to keep check on speculative activity. Hence, even without the CGT around, investors are not off the FBR's ambit.

Table: Sens. of CGT under diff. returns

	Market Return	CGT (Rs bn)	% of GDP
Scenario 1	30%	41	0.34%
Base Case	25%*	34	0.28%
Scenario 3	15%	20	0.17%
Scenario 4	10%	14	0.11%

Source: KSE & JS Research

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ANALYST CERTIFICATION

We, Farhan Rizvi, CFA, Syed Atif Zafar & Rabia Tariq, the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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