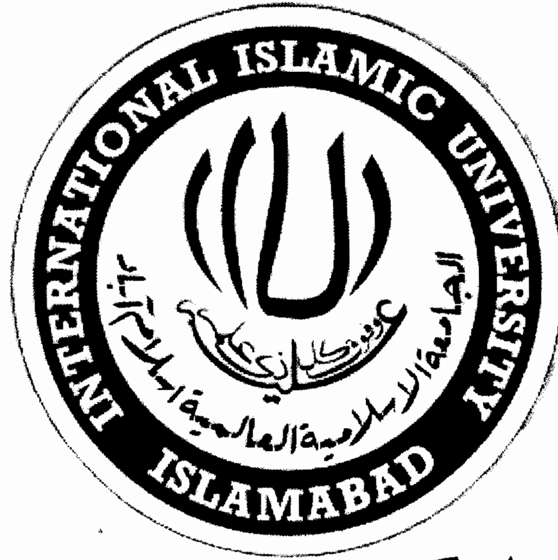
# TAXATION OF PETROLEUM EXPLORATION AND PRODUCTION COMPANIES IN PAKISTAN

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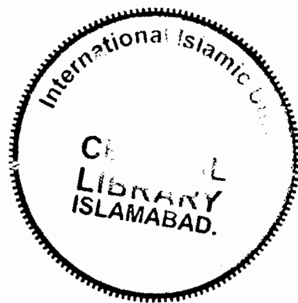

Accession No. TH: 6329 EW


Petroleum production Econometric models

oil and gas prices; Taxation., Exploration

Economics and economic theory

Petroleum industries - Taxation

Petroleum industry and trade - taxation

بسم الله الرحمن الرحيم

**IN THE NAME OF ALLAH, THE MOST BENEFICENT, THE MOST MERCIFUL**

## FINAL APPROVAL

It is certified that we have read the thesis submitted by Muhammad Rizwan entitled "TAXATION OF PETROLEUM EXPLORATION AND PRODUCTION COMPANIES IN PAKISTAN" as a partial fulfillment for the award of degree of LLM (International Trade Law). We have evaluated the thesis and found it up to the requirements in its scope and quality for the award of degree.

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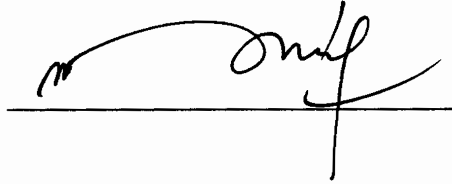

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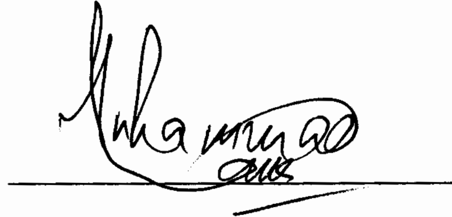

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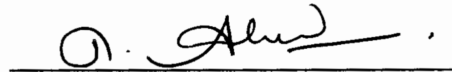

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## DEDICATED TO

**MY LATE GRAND MOTHER** (May Allah rest her soul in paradise) Amin.

**WHOSE PRAYERS ARE STILL A SOURCE OF INSPIRATION FOR ME AND SHALL REMAIN SO TILL THE CALL OF ALMIGHTY ALLAH COMES.**

# DECLARATION

I, hereby declare that this thesis neither as a whole nor as a part thereof has been copied out from any source. It is further declared that I have developed this project entirely on the basis of my personal efforts under the sincere guidance of my teachers and supervisors. No portion of my work presented in this project has been submitted in support of any application for any degree or qualification of this or any other university or institute.

# ACKNOWLEDGEMENT

All praise to Almighty Allah (SWT), Lord of the Universe, the most Benevolent, the most Merciful, Lord of the day of resurrection and the Creator, who gives me understanding, courage and patience to complete this project inspite of numerous barriers and bottle nicks.

All respect for the teacher of the worlds Hazrat Muhammad (SAW), who is forever minaret of knowledge and wisdom for whole world in all times, who disseminated all kinds of knowledge which had been bestowed from the Lord of the Worlds.

I owe my deep gratitude to my kind supervisor Mr. Muhammad Arif for providing consecutive guidance, suggestions, keen interest and sympathies throughout the research work regarding this project. It was not possible for me to complete this project without his guided supervision. It shall be unjust if I do not appreciate the efforts of my internal and external examiners, so I am grateful to both of my sincere examiners. I am also thankful to all my seniors, friends and well wishers who guide and pray for me to achieve this target specially my beloved parents, kind senior Muhammad Nasir and Mr. Ghulam Baqir senior accounts officer OGDCL head office Islamabad.

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## LIST OF PRINCIPLE ABBREVIATIONS

| | | |
|---|---|---|
| bbl | = | Barrel |
| CNG | = | Compressed Natural Gas |
| C&F | = | Carriage and Freight |
| E&P | = | Exploration and Production |
| FBR | = | Federal Board of Revenue |
| FDI | = | Foreign Direct Investment |
| GHPL | = | Government Holding Private Limited |
| GOP | = | Government of Pakistan |
| GST | = | General Sales Tax |
| FOB | = | Freight on Board |
| IAS | = | International Accounting Standards |
| IT | = | Income Tax |
| ITO | = | Income Tax Ordinance |
| IMF | = | International Monetary Fund |
| LPG | = | Liquid Petroleum Gas |
| LTU | = | Large Taxpayer Unit |
| MTU | = | Medium Taxpayer Unit |
| OGDCL | = | Oil and Gas development Company Limited |
| OPEC | = | Organization of Petroleum Exporting Countries |

| | | |
|---|---|---|
| PCA | = | Petroleum Concession Agreement |
| PCT | = | Pakistan Customs Tariff |
| PDL | = | Petroleum Development Levy |
| POL | = | Pakistan Oil Limited |
| PPEPCA | = | Pakistan Petroleum Exploration and Production Companies Association |
| PPL | = | Pakistan Petroleum Limited |
| PSA | = | Production Sharing Agreement |
| SRO | = | Statutory Regulatory Order |
| STA | = | Sales Tax Act |
| U/S | = | Under Section |

# ABSTRACT

Petroleum is the largest primary commodity of international trade in terms of both volume and value. There is also a national security component involved in it for both producing and importing countries. The political stability and economic endurance of both groups of countries are involved in this regard. Hence the entire international community depends to a large extent on the availability and affordability of oil in the international market.

On the other hand, the opulence and perfection of every nation generally increases with the increase of its revenue. Similarly opulence and perfection of every nation grow and flourish together, but the collection of revenue must not be beyond limits and on the basis of apartheid and unequal treatment of fellows. Taxes are considered the financers of the state; they enable the government to take over and utilize resources among the citizens and spend for the welfare of state as a whole.

Fortunately a number of the petroleum companies whether national or international prefer Pakistan for investment purposes in the petroleum sector due to the presence of petroleum reserves scattered through out country. The Government of Pakistan wants to promote investment in this particular field to meet the domestic requirements in order to reduce foreign import in this sector which is a huge burden in terms of foreign payments. On the other hand if these companies come to Pakistan there shall be a mega technology transfer which shall benefit the Government and the people of Pakistan by gaining employment and profound experience in this field. The country will take a number of other allied benefits in various sectors like revenue generation, training of inhabitants, and transfer of latest technology, reduction in foreign payment for petroleum and increase petroleum production for familial use.

The reason to select this subject is that petroleum companies which are interested in this field, do not have enough information about the application of taxation on their investment, its ratio, tax benefits and tax limits. There are no specific guide lines available on the subject for the investors and the existing taxation laws are not easy to comprehend for them. Furthermore, it is also hard to understand different possible interpretation in the taxation laws. Likewise the

Government is unable to comprehend these possible interpretations. I hope this strive would inshaAllah benefit all the stake holders of this field and Government of Pakistan also.

The scheme of the thesis is that in the very first chapter the importance of the petroleum in human life is discussed. It is obvious that the human life is fulfilling much of its needs from petroleum sector. Secondly the history of petroleum, when it was discovered, its natural distribution in different areas, major petroleum producing and exporting countries, their share in petroleum production and its market is discussed. The history of Petroleum in Pakistan is discussed briefly towards the end. OPEC a major stake holder in the petroleum sector is discussed with its important and salient features as OPEC was able to control more than 50% of all the petroleum productions in the world. OPEC is performing a vital role in the supply, demand, market, market price and the fluctuation of petroleum prices through out the world.

In the 2nd chapter the history of taxation law in Pakistan is discussed. The basic document which is adopted by the Government of Pakistan was Income Tax Act, 1922 with some amendments; later on many changes were made. It is the only law that is amended annually through the Finance Act. The Income Tax law has been amended to a large extend to fulfill the demands of the new age. Secondly in this chapter the basic principles of Taxation law are discussed and explained with sub-headings like principle of impartiality, principle of certainty, principle of convenience, principle of elasticity, principle of productivity etc. Double taxation plays an important role as the foreign companies' payments and receipts are concerned whenever a Pakistani company invests abroad or foreign company invests in Pakistan. It is not possible for both types of companies to pay double tax on the same item in its own country and country of investment. Therefore most of the countries have made double taxation agreements for the promotion of investment, import and export.

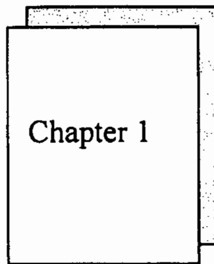
The tax policies regarding petroleum companies are discussed in third chapter, many benefits and incentives are given to the petroleum companies in these policies in offshore and onshore field. By the passage of time the Government of Pakistan increase incentives for inland petroleum companies because it wants to maximize the share of local companies in this field i.e. under petroleum policy 1997, the local exploration and production companies could use thirty per cent of their sales proceeds to fulfill their foreign currency requirement or so on. All the petroleum companies got benefit of S.R.O. 400(1)/97 which was the dare need of them.

Under petroleum policy 2007, in case of joint venture with foreign exploration and production companies the local companies including GHPL shall have working interest of fifteen per cent in Zone I, twenty per cent in Zone II and five per cent in Zone III. A new concept which is discussed in later policies is wind fall tax which is charged only from petroleum sector. The 2nd heading which is discussed in this chapter is taxation of resident and non-resident petroleum companies. The first thing which needs to be clarified is definitions of resident and non-resident. There are different provisions which are discussed under this heading through which one can easily understand the concept of resident and non-resident persons in the preview of taxation law. Royalty is a payment which is paid by all the petroleum exploration and production companies working in Pakistan to the Federal Government. It can be paid in shape of cash or kind at the option of the Government of Pakistan. There is difference of opinion on calculation of the amount of royalty. So the concept of royalty is discussed under the heading of concept of royalty and its effect on the taxation of the oil companies, opinions of the companies and the Government are also discussed in this chapter. The Income Tax Ordinance, 2001 treats the petroleum business separately for the purpose of taxation. If any person or company runs two or more businesses, the income from the petroleum sector shall be computed separately, this concept is discussed under the heading of computation of petroleum business separately. For the promotion of every field each Government gives different incentives in that particular field. The Government of Pakistan gives different types of incentives to promote the petroleum sector which are discussed under the heading of incentives given by the Government of Pakistan to the petroleum companies through Income Tax Ordinance, 2001, through petroleum policies or through different S.R.O(s).

Chapter four specifically consists on the taxation issues regarding the petroleum companies working in Pakistan. Mainly there are three issues which are facing by the petroleum companies which are related to calculation of royalty, depletion allowance and calculation of decommissioning cost. The companies and taxation department interpret and calculate these amounts in different ways. In the chapter we will see these issues one by one and try to interpret the relevant law according to the intention of the legislation and try to culminate the difference which exists between petroleum companies and taxation department through the examples and verdicts of relevant authorities of the higher and superior courts.

The fifth and last chapter is contained on the conclusions and suggestions on thesis. Under this chapter we will try to understand the law related to our topic. At the end of this chapter I give some suggestions through which the ambiguities can be brushed aside which are existed between the stake holders like department of taxation and petroleum companies.

Owing to the peculiarity of this specific topic, I have attached a list of definitions as annexure 2, which have been used in the thesis and at the same time it is necessary for understanding the topic for the readers because most of the words used in this topic are used in different sense in daily routine. Suppose the word petroleum used in this topic includes natural gas, crude oil, and petroleum spirits but in daily life the same word is used only for petrol. So it is impossible to understand this topic without attached list of definitions.




# HISTORICAL BACKGROUND

## 1.1 IMPORTANCE OF PEROLEUM

It is an established fact that petroleum is one of the most important needs of our life. No one can imagine modern life without petroleum and its different products and supplements because petroleum is finest and cheaper source in energy so far. The heroic chapter of modern life started from the discovery of petroleum. Now all the industry whether agriculture, textile, plastic, wax, fertilizers, chemicals, automobile or others are fetch their needs directly or indirectly from petroleum industry. No doubt, before the discovery of petroleum in Pakistan and other countries, electricity was generated from hydel resources but now a substantial portion of electricity is generated from diesel which is also sister product of petroleum. The means of communication gear up their move through petroleum or its sister products. All the lubricants are also the products of petroleum. The refineries separate the petroleum products by heating the raw petroleum on different heating points. The last product of petroleum industry is tar which is used in constructions of roads and water proofing in construction of buildings.

So the life of human being gets the fruits of modern world due the availability of energy which comes from the petroleum, if we get rid of petroleum the world will go back at least three century back. It is the fruit of oil or energy that makes our life brighten and without it our life shall pushed in dark. We can imagine the importance of petroleum by the war between Iran, Iraq and America and Iraq that such a powerful country fought for getting control over the oil of that developing country. The world can furnish many other reasons but the major reason or back of this major conflict was the presence of petroleum in the Middle East. Even the Western World comes to know that the presence of oil resources in the Muslim World can create a problem in the future for the non Muslim world, so they want to get control over the major resources of the petroleum in the world which is the easiest way to control the economy of the world.

## 1.2 HISTORY OF PETROLEUM IN THE WORLD

Petroleum in its natural condition, before refinery is called raw or crude oil, is a shining dark yellow in colour. Petroleum comes beneath the surface of earth where it stores in hard layers of earth. The word petroleum is combination of two Latin words *petra* stands for rock and *oleum* stands for oil.[1]

Petroleum is an organic compound which is a combination of different carbons and hydrogens. In different combinations it shapes itself in kerosene oil, gasoline, natural gas petroleum and its other sister products like diesel, mobile oil etc.[2] The geologists are agreed on this point that petroleum formed from the residue of plants and tiny animals of the ancient oceans, which were buried in deep surface of the earth. When these creatures buried in lower layers of earth, due to heavy pressure and high heat these sediments were packed and were formed rocks. A major portion of world oil is the by-product of those residues and tiny animals which were buried million years ago, that's why petroleum is also called fossil oil.[3] Some of the portion of this residue changed its form and made coal while the other shaped in the form of liquid and both are the source of energy, but petroleum is the finest source of energy and used for fulfilling different needs.

Besides coal, which can not moves due to its solid condition unless moved by the shifting crust of earth, oil migrates itself in upward through the cracks of soft layers of earth unless it is stopped by the hard surface of earth. Lastly this liquid oil stores itself in the shape of reservoir. Most of the time natural gas finds along with liquid oil. Most of the petroleum resources are present in deep surface of earth which is called anticlines; these anticlines are enshrined with hard layers of rocks which make an arch around the deposit/reservoirs of petroleum. But sometimes this trapped liquid oil breaks the hard surface that's why some oil is present in clay and sand also.

Almighty Allah spreads His blessings throughout the world in different shapes and orders for mankind who can search His blessings throughout the world. No doubt petroleum is present in different areas of the world but most of the proved petroleum wealth is present in Arabian

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[1] http://simple.wikipedia.org/wiki/Petroleum, (visited on May 9. 2009)
[2] http://www.newton.dep.anl.gov/askasci/chem00/chem00937.htm. (visited on May 9. 2009)
[3] http://stason.org/TULARC/vehicles/gasoline-faq/4-1-Where-does-crude-oil-come-from.html. (visited on May 9. 2009)

Peninsula which is two-third of all proved reserves. In Arabian countries Saudi Arabia possesses major oil reserves, it is the largest country as per extraction, production and exportation of the petroleum wealth is concerned.[1] Africa, North America, Europe and Asia possess 4% to 8% of proved petroleum reserves but only Latin America possesses 13%. A major portion of petroleum extracted from North America is explored out from Louisiana, Texas, Oklahoma, California and Alaska.[2] United States of America is the only largest refiners of the world's oil and most of the world extracted oil was refined in it.[3] At the same time USA is the world largest consumer of petroleum and possesses big artificial oil reserves but at the same time it has small petroleum supply.[4]

The history of petroleum goes back to 1814, when the first well was drilled in Ohio (a state of America), like other wells dug in America; this well was also dug for getting salt water for industrial use. The well was almost 500 feet deep. The production of this well was one barrel per day.[5]

The second oil well was drilled in Kentucky which is another state of America, in 1818. The well was also drilled for the purpose of getting salt water. According to some reports the oil was shipped to Europe for first which was extracted from this well. This well was pioneer well in the history of petroleum sector which produced oil on commercial basis.[6]

Like the other fields, the petroleum sector developed day by day. The seismic waves were used for the first time for the search of oil reserves beneath the surface of the earth in 1921.[7]

The Muslim world contributed its share at that time when the first oil well was drilled in Persian peninsula in 1908 by an oil company named Anglo Persian Oil Company. Bahrain was the second Muslim country in the history that produced oil and the first well was drilled in 1932 in that country. In 1933 Saudi Arabia granted concession on the subject of extraction

[1] http://www.eia.doe.gov/cabs/Saudi_Arabia/Background.html, (visited on May 9, 2009)
[2] http://www.travelpod.com/travel-blog-entries/jamesvanblaricu/1/316698360/tpod.html (visited on May 9, 2009)
[3] http://en.wikipedia.org/wiki/List_of_oil_refineries, (visited on May 9, 2009)
[4] http://www.springerlink.com/content/jn321544321141k5/, (visited on May 9, 2009)
[5] http://www.geohelp.net/world.html, (visited on May 9, 2009)
[6] http://www.geohelp.net/world.html, (visited on May 9, 2009)
[7] http://www.geohelp.net/world.html, (visited on May 9, 2009)

of petroleum and its production to Standards of California company which became letter on ARAMCO (Arabian American Standard Oil Company).[1]

In 1938, for the first time the oil was found in Saudi Arabia and Kuwait. In 1948, the first largest continental discovery was made in Saudi Arabia which was about 80 billion barrels in Ghawar Oil field.[2]

The major conflict during the first World War, 1914-1918, was getting control of oil supply which was needed for trucks, ships and planes so the British forces captured Baghdad in 1917.[3] In 1956 the oil was discovered in Algeria and Nigeria, both are the Muslim states.[4] Most of the conflict between the Muslim world and western world is due to the presence of unlimited oil reserves in the Muslim world.

During the Second World War in 1939-1945 the supply and transportation of petroleum to the allies (U.S., Britain, France, USSR, Australia, Belgium, Brazil, Canada, China, Denmark, Greece, Netherlands, New Zealand, Norway, Poland, South Africa, Yugoslavia), against Axis powers (Germany, Italy, Japan, Hungary, Romania, Bulgaria), was a single reason in the success of allies from Middle East and Baku, but at the same time the shorter supply of petroleum made the Japan hopeless during the event of war.[5] From this example we can understand the importance of petroleum in the life of the nations and absence of oil makes the nations weak in the walk of modernity. After the 2nd world war Arab Oil Congress made an agreement named gentlemen's agreement for oil producing countries to get control on oil production and its marketing, it was also the juggling of Americans in 1959.[6] In 1960 OPEC (Organization Of Petroleum Exporting Countries) was made by the Muslim countries to systemize oil quota for each of the partner in the world market, only one partner was non-Muslim in this organization which had a Tussle with America named Venezuela but Americans made it (OPEC) dormant like OIC. On the other hand, the shameful corner of the Muslim world is that they are unable to understand the acts of western world which has made them paralyze.

[1] http://www.geohelp.net/world.html, (visited on May 9, 2009)
[2] http://www.geohelp.net/world.html, (visited on May 9, 2009)
[3] http://www.geohelp.net/world.html, (visited on May 12, 2009)
[4] http://www.newswithviews.com/spingola/deanna89.htm, (visited on May 12, 2009)
[5] http://www.infoplease.com/ipa/A0001288.html, (visited on May 17, 2009)
[6] http://www.geohelp.net/world.html, (visited on May 12, 2009)

In 1942 Japan invaded Indonesia to get control on its oil reserves[1]. Yom Kipper war, which was fought in 1973, between Israel, Egypt and Arab countries,[2] the subject matter was the oil reserves and due to this war the prices of oil increased sharply which was recorded 78.4 dollars per barrel. After that the increase in prices of petroleum products were occurred due to short oil supply from Iraq, the exercise of nuclear weapons, formation of nuclear missiles by Northern Korea and tussles between Israel and other Arabian peninsula specially with Lebanon in 2006.[3]

The history of oil in Pakistan goes back to 1866, when seven or eight wells were drilled near Fatehjang Distt. Attock, the production of oil was few gallons per day. In 1870, the services of Mr. Lyitaan, an American, were hired to investigate the oil prospects in joint Punjab (Pakistani Punjab and Indian Punjab) by the British Government. During the last quarter, most of the oil wells were drilled in Baluchistan province from such wells 25000 barrels of oil was produced. This oil was used to run the railways.[4]

After the 1st world war, some British nationals came to survey the mineral wealth present in the Punjab region, as a result of this survey, Attock Oil Company was established because they gathered the idea that the future of the business will be bright and this company was pioneer company in the history of Pakistan.[5]

After the emergence of Pakistan, OGDCL was a company who worked as a holding company on behalf of the Government of Pakistan and made many multidimensional achievements in the oil sector. Before OGDCL two companies were working in the oil sector which are PPL and POL.

## 1.3 ROLE OF OPEC IN THE PETROLEUM SECTOR

OPEC stands for Organization of Petroleum Exporting Countries. This organization was made for the control on production and marketing of oil reserves in several member countries, most of them were third world countries at the than time. The OPEC countries decided to join their

[1] http://countrystudies.us/indonesia/15.htm, (visited on May 12, 2009)
[2] http://www.amichai.com/war/process/73war.html, (visited on May 13, 2009)
[3] http://www.globalpolitician.com/02-middle-east, (visited on May 19, 2009)
[4] http://sp.lyellcollection.org/cgi/content/abstract/50/1/503, (visited on May 21, 2009)
[5] http://sp.lyellcollection.org/cgi/content/abstract/50/1/503, (visited on May 21, 2009)

hands for the common interest, in Baghdad Conference.[1] The names of the countries were as under:-

- Iraq,
- Kuwait,
- Iran,
- Saudi Arabia,
- Venezuela,
- And some other countries got membership of OPEC in other years for the purpose of getting a portion of petroleum market, the other countries who joined OPEC in later days are as under:-
- Nigeria joined in 1970,
- Qatar joined this platform in 1961,
- Libya in 1969,
- Ecuador joined in 1973 and quitted this forum in 1992 for the purpose of making its petroleum products free from the binding of quota clutches,
- United Arab Emirates joined in 1973,
- Algeria joined in 1970, and
- Gabon in 1973.[2]

The forum of OPEC could not get substantial control on the prices, supply and market of petroleum, because the member countries were unable to unite themselves on the quota system, limits of extraction and most of the members were bound by some external forces and reasons which made the OPEC non-functional till 1970. At the same time the extraction, production, supply and transportation of petroleum were very essential for the countries which were not the members of OPEC because they were and are in need of petroleum and its by-products every time so they want to make the OPEC non-functional. In those days most of the developed countries thought that the prices of petroleum products will not be increased and

[1] http://www.wisegeek.com/what-is-opec.htm. (visited on May 23, 2009)
[2] http://www.opec.org/aboutus/history/history.htm, (visited on May 24, 2009)

remained stable, even United States was confident and thought that if the price will go up it will not be increased more than 5 dollars per barrel.[1]

The significance of petroleum increased in 1920 world widely, the annual petroleum production was 95 millions tons per annum and the production increased day by day, in 1990 the production reached at 500 millions tons, The annual production was reached three billions tons in the year 1995.[2] The development of the world at large is dependent on free supply, transportation and low prices of petroleum for long time. All the economies which have been enshrined in industries, energy production and automobiles communication totally depends on the availability of oil, its bye products and its cheap production and transportation. 42% share of oil production was controlled by the OPEC in 1997 which was a major achievement of the OPEC after 1970 when OPEC countries had had major portion of petroleum production and supply.

The countries not being OPEC members contributed 58% of the production. A spatial differentiation of oil reserves is also observed, the bulk of them, 64% are located in the Middle East.[3]

In 1970s, OPEC countries achieved control over fifty five per cent of world petroleum production and supply, so OPEC fixed the Quotas of petroleum extraction, production for member countries to develop an atmosphere of cooperation and to avoid the competition in the petroleum market to earn more and more profit and to smash the act of non member countries which was necessary in the context of growing market demand and minimized the dependency on non OPEC producers and suppliers. It was very difficult to maintain an uncompetitive environment among the oil producing countries (its members) for OPEC.[4]

As a result of war between Egypt and Israel the world sea the first oil shock because most of the Arab countries were against Israel and they minimized the oil production as a protest against this transgression.[5]

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[1] http://www.opec.org/aboutus/history/history.htm, (visited on May 24, 2009)
[2] http://www.wpcchina.org/petroleum/inauguralnew2.htm (visited on May 24, 2009)
[3] http://people.hofstra.edu/geotrans/eng/ch5en/appl5en/ch5a1en.html.(Visited on January 27, 2009)
[4] http://wps.aw.com/aw_carltonper_modernio_4/21/5566/1424964.cw/content/index.html.(Visited on June 01, 2009)
[5] http://mpra.ub.uni-muenchen.de/6431/1/MPRA_paper_6431.pdf. (Visited on June 01, 2009)

OPEC intervened in its member countries by nationalizing production facilities, reducing production by 25%, imposing export quotas and also imposed quotas on countries supporting Israel.[1] In the response of this war the price of oil reached 11.65 dollars per barrel at the end of 1973 which was 3.01 dollars in the beginning of the same year, at the same time OPEC countries took control on the price of oil.

In 1980, when Iran expelled the Islamic revolution of Iraq it caused the reduction in oil production as 8% of world oil supply and resultantly second oil shock came, during the second oil shock the oil price increased sharply from 20 dollars to 35 dollars.[2]

In the last days of 18th century and early days of 19th century, OPEC lost its control on the fixation of pricing of oil due to its economic and geopolitical conflicts; internal issues and individual approaches, which was a stupid mistake of the entire Muslim World. In the same period new producers came in the market which were Russia, Mexico, Norway, England and Colombia, they were not bound by the policies of the OPEC, even they free were from these new comers for the fixation of their oil prices and production. Saudi Arabia is one of the oil exporting countries for America, but in 1977 Mexico superseded Saudi Arabia and had become the 2nd big oil exporting country for the American oil market. A reasonable change occurred in 1982 when OPEC members reconsidered their interests by fixing oil quotas and pricing but at that time the share of OPEC countries trimmed down from 55% to 42% of world production and supply which damaged OPEC in real sense.

Saudi Arabia cut down its oil prices for achieving the major petroleum market's share. It was an oil counter shock that lowered the price of the barrel under 20 dollars, ever reaching a record of 15 dollars in 1988. At that time oil market was a market controlled by the demand and supply mechanism.

By the passage of time the previous conflict rose and OPEC member countries could not unite them on the point of quota which was fixed by OPEC. Kuwait wanted to produce more oil to capture the petroleum market, this point of Kuwait stimulated Iraq to use force to stop Kuwait from such increase in oil production because this act of Kuwait was against the interests of all

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[1] http://www.wtrg.com/prices.htm, (Visited on June 03, 2009)
[2] http://www.iranchamber.com/history/islamic_revolution/islamic_revolution.php, (Visited on June 03, 2009)

OPEC members, if Kuwait did the same then every OPEC member was do its own will in the production of petroleum which was not beneficial for all the member countries, but Kuwait sought help from America and fought a war with Iraq in 1990. The production quota of Iraq and Kuwait was squeezed due to war but other countries increased their scale of production and the short term decrease in petroleum production was deleted and price was stabled again after some days.

All the cartels are established for the same reasons which are fixation of commodity price, profit margin by limiting the production and to expel the new entries in the same field so that no competitor could not come in the market or reduce their profit margin. But at the same time they should think about the point of reduction in world's consumption of petroleum because higher price forces the consumers to reduce the use of that particular commodity, so the cartel members fluctuate the price of commodity by the upheavals of general market, it is an essential factor for the cartel members to do cumulative actions when the ratio of demand and supply fluctuates in the market, but sometime they can not take intelligent steps in fixation of commodity prices i.e. when OPEC fixed the prices of oil at forty dollars per barrel in 1980, but in consequence of this increase the consumption of oil reduced considerably.[1]

The OPEC states predicted that the price of petroleum will enhance in future, but the prediction proved adverse which pushed OPEC to reduce the price of its petroleum products. But the major problem faced by OPEC was that it could not unite its members on agreed price, agreed quota and sustain it for future.[2] The subsequent problem which was faced by OPEC was distribution of sale's quota to its members. All of the OPEC members wanted to produce more and more petroleum because at that time their cost of extraction was very low in comparison with the cost of other producers because oil reservoirs were located near the outer surface of the earth and the cost of extraction was very low comparatively. So they (member states) cheated each other by producing more petroleum to get maximum profit.[3]

At the same time Saudi Arabia freed it from the ties of OPEC and produced more petroleum on the dictates of America, but OPEC members increased their production in those days so the price of petroleum went down sharply and turned Saudi Arabia to cut its production because under these circumstances its production expenditures did not meet due to low oil

[1] http://www.wtrg.com/opecshare.html, (Visited on May 24, 2009)
[2] http://en.wikipedia.org/wiki/OPEC, (Visited on May, 25, 2009)
[3] http://www.wtrg.com/prices.htm (June 07, 2009)

pricing in the world market and it (Saudi Arabia) adopted OPEC quota binding because it was fruitful for it in those circumstances.[1]

[1] http://www.worldenergysource.com/articles/text/calderon_WE_v6n4.cfm. (June 07, 2009)

Chapter 2

TAXATION IN PAKISTAN

## 2.1 HISTORY OF TAXATION IN PAKISTAN

Revenue is the basic instrument for any sector whether public or private; no state can run its affairs without substantial amount of revenues in later and spirit. There are different means and ways to generate the revenue for financing different sectors of the country. Taxation is one of the largest sources of revenue for any country.

No doubt tax is a burden for the subjects of any country, but in reciprocity the subjects get many benefits from the Government of a welfare state, like life security, free education, free hospitalization, means of communication, job opportunities etc. Without such type of source the Government is unable to do anything for its subjects even the defence machinery of any country depends on revenue collected through taxation and the substantial amount of exchequer is used for strengthening the defence sector.

Unfortunately in Pakistan the laws are modified to benefit the executive class, the tax law is also victimize by this non serious behavior of politicians and military men who modify tax laws for the benefit of their friends, families and themselves.

When Pakistan came into being, it adopted the taxation law named as Income Tax Act, 1922, which was enforced in British India, with some amendments necessary for the then requirements. This Act was practiced in Pakistan for long time, with consecutive amendments, mostly on yearly basis through Finance Act, till 1979. When Zia-ul-Haq got power and became the President of Pakistan, he promulgated a new Income Tax Ordinance, 1979, through his executive order; this law is victimized by other military personnel Parvaiz Musharraf in 2001, at this time law is also modified by his executive orders.

Taxation laws are no longer considered as a mere device to raise revenue and to meet the cost of different sectors by the Government but in modern democratic countries it is now employed to attain economic policy objectives. The tax statute is a mixture of fiscal and

economic policy. The economic policy element of fiscal statutes insures re-distribution of wealth and has become a basic resource of recruitment for social sector development to achieve the goals of a democracy in reality.

Unfortunately in Pakistan, successive rulers, both military and civilian, used Income Tax laws for their own benefits, comforts and to obtain their luxurious life, on the other hand, the amount of taxes does not use for the benefits of the poor peoples of the country who are unable to meet out their basic needs. The ongoing tax reforms made out on the dictates of IMF and World Bank are completely lacking the perception of using tax legislation as a tool of attaining economic policy objectives for making Pakistan a self-reliant country and free from foreign debts.

The last transformation made, during the last military government, when the meeting of steering committee supervised the modification course in the FBR, held in Islamabad on February 23, 2004 for "effective implementations of the reforms". The steering group reviewed the latest position of reform process principally the ongoing pace and establishment of large taxpayer units (LTUs) and medium taxpayers units (MTUs) in the country. The committee ensured that the reform program is moving ahead as per schedule and in the right route. Tax officials have identified many deficiencies in the existing structure of tax machinery including duplication of the charter of duties, surplus positions in wings and overlaps of functions among different departments.

There exists a total misconception in the minds of our policy makers that the entire tax system will be rehabilitated through mere reframing in tax laws and establishing LTUs and MTUs in the country. This fallacy earlier resulted into promulgation of a new income tax law, which is operative from 1st July 2002. There is a consensus in the professional circles that this new law, intended to simplify the existing income tax law, has totally failed to incorporate necessary goal for inducing (FDI) foreign direct investment and swift growth. It has failed on all accounts; it is not trouble-free, fair, practical and tuneful.

Our economic managers are caught up in an impasse. On the one hand there is an escalating pressure from the donors to trim down the fiscal deficit through improved collections of revenue. On the other hand the ailing economy is not in a position to meet the growing revenue targets. Unfortunately the dignitaries of FBR forget the ground realities when they

are making polices to increase the revenue on yearly basis and burden the poor subjects of the country. According to collection figures released by the FBR on February 28.2004, in the first eight months revenue is showing positive growth from indirect taxes and marginal increase in direct taxes (infact the increase is shown by unlawfully withheld refunds, advance taxes or by creating fictitious demands against the taxpayers).

The tax machinery is under implausible pressure to collect more and more revenue whereas there is no meaningful growth in business activities. The FBR has collected Rs.308.9 billion during the first eight months of the current financial year against Rs.270.17 millions of last year showing an increase of 37.2 millions (this by no means is a satisfactory performance if growth is measured in real terms). The FBR has to collect Rs.201.1 billion in financial current year by collecting an average of Rs.17.5 billions per month for achieving the target. The tax officials will use all kinds of negative means to extract money from already overburdened taxpayers and by showing exaggerated figures, intentionally withholding refunds and keep the cases undecided where creation of funds is inevitable. The top policy makers in FBR and Ministry of Finance are obviously aware of these tactics and must be part and parcel of this unethical strategy.

The scorn of the situation is that even under these circumstances they (high profiles of FBR and Ministry of Finance) are getting full support from international donors in making the lives of ordinary people more depressed and costly because they (donors) are not willing to improve the economy of this country. Massive funds have been given at their disposal to hold workshops, vast prized resources on their lip service and luxurious entertainments. Through these workshops they intend to reform the tax system. During the last few years a lot of money has been exhausted by hiring so-called consultants who produced sub-standard reports on tax reforms, the officers of the department are being entertained in the name of workshops on tax reforms. This is an inner story of tax reforms in Pakistan that is both horrible and odious.

In all democratic countries like England and America extraordinary House Committee are formed by elected parliaments for making tax reform and policies to benefit the public at large. Here in Pakistan we are doing it through bureaucratic channels, which are old-fashioned, disorganized and corrupt. The catastrophe of Pakistan is that things are always

being done by people who are not qualified for that job. Military governments make constitutional changes and tax reforms are undertaken by officials of taxation department who have a proven track record of inefficiency, incompetence and corrupt practices.

It is a summary record that while FBR claims that our revenue collections are going "up", a vast majority of taxpayers are protesting over non-payment of refunds. In recent past, even the government-owned banks have openly expressed their displeasure on blocking huge refunds by FBR's top brass. Last year (2008) total collection of income tax and sales tax was ostensibly reached at Rs.70 to 90 billion including undoubted refunds of exporters, the banking sector and other taxpayers.

The fresh structural reforms in FBR were started in February 2002, relied broadly on huge investment in information technology. The FBR's top managers who are computer illiterate placed reliance on something which they did not understand. They had ambitious plans to develop a "National Information Technology System" providing communication support linking assessment, audit and collection processes with tax acumen structure. This dream of complete automation proved a fantasy as no serious system analyses were conducted. FBR is still lacking of trustworthy tax intelligent system and resultantly the Universal Self Assessment Scheme (USAS) is proved failure as taxpayers who filed returns u/s 114 with claim of refunds are perpetually receiving notices u/s 122 of ITO, 2001.

The recent exercise about income tax data entry at FBR, according to Daily Times, 13-07-2007, may cause loss in millions of rupees in collection of income tax returns during the current fiscal year as it is impossible to carry out parametric selection of cases for timely audit under the USAS (Universal Self Assessment Scheme). It is exposed by Federal Board of Revenue that those income tax returns which had been submitted for the income tax year 2002 were not be saved in data base and fifty per cent of data is still in hard shape. In 2006 FRB established a centralized data entry centre at a cost of Rs.20 million on the proposal of FBR's Member Information Management System (IMS) hired from the private sector. The foremost function of the centre was to develop a self-regulating centralized data entry office for feeding of income tax return forms in the data base without doing any error. In this regard, hundreds of data entry operators hired from private sector and procurement of computers and other IT related equipments were purchased by spending huge amounts of money on the project. The

astounding part of the story is that FBR has set up this centre in the presence of Data Processing Centres (DPCs) equipped with 250 Key Punch Operators (KPOs) working for FBR in different cities. But these KPOs have been sitting unused as data is being entered in Islamabad.

FBR has dreadful habit of first announcing plans and then doing groundwork. FBR wants full computerization and on the other hand FBR has 30,000 persons, majority of them do not know even the ABC of IT profession. It is quite strange that they want to achieve something for which they are not even organized and prepared themselves. The skill gaps in terms of human source have not yet been known and there are talks of highly stylish automated systems.

The culture of tax apparatus needs an entire change, which are more a matter of behavioral revolution and financial contentment rather than non-availability of IT infrastructure. FBR has yet not identified skill gaps in its present workforce, not initiated anything in terms of improving human resource management and shifted its entire focal point on IT development. Everyone knows that responsibility does not shift on tax laws but with the people who are implementing it. What is the assurance that the tax officials will perform their duties candidly under the new tax laws and with a fully automated system? FBR intends to spend between Rs.10 to 15 billion in the next three to four years on IT without realizing that its cost and benefit should be done by some thoroughly professional IT systems analyst before such a huge deal is committed.

The process of tax reforms will be a hideous joke unless first the process of accountability is completed in FBR. Those who suspended 1300 people by declaring them corrupt and have failed to prove anything against them should be taken to task first. Autonomy of FBR is necessary, but it should be tied with ruthless accountability, only then the credibility of the system can be ensured.

In present days, the concept of use of taxes has been changed, due to some dishonest government employees. Now a day taxes are being used not for the betterment of the country but for the betterment of some government employees and some feudal people for their sightless needs and demands which can not be fulfilled. Although, there are some flows in the principles of taxation but they do have the ability to minimize the above mentioned problems,

so by considering the running situation of our country the government should firmly follow the following principles for the uprising of the country's revenue, the lives of its subjects and other sectors also.

## 2.2 BASIC PRINCIPLES OF TAXATION

In common sense the government levies create a burden on the subjects of any country because they minimize the incomes and profits of whole community. But at the same time community thinks that some levies are good comparatively because they do not create more problems for them, the example of such taxes is indirect taxes like sales tax. The Tax lawmakers are trying to draft such type of law that can lower the burden of general public. The tax should be levied on income bracket of the individuals of the society, but still they could not come to the point through which the sufferings of general public may be treated positively and intelligently. A better tax system is not that which collects more and more tax but a good tax system is that which could relax the general public and imposes the limit of tax on the basis of the income bracket of its bearers. At the same the affect of good tax system is that in its exchange the whole nation get free education, free medical treatment, good communication and transportation system, speedy and favour justice system and hygienic atmosphere.

There are some characteristics of good taxation which are as under:-

- Which burden the subjects of the society according to their income bracket,
- People can pay it without any hurdle,
- The procedure of its payment should be very simple and short,
- The collection expenditure of it is very low,
- It should be understandable easily, as per importance of such tax is concerned, that even an illiterate person could pay it with this understanding that it is beneficial for him and for the country as a whole.[1]

[1] http://economistsview.typepad.com/economistsview/2005/04/_oped_principle.html. (Visited on June 10. 2009 )

It should be elastic in nature because in the changing circumstances demand of tax may change in ratio and numbers. On the other hand any state needs more taxes for the smooth running of its affairs whether defence or others, so the taxes should be community friendly and people must know that in reward of that payment they get such and such benefits and if they do not pay then they will not take those benefits.

The proponents of taxation and public finance say that good tax flourishes on the following principles:-

### *(I) __PRINCIPLE OF IMPARTIALITY AND FAIRPLAY__:-*

It is believed that some levies are better then other because they are cost effective for the state and are collected by spending low cost. The best example of that tax is sales tax because the cost of such type of tax is so low that it does not burden the state. But the bad thing in this type of tax is that there is no principle of fairness in it because it treats the subjects of the society without any difference on their pocket money. It charges the poor people as it charges to the rich, which is not fair for the general public. So the element of fairness does not involve in sales tax. A good tax is that which treats the peoples according to their income brackets and fluctuate on the increase and decrease of it like withholding tax which is charged on electricity bills who uses more electricity will pay more tax. So the good tax is equitable and fair and it treats the people on the basis of their incomes. Therefore, the ability to pay is the major principle for equity and fairness as the tax payments are concerned.

But in our country it is observed that the rich people take tax exemptions through different channels and poor remains under observations of tax department. The other thing which is practiced by the taxation department is that if any person pays tax or other government levies honestly the taxation department irritates them by using illegal and unethical ways to pay other amount. Keeping the same in mind it may be said that our taxation system is not based on basic principles of taxation which are practiced throughout the world.[1]

[1] http://economistsview.typepad.com/economistsview/2005/04/_oped_principle.html. (Visited on June 10, 2009)

*(II)* ***PRINCIPLE OF CERTAINITY:-***

The taxpayer should to be aware of the purpose, amount and mode of payment. Tax collectors should not misinform them as this would lead to irritation and uncertainty. Everything should be made clear and simple for the assistance of the taxpayer. Uncertainty leads to corruption. Hence, media hype is usually given to budget proposals for discussion as well as criticism. Undoubtedly the government wants the taxes to be accurate, so that the subjects of country could calculate their tax on their incomes without in ambiguity.[1]

*(III)* ***PRINCIPLE OF CONVENIENCE:-***

In this principle both elements i.e. time and manner of payment must be clear and expedient for the taxpayers, so that they are able to pay their taxes, in the specified time, manner and amount, before the expiry of given date and time.[2] Taxpayers feel it convenient in paying their taxes as such taxes already included in the price of commodity and they will pay tax only when they purchase the commodity. The sales tax is example of this principle, in practice.

*(IV)* ***PRINCIPLE OF ECONOMY:-***

This principle means that tax should be economical in a sense that the cost of collecting should be low. The whole amount taken out from people's pockets should go directly to the treasury. There should not be any leakage in the way that is to say any form of corruption. This principle also says that the expenditure on tax collection should be kept as low as possible.

*(V)* ***PRINCIPLE OF PRODUCTIVITY:-***

This principle means that production should be encouraged rather than otherwise. The productive capacity of the community should not be crippled. The government should avoid deficit budgeting which is not a bad phenomenon but it shows that the government is in debt. Therefore, through this canon we can avoid deficit budgeting and can collect more revenue.[3]

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[1] http://www.electronicflattax.com/?PageID=165. (Visited on June 10, 2009)
[2] http://www.electronicflattax.com/?PageID=165. (Visited on June 10, 2009 )
[3] http://www.cooperativeindividualism.org/dodson_site_value_taxation.html, (Visited on June 10, 2009 )

### *(VI)* ***PRINCIPLE OF ELASTICITY:-***

It depends upon the state of affair or circumstances prevailing in a country. As a country's need arise, like wise revenue increases or otherwise e.g. during the war the government expenditure increases and like wise its revenue increases. So this principle teaches us that the revenue generation should by elastic according to the circumstances prevailing in the country.

### *(VII)* ***PRINCIPLE OF SIMPLICITY:-***

This principle elaborates that the method of payment of tax should be simple and understandable in procedure even for the layman. It should be simple and not technical. This will allow the layman to understand why he should pay tax. More important is that simplicity will avoid corruption and will make it understandable.

### *(VIII)* ***PRINCIPLE OF DIVERSIFICATION:-***

The taxes should be levied in different ways and on different parameters. Taxes should be of all kinds so that the whole community shares its burden according to there bearing capacity. There should be a variety of direct and indirect taxes which could be levied according to the income bracket of the inhabitants of the society, simply the tax should be imposed as per the paying capacity of the population.[1]

## 2.3 CONCEPT OF DOUBLE TAXATION

Unless there is any prohibition or restriction imposed on the power of legislature to impose a tax twice on the same subject, double taxation though a heavy burden and seemingly oppressive and inequitable cannot be declared to be void or beyond the powers of the legislature.

"*It may, however, be noticed that double taxation can be imposed by clear and specific language to that effect. Where the language is not clear or specific by implication such levy cannot be permitted*"[2]

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[1] http://www.cooperativeindividualism.org/lambert-ian_on-adam-smith.html. (Visited on July 08, 2009)
[2] [(1992) 65 Tax 84 (S.C. Pak)] = 1992 PTD 576, PLD 1992 S.C. 562]

"Some references were also made to what has been called a presumption against taxation. In Manindra Chandra Nandi vs. Sectary of State[1], royalties from a coal mine were held liable both to Cess under the Cess Act, 1880 and to income tax under Income Tax Act of 1886, but it was said that it may be conceded that courts always look it disfavour upon double taxation and statutes will be construed, if possible, to avoid double taxation. Reference was made to certain dicta of American Courts and to the British case of Carr vs. Fowle.[2] But the only observation in this case was to the effect that the statute presumably did not intend that a vicar (representative or deputy of a bishop or pop) should in effect pay the same tax (land tax) twice on the same hereditament. This is plain enough. Thus the income tax is one tax, and income assessed under one Schedule cannot be assessed all over again under another.[3]

It is a general principle that no income should be taxed twice. If a person has been taxed on one type of income he should not be taxed on the same income again. This term is principally used for the non resident or foreigners who want to start business in Pakistan or send their incomes in Pakistan, if their income has been taxed in other country must not be taxed again on the arrival in Pakistan. Likewise the resident or non-resident who sends their incomes to native country if the same has been taxed in Pakistan will not be subject to tax in that country if that country has an agreement with Pakistan on the subject of double taxation. But if the tax rate is different the subject shall pay the difference of amount in that country.

It is the general practice in the world that most of the countries have signed different agreements and treaties on the subject of avoidance of double taxation with the other countries to facilitate their government and their subjects specially to their corporate entities from the burden of double taxation which is also the basic source of revenue for the host countries but at the same time the subjects of the host countries can enjoy the benefits in that other country through this agreement which is generally based on the principle of reciprocity.

Like other treaties between different states as treaties on asylum (refuge), treaties on high seas, treaties on terrorism, most of the countries have signed avoidance of double taxation treaties for bilateral benefits which promote the trade between the subject countries of double taxation. Such type of treaties are recognized and governed by international law.

[1] [(1907) I.L.R. 34 Cal.257 at P. 287; 5 C.L.J. 148]
[2] [(1893) IQ.B. 251]
[3] [1 ITC 284 (Calcutta)]

Most of the treaties create rights and obligations for subject countries on a particular subject and after signing the treaty such subject is treated between the signatory states according to the intention of the treaty. If some country does not act upon the treaty it can be challenged in international courts. The treaty has same force as other laws. As the tax treaties of Pakistan are concerned only those tax treaties have force of law if they are protected by section 107 of the Income Tax Ordinance, 2001 and if those treaties are not recognized by the same those have no force of law. If there is any contradiction or conflict between local law and treaty then the treaty shall have overriding affect on the local law. Vienna convention recognizes treaties as source of international law.

Section 107 connotes that "The Federal Government may enter into an agreement with the government of a foreign country for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income imposed under this Ordinance and under the corresponding laws in force in that country, and may, by notification in the official Gazette make such provisions as may be necessary for implementing the agreement.[1]

By going through the below sub-section we can say that practice in Pakistan is that the Federal Government has power to sign any type of treaty with other countries or it may vests such power to some department on that subject. The treaties on the subject of tax are different in nature, some treaties impose high taxes and some treaties make them lower. Most of the tax treaties signed by the Federal Government of Pakistan are drafted on American or Canadian patron. Through section 107 of ITO, 2001 we can solve any dispute arise between tax and treaty meaning thereby that if there is any conflict between Income Tax law and treaty which thing will prevail. These treaties encourage foreign investors to put their investment in those countries where the ratio of tax is low as compared to other countries.

The government of Pakistan has different types of treaties/agreements with most of the countries on the subject of avoidance of double taxation through the revenue division of Federal Board of Revenue by issuing the notification time to time as desired.[2] Double taxation treaty may be different as per the subject of treaty is concerned but the scheme in most of the agreements is working in the following manner:-

[1] Section 107 (1) of ITO,2001
[2] http://www.asiatradehub.com/pakistan/tax1.asp, (Visited on July 13. 2009)

"The Scheme of double taxation treaties can be like this that if two countries have some treaty on the subject of double taxation and a resident of one country drives some taxable income from other country who is also the party in the treaty and if the second country charge some tax on that income the first country shall not charge any tax from that person or income or it charges the difference of tax if the ratio of its tax is higher than the second country. In this way the tax payer relaxes himself from double charging on tax on the same sort of income."[1]

[1] Conclusion drawn from different double taxation treaties

Chapter 3

# TAXATION OF PETROLEUM COMPANIES IN PAKISTAN

## 3.1 TAX POLICIES FOR THE PETROLEUM COMPANIES

There are many petroleum policies which are incorporated from time to time, from the emergence of Pakistan for uplifting the petroleum sector in the country because the energy is the basic instrument for the elevation of any sector whether industry, agriculture or other sectors. Energy is the back bone of any sector which wants to develop on day and night basis. The most important policies in the petroleum sector which gear the economy are as under:-

### PETROLEUM POLICY 1997:

The first petroleum policy which was launched by the Government of Pakistan was 1991 before this Petroleum Policy of 1997. This policy (petroleum policy 1997) was followed by different policies according to subsequent demand to invite more and more national and international petroleum companies by making the procedures easier and give ample incentives to the companies, which are interested to work in Pakistan, in this specific sector. The above mentioned policy introduced new Offshore packages based on PSA (Production Sharing Agreement).[1] This policy did not affect the companies which had started their businesses before the promulgation of this very policy, but the policy offered an option to the existing license holders who want to change the regime under which they are working, to convert their concession Offshore agreements into Production sharing agreement. Many incentives were offered by the Government under this policy to strengthen the local and foreign companies in the field of oil sector like if a local company invests in petroleum sector, the Government offered it additional shares out of Government's own working interest, but that working interest of Government was offered at the time of exploration phase of that company.[2] On the other hand, if two or more companies are interested in the same, the government will offer 5%

[1] Sub-clause b of clause 2.3 of Petroleum policy, 1997 (Pakistan)
[2] Clause 2.1.5 (a) of Petroleum policy, 1997 (Pakistan)

of its share as a whole for both of the companies provided that the interested companies have no nexus with each other.[1]

The local Exploration and production companies could use 30% of their sales proceeds to fulfill their foreign currency requirements but this relaxation was given after the commercial discovery was made and not before it.[2] For the deepest drilling more incentives were given to the companies. In this policy royalty incentives were also given to the companies that they will pay 0% for initial four year, 5% of their receipts for fifth years, 10% for six year and 12.5% after six year of commercial production.[3]

This petroleum policy was framed for the systemization of the petroleum sector inland. In order to facilitate oil and gas in distant areas under the agreement with the Government of Pakistan, for the first time, the price of non-associated gas was fixed at 75%,[4] of the liquid fuel oil price minus other discounts as could be negotiated pro tempore[5], but on event when the concession agreement was signed between the stake holders, not on the stage of commercial discovery.

All the petroleum companies got benefits from the incentives given in S.R.O. 400(I)/97[6] which was the prime need of the petroleum industry. Due to this incentive international oil companies came to Pakistan to start petroleum business.[7] The corporate tax under this policy was 40% of the total income of that E&P Company.[8] After this policy the petroleum sector flourished for the first time in Pakistan.

[1] Framework of the government of Pakistan holding company, annexure III of Petroleum policy, 1997 (Pakistan)
[2] Sub-clause b of clause 2.1.5 of Petroleum policy, 1997 (Pakistan)
[3] Clause I of Pakistan Offshore package, Petroleum policy, 1997 (Pakistan)
[4] XIII of Framework of the government of Pakistan holding company, annexure III of Petroleum policy, 1997 (Pakistan)
[5] For the time being, Page#837, Rafiq's Law Dictionary, Edition 2007
[6] Clause 2.2.3 of Petroleum policy, 1997 (Pakistan)
[7] X of Framework of the government of Pakistan holding company, annexure III of Petroleum policy, 1997 (Pakistan)
[8] II of Framework of the government of Pakistan holding company, annexure III of Petroleum policy, 1997 (Pakistan)

## PETROLEUM EXPLORATION AND PRODUCTION POLICY 2001:

The 1997 policy was brushed aside by the Petroleum Policy 2001, coupled with other related laws like Exploration and Production Rules, 2001, Model Onshore Petroleum Concession Agreement (PCA) and Model Offshore Production Sharing Agreement (PSA).

No doubt the Exploration and Production activities are increasing day by day in Pakistan; still the national demand of petroleum could not be fulfilled from the local production. The local production of petroleum is only 18% of the demanded amount of oil[1]. Keeping the same in mind, the government decided to replace the power sector and transportation on gas instead of petrol because it is observed that most of the imported petroleum is utilizing to fulfill the need of industries and generation of energy.

Therefore, the then Government had taken intelligent steps for the formation of new petroleum policy after consulting with all the stake holders, subject specialists, Ministry of Petroleum and Natural Resources and members of FBR to make the exploration and production of petroleum profitable and incentive oriented for the investors. Some production bonuses were also offered through this policy.
Under this policy the ratio of royalty was 12.5% which the companies were liable to pay on the price of petroleum at field gate to the Federal Government.[2]
For determination of cost of gas at field gate the cost of transportation was also considered under this petroleum policy.[3]

Royalty was treated as expenditure under this policy.[4] The policy was launched for basic guidelines for the petroleum companies in Pakistan, way of taxation of the same sector, working of royalty, its amount and the Zones offered for drilling in Offshore and Onshore petroleum projects. This policy gave substantive importance to Offshore petroleum projects and offered major incentives to Offshore drilling because the level of risk in Offshore drilling is more than the Onshore drilling. At the end of this policy some appendixes are given

[1] Page#219 of Pakistan Economic Survey 2005-2006 and 1.1 Petroleum Exploration and Production Policy, 2009.
March 2009
[2] Clause 2.2.3 of Petroleum Exploration and Production Policy, 2001 (Pakistan)
[3] Clause 2.2.3 of Petroleum Exploration and Production Policy, 2001 (Pakistan)
[4] Sub-clause (ii) of Clause 2.2.3 of Petroleum Exploration and Production Policy, 2001(Pakistan)

regarding fiscal provisions of PSA's and land system for petroleum exploration and production (Offshore Pakistan) to provide the guide lines for all stake holders. The rate of corporate tax in this policy was 40% of the total income which was levied after the commencement of commercial production.[1]

It is opine that for taxation purpose or otherwise this petroleum policy was a better policy because it was drafted after intensive study of previous policies and after consulting with the concerned stake holders. More and more incentives were offered for the petroleum companies in future for the prime interest of the country's need of petroleum and to educate the local inhabitants to keep future perspectives in mind.[2] It was a good petroleum policy because under this policy many bids were finalized and signed.

## PETROLEUM EXPLORATION & PRODUCTION POLICY 2007:

The Government of Pakistan is committed to speed up the exploration and development programmes in order to quash the decline in crude oil production, to increase the familial gas production, supply and to cut down the trouble of imported petroleum payments and trade of different equipments. The purpose of this petroleum Exploration and Production policy was to make procedures easier, lower down the taxes and cost of petroleum industry.

The major purposes of this policy were to stimulate the petroleum industry to fulfill the national oil requirement, to increase the proficiency of the individuals by offering different incentives for the foreign and local companies and to regulate the petroleum industry in Pakistan. The format of the policy is same as previous policies but the diversity is that under this policy Offshore policy got much enormity.

Including previous incentives offered by Government of Pakistan, different other incentives were offered to the petroleum companies under this policy, some are as under:-

All the Exploration companies can start the exploration operations with 100% ownership.[3]

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[1] Sub clause (ii) of Clause 2.2.3 of Petroleum Exploration and Production Policy. 2001(Pakistan)
[2] Clause 2.3.7 of Petroleum Exploration and Production Policy, 2001 (Pakistan)
[3] Clause 5.1.3 of Petroleum Exploration and Production Policy. 2007 (Pakistan)

In case of joint ventures with foreign Exploration and Production Companies the Local Companies including GHPL shall have working interest of 15% in Zone I[1], 20% in Zone II and 25% in Zone III.[2] Corporate tax under this policy is 40% of the total income of the E&P Company.[3]

The taxes and Government levies are the same apart from the imposition of windfall tax; it is a new concept in Pakistan which is based on the increasing value of American dollar which is the means of consideration (payment) in the petroleum sector in Pakistan. It (windfall tax) is an additional source of revenue for the Federal Government but subject to the increase of value of American dollar. The basic concept behind it is that if the agreement is materialized between the Government and any Petroleum Company on some amount of dollar but afterward the rate of dollar increases the government shall take benefit of it and get some percentage on the increasing rate of dollar. So the government has established a rule that if after signing an agreement the rate of dollar increases then the petroleum producing companies shall pay additional amount to the GOP as windfall tax.

According to this policy the windfall tax will be applicable on the production of condensate and crude oil according to the following formula:-

$$WLO = 0.5 \times (M-R) \times (P-B)$$

Where:

WLO — Windfall levy on the crude and condensate;

M — Net production;

R — Royalty

P — Market price of crude oil and condensate

B — Base price, which will be as under:[4]

a. The base price for crude oil and condensate will be USD 30 per bbl.

[1] Clause 5.1.3 of Petroleum Exploration and Production Policy. 2007 (Pakistan)
[2] Clause 5.1.3 of Petroleum Exploration and Production Policy 2007(Pakistan)
[3] Clause 6.1.2 of Petroleum Exploration and Production Policy 2007(Pakistan)
[4] Clause 5.1.3 of Petroleum exploration & production policy. 2007 (Pakistan)

b. The base price for crude and condensate will escalate each calendar year by USD 0.25 per bbl starting from the date of first commercial production in control area.

This policy is totally failed policy because not a single bid is finalized under this policy, it means that this policy could not favour the petroleum companies or other stake holders.

## PETROLEUM EXPLORATION & PRODUCTION POLICY 2009

Petroleum Policy 2007 has been replaced by this petroleum policy 2009 as the new market conditions warranted urgent changes required for the promotion of investment in view of increasing international energy prices. It also reflects the intention of Government of Pakistan to accelerate exploitation of indigenous natural resources by attracting foreign investment with technology as well as promoting local companies to participate in Exploration and Production activities in this level playing field. The purpose of this Petroleum Exploration and Production Policy is to establish and make the policies and procedures easier, lower down taxes and cost of Petroleum Exploration and Production Companies.[1]

Furthermore, Government of Pakistan reviewed the increasing involvement of Pakistani companies in partnership with the foreign companies, join hands in the involvement of local stakeholders to be one of the keys to unlock the potential of the petroleum reserves in the frontier areas for the benefit of the country.[2]

Under this policy following companies are authorized to get the petroleum rights:-

1. All local and foreign companies working in Pakistan in Exploration and Production sector.

2. Foreign companies not operating but having operated concessions in other geographical area of the world will also be eligible after demonstration of technical and financial capacity.

[1] Clause 1.2 of Petroleum Exploration & Production Policy, 2009 (Pakistan)
[2] Clause 1.6 of Petroleum Exploration & Production Policy, 2009 (Pakistan)

3. All companies having joined consortia of companies in concession and having at least three years of experience as a non operator will be eligible to become operator subject to demonstration of technical and financial capability.

4. Smaller local Pakistani companies will be allowed to join consortia with other Exploration and Production companies as non operator in order to gain the necessary industry experience to allow them to expand their capacity to take on operating role in future. If any local company does not have requisite past operating experience, such company shall be required to either produce an agreement with as internationally renowned Exploration and Production company acceptable to DGPC or high calibre technical and management team with proven track record of overseeing and managing operations in the international petroleum industry.[1]

Under this policy the amount of Royalty will be payable at the rate of 12.5% of the value of petroleum at field gate.[2]

Corporate tax is payable at the rate of 40% on profit or gain in accordance with 5th Schedule of Income Tax Ordinance, 2001. Royalties shall be treated as expense for the purpose of determination of income tax liability under this policy.[3]

As the windfall levy is concerned, on the event market price of crude oil/condensate exceeds US$ 100/barrel, 100% benefit of windfall levy will pass on to the Government. The ceiling would be reviewed as and when pricing dynamics significantly change in the international market.[4]

Incentives in respect of Import Duties/Taxes and Fees for the E&P Companies and the "Service companies" are as per applicable SRO(s) on the effective date of execution of the Exploration Licenses /PCAs.[5]

Under this policy different incentives are given to the Local E&P companies, some important incentives are as under:-

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[1] Clause 3.1 of Petroleum Exploration & Production Policy. 2009 (Pakistan)
[2] Clause 5.1.1 of Petroleum Exploration & Production Policy, 2009 (Pakistan)
[3] Clause 5.1.3 of Petroleum Exploration & Production Policy. 2009 (Pakistan)
[4] Clause 5.1.4 of Petroleum Exploration & Production Policy. 2009 (Pakistan)
[5] Clause 5.1.1 of Petroleum Exploration & Production Policy. 2009 (Pakistan)

1. All E&P Companies will be encouraged to operate exploration blocks with 100% ownership.[1]

2. In case of joint ventures with foreign E&P Companies, local E&P Companies including GHPL shall have working interest of 15% in zone-I, 20% in zone-II and 25% in zone-III on full participation basis. The local E&P Companies shall contribute their share of Exploration expenditure in Pakistani currency up to minimum required Pakistani working interest.[2]

3. Local E&P Companies will, on case to case basis, be entitled, during the exploration phase, to receive foreign exchange against payment in Pakistani currency to meet out their day to day obligation under permits, licences and PCA(s)/PSA(s).[3]

4. After commercial discovery local E&P Companies will be paid up to 30% of their sale proceeds in foreign currency to meet out their day to day operational requirements.[4]

5. E&P Companies operating in Pakistan will be allowed to contract with gas transmission and distribution companies and third parties, other than residential and commercial consumers, for the sale of their share of gas in Pakistan, at negotiated prices, in accordance with the applicable laws, rules and regulations.[5]

## 3.2 TAXATION OF RESIDENT AND NON RESIDENT PETROLEUM COMPANIES:-

To understand the concept of taxation on different sources of income, one has to understand the following points:-

- Income tax is an annual tax on income on earnest money of a person,
- Income of a tax year as computed under the law is called taxable income, at the rate specified under the tax law, enforced in the relevant time, on all sources,

[1] Clause 5.1.3.1 of Petroleum Exploration & Production Policy, 2009 (Pakistan)
[2] Clause 5.1.3.2 of Petroleum Exploration & Production Policy, 2009 (Pakistan)
[3] Clause 5.1.3.2 of Petroleum Exploration & Production Policy, 2009 (Pakistan)
[4] Clause 5.1.3.2 of Petroleum Exploration & Production Policy, 2009 (Pakistan)
[5] Clause 10.4 of Petroleum Exploration & Production Policy, 2009 (Pakistan)

- Tax is levied on the taxable income of inhabitants of a society and their taxes are calculated according to the words and phrases (means according to the normal parlance of the relevant law) of the enforced law in the particular time and place.

Every tax year is treated separately and independently from other tax year and has no affect for other year, as per the income tax law is concerned. It may be possible that one person may be resident in one year can be non-resident in the other year instead of living same number of days in both the years in Pakistan. It is in practice in Pakistan that the changes are made in the tax rate on yearly basis, through Finance Act in 30th June. But the affects of these amendments are made applicable on the income in the coming year which is started on the 1st of July. The income tax returns of the last year are filed after the amendments but before 30th September. Income tax returns of the last year which has been filed in September does not affected by the amendment which have been made in the month of June, irrespective that amendments has been made before filing of returns of that year until and unless otherwise provided by special provision.

In order to determine that whether there is any difference between the taxation of resident and non resident petroleum companies, working in Pakistan, we should have an idea of the relevant clauses of Income Tax Ordinance, 2001. But before this it would be better to see the provisions which are related in determination of resident status, which is discussed as under:-

## HOW TO DETERMINE RESIDENT STATUS?

There are different provisions through which the resident status of different entities may be determined for the taxation purpose by Income Tax Ordinance, 2001 which are as under:-

(Section 2(40) and 81):-

The Income Tax Ordinance, 2001 in contrast to the repealed Ordinance of 1979, defines three expressions relating to the term "resident" in Pakistan. These are:-

"Resident company" [section 2(50)] as defined in section 83.[1]

A company shall be a resident company for a tax year if-

(a) it is incorporated or formed by or under any law in force in Pakistan;

(b) the control and management of the affairs of the company is situated wholly in Pakistan at any time in the year; or

[1] Section 2(50) Of ITO, 2001

(c) it is a Provincial Government or local authority in Pakistan.[1]

"Resident person" [section 2(52)] as defined in section 81 (1) ITO, 2001.[2]

A person shall be a resident person for a tax year if the person is-

(a) a resident individual, resident company or resident association of persons for the year; or

(b) the Federal Government.

"Resident taxpayer" [section 2(53) means a "taxpayer" who is a resident "person" [section 2(52)].[3]

The bird eye view of the above provisions reflects that clause (52) and (53) of section 2 are repetitive. In the repealed Income Tax Ordinance, 1979, the term "resident" cushioned all the categories of persons chargeable to tax, was defined in section 2(40) in a precise and comprehensive manner. In new Ordinance, which is claimed "simple" by the bureaucratic minds, a basic concept on which the entire scope of chargeability depends, has been unnecessarily repeated and scattered without any commonsensical reasoning or legal necessity.

The following principles have to be kept in mind while determining residential status of any taxpayer:-

Different taxable entities: - Tax is levied on a person under the Income Tax Ordinance, 2001. The term person is divided in the following categories for the determination of resident status [section 2(54)][4] read with section 80 to 85:-

- An association of persons[5]
- An individual[6]
- A company[7]

All these entities can either be resident or non-resident in Pakistan during any tax year.

[1] Section 83 of ITO, 2001
[2] Section 2(52) of ITO, 2001
[3] Section 2 (53) of ITO, 2001
[4] Section 2 (54) of ITO, 2001
[5] Section (2(a)) of ITO, 2001
[6] Section 80 (a) of ITO, 2001
[7] Section 80 (b(i)) of ITO, 2001

## HOW TO DETERMINE RESIDENT STATUS OF A COMPANY

Section 83 of Income Tax Ordinance, 2001 deals with the question how to determine the resident or non-resident status of a company working in Pakistan which is as under:-

A company incorporated, formed by or under any law enforced in Pakistan is always resident irrespective of that who and where it is controlled and managed.[1]

Any company, not being a company formed or incorporated by or under the laws of Pakistan, is resident in Pakistan in the year under consideration if the company's command and control is situated wholly in Pakistan at any time in that year.

Usually control and management of a company's affairs is situated at the place where meetings of its board of directors are held. If a local board of directors manages a subsidiary company of a non-resident foreign company, it will be difficult for the non-resident company to claim that control and management of its affairs vests at the place where the parent company resides (means that if the meeting s of subsidiary company of a non-resident company is held by the local board in the country where the subsidiary company located, it is difficult for that non-resident company to establish that the affairs of that subsidiary company vests where the parent company resides.

The courts have provided some guide lines in a famous case named as De Beers Consolidated Mines v Howe, it has been observed that control and management is situated where the central management and control actually abides that is to say, where the supreme command over the company's affairs rests.[2]

There is no major difference in taxation of resident and non-resident companies under the Income Tax Ordinance, 2001 except the double taxation but the result of double taxation is same because the non-resident company pays some taxes in the country where it resides. The only difference in taxation of petroleum sector companies is some rebates on customs and sales exemptions or rebates which are given to the companies just to encourage the foreign investment in Pakistan and it is also possible that the same may be given for a specific

[1] Section 83 (a) of ITO,2001
[2] [1906] 5 Tax case 198

company or all the companies who wish to work in Pakistan subject to agreement with the Federal Government.

**RESIDENTIAL STATUS IS ALWAYS IN RELATION TO TAX YEAR:-**

Residential status of any person is to be determined in respect of each tax year, as it may vary from year to year. A person may be resident in tax year 2006; it may be possible that the same is non-resident in proceeding year whether he spent same number of days in Pakistan.

***ONUS OF PROOF***: - Whether a taxpayer is resident or non-resident in a tax year is a question of fact and the burden of proof is on the shoulder of taxpayer to furnish the evidence that whether he was resident or non-resident in the year under consideration under the Income Tax Ordinance, 2001.

## 3.3 CONCEPT OF ROYALTY AND ITS AFFECT ON THE TAXATION OF THE OIL COMPANY:

The word "royalty" generally refers to a share of the produce or profit reserved by the owner for permitting another person or body to use his property. If royalty is related to personal property, it is a share on produce reserved by the owner of the product for permitting another to exploit or use the product. Ordinary it connotes a duty to make and a corresponding right to receive, payment proportionate to the use of patented method or machine. In short we can say that the payment which the licensee pays to the licensor against the lawful use of method or machine invented or owned by the licensor.[1]

The word royalty, when used with reference to patent, it means that the compensation paid to the licensor for the use of his invention by the licensee. It is a payment which is received by the grantor of a patent or payable against the use of good made by the licensor. It is not mentioned in the law anywhere that what type or amount of payment is fixed but is the brain matching between the holder of right and assignee of right and it may be fixed on the use of particular good at once or during the time of use or forever.[2]

[1] Paper written by Khurram Saddique, director legal. Pakistan Telecommunication authority
[2] Paper written by Khurram Saddique, Director Pakistan Telecommunication Authority

With reference to the literary work presented in the form of words or printing, the royalty is used to allow the publisher to print or publish writing or printing with a specific amount which the publisher is bound to pay according to the percentage agreed between the owner and publisher copy wise, like the printing of Saadqain.[1] The percentage may be 10%, 20% or any other agreed between the author and publisher. We can understand the concept of royalty through definitions given in dictionaries which are as under:-

A payment made to author or inventor for each copy of a work or article sold under a copyright or patent.[2]

A share of the producer or profit from real property, reserved by the grantor of a mineral lease, in exchange for the lessee's right to mine or drill on the land.[3]

Royalty is not a term used in legal parlance for the price of the goods sold. It is a payment reserved by the grantor of a patent, lease of a mine or similar right, and payable proportionately to the use made of the right by the grantee.[4]

From the above definitions and discussion we come to know that the owner of some property when authorizes some other person to enjoy the benefits of his property, he allows him on some conditions, which may be different, subject to the brain matching of the parties. But usually the owner allows him to use or earn profit, on some payment. This payment may be at once or otherwise.

Oil and Gas is the property of Federal Government as mentioned in Article 172 of the Constitution of Pakistan, 1973, as under:-

- **"Any property which has no rightful owner shall, if located in a province, vest in the Government of that province, and in every other case, in the Federal Government."**

- **"All lands, minerals and other things of value within the continental shelf or underlying the ocean within the territorial waters of Pakistan shall vest in the Federal Government."[5]**

[1] http://www.urdustreet.com/web%20site%20of%20art%20gallery/pakistani_art/saadqain/saadqain_portraits.html , (Visited July 20, 2009)
[2] Page#1356, Black's Law Dictionary. Eighth Edition
[3] Page#1356, Black's Law Dictionary, Eighth Edition
[4] State of Orissa v. Titaghar Paper mills Co. Ltd (1985)
[5] Article 172 of Constitution of Pakistan, 1973

- **The ownership of all mines and coal and gold washings by the state was asserted in S: 29 of Act XXXIII of 1871[1] and again in S: 41 of Act XVII of 1887,[2] where earth oil is also declared to be Government property. The title of Government being secured by legislation need not be referred to in record-of-rights.[3]**

- **Right of the Government in mines and minerals: - All mines of metal and coal, and all earth-oil and gold washing shall be deemed to be the property of the 2[1[Government] for the purposes of the 3[State]] and the 4[State] Government shall have all powers necessary for the proper enjoyment of 5[the Government's right thereto.].[4]**

So when the Government of Pakistan, allows any company to exploit the resources beneath the surface of the earth through lease agreement with the government, it allows that company with the condition that it shall pay 12.5% on the production of the petroleum to the government. This type of amount shall be paid after the commencement of commercial discovery of the petroleum.

Shortly, royalty on oil and gas means a payment made on the profit or on product reserved by the owner of the oil and gas for allowing another person to exploit the reserves owned by the owner (government) or on the generation of income from the oil and gas. The provision of royalty is given under different statutes related to petroleum like under rule 29 of Pakistan Petroleum (Production) Rules, 1949, under rule 36 and 37 of Pakistan Petroleum (Exploration and Production) Rules 1986, under the head of fiscal incentives in Petroleum Policy, 1997, under section 35 of Pakistan Petroleum (Exploration and Production) Rules, 2001, under section 5.1 of the heading of Onshore Petroleum Concession Agreement (PCA) and under section 6.1 under the heading of Offshore Production Sharing Agreement (PSA) of Petroleum Exploration and Production Policy, 2007, but the amount of royalty is same under each of the legislation, which is 12.5% of the value of petroleum produced or reserved. Income Tax Ordinance, 2001, gives us the idea that whose and which incomes are subject to royalty as under:-

[1] Cattle-trespass Act. 1871
[2] The Punjab Land Revenue Act, 1887
[3] Waste lands, mines and quarries extracts from settlement manual rules, 1887
[4] The Punjab Land Revenue Act, 1887

A royalty shall be Pakistan-source income if it is-

(a) paid by a resident person, except where the royalty is payable in respect of any right, property, or information used, or services utilized for the purposes of a business carried on by the resident, outside Pakistan, through a permanent establishment; or

(b) borne by a permanent establishment in Pakistan of a non-resident person.[1]

## AFFECT OF ROYALTY TREATMENT IN CASE OF PETROLEUM COMPANIES AND OTHER COMPANIES:

For the purpose of working out payments to the government, the royalty is inclusive in total tax liability. In case of petroleum companies, the assessment are made under the provisions contained in section 100 read with 5th Schedule of the Income Tax Ordinance, 2001. This is a separate basket assessment where certain provisions of law are specifically applicable, which are not generally applicable in the other cases where the taxpayers are doing normal business. One of the special features of assessment of the petroleum companies is that all the payments to the government are inclusive in the amount of tax whereas in other cases royalty is allowed as business expenditure. It is a very special concession which is given to the petroleum companies that they adjust the whole amount of royalty, during the computation of their income, which has already been paid by 12.5% on well-head value of the production to the Federal government. In other words royalty is considered as part of tax liability, and is included in the total amount payable to the government in shape of tax. In this manner tax liability is reduced by the amount of royalty. If royalty is included in the gross receipts representing the well-head value for working out depletion allowance, it will amount to double relief and probably it is not the intention of law. Therefore, in the light of 5th Schedule of Income Tax Ordinance, 2001 the total value of royalty paid to the government is allowed as a relief towards payments of tax, it would again not be allowed as a relief for working out depletion allowance.

[1] Section 101 (8) of ITO.2001

## COMPANIES VIEW ABOUT THE COLCULATION OF ROYALTY:

Most of the companies view about the calculation of royalty is that the mineral wealth belongs to Government of Pakistan which authorizes the companies to exploit the natural resources beneath the surface of the land under the lease agreement between the parties. In the same consideration the government has the right to collect the royalty which may be in the form of cash or kind, based on the wish of the President or need and demand of the country. However, petroleum produced is the property of the exploiting companies after payment of royalty. In other word, the depletion allowance is to be computed on the total quantity of the petroleum or gas produced instead of 87.5% of total production.[1]

As per collection of taxes, duties or other levies imposed by the government, most of the companies rely on normal parlance of law and are of the view that the words "the gross receipts representing the well-head value of the production" means the gross amount received by the company for the sale of the petroleum, whether a part of it represents royalty or other taxes, duties or levies imposed by the government. The emphasis of companies is upon the words "gross receipt". In their view, the value of the petroleum or gas produced is that what it costs to the purchaser.

## ROYALTY CALCULATION BY THE TAXATION DEPARTMENT

On the point of royalty the method of calculation of both i.e. companies and department, is totally different. The Taxation department is of the view that royalty and other payments paid to the government have to be added in profits or gains and the aggregate so arrived has to be taken for working out the tax liability in accordance with Rule 5 of 5$^{th}$ Schedule of Income Tax Ordinance, 2001. i.e. if the company earns Rs.100/- as profit and pays Rs.10/- as royalty, accordingly to Taxation department the profits plus royalty (Rs.100/- + Rs.10/- =Rs.110/=) has to be taken as the amount liable to tax. This interpretation of Rule 5 is legally incorrect because it provides that profit or gain "before deduction of payment to the government" is liable to tax according to the prescribed rates. It means that the tax will be calculated on the income of any petroleum company and not on the profit of company which is totally illegal and illogical, because tax is computed and paid on the profit of the business and not on the

[1] Assesment Order of Oil & Gas Development Company Limited for the assessment year 2007 by Additional Commissioner (Audit-II), LTU, Islamabad, dated 15-05-2008

receipts of any business. So the view of taxation department is totally wrong and against the basic principle of chargeability of tax.[1]

## ROYALTY CALCULATION BY THE COMPANIES

Contrary to the departmental view, most of the companies are of the opinion that if royalty is of Rs.10/- the same must be deducted from the profits or gains which is Rs.100/- and the balance amount is liable to tax according to the provisions of Rule 5 of 5th Schedule of Income Tax Ordinance, 2001. In this way the royalty of Rs.10/- is deductible from profit of Rs.100/- and balance amount (Rs.100/- minus Rs.10/-) of Rs.90/- is liable to tax.[2]

## 3.4 COMPUTATION OF PETROLEUM BUSINESS SEPARATELY:

It is observed by the plain reading of the 1st Part of the 5th Schedule of the Income Tax Ordinance, 2001 that for the purpose of taxation of the business of petroleum undertaking is treated separately for calculation of taxation, for any relevant tax year. It would be better to see the relevant provision of the Ordinance before stepping ahead, the provision is as under:-

"Where any person carries on, or is deemed to carry on, under any agreement with the government, any business, which consists of, or includes, the exploration of petroleum in Pakistan, ... such business or part thereof, as the case may be, shall for the purpose of this Ordinance, be deemed to be a separate business undertaking hereinafter referred to as "such undertaking" and the profits and gains of such undertaking shall be computed separately from his income, profits or gains from any other business, if any, carried on by him."[3]

It is clear from this clause of the 5th Schedule of the Income Tax Ordinance, 2001, that exploration and production of petroleum is to be treated as a business distinct and separate from any other business carried on by the petroleum companies or other persons and its profits shall be computed separately from income of other businesses. It means that in the trading account of this business, only such receipts shall be included as relate to exploration for and production of petroleum and natural gas.

[1] M/s Mari Gas Company Ltd v. Commissioner of Income Tax, Islamabad. 223 (IB) 2005&Others
[2] M/s Mari Gas Company Ltd v. Commissioner of Income Tax, Islamabad, 223 (IB) 2005&Others
[3] Clause 1 of Part 1 of 5th schedule of ITO. 2001

Further, this Part directs that "subject to the provisions of this Part, the profits and gains of such undertaking shall be computed in the manner applicable to income, profits and gains chargeable under the head income from business".[1] It means that the profits of such undertaking shall be computed in the same manner as that applicable to business income. Here it is also necessary to see the definition of business given in Income Tax Ordinance, 2001, which is as under:-

In view of section 2(9) BUSINESS includes any (a) trade, (b) commerce, manufacture, (d) profession, vocation or (e) any adventure in the nature of trade, commerce or manufacture.[2] Although the definition is not complete; it covers every facet of an occupation carried on by a person with a view to earning profits. Production of goods from raw material, buying and selling of goods to make profits and providing services to others are different forms of business, profits rising or profession. The term business is of wide import and in fiscal statues it must be construed in a broader rather than a restricted sense.

Every legislation has its own treatments regarding the particular subject and treating the same in particular meanings if necessary. As the petroleum business is concerned, for the taxation purpose the income from the business of petroleum shall be computed separately, from other businesses run by single person, under 5th Schedule of the Income Tax Ordinance, 2001.

## 3.5 INCENTIVES GIVEN BY THE GOVERNMENT OF PAKISTAN TO THE PETROLEUM COMPANIES:

The standing presumption regarding imposition of Income Tax on the income of the subjects of a state is that there is no tax except provided in specific provision of the law enforced for the time being. The same premise is placed regarding the incentives against the income tax that there is no incentive if the subject (person) who is liable to pay income tax under the Income Tax law until and unless it is specifically given in some specific provision of law in clear parlance. Likewise it is provided in the Ordinance under section 21 that no deduction, which is a type of incentive under the Ordinance, is allowed under the Ordinance except it is otherwise provided, in computing the income, under any head of income. There are different types of incentives which are enjoyed by the petroleum companies under the Income Tax

[1] Clause 2(2) of Part 1 of 5th schedule of IOT. 2001
[2] Clause (9) of section 2 of ITO.2001

Ordinance, 2001. These incentives are provided in the shape of deductions, carry forward of losses, adjustment of pre-commencement expenditures, depreciation of assets, payments made by the oil companies in favour of government, depletion allowance and de-commissioning cost which is the unique character of Oil sector.

Under section 22, the incentive in the form of depreciation is allowed as deduction to a person having taxable income, for depreciation of assets used for the promotion of person's business.[1]

The method of calculation of depreciation of the assets used in the business is computed in the light of Third Schedule and its rates shall apply on depreciated assets, against the written down value of the asset at the start of the year, which is as under:-

- Building (all types) 10% per tax year,
- All type of technical books, machinery and plants which is not specifically mentioned in else where in the Ordinance including vehicles, vessels and furniture of all kinds, 15% per tax year,
- Hard wares, soft wares of Computers including printer, monitor and allied items, other equipments and machinery used in manufacturing of IT product, air crafts and aero engines 30% per tax year,
- If the taxation is related to mineral wealth and oil its taxation shall be calculated according to the relevant portion of Fifth Schedule,
- Beneath the ground installations 100%
- Offshore platform and production installations, 20%.[2]

As provided in section 24, a person shall be allowed an amortization deduction in accordance with this section in a tax year for the cost of the person's intangible-

(a) that are wholly or partly used by the person in the tax year in deriving income from business chargeable to tax; and

[1] Section 22 of ITO.2001
[2] Part I of 3rd schedule of ITO.2001

(b) that have a normal useful life exceeding one year, however, this deduction is not allowed for more than 10 years.[1] Other principles for deduction of amortized cost of intangibles are the same as in the case of depreciable assets in section 22.

The list of intangible entitled for amortization has been expanded including trademarks, scientific or technical knowledge etc.

Under section 25 of the Ordinance, any person having taxable income is allowed a deduction for the pre-commencement expenditure incurred in the business.[2]

These expenditures shall be amortized on straight line basis at the rate mentioned in Part III of 3rd Schedule of the Ordinance which is as under:-

The rate of amortization of pre-commencement is 20%.

The total deduction (pre-commencement) allowed under this section, in the current and previous years, shall not exceed from the total amount of expenditures allowed in that year. But no deduction is allowed under this section if the pre-commencement expenses are allowed as a whole, as deduction under any of the provision of the Ordinance.

According to section 26, any person who incurred expenditure, in Pakistan, for the purpose of scientific research in connection of driving income from business, is allowed deduction of all expenses incurred in the tax year.[3]

Under sub-section 2 of section 20, any expense which any company bears for seeking any financial, administrative and legal services in the course of its amalgamation are allowed as deduction.[4]

Different other deductions are allowed for a tax year under section 28 of the Ordinance:-

- Any profit on debt incurred by a person in the tax year if the debt is used for the purpose of promotion of business by the person,

[1] Section 24 of ITO, 2001
[2] Section 25 of ITO, 2001
[3] Section 26 of ITO, 2001
[4] Sub-section 2 of section 20 of ITO, 2001

- Any lease rental which is incurred in any tax year to any scheduled bank or other financial institute by the tax payer or from any approved leasing company and approved *Modaraba*,
- any amount incurred by a person in the tax year to a banking company under a scheme of *Musharika* representing the bank's share in the profits of the *Musharika*,
- any amount incurred by a person in the tax year to a certificate holder under a *Musharika* scheme approved by the SECP and Religious Board formed under the *Modarba* Companies and *Modarba* Ordinance 1980 representing the certificate holder's share on the profits of the *Musharika*.[1]

The person having a taxable income is allowed to deduct the money under the provision of bad debts under section 29 of the Ordinance if the following conditions are fulfilled:-

The amount of the debt was:

- Previously included in the person's income from business chargeable to tax; or
- In respect of money lent by a financial institution in driving income from business chargeable to tax;
- The debt or part thereof is written off in accounts of the person in the tax year, or there are reasonable grounds for believing that the debt is irrecoverable.

But the amount claimed under this section shall not exceed to the limit written off in the accounts of the person in relevant tax year.

Where any person sustains a loss for any tax year under any head of income mentioned in section 11 (Heads of Income) is entitled to set off the same against any other head of income mentioned in section 11. But if the person has losses under two or more heads, the loss sustained under the head of business shall be set off in last, as provided in section 56.[2]

[1] Section 28 of ITO, 2001
[2] Section 29 of ITO, 2001

As provided in section 57, if any person has some business losses which have not been set off under section 56, the rest will be allowed as carry forward to the following tax years and set off against the person's income under the head income from business but no loss shall be carried forward under this section more than six years. And if the person has the losses for more than one year, the losses of earlier year shall be set off first.[1]

Under section 57 of the Ordinance, if the business losses cannot be wholly set off under section 56, the provision of carry forward is given in the Ordinance, which allows carry forward of losses of any business. Petroleum companies are also assessed under the head of income from business that's why this provision is enjoyed by the petroleum companies also but under a proviso that the losses given under section 58 are excluded from the ambit of this provision.[2]

After reading the above provision, we can say that:-

If the loss sustained by the person having the petroleum business is not set off in the tax year to which the same is incurred, the remaining portion may be carried forward for the coming tax years but the losses shall not be carried forward for more than six years.

But the provision of six years is not applicable to the depreciation of the assets; it may be carried forward till the whole amount is not claimed.

The aforesaid losses if cannot set off wholly under the above method of carry forward in six years the remaining losses are allowed as deduction under section 22, 23 and 24 of the Ordinance.[3]

Section 31 of the Ordinance allows the companies to claim the deduction if the company transfers any amount in the reserve created under the Companies Ordinance, 1984, under section 120, in the relevant tax year, under the agreement with the banking company as defined in the Banking Tribunals Ordinance, 1984, relating to the participatory redeemable

[1] Section 57 of ITO, 2001
[2] Section 57 of ITO. 2001
[3] Section 57 of ITO, 2001

capital. The deduction allowed under this provision shall not be more than five percent of the amount reserved in participatory redeemable capital.[1]

Under section 60 of the Ordinance, any person who has paid *Zakat* under the *Zakat* and *Usher* Ordinance, 1980, is entitled to get benefit of the same as deduction allowance for the whole amount in the tax year in which the *Zakat* is paid.[2]

## INCENTIVES GIVEN TO EXPLORATION AND PRODUCTION COMPANIES THROUGH DIFFERENT POLICES AND SRO (s):-

Under section 2.1.5 (a) of the Petroleum Policy 1997:-

If a local Exploration and Production Company invests only 5% of working interest during exploration phase will be assigned an additional share out of GOP working interest after the commercial discovery to such company on a pro-rata[3] basis. However, such E&P Companies should neither be affiliated, associated, holding or subsidiary companies of each other.[4]

Local E&P companies will be entitled during the exploration period to receive foreign exchange against payments in rupees to meet out daily obligations under permits, licenses and PCA's.[5]

Under section 2.1.5 (b) of the Petroleum Policy, 1997:-

After commercial discovery, local E&P companies would be paid up to 30% of their sale proceeds in foreign currency to meet out their daily operational requirements.[6]

Declaration of a commercial discovery in the Onshore areas can be accepted even on the basis of one well but subject to the justification, rules and regulations pro tempore.[7]

[1] Section 31 of ITO, 2001
[2] Section 60(1) of ITO, 2001
[3] According to an exact rate, measure or interest, Page#1257, Black's Law Dictionary, Eighth Edition
[4] Section 2.1.5 (a) of Petroleum Policy, 1997 (Pakistan)
[5] Clause 2.1.4(V) of Petroleum exploration & Production Policy, 2001(Pakistan)
[6] Section 2.1.5 (b) of Petroleum Policy, 1997 (Pakistan)
[7] Section 2.1.5 of Petroleum Policy, 1997 (Pakistan)

The expenditure incurred is allowed as deduction or reimbursed by the companies in installments from Commercial Discovery through production over 5 year period.[1]

**EXEMPTION UNDER S.R.O. 678(1)/2004 WHICH IS AS UNDER:-**

In exercise of the powers conferred by section 19 of the Customs Act, 1969 (IV of 1969), and clause (a) of sub-section (2) of section 3 of the Sales Tax Act, 1990, and in suppression of its Notification No. S.RO. 448 (1)2004, dated the 12th June, 2004, the Federal Government is pleased to exempt,-

(1) machinery, equipment, helicopters, aircraft, accessories, spares, chemicals and consumables, as are not manufactures locally, imported by the Exploration and Production (E&P) Companies, their contractors, subcontractors and service companies, from customs duty in excess of five per cent ad valorem leviable under the First Schedule to the Customs Act, 1969 (IV of 1969), and the whole of sales tax leviable under the Sales Tax Act, 1990, on their import and subsequent supply, subject to the conditions specified under the caption "CONDITIONS WITH REFERENCE TO CLAUSES (1) AND (2)";

(2) machinery and equipment, as are not manufactured locally, imported by companies other than Exploration and Production Companies, from customs duty in excess of five per cent ad valorem leviable under the First Schedule to the Customs Act, 1969 (IV of 1969), subject to the conditions specified under the caption "CONDITIONS WITH REFERENCE TO CLAUSES (1) AND (2)";

(3) goods as mentioned in CLAUSES (1) AND (2), above, as are manufactured locally, imported by Exploration and Production Companies, their contractors, sub-contractors and service companies, other petroleum and public sector companies as is in excess of ten per cent ad valorem leviable under the First Schedule to the Customs Act, 1969 (IV of 1969), except X-mass trees, wellhead and integral components and parts thereof which shall be exempted from

[1] Section 2.2.1 of Petroleum Policy. 1997 (Pakistan)

so much of the customs duty as is in excess of fifteen per cent ad valorem; imported by E&P Companies their contractors, sub-contractors and service companies, provided that goods imported by public sector companies shall be subject to provisions of Notification No. S.R.O. 827(1)/2001, dated the 3rd December, 2001, except for projects wherein an investor or multinational company has a blocking vote. Components and parts of wellhead and X-mass tree if imported for their otherwise utilization will be allowed on payment of 10% customs duty on the basis of certification of respective E&P Company. However, items not manufactured locally shall remain subject to 5% customs duty. All items falling under this serial No. (3) shall also be exempt from whole of the sales tax if these are plant, machinery, equipment and proprietary spares of parent equipment not manufactured locally.

(4) Raw material and components, as are not manufactured locally, and are imported for use in the manufacture of goods specified in clauses (1) and (2), to be supplies to the petroleum sector companies as specified in the said Notification from whole of customs duty leviable under the First Schedule to the Customs Act, 1969 (IV of 1969), subject to the conditions specified under the caption "CONDITIONS WITH REFERENCE TO CLAUSE (4)".

CONDITIONS WITH REFERENCE TO CLAUSES (1) AND (2)

(i) Only such goods shall be entitled to the exemption under this notification as have been certified, for clause (1), by an E&P company, and for clause (2), by a company other than an E&P company, for its own use or its contractors, sub-contractors, and service companies for its projects of oil and gas exploration and production, refinery, oil and gas pipeline, liquefied petroleum gas (LPG), compressed natural gas (CNG), petroleum terminals, energy conservation, environment and safety controls;

(ii) the exemption available to E&P companies shall be admissible only to such E&P companies who hold permits, or licenses, or leases or concession or production sharing agreement and who enter into supplemental agreement with Government of Pakistan;

(iii) the importers shall maintain an account of all imports along with the relevant record as prescribed by the Customs Rules, 2001 and Sales Tax Act, 1990;

(iv) in the event a dispute arises whether any item is entitled to exemption under this notification, the item will be immediately released by the Customs Department against a corporate guarantee valid for a period of nine months, extendable by the concerned Collector of Customs on time to time basis. A certificate from the relevant Regulatory Authority[1] that the item is covered under this notification shall be given due consideration by the Customs Department towards finally resolving the dispute. Disputes regarding the local manufacturing only shall be resolved through the Engineering Development Board;[2]

(v) In the event that an emergency condition occurs in connection with operations by a petroleum sector company which seriously endangers life or property of the operations of the project, the relevant Regulatory Authority[3] shall declare an emergency and the operating company shall be allowed to import any item or items considered necessary by the said company to deal with the emergency under intimation to the Regulatory

[1] Director General Petroleum Concession (Ministry of Petroleum and Natural resources Government of Pakistan)
[2] Engineering Development Board (Ministry of Industries and Production Government of Pakistan)
[3] Director General Petroleum Concession (Ministry of Petroleum and Natural resources Government of Pakistan)

Authority[1] without fulfilling such formalities as are likely to cause delay. Payment of duties and taxes, if any, will be paid upfront based on the calculations by the respective E&P Company of the declared value. Such payment can be made at the time of clearance in cash or by cheque issued by the respective E&P Company;

(vi) items imported at concessionary rates which become surplus, scrap, junk, obsolete or otherwise shall be disposed off in the following manners, namely;

(a) In the event and item other than vehicles, is sold to another company in the petroleum sector no import duties shall be levied or charged. Otherwise, it shall be sold through a public tender and duties shall be recovered at the rate of ten per cent ad valorem of the sale proceeds;

(b) For vehicles there would be a minimum retention period of five years after which the vehicles may be disposed off in the manner provided in (a) above except that the full rate of import duties, net of any import duties already paid, shall be charged subject to an adjustment of depreciation at the rate of two per cent per month up to maximum of twenty four months;

(c) Vehicles can be surrendered at any time to the Government of Pakistan without payment of any import duties under intimation to the Central Board of Revenue; and

[1] Director General Petroleum Concession (Ministry of Petroleum and Natural resources Government of Pakistan)

(d) Items imported on payment of 5% customs duty ad valorem or above, which have been rendered scrap, with change in their physical status, composition or condition and PCT classification, will be dealt with as scrap and shall be chargeable to customs duties and sales tax accordingly, at standard rates;

(vii) all petroleum sector companies, corporations and organizations including their contractors and sub-contractors and service companies shall be entitled to import machinery, equipment, helicopters, aircrafts, drilling bits, drilling and seismic (on shore or off shore) vessels, drilling rigs, specialized vehicles which fall under PCT heading 87.05 including accessories and spares that are part of such vehicles and vessels for the purpose of construction, erection, exploration and production of petroleum projects on an import cum export basis without payment of duties and taxes against corporate guarantee valid for a period of two years equal to the value of import duties and taxes exempted, extendable by the Collector of Customs on time to time basis, if the importer has a definite contact. Should the goods etc., not be exported on the expiry of the project or transferred, with the approval of the Collector of Customs, to another petroleum project, or the period of stay has been extended by the Collector of Customs, then the company or their contractors or sub-contractors or service companies, as the case may be, shall be liable to pay duties and taxes chargeable at the time or import as per clauses (1), (2) and (3) above.

(viii) each importer or E&P company shall develop a software within a period of one year from the date of issuance of said Notification and shall establish

an online connection with the customs authorities for regulating the imports made under this notification,

(ix) any item imported under this notification may be exported for replacement or otherwise, repair, modification or renovation and may be re-imported by paying concessionary duty and taxes only as per serial (1) on the actual cost of repair, renovation or modification of the respective item(s)."

CONDITIONS WITH REFERENCE TO CLAUSE (4) ABOVE

(i) The manufacturer has suitable in-house facilities and registration with the Sales Tax Department for manufacture of such goods or the importer cum manufacture is in possession of a firm contract for the manufacture of such goods with any other manufacturer having suitable in-house facilities and registered with Sales Tax Department for the manufacture of such goods;

(ii) the manufacturer cum importer shall furnish to the Collector of Customs and Collector of Sales Tax the list of such goods that he is manufacturing or intends to manufacture along with the details of raw materials and components for the manufacture of each item and the total requirement of all such inputs;

(iii) the input output ratios of items to be manufactured and total annual requirement of raw materials and components as determined by Directorate of Input Output Co-efficient Organization,[1] or any other person, association or

[1] Member (Exports) is responsible for implementation of Export Policy and its procedures. He is also responsible for the administration of manufacturing Bonds, Export Processing Zones and Special Industrial Zones. He also looks after the administration of duty drawback system. Input-Output Co-efficient Organization (IOCO) and Duty Suspension Audit Organization (DSAO). He oversees the export related issues of TEPI project. In the Board, he is assisted by one Chief (BPS-20) and two Secretaries (BPS-19).

(iv) agency authorized by the Central Board of Revenue[1] and a certificate of annual requirement issued by such designated or authorized person to the relevant Collector under intimation to the Central Broad of Revenue;

(v) the clearance of input shall be allowed through a customs Collectorate nearest to the manufacturing unit;

(vi) the manufacturer cum importer shall, at the time of import of raw materials and components make a written declaration on the goods declaration to the effect that the raw materials and components have been imported for manufacturing of goods to be supplied to the petroleum sector companies as specified in condition (i) under the caption "CONDITIONS WITH REFERENCE TO CLAUSES (1) AND (2);

(vii) the manufacturer cum importer shall maintain record of the inputs and the goods manufactured out of them in such form as may be prescribed by the Central Board of Revenue or required under any other law in force by the CBR;

(viii) the manufacturer cum importer shall communicate to the concerned Collector of Customs in writing about the consumption of imported goods within one month of consumption. In case of non-consumption within one hundred eighty days, the importer shall pay the customs duty and other taxes involved or shall give plausible reasons to the Collector of Customs and seek extension for a reasonable period;

(ix) in case the manufacturer cum importer does not provide information regarding consumption or otherwise of the imported goods within a period

[1] CBR is now called FBR (Federal Board of Revenue)

of one hundred eighty days of import or such extended period as allowed by the Collector or if otherwise deemed necessary, the records of importer cum manufacturer shall be audited by the Duty Suspension Audit Organization (DSAO)[1] or by any other person duly appointed by the Collector, if upon audit consumption of goods is not found satisfactory the Collector of Customs shall initiate proceedings for the recovery of leviable customs duty and other taxes besides penal action under the relevant provisions of laws in force; and

(x) the importer cum manufacturer of goods shall furnish a certificate from the in charge of the concerned project to the effect that the machinery has been supplied to them and duly installed.

Explanation.1. The expression "not manufactured locally" shall mean the goods, which are not included in the list of locally manufactured goods, specified in the General Order, issued by the Central Board of Revenue.

Explanation.2.Used and refurbished machinery, equipment, materials, specialized vehicles or their components and parts importable under this notification will be subject to the provisions of Import Trade and Procedure Order in effect.

Explanation.3. For the import of 4×4 single or double cabin pickup a committee will be constituted for giving approval. It will comprise nominees of CBR and Pakistan Petroleum Exploration and Production Companies Association.[2]

[1] Member (Exports) is responsible for implementation of Export Policy and its procedures. He is also responsible for the administration of manufacturing Bonds. Export Processing Zones and Special Industrial Zones. He also looks after the administration of duty drawback system. Input-Output Co-efficient Organization (IOCO) and Duty Suspension Audit Organization (DSAO). He oversees the export related issues of TEPI project. In the Board. he is assisted by one Chief (BPS-20) and two Secretaries (BPS-19)

[2] S.R.O. 678(1)/2004 issued by FBR (Government of Pakistan)

S.R.O. 750 (1)/ 98:- Under this S.R.O. the Government of Pakistan favoured the exploration and Production company in importation of specialized vehicles with mounted equipments for their traveling purposes exempt from the customs duty after the recommendation of the authority[1] empowered under this notification.[2]

The relevant clause of the said notification is as under:-

"Exploration and Production Companies and services Companies can import single or double cabin pickups and vehicles with mounted equipment and other specialized field vehicles without any restriction, keeping in view their work requirement and on the recommendations of a committee headed by Joint Secretary (Admin), Ministry of Petroleum and Natural Resources with a representative of each of the concerned Regulatory, PPEPCA[3] and Service Companies as its members"

S.R.O.336 (I) 94: Under this notification the Government has authorized the Exploration and Production Companies to import the relevant machinery, equipment, materials and their spare parts etc. free of duties under the Import and Exports (Control) Act, 1950.

The Federal Government added the following things in clause in the above notification to facilitate the E&P companies to export the goods specified as under:-

The relevant clause of the notification is as under:-

All petroleum sector companies, corporations and organization in respect of machinery, equipment, materials, specialized vehicles, accessories, spare parts, chemicals and commodities imported in accordance with the list approved by the regulatory authority[4], as specified in Petroleum Policy 1997.

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1 Director General Petroleum Concession (Ministry of Petroleum and Natural resources Government of Pakistan)

[2] S.R.O. 750 (7)/1998 issued by FBR (Government of Pakistan)

[3] Pakistan Petroleum Exploration and Production Companies Association

[4] Director General Petroleum Concession (Ministry of Petroleum and Natural resources Government of Pakistan)

EXPLANATION:

The question whether a company, corporation or organization fall within the Petroleum Sector shall be determined by the concerned regulatory authority.[1]

Under section 4 of the Sales Tax Act, 1990, some goods which are exported by the petroleum companies for the exploration and production of Petroleum are treated under zero rating. The relevant portion of that section[2] is as under:-

"Notwithstanding the provisions of section 3, the following goods shall be charged to tax at the rate of zero per cent.

Goods exported, or the goods specified in the Fifth Schedule of Sales Tax Act, 1990;
Such other goods as the Federal Government may, by notification in the Official Gazette, specify."
As mentioned above clause 6 of the 5% schedule of Sales Tax Act, 1990 which connotes as under:-
Supplies of such locally manufactured plant and machinery to the Export Processing Zones [and to petroleum and gas sector Exploration and Production companies, their contractors and sub-contractors] as may be specified by the Federal Government, by notification in the Official Gazette, subject to such conditions and restriction as may be specified in such notification.

It means that the petroleum companies can adjust their sales tax on the supplies of locally manufactured goods and claim the remaining amount from the department of Sales Tax. But it does not mean that they are exempt from sales tax.[3]

Under S.R.O. 462(I)/2007, dated 9th of June, 2007, Crude oil is treated as zero rated.[4]

Further more the Government favours the petroleum companies individually through some notification like the Shell Development and Offshore Pakistan through an exemption order No. 51/2007 in which the Government has exempted machinery, equipment, materials,

[1] Director General Petroleum Concession (Ministry of Petroleum and Natural resources Government of Pakistan)
[2] Section 4 of Sales Tax Act, 1990
[3] S.R.O. 336 (I) 94 issued by FBR (Government of Pakistan)
[4] S.R.O. 462(I)/2007 issued by FBR (Government of Pakistan)

specialized vehicles or vessels, accessories, spares, chemicals and consumables used in petroleum concerns.[1]

Under S.R.O. 400(1)/97, dated 31st May of 1997, the Government of Pakistan has exempted all E&P companies including OGDCL, their contractors and sub-contractors, and service companies to import machinery, equipment, materials, specialized vehicles, accessories, spares, chemicals and consumables as are necessary to meet their actual projects regarding Establishment (initial installation), Expansion, Modernization, and Up gradation, from Customs-duties including regulatory duty and sales tax.

If any emergency condition occurs in connection with operations by an E&P Company which seriously endangers life or property of the project, the relevant authority[2] shall declare an emergency and the company shall be allowed to import any item or items considered necessary by the said company to deal with the emergency under intimation to the regulatory authority[3] and collector of customs without fulfilling any formality.

Any item imported free of import duties and taxes under this S.R.O. may be exported for replacement, repair, modification or renovation and may be re-imported without payment of any customs duties and taxes subject to the production of a certificate from the Regulatory Authority[4] it effect such replacement, repair, modification or renovation.

Exemption available for Exploration, development, Production, Compression and Enhanced Recovery shall be available to those E&P Companies which hold permits, licenses, leases and which enter into supplemental agreement with the Government of Pakistan in terms of Petroleum Policy 1994 or those which signs new concession agreement or to Service Companies.

Refinery projects, Oil and Gas Pipeline Projects, Liquid Petroleum Gas (LPG) Projects, Compressed Natural Gas (CNG) Projects, Petroleum Terminal Projects, Energy conservation,

[1] Order No. 51/2007 issued by FBR (Government of Pakistan)
[2] Regulatory authority means DGPC (Director General Petroleum Concession)
[3] FBR (Federal Board of Revenue)
[4] Director General Petroleum Concession (Ministry of Petroleum and Natural resources Government of Pakistan)

Environment and Safety projects shall enjoy all aforesaid exemptions without any conditions mentioned ante.[1]

Under S.R.O. 749(1)/98, the Government of Pakistan exempts motor vehicles (Pajero, Toyata Land cruiser etc) from excess custom duties and sales tax as under:-

**Exploration and Production Companies are allowed to import:-**

| No. of vehicles | Customs Duty | Sales Tax |
|---|---|---|
| First two vehicles | Free | Free |
| Third Vehicle | 10% | 12.5% |
| Fourth Vehicle | 25% | 12.5% |
| **Service Companies:** | | |
| First Vehicle | Free | Free |
| Second Vehicle | 10% | 12.5%[2] |

Under S.R.O.984(1)/99 dated 30th August, 1999, the Government of Pakistan has offered more relaxation in Customs duties to E&P companies and their service companies, in respect of vehicles import, which is as under:-

| **Exploration and Production Companies** | **Amount of Customs duty** |
|---|---|
| (a) First two vehicles | Zero |
| (b) Third Vehicle | 10% of the amount of customs duties leviable u/s 18 of Finance Act, 1999 |
| (c) Fourth vehicle | 25% of aforementioned section of Finance Act, 1999 |
| **Service Companies:** | |
| (a) First Vehicle | Zero |
| (b) Second Vehicle | 10% of aforesaid section of Finance Act, 1999[1] |

[1] SRO 400 (1)/97 issued by FBR (Government of Pakistan)
[2] SRO 749 (1)/98

## EXEMPTION OF CUSTOMS DUTY, SALES TAX AND IQRA SURCHARGE ON FOODSTUFF/LIQOUOR AND HOUSEHOLD EFFECTS OF EXPATRIATE EMPLOYEES OF THE OIL DRILLING COMPANIES AND THEIR CONTRATORS/SUB-CONTRACTORS.

(a)Foreign employees and consultants of petroleum sector companies and foreign employees of such companies contractors will be entitled to import free of import duties including customs duties, sales, sales tax, Iqra surcharge and any other surcharge and license/authorization fees used and bonafide personals household effects, excluding passenger vehicles provided that the effects were acquired or were in such person's possession before his arrival in Pakistan or were imported within 6 months of such arrival. Such personal and household effects may thereafter be freely exported free of export duties and fees. Such articles shall not be disposed off or transferred in Pakistan except with the prior permission of Regulatory Authority[2] and on payment of import duties at the rate and value operating on the date the goods at the time of import less depreciation @ 10% per annum.

(b) Foreign employees and consultants of petroleum sector companies and foreign employees of such companies contractors and foreign employees of such companies contractors and sub-contractors shall be allowed to import commissary[3] goods free of import duties including customs duty, sales tax, Iqra surcharge and any other surcharge to the extent US $ 1,200 each (excluding family members) per annum or such greater amount notified from time to time subject to the condition that said goods shall not be sold or disposed off in Pakistan and no foreign exchange from Pakistan shall be involved.[4]

## LIST OF COMMISSARY STORES:

The following food stuff and commissary stores can be imported:

Food:

(i) Meat: Beef, pork, ham, bacon, miscellaneous meat tinned meat,

(ii) Vegetables tinned and glassed including juices,

(iii) Fruits tinned including juices,

[1] SRO 984 (1)/99

[2] Director General Petroleum Concession (Ministry of Petroleum and Natural resources Government of Pakistan)

[3] Commissary means the head of particular sector or head of foreign visitors

[4] Annex XIII of Model Offshore Production Sharing agreement issued by Government of Pakistan

(iv) Liquor, tobacco and cigarettes of all kinds,

(v) Sea food: Tinned tuna, salmon, sardines etc.

Note: Import of Liquor by the non-Muslim foreign shall be subject to the regulations and orders of the Government of Pakistan.[1]

[1] Annex XIV of Model Offshore Production Sharing agreement issued by Government of Pakistan

Chapter 4

# TAXATION ISSUES OF PETROLEUM COMPANIES

## 4.1 SPECIFIC TAX ISSUES FACING THE OIL COMPANIES AND THEIR SOLUTION:

There are different issues which are still unresolved between the tax authorities and petroleum companies which are alive due to some ambiguities in the relevant legislations. These ambiguities create a chance of different possible interpretations in the minds of the related parties. These issues are as under:-

### I. ISSUE OF ROYALTY

The first issue is whether royalty paid by the petroleum companies constitutes share to the government in the quantity of the petroleum produced or it is a payment made to the government for exploiting the mineral resources beneath the surface of the earth for which the lease is acquired.

Keeping in view the context in which the term royalty is used, it is not defined particularly in the present Income Tax Ordinance, 2001or previous tax legislations. In the absence of the "means" and "includes" definition, which is a special character of quality legislation, or the words used in the Ordinance, one has no choice except to rely on ordinary dictionary meaning of the words and phrases used in the legislations. According to Webster's Third New International dictionary:-

Royalty means: "A percentage paid to the Government of gold, silver and minerals taken from mines or a tax exacted in lieu thereof. A share of the product or profit of property reserved by the owner when the property is sold, leased, or used or a payment (as a percentage of the amount of property used) to the owner, for permitting another to exploit, use or market such

property (as natural resources, patents or copyrights) which is often subject to depletion with use."[1]

As per The Universal Dictionary of English Language:-

It means "a payment made to an owner for the right to exploit his property; e.g. by mining company to owner of land in which mine is situated, percentage of money derived from sales of a book, paid to author by the publisher share of profits paid by theatrical producer to the author of a play."[2]

Inderjeet singh Sial and anothers v. Karam Chand Thapar and others:-

"In its primary and natural sense 'royalty' in the legal world, is known as the equivalent or translation of jura regalia[3] or jura regia. Royal right and prerogative of a sovereign are covered there under. In its secondary sense the word "royalty" would signify, as in mining leases, that part of the reddendum, variable though, payable in cash or kind, for rights and privileges obtained."[4]

"Royalty" is not a tax. Simply because the royalty is levied by reference to the quantity of the minerals produced and the impugned cess too is quantified by taking into consideration the same quantity of the mineral produced, the latter does not become royalty. The former is the rent of the land on which the mine is situated or the price of the privilege of winning the minerals of land parted by the Government in favour of the mining lessee.[5]

From these definitions, it is clear that royalty is a payment which the licensee pays to the Government (licensor), for the production of petroleum, who is the owner of mineral deposit beneath the surface of the land. Like any expense, it (royalty) may be paid in cash or kind. A payment in kind can not be construed as receipt of a share of production. If that be the case, then such payment would not entitle for deduction under section 23 of the Ordinance.

[1] Page# 1982, Webster's Third New International Dictionary
[2] Definition as given in on page# 1031, The Universal Dictionary of English Language, Edited by Henry Cecil Wyld, 1932
[3] Royal rights, the prerogatives of the Crown Page#866, Black's law dictionary, Eighth edition, 2004
[4] Inderjeet singh Sial and anothers v. Karam Chand Thapar and others. (1995) 6 SCC 166
[5] The State of west Bengal and another v. Kesoram Industries Ltd. and others. JT (2004) 1 SC 375: (2004) 1 Supreme 590

In other words royalty is considered as part of "tax liability" and is includible in the total amount of "payment to the government" in the shape of tax. In this manner tax liability is reduced by the amount of royalty. If royalty is included in the "gross receipts" representing the "well-head" for working out depletion allowance, it will amount to double relief and probably it is not the intention of law.

The Taxation department's view about the payment of royalty is that the producer shall pay the royalty @ 12.5% of the well-head value. They further say that since the oil and gas deposits belong to Federal Government so the amount of royalty represents the government's share in the production of oil and gas. They, therefore, conclude that the company's production is 87.5% (100-12.5). It means, in their view the taxes and depletion allowance will be calculated on 87.5% of the production of petroleum.

In computing the income of the petroleum company, amount of royalty paid is allowed as deduction under the Ordinance. It may not turn round and say that for the purpose of depletion allowance, it is share of the government on the petroleum production. On this issue, the opinion of the department is totally wrong because they say that royalty is share of Government, if it is true then the E&P companies will not get the benefit of royalty in taxation and depletion allowance will be calculated on 87.5% which is also against the intention of Law. The basis of computation is to be entire production of the petroleum and not 87.5% of it.

Keeping in view the above discussion, we can say that royalty is not a share of the government on production when commercial discovery starts, but it is only a payment for allowing the petroleum company to exploit the petroleum reserves beneath the surface of earth, which is treated as special concession, through tax liability of petroleum companies, reduced by 12.5% of well-head value of the production in shape of payment on account of royalty. In other words royalty is considered as part of tax liability, and is includible in the total amount of payments made to the government in the shape of tax. In this manner tax liability is reduced by the amount of royalty. Simply, if the royalty represents as share of the government then why the rebate of the same is given to the petroleum companies during computing their income and tax liability. So it is crystal clear that the royalty is not the share of the government on the production of petroleum but it is payment by the companies to the government for allowing them to exploitation of petroleum reserves to them and similarly no

one may say on the basis that because the royalty, when paid in the shape of kind (means some quantity of petroleum), it shall represent the share of the government in the production.

## II. ISSUE OF CALCULATION OF DEPLETION ALLOWANCE

The 2nd issue is about different interpretation of various words and phases, which are used in the 5th Schedule of ITO, 2001 for the calculation of depletion allowance by the companies and the taxation department, which are as under:-

"The allowance of depletion shall be equal to fifteen percent of the gross receipts representing the well-head value of the production".[1]

Nature of allowance:-

As laid down by the Privy Council in the landmark case of Kauri Timber Company Ltd. V. Commissioner of Taxes, under the general principles of income tax law, "No deduction can be claimed from the income in respect of diminution or exhaustion of capital asset from which income is derived"[2]. However, the law expressly allows some deduction in certain cases. Depreciation allowance is one of such exceptions. The other is depletion allowance admissible under Rule 3 of part 1 of 5th Schedule to the Income Tax Ordinance, 2001. Like depreciation allowance, it is statutory allowance.

The said Rule (excluding the proviso) read as under:-

"**DEPLETION ALLOWANCE**: - In determining the income of such undertaking for any year ending after the date on which commercial production has commenced, an allowance for depletion shall be made equal to fifteen per cent of the gross receipt representing the well-head value of the production."

The view of the taxation department is that these words mean the deduction shall be allowed @ 15% of the amount that represents the Well-head value of the petroleum produced or saved. Apart from the controversy as to what constitutes well-head value the interpretation renders the words "gross receipts" superfluous.

[1] Clause 3 of Part 1 of 5th schedule of ITO, 2001
[2] Kauri Timber Company Ltd. V. Commissioner of Taxes, 1913 AC 77

On the other hand, the companies are of the view that depletion allowance is admissible on the gross amount received by the companies on the sale of the petroleum produced or saved without any deduction.

Since the issue of resolution of controversy is the interpretation of the expression "fifteen percent of the gross receipts representing the well-head value of the production", each word used in this expression here needs to be interpreted. It is also necessary to point out a few important features of the 5th schedule of ITO, 2001.

This Schedule has been added in Income Tax Ordinance, 2001 in pursuance of the provisions of section 100, relevant portions of section 100 are read as under:-

**SPECIAL PROVISIONS REGARDING THE PRODUCTION OF OIL AND NATURAL GAS, AND EXPLORATION AND EXTRACTION OF OTHER MINERAL DEPOSITS:-**

(1) Subject to sub section (2), the profits and gains from-

(a) the exploration and production of petroleum including natural gas and from refineries set up at Dhodak and Bobi fields;

(b) the pipeline operations of exploration and production companies; or

(c) the manufacture and sale of liquefied petroleum gas or compressed natural gas,

and the tax payable thereon shall be computed in accordance with the rules in Part I of the Fifth Schedule.

(2) Sub-section (1) shall not apply to the profits and gains attributable to the production of petroleum including natural gas discovered before the 24th of September, 1954.

(3) The profits and gains of any business which consists of, or includes, the exploration and extraction of such mineral deposits of a wasting nature (not being petroleum or natural gas) as may be specified in this behalf by the Federal Government carried on by a person in Pakistan shall be computed in accordance with the rules in Part II of the Fifth Schedule.[1]

The relevant portion of Part 1 of 5th schedule states as under:-

[1] Section 100 of ITO, 2001

**EXPLORATION AND PRODUCTION OF PETROLEUM TO BE TREATED AS SEPARATE BUSINESS UNDERTAKING:-**

Where any person carries on, or is deemed to carry on, under any agreement with the government, any business, which consists of, or includes, the exploration of petroleum in Pakistan, … such business or part thereof, as the case may be, shall for the purpose of this Ordinance, be deemed to be a separate business undertaking hereinafter referred to as "such undertaking" and the profits and gains of such undertaking shall be computed separately from his income, profits or gains from any other business, if any, carried on by the person.[1]

It is clear from this provision of 5th Schedule of ITO, 2001, that exploration & production of petroleum is to be treated as a business distinct and separate from any other business carried on by the taxpayer (petroleum companies) and its profits shall be computed separately from his income, profits and gains from any other business, if any, carried on by that person. It means that in the trading account of this business only such receipts shall be added which come from exploration for, and production of, oil and natural gas.

Further, Rule 2(1) of this Part directs that "subject to the provisions of this Ordinance, the profits and gains of such undertaking shall be computed in manner applicable to income profits and gains chargeable under the head from business".[2]

It means that the profits of such undertaking (means petroleum exploration and production) shall be computed in the same manner as that applicable to business income, except where the provisions of this Part specifically provide otherwise.

Keeping the above principles in mind, the first disputed term between the companies and the taxation department is "gross receipts", which needs to be clarified. The word gross receipt has a number of meanings which are as under:-

The word "receipt" means "(usually in plural) an acknowledgement in writing of goods received, or, especially; of money paid for services rendered, money lent" and "gross" means "total", without deduction, not net".[3]

[1] Clause 1 of 5th schedule of ITO, 2001

[2] Rule 2 of part 1 of 5th schedule of ITO, 2001

[3] Definition from page#972, The Universal Dictionary of English Language, Edited by Henry Cecil Wyld, 1932

Gross receipt means: - The total amount of money or other consideration received by a business taxpayer for goods sold or services performed in a year, before deduction.[1]

Thus, the expression "gross receipts" means the total amount of money received, without any deductions.

"Gross receipts" include everything in the shape of royalty, sales tax, central excise duty and development charges etc. and no deduction whatever can be made from the amount of gross receipt. By deducting government levies (sales tax and central excise) from the gross receipt, it appears "net receipts" are being considered, instead of "gross receipts".

**AFFECT OF REDUCING TAXES FROM GROSS RECEIPTS:**

Gross receipts as are reflected by the sales invoices include sales tax, central excise duty and development surcharge etc., and if these items are to be reduced from the gross receipt, it would turn the gross receipt into the net receipt while Rule 3 of Part I of 5th Schedule uses the word gross receipts and instead of net receipts.

The word gross receipt and expression representing the well-head value of production used by the legislature in Rule 3 of the 5th Schedule of Income Tax Ordinance, 2001 for the computation of depletion allowance are significant because income of exploration and development companies includes income from refinery at Dhodak and Bobi fields; pipeline operations and manufacture & sale of liquified petroleum gas etc., in accordance with the Rules contained in Part I of 5th Schedule of Income Tax Ordinance, 2001. Since redundancy cannot be attributed to Legislature, it is adequately clear that depletion allowance is to be worked out at 15% of the gross receipts representing well-head value of production being directly related to the production of petroleum from the wells while no depletion allowance is to be worked out on the gross receipt comprising of receipts from the operations of the refineries at Dhodak and Bobi fields and pipeline operations etc.

The calculation of depletion allowance is based on the same amount and/or same manner as the calculation of royalty payment is based/made because the legislature has used different language in the provisions relating to the calculation of depletion allowance under Rule 3 of

[1] Page# 722, Black's law dictionary, 2004

5th Schedule of Income Ordinance, 2001 which is based on gross receipts representing the well-head value of production and the calculation of royalty payment under Rule 36(I) of Pakistan Petroleum (Exploration and Production) Rules, 1986 based on Well-head value which as shown as under:-

| | |
|---|---|
| Depletion allowance under Rule 3 of the 5th Schedule | 15% of the Gross Receipt representing the Well -head value of the production |
| Royalty under Rule 36(1) of the 1986 Rules. | 12.5% of the well-head value of petroleum produced and saved. |

The term "gross receipts" may further be explained as the value of the production actually received by the company from the refineries or otherwise. These gross receipts representing gross value of product is inclusive of expenses on account of gathering, processing, treatment, transportation and royalty.[1]

Apart from this the expression "gross receipts" has been used at other places in the Income laws also. In section 18(2) (b) of Income Tax Ordinance, 1979, the provision provides the method of computing the interest allocable to income falling under the head "Interest on securities" where the taxpayer has income from other sources also and interest has been paid on funds borrowed means that some words may be used in qualified sense in the law. The provision read as under:-

"the amount to be regarded as interest paid on moneys borrowed shall not exceed an amount which bears to the amount of interest paid on all moneys borrowed by the assessee the same proportion as the total amount of interest on securities"[2] (inclusive of tax deducted under sub-section (2) of section 50) bears to the gross receipt from all sources included in the profit and loss account of the assessee.

Here the expression means the total amount of receipt from all sources included in the Profit and Loss account and not in the trading account, because in trading account only sales and costs are calculated whereas in P&L account total expenditures of the business are included.

[1] Order 122 (5A) assessment order dated 31.12.07
[2] Section 18(2)(b) of ITO, 2001

Thus, the expression "gross receipts" is qualified by the words "in the profit and loss account".

The expression gross receipt again appears in the Explanation to section 113 (3), of the ITO, 2001, which read as under:-

In this section, "turnover" means:-

(a) the gross receipts, exclusive of [sales tax and [Federal] excise duty or] any trade discounts shown on invoices or bills, derived from the sale of goods;

(b) the gross fees for the rendering of services [or giving benefits], including commissions;

(c) the gross receipts from the execution of contracts; and

(d) the company's share of the amounts stated above of any association of persons of which the company is a member.[1]

In the above provision again, the term means the total receipts derived from (a) sale of goods; (b) rendering, giving, supplying of services or benefits; or (c) execution of contracts. Here again, the term "gross receipts" has been qualified by three types of receipts (mentioned in (a) (b) and (c) above). It does not mean the entire receipts of the taxpayer. The gross receipt otherwise means the total receipt of the business including everything without deduction of anything. Turnover would not include dividends etc.

Next it appears in section 2((20) (e)) of Income Tax Ordinance, 1979 which states that dividend includes:-

any payment by a private company of any sum (whether as representing a part of the assets of the company or otherwise) by way of advance or loan to a shareholder or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company, in either case, possesses accumulated profits; but does not include-

(i) distribution made in accordance with sub-clause (c) or sub-clause (d) in respect of any share for full cash consideration, or redemption of debentures or debenture-stock,

[1] Section 113 (3) of ITO, 2001, omitted by Finance Act, 2008

where the holder of the share or debenture is not entitled in the event of liquidation to participate in the surplus assets;

(ii) any advance or loan made to a shareholder by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company;

(iii) any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e), to the extent to which it is so set off.[1]

In short, the expression "gross receipts" means total receipts of money without any deductions, however, where it is qualified, the scope of totality shall be determined accordingly. In the case of petroleum exploration and production, the expression is qualified by the words "well-head value"[2].

The next important word in the clause is "representing". The word represent has a number of meanings which are as under:-

Represent means "To serve as specimen, example of, to be a type, image of, to typify, to symbolize of something"[3]

Represent means "To serve as a specimen, example, or instance of, to present by means of something standing in the place of: serve as the counter part of image of: typify"[4]

Represent means "To be a sign or symbol of something, a sign, picture, model, etc. of something"[5]

The word "representing" means the amount or quantity of exploration and production of petroleum and it does not include the income from setting up refinery or pipe line operation etc. It is hereby elucidated that the word "production" means the production of oil/petroleum and word "well-head value" means the "gross receipt representing value of production".

[1] Section 2(20(e)) of ITO, 1979
[2] Section 120 A of ITO, 1979
[3] Page # 1000 of The Universal Dictionary of English language, publish in 1932
[4] Page # 1926 of Webster's Third New International Dictionary, Third edition, printed in 1986
[5] Page # 1208 of Cambridge Advanced Learner's Dictionary, Third edition

This term has been used at different sections "exclusively" in the Income Tax Ordinance,1979 and 2001. Every where, it invariably means "corresponding to". Some of these provisions may be examined for proper appreciation of the term.

Section 2(29) defines the term "income" as under:-

The term includes-

"income" includes any amount chargeable to tax under this Ordinance (ITO,2001), any amount subject to collection [or deduction] of tax under section 148, [150, 154, 156, 156A, 233 and 233A], sub-section (5) of section 234, [any amount treated as income but does not include, in case of a shareholder of a company, the amount representing the face value of any bonus share or the amount of any bonus declared, issued or paid by the company to the shareholders with a view to increasing its paid up share capital;][1]

Section 28 allows deductions against business or profession, Clause (1(h)) allows as same as followes:-

"any amount incurred by a person in the tax year to a banking company under a scheme of *musharika* representing the bank's share in the profits of the *musharika*:"[2]

Section 80C "Tax on income of certain contractors and importers" deems certain amount to be income for the purpose of presumptive taxation. Sub-section (2) enumerates these amounts. Its various sub-clauses which are as under:-

"(i) the amount representing payments on which tax is deductible under sub-section (4) of section 50. ......"

(ia) the amount representing payments from which tax is deductible under sub-section (4A) of section 50;[3]

It is clear from all the above provisions, the term "representing" means "corresponding to".

The third important word is "well-head value". This term is used only at one place in the 1st part of the 5th Schedule of the Income Tax Ordinance, 2001 and the term is defined in Rule

[1] Section 2(29) of ITO, 2001
[2] Section 28 (1(h)) of ITO, 2001
[3] Section 80C [2(a) and (ia)] of ITO, 1979

6(8) of the same Part. This means that the sole purpose of this definition is to determine the amount of depletion allowance. The definition of well-head is given as under:-

"Well-head value" has the meaning assigned to it in the agreement between the assessee and in the absence of any such definition in the agreement, the meaning assigned to it in the Pakistan Petroleum ( Production ) Rules 1949 or the Pakistan Petroleum (Exploration and Production) Rules, 1986,[1] which are as under:-

"**WELL HEAD VALUE**" of crude oil shall be the price of the competitive non-Pakistan crude oil, suitably adjusted to the same gravity and quality at the same destination as the actual destination of Pakistan crude oil, reduced by costs incurred from the point of production within Pakistan to such destination.[2]

"**WELL-HEAD VALUE**" means the market value of the Petroleum less gathering, processing, and treatment and transportation costs from the well-head to the place at which the market value is determined; and in the case of natural gas shall also include compression, dehydration and liquefaction costs."[3]

Now the lawmaker has chosen not to define the term in the Ordinance but to borrow it from the different Petroleum Rules and says that the term shall have the same meaning as it has defined in those Rules. The definition given in the Pakistan Petroleum (Exploration and Production) Rules, 1986 excludes gathering, processing, treating and transporting charges. The definition clearly indicates that the value of petroleum is being determined at the point of well-head. So all the expenses, as are incurred after the petroleum leaves the well-head are excluded.

The term "well-head value" is used in the above said Rules once i.e. Rule 36(1) of Pakistan which imposes the charge of royalty which is read as under:-

"Subject to the payment of such amount by way of royalty as may be specified in any agreement with the Government to which the holder of the lease is a party, the holder shall

---

[1] Rule 6(8) of 5th Schedule of ITO, 2001
[2] Section 2 of The Pakistan Petroleum (Production) Rules, 1949
[3] Pakistan Petroleum (Exploration and Production) Rules, 1986

pay a royalty at the rate of 12.5% of the well-head value of the petroleum produced and saved".[1]

The term "value" as used in the above Rule has not been defined in the related petroleum Rules. However, Rule 38 of Pakistan Petroleum (Exploration and Production) Rules, 1986 provides the method of determining the "value of petroleum" which is as under:-

Value of Petroleum: - For purpose of calculating the amount due by way of royalty, the value of Petroleum shall be:

(a) in the case of Petroleum delivered to the national market pursuant to rule 41, the price actually realized in such sales;

(b) in the case of Petroleum not sold pursuant to rule 41, the international market price determined in such manner as the Government subject to the term and conditions of any agreement between the President and the lessee, may, from time to time, determine".[2]

Thus, the starting point in the calculation of "well-head value" is either (a) the price actually realized or (b) the price determined by the President. Here arises the question whether "the price actually realized" includes the amount of sales tax or not. In this rule two alternative methods are being mentioned, namely:-

- The price actually realized or
- The price as determined by the President.

Obviously under sub-rule (b), the price determined by the president would not include sales tax. Therefore, the expression "price actually realized" should also be exclusive of sales tax. The sales tax should be chargeable either on the price determined by the President or the price actually realized on sale. The two prices mentioned in Rule 38 of Pakistan Petroleum (Exploration and Production) Rules, 1986 have to be of the same nature. In short, the starting point of the calculation of "well-head value" is the market price actually realized exclusive of sales tax. From this price, one has to determine the value or price of the petroleum as it leaves the well-head. Now another unique aspect of the business of exploration and production of

[1] Rule 36(1) of Pakistan Petroleum (Exploration and Production) Rules, 1986
[2] Rule 38 of Pakistan Petroleum (Exploration and Production) Rules, 1986 (Pakistan)

petroleum is that the market price, whether based on actual sale or fixed by the President, is determined at the point of sale. It is either refinery in the case of Petroleum or the site of distribution company network in the case of natural gas, or the port of export. In all cases, the first exclusion should be all expenses incurred after the petroleum leaves the well-head i.e. gathering, processing, treating, transporting charges and in case of gas, including the above expenses the cost of compressing, dehydrating and liquefying should be added.

## WORKING OF DEPLETION ALLOWANCE AS BY THE TAXATION DEPARTMENT THROUGH AN ILLUSTRATION:-

(i)Taxable income

| | |
|---|---|
| Gross sales | Rs.120, 000/- |
| Less: Royalty | Rs.15,000/- |
| | Rs.105,000/- |
| Less: Tax allowable expenses after depletion. | Rs.75, 000/- |
| Profit before deduction of payment to Government | Rs.30, 000/- |
| Add: Royalty | Rs.15, 000/- |
| | Rs.45, 000/- |

(ii) Income Tax Liability

(a) The sum of payments and taxes on income shall be limited to 52.5% of profit i.e. $\frac{45,000}{100} \times 52.5$ Rs.23.625/-

Maximum Tax payable: Rs.23, 625-15,000 = Rs.8.625/-

(b) The said aggregate shall not be less than 50% of profit before deduction of payment to the Government but after deduction of depletion i.e. @ 50% of Rs.$\frac{45,000/-}{100} \times 50$ = Rs.22,500/-

| | | | |
|---|---|---|---|
| Less: Royalty | | | Rs.15, 000/- |
| Minimum tax liability | | | Rs.7, 500/- |
| Tax already paid in the of royalty | | = | Rs.15, 000/- |
| Tax payable or balance tax | Rs.23, 625-15,000 | = | Rs.8, 650/- |

The department on the point of gross receipts is of the view that the "gross receipts representing the well-head value of the production" has to be takes into account for the purposes of working out the depletion allowance. They say that the expression "gross receipts representing well-head value of the production" means the amount received by the companies excluding the gathering, processing, treating and transportation cost and also the duties tax and royalty paid to the government. They contend that all the underground mineral wealth is property of the government and government receives royalty in the shape of cash or kind both as its share in the production of petroleum. It says that in the light of provisions contained in Rule 37 of the Pakistan Petroleum (Exploration and Production) Rules, 1986, an option is available to the government to receive royalty in the shape of cash or kind and 12.5% of the mineral wealth is received by the government from petroleum companies in the form of royalty on account of government's share in the mineral wealth which belongs to it.

The department, about the expenses, has a view that after converting the product in saleable condition, it is transported to a point from where it is handed over to the customers; they state that in this way in addition to the expenses on account of gathering, processing and treating further expenses are incurred on account of transportation. They opine that the companies cannot add up any item of expenditure in the cost of production for making it in saleable condition. These expenses may be payable either to the government or otherwise. They state that gross amount of well-head value means the product in a crude form at the well-head. It does not mean the value of the product in saleable condition after inclusion of expenses incurred for making the crude product into a condition, which is fit for sale, because when oil or natural gas is extracted from a well it is in a very crude from and in this condition it cannot be sold. Although the petroleum production is sold in a crude form but in order to make it in a marketable condition, certain expenses are incurred on gathering, processing, treating and transportation, but all these expenditure cannot be included in the value of production for the purpose of measuring of

amount of depletion allowance, similarly, in their view royalty can also not be included in the value of the product because it is paid after the extraction of production from the well and royalty can never be added to the value of production for the purpose of depletion allowance. They assert that the companies incorrectly work out the gross receipts expenses on account of gathering, treating, processing, transportation and royalty are added into the well-head value

of the production and the gross-receipts are exclusively linked with well-head value and it has no linkage with the value of product at sale point.

## WORKING OF DEPLETION ALLOWANCE AS BY THE POETROLEUM COMPANIES THROUGH AN ILLUSTRATION:

Before analyzing the working of depletion allowance allowed to the petroleum companies, it would be better to see the relevant portion of $5^{th}$ Schedule of the Income Tax Ordinance, 2001 which is as under:-

"In determining the income of such undertaking for any year ending after the date on which commercial production has commenced, an allowance for depletion shall be made equal to fifteen per cent of the gross receipts representing the well-head value of the production, but not exceeding fifty per cent of the profits and gains of such undertaking before the deduction of such allowance".

The petroleum companies are of the view that Well-head means the value of production as received by the companies. They state that well-head value does not mean the value of the commodity before extraction. The oil is pumped out and natural gas is extracted from the well(s), it is collected for sale to refineries or distribution companies. Some process is involved for making the product fit for sale. The process involves some treatment. Therefore, gathering, processing and treatment expenses have to be included in well-head value.

They further have the view that the expression "gross receipts" means the value of the production actually received by them from the customers. They state that the gross receipts representing gross value of product is inclusive of expenses on account of gathering, processing, treating, transportation and royalty. They are of the view that the gross receipts representing well-head value of the production shall be considered net of all government levies, including costs and royalty. They believe that the mineral wealth belongs to government who is the owner of that wealth and authorizes the companies to exploit the mineral wealth. Royalty is a payment made by the companies against the privilege of exploiting the petroleum. The government has the right to receive this amount either in cash or in kind as it wish or as per the circumstances demands. However, oil produces or natural gas gathered is the property of the companies. In other words, the depletion is to be computed

on the total quantity of the petroleum. As per the taxes, duties and other levies impose by the government are concerned, the companies rely mainly on the language of law and are of the view that the words "the gross receipts representing the well-head value of the production" mean the gross amount received by the companies from the sale of crude petroleum. The emphasis of the companies is on the words "gross receipts" which means the value of the petroleum produced as it costs to the purchaser, not on the value of petroleum after deduction of transportation, dehydration treating and gathering.

The companies rely on the plain parlance of Rule 2 of Schedule of the Regulations of Mines and Oil Fields and Mineral Development (Government Control), Act, 1948, that royalty shall be charged @ 12.5% of the well-head value and shall be the part of payments to the federal Government and taxes on income which shall neither be more than 55% nor less than 50% of the profits or gains before deduction of "payments to the government". They agree on this point that in the aforesaid Rule in which the range has been fixed about minimum and maximum liability payable to the government in respect of product of the companies. They opine that in the repealed Income Tax Act, 1922, the depletion allowance was termed as "Additional allowance".

We can understand the computation working of depletion allowance, by the petroleum companies, through the following illustration:-

Taxable income

| | |
|---|---|
| (i)Taxable income | |
| Gross sales | Rs.120, 000/- |
| Less: Royalty | |
| | Rs.15,000/- |
| | Rs.105,000/- |
| Less: Tax allowable expenses after depletion. | Rs.75, 000/- |
| Profit before deduction of payment to Government | Rs.30, 000/- |
| Add: Royalty | Rs.15, 000/- |
| | Rs.45, 000/- |
| (iii) Income Tax Liability | |
| (a) The sum of payments and taxes on income shall be limited to 52.5% of profit i.e. $\frac{30{,}000}{100} \times 52.5$ | Rs.15.750/- |

| | | | |
|---|---|---|---|
| Maximum Tax payable: Rs.15, 750-15,000 | | | Rs.7500/- |
| (b) The said aggregate shall not be less than 50% of profit before deduction of payment to the Government but after deduction of depletion i.e. @ 50% of Rs.45,000/- ×50 / 100 | | = | Rs.22,500/- |
| Less: Royalty | | | Rs.15, 000/- |
| Minimum tax liability | | | Rs.7, 500/- |
| Tax already paid | Rs.22, 500-15,000 | = | Rs.7, 500/- |
| Tax payable or balance tax | Rs.15, 000-7500 | = | Rs.7, 500/- |

**VIEW OF THE INCOME TAX APPELLATE TRIBUNAL (ITAT) ON THE POINT OF DEPLETION ALLOWANCE:**

In the opinion of Income Tax Appellate Tribunal (ITAT) the allowance of depletion shall be equal to 15% of the gross receipts representing the well-head value of the production. Rest of the conditions laid down in Rule 3 and Rule 4 of part 1 of the 5th Schedule relate to the minimum and maximum liability of payment to the government. The words gross receipts representing well-head value of the production are significant because the entire controversy in question is based on the interpretation of these words. In its opinion gross receipts means gross value of production without any deduction or subtraction. The well-head value of the production means the yield of the production in money at the well-head and not at the sale point. But the companies say that the money value of production as recovered/received from the customers at the sale-point. It means that the depletion allowance is calculated on the market value of petroleum produced or gathered. For working out the market value of the product at sale point all expenses incurred for making the production as saleable commodity have also been added in the sale receipts. It means that the companies are showing total receipts at sale-point and not the gross receipts of the production at well-head.[1] In Rule 3 of Part 1 of the 5th Schedule, gross receipts representing well-head value of the production is to be taken into account for working out the admissibility of depletion allowance, but the companies show total receipts of the market value of the production for this purpose. This treatment is not according to law in their opinion. In their opinion the gross receipts mean the gross amount without any deduction and well-head means value of the production at well-head as it conceives from the word itself, and not at the point of sale.[2] There is no ambiguity in the relevant law and it is not understandable that why the companies claim depletion

[1] ITA No. 223/IB/2005
[2] ITA No. 1116/IB/2006

allowance on total receipts representing market value of the production. The intention of the legislation is vary clear because the expression well-head value was deliberately used because it was in the minds of law makers that the companies may subsequently add-up all their expenses in the well-head value of production and might start claiming the sale price or market price as their gross receipts for the purpose of working out the depletion allowance. The expression gross receipts representing the well-head value, therefore, clearly mean the total receipts of the production at the well-head and not at the point of sale. It may be observed by plain reading of the relevant provisions of law that depletion allowance like depreciation allowance is a sort of notional relief which is to be allowed @ 15% of the gross receipts representing the well-head value of the production. The payment of royalty is not included in gross receipts because it is an allowance as deduction from tax liability.

Keeping in view the above discussion and pondering into the opinions and tax workings of the companies, taxation department and view of tax tribunal on depletion allowance, we can say the proper interpretation of the expression "gross receipts representing well-head value" means the market price of the petroleum produced, at the point of well-head. It should be equal to the amount on which royalty is calculated plus the value of products as are exempt from royalty plus the excise duty. In other words, it should be equal to:-

$$A-(B+C+D)$$

Where:-

A is the amount of gross receipt from sale of petroleum

B is the amount of sales tax

C is the amount of surcharge; or

D is the amount of gathering, treating, processing and transporting costs and in the case of natural gas, the compressing and liquefying cost also.

It means for the determination of depletion allowance it is necessary to calculate the amount of gross receipt which is equal to the sale price of the petroleum at the point of wellhead value minus sales tax, minus amount of surcharge and minus gathering, treating, processing and transporting cost and the compressing and liquefying cost in case of natural gas. So to reach at

gross receipt we must exclude B, C and D from A which is gross price of petroleum at wellhead.

## III. ISSUE OF DECOMMISSIONING COST:

Nature of the expense:-

One of the consequences of drilling a well for the exploration of petroleum is that the land, on which the oil is drilled, suffers considerable physical and environmental damage more so when oil is found and pumped out. In order to take care of this damage, every petroleum concession agreement between an oil company and the government contains a provision to that when the oil company surrenders an area when the petroleum reserves depleted completely or left the leased area after unsuccessful drilling, the company is required to restore the surrendered land to its original state. Likewise, if oil is found and extracted and latter the company decides to close the operation either due to the well becoming unproductive or uneconomical. In this condition the agreement gives the government an option either to take over all the installation free of cost from the company or to ask the company to remove all the installations and restore the land to its original state. Thus, the decommissioning cost not only involves repairing the damage caused to the area but also the cost of dismantling and removing all machinery, plant and equipment. This liability of the oil company is also mentioned specifically in Rule 69 of the Pakistan Petroleum (Exploration and Production) Rules, 1986.

## THE NATURE OF DISPUTE OF DECOMMISSIONING COST:-

The oil companies' claim is that the decommissioning cost is an admissible deduction in the light of international accounting standards (IAS) 37, while the taxation department is of the view that under the same standard, the said provision constitutes a contingent liability, therefore this type of cost is not admissible as a deduction under the Income Tax Ordinance, 2001.

The companies' claim is based, firstly on Rule 69 of the Pakistan Petroleum (Exploration and Production), Rules 1986 and section 77 of Pakistan Offshore Petroleum (Exploration and Production) Rules, 2003 which are as under:-

installations and facilities including equipment and title of the same shall be transferred to the government.

(4) If the Government does not wish to exercise its right to takeover the installations and facilities including equipment, the Government may demand that removal shall be carried out by the contractor at his expense, in which case the provisions of Sub-rule (1) shall apply.

(5) Unless otherwise stipulated in an agreement, at least one year prior to termination, a contractor shall submit to the Government a plan for the orderly closing down and abandonment of his operations, and for the removal of the facilities or their transfer to the Government, as the case may be.[1]

Secondly, it is based on international accounting standard No. 37. Paragraph 14 of the Standard read as under:-

Any amount is admissible and allowed as deduction under this standard No. 37, when:-

- an enterprise has a present obligation (legal or constructive) as a result of a past event,
- it is probable that an out flow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognized."[2]
- The term used in the above Standards are defined under Paragraph 10 as under:-

"The "Provision" shall be a liability of uncertain timing or amount."

The liability shall be a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

The "obligatory event" shall be an event that creates a legal or constructive obligation that result in an enterprise having no realistic alternative in settling that obligation.

[1] Section 77 of Pakistan Offshore Petroleum (Exploration and Production) Rules, 2003 (Pakistan)
[2] Paragraph 14 of IAS,1992

A legal obligation may be accrued from the following things:-

- A contract ( through its explicit or implicit terms);
- legislation; or
- Other operation of law.

A contingent liability is:-

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise: or

(b) A present obligation that arises from past events but is not recognized because:

(i) It is not probable that an out flow of resources embodying economic benefits will be required to settle the obligation:

(ii) The amount of the obligation cannot be measured with sufficient reliability.

The Companies other argument is that the decommissioning cost is an admissible deduction under Rule 2(5) of 1st Part of 5th Schedule. This Rule reads as under:-

Any expenditure, including royalty paid to the Federal Government by an onshore petroleum exploration and production undertaking on, or after, the first July, 2001, (not being in the nature of capital expenditure of personal expenses of the taxpayer) laid out or expended after the commencement of commercial production and wholly and exclusively for the purpose of the business of production and exploration of petroleum carried on by such undertaking shall be allowed as a deduction.

On the other hand, the taxation department is of the view that although Rule 69 of the Pakistan Petroleum (Exploration and Production) Rules, 1986 did impose a liability on the Companies, yet it was not a definite as under the said Rule. The Government has the option of either acquiring all the installations or requiring the Companies to remove all installations and to restore the area to its possible original state. The decision of the Government, whether it acquires or direct the company to decommission the machinery and restore the area in its original condition, may not be ascertained before the happening to closure of petroleum Exploration and Production business, it renders the liability as anything but definite.

The second argument of the department is that the liability is incapable of being measured with sufficient reliability.

As regards the applicability of Rule 2(5) of the 1st Part of 5th Schedule, it is argued by the Taxation department that the liability is neither ascertained nor the expenditure is incurred when it is claimed. But the Companies are of the view that the liability is definite and ascertainable or measurable. The simple answer of this argument of Taxation department may be that if the measurement of such expenditure is not possible why the legislature allowed such type of uncertain and immeasurable expenditures as deduction.

As regards, the liability to remove installations and to restore land, there is no dispute about the fact that under Rule 69 of the Pakistan Petroleum (Exploration and Production) Rules, 1986, a permit holder or a lessee has to remove all machinery & equipment installed in the leased area and restores the land to its original state. The liability is both legal as well as contractual.[1]

The next issue in decommissioning cost is whether such liability is a liability proper or contingent. The Petroleum Companies rely on the case laws cited below:-

1. Commissioner of Income Tax, West Bengal-I v. Remington Rand India Ltd. and Others.

When the liability for payment of gratuity is ascertained by actuarial valuation in which all contingencies are taken into consideration, such liability is in praesentia and the amount so set apart is permissible business expenditure in the year concerned for an assessee following the mercantile system of accounting.

The assesee company claimed deduction of the liability on the basis of actuarial valuation for payment of gratuity to its employees in accordance with the terms of a gratuity scheme of the company. The Income-tax Officer disallowed the deduction on the grounds that the liability as at the end of the relevant accounting year was a contingent liability and not an accrued liability and that the deduction claimed was not in respect of any contribution to any approved gratuity fund, which alone was admissible as a deduction under the provisions of the Act. The tribunal allowed the claim of the assessee on the ground that the liability had accrued during

[1] Rule 69 of Pakistan Petroleum (Exploration and Production) Rules, 1986 (Pakistan)

the relevant previous year. On a reference, the Revenue contended that the liability for payment of gratuity was under a scheme and not under the West Bengal Employees payment of Compulsory Gratuity Act, 1971:

Held, that there could not be any distinction in principle between a liability flowing from a control and a liability created under a statute. The provisions of the West Bengal Employees' Payment of Compulsory Gratuity Act, 1971, came into force in the relevant previous year and a liability was created by the statute for payment of gratuity in the relevant previous year. However, the Act did not preclude the employer from framing its own scheme for payment of gratuity to its employees so long as such scheme was not inconsistent with or repugnant to the provisions of the said Act. The assessee was under a liability to pay gratuity to the employees either under the scheme or under the Gratuity Act. In a case where the actuarial valuation was made in respect of large number of employees retiring in different years, such actuarial valuation of the liability must be treated as an accrual liability of the year in question. Therefore, the actuarial valuation of the gratuity payable in future was as allowable deduction.

2. Commissioner of Income Tax Verses Oriental Dyes and Chemical Co. Ltd.

Briefly the facts are that respondents are assessees and claimed deduction of gratuity for the year 1979-80, which was allowed to the extent of gratuity paid and not allowed to the extent of Rs.27,295, which was to be paid in future on happening of contingencies on retirement, termination and resignation of employees. Reasons assigned by Income Tax Officer for disallowance was that liability of payment of gratuity had not yet accured during the relevant period and, therefore, the same could not be treated as allowable deduction, Appeals of assessees before Appellate Assistant Commissioner and Appellate Tribunal failed and consequently at their request the question was framed by appellate Tribunal and referred to the High Court as under: —

"Whether in the facts and circumstance of the case the Appellate Tribunal was justified in upholding the disallowance of the claim of gratuity payable to the employees?"

High Court after hearing the counsel for both parties answered the question in negative following two decisions of the same High Court rendered earlier in the case reported as Commissioner of Income Tax, Karachi v. Messrs Pakistan Security Printing Corporation (1985) 51 Tax, 137 (H.C. Kar.)= (1985 PTD 413) and Messrs S.J.G. Fazal Elahi Ltd. v.

Commissioner of Income Tax Central Zone, Karachi 1989 PTD 579. In fact latter reported case has followed rule laid down by the former reported case in which there is detailed discussion in the light of Sections 10 (2) and 2 (6-BB) of Income Tax Act No. XI of 1922 on description of free reserve, gratuity and trading liability'. In support of the proposition, reliance is placed upon a large number of reported cases, relevant paragraph from the aforementioned judgment in (1985) 51 Tax 137 (H.C. Kar.) = 1985 PTD 413 is reported as under: -

"We have quoted the relevant portion of the order of the Income Tax Officer hereinafter in para. 4, from which it is evident that every year the respondent assessee made a provision for the gratuity of the staff on the basis of the emoluments received by them and the amount was credited to this account, on the basis of the accounting principle that the amount of gratuity is earned every year by the employees and thus it is debitable against the profits of the year in which it is earned though it is payable only when the employees retire from the service. The learned Income Tax Appellate Tribunal in its order, dated 3rd April, 1973 has held that the reserve for gratuity has been created to meet ascertained liability incurred by the respondent assessee towards its employees in respect of the gratuity of the years in question nor it is the case of the department that the respondent assessee was not liable to pay the above gratuity either under the contract or under the statutory provision. Factually the case proceeded before the Income Tax Tribunal on the assumption that the respondent assessee's liability to pay gratuity is a legal liability and it is not an ex gratia payment by the respondent to its employees. We may place on record that Mr. Shaikh Haider, learned counsel for the appellant has fairly cited the cases which were in fact against the department, namely, the cases referred to hereinabove in paras, 5(a) (vii) (viii) and (ix) which are the decisions of the Madras High Court and which clearly lay down that the liability of gratuity ascertained each year is a proper charge against P &L accounts though the liability to pay may accrue subsequently. Reference may also be made to the House of Lord's case Owen (H.M. Inspector of Taxes) v. Southern Railway of Peru Ltd. 1953-56TC 602 referred to hereinabove in para.5 (b) (iv), in which it was held that provision for the payment of compensation to the assessees' rate of pay etc. is a proper charge on P& L upon the basis of proper principles of commercial accountancy from year to year. Further reference may also be made to the case of the Indian Supreme court reported in (1969) 73 ITR 53 quoted hereinabove in para.5(b)(vii), in which it has been held with reference to a scheme of gratuity that liability already accrued through to

be discharged at a future date would be a proper deduction while working out the profits and gains of business under the accepted principles of commercial practice and accountancy and that it is not necessary that the amount actually be expended or paid."

Mr. Shaikh contended before us that gratuity paid in the relevant year is allowable deduction but amount can be within the control of the company for payment in future is not an allowable deduction. Secondly, that under the provisions of Labour laws, liability for payment arises only on resignation, retirement or termination; hence Income Tax authorities were justified in disallowing the same. Both these contentions stand answered in the judgment of the reported case mentioned above, relevant paragraph of which is quoted above. High Court has rightly relied upon case-law in support of answering the questions negatively formulated in the reference placed before it. In support of his contentions, reliance is placed by Mr. Shaikh Haider on the case of Commissioner of Income Tax, U.P v. N.L. Laxmi Sugar and oil Mills Ltd. 1889 PTD 169 (Supreme Court of India), which is misplaced for the reason that the point discussed in that case is different and distinguishable from the point in issue of the instant case.

For the facts and reasons stated above, we are of the considered view that no exception can be taken to the judgment of the High Court impugned in this petition for the reason that it has answered the question correctly to the effect that claim of gratuity payable to the employees cannot be disallowed in the light of and for the reasons stated in the case-law mentioned above. No interference is warranted, as such leave is refused and petition is dismissed.

3. Commissioner of Income Tax (Central-I v. Eastern Spinning Mills Ltd

Where statutory liability has accrued for the first time during the relevant year and an assessee deducts or seeks to deduct the estimated value of the liability for computing the profit for that year and the contingent part is so insignificant or so irrelevant that it cannot be considered contingent in the real sense of the term, in earning the income for that year, that liability has been incurred by the assessee by virtue of the statute.

The assessee, which maintained its accounts under the mercantile system, has created a provision for gratuity to the extent of Rs.8, 57,863 on actuarial basis in accordance with the statutory provisions of the W.B. Employees/ Payment of Compulsory Gratuity Act, 1971,

which was a special liability created for the first time in 1971, and claimed the entire provision as permissible business expenditure in the assessment year 1972-73. The ITO held that the allowable amount pertaining to the relevant year was only Rs.1, 79,595 and disallowed the balance of Rs. 6,78,267 as excess provision. The AAC and the Tribunal accepted the assessee's claim. On a reference:

Held, affirming the decision of the Tribunal, that a prudent businessman, in the circumstances, was bound to make a fair estimate of his liability under the Act from year to year, but as in the relevant year the liability had come for the first time the assessee was entitled to make a prudent estimate of the liability which could accrue for the payment of gratuity in the form of a deferred payment of wages for the employees concerned, which was necessary for earning its profit. In a case where the liability itself was contingent, there was no accrued liability. But in a case where a large number of employees were concerned and the circumstances under which it could be defeated were remotely contingent and so insignificant in reality in view of the number of employees concerned, it could not be said to be contingent in the real sense of the term.

ii. That the statute of 1971 had created a liability for the first time and whereas estimate of the liability was possible, such liability was properly deductible, in computing the profit of the relevant year of the assessee. There was nothing improper in admitting, as deductions, provisions to meet contingent liabilities if by so doing a true balance was arrived at between the receipts of the year and the cost of earning them, or between the expenses of the year and the fruits of incurring them. Any sum claimed as such a provision must, however, be seen to be an essential charge against the receipts of the year in which it appeared in the accounts in order to enable a true profit from that source to be stated.

iii. That as the estimate made was not excessive and unreal and the W.B. (West Bengal) 4Employees' Payment of Compulsory Gratuity Act, 1971, came into operation for the first time, in arriving at the true profit of the company under s.37 of the Act, the provision for gratuity was a permissible deduction. The fact that under clause (v) of sub section (1) of section 36 of the I.T. Act, 1961, the sum paid by the assessee by way of contribution towards approved gratuity fund for the exclusive benefit of the employees was deductible did not affect the position. The assessee claimed its right to deduct the sum because the amount was a special liability which was created for the first time in 1971. Nor did the contingency, that

because the assessee had dominion over the money, there was a possibility of misuse, affect this position.

In this reference under s. 256 (1) of the I.T. Act, 1961, the following question has been referred to this court:

"Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the provision for gratuity amounting to Rs.8, 87,863 was allowable in its entirety as a revenue deduction for the assessment year 1972-73?"

As is apparent from the question, the assessment year involved is the assessment year 1972-73. The ITO had noticed that the assessee had created a provision for gratuity to the extent of Rs.8, 57,863. The ITO was of the opinion that the allowance amount pertaining to the year of account was only Rs.1, 79,595, in that view of the matter he disallowed the sum of Rs.6, 78,595 he held that the amount represented excess provision. The assessee preferred an appeal before the AAC.

It was before the AAC that the entire provision of Rs.8, 57,863 was made on actuarial basis and was in consonance with the statutory provisions of the West Bengal Employees' Payment of Compulsory Gratuity Act, 1971 (hereinafter referred to as "the said Act"). It was submitted that in view of the decision of the Allahabad High Court, which we shall presently note, the disputed amount has been wrongly disallowed. The ACC accepted the assessee's contention. He, therefore, deleted the addition made by the ITO on this score.

Being aggrieved by the decision of the AAC, there was a further appeal to the Tribunal and reliance was placed on several decisions to which we shall presently refer and after discussing the contentions of the parties the Tribunal was of the opinion that the AAC was right in allowing this appeal of the assessee. Accordingly, the appeal by the revenue was dismissed by the Income-tax appellate Tribunal. In these circumstances, the question as indicated before has been referred to this court.

The fundamental question involved in this reference is how to compute the profit for the purpose of income tax for the relevant accounting year. In the facts and circumstances of the case, it is important in this connection to bear in mind the provisions of the West Bengal Employees' Payment of Compulsory Gratuity Act, 1971. This Act came into effect during the

year in question with which we are concerned. The relevant provision of this Act which is material from our present purpose is section 4 which makes payment of certain gratuity compulsory for certain companies and the petitioner is one of those companies. The said section reads as follows:

Payment of gratuity- (1) Gratuity shall be payable to an employee:-

(a) On his superannuation,

(b) On his retirement or resignation,

(c) On his death or total disablement due to accident or disease, after completion of not less than five years of continuous service:

Provided that the completion of continuous service of five years shall not be necessary where the termination of the employment of any employee is due to death or disablement.

Explanation:- For the purpose of this section, total disablement means such disablement as permanently incapacitates an employee for all work which he was capable of performing before the accident or disease resulting in such disablement.

(2) Notwithstanding anything contained in sub-section (1), no gratuity shall be payable to an employee whose employment has been terminated for his gross misconduct.

Explanation: - For the purpose of sub-section (2), 'gross misconduct' means:

(a) Any act or willful omission on the part of the employee resulting in loss or damage to, or destruction of, property belonging to or owned by the employer; or
(b) Any serious act of violence on the part of the employee; or
(c) Any act on the part of the employee which constitutes an offence involving moral turpitude punishable under the Indian Penal Code (45 of 1860).

(3) In the case of death of an employee, the gratuity shall be payable to the nominee of the employee or in the absence of a nominee to his heirs.

(4) The employer shall pay gratuity to an employee at the rate of fifteen days' wages based on the rate of wages last drawn by the employee concerned, for every completed year of service or part thereof in excess of six months:

Provided that the amount of gratuity payable to an employee shall not exceed fifteen months' wages:

Provided further that nothing in this section shall affect the right to any better terms of gratuity or retirement benefits under any award or agreement or contract with the employer."

The assessee claims that as it maintains its accounts on the mercantile basis, in order to arrive at its proper income assessable to tax, the liability accrued should be deducted in computing its profits for the purpose of tax. The question, therefore, is whether this sum of Rs. 8, 57,863 could be said to be a liability which had accrued to the assessee on account of payment of gratuity to the employees which the assessee was entitled to deduct for arriving at its net profits? Section 36 of the I.T. Act, 1961, provides for deduction in computing the income referred to under section 28 of the said Act and Sub-clause (v) of Sub-section 36 covers "any sum paid by the assessee as an employer by way of contribution towards an approved gratuity fund created by him for the exclusive benefit of his employees under an irrevocable trust". Section 37 of the Act under which this deduction is claimed provides that any expenditure (not being expenditure of the nature described in sections 30 to 36 and section 80VV and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purpose of the business or profession shall be allowed as a deduction in computing the income chargeable under the head "profit and gains of business or profession". The question, therefore, is whether this provision which assessee claims to have accrued for the year in question was an expenditure which should be allowed in computing the income chargeable as profit.

Several decisions, both in England and in India, have examined on this question from various angles. In this connection, we may first refer to the decision of the House of Lords in the case of Southern Railway of Peru Ltd. v. Owen (Inspector of Taxes) [1957] 32 ITR 737; [1957] AC 334. There, under the relevant legislation of Peru, an English company, operating a railway there, was bound to pay its employees compensation on the termination of their services, the legislative provisions being deemed to be incorporated into all contract of

service. The right arose on dismissal or on termination of the employment by the employer by proper notice, or such termination by the death of the employee or on the expiry of the term of employment. Exception were: (a) in the case of fixed term contracts, where the contract was determined by the employee before the expiry of the term otherwise than on account of infringement by the company, and (b) in the cases of all contracts of service where there had been wrongful conduct of certain kinds of employee (e.g., dishonesty or insubordination). The compensation was an amount equivalent to one month's salary at the rate in force at the date of determination for every year of service. The company claimed to be entitled to charge against each year's receipt the cost of making provision for the retirement payments which would ultimately be thrown on it, calculating what sum would be required to be paid to each employee if he retired without forfeiture at the close of the year and setting aside the aggregate of what was required in so far as the year had contributed to the aggregate. In the facts of that case, it was, however, held that the company was not entitled to make the deductions sought to be made. It was held by the majority of the law Lords that the company was entitled to charge against each year's receipt the cost of making provision for the retirement payments which would ultimately be payable as it had the benefit of the employees' services during that year, provided that present value of the future payments could be fairly estimated.

The question was also considered by several High Courts. In the case of Madho Mahesh Sugar Mills (P.) Ltd v. CIT [1973] 92 ITR 503, the Division Bench, Allahabad High Court, had to consider this question. There in the case of an assessee maintaining its accounts on the mercantile system a liability already accrued, though to be discharged at a future date, would be a proper deduction while working out the profits and gains of his business, regard being had to the accepted principles of commercial practice and accountancy. The estimated liability of an assessee for payment of gratuity to its workers based on actuarial valuation is a permissible deduction. Such a liability was as ascertainable liability *in praesenti*[1] though payable in future. There, in 1961, the U.P. Government issued a notification with regard to the sugar industry imposing a liability on persons running sugar mills to provide gratuity to their workmen in accordance with the scale provided in the notification. In pursuance of this notification the assessee set apart the sum of Rs.1,37,811 representing the sum that the

[1] In present, page#808, Black's law dictionary, eighth edition 2004

assessee would be required to pay to its workmen as gratuity and made an appropriate entry in its books of accounts, crediting the gratuity account and debiting the profit and loss account for the assessment year 1962-63. This sum was claimed by the assessee as business expenditure but the claim was disallowed by the ITO, the AAC and the Appellate Tribunal. On a reference to the High Court it was contended for the revenue that at best the assessee could claim only the gratuity relevant to the previous year. The discounted value of the assessee's liability to pay gratuity based on actuarial valuation was determined at the instance of the High Court at Rs.1, 05,200. It was held that the Government order provided that the gratuity would be payable to an employee not only in respect of his future services but also for his past services. Thus, in order to ascertain the quantum of liability as on the date the order came into effect, the past services of the employees had also to be taken into account. In the circumstances every businessman would make provision every year for his liability under the notification. Though no part of the gratuity might have been payable by the assessee in any of the earlier years, the past services of the employees had to be taken into account merely to arrive at the quantum of the liability which became ascertained on actuarial calculation, in which all contingencies were taken into consideration, was a liability in praesenti and was capable of ascertainment and, therefore, the sum of Rs.1, 05,200 was a permissible business expenditure in the assessment year concerned.

In that view of the matter as the estimate made was not excessive and unreal and the Act in question came into operation for the first time, in arriving at the true profit of the company, in our opinion, under section 37 of the Act, this was a permissible deduction. The fact that under clause (v) of the sub section (1) of section 36 of the Act the sum paid by the assessee by way of contribution towards approved gratuity fund for the exclusive benefit of the employee is deductible does not, in our opinion, affect the position. The assessee claimed its right to deduct this sum because this amount was a special liability which, we have noticed before, was created for the first time in 1971. If the assessee had dominion over the money, such money was not beyond the reach of assessee, and there was a possibility of misuse, it was sought to be urged on behalf of the revenue. But upon the possible contingency of misuse by the assessee the rights of the parties under the Act cannot be decided. It seems that the legislature has taken note of that possibility by sub section (7) of section 41A of the I.T. Act, 1961.

In that view of the matter, in the facts and circumstances of the case, we are in agreement with the conclusion arrived at by the Tribunal and the question referred to us is answered in the affirmative and in favour of the assessee.

Each party will pay and bear its own costs.

In all cases the issue is a provision of gratuity to the employees which is a future liability. In all the cases, it was held by the Superior and High Courts that where a liability is certain and also capable of being estimated with reasonable certainty, though actual quantification may not be possible, the provision qualifies for deduction as business expense. In light of the above cases, the liability for which the provision of decommissioning cost is made is a definite liability and is capable of being estimated with reasonable certainty is measurable.

The companies also rely on IAS 37. Paragraph 14 of this Standard requires that "a provision should be recognized when:

(a) An enterprise has a present obligation (legal or constructive) as a result of past events;

(b) It is probable that an out flow of resources embodying economic benefits will be required to settle the obligation; and

(c) A reliable estimate can be made of the amount of obligation. If these conditions are not met, no provision should be recognized.

But the argument of the department is that the arising of liability depends upon the exercise of option by the Government whether it takes over the installations or requires the companies to remove these installations and restore the area to its original state. The department, therefore, claims that it is a contingent liability. The view of the department is not correct because decommissioning is the present obligation of the company if the Government asked the company to decommission the machinery and restore the land in its original state. Decommissioning is required for economic benefits to land owner and the E&P Company when reliable estimate is be made. All the requirements of IAS 37 paragraph are fulfilled.

But one may say that problem in the application of IAS 37 is whether a reasonable estimate can be made of the liability, but the option is available with the Government either to takeover the installations or orders the companies to remove these fixtures and clean the area. The second problem is that the amount which may be claimed is on the basis of estimation by the staff of the companies.

The courts of the country and foreign courts accepted the claim or liability as the estimate was backed by actuarial valuation. The liability is certain and is capable of being fairly estimated by the relevant staff of the companies. In this behalf, it may be stated that the estimate of the cost is not constant figure. It is the present cost of a future liability. If the prices go up, the cost would go up and if the prices go down or the technology improves, the cost would go down. At the end of the each income year, the estimate is to be revised accordingly.

One may contest the accuracy of the figure estimated but no one can deny that such cost can not be estimated with reasonable reliability. *Considering all aspects of the issue, there is no choice but to hold that it is a liability that is to be recognized.*

The next question is how the liability is to be adjusted. Can it be adjusted in one go or spread over a number of years? The standard is silent about it. However, IAS 16, on which the Companies rely, provides sufficient guidance. This Standard prescribes the accounting treatment for property, plant and equipment. Paragraph 15 of this Standard prescribes the method of measurement of cost. It counts the components of the cost as under:-

(a) The cost of site;

*(b)* Initial delivery and handling costs;

*(c)* Installation costs

*(d)* Professional fees such as for architects & engineers; and

*(e)* The estimated cost of dismantling and removing the asset and restoring the site, to the extent that it is recognized as a provision under IAS 37.......

Paragraph 41 of this Standard then provides for depreciation and read as under:-

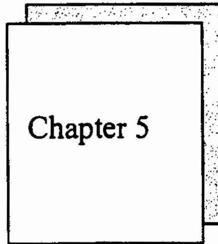
"The depreciation amount of an item of property, plant and equipment should be allocated on a systematic basis over its useful life. The depreciation method used should reflect the pattern in which the asset's economic benefits are used. The depreciation charges for each period should be recognized as an expense unless it is included in the carrying amount of another asset."

It is noticed that this Standard makes the decommissioning cost a component of the cost of machinery, plant and equipment and makes it eligible for depreciation. So the only way to resolve the matter of decommissioning cost is to spread the decommissioning cost over the years. Such spreading could either be on a percentage-of-the-amount basis, on times-basis (spreading it on the average expected life of various areas) or on unit-of-production basis. The quantity of the petroleum in the reservoirs is known. If the cost is spread over that quantity but the yearly cost will be related to the quantity extracted. The unit of production method, therefore, appears to be the most reasonable one.

The department's objection that the amount of decommissioning provision is not supported by any third party, competent to estimate such cost, can be taken care of. The provision is not a constant figure. It is to be estimated every year. Since every year it is the present cost of the future liability, it can go up if the price go up or come down if the technology improves or the prices go down. Necessary adjustments have to be made annually. If the department is not satisfied by the figures supplied by the companies, the estimate may be made by a competent third party and necessary adjustments may be made in the succeeding assessments.

Finding:

The amount of decommissioning cost will be amortized on "unit of petroleum" produced or saved by the E&P companies, on yearly basis.




CONCLUSION AND SUGGESTIONS

## 5.1 CONCLUSION AND SUGGESTIONS

By wrapping up the topic and after grasping the relevant laws and legislation we come to the conclusion that:-

1. Petroleum reservoirs are the property of the Federal Government of Pakistan and no body can start Petroleum Exploration and Production business in Pakistan without the prior permission of the Federal government.
2. For the Petroleum Exploration and Production business an agreement with the Federal government is necessary.
3. In Pakistani business atmosphere a person can do different types of businesses but as the taxation is concerned the income generated from the petroleum Exploration and Production business shall be treated separately, meaning thereby the income from petroleum Exploration and Production shall be computed and tax separately where the person earns income from more than one business including Petroleum Exploration and Production business.
4. There are different types of income under the Income Tax Ordinance, 2001 but the profits and gains from petroleum extraction shall be computed as income from business.
5. If the petroleum business started but stopped before the commercial production is made the expenses incurred thereupon shall be treated as lost and may be claimed under the Income Tax Ordinance, 2001 but the claim will be admissible if the same is allowed as loss under the agreement with the Federal government.
6. If the agreement, between the E&P company the and Federal government, treats any expenditure as loss, it may be claimed in the following manner:-
    a) If the business is stopped before the commercial production, the loss shall be set off against the income from business of that year or any other income of the person or company (other than dividend income), but if the loss may not be

wholly set off, the remaining portion thereof shall be carried forward and set off accordingly but such loss cannot be carried forward for more than six years.

**b)** If the business is carried on after the commercial production, the losses made shall be set off against the income of that year and if the loss may not wholly set off the remaining part of loss shall be carried forward but not more than ten years.

**c)** If all the expenses incurred before the commercial production is started and not treated as loss, not allowed under set off provision as above and not presented in physical assets (like machinery), shall be allowed as deductions and claimed under the provisions of this Ordinance, but the deductions claimed under any year shall not be more than 10% percent of the deduction allowed under the same year in case of onshore and 25% percent in case of offshore explorations and production.

**d)** Royalty paid to the Federal Government shall be allowed as business expenditures and shall be paid as per the percentage provided in the agreement, between the company and the Federal government, which is usually increased afterward but the outer limit of royalty shall not be more than 12.5% of well head value of petroleum produced and saved.

**e)** Any other expenditure incurred on or after 21st July of 2001 and not represented as capital expenses and personal expenses shall also be allowed as deduction according to ITO, 2001.

**f)** Depreciation of the assets and machinery is claimed under section 22, 23 and 24 of the Income Tax Ordinance, 2001 but if the physical assets are acquired before the commercial production and used after the commercial production is made for the business of petroleum concerns, the deduction is allowed as the assts are acquired at the time of commercial production but the deduction claimed before the commercial production shall be reduced.

**g)** The limitation of set off of six years shall not be applicable in case of depreciation of machinery, plant and other equipment used in the offshore petroleum concerns and the entire amount may be claimed but in different years until the whole amount is claimed.

**h)** If the deductions allowed, under Part IV of Chapter III (i.e. under sections 20 to 31) of ITO, 2001 and sub Rules 3 and 4 (i.e. depletion allowance and limitation on payment to Federal Government and taxes) of ITO, 2001 are exceeded from the gross receipt of that year from the petroleum produced, shall be set off against the other income of that person (except dividend) and remaining shall be carried forward but not more than six years. It means the carry forward of deductions in the E&P business are allowed for six years only.

7. When the commercial production is started, another allowance named depletion allowance shall be allowed @ 15% of the gross receipt representing the well-head value of total production but the same shall not exceed 50% percent of the profits or gains before deduction of depletion is made.
8. Before deduction of payments to the Federal government, specified in Pakistan Petroleum (Production) Rules, 1949 and Pakistan Petroleum (Exploration and Production) Rules 1986, the aggregate of income tax shall not be less than 50% in case of onshore and 40% in case of offshore on profits or gains of petroleum exploration and production if limit of income tax is not specified in the agreement between the company and the Federal government, but normally this limit shall be provided in the agreement.
9. In general practice in Pakistan, every agreement, between the GOP and E&P companies, on the subject of petroleum exploration and production, fixes the liability of taxes and levies on the person working in the field petroleum exploration and production and if additional tax is made by the taxpayer in excess, the excess shall be paid back to the taxpayer or may be adjusted against any other tax payable to the Government in any year.
10. Windfall tax, which is a new concept in Pakistan, is charged on the rising rate of dollar, by the Federal government from the Petroleum companies working in Pakistan because only dollar is used as money of consideration in Pakistan for petroleum business.

But there are some catches in the petroleum laws regarding some clarifications which may be over come through the intelligent steps of the legislators and rank and files seated in different places. These difficulties can be brushed aside by the following suggestions:-

1. The words used in different legislation should be clarified through insertion of definitions in the definition clause if they are used for specific meaning in the petroleum sector like the meaning of gross receipts which is used commonly without deduction of any expense.

2. As the decommissioning cost is concerned, for the removal of doubt, it is necessary that there should be a body which should be comprised of persons from the concerned petroleum company, department (ministry of petroleum and natural resources) and taxation department for true calculation of decommissioning cost, or this type of dispute may be settled down by the formation of dispute resolution board like other dispute resolution committees already working in Pakistan under the umbrella of FBR.

3. The ambiguity regarding royalty between the petroleum companies and taxation department should be removed through the modification in the substantive law by the law makers which reflect the single meaning interpretation. In this way the calculation may become clear and unambiguous.

4. The provisions related to the taxation of the petroleum companies should be compiled in one book for the ease and understanding of petroleum companies working in Pakistani business atmosphere and for taxation department also.

The single interpretation of words and phrases, used specially for petroleum sector, should be made possible otherwise if two or more interpretations are possible the taxpayer favored interpretation must come into play which is one of the basic principles of taxation legislation and other. So due to ambiguous legislation the companies shall take benefits, which is not in the favour of the Government.

## TAX COMPUTATION WORKING CHART

**We can understand the taxation of E&P Companies through the following tax computation chart**

| | | |
|---|---|---|
| Net Profit before Tax as per Accounts* | | 50,000,000 |
| Additions: | | |
| Royalty Paid | | - |
| Amortization of Exploration & Development Expenditure | | 5,000,000 |
| Accounting Depreciation | | 3,000,000 |
| | | 8,000,000 |
| | | 58,000,000 |
| **Deductions:** | | |
| Exploration & Development Expenditure for the year | | 10,000,000 |
| Decommissioning Cost for the year | | 500,000 |
| Amortization of prior years Decommissioning Cost | | 150,000 |
| Tax Depreciation | | 3,500,000 |
| Depletion Allowance: | | |
| 15% of Gross Receipts representing well head value | - | |
| but not exceeding 50% of Profit before such allowance | 20,275,000 | |
| which ever is less | | - |
| Interest Income (Separate Block of Income) | | 3,000,000 |
| Dividend Income (Separate Block of Income) | | 300,000 |
| | | 17,450,000 |
| Income from Business | | **40,550,000** |
| Income Tax | 50.00% | **20,275,000** |
| Less: Royalty Paid | | - |
| Net Tax on Business Income | | 20,275,000 |
| Tax on Interest Income (Taxable @ 35%) | 35% | 1,050,000 |
| Tax on Dividend Income (Taxable @ 5%) | 5% | 15,000 |
| Total Tax Payable for the Year | | **21,340,000** |
| In case of Offshore company or Onshore company, following will apply | | |
| Offshore | 40% | 16,220,000 |
| Onshore | 50% | 20,275,000 |

* Net Profit after deducting Lease Rental and other expenses.

## LIST OF PRINCIPLE DEFINITIONS

**"PETROLEUM"** means the crude oil, natural gas, and case-head petroleum spirits as defined in the Pakistan Petroleum (Production) Rules, 1949, or the Pakistan Petroleum (Exploration and Production) Rules, 1986, but does not include refined petroleum products.[1]

The definitions given in the referred legislation are as under:-

**"PETROLEUM"** means all liquid and gaseous hydrocarbons existing in their natural condition in the strata, as well as all substances, including sulphur, produced in association with such hydrocarbons, but does not include basic sediments and water.[2]

**"PETROLEUM"** includes any mineral oil or relatively hydrocarbons and natural gas existing in its natural condition in strata, but does not include coal or bituminous shale's or other stratified deposits from which oil can be extracted by destructive distillation.[3]

**"COMMERCIAL DISCOVERY"** means a discovery of petroleum duly evaluated by appraisal well(s), which discovery, in the opinion of the operating committee, with the concurrence of the Government would justify, particularly by its quality, quantity, gravity, place and depth where found, its Economic development, and depth where found, its Economic development, and assures a continuous commercial production for a reasonable period. In the event that the Discovery so made does justify the drilling of an appraisal well, then the working interest owners will upon submitting detailed technical and/or economic justification, seek the approval of the Government for declaration of a commercial discovery on one well basis.[4]

**"COMMERCIAL PRODUCTION"** means production of petroleum out of a commercial discovery, which production ensures at least the recovery of all expenditure directly attributable to such discovery within a reasonable time and the earning of a reasonable profit.[5]

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[1] Rule 6 (4) of 5th schedule of ITO,2001
[2] Clause 2 sub clause h of part 1 of Pakistan Petroleum (Exploration and Production) Rules, 1986 (Pakistan)
[3] Section 2 of The Pakistan Petroleum (Production) Rules, 1949 (Pakistan)
[4] Section 1.6 of PCA between President of Pakistan and OGDCL
[5] Section 1.7 of PCA between President of Pakistan and OGDCL

**"CONDENSATE"** means the liquid petroleum excluding crude oil and LPG produced, at surface by processing of separation of natural gas from a gaseous/gas condensate reservoir.[1]

**"CRUDE OIL"** means Liquid petroleum as it comes out of the ground, as distinguished refined oils manufactured from it, also called simply crude. Crude oil varies radically in its properties, viz, specific gravity and viscosity. Depending on the chemical nature of its chief constitutes, crude oil is classified as paraffin base, asphaltic base, or mixed base.[2]

**"CRUDE OIL"** means oil in its natural state before the same has by refined or otherwise treated, but excluding water and foreign substance.[3]

**"DISCOVERY"** means the finding of a deposit of petroleum from an exploration well not previously known to have existed which produces a flow at the surface which is measurable by conventional petroleum industry testing methods.[4]

**"WELL-HEAD VALUE"** shall have the meaning assigned to it in the agreement between the Federal government and the taxpayer and in the absence of any such definition in the agreement, the meaning assigned to it in the Pakistan Petroleum (Production) Rules, 1949, or the Pakistan Petroleum (Production) Rules, Rules, 1986.[5] Which are as under:-

**"WELL HEAD VALUE"** of crude oil shall be the price of the competitive non-Pakistan crude oil, suitably adjusted to the same gravity and quality at the same destination as the actual ultimate destination of Pakistan crude oil, reduces by costs incurred from the point of production within Pakistan to such destination.[6]

**"WELL HEAD VALUE"** means the market value of the petroleum less gathering, processing, treatment and transportation costs from the well head to the place at with the

[1] Section 1.8 of PCA between President of Pakistan and OGDCL
[2] Merril Lynch report on Pakistan Oil and Gas-17 November 2003
[3] Clause 1.14 Of Petroleum Concession agreement between President of Pakistan and OGDCL on Block no. 3072-2
[4] Section 1.14 of PCA between President of Pakistan and OGDCL
[5] Sub-section 4 of definition clause of 5th Schedule of Income Tax Ordinance, 2001
[6] Section 2 of The Pakistan Petroleum (Production) Rules, 1949 (Pakistan)

market value is determined, and in case of natural gas also include compression, dehydration and liquefaction costs.[1]

"**BUSINESS**" includes any trade, commerce, manufacture, profession, vocation or adventure or concern in the nature of trade, commerce, manufacture, profession of vocation, but does not include employment.[2]

"**BUSINESS**" The term business has been defined in section 2(4) of the Act. Business includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture. It has repeatedly observed that business with the aid of meaning given in the dictionary be deprecated"[3]

"The definition of the word business, as contained in section 2(4) of the Act, embraces only such activities as are in the nature of trade, commerce or manufacture."[4]

"**AGREEMENT**" means an agreement entered into between the Federal Government and a taxpayer for the exploration and production of petroleum in Pakistan.[5]

"**CAPITAL ASSETS**" means a capital asset as defined in section 37.[6]

"**CAPITAL ASSET**" means property of any kind held by a person, whether or not connected with a business, but does not include-

[(a)] any stock-in-stock (not being stocks and shares), consumable stores or raw materials held for the purpose of business;]

(b) Any property with respect to which the person is entitles to depreciation under 22 or amortization deduction under section 24;

(c) Any immovable property; [or]

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[1] Clause (K) of section 2 of Pakistan (Exploration and Production) Rules, 1986 (Pakistan)
[2] Clause 9 of section 2 of ITO, 2001
[3] [(1974) 30 Tax 158 (H.C. Kar)]
[4] [(1977) 35 Tax 74 (H.C. Lah)]
[5] Clause (1) of definitions of 5$^{th}$ Schedule of ITO, 2001
[6] Clause (10) of section 2 of ITO, 2001

(d) Any movable property [(excluding capital assets specified in sub- section (5) of section 38)] held for personal use by the person or any member of the person's dependent on the person.[1]

**"MEANING OF TAX"**A monetary charge imposed by the government on persons, entities, transactions, or property to yield public revenue. Most broadly, the term embraces all governmental impositions on the persons, property, privileges, occupation, and enjoyment of the people, and includes duties, impositions and exercises. Although a tax is often thought of as being pecuniary in nature, it is not necessarily payable in money.[2]

**"TAXATION ON INCOME" and "TAX"** includes income tax, but does not include payments to the Federal Government.[3]

**"ROYALTY"** the term royalty is defined in section 2(54) as under:

The use of, or right to use any patent, invention, design or model, secret formula or process, trademark or other like property or right;

- The use of, or right to use any copyright of a literary, artistic or scientific work, including films or video tapes for use in connection with television or tapes in connection with radio broadcasting, but shall not include consideration for the sale, distribution of exhibition of cinematograph films;
- The receipt of, or the right to receive, any visual images of sounds, of both, transmission by satellite, cable, optic fiber or similar technology in connection with television, radio or internet broadcasting;
- The supply of any technical, industrial, commercial or scientific equipment;
- The supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as

[1] Section 37 of ITO,2001
[2] Black's Law Dictionary, Eighth edition 2004, page# 1496
[3] Clause (7) of definitions of 5th Schedule of ITO,2001

mentioned in [sub-clauses] (a) through (e); the disposal of any property or right referred to in sub-clauses (a).[1]

**"PRE-COMMENCEMENT EXPENDITURE"** means a pre-commencement expenditure as defined in section 25;[2] which is as under:

**"PRE-COMMENCEMENT EXPENDITURE"** means any expenditure incurred before the commencement of a business wholly and exclusively to derive income chargeable to tax, including the cost of feasibility studies, construction of prototypes, and trial production activities, but shall not include any expenditure which is incurred in acquiring land, or which is depreciated or amortized under section 22 or 24.[3]

**"TAX"** means any tax imposed under Chapter II, and includes any penalty, fee of other charge or any sum or amount leviable or payable under this Ordinance.[4]

**"TAXABLE INCOME"** means taxable income as defined in section 9;[5] which is given is below:

**"TAXABLE INCOME"** The taxable income of a person for a tax year shall be the total income of the person for the year reduces (but not below zero) by the total of any deductible allowances under Part IX of this Chapter of the person for the year.[6]

**"TOTAL INCOME"** The total income of a person for a tax year shall be the sum of the person's income under each of the heads for the year.[7] There are different heads of income under ITO. 2001 which are given below:

**"HEADS OF INCOME"** (1) For the purpose of the imposition of tax and the computation of total income, all income shall be classified under the following heads, namely:-

- Salary;
- Income from property;

[1] Clause (54) of section 2 of ITO,2001
[2] Clause (43) of section 2 of ITO,2001
[3] Sub-section (5) of section 25 of ITO,2001
[4] Clause (63) of section 2 of ITO, 2001
[5] Clause (29A) of Section 2 of ITO, 2001
[6] Section 9 of ITO, 2001
[7] Section 10 of ITO, 2001

- Income from business;
- Capital gains, and
- Income from other sources.

(2) Subject to this Ordinance, the income of a person under a head of income for a tax year shall be the total of the amounts derived by the person in that year that are chargeable to tax under the head as reduced by the total deductions, if any, allowed under this Ordinance to the person for the year under that head.

(3) Subject to this Ordinance, where the total deductions allowed under this Ordinance to a person for a tax year under a head income exceed the total of the amounts derived by the person in that year that are chargeable to tax under that head, the person shall be treated as sustaining a loss for that head for that year of an amount equal to the excess.

(4) A loss for a head of income for a tax year shall be dealt with in accordance with Part VIII [LOSSES] of this Chapter.

(5) The income of a resident person under a head of income shall be computed by taking into account that are Pakistan-source income and amounts that are foreign-source income.

(6) The income of a non resident person under a head of income shall be computed by taking into account only amount that are Pakistan-source income.[1]

**"CALENDAR YEAR"** means the period from January 1 to December 31, both inclusive, according to the Gregorian calendar.[2]

**AD VALOREM:**

Latin "According to the value" (Of a tax) proportional to the value of the things taxed.[3]

**"DEPLETION ALLOWANCE"** According to Merrill lynch: - The amortization of capitalized costs of a mineral property is called depletion allowance. The deduction is based

[1] Section 11 of ITO, 2001

[2] Clause 1.10 of Petroleum Concession Agreement between President of Pakistan and OGDCL on Block no. 3072-2

[3] Page 57 of Black's law dictionary, eights edition

upon minerals produced. For federal income tax purpose, depletion may be based in part on the amount of gross income from the property.[1]

**"DEPRECIATION"**:- A tax deduction for tangible (equipment) costs whereby part of the purchase price is deducted every year until an amount equal to the cost of the item has been deducted.[2]

**"DEPRECIABLE ASSET"** means a depreciable asset as defined in section 22.

**"INCOME"** includes any amount chargeable to tax under this Ordinance, any amount subject to collection [or deduction] of tax under section 148 (Imports), 153 (payment for goods and services), 154 (Exports) and 156 (Prizes and winnings), sub-section (5) of section 234 (Transport business), [any amount treated as income under any provision of this Ordinance] and any loss of income but does not include, in case of a shareholder of a company, the amount representing the face value of any bonus share or the amount of any bonus declared, issue or paid by the company to the shareholder with a view to increasing its paid-up share capital.[3]

**"TAX YEAR"** This Ordinance defines the Tax year in section 74, which is as under,

For the purpose of this Ordinance and subject to this section, the tax year shall be a period of twelve months ending on the 30th day of June (hereinafter referred to as normal tax year) and shall, subject to sub-section (3) be denoted by the calendar year in which the said date falls.

(3) a person may apply, in writing, to the Commissioner to allow him to use a twelve months, period, other than normal tax year, as special tax year and the Commissioner may, subject to sub-section (5), by an order, allow him to use normal tax year.

(4) A person using a special tax year, under sub-section (2), may apply in writing, to the Commissioner to allow him to use normal tax year and the Commissioner may, subject to sub-section (5), by an order, allow him to use normal tax year.

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[1] Merrill Lynch report on Pakistan Oil and Gas- 17 November 2003
[2] Merrill Lynch report on Pakistan Oil and Gas- 17 November 2003
[3] Clause (29) of section 2 of ITO,2001

(5) The Commissioner shall grant permission under sub-section (3) or (4) only if the has shown a compelling need to use special tax year or normal tax year, as the case may be, and the permission shall be allowed him to use normal tax year.[1]

[1] Section 74 of ITO, 2001

**CONVENTION BETWEEN THE GOVERNMENT OF THE ISLAMIC REPUBLIC OF PAKISTAN AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF BANGLADESH FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME**

Desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income have agreed as follows:

Scope of the Convention

**Article 1**

**Personal Scope**

This Convention shall apply to persons who are residents of one or both of the Contracting States.

**Article 2**

**Taxes Covered**

This Convention shall apply to taxes on income imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

There shall be regarded as taxes on income all taxes imposed on total income or on elements of income, including taxes on gains from the alienation of movable or immovable property and taxes on the total amounts of wages or salaries paid by enterprises.

The existing taxes to which the Convention shall apply are:--

in the case of the People's Republic of Bangladesh:

(i) the income tax; and

(ii) the super tax and surcharges; (hereinafter referred to as "Bangladesh tax");

in the case of the Islamic Republic of Pakistan:

(i) the income tax; and

(ii) the super tax and surcharges: (hereinafter referred to as "Pakistan tax").

The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes by either Contracting State or by the Government of any territory to which the Convention is extended under Article 28 of the Convention. The competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

**Definitions**

**Article 3**

**General Definitions**

In this Convention, unless the context otherwise requires:

the term "Bangladesh" means the People's Republic of Bangladesh and when used in a geographical sense, the territory in which the Constitution of the People's Republic of Bangladesh is in force, as well as any area adjacent to the territorial waters of Bangladesh specified to be the Continental Shelf and Economic Zone of Bangladesh under any law made in pursuance of Article 143 of the Constitution;

the term "Pakistan" used in a geographical sense means Pakistan as defined in the Constitution of the Islamic Republic of Pakistan and also includes any area outside the territorial waters of Pakistan which under the laws of Pakistan is an area within which the right of Pakistan with respect to the sea bed and sub-soil and their natural resources may be exercised;

the terms "a Contracting State" and "the other Contracting State" mean Bangladesh and Pakistan as the context requires;

the term "person" includes as an individual, a company and any other entity or body of persons;

the term "company" means anybody corporate or any entity which is treated as a body corporate for tax purposes;

the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

the term "national" means:

(i) any individual possessing the nationality of a Contracting State;

(ii) any legal person, partnership and association deriving their status as such from the law in force in a Contracting State;

the term "international traffic" means any transport by ship or aircraft operated by an enterprise of a Contracting State except when such ship or aircraft is operated solely between places in the other Contracting State;

the term "competent authority" means:

(i) in Bangladesh, the National Board of Revenue or their authorized representative; and

(ii) in Pakistan, the Central Board of Revenue.

As regards the application of the Convention by a Contracting State, any term not defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State concerning the taxes to which the Convention applies.

**Article 4**

**Resident**

For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reasons of his domicile, residence, place of management or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State.

Where by reason of the provisions of paragraph (1) an individual is a resident of both Contracting States, then his status shall be determined as follows:

he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);

if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

Where by reason of the provisions of paragraph (1) a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated.

**Article 5**

Permanent Establishment

For the purposes of this Convention, the term "permanent establishment" means a fixed place of business in which the business of the enterprise is wholly or partly carried on.

The term "permanent establishment" shall include especially:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop;

(f) a warehouse;

(g) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;

(h) a building site or construction or assembly project or the like which exists for more than 183 days.

Notwithstanding the provisions of the preceding paragraphs the term "permanent establishment" shall be deemed not to include:

the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise; (e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise.

Notwithstanding the provisions of paragraphs (1) and (2), an enterprise of a Contracting State shall be deemed to have a permanent establishment in the other Contracting State if it has in that other State an agent--other than an agent to whom paragraph (5) applies—who has and habitually exercises, a general authority to negotiate and conclude contracts for or on behalf of the enterprise, unless the activities of the agent are limited to the purchase of goods or

merchandise for the enterprise; or he has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise belonging to the enterprise from which he regularly fills orders or makes deliveries on behalf of the enterprise and additional activities conducted in that State on behalf of the enterprise have contributed to the conclusion of the sale of such goods or merchandise.

An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status provided that such persons are acting in the ordinary course of their business.

The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself make either company a permanent establishment of the other.

**Taxation of Income**

**Article 6**

Income From Immovable Property

Income derived by a resident of a Contracting State from immovable property situated in the other Contracting State may be taxed in that other State.

The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture, forestry and fishery, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

The provisions of paragraph (1) shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

The provisions of paragraphs (1) and (3) shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

**Article 7**

**Business Profits**

The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

Subject to the provisions of paragraph (3), where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated herein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred whether in the State in which the permanent establishment is situated or elsewhere, as are admissible under the laws of that State.

In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph (2) shall preclude the Contracting State from determining the profits to be taxed by such apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principle laid down in this Article.

No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there are good and sufficient reasons to the contrary.

Where profits include items of income which are dealt with separately in other Articles of this Convention then the provisions of those Articles shall not be affected by the provisions of this Article.

**Article 8**

**Air Transport**

Profits derived by an enterprise of a Contracting State from the operation of aircraft in international traffic shall be taxable in that Contracting State.

The provisions of paragraph (1) shall also apply to profits from the participation in a pool, joint business or an international operating agency.

For the purposes of this Article, profits from the operation of aircraft also include income derived from:

the rental, lease or maintenance of aircraft.

training scheme, management and other services rendered by an air transport enterprise of one Contracting State to the air transport enterprise of the other Contracting State:

Provided that such income accrues to an enterprise of a Contracting State whose income is wholly or mainly derived from the operation of aircraft in international traffic.

**Article 9**

**Shipping**

Income of an enterprise of a Contracting State derived from the other Contracting State from the operation of ships in international traffic may be taxed in that other Contracting State, but the tax chargeable in that other Contracting State on such income shall be reduced by an amount equal to fifty per cent of such tax.

For the purposes of paragraph (1) of this Article, income derived of an enterprise of a Contracting State from the operation of ships from the other Contracting State shall mean income from the carriage of passengers, all; livestock or goods shipped in that other Contracting State.

The provisions of paragraph (1) of this Article shall likewise apply in respect of participation in pools of any kind by an enterprise of either Contracting State engaged in shipping.

**Article 10**

**Associated Enterprises**

Where

an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case, conditions are made or imposed between the two enterprises in their commercial or financial relations, which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

**Article 11**

**Dividends**

Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed 15 per cent of the gross amount of such dividends. The provisions of this Article shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the taxation law of the State in which the company making the distribution is a resident.

The provisions of paragraphs (1) and (2) shall not apply if the recipient of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State professional services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 or Article 15, as the case may be, shall apply.

Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other Contracting State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

**Article 12**

**Interest**

Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

However, such interest may be taxed in the Contracting State in which it arises, and according to the law of that State; but if a resident of the other Contracting State is the beneficial owner of the interest, the tax so charged shall not exceed 15 per cent of the gross amount of the interest.

Notwithstanding the provisions of paragraph (2):

the State Bank of Pakistan shall be exempt from Bangladesh tax with respect to interest from sources within Bangladesh;

the Bangladesh Bank shall be exempt from Pakistan tax with respect to interest from sources within Pakistan;

the Government of a Contracting State shall be exempt from the tax of the other Contracting State with respect to interest on loans derived by that Government from sources within that other Contracting State;

Any financial institution, other than a scheduled bank, owned or controlled by the Government of a Contracting State shall be exempt from the tax of the other Contracting State with respect to interest or loans derived by that institution from sources within that other Contracting State.

The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from Government securities and income from bonds

or debentures, including premiums and prizes attaching to such securities, bonds or debentures, as well as income assimilated to income from money lent by the taxation law of the State in which the income arises. However, the term "interest" does not include for the purposes of this Article penalty charges for late payments nor income dealt with in Article 11.

The provisions of paragraphs (1) and (2) shall not apply if the recipient of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 15, as the case may be shall apply.

Interest shall be deemed to arise in a Contracting State when the owner is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment of a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and that interest is borne by that permanent establishment or fixed base, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

Where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the interest paid, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of the Convention.

**Article 13**

**Royalties**

Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

However, such royalties may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but if the beneficial owner of the royalties is a resident of

the other Contracting State, the tax so charged shall not exceed 15 per cent of the gross amount of the royalties as defined in paragraph (3).

The term "royalties" as used in this Article means:--

payments of any kind received as a consideration for the use of, or the right to use, any copyright, patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment and includes payments of any kind in respect of motion picture films and films or tapes for radio-broadcasting or television, copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work;

payments received as consideration for technical know-how or information concerning industrial, commercial or scientific experience.

The provisions of paragraphs (1) and (2) shall not apply if the recipient of the royalties arising in the other State, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 15, as the case may be, shall apply.

Royalties shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or fixed base in connection with which the obligation to pay the royalties was incurred, and those royalties are borne by that permanent establishment or fixed base, then such royalties shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

Where, by reason of a special relationship between the payer and the recipient or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such a case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

**Article 14**

**Capital Gains**

Gains derived by a resident of a Contracting State from the alienation of immovable property, as defined in Article 6, or from the alienation of shares, in a company the assets of which consists principally of such property, may be taxed in the Contracting State in which such property is situated.

Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in that other State.

Notwithstanding the provisions of paragraph (2) of this Article, gains derived by a resident of a Contracting State from the alienation of ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft shall be taxable only in that Contracting State.

Gains from the alienation of any property other than those mentioned in paragraphs (1), (2) and (3) of this Article shall be taxable only in the Contracting State of which the alienator is a resident.

**Article 15**

**Independent Personal Services**

Income derived by a resident of a Contracting State in respect of professional services or other independent activities of a similar character shall be taxable only in that State. However, in the following circumstances, such income may be taxed in the other Contracting State:--

If he has a fixed base regularly available to him in the other Contracting State for the purposes of performing his activities, in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State, or

If he is present in the other Contracting State for a period or periods amounting to or exceeding in the aggregate 120 days in any fiscal year.

The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

**Article 16**

**Dependent Personal Services**

Subject to the provisions of Articles 17, 19 and 20 salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the Contracting State. If the employment is so exercised, such remuneration as is derived therefrom shall be taxable in that other State.

Notwithstanding the provisions of paragraph (1), remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:--

the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned, and

the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

Notwithstanding the preceding provisions of this Article, remuneration in respect of an employment exercised aboard a ship or aircraft operated in international traffic, by an enterprise of a Contracting State shall be taxable in that State.

**Article 17**

**Directors Fees**

Directors' fees and similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State shall be taxable in that other State.

**Article 18**

**Artistes and Athletes**

Notwithstanding the provisions of Articles 15 and 16 income derived by public entertainers, such as theatre, motion picture, radio or television artistes, and musicians and by athletes from their personal activities as such shall be taxable in the Contracting State in which these activities are exercised:

Provided that such income shall not be taxable in the said Contracting State if the visit of the public entertainers or athletes to that State is within the scope of a cultural or sports exchange programme agreed to by both the Contracting States.

Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 15 and 16, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised.

**Article 19**

**Pensions and Annuities**

Subject to the provisions of paragraph (2) of Article 20, pensions, annuities and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

The term "pension" as used in this Article, means periodic payments made in consideration for services rendered or by way of compensation for injuries received.

The term "annuity" as used in this Article, means a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time under any obligation to make the payments in return for adequate and full consideration in money or money's worth.

Article 20

Government Service remuneration, other than a pension, paid by a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division or authority shall be taxable only in that State.

However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:--

(i) is a national of that State; or

(ii) did not become a resident of that State solely for the purpose of rendering the services.

(2)

Any pension paid by, or out of funds created by, a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division or authority shall be taxable only in that State.

However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.

(3) The provisions of Articles 16, 17 and 19 shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political sub-division or a local authority thereof.

**Article 21**

**Teachers, Students and Trainees**

Remuneration which a professor or teacher who is, or immediately before was, a resident of a Contracting State and who visits the other Contracting State for a period not exceeding two years for the purposes of teaching at a University, College, School or other educational institution receives for such work shall not be taxed in that other State, in respect of that remuneration.

An individual who was a resident of a Contracting State immediately before visiting the other Contracting State and is temporarily present in that other State solely as a student at a University, College, School or other similar educational institution in that other State or as a business or technical apprentice shall, from the date of his first arrival in that other State in connection with that visit, be exempt from tax in that other State.

on all remittances from abroad for purposes of his maintenance, education or training; and

on any remuneration for personal services rendered in that other Contracting State with a view to supplementing the resources available to him for such purposes for a period not exceeding five years.

An individual who was a resident of a Contracting State immediately before visiting the other Contracting State and is temporarily present in that other State solely for the purpose of study research or training as a recipient of a grant, allowance or award from a scientific, educational, religious or charitable organisation or under a technical assistance programme entered into by the Government of a Contracting State shall, from the date of his first arrival in that other State in connection with that visit, be exempt from tax in that other State:--

on the amount of such grant, allowance or award;

on all remittance from abroad for the purposes of his maintenance, education or training; and

on any remuneration for personal services rendered in that other Contracting State with a view to supplementing the resources available to him for such purposes for a period not exceeding three years.

**Article 22**

**Income Not Expressly Mentioned**

Items of income of a resident of a Contracting State which are not expressly mentioned in the foregoing Articles of this Convention shall be taxable only in that Contracting State, except that if such income is derived from sources within the other Contracting State then it may also be taxed in accordance with the laws of that other State.

**Article 23**

**Elimination of Double Taxation**

*Subject to the provisions of the law of Bangladesh regarding the allowance as a credit against Bangladesh tax of tax payable in a territory outside Bangladesh (which shall not affect the general principle hereof), tax payable under the laws of Pakistan and in accordance with this Convention, whether directly or by deduction on profits income or chargeable gains from sources within Pakistan shall be allowed as a credit against any Bangladesh tax computed by reference to the same profits, income or chargeable gains by reference to which the Pakistan tax is computed.*

*Subject to the provisions of the law of Pakistan regarding the allowance as a credit against Pakistan tax of tax payable in a territory outside Pakistan (which shall not affect the general principle hereof), tax payable under the laws of Bangladesh and in accordance with this Convention, whether directly or by deduction, on profits, income or, chargeable gains from sources within Bangladesh shall be allowed as a credit against any tax computed by reference to the same profits, income or chargeable gains by reference to which the Bangladesh tax is computed.*

*(3)Notwithstanding anything contained in the foregoing paragraphs 1 and 2, where any profits, income or chargeable gains are not subject to tax or are taxed at a reduced rate in one of the Contracting States by virtue of any exemption or concession allowed under the laws of that State or in accordance with this Convention and the same profits, income or chargeable gains are subject to tax in the other Contracting State, credit shall, subject to the laws of that State, be allowed in the latter mentioned State for the whole of the tax, which would have been payable on the said profits, income or chargeable gains had the same*

*profits, income or chargeable gains not been exempted from tax or had it not been taxed at a reduced rate in the first-mentioned State.*[1]

Special Provisions

**Article 24**

**Non-Discrimination**

Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances.

Nothing contained in this Article shall be construed as—

obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, relief and reductions which it grants to its own residents;

affecting any provisions of the tax laws of the respective Contracting States regarding the imposition of tax on non resident persons as such; and

affecting any provisions of the tax laws of the respective Contracting States regarding any tax concessions granted to persons fulfilling specified conditions.

Except where the provisions of Article 9, paragraph (7) of Article 12, or paragraph (6) of Article 13 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. The provisions of this paragraph shall not affect the application of the national laws of the Contracting States requiring the deduction of tax at source, from interest, royalties and other disbursements as a condition for deduction.

Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first mentioned State to any taxation or any requirement connected

[1] Article relating to double taxation

therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

In this Article the term 'taxation' means taxes which are the subject of this Convention.

**Article 25**

**Mutual Agreement Procedure**

Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic laws of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph (1) of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic laws of the Contracting States.

The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States.

**Article 26**

**Exchange of Information**

The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention so far as the taxation thereunder is not contrary to the Convention. The exchange of information may not be

restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons, or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

In no case shall the provisions of paragraph (1) be construed so as to impose on a Contracting State the obligation:

to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.

**Article 27**

**Diplomatic Agents and Consular Officials**

Nothing in this Convention shall affect the fiscal privileges of diplomatic or consular officials under the general rules of international law or under the provisions of special agreements.

**Article 28**

**Territorial Extension**

The Convention may be extended, either in its entirety or with any necessary modifications to any State or territory for whose international relations either of the Contracting States is responsible and which impose taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications, if any, and conditions including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.

Unless otherwise agreed by both Contracting States, the denunciation of the Convention by one of them under Article 30 shall terminate, in the manner provided for in that Article, the

application of the Convention to any State or territory to which it has been extended under this Article.

Final Provisions

**Article 29**

**Entry Into Force**

This Convention shall be ratified and the instruments of ratification shall be exchanged at Islamabad or Dacca as soon as possible.

The Convention shall enter into the force upon the exchange of the instruments of ratification and shall have effect as respects income arising or accruing in either of the Contracting States on or after the first day of January, 1980.

**Article 30**

**Termination**

This Convention shall remain in effect indefinitely but either Contracting State may, on or before June 30 in any calendar year after the fifth year following the exchange of instrument of ratification, give notice of termination to the other Contracting State and in such event the Convention shall cease to have effect as respects income accruing or arising on or after the first day of July in the calendar year next following that in which the notice of termination is given.

In witness whereof the undersigned, duly authorized hereto, have signed this Convention.

Done in duplicate at Dacca this Fifteen day of October. One thousand nine-hundred and eighty one in the English language.

FOR THE GOVERNMENT OF THE ISLAMIC REPUBLIC OF PAKISTAN:

FOR THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF BANGLADESH:

## SECTION 100

**SPECIAL PROVISIONS RELATING TO THE PRODUCTION OF OIL AND NATURAL GAS, AND EXPLORATION AND EXTRACTION OF OTHER MINERAL DEPOSITS.-**

Subject to the sub-section (2), the profit and gains from-

(a) the exploration and production of petroleum including natural gas and from refineries set up at the Dhodak and Bobi fields;

(b) the pipeline operations of exploration and production companies; or

(c) the manufacture and sale of liquefied petroleum gas or compressed natural gas,

and the tax payable thereon shall be computed in accordance with the rules in Part I of the Fifth Schedule.[1]

(2) Sub-section (1) shall not apply to the profits and gains attributable to the production of petroleum including natural gas discovered before the 24th day of September, 1954.

(3) the profits and gains of any business which consists of, or, includes, the exploration and extraction of such mineral deposits of a wasting nature (not being petroleum or natural gas) as may be specified in this behalf by the Federal Government carried on by a person in Pakistan shall be computed in accordance with the rules in Part II of the Fifth Schedule.[2]

[1] Fifth Schedule of Income Tax Ordinance, 2001
[2] Fifth Schedule of Income Tax Ordinance, 2001

# THE FIFTH SCHEDULE

(See Section 100)

## PART I

## RULES FOR THE COMPUTATION OF THE PROFITS AND GAINS FROM THE EXPLORATION AND PRODUCTION OF PETROLEUM

### Exploration and Production of Petroleum a Separate Business

1. Where any person carries on, or is treated as carrying on, under an agreement with the Federal Government, any business which consists of, or includes, the exploration or production of petroleum in Pakistan or setting up refineries at Dhodak and Bobi fields, income of exploration and production companies from pipeline operations, and manufacture and sale of liquefied petroleum gas or compressed natural gas, such business or part thereof, as the case may be, shall be, for the purposes of this Ordinance, treated as a separate business undertaking (hereinafter referred to as "such undertaking") and the profits and gains of such undertaking shall be computed separately from the income, profits, or gains from any other business, if any, carried on by the person.

### Computation of Profits

2. (1) Subject to the provisions of this Part, the profits and gains of such undertaking [1][shall be] computed in the manner applicable to income, profits and gains chargeable under the head "Income from Business".

(2) Where such person incurs any expenditure on searching for or discovering and testing a petroleum deposit or winning access thereto but the search, exploration, enquiry upon which the expenditure is incurred is given up before the commencement of commercial production, the expenditure allocable to a surrendered area or to the drilling of a dry-hole shall be treated as lost at the time of the surrender of the area or the completion of the dry-hole, as the case may be.

(3) Where the agreement provides that any portion of the expenditure is treated as lost under sub-rule (2) (hereinafter referred to as the "said loss") and is allowed against any income of such undertaking, it shall be allowed in either of the following ways as may be provided for in the agreement, namely:–

(a) The said loss in any year shall be set off against the income of that year chargeable under the head "Income from Business" or any income (other than income from dividends) chargeable under any other head and where the loss cannot be wholly set off in this manner the portion not so set off shall be carried forward to the following year and set off in the same manner and so on, but no loss shall be carried forward for more than six years; or

[1] Substituted for the word "are" by the Finance Act, 2003

(b) The said loss in any year shall be set off against the income of such undertaking of the tax year in which commercial production has commenced and where the loss cannot be wholly set off against the income of such undertaking of that year, the portion not set off against the income, if any, of such undertaking of that year, and if it cannot be wholly so set off the amount of loss not so set off shall be carried forward to the following year, and so on, but no loss shall be carried forward for more than ten years.

(4) After the commencement of commercial production, all expenditure incurred prior thereto and not [treated as] lost under sub-rule (2) and not represented by physical assets in use at the time the commercial production shall be allowed as a deduction, so, however, that the portion of such deduction to be so allowed in any year shall be such amount not exceeding ten per cent of the aggregate amount deductible in respect of [onshore] areas, and not exceeding twenty five per cent for offshore areas, as may be selected by the taxpayer.

(5) Any expenditure, including a royalty paid to the Federal Government by an onshore petroleum exploration and production undertaking on, or after, the first day of July 2001 (not being in the nature of capital expenditure or personal expenses of the taxpayer) laid out or expended after the commencement of commercial production wholly and exclusively for the purpose of the business of production and exploration of petroleum carried on by such undertaking shall be allowed as a deduction, provided that –`

(a) no deduction shall be allowed in respect of such expenditure incurred in the acquisition of depreciable assets to which section 22 applies or in the acquisition of an intangible to which section 24 applies;

(b) [deductions under sections 22, 23 and 24 shall be admissible] in respect of assets referred to in clause (a);

(c) a depreciation deduction shall also be allowed under section 22 in respect of such expenditure incurred on the acquisition of the physical assets acquired before the commencement of commercial production and were being used by such undertaking on and after that date, as if such assets had been acquired at the time of the commencement of commercial production at their original cost, as reduced by the amount of depreciation deduction, if any, previously allowed to be deducted under this Ordinance.

(6) If, in any year, the deductions allowed Part IV of Chapter III and sub rules (3) and (4) exceed the gross receipts from the sale of petroleum produced in Pakistan, such excess shall be set off against other income (not being dividends) and carried forward in the manner and subject to the limitations in section 57, so however that no portion of such excess shall be carried forward for more than six years.

(7) The limitation of six years specified in [1][sub-rule] (6) shall not apply to depreciation allowed to a person carrying on the business of offshore petroleum exploration and production, in respect of any machinery, plant or other equipment used in such exploration or production.

(8) For the purposes of section 22, where any asset used by a person in the exploration and production of petroleum is exported or transferred out of Pakistan, the person shall be treated as having made a disposal of the asset for a consideration received equal to the cost of the asset as reduced by any depreciation deductions allowed under this Ordinance (other than an initial allowance under section 23).

## Depletion Allowance

3. In determining the income of such undertaking for any year ending after the date on which commercial production has commenced, an allowance for depletion shall be made equal to fifteen per cent of the gross receipts representing the well-head value of the production, but not exceeding fifty per cent of the profits or gains of such undertaking before the deduction of such allowance.

## Limitation on Payment to Federal Government and Taxes

4. (1) The aggregate of the taxes on income and other payments excluding a royalty as specified in the Pakistan Petroleum (Production) Rules, 1949 or the Pakistan Petroleum (Exploration and Production) Rules, 1986 and paid by an onshore petroleum 2[exploration] and production undertaking on, or after, the first day of July 2001 to the Government in respect of the profits or gains derived from such undertaking for a tax year shall not exceed the limits provided for in the agreement, provided the 1[said aggregate shall not be] less than fifty per cent of the profits or gains derived by an onshore petroleum exploration and reduction undertaking and forty per cent of the profits or gains derived by an offshore petroleum exploration and production undertaking, before deduction of the payment to the Federal Government.

(2) In respect of any tax year commencing on, or after, the first day of July, 2002, the aggregate referred to in sub-clause (1) shall not be less than forty per cent of the profit or gains derived by an onshore petroleum exploration and production undertaking before the deduction of payment excluding royalty paid by an onshore 2[petroleum exploration and production undertaking] to the Federal Government.

(3) If, in respect of any tax year, the aggregate of the taxes on income and payments to the Federal Government is greater or less than the amount provided for in the agreement, an [additional amount of tax] shall be payable by the taxpayer, or an abatement of tax shall be allowed to the taxpayer, as the case may be, so as to make the aggregate of the taxes on income and payments to the Federal Government equal to the amount provided for in the agreement.

(4) If, in respect of any year, the payments to the Federal Government exceed the amount provided for in the agreement, so much of the excess as consists of any tax or levy referred to in sub-clause (b) of clause (3) of rule 6 shall be carried forward and treated, for the purposes of this rule, as payments to the Federal Government for

the succeeding year, provided that the whole of the payments to the Federal Government exceeding the amount provided for in such agreement may be carried forward if so provided for in any agreement with a taxpayer made before the first day of 1970.

## Provision Relating to Rules

5. The Central Board of Revenue may make rules for the purposes of any matter connected with, or incidental to the operation of this Part.

**Definitions**

6. In this Part, –

(1) "agreement" means an agreement entered into between the Federal Government and a taxpayer for the exploration and production of petroleum in Pakistan;

(2) "commercial production" means production as determined by the Federal Government;

(3) "payments to the Federal Government" means amounts payable to the Federal Government or to any Federal Governmental authority in Pakistan –

(a) in respect of royalties as specified in the Pakistan Petroleum (Production) Rules, 1949, or the Pakistan Petroleum (Exploration and Production) Rules, 1986; and

(b) in respect of any tax or levy imposed in Pakistan peculiarly applicable to oil production or to extractive industries or any of them and not generally imposed upon all industrial and commercial activities;

(4) "Petroleum" means crude oil, natural gas, and case-head petroleum spirits as defined in the Pakistan Petroleum (Production) Rules, 1949, or the Pakistan Petroleum (Exploration and Production) Rules, 1986, but does not include refined petroleum products;

(5) "Surrender" means the termination of rights with respect to an area including the expiration of rights according to the terms of an agreement;

(6) "Surrendered area" means an area with respect to which the rights of the person have terminated by surrender or by assignment or by termination of the business;

(7) "Taxes on income" and "tax" includes income tax, but does not include payments to the Federal Government; and

(8) "well-head value" shall have the meaning assigned to it in the agreement between the Federal Government and the taxpayer and in the absence of any such definition in the agreement, the meaning assigned to it in the Pakistan Petroleum (Production) Rules, 1949, or the Pakistan Petroleum (Exploration and Production) Rules, 1986.

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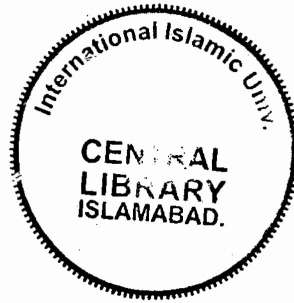
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