

THE KARACHI STOCK EXCHANGE (GUARANTEE) LIMITED

PROPOSALS FOR THE FEDERAL BUDGET 2009-10



KSE

The Karachi Stock Exchange (Guarantee) Limited



BUDGET PROPOSALS FOR 2009-10

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Background

The capital markets play a crucial role in mobilizing savings for the most productive investments. They provide an efficient and transparent securities market to investors allowing them to diversify their risk across different sectors as well as allow them to benefit from a higher rate of return when compared to depositing funds in banks. To issuers, the capital markets provide an alternative means to raise cheap capital as well as allows a company to re-brand itself by conforming to a higher level of integrity, transparency and corporate governance.

The global liquidity crisis has provided for an onslaught of a recession in many developed and emerging markets. Pakistan too, although relatively cushioned has not been immune to the global recession. Its foreign currency reserves have declined to under US \$ 10 billion, the rupee has depreciated considerably and tax revenue targets are unlikely to be met. As a result, Pakistan is likely to achieve a GDP growth of 2.5% (as forecasted by the IMF) instead of a 5.5% growth rate that was achieved during the fiscal year 2007-08. Accordingly, it is essential that the Government come up with incentives that promote investment in Pakistan especially in the stock markets of the country as this will not only bring valuable foreign exchange to the country but will also result in a higher level of economic activity.

Historically, the market capitalization of the Karachi Stock Exchange (KSE) had touched a record high of over US\$ 76 billion on April 18, 2008. However, at present the market capitalization is around US\$ 29 billion. Similarly the KSE -100 Index recorded a record high of 15,676 points on April 18, 2008 declining to 4,815 points on January 26, 2009. The market has since then rebounded to the 8,000 level on the back of strong corporate results, improving economic indicators and reduced political uncertainty.

The largest beneficiary of the stock market activity in the country has been the Government itself as about 25 percent of the equity market is still directly or indirectly owned by the Government of Pakistan. In order to provide a more transparent and robust platform for the equity market of Pakistan, KSE has introduced a new Risk Management System based on VaR and implemented the UIN system where no trade can now be executed without first recording the identification of the buyer or the seller.

In order to attract more investment into the country, the Government needs not only to provide consistency in the economic policies but also provide for more incentives and facilities to equity investments to convert investor “interest” into real investment. Furthermore, steps need to be taken to create new job opportunities and enhance Government revenues.

Our proposals for the Federal Budget 2009-2010 are, therefore, directed towards the continuation and consolidation of the Governments economic policies and various supportive measures for the securities' market. Additionally, we seek to encourage the creation of an investment friendly environment which would spur investment and industrial activity in the country.

1. CVT AND WITHHOLDING TAX ON STOCK MARKET TRANSACTIONS

In the Federal budget 2006-2007, an increase of 100% in CVT and withholding taxes on stock market transactions was announced. This remains a matter of great concern to investors. Taxes levied on securities trades irrespective of the whether the trade is gainful, are detrimental to the development of the market. An analysis of daily turnover during previous years shows that due to the increase in CVT and withholding tax rates, the average daily share volume has gone declined drastically. This has not only affected the income of the Exchanges against trading fees and that of Regulator fees paid to the SECP as it is linked to trading volumes but has also shattered the confidence of small and retail investors as reflected by the reduced daily turnover (leading to inefficient price discovery, high impact costs and reluctance of large funds to enter market). Needless to say, increase in the number

of small investors should be the prime consideration for the Government which is considered to be one of the pre-requisites for a developed securities market.

A study conducted in the context of an existing tax structure in other developed and emerging markets, reveals that in most of those countries no such taxes are levied and collected from investors/ brokers on sale/ purchase of shares from the stock market. **We, therefore, urge the Government to withdraw the CVT and Withholding Tax so as to encourage an increase in retail base in the country thereby helping develop our securities market.**

Note:

Prior to imposition of CVT (July 1, 2004), average Daily volume in the Ready Market was 389 million shares; this started to drop on yearly basis after imposition of CVT as illustrated in table below.

YEARS	Avg Daily Volume(Million)	Remarks
2005	350.43	Imposition of CVT
2006	324.30	-
2007	221.48	Rate of CVT Doubled
2008	256.34	-
July 2008 to Feb 2009	78.35	-

As an alternative, if it is not possible for the Government to withdraw the tax withholding on trading of shares, **it is suggested that the withholding of tax from Stock Exchange brokers under clauses (a) and (b) and under clause (c) of section 233A of the Ordinance may be reduced to its original level of 0.005%.**

Minimum Tax on Members

By insertion of Section 233(A)(2) [vide Finance Act 2008] tax deducted U/S 233A(1)(a) & 233A(1)(b) [out of commission earned by the members] has been pronounced as Minimum Tax. This deduction used to be

Presumptive Tax. This deduction may be restored as Presumptive Tax.

Concept of Minimum Tax, which was in practice in our Tax culture was done away with vide Finance Act 2008, for all Industries. Unfortunately it has been levied on commission income of members of Stock Exchanges.

In view of above it is requested that the above amendment made in the Finance Act, 2008 be withdrawn and Presumptive Tax be restored.

The tax under clause (d) of section 233A is being collected @10% in respect of financing of carry over trade (COT This adjustable withholding has not only created hardships for genuine investors but also difficulties for the department as the verification of the claim of tax withholding is extremely challenging . The tax is deposited by the Stock Exchanges in the name of the respective brokers whereas the Stock Exchange member / Broker issues a broker note in favour of the customer/financers who claim the adjustment or refund of tax on the basis of such a broker-note.

On the other hand, it has come to light though various news items that the FBR has confirmed that a large volume of refunds that are not genuine had been issued and therefore internal investigations are being conducted to ascertain the matter.

In view of the above, it is humbly suggested that tax withholding under clause (d) of Section 233A of the Ordinance may be treated under Section 169 as final tax so as to stop the hardship faced by genuine taxpayers and eliminate chances of misuse as well.

2. CAPITAL GAINS ON DEMUTUALIZATION & CORPORATIZATION

Members of the Karachi Stock Exchange (currently owners of the Exchange) have agreed to segregate their ownership rights from trading rights, retaining trading rights after the demutualization as per terms and conditions agreed upon through the Memorandum of Understanding (MoU) signed with the SECP. In this regard, KSE has appointed a leading international investment bank to advise and assist KSE to take the demutualization plan forward.

In order to facilitate a speedy corporatization and demutualization of the KSE, certain exemptions are required in the Income Tax Ordinance, 2001 as well as Stamp Act. Although through the Finance Act, 2007 clauses (110A) and (110B) have been inserted in Part I of the Second Schedule to the Income Tax Ordinance, 2001,, one of the exemptions that was demanded at that time was not considered in the previous budget. **In this regard a new clause 110C may be inserted in Part-I of the Second Schedule to the Income Tax Ordinance, 2001 mentioned as under:**

“Any income chargeable under the head "Capital Gains" being income from the sale of shares of a public limited company setup in connection with the corporatization and demutualization of Karachi Stock Exchange to financial institutions and general public by the shareholders on divestment of their holding in connection with the corporatization and demutualization.”

The exemption in respect of gain on sale of membership of the Stock Exchange by an individual to a company as contained in clause 133A of the Second Schedule has been withdrawn through the Finance Act, 2008. **We suggest that KSE should propose revival of the aforesaid exemption to cover the transfer of membership from an independent member to a corporate member till such time that the process of Demutualization of Stock Exchanges is completed.**

Appropriate provisions be inserted in the Stamp Act by the Government of Sindh to allow exemption of stamp duty in case of transfer of immovable assets in the name of new entity.

3. TAX REBATE FOR LISTED COMPANIES

When more companies from a broad array of sectors/industries chooses to list on the KSE, the stock market performance will become more representative of the national economy. The Government often expresses its concern that despite the stock market boom, new listings have not picked up. Although recently, some public offers have taken place mainly under privatization programme of the Government as well as listings of mutual funds and banking sector, private industrial units are still shy of getting them listed.

The main reasons for this are as follows:-

- (i) Until June, 2002 there was a tax differential of 10% for listed Companies. Unlisted Companies were subject to income tax rate of 45% whereas listed Companies 35%. In the budget of 2002-03 the government decided to progressively reduce the tax rates of private companies thereby removing the tax difference of 10% between a private company and public company leaving no tax incentive for listed Companies.
- (ii) Tax rate on dividend from unlisted Companies and listed Companies is currently at 10% which once again highlights that there is no advantage to listed Companies. Until June, 2002 tax rate on dividend from unlisted Companies was 20%.
- (iii) The Stock Exchanges on directives from SECP have introduced Code of Corporate Governance on the listed Companies making them subject to much desired discipline to protect the shareholders of the

listed Companies. Many of the listed Companies consider it a burden on them with no advantages to them vis-à-vis unlisted companies particularly under the present environment of easy accessibility to credit.

In order to attract more and more companies for listing, it is proposed that the tax rates for the public limited listed companies be also reduced in the same ratio as that of private companies so that not only the corporate tax rates for the listed companies is brought down to the level of 25% as against the non-listed private companies at 35% but differential tax treatment of 10% between the listed and non-listed companies is also maintained. Or, the tax differential can also be achieved by offering a tax rebate to those companies whose free float is over 25% of its paid up capital. The tax rebate may be calculated in a manner mentioned as under:

Tax Rebate (on Tax rate)	Free Float Percentage of Paid up Capital
10%	25%
15%	35%
20%	45%
25%	60%
30%	70% and over

This will help in promoting and encouraging better corporate disclosures by the listed companies and corresponding better returns to the equity investors. This process will not only off-set the revenues losses for the exchequer, if any, but would lead to disclosure of better profitability and growth of corporate taxes.

Alternatively, all IPOs should be exempt from any capital market related taxes for a period of 5 years from listing date.

4. TAXATION OF DIVIDEND

In order to promote the process of consolidation and group formation, it is suggested that tax may not be charged on dividend received by companies as this results in dual taxation of dividend in the hands of the company and then in the hands of the ultimate shareholders. However, if complete elimination of tax on dividend received by companies is not possible due to revenue consideration, it is suggested that dividends received by all residents companies may be taxed at 5% instead of the prevailing rate of 10%. It should be noted that in the past companies have been subjected to tax on dividend income at 5% of the gross amount of dividend and it is only since the adoption of Finance Act, 2007 when the reduced rate of dividend for companies at 5% was abolished and a uniform rate of 10% was introduced for all shareholders including companies. **It is therefore suggested that either the dividend received by companies may be exempted from tax or the rate of dividend received by companies be reduced to 5%.**

5. COMPULSORY DISTRIBUTION OF DIVIDEND BY LISTED COMPANIES

Finance Act of 1999-2000 made it compulsory for listed companies with free reserves of more than 50% of its paid up capital to distribute at least 40% tax is to be paid on such excess reserves. This measure proved very effective resulting in the payment of ADDITIONAL cash dividend of Rs. 553 million by 39 companies listed on the Exchange for the year 1998-99. While 40% cash distribution takes care of the due return to investors, the balance 60% retention in addition to cash flow available against the depreciation meets the needs of the company for expansion and growth. This compulsory distribution is necessary both to broad base the equity investment and to enhance investors' confidence besides nullifying the oppressive practice of the controlling shareholders who more often than not, choose to ignore the expectations of minority shareholders. Besides, this measure in the past had also contributed an additional Rs. 55.3 million to the government exchequer through withholding tax of 10% on such dividend income. **In view of its very healthy effect on the investor's confidence, we urge its re-introduction in the coming budget.**

6. TAX CREDIT ON INVESTMENT IN SHARES UNDER SECTION 62 OF THE INCOME TAX ORDINANCE, 2001

A tax credit is available to a person other than a company for acquiring new shares offered to the public by a public company listed on a Stock Exchange in Pakistan. In this regard the present ceiling of maximum investment on which tax credit can be availed is Rs.300,000. The Government is striving to promote listing of companies in Pakistan on the stock exchanges and is trying to create more and more incentives to attract initial public offering's. The availability of tax credit is a major incentive for the individual investor to subscribe for shares of listed public companies. In order to promote the listing of more companies on the stock exchange, **it is suggested that present ceiling of Rs. 300,000 or 10% of the persons' taxable income for the year on the cost of acquisition of shares be raised to Rs. 600,000 and 25% of the persons' taxable income for the year respectively.**

7. TERM FINANCE CERTIFICATES (TFCS)

Presently, the definition of share given in the Ordinance does not include redeemable capital like TFCs and therefore, the provisions of section 233A of the Ordinance are not applicable on the trading of TFCs. However, for CVT purposes TFCs have been specifically brought in the scope of the levy as per clause E of sub-section (2) of section 7 of the Finance Act, 1989. **It is therefore suggested that redeemable capital which includes TFCs may be removed from the scope as provided for in clause E referred above in order to develop the secondary market for these securities.** At present, the debt securities, though listed at the Stock Exchange, are not actively traded and the capital value tax collection hinders the growth in the secondary market for debt securities. Hence, the said amendment has been proposed in order to promote and facilitate the development of secondary market for debt instruments.

8. STOCK INDEX FUTURES CONTRACT & OTHER DERIVATIVES PRODUCT

KSE launched Futures contracts - a standardized ninety day contract denoted by the month in which the contract expires. The value of the contract is the price agreed by the parties multiplied by the contract multiplier and expressed in Pak Rupees. Under the contract the underline scrip / share would not be received or delivered by the parties, the difference between the value of contract at the commencement and the value of contract on the completion date would be paid by the respective parties.

Capital Gain Tax exemption provided under clause (110) of Part I of the Second Schedule to the Ordinance does not cover the above contracts. **Accordingly, it is desired that in order to promote dealings in the above future contracts, clause (110) above may be amended suitably so that exemption is also extended to gains arising from the above contracts.**

9. CAPITAL GAIN TAX EXEMPTION

The Capital Gain Tax exemption was provided for a period of 2 years in the last Federal Budget till June 30, 2010. We appreciate the initiative of the Government of Pakistan and the continuity of this policy.

10. OTHER PROPOSALS

The Pension Funds are important capital market players and even the world over their growth is on the basis of tax credits or mandatory requirements. Thus, to bring all retirement schemes at level playing field it is suggested to remove all existing tax anomalies since the tax advantage enjoyed by Occupational Savings Schemes (OSS) over Voluntary Pension System (VPS) has been the major factor hindering VPS growth. Also it is suggested that Government Pensions may be funded in phases.

Therefore, in line with the above, the following additional proposals are submitted:

- i. Tax exemption allowed in case of Provident Fund should be removed and Provident Fund and VPS should both be allowed equal tax credit
- ii. In case of VPS, there is an upper limit of Rs. 500,000/- for tax credit, whereas there is no such limit for gratuity and pension; the upper limit should be removed, leaving the tax credit limit to 20% of the taxable income
- iii. Pre-retirement withdrawals to be taxed under all schemes – OSS or VPS. However, transfer of accumulated balance from one scheme to another (including VPS) not to be taxed
- iv. Withdrawal after retirement under VPS to be exempt from tax to bring it at par with other schemes
- v. On retirement upto 25% lump sum withdrawal should be allowed without tax and remaining amount shall be allowed to be withdrawn on a monthly basis under an annuity scheme or income plan whereby income from Income Payment Plan to be tax exempt
- vi. Tax credit should be allowed for individuals under presumptive tax regime

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