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**SIGNIFICANT CHANGES IN THE  
INCOME TAX LAW**

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**SIGNIFICANT CHANGES IN THE INCOME TAX LAW**

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## SIGNIFICANT CHANGES IN THE INCOME TAX LAW

### 1. SALARY

- 1.1. Salary has been made taxable on receipt basis.
- 1.2. Capital receipt on termination of employment has been made chargeable to tax.
- 1.3. Allowances, except water, gas and electricity, which are exempt up to 10 % of basic salary, and value of perquisites are fully taxable.
- 1.4. Medical allowance, benefit or reimbursement is fully exempt, if provided in accordance with the terms of employment, otherwise medical allowance is exempt up to 10% of basic salary.
- 1.5. Special allowance continues to be exempt.
- 1.6. Free use of company's car, taxable as may be prescribed.
- 1.7. Salary of house-keeper, gardener or domestic servant is fully taxable.
- 1.8. Salary is to be grossed-up by the amount of tax paid by the employer on behalf of the employee.
- 1.9. Interest free loan to employee or at concessional rate, taxable at the difference between the benchmark rate and the rate charged, as applicable. Benchmark rate has been fixed at 5% for the tax year 2003 and will be increased by 1% for each succeeding year, until notified by the Federal Government.
- 1.10. Waiver of loan by the employer is taxable.
- 1.11. Discharge of debt of an employee by an employer is taxable.
- 1.12. Transfer of an asset or property by an employer to an employee is to be included in income of the employee at fair market value less value of consideration paid.
- 1.13. Value of accommodation provided by an employer is to be included in the income of the employee at an amount as may be prescribed.
- 1.14. Value of any other perquisite is to be included in the income of the employee at fair market value or at an amount as may be prescribed.
- 1.15. Foreign source salary received by an individual has been exempted if foreign income tax thereon has been paid or deducted.
- 1.16. EMPLOYEE SHARE SCHEMES  
A new concept of taxability of share option scheme has been introduced:
  - 1.16.1. The value of a right or option to acquire shares under an employee share scheme granted to an employee is not chargeable to tax.

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- 1.16.2. At the time of issue of shares, the value of shares are chargeable to tax at fair market value (FMV) of shares at the date of issue less the value of consideration paid, if any, by the employee to acquire the shares including any amount given as consideration for grant of a right or option.
- 1.16.3. If the shares are issued with restriction to transfer, the amount, being the difference between the FMV of shares at the time the restriction is waived and amount paid as consideration to acquire the option or right and such shares will be included in employees' income at the earlier of:
- 1.16.3.1. the time of free right to transfer such shares; or
  - 1.16.3.2. the time the shares are disposed off by the employee.
- 1.16.4. The amount of gain on disposal of right or option to acquire the shares will be included under the head salary as the difference between the consideration received for disposal of right or option and employee's cost in respect of such right or option

Despite the proclaimed rationalization of perquisites and increment of Rs. 20,000/- in the non-taxable limit, the revised provision of law charges a much higher tax on lower income class, whilst reduction in the tax liability of higher income brackets by a nominal amount. However, it has been proposed that the previous threshold of Rs. 300,000/-, which is not adopted yet under the new law, should be enhanced to Rs. 600,000/-.

## 2. INCOME FROM PROPERTY

- 2.1. The concept of annual value has been substituted by rent received or receivable.
- 2.2. Due to the above substitution, repairs and collection charges are now allowable on that portion of the year in which the property was actually let out.
- 2.3. Any amount which is allowed in a tax year as deduction from income from property, which is not paid within three years of the end of that tax year, is chargeable to tax in the fourth year. However, if such liability is paid subsequently, the amount is allowable in the year of payment.

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### 3. BUSINESS INCOME

#### 3.1. DEPRECIATION

- 3.1.1. Depreciation is now allowable on only that part of the year during which a depreciable asset has been used in deriving income from business chargeable to tax.
- 3.1.2. Initial allowance is now allowable at a rate of 50% on the cost of an eligible depreciable asset placed in use for the first time in Pakistan.
- 3.1.3. During the year of acquisition of an asset, whereon initial allowance is applicable, depreciation is now allowable on the residual amount, which is arrived at after deducting initial allowance from the cost of the eligible depreciable asset.
- 3.1.4. Any deduction other than initial and depreciation is not allowable.
- 3.1.5. Allowable limit on eligibility for depreciation on vehicles has been increased from Rs. 0.75 M to Rs. 1 M.

#### 3.2. INTANGIBLES

- 3.2.1. A new concept has been introduced, whereby any patent, invention, design or model, secret formula or process, copyright, or other like property or right, contractual rights and any expenditure that provides an advantage or benefit for a period of more than one year (other than expenditure incurred to acquire a depreciable asset or unimproved land) are to be treated as intangibles.
- 3.2.2. Amortization is allowable against intangibles in equal proportion by way of allocating the cost of intangibles over normal useful life up to a maximum of ten years.
- 3.2.3. Amortization is allowable only for such number of days in a year during which the intangible is used in deriving income from business chargeable to tax.
- 3.2.4. No Amortization is allowable in the year of disposal.
- 3.2.5. Any gain or loss on disposal of intangibles are chargeable/ deductible to/ from business income.

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### 3.3. PRE-COMMENCEMENT EXPENDITURE

3.3.1. Pre-commencement expenditure has been defined as 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 depreciable or amortizable as intangibles.

3.3.2. Amortization is allowed on a straight-line basis at a rate of 20%, such that the amount of amortization does not exceed the actual expenditure.

### 3.4. METHOD OF ACCOUNTING FOR COMPANIES

Accrual basis of accounting has been made compulsory in case of companies.

### 3.5. STOCK-IN-TRADE

3.5.1. Closing stock-in-trade is to be valued at lower of cost or net realizable value.

3.5.2. Persons following cash basis of accounting may value their stocks either on prime cost (variable cost) method or absorption cost (full cost) method, however persons following accrual basis of accounting should follow absorption cost method.

3.5.3. Stock-in-trade is to be valued on specific identification basis, however, if it is not possible, stock-in-trade may be valued on first-in-first-out or weighted average cost method. The method adopted can only be changed with the prior approval of the Commissioner in writing.

### 3.6. LONG-TERM CONTRACTS

3.6.1. The law defines a long-term contract as “a contract for manufacture, installation, or construction, or, in relation to each, the performance of related services, which is not completed within the tax year in which work under the contract commenced, other than a contract estimated to be completed within six months of the date on which work under the contract commenced.”

3.6.2. A person accounting for income chargeable to tax under the head “Income from Business” on an accrual basis is required to compute such

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income arising for a tax year under a long-term contract on the basis of the percentage of completion method.

- 3.6.3. The percentage of completion of a long-term contract in a tax year is to be determined by comparing the total cost allocated to the contract and incurred before the end of the year with the estimated total contract cost as determined at the commencement of the contract.

### **3.7. SET OFF AND CARRY FORWARD OF BUSINESS LOSSES**

- 3.7.1. Depreciation, initial allowance and amortization to be carried forward for unlimited period.
- 3.7.2. The law has also included the concept of setoff and carry forward of losses of amalgamating companies by amalgamated company, including losses on account of depreciation, initial allowance and amortization.
- 3.7.3. Concessional period of ten years for carry forward of loss of sick units has been abolished.
- 3.7.4. Losses of banking companies, for assessment year commencing on or after July 1, 1995 and ending on June 30, 2001, which are wholly owned by the federal government as on June 1, 2002 is allowed to be carried forward for ten years.

## **4. CAPITAL GAIN**

- 4.1. Capital gain for all class of persons has been made taxable on uniform basis.
- 4.2. In case of gain arising on disposal of a capital asset, held for a period of more than twelve months, twenty-five percent of the amount of gain is exempt from tax for all class of persons and remaining amount is chargeable to tax at the applicable rate of the taxpayer.

## **5. INCOME FROM OTHER SOURCES**

- 5.1. Fee for technical services has been excluded from this head and is now classified under the head income from business.
- 5.2. Profit on debt (previously referred to as interest on securities) is now taxable under the head income from other sources and has been excluded from the ambit of presumptive tax regime.

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- 5.3. Income from sub-lease of building has been included under this head. Previously it was taxable under the head income from house property.
- 5.4. Income from letting of building together with plant or machinery has now been made entirely taxable under this head. Previously, if the hire of building was separable from the hire of machinery, the former was taxable under the head income from house property.
- 5.5. Bonus shares received have been excluded from the definition of income.

### 6. ADVANCE TAX

- 6.1. Quarterly advance tax has now been made payable for all tax payers on the basis of turnover.
- 6.2. Provisions of quarterly tax do not apply to the following:
- 6.2.1. Income chargeable under the head capital gain.
- 6.2.2. Income chargeable on the basis of presumptive tax.
- 6.2.3. Individuals whose latest assessed income is less than Rs. 150,000/-.

### 7. APPLICABLE RATES OF WITHHOLDING/ ADVANCE TAX

Nature of payment	Tax Rate	Advance tax/ Final tax	Deducting Agencies
Dividend paid to public or insurance companies	5%	Final tax	2
Dividend paid to any other person	10%	Final tax	2
Royalty or fee for technical services paid to a non-resident	15%	Final tax	1-8
Imports by commercial importer	6%	Final tax	5
Imports by industrial undertaking	6%	Advance tax	5
Profit on debt (previously referred to as interest on securities)			
<input type="checkbox"/> Yield under the National Savings Schemes	10%	Advance tax	1 & 2
<input type="checkbox"/> On deposit with banks and financial institutions	10%		
<input type="checkbox"/> On securities issued by Federal or provincial government	20%		
Payments to non-residents other than royalty or fee for technical services	30 %	Final tax	1-8
Payments for goods		Final tax (other than for manufacturer)	1-4
<input type="checkbox"/> In the case of the sale of rice, cotton, cotton seed or edible oils	1%		
<input type="checkbox"/> In the case of the sale of any other goods	3.5%		
Payments for services		Advance tax	1-4
<input type="checkbox"/> In the case of transport services	2%		
<input type="checkbox"/> In any other case	5%		



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Nature of payment	Tax Rate	Advance tax/ Final tax	Deducting Agencies
Payment on account of execution of contract <input type="checkbox"/> In the case of a contract with a value exceeding thirty million rupees <input type="checkbox"/> In any other case	6% 5%	Final tax	1-4
Payments to non-residents for contracts <input type="checkbox"/> In the case of a turnkey contract <input type="checkbox"/> In the case of a contract or sub-contract for the design, construction, or supply of plant or equipment – <input checked="" type="checkbox"/> under the hydel power project or a transmission line project <input checked="" type="checkbox"/> under any other power project <input type="checkbox"/> in the case of any other contract – <input checked="" type="checkbox"/> where the value of the contract exceeds thirty million rupees <input checked="" type="checkbox"/> where the value of the contract does not exceed thirty million rupees	8%  5% 4%  6% 5%	Final tax	1-4
Exports	0.75% 1% & 1.25%	Final tax	7
Indenting commission	10%	Advance tax	7
Payments for rental of property	7.5%	Advance tax	1, 2 & 8
Prizes and winnings	10%	Final tax	1-8
Brokerage and commission	5%	Advance tax	
Tax on vehicles <input type="checkbox"/> in the case of road transport and passenger transport vehicle <input type="checkbox"/> in the case of private vehicles	Various rates	Final tax Advance tax	
Electricity bills	Various rates	Advance tax	
Telephone bills	Various rates	Advance tax	
Mobile phone bills and prepaid telephone cards	10%	Advance tax	
Shipping income of non-residents	8%	Final tax	
Air transport income of non-residents	3%	Final tax	

Deducting Agencies:

1. Federal Government
2. Company
3. Association of persons
4. Foreign contractor or consultant or consortium or joint venture
5. Collector customs
6. Individual
7. Authorized dealer in foreign exchange
8. Provincial government, local authority, non-profit organization and diplomatic mission

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- 7.1. If a person fails to collect or deduct any tax or having collected or deducted such tax fails to pay the tax from any amount on which he was liable to deduct and pay withholding tax, he shall be personally liable to pay that tax. However, he shall be entitled to recover that amount from the person from whom the tax should be collected or deducted.
- 7.2. Separate rates for tax to be deducted from payments to non-NTN holders have been abolished.

### 8. RETURNS

- 8.1. It has been made mandatory to furnish return of income in the following additional cases regarding a person who:
  - 8.1.1. claims a carry forward of loss in a tax year;
  - 8.1.2. owns any flat;
  - 8.1.3. subscribes for a mobile phone;
  - 8.1.4. is a member of a club where the monthly subscription exceeds five hundred rupees or the admission fee exceeds twenty five thousand rupees;
  - 8.1.5. is a pensioner who fulfils any of the above or previously specified criteria.
- 8.2. The Commissioner may also require any person or his representative, by a notice in writing, in the following additional cases to furnish a return of income for a period of less than twelve months where:
  - 8.2.1. the person has died;
  - 8.2.2. the person has become bankrupt;
  - 8.2.3. the Commissioner considers it appropriate to require such a return to be submitted.

### 9. WEALTH STATEMENT

- 9.1. It has been made mandatory for every resident taxpayer to file a wealth statement.
- 9.2. However, the requirement of filing a wealth statement does not apply in case of taxpayer whose entire income in a tax year consists of salary, which is below Rs. 200,000/-.

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9.3. The Commissioner may also require any person to furnish a wealth statement.

### 10. ASSESSMENT AND AUDIT

10.1. A return of income submitted will be considered as an assessment order on the day on which the return is furnished.

10.2. A revised return may be furnished within five years of the date of furnishing of the original return, which will be taken to be an amended assessment order on the day on which the revised return is furnished.

10.3. The Commissioner may select any person for an audit of the person's income tax affairs having regard to:

10.3.1. the person's history of compliance or non-compliance with the Ordinance;

10.3.2. the amount of tax payable by the person;

10.3.3. the class of business conducted by the person; and

10.3.4. any other matter that the Commissioner considers relevant.

10.4. The fact that a person has been audited in a year shall not preclude the person from being audited again in the next and following years where there are reasonable grounds for such audits.

10.5. In case of non-furnishing of return, the Commissioner may, based on any available information and to the best of his judgment, make an assessment of the taxable income of the person and the tax due for the year.

10.6. The Commissioner may amend an assessment order within five years of the date of assessment order.

10.7. Where an assessment order is amended, the Commissioner may further amend that order within five years of the date of the original order or one year after amended assessment order, whichever is later.

### 11. APPEALS

An appeal may not be preferred against an assessment order unless:

11.1. Tax payable along with return has been paid, and

11.2. Lower of the following amount has been paid:

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- Fifteen percent of the disputed amount
- OR
- Twenty percent of the amount of tax assessed for the immediately preceding tax year, and
  - Where a person has not been assessed to tax for preceding tax year, thirty percent of the amount of tax payable along with return.

### 12. TAX CREDITS

#### 12.1. RETIREMENT ANNUITY SCHEME

Ceiling of Rs. 50,000/- has been enhanced to Rs. 100,000/- for credit on contribution to retirement annuity scheme approved by SECP.

#### 12.2. PROFIT ON DEBT FOR CONSTRUCTION OR ACQUISITION OF HOUSE

12.2.1. Ceiling of Rs. 600,000/- on amount of debt has been abolished.

12.2.2. Ceiling of Rs. 50,000/- has been enhanced to Rs. 100,000/- for credit on profit or share of rent or appreciation in value of property.

### 13. GENERAL RULES

#### CURRENCY CONVERSION

Every amount taken for the purpose of tax shall be in rupees. In case an amount is in a currency other than rupees, the amount shall be converted to the rupees at the State Bank of Pakistan mid-exchange rate applying between the foreign currency and the rupee on the date the amount is taken into account.

### 14. ASSOCIATION OF PERSONS

The concept of difference between the provisions of chargeability of tax for registered and unregistered firms or association of persons has been made consistent and all are to be termed and taxed as association of persons. Now the situation stands as under:

14.1. an association of persons shall be liable to tax separately from its members.

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14.2. any amount received by a member of the association in his capacity as member, out of the income of the association, shall be exempt from tax, however, it shall be included in any other income of the members for rate purpose.

14.3. however, 14.1. and 14.2. will not apply in case of an association of persons:

14.3.1. that is a professional firm prohibited from incorporating by any law or the rules of the body regulating the profession; or

14.3.2. in which a company is a member.

Such an association shall not be liable to tax, however, the income of a member of such association shall be taxed under the head Income from Business.

However, such an association is liable to file a return of income for each tax year.

Where such an association of persons sustains a loss that cannot be set off against any other income of the association, the amount of the loss shall be apportioned among the members of the association according to their interest in the association and the members shall be entitled to have their share of the loss set off and carried forward in computing their taxable income.

### **15. DISPOSAL OF BUSINESS BY INDIVIDUAL AND ASSOCIATION OF PERSONS TO A WHOLLY-OWNED COMPANY**

15.1. The law seeks to promote the corporate culture and, in line with that, chargeability of tax is made avoidable if legal form of business is changeover to a corporate base.

15.2. No gain or loss shall be taken to arise on the changeover if the following conditions are satisfied:

15.2.1. The consideration received by the transferor or association for the disposal is a share or shares in the company (other than redeemable shares);

15.2.2. the transferor or association

15.2.2.1. in case of individual, must beneficially own all the issued shares in the company immediately after the disposal;

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- 15.2.2.2. in case of association, members must own all the issued shares in the company immediately after the disposal in same proportion as was before the disposal.
- 15.2.3. the company must undertake to discharge any liability in respect of the assets disposed of to the company;
- 15.2.4. any liability in respect of the assets disposed of to the company must not exceed the transferor's or association's cost of the assets at the time of disposal;
- 15.2.5. the fair market value of the share or shares received by the transferor or association for the disposal must be substantially the same as the fair market value of the assets disposed of to the company, less any liability that the company has undertaken to discharge in respect of the assets; and
- 15.2.6. the company must not be exempt from tax for the tax year in which the disposal takes place.

### 16. DISPOSAL OF ASSET BETWEEN WHOLLY-OWNED COMPANIES

If it is intended to avoid chargeability of tax on gain or loss from transfer of assets between wholly-owned resident companies, the prescribed conditions for valuation of asset(s) transferred shall be made as under:

- 16.1 Both companies belong to a wholly-owned group of companies at the time of the disposal;
- 16.2 The transferor and transferee companies belong to a wholly-owned group if:
  - 16.2.1 one company beneficially holds all the issued shares of the other company; or
  - 16.2.2 a third company beneficially holds all the issued shares in both companies.
- 16.3 the transferee must undertake to discharge any liability in respect of the asset acquired;
- 16.4 any liability in respect of the asset must not exceed the transferor's cost of the asset at the time of the disposal; and

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16.5 the transferee must not be exempt from tax for the tax year in which the disposal takes place.

### 17. CHANGE IN CONTROL OF AN ENTITY

Where there is a change of fifty percent or more in the underlying ownership of a company or association of persons (entity), any loss incurred for a tax year before the change shall not be allowed as a deduction in a tax year after the change, unless the entity:

- 17.1. continues to conduct the same business after the change as it conducted before the change until the loss has been fully set off; and
- 17.2. does not, until the loss has been fully set off, engage in any new business or investment after the change where the principal purpose of the entity or the beneficial owners of the entity is to utilize the loss so as to reduce the income tax payable on the income arising from the new business or investment

### 18. NON-RESIDENTS

#### 18.1. PERMANENT ESTABLISHMENT

- 18.1.1 A new concept of permanent establishment in case of non-residents has been introduced.
- 18.1.2 Permanent establishment in relation to a person, means a place of business through which the business of the person is wholly or partly carried on, and includes
  - 18.1.2.1. a place of management, branch, office, factory or workshop, other than a liaison office except where the office engages in the negotiation of contracts (other than contracts of purchase);
  - 18.1.2.2. a mine, oil or gas well, quarry or any other place of extraction of natural resources;
  - 18.1.2.3. a building site, a construction, assembly or installation project or supervisory activities connected with such site or project;
  - 18.1.2.4. the furnishing of services, including consultancy services, by any person through employees or other personnel

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engaged by the person for such purpose, but only where activities of that nature continue for the same or a connected project within Pakistan for a period or periods aggregating more than ninety days within any twelve-month period;

18.1.2.5. a person acting in Pakistan on behalf of the person (hereinafter referred to as the “agent”, other than an agent of independent status acting in the ordinary course of business as such, if the agent –

18.1.2.5.1. has and habitually exercises an authority to conclude contracts on behalf of the other person;

18.1.2.5.2. has no such authority, but habitually maintains a stock-in-trade or other merchandise from which the agent regularly delivers goods or merchandise on behalf of the other person; or

18.1.2.6. any substantial equipment installed, or other asset or property capable of activity giving rise to income;

### 18.2. TAXATION OF A PERMANENT ESTABLISHMENT

18.2.1. Royalty and fee for technical services received by a permanent establishment is out of the ambit of presumptive tax regime.

18.2.2. All the provisions of withholding tax as applicable to a resident person for royalty, fee for technical services, supply of goods and rendering of services have been made applicable to a permanent establishment.

### 18.3. PROFIT ON DEBT

Any profit received by a non-resident person on a security issued by a resident person has been exempt from tax under this Ordinance where:

18.3.1. the persons are not associates;



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- 18.3.2. the security was widely issued by the resident person outside Pakistan for the purposes of raising a loan outside Pakistan for use in a business carried on by the person in Pakistan;
- 18.3.3. the profit was paid outside Pakistan; and
- 18.3.4. the security is approved by the Central Board of Revenue.

### 18.4. FOREIGN-SOURCE INCOME OF SHORT-TERM RESIDENT INDIVIDUALS

- 18.4.1. The foreign-source income of an individual, other than a citizen of Pakistan, has been exempted from tax:
  - 18.4.1.1. who is a resident individual solely by reason of the individual's employment; and
  - 18.4.1.2. who is present in Pakistan for a period or periods not exceeding three years,  
shall be exempt from tax under this Ordinance.
- 18.4.2. The above does not apply to:
  - 18.4.2.1. any income derived from a business of the person established in Pakistan; or
  - 18.4.2.2. any foreign-source income brought into or received in Pakistan by the person.

### 18.5. THIN CAPITALIZATION

Where a foreign-controlled resident company (other than a financial institution), in which fifty per cent or more of the underlying ownership of the company is held by a non-resident person either alone or together with an associate or associates, has a foreign debt-to-foreign equity ratio in excess of three to one at any time during a tax year, a deduction shall be disallowed for the profit on debt paid by the company in that year on that part of the debt which exceeds the three to one ratio.

## 19. TRANSACTIONS BETWEEN ASSOCIATES

The Commissioner may, in respect of any transaction between persons who are associates, distribute, apportion or allocate income, deductions or tax credits between

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the persons as is necessary to reflect the income that the persons would have realized in an arm's length transaction.

### 20. TAX RATES

#### 20.1. INDIVIDUALS AND ASSOCIATION OF PERSONS

The non-taxable limit has been enhanced from Rs. 60,000/- to Rs. 80,000/-.

#### 20.2. COMPANIES

Tax year	Banking Company	Public Company other than a Banking Company	Private Company other than a Banking Company
2003	47%	35%	43%
2004	44%	35%	41%
2005	41%	35%	39%
2006	38%	35%	37%
2007	35%	35%	35%

### 21. EXEMPTIONS AND TAX CONCESSIONS

#### 21.1. PROFIT OR INTEREST OF NATIONAL SAVING SCHEMES

The investment limit of Rs. 300,000/- has been reduced to Rs. 150,000/- for non-taxability of investment income.

#### 21.2. PENSION

21.2.1. Pension received from any employer is exempt only when the person is not employed by the same employer or any of his associates.

21.2.2. If more than one pension is received, the higher amount is exempt.