Examiner's report

P6 Advanced Taxation (CYP)
June 2011

General Comments
The paper consisted of two sections. Section A comprised two compulsory questions, both of which were worth 35 marks. Section B comprised three questions, each worth 15 marks and candidates were requested to choose two from three.

Practically all candidates attempted 4 questions however in doing so many answers were incomplete or question parts were omitted. Time management appeared to be an issue, which is a step back from that achieved in the previous sitting. Overall the performance was satisfactory. Question 1 produced excellent replies with questions 3 and 5 also scoring high average marks. Marks gained were lower for question 2 mainly due to the VAT elements in the question. Question 4 was very poorly answered.

The biggest criticisms that came out of this sitting were the following two:

(1) There were many instances where candidates appeared to rush into the answer without fully comprehending the requirement or without fully appreciating the scenario. I have tried to point out in analysing each question part below where such evidence existed. The philosophy of 'thinking more and writing less' is an important one and candidates who learn to appreciate this will do well in the exam.

(2) All question parts that examined VAT matters were poorly answered. What was noticeable was that had some candidates been better prepared for VAT and scored some of the marks available for VAT, more candidates would have passed the exam. I particularly stress the importance of VAT as a topic. Candidates will struggle to pass the exam if they ignore VAT as a topic in its entirety.

Specific Comments

Question One
Question 1 was a 35 mark question. It focused on a variety of tax matters including computation of the personal tax of Aizer Mari, computation of capital gains tax on exchange of property, tax planning relating to the incorporation of a business as well as on the use of a branch. Overall answers to question 1 were of a good standard and scored high marks.

Part (a) was worth 6 marks and asked candidates to calculate Aizer's 2010 income tax and SDC liability. The vast majority of answers spotted that it was more tax efficient to tax the overseas pension under the special mode of taxation. A large number of scripts did not show the dividend and the interest income on the tax computation and stated that it was exempt. This was worth a half mark and often appears in questions so it is worth noting this point. Very few were the answers that deducted the value of the donation of the land to the Church of Cyprus. I would like to point out that a large number of answers omitted to calculate the SDC liability entirely thus failing to achieve a possible 2 marks. I feel that this only happens when candidates rush to produce the answer. I would recommend for candidates to review their responses after each section part and ascertain that the requirements have been addressed. A descriptive response to question (1)(a) was prepared by some candidates. The requirement was to 'calculate' and only a calculation was required. Explaining the calculation may to some extent aid the examiner and the marker but this would require time and was not really necessary for the current question part: the conclusion is that when the requirement is only for a calculation, then only this should be produced and any text should be restricted to a minimum.

Part (1)(b) required candidates to draft a memorandum and I was glad to see that the vast majority of answers obtained both marks for format and presentation.

Part (b)(i) was worth 5 marks and required the computation of Aizer's capital gains tax position given the exchange of property with Mike and Gabby. On the whole answers were correct. Commonly the life-time exemption was given for Aizer even though the question hinted that this would have been used up during

previous disposals. Weaker candidates gave rollover relief for the full amount of the gain. Around half of the answers gave the correct date for the filing of the capital gains tax return. There was a small inconsistency noted in the question in that as per Aizer's dialogue, there were two dates for signing the contract: the 21 February 2010 and the 28 February. As such the date of filing, being one month from the date of disposal, could potentially have been 31 March 2010 or 20 March 2010. Full marks were awarded in both cases.

Part (b)(ii) tested candidates knowledge on immovable property tax and was worth 3 marks. Answers were on the whole not good. There was confusion as to how the tax arises. The tax applies the rates to the 1.1.1980 value of any property physically held in the name of the taxpayer on 1 January each tax year, to the extent of his or her ownership, and is payable by 30 September of the same tax year. The tax brackets could be found at the front of the exam paper. The most common mistakes were to multiply by a percentage rate rather than a 'thousandths' rate, which would result in a much larger tax payable. Another issue was not to spot that in 2011, the only property that Mike and Gabby would have was the land. They would own 50% each meaning that the 1.1.1980 value would have to be divided between them and taxed separately using the brackets. This would result in no tax payable in 2011 as the amount was within the nil tax bracket for both Mike and Gabby. Most candidates incorrectly taxed the full amount on Mike and then again on Gabby.

Part (b)(iii) was worth 2 marks and examined the exemption under capital gains tax of donating immovable property to a charitable institution as is the Church of Cyprus. Almost all answers achieved full marks.

Part (b)(iv) was worth 9 marks and required that candidates calculate the tax saving from incorporating Aizer's business, given a pre-required amount that he wanted to receive net of tax and a plan to sell one the businesses in the future. In terms of marks, this was the largest question part. Answers were mostly good and on the right lines. All answers correctly recommended incorporation as the way forward and many also picked up on the fact that Aizer wanted to sell the fruit-selling business and thus it was advisable to use a separate company for this and sell the shares, although weaker candidates did not calculate the saving. Many answers discussed the merits of incorporation and gave a descriptive response to the tax savings with reference to the effective rate of taxation. However calculations would be required to address the requirements (maximum amount of money he could put in his pocket, comparison of tax payable) and thus full marks were not achieved where calculations were not produced.

Part (b)(v) was worth 3 marks and examined the VAT treatment of the consulting business. This question part was badly answered. Candidates who did achieve marks, did so for correctly stating that the transaction was B2B and the place of supply was where the recipient was based. However many answers went on to say that the place of supply was the UK and France (correct) and that Aizer would have to register in both countries and apply UK and French VAT (incorrect), thus failing to mention that the invoices from Cyprus would be zero rated and subject to the reverse charge by the recipient. Weaker candidates incorrectly stated that the place of supply was where the service provider was based and Cyprus VAT would be charged.

Finally part (b)(vi) which was worth 5 marks required an analysis of the tax treatment of using a branch to structure the Ismini cloth business. On the whole answers were good and the main points were made. Weaker candidates did not mention the SDC effect of the increased accounting profits in the company as a result of maintaining the branch.

Question Two

Question 2 was worth 35 marks. The main focus of this question centered on tax structuring of an international businesses. There was also examination of certain VAT aspects of the business. The answers relating to the tax advice on structuring were broadly on the right lines. Answers on the VAT matters, which totalled 9 marks, were poor.

Part (a)(i) was worth 3 marks and required candidates to advise on structuring the coal and transportation business. Most answers correctly advised on the formation of two separate Cyprus companies for the businesses. However, only a handful of answers spotted the potential transfer pricing issue that may arise.

Part (a)(ii), which was worth 3 marks, required the explanation of the VAT treatment of commission payments made from Cyprus to agents situated in other countries. The answers were very poor and showed confusion over the VAT treatment of the commission payments. What the vast majority of candidates failed to notice was the following: if Cyprus is paying agents for commission, this means that the Cyprus company received an invoice and consequently received a service. Most answers stated that it was the Cyprus company that was offering the service. A 'commission' is simply another word for 'payment'. The question from a VAT point is 'what is it that the Cyprus company is paying commission for?' In this case the service received was that of the agent – the intermediary service. Given that it is a B2B service, then the place of supply follows the basic rule of where the recipient is, which in this case is Cyprus. Thus the Cyprus company will apply the reverse charge. A significant number of answers stated that the service was a B2C service and that Cyprus VAT should be charged (which in any case does not follow from the existence of a B2C service). Other answers incorrectly stated that the intermediary service place of supply is where the main transaction takes place – which was the rule that existed prior to the 2010 changes that are being examined in this sitting. Very few answers correctly gave the VAT treatment.

Part (a)(iii) also examined VAT and was also poorly answered. It was worth 6 marks. Most answers stated that the transaction was B2C instead of B2B. Candidates should clear up their understanding of these fundamental terms. If a service, supplied by a business, is received also for the purposes of a business, then it is a B2B service. Otherwise it is a B2C supply of service. There was a mixture of replies and some aspects of these replies were on the right lines. However, there appeared to be much confusion over the VAT treatment of transportation of goods. In this case, the basic B2B rule, of where the recipient is located, applies. At the same time, given that in the scenario this is an international transportation of goods, then where the place of supply under the basic rule is Cyprus, the 'use and enjoyment' provisions 'kick-in'. Thus when, as per the question scenario, one Cyprus company will invoice another Cyprus company for international transport of goods, it will not charge Cyprus VAT as the place of supply will be where the transportation takes place. Neither will the Cyprus company undertake the reverse charge on purchasing transportation services from suppliers located in Ildoria. Many answers claimed the services were B2C (incorrect) and that the place of supply was where the transport physically took place (partly correct), without however explaining why. Generally it was clear that candidates could not display sufficient knowledge over the specific VAT treatment.

Part (a)(iv) was worth 6 marks and examined the use of a Cyprus company to undertake lending activities. This part was generally well answered with most candidates able to demonstrate how much tax could be saved by using a Cyprus company. Weaker candidates failed to note that the 5% Ildorian withholding tax on the gross interest received by the Cyprus company, would reduce the Cyprus tax to nil. A significant number of candidates stated that there would also be transfer pricing issues given the margin of 3,5% that the Cyprus company would charge. This is not only incorrect it is also unreasonable. The 3,5% margin is more than sufficient for the Cyprus company.

Part (a)(v), worth 6 marks, looked at the validity of assumptions made by Mr Ivanovitch. His first assumption related to paying out a dividend whenever he wanted between two Cyprus companies in a vertical structure. The vast majority of answers correctly identified that this would not be possible due to the deemed distribution rules, thus scoring the full 2,5 marks. The second assumption was the use of group relief for tax losses. Most answers analysed the rules surrounding group loss relief including the holding period (part of group for full year), and minimum percentage of holding (75%), the use of same year losses only etc and then concluded that it would be possible to claim loss relief. In fact candidates only had to spot that the losses in question were the result of trading in listed shares and thus they were not available for group relief in any case – 1,5 marks. Finally, candidates were asked to give advice to Mr Ivanovitch with regards to the selling price for his shares. Most

answers did not address this part requirement at all. Those that did simply stated that an arm's length price would have to be used.

Part (a)(vi) which was worth 4 marks examined the taxation of private expenses of a shareholder which appeared in a company. This was well answered by the majority of candidates. Weaker answers incorrectly stated that the amount of EUR 60.000 would be taxed as a benefit-in-kind on the shareholder and calculated the tax on this.

Most candidates achieved the 2 marks available for format and presentation. Some answers produced a memorandum instead of a letter which was careless.

Part (b) was worth 5 marks, examined certain aspects of the Cyprus International Trust and was answered satisfactorily. Part (b)(i) which was worth 4 marks was very well answered with the vast majority of candidates listing the specific requirements for a Cyprus international trust and achieving full marks. Part (b)(ii), worth 1 mark, was poorly answered as almost all candidates were unaware of the two-year period during which creditors can challenge the formation of the Cyprus international trust.

Question Three

This 15 mark question focuses primarily on the choice of a jurisdiction for the purposes of entering into an agreement for royalties. Candidates were also asked how royalties were treated for VAT purposes as well as how emoluments from Cyprus source performance income would be taxed in Cyprus. Generally a good attempt was made by candidates, however, the VAT part of the question was badly answered.

Part (a) was worth 9 marks and answers were on the whole good, although some common errors I believe could have been avoided with more attention. The most common error, which was surprising, was for the calculation in the answer to only include the income from the first year of the contract instead of the entire income over the period of the contract. In addition, a significant number of scripts, no doubt due to lack of time, ignored the double tax implications in Nordia (no relief was available for double taxation) as well as the double tax relief that *was* available in Cyprus. Finally some answers did not address what happens to the profits once they had been taxed at company level, by not discussing the dividend tax treatment at all. A large number of scripts correctly stated that under a Cyprus company the dividends would not be taxed under SDC given that Andy is not a Cyprus tax resident. However they did not take the next step to address how the dividends would be taxed under Nordia rules given that he was a Nordia tax resident. These omissions can be avoided with more forethought and attention.

Part (b) examined the VAT treatment of the royalty payments received by the Cyprus company. The answers were very poor and showed a lack of knowledge over the VAT rules. This mirrors the weakness shown in VAT knowledge throughout this paper. There was also confusion as to who was receiving the service. If the Cyprus company is receiving funds, it means that the Cyprus company is the one who should raise an invoice, which in turn means that the Cyprus company is the one providing a service. The service would be provided to the US company, the place of supply being the US, where the recipient is based. Most answers failed to acknowledge this.

Part (c) was worth 3 marks and examined the special mode of taxation for artistic performances that took place in Cyprus. This was well answered. Notable errors included not grossing up the EUR 9.000 to find the taxable amount as well as not multiplying the amount he would receive *every night* by 3 to take into account the three nights he would be performing. Weaker candidates taxed the income under the normal brackets instead of under the 10% special mode of taxation, thus failing to achieve any marks.

Question Four
Question 4 was a 15 mark question that examined specific aspects of capital gains tax and corporation tax resulting from the disposal of immovable property including by way of gift.

Question 4 proved to be the most popular choice question but the answers were on the whole not satisfactory. Candidates appeared to launch into the answer without addressing what was being asked for. I believe it would have been especially wise to apply the concept of 'think more and write less' to this question. The reason is the following. On the surface the question may appear simpler than it really is. Candidates would have to apply knowledge following a careful analysis of the scenario and following through the tax consequences. This is the point of the advanced taxation paper.

Part (a) was worth 2 marks and tested the knowledge of a specific exemption within the capital gains tax law. Although there is an exemption of transferring immovable property to a family company by way of gift, there is no exemption in the law for gifting shares of a company that holds immovable property, to another company, regardless if it is a family company. This is a chargeable disposal. Around half of the answers spotted this.

Part (b) examined the implications to Popi Ltd if it sold the apartment building in the future. Part (i) which was worth 4 marks looked at the corporation tax implications. What I was looking for was the knowledge that, given that the apartment building yielded rental income and capital allowances were claimed throughout the years, then a balancing statement would have to be produced. This is the only corporation tax implication. Most answers took the requirements to mean that the disposal must have been a trading one and presented the computation in this manner. A significant number of answers tried to justify this by stating that the building generated rental income and as such it was used for trading purposes and thus the disposal is a trading one. This resulted in not achieving many marks. If we were to examine the badges of trade, emphasis would be placed on the fact that the building was owned by Popi Ltd for over 20 years and that rental income was received for 18 years, thus concluding that the gain would have been a capital one.

Part (b)(ii) was worth 2 marks and examined a simple explanation of how a capital gains tax computation is calculated. On the whole most answers scored full marks. Part (b)(iii) was also worth 2 marks and required an explanation with calculations of the SDC implications as a result of the sale. Candidates who rushed to answer discussed the SDC implications of the rental income, an answer for which no marks were available. The requirement specifically stated that the advice related to the sale of the apartment building. This would lead to an accounting profit in the books of Popi Ltd which in turn would be subject to the SDC deemed distribution rules, which was the correct answer.

Part (c) produced an array of answers. Some answers correctly addressed most of the implications of the advice from Zoe. The facts were that Dona gifted some land to a personal company. There is thus the exemption available in the capital gains tax law for Popi Ltd to gift the land back to her. So now there was also a building on the land. Although this is not a scenario that candidates would have likely come across before, they are equipped with the knowledge to be able to deal with this issue – it would however be imperative to think the consequences through before putting pen to paper. Most answers simply stated that Zoe's advice would result in a full capital gains tax for Popi Ltd and then a subsequent capital gains tax for Dona. Most answers also did not mention the potential loss of the general life-time exemption as a result of the three year rule.

Question Five
Question 5 was a 15 mark question that examined working out the gross salary cost, including taxes, for a company that wanted to pay its employee, Mr Mariov Stella, a net salary of EUR 120.000 net of taxes and social insurance. The scenario was further complicated by the fact that Mr Stella could claim the 90 day rule exemption for one third of the year.

This question was a popular question and candidates made a good attempt at calculating the total cost to Valyiana Cyprus Ltd. Overall answers were satisfactory.

Part (a), worth 4 marks, required an explanation of the circumstances under which the 90-day exemption rule was granted. Most answers scored 3-4 marks showing a clear understanding of the rule. Common mistakes included not mentioning that only a Cyprus tax resident could benefit from the 90-day rule thus where the answer made reference to an employee of a company without specifically stating that the said employee was a Cyprus tax resident, candidates did not achieve full marks. Some answers mistakenly stated that the period had to be *less* than 90 days instead of *more*. This then created issues in part (b) where the same candidates went on to say that since Mariov was out of Cyprus for one third of the year, he was not allowed the exemption.

Part (b) was worth 10 marks and required the calculation of the gross salary and the subsequent cost of employing Mariov by the company, given a pre-determined annual net salary. This required backwards thinking by candidates. This has never been tested at the advanced level before however candidates were expected to be able to work out the answer. In the real world it is quite often that we find certain salary contracts negotiated at the *net* level rather than the *gross*, especially with employees who are coming to work from abroad for a fixed amount of time.

The starting point was to recognise that the social insurance of the employee was capped at the maximum annual insurable amount. The next point was that as a result of the 90-day rule, one-third of the emoluments of Mariov would be exempt from taxation. With this in mind, it would then be possible to work out what the gross emoluments would be. Having done this, the only thing remaining would be to work out the employer's social insurance contributions, which would also be capped at the maximum annual insurable amount. The only exception is the social cohesion fund contribution of 2% which has no upper limit. Having worked all this out it would then be possible to work out the tax deduction the company could claim from paying the gross emoluments, given that they are all tax deductible, except for the social cohesion fund. This would then determine the total cost to Valyiana Cyprus Ltd of employing Mariov.

Candidates made a very good attempt at this. Most of the answers encountered problems early on when candidates tried to 'mix' the employee and the employer social insurance contributions in the equation from the start, not spotting that once the gross salary was calculated using only the employee SIC and the 90-day rule, then the employer's contributions as well as the tax deduction for corporation tax purposes, could easily be calculated after. Many answers also used 'trial and error' by taking a gross salary by chance (such as EUR 160.000) and working out how close this would be to a net salary of EUR 120.000. The gross salary was then adjusted accordingly. Although this is a way that could be used in practise, it was not of help in the exam simply because of the lack of time available to adjust and readjust the gross salary.

Part (c), worth 1 mark, examined the tax treatment of the company paying Mariov's rented accommodation. This was well answered and almost all candidates recognised that this would be treated as a benefit in kind for Mariov.