



Examiner's report

P6 Advanced Taxation (HKG)

June 2011

General Comments

This paper covered topics which are commonly examined such as the source rule, deductibility principles, employment payments, stamp duty and tax due diligence issues. Meanwhile, the less expected topic of outbound investment by a Hong Kong taxpayer, together with related transfer pricing issues, was also incorporated in Question 1. This topic is not often examined but is becoming topical and contemporary. This seemed to be the most difficult part of the paper and the general performance on this part was not satisfactory. It indicates that candidates had not equipped themselves well enough for the current development of Hong Kong tax issues. Another topic which is common but yet poorly answered is terminal payments withdrawn from a retirement scheme, under Question 2(a) and (b). The examiners are disappointed to note that most candidates were not able to distinguish termination from retirement, and the different tax implications for pension income.

Apart from repeating the facts given in the question without giving answers, candidates are also found to have given excessive notes on general rules which were not relevant to the requirements. A typical example is Question 2 on salaries tax where most candidates started their answers with detailed explanations of the *Goepfert* principle and basic rules on taxing Hong Kong employment income. As these areas are not covered by the requirements, minimal to little marks would be given albeit excessive time was spent.

In terms of the order of answering the questions, some candidates were found to have not followed the order of the requirements as stated, but chose to combine or mingle all the points together in the context. Some others were found to have included their answers under the wrong parts of the questions. For example, answers for Question 1(b)(i) were found under Question 1(a)(i) and (ii); and answers for Question 2(a) and (c) were mixed. It was uncertain whether this was caused by the time pressure during the examination, or simply due to candidates being inattentive.

Despite that the style and approach taken in this diet being consistent with those adopted in the previous diets, the overall performance of this diet was disappointing. Apart from the problems already mentioned, it was generally observed that the foundation concepts of most candidates were not strong. These include, for instance, the 2-limb test to determine the basic scope of charge under the profits tax regime. Examiners sincerely advise all candidates to put more efforts into understanding the fundamental concepts of the Hong Kong tax regime.

Specific Comments

Question One

This question was a scenario of outbound investment by a Hong Kong taxpayer, choosing between direct investment or investment through a locally established subsidiary. The majority of candidates started their answers for Question 1(a)(i) with all kinds of source rules and principles as well as court cases, without knowing that the source issue was mainly applicable to Question 1(b)(i), not Question 1(a)(i). In particular, not many candidates were able to explain that a Vietnam subsidiary was a separate legal entity from HK Co and thus income earned by the subsidiary was not income of HK Co. This indicates that some candidates were not able to distinguish the tax implications with a subsidiary from those without a subsidiary. Apart from this, candidates' knowledge and understanding on transfer pricing issues (as required under Question 1(a)(ii) were found to be very weak. Some answers demonstrated that even the term 'transfer pricing' was not well understood.

Other specific comments and errors were highlighted as follows:

- For Question 1(a)(i), most answered that all income earned by the Vietnam subsidiary would be taxable in Hong Kong simply because the project was handled by HK Co. This is a fundamentally wrong concept. Only a few candidates were able to mention about Vietnam tax including recommendation to seek Vietnam tax advice. As regards the permanent establishment risk of HK Co for Vietnam tax purposes, it is not the intention of the examiners to test candidates' knowledge about Vietnam tax (which is outside the syllabus);

but it would not be unreasonable to expect candidates to be sensitive enough to offshore tax risk and thus be able to raise the appropriate concern.

- For Question (1)(a)(ii), for those who were aware of transfer pricing issues/rules, scoring high marks would not be difficult, except that excessive efforts were spent on explaining the 'effects' of transfer pricing (e.g. profit shifting from high-tax to low-tax jurisdictions). However, it was very disappointing to see that quite a few candidates had not given relevant answers to this part, indicating that they simply did not understand what 'transfer pricing' means.
- For Question (1)(b)(i), most candidates could score good marks for this part by discussing and explaining source rules, except that some candidates had wrongly included these points in other parts of the question. It was interesting to note that quite a few candidates have mistreated this case as contract processing arrangement, which prompted them to discuss the 50:50 apportionment issues. There were also answers which treated equipments to be eligible for depreciation allowance by HK Co, and even elaborated with the new deduction rules on environmental protection machinery, which unfortunately would not score any marks. In answering the tax deductibility of equipment cost, staff cost and bank loan interest, some candidates gave a simple answer that these costs would be tax deductible for the reason that they were used in the production of assessable profits. Without elaborating on other aspects of the deductibility issue, full marks would not be earned. Regarding the bank loan interest, nearly all candidates were able to demonstrate a good understanding of the deduction rules under ss.16(2)(d), 16(2A) and 16(2B). However, s.16(2)(e) was almost forgotten.
- For Question (1)(b)(ii), most candidates focused only on the source rules, including the contract effected test and what had been done by HK Co in Hong Kong. However, in determining whether a company is taxable in Hong Kong or not, the test involves 2 limbs: carrying on business in Hong Kong and profit sourced in Hong Kong. Most candidates were not able to earn the marks allocated for the first limb. Others were found to have confused the two limbs.

Question Two

This was a rather standard question on personal taxation covering salaries tax and treatments for remuneration items. As consistent with previous diets, performance was comparatively better than Question 1 and others. The most common problem found was that many candidates started their answers with the *Goepfert* principle and spent the whole page analysing the source of employment of Mr Kwok. This was irrelevant and bearing no credit. Another common problem was that most candidates included nearly all remuneration items under Question 2(a) while most of these items should have been included under Question 2(c). Other common errors were:

- Top-up bonus was wrongly treated as taxable in the year of assessment 2012/13.
- Only a few candidates were able to mention the point that payment received after termination was deemed to be received on the last day of employment.
- Leaving service benefit received upon termination of service was mistreated as fully taxable for the reason that it was similar to gratuity arising from employment and services. It was disappointing to see that proportionate benefit was not covered in most answers. Unfortunately, for those who were able to answer proportionate benefit, this formula was wrongly regarded as also applicable to retirement benefit under Question 2(b).
- Retirement benefit under Question 2(b) was poorly answered, as most candidates wrongly treated the benefit the same as termination benefit, fully taxable due to relating to employment, and carrying the same nature as gratuity. Others correctly concluded that retirement benefit was not taxable but wrongly explained that it was not taxable because it was not paid for services.
- Regarding the consultancy service fee earned after employment ceased, quite a few candidates treated the consultancy business as quasi-employment and thus concluded that the fee should continue to be subject to

salaries tax. Although this conclusion is not consistent with the suggested solution, marks would also be scored if justified reasons are given to support the conclusion.

- Most candidates were able to suggest holding over the provisional profits tax but for the reason that the amount of net chargeable income would likely be less than 90% of the current year income, rather than for the reason that employment income has ceased.

Question Three

This question was on a non-resident conducting share-trading activities in Hong Kong through a Hong Kong stockbroker. This question was least attempted. For those who chose to answer this question, marks were scored mainly for part (a) where only rules surrounding carrying on business in Hong Kong, badges of trade, and source rule for share-trading were required. Unfortunately, part (b) was not satisfactorily answered. Most candidates were able to state the withholding obligations of the Hong Kong agent, but failed to discuss the exemptions applicable to stockbrokers, and finally why the exemptions were not applicable to Peter.

Question Four

This question was a combination of stamp duty provisions and loss relief rules under profits tax. The anti-avoidance provision on a loss company was also incorporated. Performance for this question was generally satisfactory, except that most candidates were not able to list out the general rules governing the treatment of tax losses other than that losses were eligible for carry forward for future offsetting. Regarding stamp duty, it was encouraging to see that this aspect was well-answered by most candidates. The common pitfall was that the expected revenue of \$9 million instead of the maximum of \$8 million was used for calculating stamp duty. The principle of contingency was not taken into account, nor correctly mentioned to score an additional mark.

Question Five

This was a question on tax due diligence issues, and examiners were glad to see that this was also well-answered. Most candidates demonstrated a good understanding of the critical tax issues required to be examined in a tax due diligence exercise. A common mistake was that most candidates were mistaken that any outstanding tax liabilities found after the acquisition would be for the account of Buying Co. instead of Selling Co. The correct entity to be responsible for any future tax liabilities should remain with Selling Co.