Examiners' report

F6 Taxation (MLA)
June 2008

The paper in this session was the second one in the new format - having five compulsory questions. The five questions in the paper dealt with the following topics and had the following marks:

Question	**Topic**	**Marks**
1	Personal income tax	30
2	Corporate income tax	25
3	Capital gains tax	20
4	Foreign Income Account	15
5	Value Added Tax	10

The candidates' performance was very disappointing. Candidates' performance was extremely poor in the answers to Questions 1(a), 3, 4 and 5. VAT continues to be poorly tackled and it is evident that candidates lack the basic knowledge and understanding of basic VAT principles such as 'taxable value of supplies' and 'place of supply'. Some candidates did not attempt to answer this question.

Even in areas such as Capital Gains Tax (CGT) (Question 3) and the income which stands to be allocated to the Foreign Income Account (FIA) (Question 4) the candidates showed that they did not have sufficient knowledge of the basic income tax principles emerging from the tax legislation itself or the subsidiary legislation. This lack of knowledge of the basic income tax principles was also evident in the answers to Question 1(a) which dealt with the basis of taxation for individuals who are not ordinarily resident and not domiciled in Malta.

Some candidates fared better in Question 1(b) which dealt with Fringe Benefits and Question 2 on Corporate Income Tax but the overall performance even in these particular questions remained disappointing. Candidates should not forget that Questions 1 and 2 carry more than half of the total marks and a poor performance in these two questions will inevitably lead to an overall poor result even if the other three questions are tackled satisfactorily.

The presentation of answers by many candidates wasn't satisfactory, and in some instances time was lost, or answers were not tackled and presented in a correct manner leading to incorrect answers and loss of marks. This was mainly evident in the answers to Question 1(a) and 4. Workings were generally shown where necessary but were at times difficult to follow.

Too many candidates continue to display their answers poorly, with a lack of clear labelling to indicate which questions are being attempted. Each question should be started on a new page and candidates must give more thought to the layout and organisation of their answers. Valuable time can be easily wasted, for example by not tabulating the answer properly. This was particularly applicable to Questions 2 and 4.

Question 1

This 30-mark question was divided into two parts – part (a) dealing with the basis of taxation for individuals who are not ordinarily resident and not domiciled in Malta and part (b) dealing with fringe benefits.

Although the majority of candidates fared quite well in part (b) of the question, a number of common mistakes were found in the following areas:

- The fringe benefit value of accommodation which is owned by the company is 5% of the market value (and not 5% of the cost);

- In the case of executive health insurance, the exempt portion is three times the value of the insurance cover given to all other employees;

- Mobile telephony is exempt under the fringe benefits rules;

- Either no deduction at all or no correct deduction was given with respect to the private school fees.

On the other hand, in part (a), very few candidates, if any, gave a correct answer. This part of the question was based on the principles and the applicability of remittance basis and source basis for an individual who is resident but not domiciled in Malta. The principles may be summarised as follows:

	Worldwide basis	**Remittance basis**	**Source basis**
Resident and domiciled	✓	-	-
Either resident or domiciled	-	✓	✓
Temporary resident	-	-	✓
Neither resident or domiciled	-	-	✓

In answering 1(a) correctly, candidates were only required to be aware of the basis of taxation for an individual or a married couple who is resident but not domiciled as shown in the last column:

	Resident and Domiciled	**Resident but not Domiciled**
Malta Source Income	✓	✓
Foreign Source Income – Remitted	✓	✓
Foreign Source Income – Not Remitted	✓	X
Malta Source Capital Gains (subject to exemptions)	✓	✓
Foreign Source Capital Gains – Remitted	✓	X
Foreign Source Capital Gains – Not Remitted	✓	X

The various sources of income and capital gains given in the question (points 1 to 9) had to be classified into one of the six categories shown above to determine whether or not the amount is subject to tax in Malta.

There is no point in trying to comment on the various answers given by the candidates but the answers clearly show that candidates are not aware of the above basic principles.
Even in answering part (iii) of Question 1(a) many candidates are not aware that there are different tax rates and tax bands for persons who are resident and domiciled in Malta and persons who are not resident (and not domiciled) in Malta – even though these tables are given in the paper itself.

Question 2
This question was split into three parts and carried 25 marks but the main part of the question was the preparation of the company's income tax computation which carried 19 marks (out of 25 marks).

Although candidates fared better in this question than in the other questions the answers are still rather disappointing with the most common mistakes including:

- The donation amounting to Lm240 was not added back [Article 26(g) of the Income Tax Act];
- The loss on disposal amounting to Lm3,170 was not added back [Article 26(c) of the Income Tax Act];
- Unrealised exchange loss amounting to Lm2,000 was not added back [Article 26(b) of the Income Tax Act];
- Interest paid to the Inland Revenue Department amounting to Lm300 was not added back [Article 26(b) of the Income Tax Act];
- Legal fees of Lm500 related to the contestation of tax in dispute was not added back [Article 26(b) of the Income Tax Act];
- The general provision for bad debts as well as the specific provision for bad debts amounting to Lm5,430 were not added back [Article 26(b) of the Income Tax Act];
- The capital expenditure totalling Lm6,620 was not added back [Article 26(d) of the Income Tax Act];
- Repairs recovered by insurance amounting to Lm1,900 were not added back [Article 26(e) of the Income Tax Act];
- Unrealised exchange gain amounting to Lm1,200 was not deducted;
- Insurance compensation amounting to Lm1,900 was not deducted;

Apart from the above, in some cases candidates adjusted for the interest paid to the VAT Department when this is allowable in terms of article 74(b) of the Value Added Tax Act. Also, in some cases, no adjustment was made so as not to bring to charge the exempt dividends (amounting to Lm35,000), the dividends which were distributed by another company from its untaxed account (amounting to Lm8,500 and which are allocated to the untaxed account) and the interest which was subject to the final withholding tax of 15%.

In the workings to calculate the balancing adjustment in respect of the disposal of motor vehicle very few candidates took the original tax cost at Lm3,000 and very few adjusted the sales proceeds to scale them down from Lm4,830 to Lm906 (being Lm3,000/Lm16,000 of Lm4,830 where Lm3,000 is the tax cost, Lm16,000 is the original cost of motor vehicle 2 and Lm4,830 is the full sales proceeds).

The Lm3,000 limitations on the cost had to be applied also in calculating the wear and tear in respect of motor vehicle 1 (whose original cost was Lm27,000).

In answering part (c) of Question 2 very few candidates pointed out that the company's net accounting profits for the year in question were Lm198,996 and therefore in order to make a dividend distribution of Lm200,000 the company must have had retained earnings. Although this wasn't required in the answer and did not affect the marking allocation it shows that candidates are not always attentive to the details.

Question 3
Although a question on capital gains tax has always featured in the previous sessions, it is obvious that many candidates encountered difficulties in this question and the answers were rather poor.

In part (a) few candidates gave a correct and comprehensive definition of the term 'controlling interest'. The main difference in the calculation of the chargeable capital gains of a share transfer which constitutes a controlling interest and that which is not a controlling interest, that is, taking the deemed consideration in the case of a transfer of a controlling interest as opposed to the actual consideration in the share transfer of a non controlling interest was rarely pointed out by the candidates.

Part (b) of the question was tackled by many candidates but in arriving at the market value of the shares some failed to make the correct adjustment in respect of the market value of the immovable property, the investment in Creams Limited and the goodwill element. In the case of the adjustment for Creams Limited the most common mistake was that of not taking 80% of Lm220,000 less Lm20,000.

In the calculation of the chargeable capital gain in respect of the shares transferred by Ruth, candidates had to take into account that the shares were acquired in two stages (in 1990 and in 1996) and therefore the cost of acquisition of these shares was different. In the case of the shares acquired in 1996 the cost of acquisition is the actual cost whereas in the case of the shares acquired in 1991 (and therefore pre 1992) the cost of acquisition is based on the net asset value of the audited financial statements submitted to the Inland Revenue Department by 25 November 1992 (this was highlighted in note 5 of the question).

Apart from the issues related to the cost of acquisition, it appears that many candidates ignored the fact that the inflation element also had to take into account that the shares were acquired in two stages. As a result no inflationary element may be claimed in respect of the shares (32%) which Ruth did not own between 1991 and 1996.

Part (c) of the question was similar to part (b) since in both cases the transfer constituted a transfer of a controlling interest – in one case it was 72% whereas in the other case it was 28%. Part (c) was more straightforward since all the shares being transferred were acquired in one go and after 25 November 1992 and therefore the actual cost of acquisition is to be taken in calculating the chargeable capital gain.

In part (d) few candidates pointed out that the computation of the capital gain would not change even if the two shareholders are not resident in Malta, since article 12(1)(c)(ii) of the Income Tax Act only exempts transfers by non resident persons when the Malta company is not a company, the assets of which consist wholly or principally of immovable property situated in Malta. In this case Marshy Limited had immovable property situated in Malta and this constituted a substantial part of the company's total assets.

As an overall comment, one may say that it is expected that candidates should have a much better understanding of the Capital Gains Rules (Legal Notice 102 of 1993 as amended by Legal Notices 379 of 2002 and 5 of 2005) and also of the Tax on Property Transfers Rules (Legal Notice 112 of 2006) considering that these topics will always feature in question 3 and it will always carry 20 marks (see Syllabus and Study Guide).

Question 4
This question tested the candidates' knowledge on the income which stands to be allocated to the Foreign Income Account (FIA), the definition of participating holding (as amended by Act II of 2007) and the applicability of the participation exemption as defined in Article 12(1)(u) of the Income Tax Act.

Many candidates are still finding difficulty in determining whether a particular investment constitutes a participating holding or not and that the amounts which may be allocated to the Participating Holding category within the Foreign Income Account (FIA) may be dividend income as well as capital gains.

It should also be pointed out that in terms of the Income Tax Act (Articles 2 and 92) the Flat Rate Foreign Tax Credit (FRFTC) may be applied to dividend income as well as capital gains. The FRFTC is added to the net income and then deducted from the tax charge in arriving at the Malta tax payable.

In answering part (b) candidates failed to point out that it is beneficial and tax advantageous to distribute first all the profits which originate from a participating holding and then distribute the rest from income originating from non participating holdings. Candidates also failed to distinguish between the Malta tax and the relieved tax as is required in Article 59(5)(b)(ii) of the Income Tax Act.

Question 5
The question dealt with the principle of determining the taxable value of supply as defined in the Seventh Schedule to the Value Added Tax and the general rule in determining the place of supply for goods and services as defined in the Third Schedule to the Value Added Tax Act.

In both cases candidates were only required to briefly state, even in their own words, what the relevant paragraphs of these two schedules contained with respect to 'taxable value' and 'place of supply'.

It appears that a number of candidates were not adequately prepared and failed to answer this question.