# Examiner's report

## F6 Taxation (PKN)
## June 2011

**General Comments**

The examination paper consisted of five compulsory questions. Question one for 30 marks and Question two for 25 marks, focused on income tax affairs of a company and an association of persons, respectively. Question three, carrying 20-marks, covered capital gains. Question four having 15 marks focusing on different areas of the syllabus and was mainly narrative in nature. Question five was set on sales tax and was for 10 marks.

Most candidates attempted all five questions. Overall performance of the candidates who attempted all five questions was good. The level of marks obtained by the candidates who fell short of achieving passing marks indicates that they needed a bit more organised studies enable them to:

- cover the entire syllabus; and
- recognise all the deciding points in the given situation for the correct answer.
- know the amendments made in the Finance Acts being examined as given in the syllabus guide.

**Specific Comments**

**Question One**
Question one was about the income tax liability of a listed public company. The question was split in four parts. Most candidates answered this question reasonably well except part (c) carrying three marks.
The following common mistakes were found.

i. Agricultural income Rs. 200,000.
Majority of the candidates treated it as exempt income correctly. However, some candidates treated it as income from other sources. Agricultural income of companies is also exempt.

ii. Bad debt of Rs. 400,000 recovered during the year.
Many candidates did not deduct this amount from turnover/income of the company. The amount was claimed but not allowed as a deduction in the tax year 2005. Hence, its deduction from the turnover was necessary to avoid double taxation of the same amount.

iii. Unrealised exchange gain of Rs. 100,000.
Exchange gain on notional basis is not taxable, hence non-deduction of it from the accounting income of the company to arrive at the total/taxable income of the company was not the correct treatment, as meted out by some candidates.

iv. Donation of Rs. 200,000 paid to flood relief fund established by a social worker.
Many candidates treated this item, incorrectly, either by treating it as a straight deduction or by giving a tax credit on this amount. None of these treatments were allowable as it was not a fund recognised by the Commissioner or Federal Board of Revenue (FBR).

v. Lease rentals of Rs. 200,000 and tax depreciation of Machine A.
In the case of an asset taken on a finance lease, lease rentals instead of depreciation are allowable during the period of the lease. When such an asset is transferred by the leasing company to the lessee (the taxpayer company in this case), the residual value is taken as the cost of the asset which is then eligible for tax depreciation. Hence in this case, lease rentals paid were allowable at Rs. 200,000 and then tax depreciation at 15% of the residual value of Rs. 500,000 was allowable at Rs. 75,000. Only a

few candidates treated both the items correctly. A few gave initial allowance also, which is allowable only in the case of eligible assets. Assets already in the use of a taxpayer are not included in the definition of eligible asset.

vi. Rent payable Rs. 450,000 without tax deduction
The amount was claimed on an accrual basis. Since no tax was deducted, many candidates disallowed this amount. However, tax is deductible at the time of payment of the rent and not on the basis of a mere accrual. The amount was therefore not inadmissible. Many candidates disallowed this amount without appreciation of these facts.

In part (b) the common mistake was the wrong calculation of the tax credit on the share of income from an association of persons ('AOP'). Tax was to be worked out on taxable income including the share from the AOP. However, tax paid (Rs. 125,000) by the AOP in respect of the share of the company was to be deducted from the tax liability of the company. Some candidates did not work out the minimum tax payable on the basis of turnover for comparison with the tax payable on taxable income. Others did not give credit for the tax paid on the basis of turnover in the tax year 2010 and tax withheld at source.

In part (c), the taxable amount paid to the employee was Rs. 1,150,000 on which the tax liability worked out at Rs. 115,000. Since tax was not deducted , a penalty of Rs. 25,000 could have been levied being higher than 10% of the tax liability. Most of the answers to this part were either incomplete or partly correct.

Part (d) was answered fairly well except a few candidates only gave a vague reply about selection of a case for audit. Audit can be conducted for successive years and a taxpayer can be selected for audit either by the FBR through computer balloting, or by the Commissioner by conveying reasons of selection of the case.

**Question Two**
This question carried 25 marks and was set mainly around the taxation of business income of an association of persons and its members.

Part (a) required identification of entities included in the definition of an association of persons. The majority of candidates correctly identified that a firm, a Hindu undivided family, an artificial juridical person, and a body of persons formed under a foreign law are the entities included in the definition.

Part (b) was well attempted for the computation of income. Common mistakes found were:

i. Bad debt written off of Rs.50,000
The amount represented a loan which became irrecoverable and was written off by the company. The amount was not previously offered for tax and the business of the AOP was also not one of advancing loans, therefore, the amount was not admissible.

ii. The tax written down value of the vehicle was not restricted to Rs.1,500,000 for depreciation purposes which resulted in the wrong calculation of admissible tax depreciation.

iii. Many candidates added back Rs. 300,000 received in cash on account of advance for the sale of goods which is not the correct treatment as per law.

Part (c), carrying three marks, was also not correctly answered by many candidates. Common errors were:

i. The amount to be added on account of the unexplained investment was Rs. 5,000,000 being the actual amount of investment and not its market value of Rs. 7,000,000 at the time of discovery by the Commissioner. Many candidates treated Rs. 7,000,000 as unexplained.

ii. It was chargeable to tax in the tax year 2009 being relevant to the year of investment and not that of discovery.

iii. In the case of concealment of income, a penalty equal to the amount of tax which the person sought to evade by concealment of income or Rs. 25,000, whichever is higher, is imposable.

The incorrect answers seemed due to not giving due attention to the changes in law brought about in the Finance Act, 2010.

**Question Three**

This question was mainly set for the calculation of capital gains and carried 20 marks. The question was well answered by the vast majority of candidates.

However, some mistakes were:

Part (a)(i) carried three marks for mentioning moveable properties, held for personal use of the taxpayer or the dependents of the taxpayer, which are treated as a capital asset. A few candidates mentioned properties like building, land, and plant & machinery, etc. in this category which obviously was not the correct answer. The correct answer included the following moveable assets:

- a painting, sculpture, drawing or other work of art;
- jewellery;
- a rare manuscript, folio or book;
- a postage stamp or first day cover;
- a coin or medallion ; and
- an antique.

Part (a)(ii) tested the new concept of 'security' and carried two marks. Most candidates answered it correctly but a few candidates did not answer that a security means:

- a share of a public company;
- vouchers of the Pakistan Telecommunication Corporation ;
- a Modaraba certificate; and
  an instrument of redeemable capital and any derivative products.

Part (b) was one of the best answered questions. However, in some scripts the following errors were noted:

i. Capital gains were not restricted to 75% for taxation where the asset was held for more than one year which resulted in the incorrect taxable income.

ii. Whereas no gain or loss was to be recognised on the disposal of the cricket bat by way of a gift, some candidates taxed the gain on this asset.

iii. Whereas an immoveable property is not included in the definition of a capital asset, some candidates taxed incorrectly a gain of Rs. 1,000,000 on the sale of a commercial plot of land.

**Question Four**

This question carried 15 marks and covered different important areas of the income tax law.

Part (a) dealt with tax reduction available in a tax year to a taxpayer who is aged 60 or more on the first day of the said tax year provided that his taxable income (other than FTR) does not exceed Rs.1,000,000. No reduction is available in respect of the tax liability on an income covered under FTR. Some candidates were not aware of this tax reduction. Others reduced taxable income by 50% and calculated tax on the balance amount. The correct treatment was to calculate tax at 10% of taxable income of Rs.600,000 and reduce the tax liability so calculated to 50% at Rs.30,000.

Part (b) was well answered by the majority of candidates. Since shares of the Mr. Daud and Mr. Akmal were definite and ascertainable in the immoveable property given on rent, the income from property was to be assessed to tax separately for their respective shares of the rental income and not as an association of persons. Some candidates taxed income from this jointly owned property as an AOP. Others, while computing the taxable income, deducted repair allowance at 20% and collection charges at 6% of the rental income. This treatment was incorrect because the provision of the law allowing such deductions had been omitted in the Finance Act, 2006.

Part (c) dealt with provisional assessment and how it can be prevented from becoming a final assessment. Many candidates were not fully aware of this concept explained again here.
If a person does not file a return of income in response to a notice calling for filing of the income, the Commissioner can frame a provisional assessment which becomes final assessment after the expiry of 60 days from the date of service of the provisional assessment order on the person. However, if during this period of 60 days, a return of income is filed along with a wealth statement, wealth reconciliation statement and an explanation about sources of acquisition of the assets specified in the wealth statement, the provisional assessment shall not become final.

Part (d) tested fundamental concepts of a complete return and an invalid return for the purposes of income tax. All subsequent rights and obligations flow from a complete return and invalid return is treated as non-existent. The answers given were vague in most of the scripts.
A return of income is complete if :

- it is in the prescribed format and accompanied by the prescribed annexures, statements or documents;
- all the relevant particulars are given as specified in the return and declaration of the records is also given; and
- is signed by the taxpayer or taxpayer's representative.

If a return is not complete, the Commissioner shall issue a notice to the taxpayer requiring him to make good the deficiencies by a given date. In the case of non-compliance of such notice, the return filed shall be treated as invalid.

**Question Five**

Part (a) tested the candidates' ability to compute sales tax payable for a tax period with an explanation of the treatment. Common mistakes noticed were:

- Sales to the associated company were made at a lower price than the open market price. The value of total taxable supplies to the associated company was to be adjusted to Rs. 16,200,000. Many candidates did not make this adjustment.
- Since the amount of input tax paid during the period was less than 90% of the output tax, the full amount of input tax relatable to taxable supplies was admissible. Many candidates unnecessarily and wrongly reduced admissible input tax.

Part (b) carried four marks and required candidates to identify the situations where a registered person was liable to be de-registered. Many candidates identified only one or two situations whereas the complete answer should have mentioned the following situations:

- the registered ceases to carry on his business;
- the supplies made by the registered person become exempt;
- the taxable turnover of the registered person during the last 12 months remains below the taxable limit;
- the registered person fails to file a tax return for six consecutive months; or
- the registered person is not required to remain registered under the Sales Tax Act, 1990.

Further, where the Commissioner is satisfied that a registered person has issued fake invoices or has otherwise committed tax fraud, he may blacklist such a person or suspend his registration after following the procedure prescribed in law.