



Examiners' report

F6 Taxation (PKN)

December 2007

This examination was the first sitting in the new syllabus and consisted of five questions all of which were compulsory and required to be attempted.

It was pleasing to observe that there were some good performances across the paper and excellent answers were presented by a fair number of candidates especially on the question relating to the computation of taxable income of a corporate entity and the question on sales tax.

The poor performance of many candidates continued to disappoint and this could seemingly be attributed to:

- inadequate preparation for the examination
- selective study and not covering the entire syllabus
- failure to study and learn from the past examination papers
- superficial knowledge of the core areas of the syllabus
- failure to carefully read the context and requirement portion of the question to understand what is required

The markers comments on the standard of writing legibility were fair and it was also observed that there was no evidence of the exam paper being time-pressured. However, many candidates failed to tick the appropriate box on the cover sheet of the answer paper to indicate the question attempted and a few did not follow the instruction of starting each question on a fresh page. Not following these simple instructions results in putting pressure on markers.

The presentation of the answers to the computation questions was generally poor. Questions 1, 2 and 3 specifically required candidates to give clear reasons / explanations for the inclusion or exclusion in the computation of taxable income of each of the items listed in the scenarios of the questions. The reasons / explanations given were in most cases superficial and vague resulting in candidates being unable to communicate to the markers a clear justification for the treatment given in the context. Furthermore, very few candidates gave any explanation as to why a particular item was not included in the computation of income, despite the fact that all the three questions clearly indicated that specific marks were allocated for this part of the answer. Examiner's feedbacks on past exams highlighted these weaknesses but candidates continue to ignore this essential part of the requirement and lose valuable marks.

My advice to the candidates sitting for the next examination is to:

- avoid selective study
- ensure that their preparation involves a broad coverage of the syllabus closely following the study guide
- use the past examination papers for preparation of the exam and as a revisional aid
- show workings for all figures wherever possible
- read carefully the examiner's feedback on past examination papers
- use short sentences when answering the requirements of a question thereby ensuring good time management
- use the style of expanded bullet points when pressed for time unless the question requires a particular format
- give more thought to the layout and structuring of the answers especially in the computational questions with emphasis on giving clear explanations for the inclusions or exclusions of each of the items given in the scenario to the question

- give comprehensive workings in all computational questions to enable markers to award marks for methodology in cases where candidates fail to get a 100% correct answer

Question 1

Part (a) of the question tested candidates' knowledge of the definition of a public company for tax purposes. The question was worth only two marks and a simple direct answer was needed. Instead many answers contained much extraneous material. Marks awarded to each question are intended as a guide on how much time is required to provide the answer. Although similar questions regarding a public company have featured in previous exams, many candidates failed to pick up from the scenario that since 50% of the shares in Wheels Pakistan Limited (WPL) were held by a foreign government (the Government of Kuwait), WPL would be considered to be a public company.

Part (b) focused on testing candidates' ability to deal with varied aspects relating to the computation of taxable income of a company. This computational part, worth 24 marks, was frequently the best answered question on the paper with some candidates gaining high marks.

Poor presentation is a problem with many candidates' scripts. The overall standard would have been better if the presentation of the requirement of giving reasons / explanations for the inclusion or exclusion in the computation of income of each of the items listed in the scenario, were in the style and format given in the answers of past examination papers. In most scripts the explanations given were vague and not self-explanatory. The majority of candidates even those securing pass marks gave no explanations for the excluded items thereby losing the specific marks awarded to this requirement.

Other common errors included:

- incorrect calculation of tax profit on disposal of building – candidates were not aware of the special treatment to be accorded for calculating the tax profit / loss on disposal of buildings
- workings of tax depreciation claimed not clearly shown. Candidates should aim to present depreciation workings in the format given in the answers of the past exam papers
- face value of bonus shares received from Geers Limited erroneously treated as taxable income
- initial allowance not claimed on second-hand plant not previously used in Pakistan
- Rs. 1,000,000 temporary advance received in cash from a director erroneously shown as Income from business instead of Income from other sources
- recovery of a debt of Rs. 175,000 previously written off and not allowed as a deduction, erroneously treated as taxable income
- no adjustment was required in the computation of income on the transfer of Rs. 2,000,000 to general reserve account, since the transfer to general reserve is after determination of the profit of Rs. 20,000,000.

Question 2

This 25 mark question tested candidates' ability to cope with various aspects of the computation of income and tax payable of an individual having income from diverse services. Besides multiple aspects of salary income such as arrears of salary, gratuity, pension and compensation for agreeing to a restrictive covenant, the question also tested candidates' comprehension of the tax treatment relating to:

- income from property;
- income from the lease of a building together with plant or machinery;
- income from dividends; and
- share of profits received from a partnership firm

The question was badly answered by a significant number of candidates. This was disappointing since the question covered a number of issues which have been examined in the past papers.

The computation of salary income was not to the required standard. Many candidates made an erroneous calculation of the exemption on gratuity and were not aware that cash allowances for utilities and housing are now fully taxable.

As in Question 1, the explanations given for the treatment of items included in the computation of income were superficial and vague and in almost all cases no explanations were given for items not included in the computation of income.

Many candidates had little idea of the tax treatment of income from the lease of the Korangi Property consisting of a building together with plant for preparation of bakery products. Candidates were not aware that the income after permissible deductions was chargeable to tax as 'Income from other sources' and not income from property.

A very large percentage of the candidates committed the following errors:

- Rs. 90,000 tax deducted at source by Gulab (Private) Ltd from the rent received on the Gulshan building was not treated as the final tax on the income from property.
- erroneous treatment to Rs. 1,250,000 received from Sorab Associates as the share of profits in the partnership firm – the above income was not shown as exempt from tax under the head 'Income from business'.
- the computation of tax payable was erroneous since the share of profit of Rs. 1,250,000 received from Sorab Associates was not included in the taxable income for the purpose of calculating the rate of tax that would be applicable to the taxable income other than the share of profits from Sorab Associates.

Question 3

The performance of candidates in this question on the subject of capital gains was disappointing although some good answers were provided. Overall the results should have been better considering that capital gains under the Pakistan tax statute is not a complicated subject and the laws are common for corporate and unincorporated taxpayers. Difficulties experienced by candidates could be due to lack of understanding of the fundamental concepts of taxation of capital gains.

Part (a) worth 3 marks dealt with the tax treatment of income derived by Mr. Murad, a resident for tax purposes from the transfer of his share in Karachi Stock Exchange (Guarantee) Ltd along with the occupancy rights of a room in the stock exchange, to a partnership firm.

Many candidates appeared to be unaware of the provisions of clause (133A) of Part I of the Second Schedule under which such income is exempt from tax only if the said assets are transferred to a company at any time between 1 July 2005 and 30 June 2008. As the assets were transferred to Murind Associates, a partnership firm treated as an association of persons, the exemption under clause (133A) is not available to Mr. Murad.

Part (b) of the question worth 17 marks was computational primarily on the subject of capital gains and candidates were required to compute the total and taxable income of an individual. The question focused on the issue of gains arising under an employee share scheme and the tax treatment on the gain / loss on the sale of shares in companies, agricultural land and personal jewellery.

The presentation of the answer was poor and candidates continued to ignore the instructions of giving clear reasons and explanations for the inclusion or exclusion in the computation of income of the items listed in the scenario resulting in not gaining easy marks which were available.

The answers to the transactions under the employee share scheme were disappointing considering that the topic has been examined very frequently in past papers. A significant number of candidates were unaware that where the shares issued to an employee are subject to a restriction on the transfer of the shares, no amount is chargeable to tax until the earlier of the time the employee has the free right to transfer the shares or the time the employee disposes of the shares. Workings of the amounts chargeable to tax on the acquisition of the shares and on its disposal were not clearly shown in most cases. As indicated earlier, comprehensive workings could enable markers to award marks for methodology where a 100% correct answer is not available. In some cases the income was not shown under the appropriate head of income.

Other common errors included:

- gain on disposal of the right to acquire shares under the employee share scheme not shown as salary income
- loss on sale of shares in Fibres Ltd erroneously shown as deductible – a loss on the disposal of a capital asset is not deductible where a gain on the disposal of such an asset is not chargeable to tax
- gain on sale of shares in Highlands Ltd not claimed as exempt from tax. Highlands Ltd is a public company for tax purposes since 50% of its shares are held by a foreign government and therefore the gain on sale of the shares are exempt from tax
- zakat paid erroneously claimed as a deductible charge in the computation of total income instead of as a deductible allowance from the total income to arrive at the taxable income.

Question 4

This wholly narrative question worth 15 marks was the least well-answered question on the paper. The question was designed to test some very basic concepts of the tax law - allowability of business expenditure, levy of minimum tax and capital and revenue expenditure. The scenario related to a partnership firm styled Jasmine Pharmaceuticals Company (JPC) whose assessment for the tax year 2007 was audited by the Commissioner who intends to revise the assessment on seven issues arising out of the audit. The question presented seven queries raised by the Commissioner. On the basis of the information given by JPS on the issues raised, candidates were required to state, giving reasons, whether or not in each case, the amendments proposed by the Commissioner were or were not in accordance with the provisions of the tax statute.

Very few candidates were able to provide correct answers with adequate reasons. The issues raised were basic concepts relating to tax law and the question should not have posed any problem to a well-prepared candidate. However, most answers were below the pass standard indicating that candidates' understanding and application of tax law was generally weak. The poor results on this question could also be attributed to a general aversion to questions requiring narrative answers. An opportunity was missed to gain easy marks which were available.

A significant number of answers were correct on the issue of travelling expenses incurred to secure the purchase of a mixing machine and on the issue of donations paid to a hospital run by the Federal Government.

Relatively few candidates were aware that:

- minimum tax is leviable on a resident company and not to JPC which is assessed as an association of persons [s.113(1)]
- the contribution to the unrecognized JPC provident fund is deductible as JPC (the employer) had made effective arrangements to secure that tax would be deducted from any payments made by the fund which are chargeable to tax under the head 'salary' [s.21(f)].
- salary paid to Mr. A a member of an association of persons is not deductible [s.21(j)]
- expenditure on the Eid-Milan party is deductible on grounds of commercial expediency – an expense incurred to maintain cordial relations with employees thereby indirectly facilitating the carrying on of the business
- damages paid to the sole distributor due to failure to deliver supplies within the time stipulated in the contract is an expenditure incurred in the carrying on of the business and is deductible irrespective of whether or not the failure to deliver supplies is due to the negligence of the taxpayer's employees – it is an expenditure incurred wholly and exclusively for the purpose of the business [s.20(1)].

Question 5

This question on the subject of sales tax was frequently well – answered with some candidates scoring very high marks. The question focused on the calculation of sales tax payable by / refundable to Mr. Miskeen, a registered person engaged in the manufacture of electric appliances, for the month of June 2007. The answers were generally to a good standard. Most candidates correctly calculated the output and input tax and the sale tax payable. Clear explanations were given for the treatment of sales tax on purchases of packing materials from unregistered persons, the supply of goods to unregistered persons and the supply of goods at a trade discount of 35% which was not in accordance with Miskeen's normal business practice. Candidates who were unable to score passing marks in this question appeared to be totally unprepared on the subject of sales tax.