Examiner's report

F6 Taxation (PKN)
December 2010

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 company and an individual, 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 was not bad. The level of marks obtained by the candidates who could not achieve passing marks also indicates that they need just a bit more organised studies to enable them:

- to cover the entire syllabus
- to give to the point answers [It saves time and shows their correct understanding of the issue.]
- and to recognise all the deciding points in the given situation for correct answer.

Specific Comments

Question One

This Question one was about the income tax liability of a listed public company. It was encouraging to note that most candidates secured good marks in this question. However, the following common mistakes were found in the scripts.

i. Many candidates allowed commission (Rs. 50,000) as expenditure whereas it was inadmissible due to non-deduction of tax from this amount. [s.21(c)]

ii. Tax depreciation and initial allowances were generally computed correctly. However, some candidates made a mistake of allowing initial allowance and depreciation on the full cost of the assets eligible for initial allowance. In these cases cost for computing tax depreciation was to be taken after deducting the initial allowance.

iii. Trading liability of Rs. 500,000. Where a taxpayer is allowed expenditure in the computation of taxable income on accrual basis without its actual payment and such liability is not paid within 3 years of the end of the tax year in which it is paid, it is to be added back in the first tax year following the end of the three years. In the question, this trading liability could have been added back only in the tax year 2007 and not thereafter as it related to the tax year 2003. But most candidates added it back in taxable income incorrectly. [s. 34(5)]

iv. Bad debts claims.
- Rs. 100,000 for possible default in future
- Rs. 200,000 given to ex-director as loan

The above claims were not admissible because in the first case it was still a contingency and in the second case, the amount was not previously offered for tax and the company was not in the business of advancing loans.

Some candidates allowed these amounts incorrectly presuming that every claim of bad debt was allowable.

v. Many candidates disallowed the surcharge Rs. 100,000 paid on utility bills. However, this amount was not in the nature of a penalty for infraction of any law, hence allowable.

vi. Payment on account of supplies without tax deduction. Though there are other adverse consequences which may arise due to non-deduction of tax from payments made for supply of goods, it does not make such expenditure inadmissible. [s.21(c)] Most candidates wrongly disallowed this amount in the computation of taxable income.

In part (b) the common mistake was incorrect calculation of 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.77,000) 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.

Part (c)-Withholding tax rate on payments for the purchase of goods whether under a contract or otherwise, is 3.5%. It does not change to 6% for being a supply under a contract which was wrongly assumed by many candidates. [s.153(1)(c)]

Question Two

This question carried 25 marks and was set around taxation of salary income and the consequences resulting from non-deduction of tax by an employer on payment of salary.

Part (a) was well attempted for computation of income. Mistakes found in different scripts are discussed below:

i. Mere grant of option to purchase share is not taxable unless it is exercised by the employee. A few candidates wrongly computed perquisite on this account. [s.14(1)]

ii. Medical allowance upto 10% of the basic salary was not exempt because the employee was allowed reimbursement of medical expenses. [Cl. (139)(b), Pt. I of the Second Sch.]. A few candidates treated it as exempt, wrongly.

iii. In some scripts, full cost of durable items like laptop was treated as perquisites whereas only 20% value was to be included as perquisite as the employer had not parted with the ownership and was charging the 20% of the value as deduction in its profit and loss account.

iv. Concessional loan was utilised for six months only. Many candidates calculated the perquisite for the whole year which was incorrect.

v. Salary from his ex-employer in Canada was not taxable in this year due to his return to Pakistan in the tax year 2010. [s. 51(1)]. In some scripts it was wrongly treated as taxable income.

vi. Tax credits on different investments/contributions were not worked out correctly by a number of candidates. In these cases, wrong amounts were taken for working out the tax credit. The tax credit was allowable at the average rate of tax [20%] on the taxable income of the employee on the following eligible amounts :

   a. Profit on debt obtained for purchase of house at Rs. 130,000/- [s.64]

   b. Investment in shares of Good Luck Ltd. Rs. 300,000 [s.62]

   c. Contribution to the approved pension fund Rs. 500,000 [s.63]

Part (b) was answered fairly well. However, candidates could have secured higher marks, if they had recognised that the period of default for the purpose of levy of additional tax [now called default surcharge] commences from the date tax was deductible to the date the employee paid his tax.

Part (c) was attempted poorly by many candidates. If a person was allowed a tax credit on account of eligible investment in shares and the shares were sold within one year of their purchase, the tax credit allowed earlier shall be added back in the tax liability of the tax year in which disposal is made. [s.62]

Question Three

This question was mainly set for the calculation of capital gains and carried 20 marks. The question was well answered in almost all the scripts.

However, some mistakes noticed in part (a) of answer were that:

i. capital gains were not restricted to 75% for taxation where the asset was held for more than one year which resulted in the wrong taxable income. [s. 37(3)]
ii. capital loss on the sale of necklace was deducted from capital gains by some candidates whereas it is not tax deductible being loss on jewellery. [s.38(5)]
iii. Some candidates wrongly taxed the capital gain on sale of machinery which was compulsorily acquired by the Government despite that investment of the consideration received by the taxpayer was re-invested by him in the similar asset within one year of the compulsory acquisition. [s. 79(1)(d)]

Part (b) was answered correctly by most candidates. They rightly answered that where an asset is still held by the taxpayer, any fluctuation in its value is neither taxable nor deductible.

Question Four

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

Part (a)

In the Income Tax Ordinance, 2001, a tax credit @ 2.5% of tax payable was introduced in the Finance Act, 2009 for manufacturers of goods who are also registered under the Sales Tax Act, 1990 subject to fulfilment of certain conditions. Since the taxpayer's income was assessable under the final tax regime [FTR], he was not eligible for this tax credit despite fulfilling other conditions. A large number of candidates did not recognise that the income was taxable under FTR which consequently resulted in the wrong conclusion by them. [s.65A]

Part (b)

Total income of a person for a tax year is the sum of that person's income under each head of income for the year. When Zakat paid, contributions, if any, made to the workers' participation fund and workers welfare fund are deducted from total income, the resultant income is called taxable income. [ss. 9 & 10]. Answers of very few candidates were fully correct. Correct understanding of these concepts would help in correct computation of total income, taxable income, tax credits and tax payable.

Part (c) was well attempted. However, some candidates treated income from lands situated outside Pakistan as agricultural income. The Income Tax Ordinance, 2001 does not recognise income arising from agricultural land situated outside Pakistan as "agricultural income". [s.41]

Part(d) tested both the concept of deduction of tax and limitation of exemption. Where any income is exempt, its exemption is limited to the original recipient of that income. [s.55]. Dividend distributed out of exempt income, therefore, was taxable and tax was required to be deducted at source [u/s150]. Replies on this part were mixed.

Question Five

Part (a)

This question tested the candidates' ability to compute the sales tax payable for a tax period with an explanation of the treatment. Common mistakes noticed were as under:

- Output tax on goods given to the chief executive was not computed whereas the same fell in the definition of supply and were liable to tax.
- The input tax of Rs. 100,000 pertaining to the raw material purchased in November 2009 was not eligible for adjustment but many candidates adjusted it incorrectly. [First proviso to s.7(1)]
- The value of supply was reduced by the amount of discount. The reduction was not permissible because the discount was not shown on the sales tax invoices. [s.2(46)(b)]

Some candidates did not restrict the claim of input tax at 90% of the output tax for the tax period. [s. 8B]

Part (b)

If a registered person receiving a taxable supply from another registered person is in the knowledge or has reasonable grounds to suspect that part or all of the tax payable in respect of that supply or any previous or subsequent supply of the goods supplied would go unpaid, the registered person receiving the supply could also be required to pay such unpaid amount of tax. Very few candidates were fully aware of this provision of law. [s. 8A]