Examiner's report

F6 Taxation (PKN)
December 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 individual, respectively. Question three, carrying 20-marks, covered capital gains. Question four having 15 marks focusing on different areas of the syllabus and was mostly narrative. Question five was set on sales tax and was for 10 marks.

Most candidates attempted all five questions. Overall performance of the candidates was quite encouraging. Many candidates got very good marks. Answer scripts of the candidates who fell short of passing marks indicate that they could have achieved passing marks by:

i. covering the entire syllabus enabling them to attempt all questions;

ii. following the directions given in the question paper;

iii. identifying the deciding factors in the given scenario and giving answers to the point; and

iv. knowing 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 non-listed public company. The question was split in four parts. Most candidates answered this question very well, specially part (c).

Common mistakes found in different scripts are commented below:

Part (a) Status of the company

Since the shares of the company were neither owned by any government, nor listed on any Stock Exchange in Pakistan, the company was not a public company for determination of its tax obligations. Some candidates wrongly treated it a public company for the wrong basis that it was incorporated as public company under the companies Ordinance, 1984. However, due to its being incorporated under the Companies Ordinance, 1984, it was to be treated as resident person irrespective of its place of control and management.

Part (b) The determination of the correct tax year is very important as income tax liabilities and other compliance requirements vary with different tax years. The tax year of the company in question was 2011 and the return was required to be filed by 30 September 2011. A number of candidates did not answer it correctly.

Part (c)

i. Charges paid of Rs. 350,000 for late delivery of vaccines.

Some candidates added it back in taxable income wrongly. Since it was not in the nature of a fine or penalty for infraction of any law, rules or regulation, it was rightly claimed as allowable deduction.

ii. Contribution of Rs. 500,000 to the approved gratuity fund of the company

Contribution to an approved gratuity fund is an admissible deduction irrespective of the fact whether any amount was paid to any employee or not out of such fund during the year. Some candidates disallowed it incorrectly.

iii. Contribution of Rs. 700,000 to the Prime Minister's Flood Relief Fund 2010

While it was to be allowed as a straight deduction from the income, a few candidates allowed a rebate on it like a donation which was incorrect. A couple of candidates deducted it from the tax computed on the taxable income of the company which was also incorrect.

v. Taxable gain or loss on sale of car

The car was sold for Rs. 1,000,000 and its tax written down value was Rs. 710,000. A number of candidates calculated taxable gain of Rs. 290,000. However, as the tax depreciation on the car had been allowed on the restricted value of Rs. 1,500,000 (instead of its higher purchase price), sales consideration was to be proportionately reduced to Rs. 600,000. Hence for tax purposes there was a loss of Rs. 110,000.

Part (d) was answered fairly well except a few candidates only did not deduct tax paid in the tax year 2010 (on the basis of turnover) from the tax liability of the tax year 2011. Some candidates did not compute the tax payable on the basis of turnover for comparing it to the tax liability worked out on the basis of taxable income computed in part (c) referred above.

Question Two

This question carried 25 marks and was set around a salaried individual who also derived income falling under other heads like "Income from property", "Income from other Sources" , etc.

The question was attempted fairly well by the majority of the candidates. Common mistakes found were:

i. Taxation of Encashment of leave preparatory to retirement Rs. 456,000; and commutation of pension Rs. 4,250,000

The above amounts received on account of being an employee of the government, were exempt under the Second Schedule to the Income Tax Ordinance, 2001 ('second schedule), but some candidates included them in the taxable income.

ii. Salary received from the Medicare Institute

Salary is taxed on the receipt basis and not on the accrual basis. Therefore, salary of only eight months was taxable in the tax year 2011. Some candidates ignored this aspect of the basis of taxation.

iii. Travelling allowance and daily allowance

Although the amount received at Rs. 150,000 on account of travelling allowance and daily allowance was more than the actual expense of Rs. 114,500 incurred by the employee, the whole amount was exempt from tax under the second schedule. Many candidates taxed Rs. 35,500 wrongly assuming that only the actual amount incurred was exempt from tax.

iv. Exemptions on account of amount paid to:

- Prime Minister's Special Fund for victims of terrorism Rs. 118,000

- Chief Minister's (Punjab) Relief Fund for internally displaced persons of Pakhtunkhwa Rs. 200,000

Some candidates gave tax credit on these amounts. However, they were to be allowed as straight deductions as provided in the second schedule.

v. Many candidates wrongly deducted property tax paid either from the income tax liability or from the income from property. Both treatments are incorrect. No deduction is allowed while computing income from property. Similarly credit of property tax paid cannot be claimed against the income tax liability.

vi. Income of Rs. 1,000,000 from agricultural land

Any rent received by the owner of a land used for agricultural purposes is included in the definition of agricultural income, which is exempt from income tax. Some candidates wrongly treated it as income from property and taxed it.

Question Three

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

However, a few mistakes were found which are discussed below:

i. Gift of golden bangles to non-resident sister

Since the sister was non-resident under the tax laws of Pakistan, the non-recognition rule, under which no gain or loss is to be recognised on the gift of an asset from a taxpayer to a resident person, is not applicable. A few candidates exempted the capital gain (Rs. 200,000) wrongly.

ii. Some candidates could have gained more marks if they had kept the holding period of the capital asset in their mind while computing taxable gain. Where a capital asset (other than a 'security' as defined in the Income Tax Ordinance, 2001) is held for one year or more before its disposal, only 75% of the capital gain is taxable.

iii. A dividend in specie derived in the form of shares of a company registered under the Companies Ordinance, 1984, is taxed at the time of disposal of such shares and not at the time of their receipt. Although 12,000 shares were received as dividend in specie, only 10,000 shares were sold during the tax year 2011. According to the second schedule the fair market value of 10,000 at the time of acquisition was to be taxed as a dividend in the tax year 2011. Many candidates did not answer this point correctly.

iv. Zakat paid Rs. 50,000

Zakat paid is deductible from the total income to arrive at the taxable income. However, some candidates deducted it from the tax liability which was not the correct treatment.

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

Part (a) dealt with tax implications of a loan given by a company to its shareholder. If a private limited company, as defined in the Companies Ordinance, 1984, which is not in the business of lending of money, makes any payment as advance or loan to its shareholder, the amount of loan not exceeding the amount of accumulated profits of the company, shall be treated as dividend. The company shall also have to deduct tax on this dividend. However, this provision does not apply to a company which is public limited company as defined in the Companies Ordinance, 1984. [underlining for emphasis]

The majority of candidates did not answer this fully correct.

Part (b), carrying five marks, was about the qualifying conditions for a company to be treated as a small company. A small company is taxed at a reduced rate of 25% and also enjoys some other benefits . Therefore, the correct definition is important. While the majority of candidates replied quite well, many only answered it partly. It may be noted that all of the following five conditions should be fulfilled to qualify as a small company:

(i) it is registered on or after 1 July 2005, under the companies Ordinance, 1984;
(ii) the sum total of its paid up capital and undistributed reserves does not exceed Rs. 25 million;
(iii) its number of employees does not exceed 250 at any time during the year;
(iv) its annual turnover does not exceed Rs. 250 millions ; and
(v) it is not formed by splitting up or by the reconstitution of an existing company.

Part (c). Time is of essence in the tax proceedings. Any order passed after time limitation provided in the law is invalid. A taxpayer has also to discharge his or her tax obligations in the prescribed period of time to avoid adverse tax implications. Part (c), carrying four marks, dealt with different time limitations prescribed for:

(i) filing an application of refund by a taxpayer;
(ii) passing order by the Commissioner on an application of refund filed by a taxpayer; and
(iii) for filing an appeal against the order passed by the Commissioner (Appeals).

Many candidates did not specify these limits correctly.

Part (d) carried two marks, and was also about the time limitation in which a rectification order can be passed. Rectification of an order cannot be made by the Commissioner, on his own or on the request of the taxpayer, after five years from the date of the order sought to be revised. Mix responses were found in the answer scripts.

Question Five
Part (a), carrying three marks, tested the candidates'knowledge of a cottage industry in the Sales Tax Act, 1990. Many candidates defined the term "cottage industry" as it is understood by a layman.

While dealing with tax matters (or for that matter any other law), it needs to be kept in mind that if certain expressions/ words are defined in a statute, the same meaning are to be taken for the statute (to the exclusion of all other meanings).

Part (b) carried seven marks and was computational and most of the candidates who attempted this part got good marks. However, some candidates applied the wrong rate of tax and some scripts did not correctly prorate input tax relatable to taxable supplies.