Examiner's report

P6 Advanced Taxation (CYP)
December 2011

General Comments
The paper consisted of two sections. Section A comprised two compulsory questions. Question 1 was worth 40 marks and Question 2 was worth 30 marks. Section B comprised three questions each worth 15 marks, and candidates were requested to choose two from three.

Overall, candidates performed well and produced full answers to four questions. Answers were well structured and conveyed a strong understanding of the various topics examined. Candidates managed their time well, having practised this aspect of exam technique as part of their preparation. The VAT elements examined were addressed satisfactorily in the answers produced. There was no question that stood out as being answered particularly well, although candidates produced better answers for some question parts than others. Overall, there was a good balance in the understanding displayed by candidates of the various topics examined, which was very pleasing. I do urge candidates, where they are asked to give advice and there is a choice of options, to state which option they recommend. Usually there are marks available for stating the conclusion reached following on from the analysis provided by the candidate. Finally, I would encourage candidates to practise spending time in planning their answers, so as to demonstrate their higher level skills.

The analysis below will give more information on the performance recorded in the December 2011 P6 Advanced Taxation (Cyprus) paper and highlight some areas future candidates may wish to focus upon in order to improve their performance.

Specific Comments

Question One (compulsory)
Question 1 was a 40 mark question. The scenario examined a variety of tax matters including transfer pricing, reorganisations (merger), VAT triangulation and use of a holding company in structuring an investment. Overall, answers to question 1 were of a good standard.

Almost all answers were awarded the full 2 marks for format and presentation.

Part (a) was worth 8 marks and asked candidates to discuss VAT triangulation. The vast majority of candidates produced strong answers, explaining how triangulation worked and spotting that sales to Russia could not use the simplified procedure given that it was outside the E.U. The best candidates explained that Ivana Ltd would <u>not</u> apply the reverse charge on the invoices from the Netherlands given that the goods were never shipped to Cyprus, and that the invoice from the Netherlands would not include Dutch VAT given that Ivana Ltd was VAT registered in Cyprus. Candidates need to be careful to use the correct terminology with respect to VAT. The sales to Russia are not 'exempt' from VAT (transactions that are *exempt* are listed in a separate Schedule in the VAT law, moreover, no related input VAT can be recovered for *exempt* transactions); they are *outside the scope* of Cyprus VAT, and Ivana Ltd has the right to reclaim any related input VAT.

Part (ii) was worth 6 marks and required candidates to recommend whether to use a Cyprus holding company for a 50% investment in a Russian joint venture. The vast majority of answers correctly addressed the issues stating that, by using a Cyprus holding company, Ivana Ltd would avoid the Russian 20% capital gains tax and would also be able to delay the dividend from the Russian company, Vasilis Ltd. A common error was the statement that, by structuring the investment through Cynthia Ltd, Ivana Ltd would avoid the 5% withholding tax on dividends - this is not the case because both Ivana Ltd and Cynthia Ltd are Cyprus tax resident holding companies and the 5% WHT would apply for all dividends from Russia to Cyprus. Another, that by using Cynthia Ltd there was a corporation tax benefit of 10% being the difference between the Russian corporation tax rate of 20% and the Cyprus rate of 10%. – this is not the case because Vasilis Ltd would continue to have taxable income in Russia which would be subject to Russian corporation tax at 20%, regardless of who the shareholders were (which is where Cynthia Ltd or Ivana Ltd feature). The advice required here follows the tax treatment of the *subsequent* income i.e. the dividends.

Part (iii) was worth 2 marks. A significant number of candidates appeared to misread the question, taking the loan interest to be income for Ivana Ltd instead of an expense. A number of candidates argued that the purchase of the shares was to enhance the business activities of Ivana Ltd, which was investing and so would be allowable. Although there is

some logic in this approach, in practice the loan interest would be disallowed given that it was used for the purpose of investing in a transaction of a capital nature.

Part (iv) was worth 9 marks and examined candidates' understanding of transfer pricing rules and the arm's length principle. The majority of answers correctly identified that Ivana Ltd and Vasilis Ltd would become related parties, and the ensuing transfer pricing problem that would arise from the proposed 70% discount. A few candidates went further to recommend an alternative strategy, other than to charge market price, thereby demonstrating the higher level skills of the advanced paper.

Part (v) examined the 'merger' reorganisation schemes. Answers were very good with candidates scoring highly in this 8 mark part question. Candidates displayed a solid understanding of the choices that the shareholders of CPL and AGL had with regards to merging their companies, as well as of the resulting tax benefits, including the use of AGL's losses in the merged entity and the continuance of capital allowances. On the whole answers to this part question were very good.

Part (vi) was worth 5 marks and examined the time limits for filing objections with the income tax office. Most answers were correct, but were limited to the objection to the commissioner and then to the tax tribunal or the courts. Stronger candidates also noted the possibility to file a recourse with the Supreme Court against the decision of the Tax Tribunal. Some candidates provided an incorrect answer to the deadline for filing an objection against a tax assessment, but correctly stated the deadline for filing a recourse with the Tax Tribunal or the Supreme Court. A significant number of candidates incorrectly stated that the taxpayer could file a recourse with the Minister of Finance, following the ITO's final determination. This is no doubt as a result of some confusion with the VAT law in which a recourse *can* be filed with the Minister of Finance.

Question Two (compulsory)

Question 2 was worth 30 marks. The question covered a variety of topics, mainly tax groups for loss relief, understanding of a permanent establishment, and advising on the sale of company assets versus the sale of company shares. There was also a small part question on VAT registration. Overall, the answers were of a good standard.

Part (i) was worth 2 marks and required candidates to display their understanding of an anti-avoidance provision in the law, with regards to selling loss-making companies. Most answers correctly stated that losses of Moore Ltd could not be used, but justified this answer by stating that Moore Ltd was not part of the group for a whole year which, if correct, would have meant that Moore Ltd would be able to use these losses against future profits. This is not the case: the anti-avoidance provision would mean that Moore Ltd would never be able to carry forward these losses, which would be lost, because there was a change in ownership as well as a substantial change in the nature of the business within a three-year period.

Part (ii), which was worth 3 marks, required the explanation of the tax groups for loss relief purposes of all of Alexis's companies. On the whole, answers were excellent with candidates displaying a comprehensive understanding of the provisions for group loss relief. Common errors were answers that dealt only with Matisse Ltd rather than for all of the companies, and described the general provisions of the law rather than descriptions tailored to the particular circumstances in the scenario.

Part (iii) was a 2-mark question and examined candidates' knowledge of VAT registration. Most answers correctly stated that Kashialos was VAT registered in Cyprus due to it exceeding the registration threshold of €15.600. With regards to being VAT registered in France, stronger candidates deduced that this would be as a result of importing goods directly from China to France. Most answers used the same reasoning for VAT registration in France as for Cyprus i.e. that the registration threshold was passed due to French sales. However the question did not state that any sales occurred in France so this was not justified.

Part (iv) was worth 3 marks and examined candidates' knowledge of what constitutes a permanent establishment. Once one understood that Kashialos Ltd's factory in France was a permanent establishment, the tax treatment (which was the requirement) was clear – any profits would be taxed in France and exempt in Cyprus.

Part (v) required candidates to advise between two options, providing supporting calculations and explanations. The first option was for Kashialos Ltd to sell only its properties to Savva Ltd. The second option was for Alexis to sell his shares in his companies to Savva Ltd. Each option had a different sales price attached. The calculation would have to include the capital gains tax computation in Cyprus (warehouse) as well as France (factory), calculation of the capital allowances claimed under Cyprus income tax for the warehouse, a balancing statement for both properties, and finally the SDC calculation of the dividends from the accounting profit that would be generated under option 1. Finally, candidates needed to state a conclusion. Answers on the whole were of a high standard. Most candidates produced excellent computations of the capital gains arising in Cyprus and France, with strong candidates including workings, completing balancing statements, and including the SDC on dividends in their calculations and answers. Commonly omitted was the deduction of the life-time exemption available under option 2. The majority of candidates produced a solid performance for this question part, which was worth 15 marks, drawing the right conclusions from the data. Candidates are reminded that, where the requirement is to give advice, marks are available for stating the conclusion that follows on from the workings performed.

Part (vi) which was worth 3 marks examined whether candidates would spot that, by accepting option 2, Savva Ltd also obtained the benefit of not having to pay the land transfer fees for the properties which would become payable under option 1, which could help Alexis's negotiating position. A small number of candidates are to be congratulated for mentioning this benefit. This was the most frequently omitted part question.

Most candidates achieved the 2 marks available for format and presentation, although unfortunately a number of candidates produced a memorandum instead of the letter requested.

Question Three

Question 3 was the first of the 15 mark optional questions of Section B. The question focused primarily on the choice of a jurisdiction given specific circumstances, as well as examining the place of supply rules relating to immovable property and the definition of management and control. Around 40% of candidates chose this question and performed well. Parts (a) and (b) were particularly well answered. Answers to part (c) were generally good, and would have benefitted from the provision of more detail.

Part (a) was worth 3 marks and examined the special place of supply rule relating to immovable property. Most candidates showed that they were aware of the special rule and achieved full marks (the general B2B rule, that the place of supply is where the recipient of the service is located, is incorrect in this situation).

Part (b), which was also worth 3 marks, examined the Cyprus criteria which determined the tax residency of a company. Answers were excellent.

Part (c) required candidates to choose between two jurisdictions for the purposes of residency of a company and of an individual. Most answers correctly stated the tax of Margela Ltd in Guan and in Cyprus, with some candidates going on to calculate Mr Tsum's dividend income both from Margela and from Marex Ltd, especially for the Guanese jurisdiction. Stronger candidates noted the withholding tax of 20% that Margela Ltd's income from Guanese subsidiaries would suffer. Most answers correctly stated that, if Margela were a Cyprus tax resident company, its dividend income would be exempt from corporation tax, and some candidates correctly concluded that this income would be subject to SDC as it did not meet the criteria for exemption. In order to compare jurisdictions, one should first make a note of the various income sources and then analyse their treatment for each jurisdiction, making a note of the treatment of related expenses. In the scenario under consideration, this would require a calculation of Marex Ltd's after-tax profits in order to find the dividend that would be attributable to Mr Tsum and to Margela Ltd. It would also require a calculation of the after-tax profit of Margela Ltd to ascertain the dividend receivable by Mr Tsum. By spending some time analysing the scenario in this way candidates, could better structure their answers so as to include only the relevant calculations.

Question Four

Question 4 was a 15 mark question that examined the badges of trade. Part (a) asked candidates to list the badges of trade whilst part (b) required their application under three given scenarios. Question 4 proved to be the most popular choice question and the answers provided were fair. There appears to be some confusion as to what attributes constitute a capital or a trading transaction. A typical error was an argument that a transaction was of a capital nature but citing examples that should have led to the opposite conclusion. Candidates need to ensure that they understand the badges of trade, as well as knowing them.

Part (a) was worth 5 marks and was generally well answered. Candidates had memorised the badges of trade well, and were able to produce the straightforward list requested (for this part there was no need to explain each one in detail – in that case the requirement would have been to 'list and explain').

Part (b)(i) was the first of the scenario based questions and was worth 5 marks. Strong candidates addressed the implications of Eleni placing the London apartment directly in her name.

Part (b)(ii) which was worth 2 marks was well answered with most candidates understanding the importance of the very short period of ownership pointing towards a trading transaction.

Part (b)(iii) was worth 3 marks and was the scenario for which it was purposely unclear from the data if the transaction was a capital or a trading one. To demonstrate their understanding of the badges of trade, candidates needed to know that the loan and renovations were signs of a trading (rather than a capital) transaction.

Question Five

Question 5 was a 15 mark question that examined candidates' understanding of the reverse charge principle and the B2B and B2C concepts for VAT purposes, the special rule for tax at source of non-Cyprus tax resident professionals who earn Cyprus source income, as well as the tax deductibility of various expenses.

This question was a popular question and candidates made a good attempt at all parts. Overall, answers were good.

Part (a), worth 4 marks, required an explanation of the reverse charge principal including the way it is practically applied in the accounting of a company. Answers were on the right lines showing that candidates understood the underlying concept. Candidates displayed a basic understanding of the reverse-charge principal and how it is accounted for, and a few candidates are to be congratulated for producing a more complete explanation.

Part (b) was worth 5 marks and examined the definition of B2B and B2C under the VAT law. B2B and B2C are new concepts, introduced in the European VAT Directive as of 1.1.2010. The June and December 2011 sittings were the first exam papers to incorporate these changes. Given their significance, I decided that it was important to include a question part on their definition. Overall, candidates understood the underlying concept of B2B and B2C transactions, and a handful of candidates did exceptionally well to produce a more complete explanation.

Part (c) examined the special rule of deduction of tax at source for Cyprus non-resident professionals earning Cyprus source income. Answers to this part question were on the whole very good. A common error was not to gross up the net salary in order to calculate the 10% tax deduction. Weaker candidates taxed the Italian freelance professional under the normal income tax brackets rather than under the special mode of taxation.

Part (d) was also worth 3 marks and examined the tax deductibility of three given expenses. Candidates showed a solid understanding of how to account for such expenses in the tax computation. The most common error was to allow the *ex-gratia* payment as a tax deduction, stating that it was made for the purposes of employment. This would only be the case if such a payment was provided for in the employment contract of the individual receiving the payment, which was not the case here. Another common error was to allow the entertainment expenses without mentioning the limit as per the law (the lower of 1% of turnover or €17.086).