

Examiner's report

P6 Advanced Taxation (HKG)

Dec 2011

General Comments

This paper covered common topics such as capital versus revenue, source rule, deductibility principles, remuneration packages, stamp duty and tax administrative issues. Other topics that are relatively less expected were non-resident entertainers, double taxation issues and property tax application on incorporated owners. To ensure a balanced distribution of levels of difficulty within Section B, these less common topics have been allocated to different questions, and marks allocated are less than half of the total for that question. In this paper, total marks for Section A were 66, therefore candidates who achieved above average performance in Section A should be able to pass the paper, unless their attempts in Section B were far from satisfactory.

The overall performance of the paper was not as satisfactory as expected. Other than the less common topics as abovementioned, the most typical parts of the paper that candidates found difficult were Mi's tax implications on selling shares under Q1(c)(ii), non-arm's length transfer of properties under Q1(c)(iii), change of intention of property holding under Q1(c)(iv), share options versus share awards under Q2(a) and failure to identify hire purchase arrangement under Q3(b). These are actually common and straightforward topics but unfortunately, most candidates failed to demonstrate a clear and sufficient understanding of the issues or were not able to address the issues in enough depth to score more marks. Common errors are summarised below in the specific comments.

Some candidates were found repeating the facts given in the question as their answers without elaborating with tax rationale. Other candidates were also found to have given excessive details on irrelevant points which were not being asked in the requirements. A typical example is Question 2 on salaries tax where most candidates started their answers with excessive detailed explanations of the *Goepfert* principles and basic rules on source of employment. However, the requirement started with asking for the Hong Kong salaries tax position of the draft package, and the question did not contain any ambiguous facts leading to the argument for source of employment. It is therefore not a requirement for candidates to address the source issue.

It was disappointing to observe that the foundation concepts of most candidates for this level of paper were still not strong enough. Moreover, it was surprised to see that not all candidates were able to correctly identify the hire purchase transaction as described in Q3(b); or even for those who could, the explanations of the tax treatments were not clear and detailed enough to score full credit. Hire purchase is in fact one of the most common topics examined in computational questions and usually high marks were warranted. However, examiners were disappointed that the same topic being examined in essay-type question would not warrant the same result. This obviously reflected that some candidates might have overlooked the theories behind the practical computational issues. Examiners would emphasise that theories and tax concepts are equally important for both computational and conceptual issues.

Specific Comments

Question One

This question involved different structures of shareholdings and funding. Although they appeared to be complicated, the issues being examined were surrounding common topics such as interest deduction rules, capital versus revenue principles of taxing income from transfers of shares and properties, arm's length principle of transaction, and change of intention of property holding. If candidates were able to follow the orders of requirements as stated in the question, they should have been able to address the correct scope of issues in their answers.

Most candidates achieved average performance for parts (a), (b)(i) and (ii), and (c)(i). However, for part (c)(ii), quite a few candidates attempted to elaborate their answers with tax implications on H Ltd and K Ltd arising from transfers of shares/properties. As the question only asked for tax implications on Mi, no marks were available for irrelevant answers. Other common errors included:

- For part (a), most candidates were able to address all of the tax deduction principles for loan interests but overlooked that the loan was used to acquire the shares which generate non-taxable dividends to Mi, and thus the loan interest was not tax deductible.
- Some candidates mentioned that the bank loan was used to acquire shares which are capital investments and thus the loan interest was not tax deductible. By concept, this is strictly not correct since deduction is given for expenses incurred to produce 'taxable income' rather than 'revenue asset'.
- For part (c)(ii), some candidates jumped to the conclusion that Mi was not subject to tax on the profits from the sale of shares because the shares were capital investments, without first analysing how to arrive at the conclusion that the shares were capital investments.
- Quite a few candidates only addressed stamp duty implications under part (c)(ii), without mentioning enough on profits tax implications.
- Wrong rates were sometimes used for stamp duty, eg 1% or 2% instead of 0.1% or 0.2%.
- For part (c)(iii), most candidates only mentioned that no profits were arising from the transfers at cost and thus no tax implication arose, but failed to address the non-arm's length issues.
- Other candidates could address the stamp duty issues, but failed to specify the range of ad valorem rates from \$100 to 4.25%. Also, most failed to address that market value would be applied.
- For part (d), performance was disappointing as most candidates incorrectly answered the property tax versus profits tax implications on the property rental income earned, including the set-off and exemption.

Question Two

As in previous diets, Question 2 was a standard question on personal taxation covering salaries tax and treatments for remuneration items. It is observed that most candidates spent great efforts in studying salaries tax regime so that in general, the performance of this question was comparatively better than the others. The most common problem found was that many candidates started their answers with the *Goepfert* principles and spent a whole page (or even two pages) analysing the source of employment. This was irrelevant and bearing no credit. Other common errors were:

- Premium on medical insurance scheme was correctly stated as not taxable but rationale was wrongly stated as because the payment was directly made by the employer to the insurance company.
- The statement in the question that a staff quarter can be provided by the Company 'at a rent equivalent to 5% of ...' was misinterpreted by some candidates as the Company making cash payment equivalent to 5% for use of accommodation.
- Share option and share award benefits were not well distinguished, and thus tax treatments were mixed up. Share awards are not required to be 'exercised' but most candidates gave their answers along this direction.
- S11D was wrongly applied to deem the share option gain to fall on the last day of employment;
- Re ideas to restructure the package, not many candidates were able to mention about restrictive covenants and severance payments. However, most candidates made a suggestion to convert the employment from Hong Kong sourced to foreign employment, or to ask the taxpayer to spend less than 60 days in Hong Kong. These suggestions however, are not relating to restructuring of the package, and moreover, may not be workable by fundamental facts.

Question Three

Part (a) of this question was on a non-resident entertainer making income earning performances in Hong Kong. This area has been examined in recent years but performance was still discouraging. For those who chose to answer this question, marks were scored mainly on withholding obligations, but deemed profits rate was incorrectly stated as 30% and applicable tax rate was incorrectly given as 16.5%. For part (b), quite a few candidates were not able to correctly state that this transaction was hire purchase. Some candidates treated this as sale and lease back and thus gave answers surrounding s39E. Other candidates were only able to address the stamp duty issue on lease agreement for this part.

Question Four

This was a question on source of employment and relevant tax principles surrounding rendering services overseas in the case of Hong Kong-sourced employments. Most candidates gave combined answers for parts (a) and (b), which were over-simplified to score a total of 12 marks. Other candidates focused on 183 days rule instead of 60 days. Re part (b), some candidates did not demonstrate an understanding of how Article 14 would apply in the case of HK employees rendering services in the PRC. Some were mistaken that satisfying Article 14 would render the income to be taxable in the PRC. Some others were mistaken that satisfying Article 14 would get exemption from HK tax. Moreover, in some cases, the answers were only replications of wordings from Article 14 as given in the question, without elaborating on how the article should apply. Re part (c), it was disappointing to see that most candidates mixed up tax credits under Article 21 of DTA with income deduction under s8(1A)(c). Some others failed to distinguish that tax credits refer to offsetting China tax against HK tax, whilst s8(1A)(c) refers to deducting China-taxed income from HK-taxable income.

Question Five

The last question was on tax administration, in particular on a commonly examinable topic, s70A. Most candidates could address this, but not all could elaborate the answers sufficient enough to score full credit. For part (b), this was one of the weakest areas in this paper. Most candidates failed to address the definition of 'owners' to include incorporated owners. Some others incorrectly answered that profits tax should be payable instead of property tax.