

Examiner's report

F6 (LSO) Taxation

December 2016

General Comments

There were two sections to the examination paper and were compulsory. Section A consisted of 15 multiple choice questions (two marks each) which covered a broad range of the syllabus topics. Section B had six questions. Four shorter questions worth 10 marks each, and two longer questions worth 15 marks each. The Section B questions tested the candidates' understanding and application of income tax and value added tax in more depth. The following paragraphs report on each section and focus on some of the key learning points.

Specific Comments

Section A

It was very pleasing to see that almost all candidates attempted all of the questions. Candidates preparing for the next examination of F6 (LSO) are advised to work through the pilot paper and a sample question discussed here and to carefully review how the correct answer was derived. Section A questions aim to provide a broad coverage of the syllabus, and future candidates should aim to revise all areas of the F6LSO syllabus, rather than attempting to question spot. The following question is reviewed with the aim of giving future candidates an indication of the types of questions asked, guidance on dealing with exam questions and to provide an examination technique on the topic covered by the specific question selected.

Sample Question for Discussion

Teboho, Thabang and Hloni (all resident individuals) have been in a partnership, sharing profits and losses equally for several years. Hloni withdrew from the partnership on 31 March 2016, and Teboho and Thabang decided to continue operating as a partnership sharing profits and losses equally. On 31 March 2016, the deemed gain in relation to the partnership's assets totalled M60,900. The tax payable by each of the three partners for the year ended 31 March 2016 before taking into account the effect of the deemed gain was M5,300.

What is the amount of the tax saved by each of the remaining partners, Teboho and Thabang, as a result of their agreeing to share profits and losses equally following the withdrawal of Hloni?

- A M20,300
- B 0
- C M6,090
- D M5,300

The question tests tax principles pertaining to a partnership reconstitution. The Act provides that a change in a partnership composition is treated as a complete disposal of all the assets of the old partnership to the new partnership. The implication is that the gains or losses which had accrued during the period the assets were held by the old partnership are taxed to the partners of the old partnership in accordance with their distributive share of partnership income. However, there is an exception, where there is a continuity of 50% or more of the interest in the partnership after the change in composition. In which case, there is no recognition of loss or gain for tax purposes.

In the accompanying scenario the two partners Teboho and Thabang had the required continuity of interest in the reconstituted partnership. To calculate the tax saved, candidates were expected to determine the deemed gain first, and this was given in the question. Partnership is one of the highly examinable areas of the syllabus and therefore candidates are expected to have a thorough understanding and application of the relevant provisions.

Option **A** suggests that the tax saved is the distributive share of partnership gain arising from a deemed disposal of all partnership assets.

Option **B** suggests that there is no tax saved, meaning that all partners are liable to tax on the gain arising from a deemed disposal.

Option **C** suggests that the tax saved is calculated on the deemed gain as given in the question, which is not recognised for tax purposes. This is so because the remaining partners hold 50% of interest in the new partnership.

Option **D** suggests that the tax saved is the amount given, representing the tax payable by each partner before taking into account the effect of the deemed gain.

The correct answer is option **C**.

Section B

Question One

This 10-mark question covered aspects of employment income. It would appear that many candidates were not familiar with this area of the syllabus nor did they read the question fully.

Part (a) for 2 marks required candidates to explain the resident status of Nava, the taxpayer in question. In this regard, candidates were expected to reflect on the factors which are used to determine residence in Lesotho, and on that basis, identify which of those were relevant.

Part (b) for 5 marks required candidates to calculate Nava's chargeable income for the year ended 31 March 2016, based on the annual entitlements per the employment contract. The fact that Nava did not spend the entire year of assessment in Lesotho, it was necessary to apportion the annual salary and other benefits. Most candidates did not score high marks because they simply calculated the chargeable income irrespective of the number of months that were spent by Nava in Lesotho. Additionally, the tax treatment of gratuity and severance payments was a problem to many candidates. There was a lot of confusion as to whether these payments are exempt or not, and in some cases, how much of the severance payment should be exempt.

Part (c) for 3 marks required candidates to state the circumstances in which a gift and a terminal benefit are exempt. The responses for this part clearly demonstrated that many candidates did not read the question thoroughly as they did not do what was required.

Question Two

This 10-mark question focused on fringe benefits tax (FBT). Although the majority of candidates appeared to be knowledgeable on this part of the syllabus, candidate performance was again disadvantaged by their failure to fully read and understand the question.

Part (a) for 8 marks required candidates to calculate FBT payable by a tax exempt employer, Basutoland Agricultural College (BAC), for the year ended 31 March 2016. The common mistakes identified from most answers relate to the calculations of the following items:

- Car fringe benefit: the current market value was used instead of the market value of the car when it was first provided to the employee.
- Domestic assistance fringe benefit: there was confusion as to whether to exempt a chauffeur or a body guard.
- Loan fringe benefit: the value of the amount waived was very often subtracted from the loan when calculating the taxable value of the loan fringe benefit, which was incorrect. Again, some candidates did not discount the average interest rate.
- Excessive superannuation contribution fringe benefit: some candidates incorrectly suggested that there was no fringe benefit of this kind, as the employer is tax exempt.

Part (b) for 2 marks required candidates to state how the employee's tax position would change if BAC was a public international organisation (PIO). The question tested candidates' ability to differentiate between a tax exempt employer and PIO. The majority of candidates were able to explain that the employee's chargeable income would be increased. There was a notable challenge as to whether the increase would be due to taxable values or taxable amounts FBT. In this case, what increases the chargeable income is the taxable value of all the TFBs provided to the employee during the year.

Question Three

This 10-mark question tested value added tax (VAT). The performance in this question was moderate.

Part (a) for 7 marks required candidates to calculate VAT payable for the month of November. The question further required candidates to indicate by the use of zero (0) any items which are exempt, zero-rated or disallowed. This implies that, to attain full marks, where there is a zero, it should be clearly indicated that the item is either exempt, zero rated or disallowed.

The major item which seemed to pose a problem to most candidates was the treatment of credit notes. Most candidates were unable to establish the effect of the issue of credit notes on the output tax, as in a number of answers, the VAT relating to goods returned by customers increased instead of decreasing output tax. This is in addition to the failure of some candidates to justify why they have zeros for other items such as water consumption.

Part (b) of the question required candidates to explain when a vendor is eligible to claim input tax in respect of a debt written off. It was clear from the candidates' answers that most of them did not grasp the VAT provision covering bad debts; hence they could not apply their knowledge to the given scenario. Candidates need to revise this part as it is often examinable.

Question Four

This 10-mark question tested chargeable gains. Candidates were required to calculate the chargeable gains and/or chargeable business income arising on sale of assets by an individual taxpayer, Maja. The performance in this question was extremely good for a vast majority of candidates. As indicated in previous diets, this part of the syllabus used to pose some problems for candidates, especially with regard to the application of the indexation rule. The majority of candidates seemed to be very familiar with this part of the syllabus. There was, however a minority of candidates who did not score high marks. This was due to the common mistakes in relation to the following items:

- Unimproved land: most candidates indexed the negotiated price of M38,000 instead of the market value of M45,000 on the date of acquisition.
- Extension: some few candidates incorrectly indexed the cost of extension .
- Office equipment: most candidates depreciated this asset, yet it was clearly stated that the amount of M22,500 was the adjusted cost base on the date of sale. This implies that there was no need for further depreciation.

Question Five

This 15-mark question was based on business income of an individual taxpayer, Makume. The question in general tested candidates' knowledge where a taxpayer has different sources of income with one source resulting in a loss. The performance was satisfactory for most candidates.

Part (a) for 12 marks required candidates to calculate tax payable by Makume for the year ended 31 March 2016. Most candidates appeared to be struggling to get the allowable hire purchase interest. For those who got the total interest correct, the main challenge was how to apportion the interest. On the same note, some candidates omitted the depreciation allowance for the very same asset acquired on hire purchase agreement. Since, Makume realised a trading loss from the construction business, it was disappointing to see some candidates off-setting it against the rental income.

Part (b) for 2 marks required candidates to explain the tax treatment of the trading loss realised by Makume. This part was well done. Ironically, even those who got the tax treatment wrong in part (a) provided the correct explanation for this part.

Part (c) for 1 mark required candidates to state the due date for filing a tax return by Makume. This is an individual, and the due date should 30 June 2016. While this part was often omitted by some candidates, there were still some of them who got the due date wrong.

Question Six

This 15- mark question was based on principles of corporation tax. The performance in general was moderate. Candidates were required to calculate the corporation tax payable for the year ended 31 March 2016. The company in question had both local and export sales. There was a significant number of candidates who did not recognise export sales as part of chargeable income on the basis that they are zero-rated, thus confusing income tax with VAT.

The company had a number of expenses which were supposed to be adjusted for tax purposes. Candidates were required to read the information very carefully so that they used the correct allowable expenses. Notably, staff costs seemed to provide the majority of candidates with a challenge. These needed to be adjusted for entertainment and training costs for both resident and non-resident staff.

It is worth noting that most candidates, even in previous diets were unable to make adjustments for either income or expenses. For instance, if staff costs include entertainment costs, to adjust, simply reduce the costs by 50% disallowed entertainment expenditure. With regard to training expenditure for resident and non- resident staff, this is a business expense and rightfully allowable for tax purposes. The only adjustment required related to part of the expenditure attributable to Lesotho residents; only 25% of this expense needed to be added as 100% had already been accounted for. This is in compliance with the approved training expenditure provision. Most candidates disallowed training expenditure for non-resident staff members, claiming yet again 125% for resident staff members. What is important in this case is simply to read and understand the information provided in the question. The thin capitalisation rule was correctly applied by most candidates to get the correct amount of interest allowable.