

Examiner's report

F6 Taxation (LSO)

June 2015

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 being four shorter questions worth 10 marks each, and two longer questions worth 15 marks each. The questions tested the candidates' understanding and application of the Lesotho tax system in more depth. This is the first examiner's report since the introduction of the new exam format and question types. 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 specimen questions and the 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

The financial records of Clement Milling Ltd for the year ended 31 December 2014 showed the values of taxable fringe benefits as M360,000 in total. 20% of this amount represents the cost of exempt benefits.

Which is the tax deductible expense in respect of the fringe benefits provided by Clement for the year ended 31 December 2014?

- A M123,429
- B M72,000
- C M195,429
- D M360,000

The question tested candidates' understanding of the different tax treatment of taxable fringe benefits and exempt fringe benefits. Both types of fringe benefits form part of an employee's remuneration package. From the tax point of view, taxable fringe benefits, as the name denotes, attract fringe benefit tax (FBT) which is borne by the employer. Again, the FBT, as opposed to the cost of providing a taxable fringe benefit, is a tax deductible expense to the employer. On the other hand, exempt fringe benefits do not attract tax at all. However, the cost of providing an exempt fringe benefit is a tax deductible expense to the employer.

The distinction between the two types of fringe benefits but candidates tend to confuse the two.

The alternative answers given to this question suggest the tax deductible expense to the employer should be one of the following:

- A M123,429 - FBT on taxable fringe benefits
- B M72,000 - Value of exempt fringe benefits
- C M195,429 - A plus B
- D M360,000 - The values of taxable and exempt fringe benefits

All alternatives may appear to be possible to a candidate who is uncertain of the principles regarding the taxation of fringe benefits.

Only a minority of candidates were able to choose the correct answer, which is option C. As noted above, this represents the sum of FBT on taxable fringe benefits and the cost of providing the exempt fringe benefits, the total of which is all tax deductible.

Section B

Question One

This 10-mark question covered the taxation of branches and withholding taxes. In general, candidates' performance in this question was not satisfactory. The main reasons were a failure to read and understand the questions before answering; coupled with a lack of technical knowledge in some parts of the question.

Part (a)(i) for 2 marks required candidates to explain why a branch of a non-resident company qualifies to be treated as a resident company. The answer to this question stems from one of the three tests used to assess whether a company is a resident. The last test, which is the place where the operations are undertaken, is the basis of the answer. Most candidates listed all the three tests as provided by the Act, without identifying the test relevant to the scenario.

Part (a)(ii) for 2 marks required candidates to indicate the extent to which income of a branch of a non-resident company is taxable in Lesotho. The scenario given was a manufacturing company, Niki Manufactures, as a branch of a Chinese company. Most candidates misinterpreted the question. They provided the tax rates applicable to different sources of income derived by a manufacturing company. Some candidates further provided that Niki Manufactures did not qualify to be taxed at a reduced rate of 10% as it is owned by a non-resident company. A branch of a non-resident company is a separate person, thus a resident company. It is therefore taxable on its worldwide income, meaning on both Lesotho source and foreign source income. However, the majority of candidates indicated that only Lesotho source income is taxable in Lesotho.

Part (b)(i) for 4 marks required candidate to calculate the repatriated profits of Niki Manufactures as branch of a non resident company. Only a small number of candidates performed well on this part. It was very clear that most candidates did not revise this area of the syllabus. Most candidates added back the tax deductible expenses yet it was clearly stated the chargeable income of M1,200,000 was after deducting such expenses. Again, candidates could not recognise the fact that Niki Manufactures should be taxable at the rate of 10% and 25% on manufacturing income and property income respectively. Most of them charged 25% on the entire income, notably because they suggested in part (a)(ii) that Niki Manufactures, as a branch of a non-resident company, does not qualify to be taxed at 10%, which was not correct.

Part (b)(ii) for 2 marks required candidates to calculate the amount of tax which ought to have been withheld by Niki Manufactures on the management and hire of equipment fees. In the first instance, these two types of expenses are tax deductible. Most candidates did not read the question clearly. Interestingly, the withholding tax rates were given, and it was very easy for candidates to apply the applicable rates, by looking at the given scenario. Some candidates used withholding tax rates which were not provided in the question paper.

Question Two

This 10-mark question focused on the calculation of chargeable income arising from disposal of both investment and business assets of the taxpayer in question, Mr Phuthi. The overall performance on this question was satisfactory.

The majority of candidates were able to correctly calculate the adjusted cost base (ACB) where the indexation rule needs to be applied. However there were a number of common mistakes which were identified as follows:

- **Incorrect treatment of non-arms length transaction**
Instead of using a market value, most candidates suggested that a transaction of this kind is not recognised for tax purposes.
- **Calculating depreciation on business assets disposed of**
There was no need to calculate depreciation on the business assets disposed. The recent ACB given was to be used to determine the chargeable income or loss. Most candidates wasted quite a lot of time calculating depreciation from the period when the assets were acquired.
- **Omission of income arising from sale of livestock**
While most candidates correctly identified this income as business income as opposed to investment income, it was equally right to include this income as part of chargeable income.
- **Recognition of income from sale of residential house**
Although most candidates correctly exempted this income for tax purposes as it is of personal nature, there were still some candidates who recognised this income as part of chargeable income.

Question Three

This 10 mark question was based on value added tax (VAT). Overall performance on this question was moderate.

Part (a) for 6 marks required candidates to calculate VAT payable by a vendor. Most candidates were able to prepare a reasonable answer here. Where candidates were unable to answer satisfactorily, this was due to a lack of technical knowledge regarding the treatment of the operating lease and credit note. In the question, quarterly rent payable of M4,500 for a five-year operating lease amounting to M22,500 was provided. Many candidates could not determine the correct input VAT. Many candidates used M4,500 as a taxable value, while others used M22,500. The correct approach was to calculate the monthly rental payable as a taxable value for a tax period, and then calculate the relevant input VAT. Again, there was a lot of confusion as to whether a credit note gives rise to output or input VAT. Some candidates decided to show it under both input and output VAT. In principle, when a vendor buys/pays for goods, input VAT may be claimable. When goods bought are later returned, the vendor receives a credit note from a supplier. The implication would be that the VAT paid or claimed earlier on the returned goods would be reversed. This should be reflected as output VAT on the VAT return in the tax period when the event giving rise to the adjustment takes place.

Part (b) for 2 marks related to the treatment of VAT relief on bad debts. Most candidates correctly calculated the input VAT on the bad debt. However, the majority of candidates were not able to determine the tax period when the vendor was entitled to make the claim. This is because candidates often suggested that once the twelve month period after the period the debt was written off in the books has expired, the vendor can claim input VAT. Candidates should note that according to VAT Act, the credit arises on the later of:

- The date on which the debt was written off in the books of the vendor; and
- Twelve months after the end of the tax period in which the VAT was paid in respect of the supply.

Clearly, the twelve months relates to the payment of output VAT as opposed to when the debt was written off in the books of the vendor.

Part (c) for 2 marks required candidates to explain the treatment of the operating lease. This part was frequently omitted by candidates. Some candidates provided the treatment of a finance lease. On the other hand, other candidates wrote about the financial accounting rather than the tax treatment. Candidates should note that an operating lease is treated in the same way as other rental agreements providing for periodic payments. The supply is treated as being on a continuous basis, and it occurs at the earlier of payment being received or when payment becomes due. This implies that for each tax period, VAT is determined on the relevant supply.

Question Four

The 10 mark question focused on fringe benefits tax (FBT). The overall performance was moderate.

Part (a) required candidates to calculate FBT payable by an exempt taxpayer, BCE. From the question, it was clear that the taxpayer was exempt by virtue of being an educational institution. A lot of candidates displayed the tendency of not thoroughly reading the question. Consequently, a lot of candidates tended to forget to time apportion the values of the taxable fringe benefits and, instead, assumed they were provided for twelve months.

In addition, candidates notably waste a lot of time calculating FBT for each taxable fringe benefit instead of simply determining the sum of all taxable values, taxable amount and FBT. There are no specific marks for detailed calculations of FBT for each taxable fringe benefit if this is not part of the requirement.

In addition, a lot of candidates seemed to confuse the treatment of a tax exempt employer, taxable employer and a public international organisation (PIO), specifically when dealing with the excessive superannuation fund. From the question, there was an excessive superannuation fund fringe benefit, but the majority of candidates failed to recognise this. Some candidates treated the taxpayer as taxable due to a failure to read the question.

Whilst it was apparent that many candidates were knowledgeable on this area of the syllabus, many could have performed better if they had read the question more thoroughly.

Part (b) for 1 mark required candidates to state, in general terms, by when BCE is expected to file a tax return for fringe benefits. Again, there was evidence of failure to read the question carefully. Candidates were expected to provide a general statement encompassing all the quarterly returns but many simply provided the due date for the last quarter.

Part (c) of the question focused on the treatment of a PIO with respect to FBT. This question part had three components. Firstly, an explanation regarding the tax position of the employee, Eric; secondly, an explanation regarding the tax position of the employer, BCE; and, thirdly, provision of relevant calculations. For most candidates, the responses regarding both the employee and employer were inadequate. The last component dealing with calculations was also not performed satisfactorily. Instead of dealing with the taxable amount from the FBT calculations done in part (a) in order to calculate the additional tax, many candidates presented a long list of a remuneration package of Eric to calculate chargeable income and tax payable. This requirement only carried 2 marks and candidates are reminded of the importance of using the mark allocation to determine the appropriate amount to write.

Question Five

This 15 mark question focused on taxation of a long term contract involving an electing non-resident taxpayer, Kumdah. In general, the performance in this question was not satisfactorily and the majority of candidates did not appear to be sufficiently conversant with this area of the syllabus.

Part (a) for 6 marks required candidates to calculate the tax payable for the years ended 31 March 2014 and 2015 respectively. Candidates were to use the percentage of completion method to determine the chargeable

income. To get the answer correct, candidates were expected to know the formula as provided by the Act. Chargeable income is expressed as the estimated profit multiplied by the percentage of contract completed. All the necessary information was provided to calculate both the estimated profit and percentage of completion, provided candidates had learned the formula. Although some candidates correctly calculated chargeable income, many then did not use the appropriate tax rate. Some suggested that marginal rates should be used, while others used 25%. The correct tax rate for an electing non-resident as per the fourth schedule of the Act is 30%. On the same note, a credit in respect of the withholding tax paid by Kumdah was overlooked by some candidates, whilst other candidates provided incorrect withholding tax. Kumdah was a non-resident from South Africa and thus was entitled to 10% withholding tax of the instalments paid up, bearing in mind that such instalments were given net of tax in the scenario.

Part (b)(i) for 1 mark required candidates to explain the advantage of being an electing non-resident. A variety of different answers were given. Electing non-resident implies that the taxpayer is expected to file an income tax return, as opposed to paying withholding tax as a final tax. The main advantage is that all the tax deductible expenses are claimable.

Part (b)(ii) required candidates to indicate whether it was advantageous for Kumdah to be an electing non-resident. Candidates were expected to use their calculations in part (a) to support their answer. Marks were given to candidates who used their calculations in support of their answers, even where the calculations were not correct. What was required was for candidates to determine whether there was a tax saving to Kumdah, by considering the two options - either paying withholding tax as a final tax or being an electing non-resident.

Part (c) for 5 marks tested candidates' knowledge regarding the utilisation of the overall loss of a long term contract. Most candidates knew that the loss may not be carried forward subject to some conditions as laid down by the Act. However, some candidates confused this loss with the trading loss, as they suggested that it may be carried forward to the following year, yet it was clearly stated that this was a one-off project in Lesotho.

Question Six

This 15 marks question focused on corporation tax, incorporating some general principles of income tax as a whole.

Part (a) for 2 marks required candidates to calculate the total instalments payable by the company in question, JJ, for the year ended 30 November 2013. The majority of candidates seemed to have a general understanding of the calculation of income tax instalments. However, there were some candidates who did not perform well on this part mainly because they did not read the question carefully. In principle, income tax instalments are calculated as 30% of the tax payable for the preceding year of assessment. The tax payable should be net of all withholding taxes. From the question, the tax payable was stated before deduction of withholding taxes and advance corporation tax (ACT). This suggests that only the withholding tax required to be deducted. In some cases, candidates added back ACT, while others decided to deduct it together with the withholding tax, without realising that no adjustment was required for ACT. Some candidates provided the due dates for each instalment which were not required by the question, and as such no marks were awarded. To arrive at the total instalments, the individual instalments should be multiplied by 3 as there are three instalments in total. This part of the calculation was often ignored by candidates.

Part (b) for 2 marks required candidates to calculate ACT liability of JJ for dividends paid on 30 June 2014. From the question, it was clearly stated that the said dividends were paid entirely out of unqualified income. However, some candidates incorrectly calculated the ACT, presumably because they misinterpreted or ignored this information relating to the dividends. Such candidates deducted the local dividends from the dividends paid. This adjustment was not necessary as the dividends were paid out of unqualified income. This question part further required candidates to indicate how the instalments in part (a) could be utilised to settle the ACT.

The answers provided clearly indicated that many candidates failed to read the question carefully before they answered. In the majority of answers, details of how ACT may be utilised was provided. However, many candidates didn't realise that they were to use the instalments calculated in part (a) to settle the ACT liability.

Part (c) for 11 marks required candidates to calculate the tax payable by JJ for the year ended 30 November 2014. It was clearly indicated from the question that candidates were expected to start their calculations with the profit before tax figure. The objective of this question was to test candidates' knowledge of how to adjust the accounting profit for tax purposes. Performance was unsatisfactory by the majority of candidates and the following common mistakes were noted as follows:

- There was a clear evidence of poor time management. In some cases, this question part was either left entirely unanswered or incomplete answers were provided. This was despite this part carrying a lot of marks.
- Some candidates ignored the requirement and calculated the chargeable income starting with the trading income rather than the profit before tax as instructed.

Even candidates who appeared to have read and understood the question seemed to be struggling with either adjusting income or expenses to get to chargeable income despite this having been examined in the past.. Candidates preparing for the next examination of F6 (LSO) are therefore advised to go through the past examinations and examiner's reports for guidance regarding their approach to this type of question.

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- Lastly, there were a number of cases where candidates ignored the calculations for chargeable income and moved straight to the calculations of tax payable. A common mistake was noted regarding the treatment of ACT and income tax instalments. The majority of candidates who correctly indicated that the liability for ACT was fully settled in part (b) contradicted themselves by deducting the very same amount of ACT from the figure for tax payable. On the other hand, candidates who were able to calculate the correct amount of the total instalments in part (a), and correctly set off the ACT against the first instalment in part (b), did not recognise that, in principle, the total instalments are set off against the tax liability at the end of the year, irrespective of whether they were used to settle the ACT liability.