

# Examiner's report

## F6 (PKN) Taxation

December 2015

### General Comments

There were two sections to the examination paper and all of the questions were compulsory. Section A consisted of 15 multiple choice questions (two marks each) which covered a broad range of syllabus topics. Section B had six questions, four of which were worth 10 marks and two questions were worth 15 marks each, testing the candidates' knowledge and skills to compute taxable income and tax payable by corporate and non-corporate taxpayers. 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 candidates attempted all of the questions. Candidates preparing for the next examination of F6 are advised to work through the sample questions discussed here and to carefully review how each of the correct answers were derived. Section A questions aim to provide a broad coverage of the syllabus, and future candidates should aim to revise all areas of the F6 PKN Taxation syllabus, rather than attempting to question spot. The following two questions are 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 a technical debrief on the topics covered by the specific questions selected. The questions selected highlight the likely problems faced by the candidates to reach the correct answers.

### Sample Questions for Discussion

#### Example 1

For the tax year 2014, the tax payable by Moon Lights Ltd on its declared income of Rs. 900,000 was Rs. 306,000. However, the company did not maintain the records as prescribed under the Income Tax Ordinance, 2001.

**What is the minimum penalty amount which can be levied on Moon Lights Ltd by the Commissioner for the non-maintenance of the prescribed records?**

- A** Rs. 15,300
- B** Rs. 10,000
- C** Rs. 30,600
- D** Rs. 45,000

This question tested the knowledge of the candidates about penalty leviable for non-maintenance of the prescribed record. Such penalty is leviable at 5% of the amount of tax chargeable on the taxable income of the defaulter taxpayer subject to the condition that minimum penalty shall not be less than Rs. 10,000. The penalty under option A was 5% of the tax payable, since it was more than the minimum amount of Rs. 10,000, hence it was the correct answer [**Rs. 15,300** ( $306,000 \times 5\%$ ) serial no. 7 of the table under s. 182 (1)]. For option B, the minimum penalty was given but since 5% of tax was more than this, it was not the correct answer. Option C was based on the wrong rate of penalty with reference to correct tax payable. In Option D, the base of the penalty adopted was taxable income instead of tax payable on taxable income. Hence, it was also incorrect.

A number of candidates either applied incorrect rate of penalty or applied it on income instead of tax. Others seemed to lack knowledge that the penalty to be paid was the higher of Rs. 10,000 or 5% of the tax chargeable on the taxable income.

For this type of question, candidates should figure out the correct rate of penalty and the base on which this rate is to be applied. Further, restrictions of minimum [and sometimes maximum] limits are also decisive and should be kept in mind to reach the correct answer.

**Example 2**

Mazhar, aged 35, has been issued with a computerised national identity card for disabled persons by the National Database and Registration Authority ('NADRA'). His income from business for the year ended 30 June 2015 is Rs. 750,000.

**What will be the tax liability of Mr Mazhar for the tax year 2015?**

- A Rs. 35,000
- B Rs. 17,500
- C Rs. 26,250
- D Rs. 0

This question tested ability of the candidates to compute the tax liability of a disabled person who is allowed a tax reduction of 50%. The correct approach to this question was to compute tax chargeable on business income of the taxpayer and then reduce it by 50% which gave the correct answer as below:

Rs. 17,500  $[(750,000 - 400,000) \times 10\%] \times 50\%$  [clause (1B) of Div. I of Part I of First Schedule]

Thus, the correct answer was option B.

The distracters were set to test whether candidates were aware of this tax reduction or not. If they were aware of it, they also needed to know the exact amount/rate of tax reduction. Hence, option A was based on the assumption that no tax reduction was available to disabled persons. Option C assumed that the reduction of liability was allowable by 25% only. Option D was also wrong on the assumption that a 100% reduction was available to such persons. It seems that majority number of candidates were not aware of the tax credits/reductions given. Candidates sitting in future sessions should give full attention to the areas of tax concessions, tax reductions and conditions under which such tax concessions or tax reductions can be used.

**Specific Comments****Section B****Question One**

Part (a) carrying five marks covered the powers available to the Commissioner under section 122A of the Income Tax Ordinance, 2001 to revise an order passed by an authority subordinate to the Commissioner. This exercise of power cannot be used to increase the liability of the taxpayer. Further, this power can only be exercised when no appeal has been filed and time to file appeal against such order of the subordinate has also expired. A number of candidates were found not aware of these conditions. Some candidates did not realise that Commissioner (Appeals) was not an authority subordinate to the Commissioner Inland Revenue. The future candidates should give attention to the provisions given in the Income Tax Ordinance, 2001 which a taxpayer can invoke against assessment orders, etc. increasing their tax liability and the conditions which are required to be fulfilled for availing these remedies.

Part (b) for five marks required candidates to apply their knowledge of the implications of non-deduction of tax while making payment of a salary. Where a withholding agent fails to deduct tax, a sum of Rs. 25,000 or 10% of tax required to be withheld, whichever is higher, is leviable as penalty. A number of candidates were found not to be aware of this minimum fixed penalty of Rs. 25,000. In addition to the penalty, a default surcharge at 18% per annum was also leviable on the amount not deducted for the period of default. Many candidates did not take into consideration that default surcharge rate was on an annual basis and was to be calculated with reference to the number of days it was not deducted and paid as required under the law.

The candidates should also realise that when either of the payer or the payee of the amount liable to withholding tax pays tax, the amount earlier paid without tax deduction would become deductible and disability due to non-deduction of tax will be removed. Many candidates treated such expenditure as inadmissible. Candidates should be aware of exceptions given in the law for such items.

## Question Two

This 10 mark question tested knowledge of the term 'rent' for computing income under the head, "Income from property" and computation of income chargeable to tax under the heads "Income from property" and "Income from other sources". Whereas the term 'rent' was not correctly defined by a number of candidates, the computation of income was satisfactory because the question was set around the familiar scenario of earning rent. Candidates are advised to keep in mind the base of tax under each head of income. Any income received in respect of use of land or building, the occupation of the land and building or the right to use such land and building is treated as 'rent'.

Further, it may be noted that a forfeited deposit received under a contract for the sale of land or a building is also deemed as rent, though in ordinary sense of the word it is not rent. Any amount received purely for rendering services in a building is not to be treated as rent because such amount is to be treated as 'Income from other sources.'

The common mistake in the computation was deduction of legal fees paid to defend the title of the house. It may be noted by future candidates that the law provides an exhaustive list of deductible expenses against rent taxable under the head "Income from property" and no other expenditure is deductible.

## Question Three

This 10-mark question dealt with income chargeable to tax under the head, "capital gains". Part (a) for two marks required the point in time when a person is treated to have acquired an asset. Some candidates gave the definition of a capital asset which was not relevant. Candidates should read questions carefully to know what is required to be answered. An asset is said to have been acquired by a person at the time the person begins to own the asset or is granted any right of the asset. Similarly application of a personal asset to business use is treated as an acquisition of the asset by the person at the time the asset is put to business use.

In part (b) of the question, the common mistake was incorrect computation of taxable gain on the disposal of shares in Zaheer (Pvt.) Ltd. The amount of capital gain computed was to be restricted to 75% for taxing it in the case of 1,500 shares only which were held for more than one year before their disposal.

Another common mistake was non deduction of Rs. 5,000 paid on account of bank charges while computing taxable gain on the disposal of Pakistan Investment Bonds. The payment being in connection with disposal of the capital asset was duly admissible.

Overall performance of the candidates in this question was satisfactory.

## Question Four

This 10-mark question covered another important topic of sales tax, regularly examined in each session.

Part (a) for three marks dealt with export of goods. Sales tax is charged at zero per cent on exports subject to certain exceptions. This question required the candidates to describe those three exceptions. The candidates were expected to know all these exceptions but they missed one or two of them. Candidates should prepare for this important area of syllabus regarding sales tax. The exports which are not eligible for zero rating are given below:

- (a) goods exported with the intention of re-import into Pakistan;
- (b) goods which have been entered for export under the Customs Act, 1969 but are not actually exported;
- and
- (c) goods which have been exported to notified countries to which no zero rating is allowed.

Part (b) for seven marks was satisfactorily attempted by most candidates. Some candidates made the mistake of allowing credit of input tax paid in respect of purchase of raw material of which payment was made either in cash (being the total payment in excess of Rs. 50,000) or in the personal bank account of the supplier of the raw material. No credit of input tax was admissible in these situations under section 73 of the Sales Tax Act, 1990.

The future candidates are expected to know all such restrictions given in the said important provision of the law. [Note that reference to sections is not required.]

### Question Five

The first long question carrying 15 marks required computation of taxable income and consequent tax liability of a listed company, resident in Pakistan, engaged in the business of manufacture and sale of goods not chargeable to sales tax. Part (a) for 13 marks required the computation of taxable income and part (b) for two marks required computation of tax payable by the company on the basis of taxable income computed in part (a).

A common mistake found in part (a) was incorrect treatment of an export quota licence, an intangible. An intangible used for the business is amortised over its ascertainable useful life in years. In the instant case, the intangible was not used during the tax year 2015, hence no amount was deductible. Candidates ignored this fact and deducted an amortised amount wrongly. Future candidates should read the information given in the question paper carefully so that they apply the correct provision of law.

A company is required to use accrual based accounting for computing taxable income under the head "Income from business". This principle is examined in almost every paper with respect to either expenditure or income. A deposit of Rs. 150,000 against a future supply of goods did not accrue during the tax year 2015. Hence, the amount of this deposit included in the sales of the company was to be excluded to reach taxable income. Some candidates taxed it during this year wrongly.

Addition of plant and machinery during the year was Rs. 1,000,000 on which an initial allowance was admissible at 25%. Despite the rate being given in the question paper, some candidates applied a different rate. Others allowed the initial allowance on furniture which was not an eligible asset for initial allowance. Candidates are advised to look for rates given in the question paper.

Part (b) was well attempted by most of the candidates who gave the correct credit of tax withheld by different withholding agents of the taxpayer.

### Question Six

This 15-mark question was set on the computation of taxable income of a salaried person and tax thereon. The taxpayer also earned profit on debt which was to be treated under the final tax regime (FTR). This question was very well attempted by many of the candidates.

There were some errors relating to the computation of value of the perquisites, which are explained here.

The value of the perquisite provided in the form of accommodation was to be computed as 45% of the basic salary as prescribed in the income tax rules. Some candidates computed the value of the perquisite on the basis of fair market rental value of similar properties at Rs. 30,000 per month. The valuation of this perquisite was to be computed with reference to the formula given in the rules and not on the basis of market value.

Where a car is provided for personal as well as business use, 5% of the cost of the car accrued to the employer is treated as salary income on account of this perquisite. The tax written down value of the car is not relevant for the computation of the value of the perquisite. The perquisite was to be determined as under:

Purchase cost	Rs. 1,500,000
5% to be treated as the value of the perquisite (1,500,000 x 5%)	75,000
[s.13(3) with rule 5 of the Income Tax Rules, 2002]	

Some candidates exempted the amount of special allowance of Rs. 180,000 given to Rameez for entertainment expenses. Special allowance allowed for entertainment expenses is not exempt from tax.

In conclusion, future candidates should keep in mind that very good marks can be secured by studying the whole syllabus and by keeping mind the decisive points in the given situations of each question.