

Examiner's report

F6 (PKN) Taxation

December 2017

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 consisted of six questions. Each of the first four questions carried 10 marks and required candidates to accomplish multiple tasks given in the question covering different areas of the syllabus. The final two questions each carried 15 marks with one question requiring the computation of taxable income and tax of a company and the other question requiring the computation of taxable income and tax liability of a salaried person.

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 future examinations of F6 (PKN) are advised to work through the sample questions discussed here and to carefully review how 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 syllabus. Spot studies are not the best study method to obtain good marks. Candidates should keep in mind the facts given in the question and law on the subject to reach the correct answer. 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.

Sample Questions for Discussion

Example 1

Which of the following utility connections can only be applied for if the applicant person is registered under the Income Tax Ordinance, 2001?

- (1) An industrial connection of natural gas or electricity
- (2) A commercial connection of natural gas or electricity
- (3) A residential connection of natural gas or electricity
- (4) An industrial connection of water

- A** 1, 2, 3 and 4
- B** 3 and 4 only
- C** 1, 2 and 4 only
- D** 1 and 2 only

In order to broaden the tax base, the legislature has taken a number of measures so that potential taxpayers register with the tax authorities. One such measure was to make registration with the income tax department a pre-requisite to apply for electricity and gas connections for commercial and industrial purposes. Since this requirement did not apply for residential connections of these utilities, Option **A** and **B** were incorrect on this basis alone. Similarly, as regards Option **C**, it

included an industrial connection for water which also did not require registration, hence this option was also incorrect. The only option remaining was **D** which was the correct answer. The candidates could have reached the correct answer by this method of elimination of incorrect options.

Example 2

The following amounts were received by Ms Abrish from her employer Qadeer (Pvt) Ltd in the tax year 2017:

(1)	Gratuity from an unapproved gratuity fund	Rs. 150,000
(2)	Basic salary	Rs. 800,000
(3)	Utility allowance	Rs. 80,000

What amount will be taxable as income from salary in the hands of Ms Abrish for the tax year 2017?

- A** Rs. 1,030,000
- B** Rs. 955,000
- C** Rs. 800,000
- D** Rs. 950,000

The basic salary and utility allowance are fully taxable under the head 'salary'. However, a gratuity from an unapproved gratuity fund is exempt up to Rs. 75,000, or 50% of the actual amount of gratuity received from an unapproved gratuity fund, whichever is lower [Clause (13)(iv) of Part I of the Second Schedule]. Hence the correct answer was option **B**. However, many candidates selected option **A**, which included all three amounts, perhaps prompted by the word "unapproved" in respect of the gratuity, making them believe that it was fully taxable which is not in accordance with the law on the subject. Similarly option **C** was also incorrect because it only included basic salary and excluded the full amounts of the gratuity and utility allowance. Option **D** taxed the basic salary and gratuity in full but excluded the utility allowance. This option was also incorrect because whereas the utility allowance will be fully taxed, out of gratuity, only Rs. 75,000 is taxable.

Salary taxation is a very important area of the syllabus. Future candidates are advised to ensure that they learn the different types of allowances and perquisites which are treated as part of salary and the extent and manner of their valuation and taxation.

Section B

Question One

This 10 mark question covered the method of accounting for, and the set off of, different categories of losses.

Part (a) for 2 marks required candidates to explain the difference between the cash basis of accounting and the accruals basis of accounting. Whilst the answers of most candidates were correct regarding the cash basis of accounting, some were incorrect as regards the accrual basis of accounting. The correct understanding of the methods of accounting is important because the

method of accounting determines whether a revenue receipt is to be offered for tax in a particular tax year or not. Similarly, allowability of expenditure during a particular tax year also depends on the method of accounting permissible to the taxpayer. In accrual-basis accounting, income is accounted for when it becomes due to the person whether received or not and expenditure is recorded when it becomes payable by the person whether actually paid or not. [s.34(1)]. In cash-basis accounting the revenue is recorded when payment is received and expenses are debited at the time of their payment.

Part (b) for 4 marks dealt with the procedure to be adopted for changing the method of accounting employed by a taxpayer. Many candidates were not aware of the correct procedure. The change in the method of accounting is allowed by the Commissioner Inland Revenue (‘CIR’) on the application of a taxpayer after the CIR is satisfied that the change was necessary to clearly reflect the taxpayer’s business income chargeable to tax. In the changing process it is ensured that each item of expenditure and income is necessarily accounted for once (that is neither missed from accounting nor recorded more than once).

Part (c) carried 4 marks. A brought forward business loss was to be set off against income from the business only and not against salary income or income from other sources. Further loss from a speculation business could have been set off against income from another speculation business only and not against any other head of income. Some candidates were not aware of these points of law.

Question Two

This 10 mark question was not answered well by the majority of candidates. It dealt with admissible tax credits on taxable income earned by a company from the establishment of a new industrial undertaking [u/s 65D]. A number of candidates were not aware of the relevant points to the admissibility of this tax credit.

Part (a) carrying 2 marks required candidates to state the initial and terminal dates during which period the tax credit was admissible. The tax credit under consideration is available for a period of five years beginning on the later of the date of setting up of the business or the commencement of commercial production (1 July 2016). Hence the terminal date will be 30 June 2021.

Part (b) carried 3 marks for the calculation of the tax credit. Only a few candidates computed the correct amount of tax credit, by calculating the amount of tax payable before the tax credit and then multiplying it with the figure of equity capital and dividing by total capital:

The tax on the taxable income was Rs. 372,000 and the tax credit was Rs. 318,857($372,000 \times \frac{6,000,000}{7,000,000}$).

Part (c), for 5 marks, required candidates to identify the situations where the tax credit allowed [u/s 65D] may be subsequently treated as wrongly allowed, and the consequences thereof. A tax credit allowed earlier to a company can be treated as wrongly allowed if the business is discontinued within the five years subsequent to the tax credit being allowed or if it was subsequently found that any of the conditions were not fulfilled. Many candidates were not aware of the first situation of discontinuance of business in the immediately following five years. If the tax credit is found to have been wrongly allowed, it would become recoverable and all the relevant provisions for recovery of tax shall apply.

Question Three

This 10 mark question covered the topic of capital gains. The question was fairly well attempted by the majority of candidates. However, the following common mistakes found in some papers are pointed out to be kept in mind by future candidates:

- Candidates need to recognise capital gains which are taxable as a separate block of income and the others which are taxable as part of the total income. Capital gain or loss on disposal of securities, as defined in section 37A, and immoveable assets are not eligible for tax depreciation and are treated and taxed as separate blocks of income.
- The gain on the disposal of an antique is taxable but the loss on the disposal of such an antique is not deductible when computing the taxable capital gain assessable under the normal tax regime. Hence, while the capital gain on the disposal of an antique saloon car was taxable, the loss on the disposal of an antique coin was not allowable for set off. Furthermore, some candidates did not restrict the capital gain on the disposal of the antique saloon car to 75%. Where an asset is disposed of after holding it for at least one year, only 75% of the capital gain will be taxed.
- When computing the capital gain on the disposal of the guest house, many candidates deducted expenditure of Rs. 50,000 incurred on minor repairs, which was not deductible from the sale proceeds because it had not added to the value of the guest house.

Question Four

This 10 mark question covered the topic of sales tax. Part (a), carrying 2 marks, asked the candidates to explain the meaning of the term, “business bank account” for the purposes of the Sales Tax Act, 1990. A business bank account means a bank account which is used by the registered person for carrying out his business transactions and which is declared to the concerned Commissioner Inland Revenue (‘CIR’) as such. The declaration to the CIR was not mentioned by some candidates.

Part (b) for 8 marks required computation of sales tax on different transactions conducted by a registered person during February 2017. The majority of candidates attempted the question very well. However, two common mistakes were made:

- local supplies to diplomatic missions in Pakistan were taxed rather than treated as exempt; and
- exports made to Dubai with the intention of their re-import into Pakistan were treated as exempt whereas they are chargeable to tax.

Question Five

This 15 mark question was split into three parts. Part (a) for 2 marks required candidates to state whether Plastic Goods (Pvt) Limited (‘PGPL’) incorporated under the Companies Ordinance, 1984 and having its control and management partly outside Pakistan, was a tax resident in Pakistan or not during the tax year 2017. Some candidates treated PGPL as non-resident on the basis that full control and management of the affairs of the company were not in Pakistan at any time during the tax year. Future candidates should keep in mind that if a company is incorporated or formed by or under any law in force in Pakistan, it is to be treated as resident in Pakistan irrespective of whether other conditions are fulfilled or not. *[Note : The Companies Ordinance, 1984 has now been replaced by the Companies Act, 2017.]*

Part (b) carried 11 marks and required the computation of the taxable income of a company. The following common mistakes were noted:

- The expenses already deducted to arrive at the figure of profit before tax and are admissible under the tax law, should not be deducted again to calculate taxable income, otherwise it will result in the double deduction. These items should be mentioned and explained separately as, 'Items not included in the computation of taxable income'.
- Accounting depreciation should be added back to the profit before tax, and tax depreciation should then be computed on the eligible depreciable assets as per the law and at the rates given in the initial pages of the question paper itself (taken from the Third Sch.).
- The car prize valued at Rs. 1,700,000 given to a dealer without deduction of tax is inadmissible expenditure and should have been added back to the profit before tax to calculate taxable income.
- Entertainment expenditure of Rs. 400,000 incurred at the time a new sales outlet was opened is allowable because the law considers it to be for the purposes of business [s.20(1) and Rule 10(1)(e) of Income Tax Rules, 2002]. Some candidates disallowed it incorrectly.
- The initial allowance of 25% of the value of the new computer hardware added during the year was admissible. Some candidates were found to be unaware of this provision of law.

Part (c) for 2 marks required the computation of tax payable on the taxable income computed in part (b) of the question. The majority of candidates secured full marks.

Question Six

This 15 mark question required candidates to calculate taxable income and tax payable for a salaried person.

Mistakes noted in the scripts included:

- The training allowance was incorrectly treated as exempt from tax whereas it fell in the definition of salary and was taxable.
- The dangerous working conditions supplement was wrongly treated as exempt by some candidates.
- Where both a medical allowance and reimbursement of medical expenditure are part of salary as per terms of the employment, reimbursement of medical expenditure would be exempt and the medical allowance would be taxable. However, where only medical allowance is given to the employee, it is exempt upto 10% of the basic salary. Some candidates taxed the amount of reimbursed medical expenses. A few others exempted the medical allowance wrongly.
- Perquisite of car was also not correctly computed and was taxed by a number of candidates. The cost of the car incurred by the employer was Rs. 1,150,000. Since the car was given to Ejaz for personal as well as business use, only 5% of the cost was taxable. However, the running expenses of the car should have been prorated according to the 20% use of the car for personal purposes. Many candidates taxed the whole amount of expenses of Rs. 230,000 instead of restricting it to 20% at Rs. 46,000.

It should be remembered that giving a car to an employee for their use and reimbursement of the running expenses are two different perquisites and are to be valued differently as was the case in this question.

- Future candidates are advised to give attention to the dates mentioned in the question. In this question a concessional loan advanced to Ejaz on 1 January 2016 was carried forward to the tax year 2017, hence, it was utilised for the whole year. Some candidates computed the value of the perquisite for six months only which gives the impression that they misread the date of advancing the loan as 1 January 2017 instead of 1 January 2016.