



Examiner's report

F6 (PKN) Taxation

June 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 (carrying two marks each) which covered a broad range of syllabus topics. Section B had four questions worth 10 marks each, and two longer questions worth 15 marks each, testing the candidates' understanding and application of tax laws at Fundamental level to corporate and non-corporate entities.

Before proceeding further, I would advise candidates of F6 to make sure that they apply for and prepare for the same variant of F6. F6 PKN Taxation (Pakistan) deals with Pakistan tax laws. Perusal of a number of irregular scripts appeared to show that they prepared for F6 UK but by mistake had opted for F6 PKN Taxation (Pakistan). A few answer scripts contained references to HMRC, NSI, £, etc. which did not relate to Pakistan taxation. Before applying for the examination, make sure that you are applying for the variant which you actually intend to sit in the examination and prepare accordingly to earn good marks. It may be noted that the staff conducting the examination in the examination hall are not authorised to change the paper and will provide only that question paper which was entered in the examination docket.

The following paragraphs report on each section and focus on some of the key learning points.

Specific Comments

Section A

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 (Pakistan) syllabus, rather than attempting to question spot. Each question is structured so that only one given choice is correct. All others contain one or more mistakes. The candidates can reach the correct answer by eliminating the incorrect choices [on the basis of errors therein]. Mere guess-work is normally not helpful. 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

On 23 September 2016, Mr Gulzar acquired a diamond from his brother against a payment in cash of Rs. 210,000 and a motor bike having a market value of Rs. 50,000. On 30 June 2017, the fair market value of the motor bike and the diamond were estimated to be Rs. 55,000 and Rs. 300,000, respectively.

What amount will be the cost of the diamond for the purposes of its treatment under the head, 'capital gains'?

- A Rs. 260,000
- B Rs. 300,000
- C Rs. 265,000
- D Rs. 210,000

This question tested knowledge of the candidates regarding determination of cost of an asset acquired for a consideration paid both in cash and kind. According to section 76 (2)(a) of the Income Tax Ordinance, 2001 (the 'Ordinance'), the cost of an asset purchased by a person shall be the "total consideration given by the person for the asset, including the fair market value of any consideration in kind determined at the time the asset is acquired."

The correct answer was option **A** because it consisted of cash paid of Rs. 210,000 and the fair market value of the motor bike of Rs. 50,000 on the date of acquisition. All other options were incorrect because:

- (i) Option B took into consideration the fair market value of the diamond on the last day of the tax year and not of the assets [cash and motorbike] given as consideration;
- (ii) Option C took into consideration cash paid and the fair market value of the motor bike *on a date other than the date of acquisition* of the asset; and
- (iii) Option D did not take into consideration the value of motor bike given in consideration on the presumption that only consideration paid in cash was the cost of the asset.

The point examined in this question is often part of 10 marks question in one form or the other or tested in MCQs. The candidates can perform well if they keep in mind the factors [given in Section 76 of the Ordinance] which are to be taken into consideration while computing the cost of acquisition of an asset.

Example 2

Fauzia purchased a saloon car for Rs. 3,000,000 on 1 January 2017 for exclusive use in her decoration business.

What is the maximum amount of capital allowances which Fauzia can claim for the year ended 30 June 2017?

- A** Rs. 450,000
- B** Rs. 187,500
- C** Rs. 225,000
- D** Rs. 375,000

The question simply tested the following basic knowledge:

- a. Depreciation allowance on an asset is allowed for the whole year even if it is used for one day.
- b. The value of a car used for business for tax depreciation purposes is to be restricted to Rs. 2,500,000, except where it is used for plying for hire.
- c. Rate of depreciation to be applied was 15% as given in the paper itself.

So the correct answer was **D** i.e. $\text{Rs. } 2,500,000 \times 15\% = \text{Rs. } 375,000$.

The topic of Capital allowances is regularly tested in each F6 PKN Taxation (Pakistan) paper in one or more questions. Study of Section 22 and 23 of the Ordinance can equip the candidates with the principles to be applied while computing capital allowances. The rates of the capital allowances are provided in the paper itself. Section 22(13)(a) states that value of a car not used for plying for hire is to be reduced to Rs. 2,500,000. There is no restriction on the tax depreciation claim on the basis of number of days or months used. Further such car was not eligible for initial allowance. Thus the options other than **D** were incorrect, because:

- (i) In option **A**, the cost of the car was not reduced, for tax depreciation purposes, to Rs. 2,500,000 ; therefore tax depreciation amount computed was not correct;
- (ii) In option **B**, though rate was correctly applied on the correct value, the tax depreciation was computed for six months, hence the computed amount of tax depreciation was not correct;
- (iii) In option **C**, value of car was not reduced to Rs. 2,500,000 which led to wrong calculation. Further, tax depreciation computed was wrongly reduced to half on account of six month use.

Section B

Question One

This 10-mark question covered the topics of filing of return and consequences relating to non-filing or late filing of return and late deposit of tax.

Part (a) for five marks required candidates to explain the conditions which were to be fulfilled to prevent a provisional assessment from being a final assessment. This question was not attempted well by the majority of the candidates. If due to non-filing of return of income, the Commissioner Inland Revenue frames a provisional assessment, the taxpayer can get this assessment abated by filing a return of income within 45 days of the receipt of the provisional assessment. So in the given case, the return is to be filed by 30 July 2017 and is required to be accompanied by audited accounts or final accounts, as the case may be, and documents for audit by the Commissioner Inland Revenue.

Part (b) for five marks required candidates to compute penalty for late filing of return of income and default surcharge for late deposit of the tax. In the given scenario, the return of income was filed late by 10 days. Tax payable with the return was Rs. 32,000 on which penalty was to be computed at 0.1% per day. Hence, it computed to Rs. 320 [32,000 x 0.1% x 10]. Because the computed amount was less than the minimum amount of penalty of Rs. 20,000, the amount of penalty to be paid by the taxpayer was Rs. 20,000. Default surcharge was to be computed at 12% per annum of the amount of tax for the 20 days of default in the given scenario. Hence, default surcharge to be paid was Rs. 210 [32000 x 12% x 20/365].

Many candidates failed to score marks because they did not know the correct amount of minimum penalty to be levied in such cases. Most of the candidates were not aware of the parameters to be used in the computation of penalty and default surcharge.

Question Two

This 10 mark question tested knowledge of the candidates about taxation of income from property. On the basis of analysis of different scripts, the future candidates of this paper should realise that:

- (i) In the case of a non-corporate taxpayer, the gross income from property is taxed as a separate block without any allowing any expenditure or allowance like repair allowance, etc. However, no tax is charged if gross income from property does not exceed Rs. 200,000 per annum and there is no other income.
- (ii) Where a property is held by more than one individual and they have definite and determinable shares in the property, income from property is taxed in the individual hands as per share of each person and not as an association of persons.
- (iii) In the case of a company, certain listed deductions and expenditures [listed in section 15A] are allowed while computing income from property and the income is assessed by adding to any other income under any other head of income. In the given case there was no other income of the Landowner (Pvt) Ltd. Hence, it was to be taxed at 31% after allowing the admissible deductions.

A common mistake found in the answers was allowing actual expenditure of repair and maintenance. The candidates should remember that law allows 1/5th of the rent chargeable to tax in respect of the building for the year as repair allowance irrespective of the actual expenditure incurred on the repair and maintenance of the property.

Future candidates must take note of the above points to earn good marks from this important area of the syllabus.

Question Three

This 10-mark question covered the topic of capital gains. The majority of the candidates did well. However, the following mistakes were found, despite featuring in examiner's reports of the previous examinations.

- (i) Capital gain on the disposal of the assets [other than immovable property and securities] held for more than one year is to be reduced to 75% and added to income, if any, under other heads of income. The rate of tax is applied as applicable to that person's taxable income.
Capital gain on the disposal of each security and on each immovable property is taxed separately at the applicable rates given in the paper.
- (ii) Candidates should know that shares of the private limited companies are not to be taxed as a separate block of income because they are not included in the definition of "securities" for the purposes of computing capital gains under the Ordinance.
- (iii) Gain on the disposal of land to the Punjab government was taxable and not exempt because it did not fulfil the conditions of the exceptions from taxation. The proceeds were not invested in the asset similar to the one compulsorily acquired by the Punjab Government, hence the gain was not exempt from tax.

Question Four

This 10-mark question covered the topic of sales tax. Part (a) required computation of sales tax on the given transactions during September 2016. Part (b) for two marks required the candidates to give names of any four goods on which sales tax is charged on a retail basis under the Third Schedule to the Sales Tax Act, 1990.

In Part (a), the mistakes noted included taxing exports at 17% instead of zero percent, non-charging of tax on goods consumed at home, and non-charging of extra tax at 2% on the goods sold to un-registered persons. Input tax was also not correctly computed by some candidates. Sales tax paid on purchase of Rs. 100,000 of which payment was made through cash was not admissible.

Answers to part (b) included many household items such as shampoo, toothpaste, toilet soap, ice cream, tea, shaving cream, bottled water, shoe polish, detergents, etc on which tax is charged at 17% of their retail price. Only four such names were required. Many candidates were unaware of these goods. Candidates should familiarise them with the different categories of supplies, like zero rated, exempt supplies and supplies taxable on a retail price basis.

Question Five

This 15-mark question was based on a manufacturer company listed on a stock exchange in Pakistan. The goods were exempt from the sales tax. Part (a) for 12 marks required computation of taxable income of the company and part (b) required computation of tax on the taxable income. Although a few candidates obtained very good marks, the majority of the scripts were unsatisfactory. This core area of the syllabus deserves more attention of the candidates seeking high marks in the examination. Many candidates seemed to have not prepared for this area of the syllabus properly.

To compute taxable income from a given income and expenditure statement like part (a) of this question, the candidates, to avoid mistakes, should begin their answers with the figure of profit before tax and then addback

the amounts which are not deductible under the Ordinance and subtract the amounts which are not included in the computation of accounting income but are admissible in the computation of total income/taxable income. A number of candidates started with the figure of turnover, then were confused which figures were to be added back or deducted, leading to either double additions or double deductions. If you start with the figure of turnover [which is not recommended] then make sure that you only subtract the tax admissible deductions to reach the taxable income.

Some candidates added back full amounts of non-current assets to compute taxable income which was wrong. Non-current assets were not to be added back because none of them were subtracted while computing accounting income. Only accounting depreciation was to be added back and tax depreciation was to be deducted as per section 22 read with the Third Schedule to the Ordinance. Total payment for raw material of Rs. 100,000,000 was paid without tax deduction. Some candidates added back the whole amount, others did not add back any amount. The disallowance was to be made but it was to be restricted to 20% of the raw material. Hence, on account of non-deduction of tax only Rs. 20,000,000 were to be added back [u/s 21(c)].

Some candidates wrongly added back leave fare assistance paid to the employees of the taxpayer according to their terms of the employment. The amount being part of the salary was fully admissible. Expenses incurred on the failed takeover at Rs. 800,000 was not admissible because it was not for the purposes of the existing business. It was capital in nature and was to be added back. Professional fee of Rs. 450,000 paid to an arbitrator for resolution of a trade dispute was fully admissible and did not need any adjustment. Many candidates added back it wrongly.

The basic principle to be kept in mind is that only those expenses which are incurred for the purposes of the running the taxable business of a taxpayer are admissible provided that they are not inadmissible under section 21 of the Ordinance. It is recommended that the candidates should study and practice computation of income under each head of income.

Part (b) for three marks required computation of tax payable on the taxable income and then deducting:

- i. 20% of tax as tax credit admissible for listing of the company on the Karachi Stock Exchange [s. 65C]
- ii. the amounts of tax already paid/deducted at source during the tax year 2017.

The majority of the candidates did not allow the tax credit admissible on account of listing of the company on the Karachi Stock Exchange. Some candidates also made the mistake of deducting the amounts of tax paid from the taxable income instead of from the tax payable on such taxable income.

Question Six

This question carried 15 marks and was set to compute taxable income of a salaried person and the tax payable thereon. In case of salary income, the general principle should be kept in mind that all allowances, benefits received by an employee in connection with performance of his employment are taxable provided that they are not exempt under any clause of the Second Schedule to the Ordinance. As regards perquisites, their value is to be computed as provided in section 13 of the Ordinance and the related rules. In case there is any benefit derived under the employee share scheme, section 14 the Ordinance comes into play. By correctly applying the principles given in these few provisions, the candidates can earn 15 easy marks.

In this session mistakes found in respect of certain items are clarified below:

- i. Medical allowance is exempt only to the extent of 10% of the basic salary. The excess amount of Rs. 21,600 was therefore taxable in the hands of Saima.

- ii. Where a car is provided for personal as well as business use, 5% of the cost of the car incurred by the employer is to be treated as salary income. The value of the car on 30 June 2017 was not relevant for the purpose. Hence, Rs. 100,000 [2,000,000 x 5%] was to be added back as salary income. Many candidates added full amount or wrong amount. [Rule 5 of the Income Tax Rules, 2002 gives guidelines for the valuation of this perquisite for tax as salary income].
- iii. Profit of Rs. 500,000 paid on loan for the acquisition of the residential house by Saima was eligible for deduction being lower than both: 50% of the taxable income and maximum ceiling of Rs. 2,000,000.
- iv. Donation of Rs. 50,000 paid to a school run by the local government was eligible for tax credit. Many candidates did not give this credit. Others deducted it fully from the taxable income whereas it was eligible for a tax credit at average rate of tax from the tax payable by Saima as under:
- | | |
|-----------------------|---------------|
| Taxable income | Rs. 3,160,600 |
| Tax on taxable income | Rs. 395,635 |
- Donation was within the upper ceiling of 30% of the taxable income, tax credit was admissible as Rs. 6,259 [Rs. (395635/3,160,600) x 50,000].

In conclusion future candidates should study the whole syllabus and keep in mind the deciding factors in the given situations to reach a correct answer.