



Examiner's report

P6 Advanced Taxation (HKG)

December 2015

General Comments

The examination consisted of two compulsory questions in Section A and two to be selected out of three questions in Section B. Section A contained question 1 for 35 marks and question 2 for 25 marks. Section B comprised three further questions of 20 marks each.

The vast majority of candidates attempted all five questions, and there was little evidence of time pressure. Where questions were left unanswered by candidates, this appeared to be due to a lack of knowledge or poor exam technique, as opposed to time pressure.

Most candidates followed the order of questions and answered question 1 first, followed by question 2 and so on. As question 1 gave the highest mark of 35, this approach is recommended but caution should also be taken to avoid spending too much time in questions 1 and 2, leaving inadequate time to complete the remaining two questions from Section B.

Most candidates who passed the paper earned substantial marks from questions 1 and 2. In general, relatively better performance was found in questions 1(a)(i), 1(b), 1(c)(ii), 1(d), 2(b), 2(c), 3(c)(ii), and 4(a). The questions candidates found most challenging were questions 1(a)(ii), 1(c)(i), 2(a), 3(a), 4(b), 5(a), 5(b) and 5(c). This was mainly due to candidates' difficulty in understanding the underlying concepts and applying the integrated knowledge in practical scenarios, and also due to the failure to read the question requirements carefully. Question 5 was the question where performance was the least satisfactory and this question tested the tax position of an overseas entertainer. Some candidates misinterpreted the engagement of the entertainer as an employment contract while others failed to give adequate explanations of the tax treatment.

Broadly speaking, most candidates confused the underlying concepts of taxability and deductibility of similar items between individuals and corporates, and between salaries tax and profits tax. For example, a compensation payment to staff was treated as deductible to the employer for the reason that the same payment was taxable on the staff, or vice versa. Another common problem was that some candidates tended to repeat the facts given in the question without relating these facts to technical reasoning.

A number of common issues arose in candidate's answers:

- Using inappropriate language to describe the tax treatment. For example, 'income is taxable' was described as 'income does not need to be added back'; or 'expense is deductible' was described as 'expense does not need to be deducted'. As in question 1(a)(ii) where a dividend is not taxable on the shareholder and non-deductible to the paying subsidiary, some candidates answered that 'there is no tax implication of the dividend'.
- Failing to read the question requirement clearly and therefore providing irrelevant answers which scored few if any marks. For example, in question 1(c)(i) and (ii) where part (i) dealt with the deductibility of items under profits tax and part (ii) dealt with the taxability of items under salaries tax - some candidates mixed up both.
- Poor time management between questions, some candidates wrote far too much for some questions (for example question 1) and this put them under time pressure to finish remaining questions.
- Poor layout of answers and simply repeating the facts given in the question.

Specific Comments

Question One

This 35-mark question was based on a business restructuring plan of a Hong Kong company manufacturing and selling macaroons after its shares were acquired by a new shareholder. It tested candidates' ability to integrate knowledge of profits tax, salaries tax and stamp duty in treating similar items, such as capital injection as opposed to borrowing, termination payments to staff, and restructuring of employment into a service company. Candidates were required to present their answer in the form of report for the company's directors.

Part (a)(i) and (ii) asked about stamp duty implications on the share acquisition and the different tax positions arising from capital injection and borrowing from the shareholder. The performance was generally average for (i) except that some candidates incorrectly answered that Head 2 only applied to listed shares. Most candidates failed to define 'Hong Kong stock' correctly or wrongly explained that a company incorporated or carrying on business in Hong Kong was 'Hong Kong stock'. Performance for (ii) was not satisfactory as most candidates only focused on the 'source' of interest income but failed to address that the shareholder was an individual who might not be a money-lender. Some other candidates incorrectly answered that interest income was capital and non-taxable for the reason that the loan was extended from a shareholder or the loan fund was capital in nature. Other candidates incorrectly applied 'exemption order' to interest earned by the shareholder. Another common mistake was that most candidates spent too much time on explaining each of the conditions [under s16(2), s16(2A) and s16(2B)].

Part (b) was, in general, fairly answered as most candidates were able to address the tax position [under s15(1)(b)]. Some candidates were only able to state that the 100% basis applied for the reason that the payer and recipient were associates, but forgot that the brand name had been owned by a company carrying on a business in Hong Kong before.

Part (c)(i) and (ii) were confused by some candidates. Some candidates explained that the taxability of the payment items to the staff depended on the deductibility of the same items to the employer. The analysis of the payment for the restrictive covenant was not satisfactory. The fact that the payment for the restrictive covenant was pre-arranged and included in the employment contract would render the payment taxable to the employee but does not affect the deduction position to the employer. To the employer, the deductibility depends on whether the payment is capital in nature or not.

Part (d) tested a Type I service company [under s9A]. Performance here was generally good, except that some candidates misinterpreted the mechanism as self-employment. Strictly speaking, the self-employed scenario is different from the service company scheme.

Question Two

This 25-mark question covered individual tax issues.

Part (a) required candidates to analyse the different implications under offshore employment as opposed to Hong Kong employment, as well as choosing between moving the whole family to Hong Kong or not. Most candidates got marks for explaining the *Goepfert* principles, but were weaker in explaining the different treatments under offshore and onshore employment. Some candidates incorrectly answered that the *Goepfert* principles were applied to determine whether the employment income was taxable or not. Employment income was confused with director fees. The 60-day rule was wrongly applied only to offshore employment. The general observation was that candidates did not master the concept well enough, and chose to include all points in their answers (even including contradictory points) for all scenarios. As for the decision to move the family back to Hong Kong, most candidates included the related Part V allowance here, without noticing that the Part V allowance was actually separately tested under Part (b). The consequences were repetition of points under both parts. Candidates should be aware that no duplication of marks would be given.



For part (b) on Part V allowance, most candidates performed satisfactorily except that married persons' allowance was incorrectly applied only when the wife was in Hong Kong.

Part (c) involved the tax treatment of housing accommodation as opposed to housing allowance. Performance was generally satisfactory, except that 8% instead of 10% rental value was often incorrectly applied. Part (d) was answered reasonably well but many answers were only confined to the treatment of income from property in Canada. As for the share option granted when the employee was under offshore employment, some candidates did not address this correctly, and explained the whole formula of calculating the taxable amount arising from exercise of share option.

Question Three

This 20-mark question was focused on the taxability of interest income by corporate and individuals, as well as deductibility of interest expense for individuals. Future candidates are referred to a recent technical article published on the ACCA website on interest expense pitfalls for individuals and available at the link below –

<http://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f6/technical-articles/interest-deduction.html>

Candidates are encouraged to read technical articles written by the examining team which are available on the website.

Performance on this question was not satisfactory. Under part (a), many candidates were confused between the provision of credit test and the operation test or the contract effected test. While the provision of credit test was applied when the loan was extended not in the course of a money-lending business, some candidates incorrectly concluded that interest income arising from the loan to employees was not taxable for the reason that the employer was not a money-lender. The underlying concepts appear to have been confused.

For part (b), most candidates were able to state the s16(1) applied but failed to give the correct conclusion. Some said that the write-off of the loan balances was not taxable as the loan interest income had not been taxed (but interestingly, the same candidates concluded that the interest income was taxable under part (a)) Other said that the write-off of the outstanding loan balances was not taxable without giving reasons. It is suggested that these candidates only memorised the treatment of the items but did not master the correct reasoning.

A similar problem was observed in part (c)(i) where the conclusion was correct but the reasoning was either incorrect or absent. Savings in loan interest is not a taxable income item to staff, but most candidates failed to give the correct reasoning. Quite a few candidates cited that it was only a 'fringe benefit' and thus not taxable. Part (c)(ii) was relatively better tackled, in particular the conditions giving rise to a deduction of home loan interest. However, some candidates wrongly concluded that no home loan interest was deductible for the reason that the loan was not obtained from a financial institution.

Question Four

This 20-mark question was based on a group restructuring, and the majority of marks were assigned to stamp duty and capital vs revenue analysis. Performance under part (a) on analysis of 'trade' was average if candidates correctly addressed the 'badges of trade'. However, some candidates only concluded that the profit was taxable because the subject was Hong Kong shares.

Part (b) on the treatment of trading stock upon cessation was not well-addressed by many candidates. Some candidates answered that the sale of the trading stock upon liquidation was not a sale and thus not taxable. Other candidates provided too much detail on balancing charges arising from the sale of properties, without being aware that the properties were treated as trading stock and thus no depreciation should have been given.

Performance in part (c) was fair in relation to stamp duty. The part relating to the distribution of properties as *specie* upon liquidation was not satisfactory, in particular some candidates treated the distribution as asset deal/transfers.

Question Five

This 20-mark question tested a scenario involving an overseas entertainer giving performances in Hong Kong. Performance was not as good as expected as most candidates either incorrectly applied s15 or mistakenly applied salaries tax to the entertainer. Other candidates applied the concept of 'permanent establishment' and deemed Queens Ltd to be the PE of the entertainer. Most candidates managed to attempt the tax withholding parts of this question, but struggled to provide the other relevant parts of the solution. Performance was poorest in part (c) as most candidates concluded that no more withholding applied upon the set up of the limited company.