

Examiner's report

P6 (HKG) Advanced Taxation

December 2016



ACCA

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 optional questions of 20 marks each.

Most candidates were able to finish four questions as required, however, some candidates were found to have spent too much time on questions 1 and 2, leaving inadequate time to complete the remaining two optional questions. Time management remains a challenge to most candidates.

Despite the fact that most candidates attempted all questions, performance remains disappointing, and in particular the weakness in understanding the fundamental concepts of profits tax charge as examined in question 1. Some other candidates demonstrated deficiency in understanding the basic tax rules such as interest deduction rules and employment income assessability principles.

Overall candidates performed reasonably well in questions 1(a)(i), and 4(a). On the other hand, many candidates performed unsatisfactorily in questions 1(a)(ii), 1(b)(iii), 3(b), 4(b) and 5(a) and (d).

Specific Comments

Question One

This 35-mark question was a typical scenario of a Chinese company making sales in Hong Kong via a consignment agent, which is subsequently changed to an incorporated subsidiary in Hong Kong. It examined the chargeability of non-residents to Hong Kong profits tax arising from sales made in Hong Kong through an agent as opposed to a subsidiary, the eligibility of carrying forward the tax losses in a company due to a change in shareholding, and the rules on interest deduction. All the topics are commonly examined although this question focused on non-resident rather than Hong Kong taxpayers. The specific observations and common issues experienced by candidates were:

- (a) Not all candidates were able to identify limb 1 and limb 2 under s14. Some quoted that tax would be charged if business is carried on in Hong Kong, some others quoted that tax would be charged if only business or profits are sourced in Hong Kong.
- (b) Some candidates lack or have inadequate knowledge in the definition of 'permanent establishment' under IRR5; some candidates were only able to mention 'agent with full authority' but not 'agent with inventory of merchandise for regularly filling the customers' orders'; and other candidates simply regarded any type of 'agent' as 'permanent establishment'
- (c) Quite a number of candidates explained that the 'agent' in Hong Kong is not a permanent establishment but the Chinese company is 'still' subject to tax in Hong Kong, because sales are made in Hong Kong.
- (d) Most candidates could not explain how to arrive at the tax figure withheld by the agent, ie. the 1% (in practice, 0.5%) on gross sales proceeds. A lot of candidates just explained the calculation by way of sales minus agent's commission.
- (e) Most candidates missed the point that the agent is protected from any claim for withholding.
- (f) Most candidates concluded that the tax position of making sales through an agent is the same as that through a subsidiary.
- (g) On s61B tax avoidance rule, quite a few candidates were able to quote that tax loss after change in shareholding was subject to challenge, but could not cite the requirements of s61B correctly.
- (h) On interest deduction, a lot of candidates gave answers on taxability of interest income rather than deduction rules.

- (i) Candidates demonstrated weak understanding in interest deduction rules, and only repeated the question rather than explained with rationale.
- (j) Most candidates wrongly interpreted that interest expense's deductibility depends on interest income's taxability.

Question Two

This 25-mark question covered salaries tax and related principles. This topic is examined in every diet and most candidates were relatively well prepared for it.

Part (a) required candidates to analyse the principles leading to the assessability of different types of income. Most candidates started the question by analysing the source of employment by applying the *Goepfert* principles, and the exemptions under s.8(1A). Some candidates mis-interpreted that the source of employment determines the assessability of income, and thus all income would be taxable when the employment is HK-sourced. However, many went on to say that the 60-day rule applies to exempt all income and if exceeded, time apportionment is eligible. These candidates obviously have confused some principles and concepts and some specific observations include:

- (a) Candidates quoted that the 'central management and control' of the employer is in Hong Kong, thus all employment income is taxable; confusing profits tax with salaries tax.
- (b) Income would be taxable if it is paid in cash, which is wrong in concept.
- (c) Wrongly applying upfront and back-end approach on share 'option', and applying 'exercise' concept on share award.
- (d) Wrongly applying 60-day rule on HK-sourced employment
- (e) On part (c), many candidates provided appropriate analysis but drew the wrong conclusion, demonstrating that understanding in Article 14 was weak

Question Three

This 20-mark question focused on source of profits from trading and manufacturing. Most candidates who attempted this question were unable to distinguish manufacturing from trading, and thus combined location of manufacturing activity and contract effected tests together. On part (b), most candidates wrongly identified alternative 1 as 'import processing' and alternative 2 as 'contract processing' while their conclusion on taxability % was correct. This demonstrates that candidates struggled to draw a rational conclusion and were relying on rote learning.

Another significant reason for under-performance in this question was that many candidates did not answer the requirement asking for the implications arising from the transfer/sale of machinery and disposal of industrial building in this question.

Question Four

This 20-mark question focused on stamp duty arising from transfer of property and Hong Kong stock. In general, candidates' performance in this question was satisfactory, except that some candidates have obviously been following the out-dated law such as 24-month special stamp duty, and demonstrated a lack of knowledge about Scale One ad valorem duty. Part (b) for 4 marks asked about the implication if the transaction was executed outside Hong Kong. Performance of part (b) was not satisfactory as expected.

Question Five

This 20-mark question tested candidates' knowledge in tax administration, in particular to the case of additional assessment and related issues. Some candidates did not choose to answer this question although the issues covered are common and fundamental, indicating that candidates tend to skip administrative topics. Many of the candidates who chose this question did not perform well. Some candidates wrongly described additional assessment as 'additional tax assessment' which is a specific term used under s82A. Moreover, most candidates lost marks on the statutory time limit for additional assessment being 7 years instead of 6 years.