

# Examiner's report

## P6 Advanced Taxation (HKG)

### June 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. Candidates are required to attempt two out of three questions from Section B.

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.

The performance in this paper was not satisfactory. Most candidates who passed the paper earned substantial marks from questions 1 and 2. In general, more satisfactory performance was found on questions 1(a)(i), 1(a)(ii), 1(b)(i), 2(a), 2(c), 4(b) and 4(c). The questions candidates found most challenging were questions 1(b)(ii), 2(e), 3(b), 3(c), 4(a), 5(a), 5(b) and 5(c). This is mainly due to candidates not understanding core syllabus areas well enough; a lack of ability to apply and integrate knowledge in practical scenarios and also due to a failure to read question requirements carefully. Question 5, which had the poorest performance, tested the tax position of different components of rental income, and the advantages of taking a tax dispute case forward to Board of Review as opposed to court. While rental income is commonly examined, candidates were found unable to deal with similar case with variations. Question 4 tested special tax rules on a club and candidates who performed weakly on this question must not have prepared well for the topic.

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

- Using inappropriate language to describe tax treatment. For example, 'income is taxable' was described as 'income no need to be added back'; or 'expense is deductible' was described as 'expense no need to be deducted'.
- Failing to read the question requirement clearly and therefore providing irrelevant answers which scored few if any marks. For example, in question 5(b), some candidates discussed the appeal procedures instead of the advantages of appeal via Board of Review as required.
- 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.
- Not learning lessons from earlier examiner's reports and hence making the same mistakes, for example interest deduction.
- Providing more or less than the required number of points, for example in question 4(c) for 7 marks, most candidates only gave answers on stamp duty on leasing document but ignored stamp duty on conveyancing.
- Illegible handwriting, poor layout of answers and simply repeating facts given in the question.

#### Specific Comments

##### Question One

This 35-mark question was based on a group of companies manufacturing and selling smart phone accessories. It tested candidates' knowledge of ascertaining source of profits and related deductions, as well as the



implication of interest margin earned from inter-company funding arrangement. Candidates were required to present the answer in the form of a report for the company's directors.

Part (a)(i) for 14 marks required candidates to discuss whether the profits earned from the sale of smart phone accessories were taxable in Hong Kong, in particular addressing the source of manufacturing and trading profits based on the DIPN 21 and relevant court cases. Part (a)(ii) for 8 marks asked candidates to discuss the deduction issues in respect of the special machinery and moulds used in China.

Most candidates were able to address the broad guiding principles used to ascertain the source of profits and the concessionary 50:50 basis for manufacturing mode in China, but some candidates confused contract processing with import processing such that contradictory answers were given. Some candidates were able to apply different source tests to manufacturing and trading profits but not all candidates were able to conclude with reasonable explanations that the profits from the company were effectively trading profits rather than manufacturing profits. Other candidates even split the profits into two portions, one as trading and one as manufacturing profits. As for the deduction of capital cost under part (ii), a majority of candidates correctly mentioned that no deduction was allowed but incorrect or no explanation was given. Other than these, some common errors were found in this part as follows:

- Contract effected test: some candidates applied this test to both manufacturing and trading profits.
- Source tests: some candidates were not able to address the different tests applicable to manufacturing and trading profits. Some other candidates concluded that profits were sourced in Hong Kong because sales were made in Hong Kong without elaborating with reasons.
- S39E: not all candidates were able to address this. For those who were, answers mentioned that no depreciation allowance was granted as the machinery was used outside Hong Kong. This statement is strictly speaking not correct as s39E only applies to 'leased' plant and machinery. Only if the machinery was used by a person other than the taxpayer outside Hong Kong would cause the depreciation allowance to be denied.
- s16G: deduction for prescribed fixed assets was also disallowed due to the machinery being under 'lease'. However, not many candidates correctly addressed this, or mentioned that deduction was disallowed due to the fact that the machinery was not incurred in the production of assessable profits.

Part (b)(i) for 7 marks extended the source principle to interest income while deduction rules on interest expense and overseas withholding tax were also tested. The question also covered the deemed money lending transaction arising from the inter-company fund arrangement. A fair proportion of candidates were able to address the source rule on interest income and identify the deemed money-lending transaction, except that some had given confusing concepts. For example, the deduction rule of 'in the production of assessable profits' was wrongly applied to interest income. As noted in previous examiner's reports, candidates were often applying symmetrical approach to interest income and expense, which is incorrect. For example, a lot of candidates mentioned that since interest expense was not deductible, related interest income was not taxable. Although the logic may work in the opposite (i.e. if interest income is not taxable, relating interest expense is not 'in the production of assessable profits' and thus not deductible), the relationship between the two is not necessarily symmetrical. Candidates are strongly advised to read an earlier article written by the examiners entitled 'The pitfalls of interest deduction' which is available on the ACCA website.

Other common mistakes found for Part (b)(i) and (ii) were:

- Interest expense was not deductible as the loan was used by the borrower in the PRC.
- As the loans were arranged between associates, the interest income/expense must be non-taxable/non-deductible.
- Exemption order applied to exempt the interest income.
- China withholding tax was an expense item and thus deductible (no reason given).

- China withholding tax was deductible under 'tax credit' provision of China-HK double tax arrangement. (Candidates should take note that 'tax credit' provision under double tax arrangement only takes the effect to adjust the related tax payable at the residence country but not to allow for tax deduction.)

### Question Two

This 25-mark question covered individual tax issues.

Part (a) for 5 marks required candidates to discuss the different implications to Mary if she takes over the shares in a BVI company as opposed to the underlying business held by the company. A majority of candidates was able to address the difference between holding shares and holding the business, but could not articulately address the different tax implication to Mary in respect of the income earned. Moreover, most candidates did not present their answers clearly to distinguish their answers under the two different scenarios, and quite a lot of candidates spent too much time on addressing stamp duty issues on Head 2 as opposed to Head 1.

Part (b) for 4 marks tested candidates' knowledge on tax issues accrued to a partnership business. This topic is usually examined under Fundamental Level as part of a computation. In this advanced paper, no computation was required but candidates were expected to understand the specific tax rules and the implication to the partners. Performance was average.

Part (c) for 9 marks tested candidates' knowledge on salaries tax treatments on individual compensation items, and this part was the best performed. Again, salaries tax is frequently examined in the fundamental level paper and usually draws the most attention of candidates during daily life.

Parts (d) for 3 marks and (e) for 4 marks tested candidates' knowledge on home loan interest deduction and child allowance. In general, the performance on home loan interest was average but that on child allowance was unexpectedly disappointing. Not many candidates were able to address the rule that child allowance could not be split between spouses unless in special circumstances; and most candidates did not explain the eligibility rules for child allowance.

Some common mistakes found in question 2 were as follows:

- Income earned by Mary if shares are taken up would be subject to salaries tax.
- Partnership is taxed at 15%
- Salaries earned by partner's spouse are deductible.
- For source of employment, the 60-day rule under IRO and 180-day rule under PRC-HK double tax arrangement were confused.
- S8(1A)(c) was wrongly applied to offshore employment
- Correctly determined as offshore employment, but wrongly concluded that 100% income was taxable because either John is a HK resident or more than 60 days were spent in HK.
- China withholding tax on monthly salary was deducted before bringing into HK tax computation.
- Child allowance can be split between spouses

### Question Three

This 20-mark question was focused on transfer pricing and related issues. The question already stated the fact that a transfer pricing adjustment had been made by the China tax authority. The question under part (a) for 4 marks therefore asked the candidates to explain the relationship between the two subject companies and analyse how the transfer pricing adjustment done by the China authority would impact the whole group. However, a majority of candidates did not read the question carefully, and presented their answers with general transfer pricing principles and methodologies. Most candidates only repeated the facts of the question that the two companies were shareholder and subsidiary, without elaborating further with the definition of 'associated enterprise' under the related transfer pricing rules.



Part (b) for 4 marks drew on candidates' knowledge on tax administration, in particular s70A claim, and its application in this case. A fair proportion of candidates was able to address s70A claim but did not elaborate with sufficient details to score full marks.

Part (c)(i) and (ii) for 12 marks altogether tested candidates' knowledge of types of double tax relief and administrative issues. Performance on this part was weak as candidates did not read the PRC-HK double tax arrangement in sufficient detail with regards to transfer pricing topic. As this has remained a hot topic for years, candidates are reasonably expected to have mastered an adequate level of awareness of related issues.

#### **Question Four**

This 20-mark question was based on a recreation club and the related special tax rules and treatment. Although special business does not necessarily appear in every exam diet, it is included in the syllabus and the topic of 'club and trade association' is the most common type of special business to be examined. Candidates should be aware that all topics in the syllabus are examinable and should be prepared.

Part (a) for 3 marks tested candidates' knowledge on the tax treatment for club. Some candidates did not demonstrate an understanding that a club is subject to a special tax treatment, and thus presented their answers based on the general tax rules, in which case little marks were available.

Part (b) for 10 marks integrated a club's special rule with the basic tax law on property tax and profits tax. The most common mistake under this part was that candidates only focused on property tax implications for the carpark rental income but ignored the profits tax implications. Some candidates mentioned that rental earned from members were exempt but those earned from non-members were taxable. This illustrated a lack of knowledge about the special tax rule on clubs.

Part (c) for 7 marks covered stamp duty which is independent of the special tax rule on clubs. In theory, this part should be manageable by most candidates but some were found to have only covered the lease transaction but missed out the conveyancing.

#### **Question Five**

This 20-mark question also covered a lease transaction but incorporated different rental components subject to contingency. Part (a)(i) asked about profits tax and stamp duty implications and the performance was generally weak, in particular, contingency principle for stamp duty purposes was not well-addressed by some candidates. The different tax treatments on premium for profits tax and property tax were also not addressed. Moreover, a majority of students had incorrectly adopted 1% (instead of 0.5%) for stamp duty on the 3-year lease. Those candidates who were not familiar with the contingency principle did not answer well in part (a)(ii).

Part (b) for 4 marks asked about the advantages of taking an appeal to the Board of Review as opposed to the court. This was a practical question that required only general knowledge, but candidates' performance was not satisfactory. Some mistakenly mentioned that the Board of Review had a higher rank than the court.

Part (c) for 5 marks asked about the tax implication of the lump sum payment if it were disclosed differently in the accounts. This part was skipped by some candidates and some other candidates only discussed the accounting treatment rather than the tax implications.