

# Examiner's report

P6 Advanced Taxation

Jun 2016

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## 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.

Quite a number of candidates attempted only one optional question from Section B. This did not appear to be the result of time pressure. Question 4 on acquisition of business was not commonly asked and students seemed to be unprepared for it.

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

Overall, the performance in this paper was a little disappointing. Many candidates did not attempt all four questions. It is felt that candidates had not prepared fully for the less commonly asked questions (questions 4 and 5(b)) and there was evidence that they were rather weak at the fundamental concepts (treating reimbursement of rent as fully taxable; income from sub-letting as chargeable to property tax; and home loan interest deductible only under personal assessment or when conditions in s.16(2) under profits tax were satisfied (question 2)). In general, candidates who passed did reasonably well for questions 1(i) and 2.

## Specific Comments

### Question One

This 35-mark question was based on a Hong Kong company purchasing products from an associated company in the UK and selling these products in Hong Kong and PRC through a branch. It examined the chargeability of the profits from sales made in HK and PRC, the right of the IRD to raise additional assessment and the company's right to disagree, transfer pricing adjustment and double taxation relief, as well as the tax implications of replacing the PRC branch with a subsidiary. Candidates were required to present the answer in the form of a report for the company's directors.

Part (i) tested the source of trading profits, which is commonly examined in the past. Performance was generally good, except that some candidates just quoted the 'contract effected test' without providing any explanation, and some incorrectly stated that trading profits could be apportioned.

Part (ii) examined the right of the IRD to raise additional assessment under s.60(1) and the company's right to lodge an objection under s.64(1). Performance was quite good.

Part (iii) was on double taxation relief arising from transfer pricing adjustment. Most candidates failed to demonstrate an adequate knowledge and understanding of the related principles under the PRC-HK double taxation arrangement and DIPN No. 45. The topic on transfer pricing was commonly examined, and although the related double taxation relief was not, both are important issues for taxpayers.

Part (iv) asked about the profits tax implications of replacing the PRC branch with a PRC wholly-owned subsidiary, and whether the Hong Kong offshore claim and the potential transfer pricing risks would be resolved. Performance was less than satisfactory, as quite a number of candidates simply repeated what was discussed under part (i).

### Question Two

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

Part (a) required candidates to analyse the source of employment and the exemptions under s.8(1A), the application of time apportionment and to calculate the assessable income. Most candidates earned marks for explaining and applying the *Goepfert* principles, but were rather weak at explaining whether time apportionment and the 60-days rule applied. Major fundamental misconceptions include:

- applying time apportionment to Hong Kong-sourced employment;
- taxpayers under a Hong Kong employment could not visit Hong Kong;
- rental reimbursement was fully taxable as the employer did not exercise any control and the employee could sub-let the apartment; and
- assessing the reimbursement as well rental value.

For part (b) on income from sub-letting, many candidates incorrectly treated the income as chargeable to property tax only, or chargeable to both property tax and profits tax.

Part (c) examined the salaries tax treatment of home loan interest and low-interest-rate loan. Overall, performance was satisfactory. However, some candidates applied the profits tax provision of s.16 to determine the deductibility of the home loan interest, or had mistaken that the interest was only deductible under personal assessment.

### Question Three

This 20-mark question focused on stamp duty. Part (a) examined the stamp duty implications of transactions in residential property by Hong Kong permanent residents. Performance in this question was disappointing. Although candidates were aware of the difference between the Scale 1 and Scale 2 rates of *ad valorem* duty, they did not realise that when one of the co-owners already owned a residential property in Hong Kong, Scale 1 rates applied regardless of the fact that that owner was a close relative of the other owner. Instead, many candidates applied Scale 2 rates to the entire stated consideration; or Scale 1 rates to the respective share of the owner who already owned a residential property in Hong Kong, and Scale 2 rates to the respective share of the other owners. Some candidates found it difficult to explain that when one of the owners assigned his share at a nominal consideration to the other owners, the transfer had to be treated as a voluntary disposition *inter vivos* which is chargeable based on the market value; and chargeability of the instrument to buyer's stamp duty.

For part (b), most candidates were able to state the stamp duty payable on the contract notes and lease, although explanation of the application of the contingency principle was often omitted or inadequate; and the s.45 exemption was wrongly applied. In particular, instead of advising that stamp duty could be avoided by entering into the lease by oral agreement, many candidates relied on the s.45 exemption which does not apply to leases.

#### **Question Four**

This 20-mark question was based on a business acquisition, and the majority of marks were assigned to stamp duty and profits tax implications arising from the proposed sale of business assets including designs, shop premises and warehouse, plant and machinery, inventory, trade receivables and goodwill. In part (a), whilst most candidates were able to explain that profits arising from the disposal of capital assets were not taxable, there were some issues in applying the 'badges of trade' to the capital vs. revenue analysis to determine the nature of the asset. For those who were able to correctly explain the tax treatment, many did not go on to advise how the sale agreement could be negotiated in order to optimise the seller's own tax position. It is important to read the question carefully in order to correctly explain the tax implications of a sale of shares, instead of assets, of the business.

Part (b) examined the tax implications of the waiver of a debt owed by the seller to the buyer of business assets. Some candidates mixed up the stamp duty implications with the profits tax implications, and commented that the waiver of debt should be included as part of the purchase consideration for stamp duty purposes.

#### **Question Five**

This 20-mark question covered a scenario involving a newly commenced business which failed to lodge a timely profits tax return. Part (a) examined the company's compliance obligations under two scenarios with different year-end dates. Some candidates gave answers on the determination of basis periods for the year of commencement under the two different scenarios but did not address the compliance obligations under ss.51, 51C and 52 (notification of chargeability, filing of tax return, keeping of business records and compliance obligations as an employer). Candidates are reminded of the importance of reading the questions carefully.

Part (b) examined the s.82A notice and candidates were asked to identify the errors and/or defects in the notice. Although the penalty provisions are commonly examined, candidates found it difficult to apply their knowledge of the requirements for a valid s.82A notice to a given scenario.

Part (c) examined the meaning of the term 'reasonable excuse', and whether the company had any reasonable excuse for failing to lodge its profits tax return within the period required. Performance was satisfactory.