Examiner's report
P6 Advanced Taxation (CYP)
December 2012

General Comments

The paper consisted of two sections. Section A comprised two compulsory questions. Question 1 was worth 40 marks and included 4 marks for professional format and presentation, whilst question 2 was worth 30 marks. Section B comprised three questions, each worth 15 marks, and candidates were requested to choose two from three.

All candidates attempted four questions, although there was evidence that candidates were spending longer on question 1 that the marks warranted which limited the time available for other questions. This was particularly evident in candidates' final questions, where question parts were either answered briefly or omitted entirely. Effective time management is a crucial skill in passing the exam which candidates need to practise beforehand.

A number of candidates appeared to have rushed to answer the question before fully understanding what it was asking for. Candidates are advised to take time to read the question and requirement slowly and carefully, so as to be sure that they understand what they need to write to respond properly to the question set.

Candidates performed particularly well on parts (a), (b) and (e) of question 1 and parts (b) and (d)(ii) of question 2. Question 4 produced strong answers. From the optional questions, parts (b) and (c) of question 3 and part (d) of question 5 were particularly well answered.

Candidates found parts (i) and (iii) of question 2(d) challenging. In part (i) it seems candidates were looking for a more complex answer than the debt versus equity argument which was, in fact, a fairly straightforward analysis of the tax treatment of potential income and expenses. For part (iii) a large number of candidates did not consider a tax reorganisation scheme at all. Some of those who did were able to describe an appropriate scheme that would work in practice. Of the three optional questions, question 3 parts (a) and (d) were found to be the most difficult, with few candidates discussing the protector as an option for part (a).

It was particularly evident from some of the VAT points examined that, although candidates have a sound basic knowledge of how VAT works, they are not able to show they understand the more advanced VAT matters. Candidates' answers to question 4(b), which examined basic B2B and B2C rules for services, were on the whole very good. Where a more complicated situation was presented, however, as in question 2(c) where there was a trade in books between Cyprus companies but the buyer was responsible for importing the books, candidates' confusion as to the correct VAT treatment was evident. Candidates are advised to continue to study all aspects of VAT included in the syllabus as it remains an important area in practice.

There is evidence that some candidates do not understand the purpose of double tax treaties which were tested in questions 1(e)(ii) and 5(e). This is another area of practical importance which candidates need to ensure they study.

Specific Comments

Question One

This was a 40-mark question based on Dan. The question examined a variety of topics, including:

- certain VAT aspects,
- income tax computation for an employee,
- taxation of use of a Cyprus holding company and related double tax treaty matters,
- taxation of income from a Cyprus permanent establishment, and
- taxation of royalty income.

A small number of candidates attempted question 1 as their final question. This is a risky strategy, effective only when they had left sufficient time to attempt this 40-mark question.

There were 4 professional marks available for the format and presentation of the memorandum. The vast majority of candidates attained full marks. All candidates are strongly advised to do their utmost to achieve these marks, given that they are easy marks to pick up.

Part (a) for 2 marks, asked candidates to decide whether Dan should receive his golden handshake as a lump sum in 2011, or in 10 equal instalments throughout 2011/2012. It was clear that if he received it in 2011, no tax would be payable due to the nil rate tax band of €19.500, which many candidates stated. However if it was received in ten equal instalments, Dan would be taxed in 2012 at the higher rate of income tax of 35%. Candidates recommending that the lump sum should be received in 10 equal instalments usually argued that Dan could benefit from the 20% non-resident exemption, however the non-resident exemption is capped at €8.550, and Dan would reach the cap even without the lump sum, so this was an invalid argument.

Part (b) for 3 marks required the calculation of Dan's 2012 tax payable. The requirement stipulated that candidates should assume that the golden handshake was received entirely in 2011. Answers were on the whole good. A number of candidates incorrectly included the golden handshake in their 2012 tax computation despite the explicit wording of the requirement to the contrary. Some candidates only calculated the taxable income when they had been asked to determine the *tax payable*. A small minority of candidates incorrectly deducted the exemption of €8.550 from the tax payable rather than the taxable income. A common omission from answers were social insurance contributions.

Part (c) examined the choice for Cyprus property and permanent fixtures and fittings to be owned either by a Russian company (RSA) or a Cyprus company (CSA). Part (c)(i) for 5 marks examined the VAT implications of each choice. The crucial thing here was that, if RSA was the buyer, it would still be liable to pay the Cyprus VAT but would not be able to claim back any input VAT given that the property and fixtures would be used to generate rental income which was VAT exempt. Where CSA was the buyer, it *would* be allowed to claim all the input VAT given that it would be using the property to generate taxable income for VAT purposes. A few candidates are to be congratulated for spotting this point. Many candidates correctly stated that, in both cases, Cyprus VAT would be chargeable. They needed then to go on to discuss how the VAT would be treated by the companies. A small number of candidates stated incorrectly that no VAT would be charged for the fixtures and fittings if RSA was the buyer, thinking that they would be zero rated because RSA was based in Russia. This would only be correct if the fixtures and fittings were exported to Russia, which was not the case here. Another common mistake in calculating the VAT payable was failing to notice that the budget of €350.000 would have to include any VAT (given that the budget amount was fixed), as such candidates were expected to allow for the VAT element within the total figure of €350.000.

Part (c)(ii), for 4 marks, looked at the corporation tax implications of each choice. The majority of candidates correctly stated that CSA could claim capital allowances on the property and fixtures. A few candidates did well to spot that the fixtures were permanent and thus would attract capital gains tax at 3% and not 10%. A small number of candidates also realised that RSA could claim capital allowances, given that these would be allowed as a deduction from the rental income that RSA would charge CSA. The rental income constituted Cyprus source income and was thus taxable in Cyprus for RSA, and tax deductible for CSA.

Part (c)(iii) for 3 marks examined the impact, under each choice, of Dan receiving his agreed 20% stake in CSA in the future. The point to note here was that, if RSA owned the Cyprus based immovable property and RSA, being the shareholder of 100% of the shares of CSA, transferred 20% of its CSA shares to Dan, there would be no capital gains tax implications in Cyprus for RSA. However if CSA itself owned the property, then the 20% share transfer to Dan would attract capital gains tax for RSA. A small number of candidates discussed the capital

gains tax position for Dan if *he* sold his shares in CSA in the future, which was not required; this is a good example why candidates should carefully read the question, understand the requirement, and then put pen to paper.

Part (d) for 6 marks examined candidates' understanding of how a Cyprus holding company could help reduce the overall tax on dividends paid from an Italian company to a Russian tax resident. Most answers correctly pointed to a Cyprus company to hold Milania's 50% share in Sekuteen Ltd. The analysis presented was mainly on the right lines, correctly explaining that no withholding tax would apply to dividends paid from Sekuteen Ltd to the Cyprus company, or to dividends paid from the Cyprus company to Milania.

The most common errors were:

- omitting to explain how the dividend income would be taxed in the hands of the Cyprus company, notably that it was exempt from corporation tax and special defence contribution (SDC); and
- stating that the Cyprus company would have to apply the deemed distribution rule and would have to declare a dividend within two years of at least 70% of its accounting profits. In fact, this does not apply given that the company would be owned by Milania who is a non-Cyprus tax resident. As such, the Cyprus company could declare a dividend whenever it wanted to without any SDC implications, given that the deemed distribution rules only apply when one or more of the shareholders is a Cyprus tax resident.
- stating that the deemed distribution rules would apply but any SDC would be refundable given that Milania was a non-Cyprus tax-resident. This is also incorrect. The deemed distribution rules would simply not apply.

Part (e)(i) for 5 marks examined the income tax implications with respect to Cyprus source income for a non-Cyprus tax resident. Answers to this question part were on the whole good. Many candidates discussed the 10% flat-rate special mode of taxation afforded to professionals who come to Cyprus to perform services, which did not apply to the present scenario. The gymnasium would meet the definition of a permanent establishment given it constituted a fixed place of business from which the master was carrying out his lessons. As such, this was the case of a non-Cyprus tax resident self-employed person generating Cyprus source income which would be taxable in Cyprus using the normal income tax brackets. Candidates who understood this performed well. Of these, a common omission from the answers was that the royalty payment and the rent of the gymnasium were deductible in arriving at taxable profits.

Part (e)(ii) for 3 marks examined the amount of withholding tax on a royalty payment, and the procedures for effecting the payment to the tax authorities. This question part was reasonably well answered. The most common mistake was to use the 20% withholding tax rate stated in the double tax treaty (DTT), as per the question. A double tax treaty never imposes taxes. It explains which country has the right to tax and in certain cases imposes a maximum rate of tax that can apply. In this case the maximum DTT rate of tax on the royalty was 20%. This means that Cyprus *could* apply, if it chose to do so, a 20% rate but, in order to examine what rate it *does* apply, one would need to examine the rate as per Cyprus's domestic tax legislation. In fact, Cyprus local tax law applies a 10% rate and so this is the rate to be used.

Part (e)(iii) for 3 marks looked at the VAT implications of a Cyprus business paying a royalty payment to a non EU country, Dorica. Most candidates misunderstood the fact that, if the Cyprus company was paying an invoice, then it was receiving a service and not providing one. Commonly answers stated incorrectly that since the royalty payment is made to Dorica it is outside the scope of Cyprus VAT. In fact, a royalty is a service and, if the Cyprus school is paying a royalty, it means it has received a service. Given that the place of supply of the royalty follows the basic B2B rule then the place of supply is in Cyprus (where the recipient of the service is based) and the school should apply the reverse charge. A few candidates are to bve congratulated for making this point. The next step would be to examine, on applying the reverse charge, whether the input VAT is deductible. Given that the royalty directly related to the provision of the martial arts lessons, a taxable supply, then all input VAT could be claimed.

Part (e)(iv) was worth 2 marks and examined the place of supply rules for a tournament. The majority of candidates correctly pointed to the special rule being the place where the tournament physically takes place, i.e. Cyprus. The most common error was to state that the VAT rate applicable was the standard rate instead of the reduced rate of 5%.

Question Two

This 30-mark question was based on Claudia and covered group losses, certain aspects of VAT, discussion of equity versus debt financing, discussion of branch versus subsidiary, and reorganisation schemes.

Part (a) was worth 1 mark and examined whether candidates knew that educational services are exempt for VAT purposes. Most answers correctly stated this, with a small minority entering into discussions of place of supply and concluding incorrectly that this was Cyprus and that the standard VAT rate should apply. Candidates were expected to know that there is an important difference between a zero rated supply of service (for which input VAT can be claimed) and an exempt supply (for which input VAT cannot be claimed, except under certain circumstances). This point was examined further in part (c).

Part (b) for 2 marks examined candidates' understanding of group losses. This question part was very well answered. Some candidates stated that LBTH and LBT Cyprus formed a tax group without going on to explain the reasons why this was the case. Candidates are reminded to pay close attention to the wording of the requirement, and to take care to demonstrate full understanding of the tax legislation.

A significant number of candidates spent time discussing LBT Ildoria in their answers even though this was not part of the requirement, which was limited to companies in the current LBTH group.

Part (c) for 3 marks examined the VAT treatment of the sale of books from LBTH to LBT Cyprus. The fact that LBT Cyprus was the one responsible for importing the books created confusion for candidates. Most replies correctly stated that LBT Cyprus would pay VAT on importation. However, following this, it was not obvious to candidates whether LBTH should impose VAT on its invoice or not. It should have been clear that VAT would be paid on importation by LBT Cyprus and thus no VAT would be charged on the invoice from LBTH to LBT Cyprus. A significant number of candidates gave a conflicting reply by stating on the one hand that VAT should be charged on the invoice, and on the other hand that LBT Cyprus would pay VAT at customs on importation. In a few cases the rate quoted was correct; the VAT rate for books is 5% and not the standard rate. A small number of candidates discussed whether LBT Cyprus could reclaim input VAT, and of those a few are to be congratulated for correctly stating that LBT Cyprus would not be allowed to claim any input VAT given that it was undertaking exempt supplies being the provision of education. Many candidates incorrectly discussed the use of the reverse charge by LBT Cyprus on the invoice from LBTH, which created further confusion in their answers.

A significant minority of candidates entered into discussions about group VAT registration, treating the sale from LBTH to LBT Cyprus as not being subject to VAT due to the presence of a group transaction, however, there was nothing in the scenario to imply the companies were group registered for VAT purposes. There was some confusion between group VAT registration, and transactions between group companies which are not group registered. The former requires approval from the VAT Authorities, and any transactions between group VAT registered companies are outside the scope of VAT; the latter are subject to the normal VAT rules, which was the case with the LBTH Group.

Part (d)(i) for 6 marks asked candidates to discuss, mainly from a tax point of view, the use of equity vs the use of debt, in making the investment. A number of candidates were uncertain how to approach this question part. Required was a discussion of the tax consequences if equity was used (and dividends would arise) and if debt was used (resulting in interest income, withholding tax and double tax relief); and of the relevant double tax treaty provisions affecting dividends and interest. Many answers correctly noted that, if equity was used and the

Ildorian business was expected to be loss making, a cash flow problem may arise that would adversely impact the loan repayments.

Part (d)(ii) produced some excellent answers. The main point, that no loss relief could be claimed through a subsidiary whereas a foreign branch would allow the loss to be used in Cyprus subject to the recapturing rules, was made by most candidates. A few candidates mentioned that, in recapturing any losses in the future, double tax relief would be available, and explained the impact that the branch would have on accounting profits and consequently on the deemed distribution rules. Most candidates correctly stated that the branch was legally an extension of the Cyprus company, whereas a subsidiary was a separate legal entity. Overall candidates showed a sound understanding of the principles behind a discussion of branch vs subsidiary.

Part (d)(iii) for 8 marks required a discussion of the tax issues of the proposed investment, and how a company reorganisation scheme could help. Most candidates correctly stated that the current proposal would result in capital gains tax as well as increased accounting profits for deemed dividend distribution purposes. A small number of candidates also mentioned the additional cost of the land transfer fees. A few candidates mentioned the use of a reorganisation scheme, and went on to describe the use of a transfer of assets scheme correctly. Those who did not mention the use of a reorganisation scheme at all instead recommended the use of a property holding company and correctly stated the taxes that would apply, with the main benefit being the avoidance of land transfer fees.

Question Three

This 15-mark question was based on Serlov, who was considering setting up a Cyprus trust. It is the first time that an entire question has been dedicated to trusts. Overall performance was good, but it was clear that few candidates have fully grasped the trust concept. Around one third of candidates attempted this optional question.

Part (a) for 3 marks asked candidates to state the six purposes for which a trust may be used. A small number of candidates gave some of the more obvious uses, such as estate planning or protection of property.

Part (b), worth 2 marks, tested the specific requirements for a Cyprus international trust. Practically all candidates who attempted this question showed a solid understanding of the requirements. A significant number of candidates stated that no trust property could be in Cyprus, which is not the case. The international trust excludes only immovable property in Cyprus but other Cyprus based trust property, such as shares in a Cyprus company or cash in a Cyprus bank, is acceptable. A minority of candidates recommended setting up two trusts, an international Cyprus trust for Julia and a Cyprus trus for Eiresel. This would not offer any tax benefits to Julia given that, whether she is a beneficiary of an international trust or a Cyprus trust, the dividend from Bookersel Inc would be taxed in the same manner as far as she is concerned. Given that Eiresel could not participate as a beneficiary in an international trust because of his Cyprus tax residency, then a Cyprus trust would suffice.

Part (c) for 3 marks required candidates to identify the type of trust as well as the roles within the trust. The latter part of the requirement produced very good answers with candidates correctly identifying Serlov as the settlor, his two children as the beneficiaries, and the shares in Bookersel Inc as the trust property. Most candidates did not include Serlov as one of the beneficiaries.

Candidates are encouraged to be careful in their choice of words: a large number of them stated that the trust property was the dividend from Canada. This is not strictly true. The trust property would be *the shares* in Bookersel Inc which would give rise to the dividends. A significant minority included the Cyprus special home for Eiresel as a trust property even though there is nothing in the scenario to suggest that this was owned by Serlov.

Candidates were more divided when it came to the type of trust, with the majority of answers stating that the trust should be a fixed trust in order to provide income for Eiresel. This would have been a sensible choice if the amount for the medical care of Eiresel was fixed every year. However, if in a given year he required even more

funds due to his medical condition, the fixed trust would not have the flexibility to provide these. As such, the discretionary trust was the only reasonable option.

Part (d) for 2 marks required candidates to recommend the role that Marie could take in the trust. Given that Serlov trusted Marie completely, and that Marie did not want to benefit from the trust, the best position for her would be that of a protector, a watchdog over the trustees. However only a handful of candidates mentioned the protector at all. Instead the large majority of candidates recommended a trustee position, for which 1 mark was awarded. The fact that Marie lived in Canada would be impractical (but not impossible) for her to be a trustee of a Cyprus trust. Weaker candidates recommended Marie taking on the role of settlor which would not be expected given that she did not own the trust property; or the role of a beneficiary, even though the scenario specifically states that Marie does not want to benefit from the trust. Neither of these answers were awarded any marks.

Part (d) for 5 marks examined how the income of the beneficiaries would be taxable in Cyprus. Most answers correctly addressed the main points being that the dividend income would be subject to SDC for Eiresel but not for Julia. Stronger candidates stated that the tax returns were issued in the name of the trustees in a representative capacity for the beneficiaries. Overall answers to this question part were fair.

Question Four

This 15-mark question was based on Malika and examined a variety of topics including the 90-day rule for exemption from employment income, basic VAT principles and the taxation arising from an exchange of properties under capital gains tax. Around one third of candidates chose this question and overall answers were very good.

Part (a) for 4 marks examined the exemption offered under the 90-day rule to Malika for working abroad at a permanent establishment of her Cyprus employer. Where candidates did not obtain full marks, this was because they did not give the *detailed* explanations required. The wording of the requirement and the mark allocation should be used to infer the length of the answer candidates should produce.

Part (b) for 6 marks examined candidates' understanding of the VAT place of supply rules for consultancy services, if these were business-to-business (B2B), in part (i), and business-to-consumer (B2C), in part (ii). Each part was worth 3 marks. Overall part (b) produced very good answers. Again, candidates are advised to use the terminology with care; there is a difference between the terms 'exempt' and 'outside the scope'. If a service is exempt from VAT, the service is specifically mentioned in the VAT law (Schedule 7) as an exempt service and no input VAT deduction is allowable, except under certain circumstances. When a service is outside the scope of Cyprus VAT, this means that either the place of supply is not Cyprus, or the service is subject to no VAT at all (such as services rendered by an employee to the employer) e.g. in this question, the provision of services to Egypt is not exempt but outside the scope.

For part (b)(i), after correctly stating the place of supply for B2B is where the recipient is located (i.e. Greece and Egypt), a common mistake was to explain that Dagestin Ltd had to register for VAT in Greece and Egypt and charge local VAT. This is not correct. The question already stated that the Greek customer was VAT registered so, if the place of supply was Greece, Dagestin Ltd would not charge VAT on its invoice and the Greek customer would apply the reverse charge. When Cyprus VAT is being examined it is based on the EU VAT Directive that applies to all EU countries. Candidates should not concern themselves with the VAT treatment within a country outside the EU, such as Egypt. As long as the place of supply is in Egypt, it is outside the scope of Cyprus VAT.

Most answers correctly stated in part (b)(ii) that the place of supply of B2C consultancy was where the supplier was located, i.e. Cyprus. The most common mistake was to state that, for Egypt, Cyprus VAT would be chargeable. There is an exception from the basic B2C rule for certain B2C services: when the recipient is outside the EU, the place of supply is where the recipient is located. As such, no Cyprus VAT would be charged as the transaction was outside the scope of Cyprus VAT.

Part (c) was worth 4 marks and examined the capital gains tax treatment of an exchange of properties. Answers were excellent, and the majority of candidates remembered to claim rollover relief. The most common error when calculating the readjusted value of the new house for future disposal was to use the cost price of €900.000 as the sales value instead of the purchase price of €1.050.000 (being the exchanged property of €650.000 plus the cash payment of €400.000). Another common error was to claim the life-time exemption before claiming rollover relief.

Part (d) was worth 1 mark and examined the due date for the capital gains tax self-assessment return. Many candidates correctly stated that the date was 1 month from the day of the disposal.

Question Five

This 15-mark question was based on Grandpa Vyroni and tested candidates' knowledge of aspects of personal allowances as well as rental income and capital gains tax for a property situated outside of Cyprus. The question was answered by around a third of candidates and overall produced good answers.

Part (a) for 2 marks required an explanation of the tax treatment of a lump-sum received on retirement as well as of monthly pension income. In almost all cases, candidates correctly stated that the pension income was taxable in the year of receipt. Many candidates correctly answered that the lump-sum payment was exempt from income tax.

Part (b) for 2 marks tested knowledge of the tax treatment of income received from the cancellation of a life insurance policy in the sixth year from when it was made. Most answers correctly stated that the €9.500 return on investment from the policy was not taxable. Many candidates correctly stated that 20% of the allowances received from the tax deductible premiums over the life of the policy (note, not the return on investment) would be recaptured in the year of cancellation as taxable income.

Part (c) for 4 marks examined candidates' knowledge of the tax deductibility of life insurance premiums as personal allowances for the taxpayer. Answers were generally very good. Almost all candidates correctly explained the requirement in the law for the policy to be in the name of the person claiming the tax deduction.

Most candidates also stated that the allowable life insurance premium was restricted to 7% of the capital amount insured, or that all personal allowances were restricted to 1/6th of the taxable amount before the deduction of personal allowances. A few candidates are to be congratulated for explaining both.

Candidates were expected to recommend placing the life insurance policy in the name of the daughter and gifting the cash for the premiums to her, so that she could claim a tax deduction. Many candidates recommended Gradpa Vyroni taking out the insurance policy in his own name but placing his daughter as the beneficiary of the policy, which conflicts with the fact given in the scenario, that Granpa Vyroni wants his grandson to be the beneficiary of the policy. A small number of candidates recommended setting up a trust
and gave a detailed account of how this could be achieved, which was not relevant here.

Part (d) for 5 marks required candidates to explain how rental income from UK sources is taxable in Cyprus. This question part was very well answered. A common omission was not mentioning that double tax relief would be available. This arises from the fact that, being UK source income, the UK would also tax the income.

Part (e) for 2 marks asked candidates to explain the capital gains tax (CGT) consequences in the UK and in Cyprus of Granpa Vyroni selling his UK apartment. The scenario stated that the double tax treaty between Cyprus and the UK provided for CGT to be imposed only in the country of residence of the owner. This confused a large number of candidates who, having stated correctly that Cyprus CGT only applies to property physically situated in Cyprus, incorrectly concluded that CGT would in fact be chargeable in Cyprus given that this was 'imposed' by

the terms of the double tax treaty. This stems from a misunderstanding of what a double tax treaty sets out to achieve. Double tax treaties never impose taxes: they only state which country has the right to tax and, in certain cases, place a cap on the amount of tax that a country can impose. As such, the double tax treaty did not give the UK the right to tax given that the capital gain was only taxable in the country of residence of the owner of the property, which was Cyprus where Granpa Vyroni resides, and no CGT applies in the UK. Given the gain is taxable in Cyprus, we next need to look at how Cyprus imposes CGT. Cyprus CGT law only applies to Cyprus situated properties, and this property was in the UK, then the sale would be outside the scope of Cyprus CGT as well. No CGT would be due, either in Cyprus or the UK.