Examiner's report

P6 Advanced Taxation (CYP)

December 2013

General Comments

The examination consisted of five questions, from which candidates had to answer four. Section A contained question 1 for 35 marks and question 2 for 25 marks. Both questions were compulsory. Section B comprised three further questions of 20 marks each, and candidates had to choose two from three.

The vast majority of candidates attempted all four 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.

Question 1 warrants specific mention as overall answers for this question were not satisfactory. Given that this was the question that carried the most marks, this made passing the exam much more challenging for candidates. Candidates generally overcame this problem by scoring well in their two chosen questions from Section B. However the problems of question 1 related more to a lack of planning and consideration of the answer, than to any lack of technical knowledge. Candidates must appreciate the importance of exam technique, and of planning the answers to a question. This is especially true of the scenario-based questions of section A where there is generally much information to analyse and more detailed requirements to consider. A great way to practise this is for candidates to sit questions under exam conditions as part of their preparation for the exam.

Candidates performed particularly well on questions 2(a)(i) – (v), 2(b), 3(b)(i)-(ii), 4(a), 4(c), 4(e), 4(f), 5(a), and 5(b). The questions candidates found most challenging were questions 1(b), 1(c), 1(d)(i)-(ii), and 2(c). This was mainly due to weaknesses in exam technique and, to a lesser extent, a lack of technical knowledge.

A number of common issues arose in candidates' answers:

- Rushing to put pen to paper without sufficiently considering the requirement.
- Failing to read the question requirement clearly and therefore providing irrelevant answers which scored few if any marks.
- Failing to plan the answer adequately resulting in incoherent answers.
- Poor time management between questions, some candidates wrote far too much for some questions and this put them under time pressure to finish the remaining questions.

Specific Comments

Question One

This 35-mark question was based on Bracken Investment Holdings Limited which belonged to the billionaire Fern family. The question covered an array of topics including how the income of a trust is taxed, arm's length principles, as well as advice on structuring an investment using a mixture of equity and debt, and taking into account double tax treaty, and foreign local tax provisions. Overall, this question was not answered satisfactorily. This was especially true of part (d) which in total was worth 19 marks.

The 4 professional marks available for format and presentation were awarded in full to many candidates. It is good exam technique to ensure that the format and presentation marks are gained. This only leaves another 46 marks that are required to attain a pass mark - candidates should consider this. There were some instances where these marks were unnecessarily lost due to no format being drafted or due to poor presentation.

Part (a) for 3 marks required candidates to explain the arm's length principle relating to a proposed interest-free loan from Arabella to Bracken. The key here was to explain that the interest rate could not be too high. Most

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candidates correctly discussed the arm's length principle. The majority of candidates discussed the timing of the loan, in order for it to meet the back-to-back loan requisites, as well as the margins that should be considered. This discussion was not the subject matter of the question part.

Part (b) worth 7 marks required candidates to discuss how the income of the trust and the ensuing distributions to Arabella and Jane would be taxed.. Answers were generally correct and on the right lines. Where candidates did not score as well, this was mainly due to a failure to provide adequate depth to their answers. The most significant example was that candidates did not explain in sufficient detail how the trust income is assessed and taxed. Most answers correctly stated that the distribution would be subject to SDC for Jane and not for Arabella. Weaker candidates incorrectly stated that income would be taxable under income tax rates for both Arabella and Jane as it constituted Cyprus source income. Another remark was the generally short length of the answers, especially given the 7 marks allocation. The requirement was very explicit. It requested the tax consequences for the trust, the trustees, the beneficiaries and asked for calculations where applicable. The mark allocation should have been used to guide the answers for each part of the requirement. Candidates should pay particular attention to such matters as part of their exam technique, which is as vital to passing the exams as is knowledge of the syllabus.

Part (c) for 2 marks required candidates to consider how the alternative proposal was more tax efficient than the original one. Most answers correctly stated that the interest income would have been received by Arabella without the imposition of any withholding tax. Only a handful of answers then explained that Arabella could subsequently gift half the interest income to her sister Jane, which ultimately would allow Jane to save €1,7m in SDC when compared to the original proposal.

Part (d) produced an overall inadequate performance.. Candidates were requested to compare two options with regards to Bracken making an investment. The investment was part equity and part debt and candidates thus had to analyse the tax implications of each. The rate used in the model answer stemmed from part (c) of the question (being 5%) however candidates were justified in using a different rate so long as the required margins were in place. Where candidates correctly used a different rate, full marks were awarded.

Part (d)(i) related to the option of making the investment directly. Candidates had to explain the tax treatment of the equity, which would produce dividend income for Bracken. However, once again, the answers lacked depth. The marks allocated to the question part should have guided the depth of the discussion. Instead, it appeared that candidates rushed into this requirement without thoroughly considering what was required and the implications of Bracken's investment.

With regards to Bracken's tax computation, the element of the interest payable relating to the investment in 90% of equity would be restricted in full. Most answers correctly stated this. The only thing left to discuss was how the dividend income from Bracken would be taxed. This required a calculation of the withholding tax and a discussion that the dividend income would not be subject to SDC or corporation tax, with an explanation of why this was the case. Yet only a small minority of candidates included this discussion in their answers. The large majority of candidates remained silent on this matter. A significant number of candidates mistakenly stated that Bracken's dividend income would be subject to SDC. Candidates who stated that SDC did not apply had to explain why this was the case in order to obtain the full marks. A significant number of candidates discussed extensively the potential cash-flow issues that would result from Roots Ltd making losses in the initial two years, which did not form part of the requirement, and for which no marks were available.

Similarly, candidates had to discuss Bracken's taxation of its interest income. Once again there were withholding tax implications, including double tax relief. Candidates were then only required to produce relevant calculations of the taxes to complete this question part. Most answers did not include any calculations even though this was explicitly stated in the requirements, and significant marks were available for these. A number of candidates

discussed group relief provisions at length, explaining why group relief was not available. Given that there was only one Cyprus company involved, this discussion was unnecessary.

Part (d)(ii) required candidates to analyse the tax implications of the indirect option whereby Bracken invested through an overseas intermediary company. Furthermore, there was an option of investing 100% in equity or 50% in equity and 50% from debt. Once again, candidates had to discuss the tax consequences of the dividend income as well as the interest income, but this time for both Bracken as well as for NewCo. This required solid planning before putting pen to paper.

Firstly candidates had to decide where NewCo should be tax resident. Most candidates correctly identified Antheridia as the best jurisdiction given that there were no withholding taxes between Antheridian tax resident companies, and that the overseas intermediary company would lend onwards to Roots.

Having established this, candidates then had to decide whether to fund NewCo through 100% equity or 50% equity and 50% debt. The answer came from the terms of the double tax treaty which imposed a 3% withholding tax on gross dividend payments and 10% on gross interest payments. As such, it would be more tax efficient to fund NewCo through 100% equity and only receive dividend income in Cyprus from Antheridia, with the imposition of a 3% withholding tax. Having thus established the structure, candidates had to analyse the tax implications of the interest and dividend income in NewCo, and then of the dividend income in Bracken. In addition, given that Bracken would be investing in a 100% subsidiary, the interest expense would be deductible on the loan from Arabella, except for the assets held by the subsidiary which were not used in the business. The majority of answers picked up the mark for the latter. However, the discussions made with regards to the former generally lacked depth, with only a small number of candidates producing calculations. A significant number of candidates discussed in detail the fact that if Bracken owned 100% of shares, then the capital could only be returned through a liquidation, or a share capital reduction, or from selling the shares. This discussion was not relevant and marks were ultimately not available, given that the requirement was to examine the tax implications only.

Overall part (d) required careful planning of the answer, which is an integral part of exam technique. In fact the tax matters raised were not new to the syllabus and required more logic rather than detailed technical knowledge. The difference in this scenario-based question was that there was a lot of information that candidates were required to decipher, and various factors that candidates needed to consider before producing their analysis and ultimately their advice. It appears that candidates were more willing to put pen to paper rather than invest time in planning, and this ultimately led to incoherent answers that scored poorly. This point has been made in previous examiner reports. The results of not adhering to this advice were more profound in this question part.

Question Two

This 25-mark question was based on Aristotle PCL and covered topics of deductibility of expenses, debit balances, filing dates for objections, badges of trade and stamp duty. Generally the question was well answered. Many candidates presented their answers in a memorandum format which was not required and for which no marks were available. I would urge candidates to pay close attention to the wording of the requirement so as to minimise any time wasted on unnecessary actions.

Part (a)(i) for 2 marks required candidates to ascertain the tax treatment of redundancy payments to employees. The majority of candidates correctly stated that these were taxable given that they were provided for in the employment agreement. This was worth 1 mark. The second mark was for stating that the expense was tax deductible for the company. Weaker candidates stated that the redundancy payments were exempt from tax. This would have been the case had they not been provided for in the employment agreement.

Part (a)(ii) examined the tax treatment of bonus shares provided to managers. Once again, the large majority of candidates correctly stated that this constituted a taxable benefit-in-kind, gaining the 1 mark that was available.

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Weaker candidates incorrectly stated that shares in a listed company did not attract any tax and so the bonus would be tax-free.

Part (a)(iii) worth 2 marks examined the taxation of share options. Most candidates correctly stated that this was taxable. Stronger candidates stated that the tax point was the date of exercise of the option and the difference between the market price and the option price was the taxable amount. Weaker answers stated that the option related to shares which in turn were not subject to tax and so the option itself would not be subject to tax.

Part (a)(iv) worth 2 marks required candidates to note that Socrates would not be a Cyprus tax resident in 2013 or 2014, and thus would only be taxed on his Cyprus-source income. Most candidates correctly ascertained this. A significant minority discussed how he would be taxed on his world-wide income in Romania. The discussion of Romanian tax legislation was not requested and ultimately no marks were available. In any case, the question did not explain Romanian tax legislation. It is not correct to assume that other tax jurisdictions will have the same tax resident rules as Cyprus. Not all countries have the 'world-wide' income concept for their tax residents. Candidates should thus never assume but stick to what is stated in the scenario question. A small number of candidates did not calculate the number of days and discussed at length the 90-day rule for working at an overseas permanent establishment, which was not applicable for Socrates, and scored no marks.

Part (a)(v) worth 5 marks examined the difference in taxation for debit balances held by Plato, a director, and by Zena, an employee with no officer role. Here answers were less successful. Although most noted that Plato would be subject to tax on a benefit-in-kind as opposed to Zena, most did not explain how that benefit would be calculated and taxed. Many answers discussed the previous tax provisions whereby 9% deemed interest was included in the company's tax computation. A significant number of candidates also incorrectly stated that for the company the interest was not 'tax deductible'. In fact the company would have interest income and not an interest expense. Moreover such interest would be taxed under SDC. Any discussion of an interest expense for the company is clearly not appropriate and was not awarded any marks. I believe that many candidates rushed to answer this question part without sufficiently considering the requirement.

Part (b) was worth 3 marks and examined various tax deadlines. Around half of candidates stated that the objection to the assessment needed to be filed within 30 days instead of by the end of the month following the month in which the assessment was raised. Weaker candidates discussed filing an objection with the Minister of Finance, clearly confusing the income tax legislation, where it is not possible to do this, with the VAT legislation where such an option exists. With regards to filing a hierarchical recourse with the tax tribunal and applying to the Supreme Court, the majority of candidates correctly stated the relevant deadlines. Weaker candidates were simply not aware of the correct dates.

Part (c) was worth 3 marks and required candidates to explain that the tax authorities also had time restrictions for producing their final determination. Only a small number of candidates correctly stated this. A significant number of candidates discussed the 6-year rule whereby the tax authorities had the right to re-examine any tax year within 6 years. This was not applicable to the scenario. A significant number of candidates simply did not address this question part at all.

Part (d)(i) worth 1 mark required candidates to explain that any agreement for land situated in Cyprus was chargeable to Cyprus stamp duty. Answers varied for this part.

Part (d)(ii) for 5 marks required the use of badges of trade to determine whether the sale of the land to the developer would result in a charge to corporation tax or capital gains tax. The majority of answers were satisfactory here and correctly addressed the short-time frame of ownership as the most important criterion that pointed towards trading, and at the same time the fact that the circumstances responsible for the sale related to not obtaining the licenses, which pointed towards a capital gain. It was clear that candidates have a good grasp of the badges of trade and how they are used to determine whether a transaction is trading or capital in nature.

Part (d)(iii) for 1 mark examined how VAT was paid for goods invoiced from Sweden but arriving from China to Cyprus. Whilst some candidates correctly stated that the VAT is paid on importation, and self-supply did not apply to the invoice from Sweden, other incorrect answers stated that Aristotle would have to self-supply the invoice from Sweden.

Question Three

This 20-mark question was based on Barry the settlor of a Cyprus international trust which in turn owned Elvira Ltd, which had just registered a patent. This question examined the Cyprus patent box tax legislation and certain VAT matters. Overall this question was the least popular of the option questions. However candidates who attempted it generally did well. Perhaps candidates who avoided the question did so either because of the VAT element (9 marks in total) or the patent box element (8 marks), topics they had not revised. If this was indeed the case, it would be a dangerous strategy to omit topics during revision.

Part (a)(i) for 2 marks required the place of supply and VAT treatment of income relating to the use of the patent. Candidates performed satisfactorily displaying a good understanding of the place of supply rules as well as the VAT treatment. Weaker candidates, having firstly correctly identified that the place of supply was where the recipient was located being Dubai, then incorrectly stated that Elvira would have to apply Dubai VAT. Candidates need to appreciate the scope of the VAT directive. It does not apply to jurisdictions situated outside of the EU. Moreover, not all countries have VAT legislation, Dubai being one of the jurisdictions that does not.

There was an error in one of the published articles on this topic. The article incorrectly stated that the place of supply of the B2B use of intellectual property rights is where the *supplier* is located. The article has since been amended to correctly state that it follows the normal B2B rule of where the *recipient* is located. However, candidates were not penalised as a result of this error if, in this question part, they stated that the place of supply was where the supplier was located. In any case, only a handful of answers were noted stating that the place of supply was where the supplier was located.

Part (a)(ii) for 2 marks examined whether the input VAT on development costs of a pharmaceutical drug could be claimed. Once again, most candidates correctly stated that they could, explaining that the costs related to potential income for which a right of deduction was afforded. In order to gain the full two marks, the explanation of why the input VAT was reclaimable was necessary. Simply stating that Elvira did have a right to reclaim the input VAT, but without any explanation, was awarded 0.5 mark. A significant number of weaker candidates stated that Elvira was undertaking exempt transactions and had no right to reclaim any input VAT. The exempt transactions are specifically listed in the legislation (Seventh and Eighth Schedules). Elvira is not providing medical services which may be exempt, but is manufacturing pharmaceutical drugs which will result in royalty income, which in turn is a taxable supply.

Part (a)(iii) was worth 5 marks and examined the VAT treatment of overseas services received by a Cyprus company.. A significant number of candidates incorrectly stated that the transaction was B2C given that Leila was a physical person, and as such Leila should apply Kazakhstan VAT. There is no basis for stating that physical persons only carry out B2C activities. The key in any case is whether the person receiving the service (ie Elvira) was receiving the service for business purposes or not – this determines the difference between B2B and B2C and not Leila.

Many candidates also did not understand how the accounting treatment for the reverse charge should be shown in the books. I would recommend that candidates refer to this question in future in order to fully understand how the reverse charge mechanism works. Some answers did not address the requirement to give details of the accounting entries, thus losing out on valuable marks.

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Part (b)(i) was worth 2 marks and examined the calculation of corporation tax payable by Elvira for 2012 which included income from intellectual property rights. Almost all candidates displayed a solid understanding of how the property box tax regime works.

Part (b)(ii) was worth 4 marks and examined the tax of the disposal of intellectual property rights. Once again, candidates performed well here. The most common omission was the €100.000 commission for the sale of the patent, which was a tax-deductible expense.

Part (c) was worth 2 marks and required candidates to identify that further tax savings could be made if Ermijag sold its shares in Elvira rather than Elvira disposing of the patent rights, given that the gain from the sale of shares would be exempt from tax. The majority of candidates appreciated this tax planning measure. Many answers did not state the amount of tax that would be saved, which was worth 1 mark.

Part (d) was worth 3 marks and examined the recent changes in the trust legislation that allowed the settlor to become a Cyprus tax resident following settlement of the Cyprus international trust. Candidates performed satisfactorily on the whole. Most answers correctly stated that there would be no impact on the status of the international trust. Weaker candidates incorrectly asserted that the Cyprus international trust would become a non-international Cyprus trust, ignoring the change in legislation. Only a handful of candidates went the full length in their answers and explained that another tax implication for the trust of Barry becoming a Cyprus tax resident would be that the trustees would have to pay all taxes purporting to Barry on his behalf, which was worth 1 mark.

Question Four

This 20-mark question was based on Tselko Ltd and Emlond Ltd and tested candidates' knowledge on a number of items. Group relief and the use of losses were firstly examined, followed by a capital gains tax calculation involving exchange of properties, and a calculation of immovable property tax. Overall this question was the most popular of the three choice questions, and was generally well answered.

Part (a) was worth 2 marks and required candidates to state whether Tselko and Emlond could form a tax group in 2012. The large majority of candidates scored the full 2 marks by stating that they could not and providing the reason, which was that in order to form a tax group they had to be part of the tax group for the entire tax year, which was not the case. A significant number of candidates confused a recent amendment in the tax legislation that allowed companies that were incorporated by their parent company(ies) during the tax year, to form part of a tax group for that tax year, as long as all the remaining criteria were met. This was not the case in the current scenario given that Tselko was expected to acquire the shares of Elmond on 31 March 2012, and not incorporate it. Some weaker candidates incorrectly stated that a tax group could not exist as a result of the provision regarding non use of losses resulting from a change of ownership and business. This provision was examined in part (b) below, and affects the existing tax losses but not whether a company can form part of a tax group or not.

Part (b) for 5 marks examined the anti-avoidance provision in the tax legislation relating to the sale of loss companies. Most candidates showed a solid understanding of the provision here. However, most candidates omitted to discuss the capital losses, which was worth 1 mark. Weaker candidates differentiated the losses brought forward from previous tax years from the loss expected during the first three months of 2012 stating that the latter could be carried forward to be offset against future profits. This is not the case as the anti-avoidance provision applies to all losses that existed before the date of change of ownership and change of the business activities. Some candidates discussed the recapturing provisions that only apply to losses from foreign permanent establishments in discussing group relief, which showed confusion as to how various losses are dealt with. There was a minority of scripts that did not show any awareness of the anti-avoidance legislation effectively not scoring any marks.

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Part (c) worth 4 marks was well answered. It examined how overseas passive interest income was taxable for Emlond. Almost all answers correctly stated with reasons that the interest income was taxable under SDC and not corporation tax. The large majority of answers then correctly discussed that payment of the tax should be effected via self-assessment every six months. Weaker candidates incorrectly stated that the tax should be paid by the end of the month following receipt of the interest, which is the case for interest income arising from within Cyprus, but not for overseas interest income.

Part (d) was worth 5 marks. Candidates had to calculate the capital gains tax resulting from the sale of a property that had previously been exchanged. In previous sittings candidates were confronted with an actual exchange. This is the first time that I have examined the sale of a property that had previously been exchanged. Candidates thus had to firstly work out what the adjusted base cost was following the original exchange, and then calculate the capital gains tax on this indexed base cost. Some candidates did this correctly. Only a handful of candidates also deducted Elmond's brought forward capital gains tax loss. Weaker candidates attempted to undertake the entire calculation in one computation which resulted in explicit confusion in the answer. The actual calculation itself was not difficult and candidates have proved in previous sittings that generally capital gains tax computations relating to exchange of properties do not create problems. However, in this question part, candidates needed to invest some time to consider how to address the requirement. I believe those who planned their answer went on to gain good marks for this question part. Some of the weaker answers included a deduction of the life-time exemption in the CGT calculation, which is not available to legal entities.

Part (e) was worth 3 marks and examined the computation of immovable property tax. The large majority of candidates scored well on this question part. Often candidates omitted to state the due date of payment which was part of the requirement. Weaker candidates applied the tax rates separately for each property which is incorrect. A small but significant number of candidates mistakenly used 'hundredths' instead of 'thousandths' for the rate. This is an issue that I have come across in previous sittings. Candidates should be careful not to make such unnecessary errors, especially given that the rates can be found at the front of the exam paper. A significant minority also did not include the warehouse in the calculation explaining that it was sold during 2012. Immovable property tax applies to the property held by any person as at 1 January of that tax year, regardless if the property was disposed of after this date.

Part (f) worth 1 mark asked candidates to confirm their understanding that land transfer fees could be avoided if a person purchases the shares of the company holding the land, rather than the land itself. The large majority of candidates appreciated this point.

Question Five

This 20-mark question was based on Adamos and Emily and mainly tested candidates' knowledge of the taxation of self-employed persons. Following question 4, this question proved the second most popular option question.

Part (a) for 4 marks required a calculation of the taxable income of Adamos for 2011. This was generally well answered by candidates. The most common error was to include the rental income from the preserved building in the calculation. Rental income from preserved buildings is specifically exempt from income tax. Weaker candidates neglected to apportion the income from the dog-breeding business between Adamos and Emily.

One other small but important point is the following. The large majority of candidates produced the calculation of the *tax payable*, despite the requirement only being for the *taxable income*. No marks were available for the amount of tax payable and valuable time would have been lost in calculating it. I once again strongly urge candidates to read the requirements carefully and in doing so perhaps underline the key words such as 'calculate' and 'taxable income'.

Part (b), also worth 4 marks, required a calculation of Adamos's special defence contribution for 2012, and an explanation of how the payment would be effected. Once again this question part was generally well addressed.

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Weaker answers incorrectly stated that overseas rental income or rental income from preserved buildings were not subject to SDC. A significant number of candidates also calculated deemed-distribution SDC resulting from the dog-breeding business. This would only be the case if the business was carried out through a company which would be subject to the deemed distribution rules. The dog-breeding business was carried out by Emily and Adamos as self-employed persons and as such every year the income or loss from the business is apportioned to each of them separately and taxed. Deemed distribution rules do not apply in this case. With regards to the method of payment of the SDC, most candidates correctly stated that SPAD & Co LLC would deduct the SDC element from the rent payable to Adamos. Most candidates also understood that SDC on overseas rents are payable through self-assessment every six months.

Part (c) was worth 4 marks and required candidates to explain whether the dog-breeding business required VAT registration. Using the historic test, most answers correctly stated that the business should have been VAT registered. This scored2 marks. The remaining 2 marks required an explanation of the penalties for late-registration. Most candidates were able to score 0.5 mark for mentioning that interest would be applicable, but were unaware of the other penalties.

Part (d) was worth 1 mark and examined the taxation of partnerships. Most answers correctly stated that partnerships are transparent entities for Cyprus tax purposes and as such there would be no difference if Adamos and Emily registered their business under an official partnership or not.

Part (e) was worth 5 marks and required candidates to recommend how Emily and Adamos could minimise their overall tax liability. The thing to note is that Adamos pays tax at 30% whereas Emily's taxable income was below the tax-free limit of €19.500. As such, their overall tax liabilities could be reduced by transferring the dog-breeding business entirely to Emily. Another possibility was for Adamos to transfer part or the entire ownership of his immovable property that generated rental income to Emily. Only a few candidates discussed these possibilities, and supported their recommendations with calculations showing the tax that could be saved. They scored well on this question part. A significant number of weaker candidates entered into a discussion regarding how VAT registration would allow them to claim back input VAT. The requirement stated that VAT registration should be assumed and therefore input VAT would be reclaimed in any case. What was required was advice on how to further reduce the overall tax rate. As such a prolonged discussion relating to input VAT gained no marks.

Part (f) was worth 2 marks and examined whether incorporating the business would reduce the overall tax liabilities of Emily and Adamos. Given the calculations in part (e), if a large part of Adamos's income was transferred to Emily, the overall effective tax-rate would not justify incorporation. Only a handful of candidates managed this point and scored the 2 marks. Most answers focused solely on Adamos's effective tax rate stating that incorporation would reduce his overall effective tax rate, ignoring how it would affect Emily. The fact that the requirement mentioned both Emily and Adamos should have guided candidates' answers in this respect.

Overall candidates should pay more attention to the requirements. They are worded very carefully and the instructions therein are to guide candidates in their answers.