Examiner’s report

P6 Advanced Taxation (CYP)
June 2012

General Comments

The paper consisted of two sections. Section A comprised two compulsory questions, both of which were worth 30 marks. Section B comprised three questions, each worth 20 marks and candidates were requested to choose two from three of these.

The majority of candidates attempted 4 full questions. Overall the performance was good. Questions 3 and 4 produced excellent replies with parts of questions 1 and 2 also producing very good answers. Question 5 and some elements of questions 1 and 2 proved to be most challenging to candidates.

The exam paper required good time management. The overwhelming majority of candidates managed to answer all parts of four questions. A small number of candidates provided answers that were incomplete or omitted question parts, signalling that time management may have been an issue for them. A number of answers suggested that the final question was attempted under limited time. Candidates do need to be manage their time strictly. This means being careful to keep answers to the point, and not producing more lengthy answers than the mark allocation justifies when they come across ‘comfort areas’ of knowledge as these can turn into examination swamps!

Thinking through the consequences of advice given is critical in doing well at the P6 level. For example, question 3 (a) asked candidates to consider reasons why a client should voluntarily register for VAT. The reason was that the client was constructing a hotel, the construction would take 4 years to complete and, unless the company receiving the construction services was voluntarily registered from the start of the construction, significant input VAT would be lost given that a VAT registered person has the right to claim input VAT from services received only up to 6 months before the registration date. Most candidates were aware that the company could register when the EUR 15.600 registration threshold was surpassed, but this would not have occurred until the hotel was operational, which advice would have cost the client significant input VAT on the construction. This is why, when addressing such scenario questions, candidates should seek to position themselves in front of the ‘client’ and give the advice required considering the practical implications that will arise. More importantly, training the mind to think through the implications of all tax advice is even more necessary in real life, and part of the aim of studying for the paper is to develop this critical way of thinking.

VAT once again appears to be the most challenging topic for candidates. Aspects of VAT that have not been examined in the past appear to have caught candidates off-guard. Moreover VAT topics that were examined in the past were well answered, which may signal that candidates are tending to over rely on practising previous questions than on studying all aspects of VAT included within the syllabus, so as fundamentally to understand the subject area and be able to apply this understanding.

Specific Comments

Question One

Question 1 was a 30 mark question. It focused on a variety of tax matters including the comparison of different tax jurisdictions based on the tax profile of Svetlana and Kyri Tata, the place of supply rules for VAT given specific transactions, the arm’s length principle and the deductibility of donations. Overall answers to question 1 were of a good standard, although the VAT elements tested some candidates.

Part (a) was worth 3 marks and examined, for the first time, the special place of supply rule concerning short term hiring of means of transport, being a car in the present case. Many answers correctly concluded that the place of supply was Cyprus, although the ways this conclusion was reached differed widely. A significant number of candidates did explain correctly the special rule, stating that the place of supply was where the car was made available. Many answers used the term ‘use and enjoyment’ as the reason why the place of supply would be Cyprus. The fundamental rule is slightly different: the place where the car is made available and the place where it is used and enjoyed may not always result in the same country. Candidates who did not know the special place of supply rule here discussed the basic rules for B2B or even B2C services (depending on whether they argued that Kyri Tata was using the car for business), with no mention of the special rule. The most common result of this was to state, incorrectly, that the supply was B2C and that the place of supply was Ildoria, the place where the supplier was established.

Part (1)(b) required candidates to draft a memorandum and I was glad to see that the vast majority of answers obtained both marks for format and presentation.

Part (b)(i) was worth 9 marks and required a comparison between using an Ildorian (which, of course, is not a real country and was created only for the purposes of the exam question) tax-resident company and a Cyprus tax-resident company to undertake a transaction. To complicate matters slightly, there were two persons involved in the transaction with 2 different tax profiles. In providing the comparison, candidates were specifically requested to produce computations.

The scenario incorporated various proposed transactions and planning the answer was important in maintaining good time management. Overall candidates made a good attempt at this question part. Those that chose a fully discursive route, without producing a separate appendix or table with the computations, made life difficult for themselves, as the answers lacked structure so appeared somewhat confused. From the answers it was clear that a table to summarise workings, or an appendix on a separate page, helped candidates focus the analysis of the computations and make appropriate recommendations. Under exam conditions, where time is precious, it is a sensible way to address these kinds of questions.

The most common errors included the following:

- Not exempting the sale of bonds from corporation tax in the case of the Cyprus company.
- Not calculating the Russian or Ildorian tax consequences of the income that would be received by Svetlana and Kyri Tata in making the comparison. Many answers simply restricted the discussion to the Cyprus tax consequences, by stating e.g. that both were non-Cyprus tax residents and as such special defence contribution tax (SDC) did not apply to them. The requirement was to discuss and calculate how much Svetlana and Kyri Tata would receive in their pockets, and as such discussion of their overseas tax consequences was imperative.
- A number of candidates were unaware that the sale of bonds was exempt, and thought that the sale was taxable at 10% corporation tax. The exemption in the tax law does not solely apply to shares – it applies to 'titles' and this includes bonds.

Most answers correctly pinpointed the 'unfairness' to Kyri Tata resulting from the use of a Cyprus tax-resident company over an Ildorian tax resident one.

Part (b)(ii) was worth 3 marks, and asked candidates to consider a new structure which would reduce the unfairness to Kyri Tata noted in part (b)(i). In fact the majority of answers correctly recommended the use of an Ildorian tax–resident company for Kyri Tata's shareholding, whether this was through a newly incorporated company, or through Latvex Ltd, his existing company.

Part (b)(iii) was worth 6 marks and examined the VAT implications of specific proposed transactions. The first transaction related to a Cyprus company receiving B2B services from abroad. A small number of candidates are to be congratulated for deciphering this question part correctly. The first thing to establish is the place of supply rule. This followed the B2B general rule which meant the place of supply was Cyprus. This would mean the Cyprus company would have to apply the reverse charge and, given the value of the transaction exceeded the registration threshold of EUR 15.600, the Cyprus company would have to register for VAT. From applying the reverse charge, the question would be whether the input VAT is recoverable. A significant number of candidates ignored this part of the requirements i.e. the invoices from Latvex. Others incorrectly stated that the transaction was B2C and thus the place of supply followed the place where the main transaction took place. Given that NewCo Ltd would receive services from Latvex Ltd that directly relate to finding customers and thus making sales, the transaction could only be considered B2B. More generally, in analysing the place of supply, candidates should follow a specific trail of thought. The first question is to determine whether it is B2B or B2C, the next is to consider whether any of the special rules apply and, if not, then by default the general rule would apply, and finally, if the place of supply *is* Cyprus, to consider if the supply is exempt or falls within taxable supplies. If the supply is taxable then consideration should be given as to the rate of VAT – 0%, 5%, 8% or the standard rate of 15%.

With regards to the purchase and sale of corn, around half the answers correctly explained that these were outside the scope of VAT. This was clear following the place of supply rules – the place of supply is where the goods are when shipment will commence. Given that both the purchase and the sale were outside the EU, it was clear that there were no Cyprus VAT implications. A significant number of candidates explained that the purchases from South Africa were imports and that VAT would be paid on importation, and/or that the subsequent sale to Russia were exports. This is incorrect. Candidates should be careful about the terminology used. An import means the goods are <u>physically brought to Cyprus</u>. This is not the case here. The goods never arrived in Cyprus – they are shipped directly from South Africa to Russia. Similarly an export means goods are <u>physically shipped from Cyprus</u>. Once again this is not the case for the scenario under consideration.

The sale to Russia is also not zero-rated. Any zero rated transaction is specifically detailed in the VI Schedule of the VAT Law as being subject to the 0% rate, such as exports. Sales of goods to Russia that are shipped from South Africa are thus not zero rated (as they do not constitute an export), but are outside the scope of Cyprus VAT. This distinction between *outside the scope* and *zero rated* transactions is an important one for candidates to comprehend.

Part (b)(iv) was worth 3 marks and required that candidates explain the implications of arm's length transactions between related parties. However in this scenario, the potential problem would arise from the Russian tax authorities and not from the Cyprus tax authorities, given that profits would be increased in Cyprus. Most candidates picked up on the issue of arm's length and that Genady Ltd and NewCo were related parties. Stronger candidates explained that the issue arose in Russia and not in Cyprus. A small number of candidates did not discuss the potential issue of arm's length and noted instead other non-relevant potential issues such as timing delays for the stock to arrive, which were not required. Candidates are reminded of the need to ensure that they answer the question set.

Part (b)(v) was worth 4 marks. Candidates had to consider how donations by Cyprus companies could be made deductible, and this was to register a charity in Cyprus and submit it for approval with the income tax office. Most candidates correctly recommended to set-up an approved Cyprus charity, explaining that otherwise the contributions would not be tax deductible. The strongest candidates went on to recommend that the Cyprus company that had taxable profits (i.e. NewCo) should be the one to effect the donations. Some candidates recommended placing the Mayfair foundation as 10% shareholder of the structure, and thus receive dividends which would be tax free. This was an interesting suggestion, but somewhat ambitious as a proposition given that the clients, Svetlana and Kyri Tata had agreed on the important things such as shareholding structures and percentage of ownership.

Question Two (Compulsory)
Question 2 was worth 30 marks. The question was split into parts (a) and (b). Part (a) was worth 19 marks and examined mainly the income tax consequences to Julia over two options of receiving a salary, as well as of rental income from a preserved building. Part (b) was worth 11 marks and focused on the tax implications of selling shares versus the company selling its assets. The latter was subdivided into two options, one of which

constituted a reorganisation scheme and one that did not. Candidates' overall performance was very good. Candidates found parts (a)(iii) and (b) more challenging. These are discussed in more detail below.

The requirement to prepare 'briefing notes' seemed to cause some confusion to candidates with many answers not preparing a format at all, even though they had prepared the memorandum for question 1. It thus appears that many candidates were not aware of the format required for briefing notes, which in essence is the same as that of a memorandum.

Part (a)(i) was worth 3 marks and required candidates to advise on the VAT consequences of purchasing equipment from a Cyprus supplier versus purchasing them from a UK supplier. Although the question part was well answered, only a very small number of candidates stated that Julia would not be able to register for VAT given that she is a doctor and thus carries out exempt supplies (services). So the VAT would always be a cost for her.

A common error was not to charge VAT on the transportation costs from the US supplier. VAT is charged on importation on the value of the goods imported, which would include transportation costs. A small number of candidates did not take into account the importation process at all.

One further point to make: just because a physical person is making a transaction, this does not always imply the transaction is B2C. It could very realistically be a B2B transaction if the physical person is self-employed (as in the case of most doctors) and they are receiving the supply for business purposes. From the answers given, there appeared to be a misconception that Julia could not be purchasing the equipment for business purposes given that she is a physical person.

Part (a)(ii), was a straightforward 1 mark question part, requiring candidates to state that, regardless of business usage, expenses relating to a saloon car are not tax deductible. The vast majority of answers were correct. The business-use element of the Jaguar was irrelevant.

Part (a)(iii) examined the income tax and special defence contribution (SDC) tax of the rental income that Julia would receive from the preserved building. Most candidates correctly acknowledged that income from preserved buildings was exempt from income tax but was subject to SDC, although a significant number were not aware of the exemption and taxed all the income under income tax. A few candidates misunderstood the fact that Julia was the owner of the preserved building and discussed benefit-in-kind issues, or brought in irrelevant points that were not required, for example, discussing income tax deductions for maintenance work on the preserved building when there was no mention in the question of repairs being required.

A small number of candidates did well to realise that Julia was not a tax resident in 2011, and thus would only be subject to SDC from 2012 onwards, and were aware that, following a change of Cyprus tax legislation, from July 2011 onwards any business that was a renting a property had to withhold SDC from the rent and pay it by self assessment by the end of the following month, as was the case in the present scenario with Ortasa Ltd renting property from Julia.

Part (a)(iv) was worth 8 marks and required the comparison between two salary options for Julia. On the whole candidates produced strong answers.

Most candidates picked up on the fact that Julia would be allowed the non-resident tax exemption being the lower of 20% of her salary or EUR 8.550, for the tax years 2012-2014 inclusive. Social insurance contribution calculations were also correctly stated. Stronger candidates also gave the deduction for capital allowances on the equipment, although none of these answers stated that there would have to be a provision in Julia's contract for the capital allowances to be valid. A specific requirement of the question was to advise Julia on what further matters she should consider when choosing between the two options, which many candidates forgot to do. It would be very sensible to re-read the requirement following completion of each question part, to ensure that all parts of the requirement have been addressed.

Part (b) examined three specific options relating to the disposal of shares. The first resulted in capital gains tax. The second was a reorganisation scheme and thus exempt from any tax consequences. The third, although appearing like a reorganisation scheme, did not in fact meet the criteria to be one, resulting in the imposition of a variety of taxes. Candidates were on the right lines when analysing the three options, but most deferred from analysing fully the future tax consequences of the resulting structure in their answers, despite this being part of the requirement.

Option 1 presented few problems to candidates who largely acknowledged that the income from the sale of shares would not be taxable under income tax, but that there would be a capital gains tax (CGT) implication from the fact that Ortasa Ltd owned immovable property in Cyprus. Some candidates incorrectly interpreted Option 1 as Ortasa Ltd selling its property, rather than the shareholders selling their shares in Ortasa, and discussed the CGT tax implications for the company as well the resulting increase in accounting profits and effectively in SDC that such sale would create. It was clear that candidates who produced such answers did not read the question properly and hurried to produce a reply before fully understanding the facts.

Some answers incorrectly stated that the goodwill value would form part of the taxable income of the shareholders. In fact, whatever price was paid, it still constitutes income from the sale of shares which is specifically exempt under income tax.

With regards to option 2, most of the responses correctly identified that this was a reorganisation scheme and that there were no tax consequences. Stronger candidates also discussed the tax consequences of Ortasa Ltd owning shares in Amir plc.

Around half of candidates correctly concluded that option 3 did not constitute a reorganisation scheme. Of the correct answers, a significant number went one step further to explain the resulting tax consequences, namely that CGT would be applicable to the sale of the building, resulting also in higher accounting profits which would have SDC implications under the deemed dividend rules. The goodwill would also be taxable at 10%. Ortasa would in addition have to prepare balancing statements for the assets it held. A small number of candidates also correctly advised on the future tax consequences of selling shares of Amir plc, which would be free of any tax.

Question Three

Question 3 was the first of the 20 mark choice questions of Section B of the exam paper. The question focused on taxation matters relating to immovable property. These included VAT aspects, land transfer fees, immovable property tax as well as taxation of the owner's benefit. The question was very popular with the vast majority of candidates choosing it as one of their two choice questions. Answers were on the whole very good and well balanced in terms of length and detail.

Part (a), worth 2 marks, required candidates to consider the fact that the construction of the hotel, a service, would take 4 years, whereas a VAT registered person can only claim input VAT for a period of 6 months before the date of registration. As such, Savvinos Ltd should voluntarily register in order to claim back all of the input VAT on the construction services. Most candidates correctly addressed this point. Candidates who explained that the company should only register when the EUR 15.600 registration threshold was surpassed, gave advice would have cost the client significant input VAT on the construction.

Part (b) examined the special VAT place of supply rule relating to immovable property. The twist in the question is the extension of the reverse charge principal in the VAT Law to cover business-to-business (B2B) property related transactions. This meant that if Savvinos Ltd was VAT registered in Cyprus, Nicole & Co could issue their invoices without any VAT and Savvinos Ltd would apply the reverse charge. The question part was worth 4 marks. The vast majority of answers picked up on the fact that architectural services were property related for place of supply rules, and that the transaction was B2B. Stronger candidates did well to extend their answers to cover the reverse charge principal.

Part (c) was worth 1 mark and was a straight forward computation of the land transfer fees. Very few scripts incorrectly gave the calculation for immovable property tax rather than land transfer fees- there should be no confusion at this level between the two.

Part (d) examined the ethical side of a proposal to not declare gains. It is the first time I have examined this small topic, although it has always been a part of the syllabus. The subject of undeclared income is also a topical issue in Cyprus and has been gaining more attention over the last 12 months in the press. As such I was curious to see how candidates would respond. The model answer gives some of the consequences of this proposal, namely that it constitutes fraud, the macroeconomic implications, as well as the decision as to whether the firm should continue providing services to the client should the proposal be accepted. Not a single candidate who attempted this question thought that this proposal constituted a good idea, which was pleasing!

Part 3(e) was worth 3 marks and examined immovable property tax (IPT). The problem set was for candidates to acknowledge that during construction, Andreas, who owned the land and thus had to pay the immovable property tax on the value of the land, would also have to include the 1.1.1980 value of anything constructed on the land, as at every 1 January, for IPT purposes. Not all candidates appreciated this point. Around half of the scripts correctly discussed this. The remaining scripts did not pick up on this issue, although most answers correctly discussed how IPT arises and is paid, which afforded them 2 of the 3 possible marks.

Candidates who stated that that the construction would be carried out by the company and that it was the company that would thus be liable for the IPT were incorrect. IPT applies to the registered owner of the land. In this case, the registered owner was Andreas, and he would be liable to pay IPT. Another common mistake was to add the value of the owner's benefit to the value of the land and subject the combined value to IPT. The owner's benefit is a deemed source of income for Andreas under tax legislation. Deemed income does not affect the 1.1.1980 value of the property - it is not an addition on the property that is taxable. The only physical addition that would affect the 1.1.1980 value of the land and thus have IPT consequences was the construction.

Part 3(f), for 7 marks, examined the owner’s benefit arising from construction by Savvinos Ltd, which was leasing the land for 20 years, of a hotel on the land owned by Andreas. Overall candidates made a very good attempt at this part and scored well, recognising the owner's benefit as taxable income. Furthermore, most candidates correctly explained how the value of the benefit arises and is taxed.

Common errors to this part included:

- stating that the 20% statutory deduction applied to the land rental income - the 20% does not apply to land,

- stating that the owner's benefit was taxable under special defence contribution (SDC) tax – SDC does not apply to the benefit,

- stating that the rate of capital allowances for the owner's benefit was 3% rather than 4%,

- stating that the benefit was equal to the cost of construction - this was a common error. The benefit will be assessed by the Commissioner of Income Tax but cannot *exceed* the cost of construction.

Tutorial note: The Cyprus Inland Revenue Department released circular 2012/15, relating to leases that are registered with the Land Registry Office, dated 6 July 2012. Therein, the Commissioner of the Inland Revenue states that, for leases that are registered with the Land Registry Office as the lease described in question 3 would be, the lease payments are not deemed to be rental income for the purposes of Special Defence

Contribution (SDC) tax, and thus not subject to SDC tax. The Income Tax Office has also signalled (not part of the circular) that it will not subject the lease payments to income tax. As such the rent under the lease, if deposited at the Land Registry Office, would be exempt from income tax and SDC. The subsequent disposal of the lease, as per the circular, will be subject to capital gains tax. This constitutes a change of tax policy for the Cyprus Inland Revenue. This exam paper is based on legislation (and interpretation thereof) that was passed before 30 September 2011, and accordingly the model answer is correct.

Question Four

Question 4 was a 20 mark question examining the taxation of ship management and insurance businesses, which both have special modes of taxation in Cyprus. These specific topics accounted for 14 of the possible 20 marks. In addition there was a 3 mark question part on management and control, and a further 3 mark part on the tax treatment of life insurance premiums under personal allowances.

Overall this question was the least popular one, no doubt because of the very specific topics that were being examined in parts (b) and (c). However candidates who did attempt the question produced very good answers and scored well, although part (b) proved a challenge. It was clear that this question benefited those who had studied the special modes of taxation areas.

Part (a) was worth 3 marks and examined the management and control test for the tax residency of a company. The majority of answers correctly stated the criteria for residency determination in Cyprus and attained full marks. The most common error was forgetting one of the three criteria of the management and control test.

Part (b) examined the taxation in Cyprus of ship management businesses under the special mode. This part was the least well answered of question 4. The vast majority of answers correctly identified that the tonnage tax system was a choice, but then did not analyse the provisions of this special mode of taxation. Another very common error was to state that the corporation tax rate, if one chose to be taxed under the normal method for Cyprus tax-resident companies, was 4,25% instead of 10%. In fact this was one of the changes in the tax legislation for the 2012 papers.

Part (c) was worth 8 marks and examined the special mode of taxation for life and non-life insurance businesses. The requirement gave very clear guidelines as to what was expected in terms of answers. The candidates who attempted question 4 produced excellent answers for part (c), showing a solid understanding of how such businesses are taxed. Common errors included stating that the allowable deduction from head office expenses was on the gross premiums received (in fact, the allowable deduction is on the net premiums, after deducting premiums paid on re-insurance) as well as stating that losses from one type of business could not be relieved against profits from another type of business. A few candidates incorrectly discussed the recapture rules that apply to losses that a Cyprus tax resident company uses from an overseas branch when the scenario provided involved a Cyprus branch of a foreign tax resident company, and thus the recapture rule does not apply. Some candidates are to be congratulated for stating that transfers to and from reserves for unexpired risks would be considered as a deductible expense or taxable income respectively.

Part (d) was worth 3 marks and examined personal allowance deductions from life-insurance premiums. This question part was also well answered with candidates understanding the various restrictions that apply, such as the 7% on capital insured or the 1/6th of the chargeable income before allowances. Strong candidates picked up the point that Alexander's wife's premium was paid by him and as such was not tax deductible for him.

Question Five

Question 5 was a 20 mark question that mainly examined the issue of personal financial risk for Oxana in her decision of how to invest her money, as well as of the tax consequences of these decisions. The question also briefly examined badges of trade and touched upon partnerships.

This question was a popular question and candidates made a very good attempt at parts (a) to (c). Part (d) was more challenging, and this was due to candidates not following through in their discussions, as explained further below. Overall answers were good.

Part (a), worth 2 marks, required candidates to explain that a partnership under Cyprus tax law is a transparent vehicle with the profits being taxed on the partners individually in their respective proportions. Most answers correctly addressed this matter.

Part (b) examined a single transaction of Luda Ltd selling 50% of its land, under the badges of trade. In this instance the very short period of ownership would be the deciding factor for this transaction to be considered a trading one. The large majority of answers picked up on this point. Many failed to produce the tax calculation that was specified in the requirement. Some answers produced calculations using the personal rates of income tax (for physical persons) rather than the corporation tax rate of 10%, which would only be the case if Oxana owned the land personally. Candidates do need to look carefully at who is the taxable person in a transaction. In this case, it was Luda Ltd which was selling the land and thus liable to pay the tax.

Candidates who emphasised that Oxana had invested in various properties and thus was making the purchase also for investment, arguing that the subsequent resale by Luda Ltd should be a capital transaction taxed under capital gains tax, failed to note that it is in fact Luda Ltd that is making the sale and under scrutiny here and not Oxana. Luda Ltd is a separate legal entity and a taxpayer in its own right. The badges of trade would address Luda Ltd's tax profile and not that of Oxana.

One other remark I would like to make to candidates is to be careful not to '*over-answer*' a question. The 3 marks available for this question part do not justify an extensive general analysis of all the badges of trade. The model answer, which is short and to the point, is sufficient to address the requirement and obtain full marks. Also, no marks were available for simply listing the badges of trade, without applying them to the question scenario.

Part (c) looked at financial and other risks relating to the bank loan in structuring the investment. Financial risks form part of the syllabus of the P6 Advanced Taxation (Cyprus) paper and when setting this paper I had noticed that it was not an area that had been widely examined in the past. I was thus happy to see most answers touching upon the major financial risks, mainly that the LIBOR base-rate could increase thus making the loan more expensive, and that there may be a mismatch in timing of the income to offset the loan repayments, if no sales were made early in the project. Stronger candidates also addressed the matter of Oxana's personal guarantees and thus taking the loan out in Luda's name would be less risky for Oxana, than taking it out in her own name, as the bank did not require her personal guarantee in this case. Most answers managed to score 2 from a possible 3 marks.

Part (d) focused on the taxation aspects of the three options presented in the scenario questions. The requirement included considerations relating to the extraction of cash by Oxana from Luda Ltd. Candidates correctly addressed the SDC implications of Oxana earning interest income under option 2, or the tax deductibility of the interest payable by Luda Ltd under options 2 and 3, but stopped short of considering for each option the tax implications of how Oxana could extract cash.

For option 1 few answers discussed that cash could only be obtained via dividends or reduction of share capital, and the related tax implications. Most answers correctly stated that the interest payable by Oxana would not be tax deductible which would inherently lead to a higher overall tax effective rate.

One common error, which was not anticipated, was candidates explaining that if Luda Ltd issued share capital a resulting shareholders debit balance would arise, attracting 9% notional interest. This would only be the case if Oxana did not pay Luda Ltd for the new issue of shares. However the scenario refers to an injection of funds into Luda Ltd for the additional share capital. No shareholder's debit balance would arise and no notional interest. I stress the importance of reading the scenario and the requirements carefully before putting pen to paper.

Option 2 produced limited but correct explanations that Oxana's interest income was taxable under special defence contribution (SDC) and that Luda Ltd's interest payable was tax deductible. Around half the answers made these two points. Candidates who stated that the interest payable was not tax deductible giving as the reason that the funds lent would be invested in shares were incorrect. The funds would be invested in a partnership, a transparent entity for tax purposes, which would in turn trade in immovable property. As such the interest would be deductible for Luda Ltd. Some candidates stated that the SDC would be payable on the margin between interest payable and interest receivable. This shows a clear misunderstanding of how SDC tax applies. SDC on interest always applies to the gross interest receivable.

A number of candidates discussed, at length, arm's length principles for connected parties. This was unnecessary given that the scenario specifically stated that the margin was acceptable to the income tax office.

Option 3 produced clear answers, mainly that the interest was tax deductible for Luda Ltd and that Oxana could only receive dividend income taxable to SDC. A few candidates did very well to discuss the benefits for Oxana of not having the legal obligation of the loan under this option.