Examiner's report

P6 Advanced Taxation (CYP)
June 2013

General Comments
The examination consisted of five questions. Section A contained two compulsory question; question 1 for 35 marks, including 4 marks for format and presentation, and question 2 for 25 marks. Section B comprised three further questions of 20 marks each, from which candidates had to chose and answer two.

There was evidence of time pressure, which was expected, but also evidence of bad time management. A common example was producing lengthy answers not justified by the number of marks available for that question part. This is a common problem where candidates find a 'comfort zone' and want to ensure they obtain full marks on a familiar topic, a decision I suspect they later regret when they find they have little time left to answer their final question. Candidates should practise strict time management and, when the budgeted time has been used, they should stop the question part and move on. If there is time left at the end, they can return to finalise parts left unfinished.

It is also recommended that candidates look closely at the verb used in the requirement. For example, if it is 'to list' then they should produce a shopping list and nothing more; if the verb is 'to describe' then more detail will be expected and required.

I did not note any particular benefit to answering questions in a specific order. There is a theory of first attempting questions that examine topics about which the candidate has studied well, in order to boost confidence, and another that question 1, a scenario question worth 35 marks, should not be left to last as this may result in insufficient time to address the question with the most marks. Neither seems to be right or wrong. I suggest candidates find what works best for them by attempting full past exams under exam conditions during their revision.

Question parts that were worth more than 10 marks were typically poorly addressed, which I attribute to rushing to answer the question before considering the facts and tax options. The principle I recommend is to 'think more and write less'. I understand that under the stress of the exam it may be difficult to apply but, if practised during the revision period by attempting questions under exam conditions, this will become easier.

Generally candidates scored highly on the part B questions which helped balance what seemed to be a demanding part A. Candidates performed particularly well on questions 1a(i), 1b(i), 2a, 2d, 3b(ii), 3b(iv), and 4d. The questions candidates found most challenging were questions 1b(ii), 2e, 3b(iii) and 5c.

A number of common issues arose in candidates' answers:

- Failing to read the question requirement clearly and therefore providing irrelevant answers.
- Providing answers that re-produced the theory in full without applying it to the scenario at hand, thus *not* demonstrating whether the points examined were understood.
- A lack of technical knowledge.
- Poor time management between questions.
- Not learning lessons from previous examiner's reports and hence making the same mistakes, especially in relation to place of supply rules for VAT.
- Providing more than the required number of points.

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Specific Comments

Question One

This 35-mark question was based on a group of companies engaged in the preparation and analysis of reports on the use of cash in businesses. The question examined the areas of branch versus subsidiary, interpretation of double tax treaties, and various areas of new legislation in tax law. Overall candidates performed very well in some parts and poorly in others.

There were 4 marks available for format and presentation. The majority of candidates attained full marks. However a significant minority presented a memorandum in part b rather than a letter.

Part (a)(i) required candidates to analyse the potential tax benefits of three proposed transactions. All transactions related to recent changes in the tax legislation. Candidates appeared well informed on all three topics. The first transaction related to the change in legislation whereby a new subsidiary, incorporated during the tax year can still form part of a group for group relief purposes if all the other criteria are met. The most common omission was not to state the additional requirements for group loss relief companies, such as the minimum 75% holding. This requirement stated that candidates'*should include a complete explanation of the tax law relating to the benefits discussed*.' The word 'complete' will require just that – a full analysis of the legislation surrounding the matter under discussion.

The second transaction examined the tax deduction of interest on a loan used to invest in a subsidiary company. The common omission was not to explain that any interest would be restricted if the subsidiary had assets not used in the business. The third transaction related to the use of the intellectual property box regime in the legislation. Once again, candidates were very well prepared.

Part (a)(ii) required a calculation of the tax payable and of the annual net income for Paul for the tax years 2013, 2014 and 2015. This examined the new amendment to the law which allows for a 50% exemption of emoluments for five years if these exceed €100k per year, for non-residents taking up employment in Cyprus. Candidates did relatively well. The most common error was to apply the exemption of €8.550 from the 2013 tax year instead of from the 2014 tax year. The employment started on 1 January 2013 and thus the exemption applies from the following year, 2014. Another error was not to calculate the annual net income despite this being a specific requirement. Weaker candidates did not limit the social insurance contributions to the maximum amount, despite this information being on the front of the exam paper. A small minority of candidates included in their calculations the employer's contributions, including social cohesion fund, which were not relevant.

Part (b)(i) examined the choice of using a branch versus a subsidiary for an investment into Russia. The venture in Russia was expected to make a loss during the first three years, and possibly close down if by the fifth year it was not profitable, so the main concern would be to make use of these losses. Answers were on the whole very good with most candidates correctly picking up on this point and suggesting the use of a branch initially. The most common omission was the mention of the availability of double tax relief on the recaptured profits in the case that the branch was profitable in future.

Part (b)(ii) examined candidates' understanding of double tax treaties. Most candidates found this part challenging. The most common issue was to focus the answer more on local taxes when withholding taxes constituted a more important consideration, given that the withholding was on the *gross* interest or dividend amount, whereas the local taxes would be based on the net, so avoiding any withholding would result in substantially less tax leakage.

The approach candidates should have taken was to firstly identify the sources of income. In the structure there was dividends as well as interest flowing from the subsidiaries up to the parent companies. The next step was to review the double tax treaties and work out which were more beneficial for each source of income individually. It should have been clear that the Russian company should have no subsidiaries if it may be closed down within five years.

A significant minority of candidates suggested changing the management and control of the foreign companies to Cyprus, in order to benefit from a lower corporation tax. Candidates should appreciate that, in practice, tax advice is viewed as a complement to commercial considerations when forming a structure. As such, advising Capoda to move the management and control of the companies they were proposing to acquire to Cyprus is probably not commercially viable so not good tax advice.

With regards to the interest, many candidates did not appreciate that a loan could be provided *from* any company *to* any company. A loan had to be provided to Audette in Moldova. It was clear that Russia had the most favourable double tax treaty with Moldova when it came to interest payments, in that Moldova withheld tax on interest payment to Cyprus and the Netherlands, but not to Russia. Thus it would be preferable for the loan to Audette to come from the Russian entity. Russia could then be financed directly from Hommage, since there is no withholding tax on interest between Cyprus and Russia.

With regards to dividends, Moldova applied a 5% withholding tax on dividends to Cyprus and 10% to Russia. However there was no withholding on dividends from Moldova to the Netherlands, because the investment into Moldova was for more than 50% of the shares and at least US$300.000 was invested in the share capital. In addition, the Netherlands do not apply any withholding tax on dividends to Cyprus as a result of the parent-subsidiary directive. The logical proposal would thus be to structure Audette, the Moldovan company as a subsidiary of Inspiration, the Dutch company. Inspiration would itself be a subsidiary of Capoda. This would reduce the withholding tax on the dividends from Moldova to Cyprus to nil.

Question Two

This 25-mark question was based on Voudoui Ltd, which manufactures and sells plastic products. The question covered the topics of capital allowances, balancing charges, capital gains tax on exchange of property, VAT on sale of products and reorganisation schemes.

Part (a) required candidates to explain the VAT treatment of sales made by Voudoui. This part was generally answered to a satisfactory degree. It is important to use the VAT terms appropriately: a transaction that is outside the scope (place of supply is outside of Cyprus) is very different from one that is exempt (place of supply is Cyprus and the transaction is stated in the VAT legislation to be exempt from VAT).

There are also implications as to whether input VAT will be recoverable on such transactions. A significant number of answers confused the place of supply rules for the sale of goods, with those for the sale of services. Place of supply rules are the backbone of VAT legislation and are frequently examined.

Most answers correctly stated that the sale in Cyprus would be charged with the standard rate of VAT. With regards to EU sales, many candidates correctly stated that the buyer would account for VAT in their country. Fewer answers also noted the requirement to validate the VAT number, and only a handful of candidates acknowledged that Cyprus VAT would have to be charged in the event that Voudoui did not manage to validate the registration number. Weaker candidates discussed a requirement for Voudoui to register in the other member state, which is incorrect. With regards to the sale of goods to the Middle East, the place of supply is in fact Cyprus (where the goods are located when transportation begins), but the supply is zero rated given that it is specifically mentioned in the legislation as a zero rated supply.

Part (b) required candidates to advise on the tax treatment of the disposal of two machines. Answers were very good. There were two possible choices – one was for the company to pay corporation tax on a balancing charge of □20.000, and the other was for Voudoui Ltd to rollover the balancing charge in the cost of the new machines.

Part (c) required candidates to discuss how capital allowances would be treated for the two new machines and the effect of their purchase on deemed dividend distribution. This falls back to a recent change in the legislation, and it was pleasing to see that most answers correctly identified that the new machines were eligible for capital allowances of 20% and that their cost would be deductible from accounting profits for the purposes of the deemed distribution. A very limited number of candidates also correctly noted that the depreciation would impact the accounting profits. Some answers confused the term capital allowances with depreciation. Capital allowances would only impact the accounting profits through reduced corporation tax. The deemed distribution rules affect accounting profits and not taxable profits.

Where candidates claimed the rollover relief for part (b), then the accelerated capital allowances would only be available to the cost of purchase reduced by the balancing charge that was rolled over.

Part (d) was generally well answered and candidates showed that they were prepared for tackling capital gains on exchange of property. In calculating the rollover relief, the most common error was to deduct the land transfer fees whereas in fact the rollover would be the difference between the disposal value of the new property and the base cost of the previous property, without including the land transfer fees. Weaker answers did not calculate correctly the rollover relief, with many of these stating that it was simply equal to the □75k cash amount.

Part (e) examined reorganisation schemes. This question part required that candidates think of how they could get from the structure shown in diagram 1 to that shown in diagram 2. Most answers correctly stated the benefits of implementing a reorganisation scheme. The big ‘hints’ were in the two diagrams which showed clearly that the crude oil business of Anitos Ltd had to be placed in a new company (transfer of assets scheme), and that Anitos would have to become a subsidiary of Anredas whilst at the same time Voudoui would become a shareholder in Anredas (exchange of shares scheme). Both schemes were required to be discussed and applied to the scenario.

A significant minority of candidates did not mention a reorganisation scheme at all. Instead they stated that Anredas should firstly float on the stock exchange and then Mr Tryfon could sell 25% of his shareholding in Anredas to Voudoui. The scenario clearly states that the client wants to 'get from diagram 1 to diagram 2 with a <u>view to</u> floating Anredas’so suggesting that the company be floated before the reorganisation takes place would not be acceptable.

Question Three

This 20-mark question was based on Daniel, a retired resident of Ildoria who was considering moving to Cyprus, Ildoria being an imaginary country. The question tested how trusts are taxed, the capital gains tax on the sale of overseas properties, and the taxation in Cyprus of an overseas pension. This question proved the more popular of the choice questions, and candidates that attempted it generally scored very well.

Part (a) required candidates to identify the fixed trust as being most appropriate to Daniel, given that he wanted all income to be distributed equally to his two sons upon receipt by the trustees. Weaker candidates made reference to a Cyprus Trust as being most appropriate - a Cyprus trust can be a fixed or a discretionary trust.

Part (b)(i) required candidates to identify that if Daniel moved to Cyprus, and given that Daniel was the sole director in Werlek, then Werlek could easily become Cyprus tax resident by virtue of its management and control, and thus there was no need to incorporate a new Cyprus company. This would be beneficial given that corporation tax in Cyprus was 5% less than that that in Ildoria. Once again a large number of candidates managed to score full marks by explaining the management and control test, as well as the ensuing benefit of moving the company’s tax residence. Weaker answers recommended incorporating a new Cyprus company in order to take advantage of the lower corporation tax rate.

Part (b)(ii) examined the Cyprus capital gains tax position on a disposal of an overseas property. This question part was very well answered with the majority of candidates scoring full marks. The most common error was to tax the gain in Cyprus at 20% as a result of the double tax treaty stating that the gain was taxable in the country of residence of the owner. Double tax treaties never impose taxes. They only state who has taxing rights and they sometimes limit the amount of tax that can be imposed. The fact that it stated in the present scenario that the gain was taxable in Cyprus, only meant that the UK did not have a taxing right. We then would look at Cyprus local law to see how the gain was taxed, with the correct answer being that it would *not* be taxed given that Cyprus capital gains tax does not apply to properties situated outside of Cyprus.

Part (b)(iii) examined how the income of a trust was taxed. Here candidates had to consider that the trust had two different forms of income – dividend and rental income, as well as that there were two beneficiaries, one of whom was not a Cyprus tax resident. Answers were on the whole surprisingly poor.

Only a few of the answers explained how the taxation of a trust is administered. A significant number of answers did not produce any calculations, despite this being specifically requested.

Stronger candidates noted that double tax relief would be available for the UK rental income both for income tax purposes as well as SDC. The majority of answers did not address the differences on how the beneficiaries would be taxed. Although the taxation systems of Ildoria and Cyprus were similar, this would impact the payment methods.

Part (b)(iv) examined the taxation of an overseas pension. Answers were generally very good, providing an explanation or calculation of what tax was payable under the normal method and comparing that to the tax payable under the special mode of taxation.

Question Four

This 20-mark question was based on Nastyka Ltd, which manufactures children toys. The question touched upon a variety of topics. It examined how a non-Cyprus tax resident professional paid taxes on Cyprus source income, how a Cyprus tax-resident person can claim a tax exemption based on the 90-day rule, cross-border VAT transactions, as well as the new rules relating to a director's debit balance.

Answers were overall fair. Candidates could have scored better by explaining their conclusions. The verbs used in the requirement were 'explain', 'describe' and 'discuss', which merit more detail than a simple statement of what the tax treatment should be.

Part (a) required an explanation of the VAT treatment of Ina, a Russian professional, advising Nastyka Ltd. The majority of answers incorrectly concluded that this was a B2C transaction, giving as their reason that Nastyka was a physical person. The 'C' element in a B2C transaction depends solely on the person receiving the service and not the one providing it. Given that the recipient of the service was Nastyka Ltd, and that Ina was resolving the technical problems of Nastyka's new toy design (as a self-employed person), this was certainly a B2B service and not a B2C. Where candidates explained correctly that the place of supply was Cyprus, a common mistake was to state that Ina would have to register for VAT in Cyprus and charge Cyprus VAT. This was perhaps a result of believing that Ina's time in Cyprus would create a permanent establishment which would require VAT registration. In fact the one-month period would not result in a PE and Nastyka would simply apply the reverse charge on Ina's invoices.

Part (b) examined the only case in the tax legislation where income is considered Cyprus source income, despite the existence of a permanent establishment. Ina's emoluments would be taxed at a flat rate of 10%, deducted at source by Nastyka. Candidates produced very good answers. A handful of weaker candidates subjected Ina's income to the normal income tax bands, which would not apply to a professional such as Ina, who is taxed under the special mode of taxation.

Part (c) required an explanation of the VAT treatment for distance selling. A number of answers produced a spectrum of suggestions, including reverse charge by the recipient, which was incorrect.

Part (d) examined the 90-day rule for when a Cyprus tax resident works at an overseas PE of a Cyprus employer. Answers were generally excellent.

Part (e) examined the new legislation on director's debit balances. There was also an unethical option on which candidates were asked to comment. Candidates were generally well informed and produced correct explanations of the tax treatment, although the appropriate calculations requested were often incomplete, with answers not applying the 35% income tax rate to deduce the tax payable. Only a handful of stronger candidates recommended clearing the debit balance with a dividend issue, which would have resulted in less tax. A dividend would be possible given that the requirement stated that Nastyka was very profitable with a surplus of cash. With regards to the unethical option answers were on the whole good, although a significant number of candidates incorrectly stated that, had option 1 been implemented, Nastyka would have the right to claim capital allowances as well as input VAT. In fact this would not be the case since the furniture was not being used by Nastyka at all in the business.

Question Five

This 20-mark question was based on Electra Limited and tested candidates' knowledge of badges of trade, VAT de-registration, as well as the tax implications of not paying social insurance contributions by the due date. Overall this was the least popular of the choice questions.

Part (a) required candidates to use the badges of trade in order to decide whether the transaction in the given in the scenarios were of a trading nature (and taxed under income tax) or a capital nature (and subject to capital gains tax). Overall answers were fair but there were instances where candidates misunderstood how the badges of trade applied.

Scenario 1 involved the sale of an apartment that Electra Ltd acquired against the kitchens delivered to the developer. The key criteria here was the short length of ownership which was two weeks, and would be conclusive to the transaction being considered of a trading nature. A few answers incorrectly took the date of delivery of the kitchens (18 months ago) as the date of ownership. Stronger candidates noted that Electra Ltd sells kitchens and as such has no knowledge of selling apartments, being an argument for a capital transaction. Despite the requirement specifically asking for the calculation of the taxable income or gain, only a minority of candidates produced this for scenario 1.

Scenario 2 discussed the sale of Electra's large warehouse. Here the facts make it less clear if the transaction is trading or capital. On the one side, Electra took out a bank loan to acquire the warehouse and also improvements were made to the property, although these were more to aid in the business use rather than to augment the property value. These facts lean towards a trading transaction. On the other side the warehouse is shown within fixed assets and used for storage, and has been held for a relatively long period of time, being two years. Stronger candidates made the link with the previous transaction, which the question stated occurred three months previously, and correctly concluded that if Electra Ltd became a 'trader in land' as a result of the apartment sale being considered to be of a trading nature, then this would also count heavily towards the facts in scenario 2 being considered to be of a trading nature.

Scenario 3 was regarding the sale of a luxury car owned by Electra Ltd. The majority of answers correctly stated that this would neither result in a capital gain nor corporation tax. A few candidates explained that capital gains tax applies only to immovable property and not to chattels.

Part (b) examined a recent change in the legislation and the large majority of candidates offered good answers. The most common error was to state that it would be the social insurance contributions that would not be tax deductible if not paid within two years, whereas it is the entire salary to which the social contributions relate. Few candidates correctly mentioned the surcharge on the delayed payment or worked out that, if the contributions were paid in January 2015, these would be within the two years for the December 2012 contributions and so would be allowable.

Part (c) examined VAT de-registration. Clearly candidates were unprepared for this topic. For part c(i) most answers correctly stated the de-registration limit of □13.669 which in any case is sated at the front of the exam paper. A handful of candidates explained that the limit applied to taxable turnover over the last 12 months or that the deregistration date applied from the date of application. For part c(ii) most answers stated that any outstanding output VAT should be paid without analysing this further. Only a very small number of candidates correctly discussed a potential VAT charge arising on business assets, unsold trading stock or capital assets for which input VAT was claimed, and that were held on the date of de-registration.