Examiner's report

P6 Advanced Taxation (CYP)
June 2014

ACCA

General Comments

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

The vast majority of candidates attempted four full 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. It was evident in some cases that candidates were paying particular attention to time management. Some question parts were marked at the top of blank pages, no doubt with the intention to proceed with the exam and revert if there was time to complete that question part.

Candidates performed particularly well on questions 1 (ii), 1 (iii), 1 (v), 3 (d), 4 (a), 4 (b) and 5 (c). The questions candidates found most challenging were questions 1 (vi), 2 (b), 2 (c), 3 (c) and 5 (f). This appeared to be mainly due to candidates not understanding core syllabus areas sufficiently well; a lack of technical knowledge and also due to a failure to read the question requirements carefully.

A number of common issues arose in candidates' answers:

- Failing to read the question requirement clearly and therefore providing irrelevant answers which scored few, if any, marks.
- Insufficient depth in answers resulting in failure to pick up all of the available marks
- 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 the Bekov Oz Group, a group of companies involved in the wholesale of pasta. The question tested various aspects of taxation including re-organisation schemes, double tax treaty provisions, group loss relief, transfer pricing and certain aspects of VAT.

Candidates, to a very large extent, made efforts to obtain the four available marks for format and presentation. However, a small minority of candidates either produced no memorandum, or had a poor answer format. Efforts should be made by all candidates to obtain these marks as they represent four valuable marks on a paper where only 50 marks are required to pass.

Part (i) for 4 marks required candidates to recommend a structure that would satisfy Alfie's complaint over the German withholding tax on his dividends. Most answers correctly stated that a Cyprus tax resident company could be inserted between BML and AHL, to alleviate the existing withholding tax (WHT). For full marks, the explanation required justification by reference to the double tax treaty provisions, as well as an explanation of the taxation at each level. Where candidates failed to pick up marks, this was due to insufficient depth in their answers. Specifically, a common omission was a failure to discuss how the dividend would be treated when received as income by the new intermediary Cyprus company i.e. that it would be exempt from corporation tax and special defence contribution, with reasons. In addition, some candidates recommended in some detail moving the management and control of BML for it to become a Cyprus tax resident company in order not to subject the dividend to any WHT. However, given the scenario, this was not a commercially viable option. Similarly, some candidates mentioned moving the management and control of AHL even though this was specifically stated as not being an option in the scenario.

Part (ii) for 4 marks required candidates to recommend how BML and RPM could become one business, including clearly identifying the shareholders of the new company and their respective percentage shareholdings. The requirement contained the words 'new company' and 'together in one new business', hinting towards a reorganisational scheme of a merger. The majority of answers correctly stated this and explained how this scheme could arise. Generally answers were very satisfactory, with the most common omission being the analysis of the shareholding and especially the percentage that would be held by AHL and BOH.

Part (iii) for 3 marks required candidates to list the tax liabilities that could be avoided by using a reorganisation scheme. Although generally well answered the following common mistakes arose:

- The requirement required a simple list. Yet a significant number of candidates wrote a paragraph for each liability explaining in detail what was meant – this was unnecessary, especially given that the requirement specifically stated 'you are not required to provide details';
- VAT is not a tax that is avoided through a reorganisational scheme. Any scheme of reorganisation affects only direct taxes and is not an automatic exemption from VAT. A large number of answers incorrectly included VAT as a liability avoided through such a scheme.

Part (iv) for 4 marks examined candidates' understanding of the VAT rules regarding the simplification procedure for triangulation, as well as for when the goods are part of a chain transaction resulting in an export. Overall, answers were satisfactory to this park. The explanations of the simplification procedure were particularly pleasing. However, some candidates did not mention the triangulation rules and stated only that the place of supply was where the recipient was established and that the reverse charge would apply, an answer that did not adequately address the two transactions within the chain transaction.

The answers relating to the export were generally satisfactory. However, as stated in past examiner's reports, candidates should be careful with the terminology they use with regards to taxes, and especially with VAT. A very common error was for answers to state that the export was outside the scope of EU VAT. The goods were being exported from Germany. As such, they are outside the scope of Cyprus VAT but certainly not EU VAT. The place of supply for the sale of goods with transport is where the transport starts, which is Germany. It is just that all exports are zero rated, but the place of supply *is* within the EU.

Part (v) for 7 marks was a question part relating to group relief. In the past this has been an area that candidates have performed well on and this sitting was no different. Candidates were generally aware of the rules governing tax groups, including the recent amendment in the law relating to subsidiaries incorporated during the tax year, which affected BOF. In addition, candidates also showed a good understanding of the anti-avoidance provisions relating to loss companies, as in the case of BOR's €350k losses brought forward. A common error was for candidates not to separate out the tax treatment of BOR's 2013 and 2014 losses of €100k in their analysis. The 2013 losses could only be carried forward and relieved against the first available profits, given that in 2013 BOR was not part of a loss group, as it was acquired during the year. However, the 2014 losses could be used through group relief against profits of BOT.

Part (vi) worth 2 marks required candidates to discuss the tax treatment of a payment made by BOT to BOR for the use of losses. The fact that no such losses could be used as a result of the anti-avoidance rules did not impact the question, which was to discuss the treatment if such payment would be made. The answer was simply that any such payment was ignored for tax purposes, provided the funds did not exceed in value the amount of losses transferred. This is one of those facts that candidates either knew or did not. Only a small number of answers mentioned the correct tax treatment. The majority of answers discussed that the funds would be considered a loan and that given that the two companies were related parties, deemed interest would have to be imposed. Although incorrect, this was a logical deduction for a candidate who was not aware of the specific rule.

Part (vii) was worth 5 marks and required candidates to understand that the farm constituted a permanent establishment in Romania giving taxing rights to the Romanian authorities. Many answers correctly pointed this out. However, a few candidates incorrectly suggested that the current set-up was a good form of tax planning, resulting in a reduction of overall taxes from 16% to 12,5%.

The solution for the farm to sell to BOT at a discount was identified only by some candidates. Many answers did not offer any solution limiting the reply to a generic statement, typically that the current set-up would 'cause a problem with the Romanian tax authorities'. This lack of depth in the answers is one of the key reasons why candidates did not perhaps achieve their full potential in attaining marks. This is once again down to exam technique, thinking more and writing less – a statement that appears in the examiner's reports at every sitting. I once again highlight this point here.

Part (viii) was worth 2 marks and required the tax consequences for Guy and his group of companies if he became a tax resident of Monaco. The large majority of answers correctly stated that any dividend he received from his Cyprus company would no longer be subject to special defence contribution. However only a minority of candidates picked up the second mark which was that the group of companies would no longer be subject to the deemed distribution rules, given that Guy, who was the sole shareholder, would cease to be Cyprus tax resident. Many answers incorrectly stated that Guy's move to Monaco would change the tax residency of the group of companies, detailing the rules surrounding management and control, even though there was nothing in the requirement to suggest that this could occur as a result of Guy's relocation to Monaco. Moreover the length of such answers outweighed the mark allocation for the question part which should have been noted by candidates as a matter of exam technique.

Question Two

This 25 mark question covered the topics of intellectual property (IP), self-employment, and transfer of going concern for VAT purposes.

Part (a) for 6 marks required candidates to describe the tax treatment of a loan that would be received by Nicole, with an emphasis on the fact that the interest rate which was being proposed was significantly below the market rate. Candidates' answers to this requirement were mixed. A common error was to state that the rate would be subject to the arm's length principles. This was not the case given that the parties (lender and borrower) were not related parties. Many candidates stated that the Cyprus tax authorities would not accept such a rate as tax would be lost in Cyprus, without explaining how this would be the case. It was evident that candidates rushed to answer without truly considering the fact that the loan would generate interest payable in a business, and thus a lower interest rate would, in fact, mean higher profits subject to Cyprus tax. Under the option to have the loan provided by a non-Cyprus tax resident lender (the husband), the interest income would not be subject to special defence contribution (SDC), meaning that the lower rate of interest would, in fact, result in higher income for the tax authorities. Yet candidates produced generic answers based on what they perceived was being asked, without really considering the facts – another instance where the 'think more and write less' doctrine applied. However, despite the above comments, some candidates did think the scenario through and produced coherent answers, which scored well.

Another common error was to state that the loan was of a capital nature and thus the interest would not be tax deductible. There was no suggestion in the scenario that the loan would finance items of a capital nature and candidates should not assume what is not explicitly stated in the question, without fully explaining and justifying such assumptions.

Most candidates correctly explained the SDC benefit of the loan being granted by the husband, with most correctly stating the need to obtain information regarding how tax on interest income applied in the country of residence of the husband.

Part (b) worth 6 marks examined the VAT and income tax implications of income relating to a software program, in the situation where the IP remained in the possession of the sole-trader.

With regards to the VAT, a significant number of answers correctly stated that this was a B2B transaction and that the place of supply was where the recipient was based, being Luxembourg, which would require Tyhon to apply the reverse charge. Satisfactory answers emphasised the need for Nicole to verify the VAT registration number of Tyhon. Less satisfactory answers incorrectly stated that the invoice would require Luxembourg VAT.

The direct tax element of the requirement did not produce satisfactory answers. Most answers used the corporation tax rate of 12,5% rather than the income tax rate to tax the royalty income. Although Nicole was undertaking a business, she was undertaking this business as a sole-trader and thus any net income of the business would form part of her taxable profits, and be subject to the income tax rates. Another common error made by candidates was to state that the 80% exemption is not available to Nicole because it is only available to companies. This is not correct. The 80% exemption is afforded to income arising from IP and has nothing to do with whether the IP owner is a natural person or a corporate person. As such, the 80% exemption was available, both to the royalty income as well as to the sale of the royalty itself. Only a small number of answers correctly stated this.

Moreover, another common error was taxing the income progressively starting from the nil rate band even though it was clear from the scenario that Nicole was a higher rate taxpayer and thus the entire net income would be subject to the 35% rate.

Part (c) was worth 11 marks and required candidates to analyse the direct tax treatment of two options relating to IP under a company structure. This question part generally produced unsatisfactory answers. A significant number of candidates correctly stated that the royalty income would be subject to the corporation tax rate of 12,5%, and that in both options, the 80% exemption would apply. A smaller number of candidates also appropriately included the amortization charge for option 3 in their calculations. However, aside from these three points, most answers did not address the requirement in the depth required.

The most common error made was to state that if Nicole sold the right to the IP under option 3, she would have a debit balance of €200.000 with the company which would attract a 9% benefit taxable under PAYE. Once again, this appeared to be a result of candidates' rush to answer before considering the requirement. The sale of the IP would mean that the company would owe funds to Nicole, i.e. Nicole would have a credit balance with the company, and not the other way around. However, only a few candidates picked up on this point. Moreover, only some of the answers even discussed arm's length principles in relation to the sale of the IP between Nicole and her company (which were related parties). From the facts of the scenario, a conclusion could be drawn that the €200k sales price was certainly at arm's length, given that Tyhon, a third party, had offered €250k. The ensuing discussion that the price could be increased to increase the credit balance and avoid additional SDC on the difference, constituted higher marks which were awarded only to a few candidates. Another common omission was candidates' failure to discuss the purchase of the shares by Tyhon which would have avoided taxes for Nicole.

Overall, there was a lack of computations to support conclusions, which made the comparative analysis difficult to follow in many instances. Answers were too generic and lacked substance and clarity. The majority of answers did not produce sufficient detail to merit the 11 marks that were available, with a significant number leaving space on the exam answer paper no doubt to return to the question part at a later stage in the exam, without achieving this intention.

Part (d) worth 2 marks examined the VAT treatment of a transfer of a going concern. The majority of candidates did not produce satisfactory answers to this part. Most answers discussed that the incorporation of the business and the transfer of the assets and liabilities constituted a reorganisation scheme and re-iterated the benefits of such a scheme, stating that VAT would also not apply. This was the correct result but for the wrong reason. Moreover, candidates should have noted that the requirement was to discuss only the VAT implications, and that by default discussing any other taxes was unnecessary, time consuming and merited no marks. Only some candidates discussed that any transfer of a going concern was outside the scope of VAT.

Question Three

This 20 mark question was based on Fesa Ltd, a Cyprus resident company managed by Vassilis and Dona. The question tested candidates' knowledge of losses brought forward and the five-year rule; the 90-day rule for Cyprus tax residents working overseas; and permanent establishments. Overall, candidates produced strong answers.

Part (a) for 5 marks required candidates to consider the temporary tax that Fesa Ltd would declare for the 2013 tax year. In order to calculate this, candidates would have to work out which of the prior year losses could be carried forward and how they could be used. Overall, candidates showed a solid understanding of the five-year rule, especially important given that this was a relatively new part to the syllabus, following a change in the tax legislation. The thing to look out for here was that the 2007 losses could be used against the 2008, 2011 and 2012 profits, with the remaining 2007 losses of €109.200 lost as a result of the 5-year rule. Thus the 2013 profits would be reduced by the 2009 and 2010 losses and temporary tax should only be calculated on the remaining €70.000. Most candidates showed a solid understanding of this point. Where candidates applied a 75% reduction to the estimated profits for the purpose of the temporary tax, as explained in the tutorial note to the published solutions, full marks were awarded.

A significant minority of answers, perhaps due to time pressure, did not calculate the losses brought forward and based the temporary tax only on the expected profits stated for the 2013 tax year. In addition, some candidates were not aware of the change in the temporary tax dates and stated the old rules i.e. that the tax was paid over three equal instalments, on 1 August, 30 September and 31 December, rather than two on 31 July and 31 December.

Part (b) for 3 marks required an explanation of whether Dona was eligible to claim the 90-day rule exemption for the four months that she would be travelling abroad to meet with Fesa Ltd's clients. The requirement specifically asked to "explain" whether the 90-day rule could be applied. Candidates were expected to firstly explain the rule, and then decide if it applied to the scenario. Given that Fesa Ltd did not have a foreign permanent establishment, and that Fesa Ltd itself was not a foreign employer, the exemption was not available to Dona. Most answers demonstrated a correct understanding of this point.

Part (c) for 2 marks required an explanation of when VAT is applicable to the sale of the office building. Answers were typically not well thought out. Only a small number of candidates explained that VAT could only apply to 'new' buildings, with an explanation of what 'new' meant. Many answers just stated that VAT applied to 'new buildings' without explaining what was meant by this term. Thus marks were lost by candidates' failure to go into the level of depth required by the question. Many candidates discussed place of supply rules relating to immovable property, stating that if the property was located in Cyprus then Cyprus VAT would apply. The 'place of supply' rules relating to immovable property apply to services and not to the sale of the property itself which is a sale of goods for VAT purposes. A small number of candidates incorrectly stated that since Mia Ltd was not a Cyprus tax resident company, then no VAT would apply to the purchase of the property.

Part (d) for 2 marks required a straightforward calculation of the land transfer fees. The rates that should be applied were stated in the tax rates and allowances at the front of the exam paper. The majority of candidates performed the correct calculation. However, some candidates applied the immovable property tax rates instead of the land transfer fees rates.

Part (e) worth 8 marks examined candidates' knowledge of permanent establishments for corporation tax purposes and fixed establishment for VAT purposes. There were 8 marks available and three 'parts' to the requirement – corporation tax, VAT and social insurance. As such, candidates should be able to deduce that roughly 2,5 marks were available for each part.

Candidates correctly spotted, in the large majority of cases, that Mia Ltd would create a Cyprus permanent establishment and that the income attributed to this establishment would be taxed in Cyprus at the 12,5% rate of corporation tax. However only a few candidates went further to discuss the deductions that would also be available, such as the salary costs and the capital allowances relating to the office building.

The VAT part of the question produced more diverse answers. Firstly, there is a difference between a fixed establishment and a permanent establishment. The former is the equivalent for VAT purposes to what the latter is for direct tax purposes. However, the basic philosophy is the same in that any income attributed to the fixed establishment in Cyprus would be chargeable to Cyprus VAT. Once again, most candidates understood this point but there was confusion as to how the VAT should be applied. Many answers stated that Mia Ltd would be providing the services and, as such, the VAT would be applied through reverse charge by the recipient, Fesa Ltd, in Cyprus. This is incorrect. If the fixed establishment intervened in the provision of the services, which it clearly does, then there is a service from one taxable person to another, with both taxable persons based in Cyprus. As such, Cyprus VAT should be applied to the invoices, just as it would for services between two Cyprus entities, where the place of supply is Cyprus. However, only a small number of answers stated this.

The part relating to social insurance was well answered with most candidates correctly stating that the employees would be subject to social insurance contributions in Cyprus, regardless of if they were paid directly from Dubai, given that they would be exercising their employment duties wholly within Cyprus.

Question Four

This 20 mark question was based on Elnar and tested Cyprus International Trusts, personal income tax and capital gains tax aspects.

Part (a) for 3 marks required candidates to explain whether Elnar was eligible for the 20% exemption, up to €8.550, available to non-residents taking up employment in Cyprus. The requirement also explicitly asked for the years in which the exemption would apply. This question part was well answered and the majority of candidates correctly explained the 20% rule and why Elnar was eligible for the exemption. A small minority of candidates failed to fully answer the requirement as they did not state the years for which the exemption would apply.

Part (b) for 11 marks required candidates to compare the tax payable by Elnar in Ildoria with the tax he would pay if he moved to Cyprus. Candidates were also requested to state the effective tax rate in each case.

This question part produced very satisfactory answers. Most candidates coped well with calculating Elnar's tax if he stayed in Illdoria. However, some candidates did not separate the trust income into income from dividends and income from interest, which was necessary given that the two types of income are subject to different rates of tax. A small minority of candidates included the Ildorian rental income in the computation which was incorrect given that this income only arises if Elnar moves to Cyprus, and would thus not be available income if he remained in Ildoria.

The Cyprus tax calculation was more complicated given the various deductions and exemptions that were available. However, once again, answers were generally satisfactory. The most common mistake was with regards to the double tax relief calculation, with some answers simply deducting the entire foreign tax from the Cyprus tax without undertaking the calculation to show the Cyprus tax attributable to the rental income.

A significant minority of answers omitted the calculation of the effective tax rate which was a relatively simple calculation to undertake following the calculation of the tax payable. Candidates need to ensure that they maximise their marks by ensuring that they address all parts of a requirement.

Part (c) for 2 marks required candidates to explain the tax treatment of a trust. This was generally well answered with most candidates demonstrating awareness of the tax provisions relating to a trust.

Part (d) for 1 mark dealt with whether Barry becoming a Cyprus tax resident would affect the status of the trust as an international trust. Part (e) for 1 mark looked at the same in relation to Elnar's, the trust beneficiary, move to Cyprus. Many candidates correctly acknowledged that both Barry and Elnar could move to Cyprus without affecting the status of the international trust given that the only requirement was for them to be non-Cyprus tax residents in the year before the establishment of the trust. Part (e) produced less satisfactory answers than part (d), with many candidates stating incorrectly that the trust would by default become a Cyprus Trust given that no beneficiaries could be Cyprus tax-resident in the case of an international trust.

Part (f) for 2 marks required candidates to discuss the tax consequences of AFS Cyprus Ltd gifting the apartment to Elnar. In fact, no tax arises in this case given that the company had originally received the apartment as a gift and there was a specific capital gains tax exemption when it was being gifted back to a member of the family of Barry. An alternative which worked equally well was for the company to gift the apartment back to Barry and then for Barry to gift the apartment to Elnar, with both transactions specifically exempt from capital gains tax. The majority of answers correctly stated one of the two options. However, a few candidates incorrectly stated that the gifting of the apartment would be taxable under capital gains tax.

Question Five

This 20 mark question was based on Thelma and tested candidates' knowledge of the special rules regarding the place of supply for VAT and withholding taxes, as well as methods of extracting funds from a company.

Part (a) for 2 marks required candidates to determine the correct VAT treatment of a transaction. Although the transaction related to the provision of an artist for an event, it was a business-to-business (B2B) transaction for which no special place of supply rule exists. The trick here was to distinguish that this was not a B2B service relating to the *admission* to such an event, which would have meant that a different place of supply rule was applicable. Most candidates failed to make this distinction. The correct answer was that the place of supply followed the general B2B rule which was where the recipient is established. To obtain the full two marks candidates had to also explain that Achilleas Ltd would apply the reverse charge with full right of deduction. However, some candidates incorrectly stated that Greg Productions would have to apply Cyprus VAT to its invoice.

Part (b), also for 2 marks, required once again the VAT analysis of a transaction, although this time it related to the *admission* to a charity football match. In this case, the B2B and B2C place of supply rules state that the place of supply is where the event physically takes place. Most answers correctly stated this. However only a few candidates gained the full two marks by extrapolating the VAT from the gross entrance fee of €9. Candidates generally made two errors in this respect. The first was to apply the VAT rate to the gross amount rather than extrapolate it from the gross amount. The second was to use the standard rate rather than the reduced rate of 5% which applies to the admission to such events.

Part (c) for 2 marks produced generally satisfactory answers. Candidates appeared well aware of the 10% withholding tax that applied to the remuneration of the football players who came from overseas to participate in the charity match, and for which they were paid €500. In order to obtain the full two marks, candidates had to address the requirement which was to state how the tax will be paid and by whom. A significant number of answers did not address this point, possibly due to a rush to finish the paper. Part (c) therefore contained three 'parts': (i) to explain the tax treatment of the fees, (ii) to state how the tax will be paid and (iii) to state who will pay the tax. I would encourage candidates to number the question parts of each requirement whilst reading, in order to ensure that they have produced answers to every part. This is a good exam technique to ensure all requirements have been addressed thus maximising the marks that the candidate can obtain.

Part (d) for 1 mark required candidates to know that a 5% withholding tax rate applied to film royalties and to apply it to the net amount stated in the question in order to calculate the gross. The majority of answers correctly stated the amount. A small number of candidates applied the rate to the net amount rather than grossing it up.

Part (e) was worth 9 marks and candidates had to analyse four given methods of extracting funds from a company to determine the minimum amount of tax payable by Thelma and/or Achilleas Ltd. Most candidates made a good attempt to calculate the tax in each of the four cases, and explain how this arises. A common mistake included not applying the higher tax rate of 35% to the salary and drawings options, even though the question clearly stated that Thelma is a higher rate taxpayer. Discussions relating to drawings commonly did not factor in the 18 month period which was the minimum amount of time required for Thelma to repay the loan. The discussions and calculations over the interest-bearing loan, which was worth 4 marks alone, were generally lacking in depth. Many candidates correctly stated that any difference between the interest rate charged and 9% would be considered a benefit and taxed on Thelma accordingly. However only a few candidates argued that there was a benefit to charging the full 9% rate as interest, which would result in income being taxed at the 30% special defence contribution rate for Achilleas Ltd, compared with charging a lower rate which would result in a 35% PAYE tax charge for Thelma. A few candidates entered into back-to-back loan discussions which were not relevant to the scenario given.

Part (f) worth 4 marks required candidates to know the four conditions required in order for Achilleas Ltd to obtain a tax deduction for the travel allowance paid to Thelma for the use of her private car. These conditions have never been examined before but do not constitute a new syllabus topic. It was clear that candidates had not paid sufficient attention to these requirements during their studies as many candidates struggled to pick up these marks. Most candidates managed to state that the travel had to be for business purposes from the place of work to other towns but few candidates were able to go much further.