

# Examiner's report

## P6 Advanced Taxation (HKG)

### December 2013



#### General Comments

The examination consisted of five questions, of which two questions in Section A are compulsory and two out of three questions in Section B are required to be attempted. Section A contained question 1 for 35 marks and question 2 for 25 marks. Total marks for Section A are 60. Total professional marks of 4 are awarded for appropriate format and presentation, logical development, and effectiveness of communication. This is to encourage candidates to pay more attention in presenting their answers effectively. Section B comprised three further questions of 20 marks each.

The vast majority of candidates attempted all five 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.

Candidates performed particularly well on questions 1(a)(ii), 1(a)(iii), and 2(e). The questions candidates found most challenging were questions 2(b), 2(d), 3(a), 3(b), 4(c), 5(a) and 5(b). It is the general observation of examiners that candidates' performance was generally better on topics that have been examined in the past, such as badges of trade in Q1(1)(ii) and personal assessment under Q2(e). Stamp duty, especially the recently introduced special stamp duty, is another commonly examined and hot topic, and thus candidates are generally well-prepared for this for Q1(a)(iii). However, those questions that were less satisfactorily performed include basic tax rules surrounding scope of charge for profits tax (Q3(a)), expense deductions such as elderly residential care expenses (Q2(b)) and prescribed fixed asset deduction (Q4(c)); and income taxability such as interest income for financial institution (Q5(a)) and capital versus revenue profits (Q5(b)). This phenomenon seems to indicate that candidates spent excessive efforts on the past papers but failed to grasp the adequate level of knowledge and understanding of other topics that are even fundamental and basic. Moreover, question 4 was on contract processing versus import processing and the associated anti-avoidance provisions (s39E) on the depreciation claim. This is a contemporary issue for a number of tax debates in the territory, and it is disappointing to see the candidates have obviously not updated themselves with the latest developments.

A number of common issues arose in candidate's answers:

- Failing to read the question requirement clearly and therefore providing irrelevant answers which scored few if any marks. Typical example is Q3(a) asking about the principles determining a business being carried on, but not rules for determining source.
- Poor time management between questions. Some candidates were found writing too much for some questions which they were well-prepared for, leaving insufficient time to work on other questions.
- Repeating the facts given in the question without linking these facts to any tax rules/reasoning to support the answers, or without drawing any conclusion or position at all. Some candidates even provided contradicting answers in the same question (or part).
- Not learning lessons from earlier examiner's reports, hence making the same mistakes.
- Illegible handwriting and poor layout of answers.

#### Specific Comments

##### Question One

This 35-mark question was a practical scenario describing the different tax implications arising from holding properties for different purposes. Part (a)(i) actually asked about the general concept of making tax adjustments from the accounting profit/loss, including adding back of non-deductible expenses and excluding non-taxable income/profits. Not many candidates were able to answer the general types of tax adjustments, and most candidates only focused on explaining the tax treatments of each item in the given profit or loss statement. Among the adjustment items, rules governing the deduction of interest expense were poorly explained. Many

candidates explained that the interest expense incurred on loan to acquire the property was not deductible simply because the property was a capital asset, or the interest would only be deductible if the property was trading stock. Others explained that interest on loan from shareholders was not deductible for the reason that shareholder was an associate. A few candidates have mistaken that the 'personal guarantee' would be general interest income which render s16(2)(A) to apply. Last but not least, there were candidates who answered that no depreciation allowance could be granted for the reason that letting property was not plant and machinery, industrial building or commercial building. All these answers demonstrated that the candidates were fundamentally weak in tax concept and principles.

Part (a)(ii) and (iii) were well-answered except that some candidates only gave the headings of the 'badges of trade' without further elaborating the rationale behind each badge. For example, regarding the frequency of similar transaction, despite that this fact was not given in the question, candidates are expected to explain that the higher the frequency, the more likely that the transaction is trading. If candidates only stated that this factor was not given in the question, mark would not be given. As regards stamp duty, it was appreciated that most candidates were able to identify the risk of special stamp duty but unfortunately, not all candidates were able to exactly cite the effective date. Moreover, some candidates have obviously paid too much attention in special stamp duty that no answer was given on the ordinary ad valorem duty and thus some marks on these basic points were lost.

Part (b) was on the potential double taxation arising from rental income earned by the corporate taxpayer from letting property. This is a common topic but yet, some common errors were still found in candidates' answers. The most common mistake was that the corporate taxpayer had the choice to pay profits tax or property tax. While most candidates could answer that the corporate taxpayer would be subject to both profits and property tax, not all candidates were able to explain why, in particular the definition of 'business' leading to the subjection of rental income to profits tax. A few candidates were found to have only given answers on stamp duty and special stamp duty for this part, without giving answers on double taxation and other tax implications.

The last part (c) was poorly answered as most candidates were not able to identify the different roles between shareholder and director, from the perspective of the corporate taxpayer. Instead, many candidates elaborated on the individual salaries tax position of the director or shareholder in respect of the accommodation benefit.

## Question Two

This 25-mark question covered the standard topic of personal taxation covering salaries tax, property tax and personal assessment. Although most candidates were able to score relatively higher marks on this question, examiners found it disappointed that candidates were not able to demonstrate an adequate level of knowledge and understanding on even basic and straightforward points such as dependent parent allowance and elderly residential care expenses. Under part (a), most candidates did not read the questions carefully and went straight to explain the deficiencies of current tax treatments of the couple, which should have been points for part (e). Other common mistakes included:

- Home loan interest was correctly mentioned but the maximum years were wrongly stated as 10 years instead of 15 years. The maximum deduction of \$150,000 was also not correctly stated by all candidates.
- Dependent parent allowance was still eligible even after the parent moved into the elderly home or even after the parent moved to China. Some candidates were not able to correctly 'name' the 'elderly residential care expense'.
- Regarding share option, most candidates elaborated on the exercise of share option, but not the timing of assessability. Some candidates correctly cited that gain from exercising share option after the retirement was assessed in the following year but failed to explain why.
- Consultancy fee received after retirement was wrongly taken as Type I service company arrangement, and elaborated answers were given for determining factors distinguishing contract for service and contract of



service. Some candidates even recommended that the taxpayer should remain in employment, which is inconsistent with the facts given in the question.

- 'personal assessment' and 'joint assessment' were confused and used inter-changeably.

### Question Three

As one of the three questions for choice under Section B, this 20-mark question was on a non-resident scenario testing the candidates' understanding of the scope of charge for profits tax, and their abilities to identify the potential risk, if any, for profits tax in Hong Kong. Part (a) asked about one of the two 'limbs' underlying the basic scope of charge for profits tax. Unfortunately, most candidates gave elaborated answers on source rules, rather than the principles determining whether a business is being carried on by the non-resident. Some other candidates cited the broad guiding principle from Hang Seng Bank to determine the business being carried on, or if the profit is determined as sourced in Hong Kong, it would mean that the business was carried on in Hong Kong. All these answers demonstrated that candidates were weak in the foundation of tax concept.

As regards the different options of running the business, the 'subsidiary' scenario was poorly performed. Candidates were not able to cite the correct definition of 'permanent establishment', or wrongly regarded a 'subsidiary' as a permanent establishment. Moreover, most candidates used the subject 'it' without clarifying whether the 'it' referred to the non-resident or the Hong Kong subsidiary.

As regards the following 'agent' scenarios, confusion arose when candidates talked about the 'non-resident' in one sentence followed by the 'agent' in the second sentence. Moreover, some candidates concluded that, since agent is included in the definition of 'permanent establishment', the agent (instead of the non-resident) was regarded as carrying on business in HK. The fact that the distribution agent did not have authority to conclude sale was correctly cited by most candidates, but yet, not many candidates were able to conclude correctly that the distribution agent was indeed a permanent establishment for the reason that it maintains inventory for regularly filling customers' orders per instruction.

### Question Four

This question was asking about the different tax implication arising from contract processing and import processing arrangements. This topic is getting popular due to the recent tax case of Brairim Far East Ltd. Although candidates were not required to explain the tax case in details, they were still expected to keep in pace with the current development of tax issues. However, some candidates wrongly answered that the source of manufacturing profit was determined based on contract effected test. Another weak area was the knowledge and understanding of s16G deduction for prescribed fixed assets and s39E restriction for depreciation allowance claim. Most candidates were found weak in s39E, and gave different kinds of wrong rationale to support why no tax deduction was eligible for the plant and machinery.

### Question Five

This question is the least attempted by candidates. Part (a) of this question asked about the specific tax treatment of interest income for financial institutions, which is different from that applied to ordinary taxpayers. Some candidates were not aware of the different treatments and continued to apply 'provision of credit' test. Other candidates were able to correctly cite 'compromise package' but gave incorrect explanations about the package. Part (b) asked about the general concept of capital versus revenue profits and the tax treatments. However, most candidates have the wrong perception that foreign currency deposit was capital asset and thus all income from foreign currency trading was capital in nature and non-taxable. Compared with parts (a) and (b), Part (c) was answered satisfactorily.