

Examiner's report

P6 Advanced Taxation (HKG)

December 2014



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. The total marks for Section A are 60 marks. A total of 4 professional marks are awarded in question 1 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 were able to complete all the required four questions, and there was little evidence of time pressure. Where questions were left unanswered by candidates, this appeared to be due to a lack of knowledge or poor exam technique, as opposed to time pressure.

Overall, the performance in this paper was unexpectedly poor, which is concerning to examiners. Relatively speaking, most candidates earned marks on questions 1(b)(i), 1(b)(iii), 2(a)(ii), 2(a)(iii), 2(a)(iv), 2(b)(i), 3(a)(i)(stamp duty), and 4(a). The questions that most candidates attempted but lost marks on were questions 1(a)(i)&(ii), 1(c), 1(d), 2(a)(i), 2(c), 3(b), 4(c), and 5(b). It is the general observation of the examiners that candidates' performance was relatively stable on topics that often appeared in the past examinations, such as the salaries tax treatments of medical insurance benefits and profits tax deductibility of bank loan interest. Stamp duty is also a common topic and thus candidates generally earned marks on Q3(a) but limited to the stamp duty only. However, some candidates appeared to have excessively relied on memorising past examination Q&A such that they gave answers which were irrelevant to what the questions asked. For example, on Q2(a)(i), most candidates discussed the Goepfert principles to determine source of employment, which was not addressing the question that asked about the impact on accommodation arrangement. This could possibly be due to these candidates presuming that 'source of employment' usually came as the first issue on salaries tax question.

It was obvious that candidates spent excessive efforts on memorising past papers but failed to grasp an adequate level of fundamental concept and knowledge. This explained why performance on topics that were basic and straightforward was unsatisfactory. For example, the profits tax treatment of loan interest income in the hands of employers are subject to rules that are totally independent of the salaries tax treatment of loan interest payment in the hands of employees. It is because the Hong Kong tax system works on scheduler basis, and thus symmetry does not necessarily or automatically apply. Unfortunately, quite a majority of candidates assumed the automatic association between the two treatments and answered either 'interest income is not taxable to employers since interest expense is not deductible to employees' or 'if interest expense is deductible to employees, then interest income is taxable to employers'. Another area that was disappointing was Q1(c) which asked for a profits tax computation. Surprisingly, quite a fair number of candidates gave their answers by re-constructing an 'income statement' that contained taxable income and deductible expenses, which would not even be appropriate at the F6 level.

Common concerns found from candidates' answers were:

- Failing to read the question requirement carefully and therefore providing irrelevant answers which scored few, if any, marks. Typical examples are Q1(d), Q2(a)(i), Q2(c), and Q3(b). Specific comments are discussed below.
- 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/reasonings to support the answers, or without drawing any conclusion or position at all. Typical examples were Q3(b) and Q4(c). 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, causing excessive difficulty to markers in understanding what the answers tried to present.

Specific Comments

Question One

This 35-mark question was a practical scenario containing some common transactions between employers and employees, seeking to test candidates on the different tax implications to both employers and employees, i.e. under profits tax and salaries tax regimes respectively. Part (a) asked about low interest loan offered to employees, and part (b) asked about medical benefits, compensation to leaving staff, and staff quarters. The major weakness found in these two parts was that candidates were not able to demonstrate an adequate and correct understanding of fundamental principles leading to the taxability of income/profit (and deductibility of expense/payment) under profits tax and salaries tax regimes respectively. A lot of candidates grossly 'linked' the interest income and expense together and explained that, if interest income is taxable, then interest expense is deductible; or vice versa. This is a significant conceptual mistake about the 'symmetry' of tax law. Candidates are advised to read the technical article available on the ACCA website in 2014 under Student Accountant, titled: *The pitfalls of interest deduction claims by individual taxpayers*. Typical errors were:

Q1(a)(i) -

- Incorrect statements such as
 - "Loan interest income is not taxable to employer because the interest expense paid by staff is not deductible. "
 - "Loan interest income would be taxable to employer if the staff is able to deduct the loan interest payment."
 - "Loan interest income is not taxable to employer because the employer is not carrying on a money-lending business. As a result, the bad debt is also not deductible."
 - "Loan interest income is not taxable to employer because the loan is not relating to its business but to its staff on personal affairs."
 - "Loan interest income is taxable or not depending on whether it is 'in the production of assessable profits'"
 - "Loan interest income is not taxable because it is not financed by interest-bearing debt."
 - "The write-off of bad debt is not deductible because the interest saving to employee is not taxable."
- Source of loan interest income (such as provision of credit test) was obviously ignored by most candidates; whereas those who did mention the source test correctly were not able to explain or apply it in the case correctly.
- Some candidates discussed in detail 'badges of trade' to determine whether the employer carried on a trade of lending money to employees.
- The conditions for allowing bad debt deduction under s16(1)(d)(i) were not addressed by most candidates.

Q1(a)(ii) -

- Home loan interest was obviously not picked up by most candidates; or was not correctly applied. In particular, most candidates wrongly concluded that home loan interest was not eligible unless the loan was sourced from a bank.
- Some candidates demonstrated a poor understanding of the 'liability test' and 'convertibility test' when they came to ascertain the taxability of the savings in loan interest.

Q1(b)(i) -

- Most candidates were able to draw the correct conclusion that medical reimbursement directly from an employer to an employee is taxable to the employer whereas reimbursement from an insurance company is non-taxable to the employee; but most candidates failed to explain the rationale incorrectly explained.

- For reimbursement of medical expense under an insurance policy, most candidates answered that 'the reimbursement is not paid by the employer and thus it is not deductible to the employer', without addressing the deductibility of the insurance premium.

Q1(b)(ii) –

- Most candidates had incorrectly treated the compensation to leaving staff for the restrictive covenant as usual staff cost and deductible to employer; without realising that the payment is capital in nature. Some others had explained that the compensation would be taxable to the staff and thus would be deductible to employer.
- Some candidates answered that if the compensation had been included in the employment contract, then it would be deductible to the employer and taxable to employee, without supporting the treatments with tax principles.

Q1(b)(iii) –

- Most candidates who had correctly applied s16(1), 16(2) and 16(2A)/(2B) generally earned marks. However, some candidates had incorrectly concluded that the loan interest was capital in nature for the reason that the loan was used to buy staff quarters.

Part (c) of this question asked for a brief profits tax computation without calling for any explanation. Performance in this part was unsatisfactory, in particular when quite a number of candidates did not prepare a profits tax computation but instead, re-constructed another 'income statement' containing taxable income and deductible expense. This is a fundamental error which is not even appropriate at the F6 level. Other candidates had attempted to explain the tax treatments of each item 'in words' rather than a brief tax computation. For those who did a profits tax computation, errors were found as follows:

- Cost of replacing old carpets was added back
- Cost of refurbishment was fully added back without allowing 1/5
- More than one cost item are grouped and presented in the tax computation, making it difficult for marker to correctly judge the adjustment
- Careless calculation or casting e.g. \$400,000 was mistaken as \$40,000

Part (d) of the question asked about the tax treatments of common items involved in a business acquisition, leading to the judgement of price allocation. Performance was not satisfactory. Candidates either did not attempt this part, or discussed stamp duty implications or s61B.

Question Two

This 25-mark question covered the standard topic of personal taxation covering some common remuneration items such as housing, share option, and tax equalisation benefit. Except the last item, the other items are commonly found in both practical situations and past examinations. The examiners however found that most candidates were not able to correctly and adequately explain the tax treatments and related principles. As mentioned earlier in this report, a great number of candidates gave irrelevant answer to Q2(a)(i) by discussing the Goepfert principles leading to the determination of source of employment. These candidates obviously had not read the question carefully or had placed excessive reliance on past examination paper and presumed that the source of employment issue must come first in this part of the question. That said, even in the discussion of source of employment, some candidates had incorrectly stated that contracting with M Ltd (a Malaysian company) must be non-Hong Kong-sourced and thus all income would be not taxable. This illustrated a weak foundation of tax concept in these candidates. Other than Part (a)(i), common mistakes or concerns noted in other parts were as follows:

Q2(a)(ii), (iii) & (iv) –

- Rental value for one-room apartment was incorrectly calculated based on 4% instead of 10%.
- Calculation basis for rental value was not clearly explained.
- A lot of candidates grossly netted off the nominal 2% payment with the 4% rental value (4%-2%), such that only 2% was to apply in calculating the rental value.



- Most candidates failed to pick up the point that actual rent or market value is irrelevant.
- In addressing the tax efficient scheme, most candidates suggested for the lease to be signed by employer or else rental value would not be applied, which is fundamentally wrong.

Q2(b)(i) & (ii) –

- Share option is confused with share awards. For example, share award is also taxable upon ‘exercise of shares’.
- Many candidates wrongly concluded that share options exercised after leaving Hong Kong are not taxable in HK, but in Malaysia.
- A lot of candidates discussed the deemed exercise treatment at the time of leaving Hong Kong, without addressing the question whether the tax treatment was different if the option was exercised after leaving Hong Kong. Some other candidates associated the tax treatments with the market price fluctuation of the share value.

Q2(c) –

- A great number of candidates tried to address this part by discussing the double tax issues and available tax relief arrangements, such as s8(1)(A)(c) or tax treaty between Hong Kong and Malaysia.
- Other candidates who correctly addressed the issue of tax borne by the employer had unfortunately drawn an incorrect conclusion that the tax borne was not taxable since it was not a reward for services.

Question Three

As one of the three optional questions under Section B, this 20-mark question was on a scenario where a leased property was either held in the name of the individual owner or remained as owned by a corporation. This is a commonly examined topic seeking to test candidates on the integrating implications between property tax and profits tax with regard to the treatment of lease income. Stamp duty was also examined under the respective scenarios. The general observation by examiners is that most candidates focused on discussing the stamp duty costs arising from the acquisition of the property, without adequately addressing the property tax implications arising from the lease income. Some other candidates had spent too much time in discussing whether leasing the property by the individual would constitute a ‘trade’ via badges of trade. Regarding interest expense, most candidates were able to address that interest deduction was not available in property tax but personal assessment; however incorrectly concluded that deduction was further denied under s16(2)(c).

Under part (a)(ii), most candidates did not address the double taxation issue between profits tax and property tax, as well as the associated relief. Some candidates incorrectly concluded that stamp duty was not payable since Head (2) only applied to Hong Kong listed shares. Other candidates had incorrectly applied \$20m as consideration, or 1% instead of 0.1%.

Under part (b), a great number of candidates incorrectly referred to s70A and suggested Roger should make a claim to correct the error or omission. Candidates should be aware that if a s70A claim were to be made, it would be initiated by the company, not Roger. Other candidates grossly answered that Roger should report to IRD without drawing any association with the tax law requirements.

Question Four

This question was asking about the administrative requirements surrounding objection, ‘reasonable excuse’ and s82A additional tax assessments. The general observation from marking was that most candidates had mistaken ‘additional tax assessments’ with ‘additional assessments’. Moreover, not many candidates were able to explain ‘reasonable excuse’ by drawing references from case law. Most candidates simply assumed that ‘absence from Hong Kong’ is accepted as reasonable without elaboration. Performance in part (c) was the poorest, as most candidates had not correctly addressed whether s82A could be challenged, but instead had only discussed whether a late objection could be lodged and how.

Question Five

This question was on a change of accounting date. This question was the least attempted, and for those who attempted it, performance was not satisfactory. Under part (a), most candidates only explained what distinguishes a business between 'old' business and 'new' business. As for part (b), the relevant basis periods for the year of change and the preceding year of change were correctly identified but the attributable profits were incorrectly calculated. The major error was calculation of depreciation allowance and the wrong allocation of the depreciation allowance into different basis period. In general, candidates who had attempted this question were not able to demonstrate their knowledge in this topic.