

# Examiner's report

## P6 Advanced Taxation (HKG)

### June 2012



#### 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 40 marks and question 2 for 30 marks. Section B comprised three further questions of 15 marks each.

The vast majority of candidates attempted 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.

Candidates who have achieved above average performance in Section A (questions 1 and 2) were mostly able to get an overall pass for the paper, although a small minority of candidates has exceptionally poor performance in Section B. A small proportion of candidates were found to have answered question 1 last. As question 1 is the case study and represents 40 of the available marks, leaving this question until last can be a risky strategy, as many answers presented were incomplete or appeared rushed.

Candidates performed particularly well on questions 1(i), 1(iii), 1(iv), 2(a), 2(b), 2(d), 3(b), 4, and 5(b). The questions candidates found most challenging were questions 1(ii), 2(c), 3(a) and 5(a). This is mainly due to candidates' lack of applicability skills to apply technical knowledge in practical scenarios, failure to read question requirements carefully and failure to master complete understanding of all aspects covered in the syllabus. Question 1(ii) was on deduction rule taking into account transfer pricing, but most candidates only gave answers on transfer pricing rules for income determination rather than expense deduction. Question 2(c) was not well-attempted as candidates were not able to critically evaluate the extent of efficiencies under different ideas, although they were only able to list out the features under the ideas. Question 3(a) was answered only based on commonly known principles surrounding contract for services versus contract of services, but the specific provisions (section 9A) and requirements were absent. Question 5(b) was the least-attempted for the obvious reason that the area of special business (insurance business for this part) in the syllabus has often been ignored.

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.
- Poor time management between questions, some candidates wrote far too much for some questions and this put them under time pressure to finish remaining questions.
- Repeating facts given in the question rather than analysing the facts or elaborating the tax rationale to support their answers, or replicating their answers for the same question (or part), or even providing contradicting answers for the same question (or part).
- Providing more than the required number of points for question (or part) to which only a few marks were allocated; but providing not enough points for question (or part) to which higher marks were allocated.
- Illegible handwriting and poor layout of answers.
- Providing answers based on the tax law or rules of other jurisdictions (e.g. UK) instead of HK.

#### Specific Comments

##### Question One

This 40-mark question was based on a group of professional training service companies operating in Hong Kong, the PRC and Singapore. The issues examined were mainly surrounding the source concept and deduction rule.

Part (i) for 14 marks required candidates to address the Hong Kong profits tax implications of the training fee revenue received from the PRC contracts and the related sub-contracting fee. The question gave hints to suggest that the report should cover the contemporary principles/rules determining the income taxability, arguments both



for and against the offshore claim, and the role of Hong Kong operating company. It also required the candidates to express views whether they agree with the current treatment as given in the case.

Most candidates were able to address the fundamental source principles based on section 14 and DIPN 21. However, when they gave arguments for and against the offshore claim, they demonstrated a mix of confusing concepts of the source principles. Some candidates mentioned about operation test to tax the income but on the basis that the company was managed and controlled in Hong Kong, or the contract was signed by a Hong Kong company or signed in Hong Kong. A majority of candidates sought to apply contract conclusion test although they have correctly identified the nature of income to be of service income nature. A small proportion of candidates had mistaken the contract as contract processing contract based on the information that both Hong Kong and PRC entities co-operated to perform the contract, hence focusing on 50:50 basis and s39E implication. Some other candidates spent time on permanent establishment (PE) issues, either HK company having a PE in the PRC or PRC company having a PE in Hong Kong. Only a small minority of candidates were able to identify the relevant points/arguments from the contemporary cases of Li and Fung and/or ING Barings, despite that no marks were allocated to the names of the cases mentioned. Notwithstanding the confusing concepts as mentioned, the performance of this part in general was acceptable.

Part (ii) for 10 marks asked about the general deduction rule of the sub-contract fee payment, taking into account the current transfer pricing rules and practices. Unfortunately, most candidates gave their answers solely surrounding the current transfer pricing rules and practices, and wrongly applied them to the sub-contract fee to ascertain whether the recipient company would be taxable in Hong Kong. As most of the marks were actually allocated for deduction rules, most candidates have lost marks in this part. This could have been avoided with a more careful reading of the question requirement. Other common mistakes included excessive focus on section 20 and section 61A, and PRC tax on the sub-contract fee payment.

Part (iii) for 6 marks was one of the best-answered in this paper, except for the royalty paid to the Singapore company. Most candidates overlooked that the net income from Singapore was claimed as offshore and thus no HK tax deduction had been claimed on the royalty payment to Singapore. As a result, section 15(1)(ba) did not apply to the Singapore royalty. For the royalty paid to PRC company, most candidates were able to address all the relevant rules correctly, except that 100% basis was erroneously applicable for all transactions with associates without having any regard on the previous ownership of the copyright.

Part (iv) for 6 marks was well-answered by some but not all. It was believed that those candidates who did not answer or gave irrelevant answers were due to the failure to understand the questions well. Some candidates simply asked for all information about the company's operation including bank statements and employment contracts, which could be relevant for audit performance but not for assessing tax compliance.

Finally, for the purpose of question 1, candidates' attention should be drawn to the total of 4 marks being allocated to the report format (2 marks) and communication skills (2 marks). In the majority of cases, it was found that the opening greetings and introduction of the report were satisfactory to score partial marks, but the closing of the report was absent (or perhaps forgotten). Moreover, clear handwriting, simple sentence structure, concise and organised presentation of points are important, but easy, to score the last 2 marks.

## **Question Two**

This 30-mark question covered the standard question on personal taxation covering salaries tax and property tax. Most candidates were able to score high marks on this question, except that the majority has spent excessive time and space under part (a) talking about Goepfert principles which were not asked at all by the requirement.

Part (a) for 14 marks required candidates to describe the general principles to determine the taxability of each item of the termination payment. Most common items were treated correctly and explained well, and the common mistakes found included:

- Compensation for loss of office was mistakenly taken as compensation for loss of 'director's office'.
- 'accrued benefit' was incorrectly taken as the final amount paid, or as equivalent to 'proportionate benefit'
- Most candidates used the total amount of \$300,000, instead of half, for the calculation
- Most candidates had mistakenly treated proportionate benefit as maximum taxable income.
- Compensation for loss from selling car was concluded as taxable – marks were still awarded if the rationale was correct

Part (b) for 7 marks required candidates to compare the tax implications of holding property in the name of individual and by a special purpose company. This is another part of the paper that was well-answered. Common mistakes included home loan interest being mistaken as property mortgage interest deductible under personal assessment, and the failure to evaluate the residency requirement for election of personal assessment.

Part (c) for 3 marks required candidates to comment on the extent of effectiveness of the given planning ideas. Most candidates presented the answers as replicating the points given under part (b) but failed to critically evaluate the difference in the effectiveness of each idea. Moreover, most candidates were not able to explain why the offshore company was still taxable in Hong Kong. Simply holding the property located in HK was a relevant reason for property tax but for profits tax purposes, the issue of 'carrying on business' had to be addressed as well.

Part (d) for 6 marks required candidates to explain the tax implications from the disposal of property in two to five years' time. A majority of candidates only gave answers for this part based on stamp duty, with the focus on special stamp duty; without adequate elaboration on profits tax implications. Confusing concepts were also reflected by saying that disposal profits from property held by an individual were certainly not taxable since both salaries and property tax do not cover disposal profits.

### **Question Three**

Being one of the three questions for choice under Section B, this 15-mark question was asking about a Type I service company and its related tax implications to different parties. Performance in general was not satisfactory although the majority of candidates were able to address the integration test, control test and economic reality test to ascertain the difference between contract of service and contract for service. However, only these points were not adequate to score 11 marks for part (a). Candidates who failed to mention about the specific provisions governing Type I company appeared to be due to the lack of knowledge in this special area. Part (b) for 4 marks was asking for the tax implications as a consequence of Type I company. Performance varied according to the level of candidates' knowledge about Type I company.

### **Question Four**

This 15-mark question was the most-attempted question under Section B, because the question asked for general and practical knowledge rather than technical. Those items that require specific technical knowledge, such as interest income and expense, and research and development, were not satisfactorily answered, but for other items that require general taxability and deduction principles, such as salaries and rent and rates, were well-answered.

### **Question Five**

This last 15-mark question under Section B was the least attempted, due to part (a) being focused on insurance business. Very few candidates who chose this question demonstrated an adequate knowledge of the tax treatment for insurance business, and thus very low marks were scored. While some candidates may have obtained high marks for part (b) which was on stamp duty obligations for offshore execution, the poor performance on part (a) has adversely impacted their overall performance of the paper. The examiners would



urge candidates to ensure that they master an adequate level of understanding about the specific tax provisions on special businesses as these were included in the syllabus.