

# Examiner's report

## P6 Advanced Taxation (HKG)

### June 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 mark for Section A is 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 style of this paper is consistent with that of the previous diets. The topics covered by this paper are wide enough to include the most latest tax rules of trademarks acquisition under s16EA and the special stamp duty (first phase). These new rules were effective before the cut-off date for this examination sitting, and most importantly, have been the hottest debating topics in the city since their enactment. Candidates sitting for this examination are obliged to demonstrate a reasonable level of understanding of the latest developments. However, the performances in these two areas were not satisfactory. Other than these two areas, the other topics are standard subjects that are commonly found in examination.

This paper was well received by the examination review board and the level of difficulty was considered as appropriate. Yet, the overall performance of this paper was far from satisfactory. Setting aside the latest tax rules, performance was also poor in Q1(a) where candidates were not able to address factors leading to 'trade' and apply the fundamental source rules to the case. Objection requirements and rules surrounding the change of accounting date were covered by Q4 and 5, but were also poorly answered by candidates, despite that these topics are actually of F6HKG level. This is obviously unexpected, and not desirable from the perspectives of quality control. Examiners therefore urged that candidates taking this paper should include all topics of F6HKG in their studies, and should expect that topics of fundamental level would still be examined in P6HKG paper.

Most of the candidates were able to attempt four questions as required, although some have demonstrated the inability to give answers to certain parts of Question 1 by skipping pages. Question 2 (salaries tax) was the best answered while Question 5 was the worst. Question 4 was the least attempted. As in previous sessions, 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. Some candidates were found to have answered question 1 last, but in these cases, answers presented were usually incomplete or appeared rushed. It is not recommended leaving questions 1 and 2 to the last minute as these two questions require more efforts and time to study the case and they both count for the majority of the marks.

In general, the overall unsatisfactory result of this paper was partly caused by candidates' weakness in the basic concepts of tax rules and partly due to the inability to apply knowledge in practical scenarios. For example, under Q1(a), some candidates wrongly applied source rules to support a 'trade'. Under Q5(a), the majority of candidates argued that an interest income would be taxable if the corresponding interest expense is deductible; or an interest expense is deductible because the interest income is taxable. Only a few candidates were able to illustrate and differentiate the rules governing the interest income taxability and interest expense deductibility. Another example is Q4(c) where most candidates failed to express their views on each date and failed to take any position as to the date of business commencement.

Before specific comments were outlined, examiners would like to draw attention to the following common examination issues:

- Candidates should read the question requirement clearly and avoid providing answers which scored few or no marks.

- Time management between questions should be observed, so as to avoid writing too much for earlier questions and leaving too little time to finish the rest.
- Candidates tend to repeat the facts given in the question without linking these facts to any tax rules/reasonings to support their answers, or without drawing any conclusion or position at all. Some even provided contradicting answers in the same question (or part). Candidates should not expect that by providing all possible points for markers to 'choose', their chance of getting marks would be higher.
- It is the responsibility of the candidates to ensure that their answers were legible, clear, and easy to follow for markers.
- P6HKG is a paper on Hong Kong tax. Except where specifically indicated, candidates should contain their answers to the tax law or rules of Hong Kong, and not others such as China.

### Specific Comments

#### Question One

This 35-mark question was a practical scenario discussing the tax related issues associated with intellectual property right (IPR). Part (a) involved a potential sale of an IPR through internet and part (b) addressed tax implications arising from the acquisition and self-development of IPRs, their licensing income and the gains on their subsequent disposals. This question required the basic concept of the two limbs under s14 of IRO, and also covered the latest topic of IPR tax rules. A well-prepared candidate should be able to score high marks on this question.

Part (a) for 14 marks required candidates to address whether the taxpayer would be subject to profits tax in respect of the gain arising from the sale of an IPR over internet. Q1(a)(i) led the candidates to address the first limb of s14 ie whether or not a trade is being carried on in Hong Kong. This was then followed by Q1(a)(ii) which further led the candidates to look into whether or not the profit is sourced in Hong Kong. While some candidates were able to address the issues correctly, some candidates demonstrated a confusing understanding of both by using broad guiding principles of operation test to ascertain 'trade'. Some other candidates only gave answers on source principles and replicated the same answers for both (a)(i) and (a)(ii). Some candidates even mixed up badges of trade and source rules and mingled all the arguments in both parts.

Part (b)(i) required candidates to explain the tax treatments of the costs in acquiring the IPR from the shareholder. The IPR is obviously a capital asset which generates taxable licensing income, but the taxability of licensing income would not alter the capital nature of the IPR. However, a majority of candidates indicated that the IPR is a revenue asset and thus its acquisition cost is deductible because the income generated from it is taxable. Most answers relied upon s16(1) but simply ignored s17 on denying tax deduction for capital asset and overlooked s16EA allowing special deduction. Amongst these rules, only s16EA is new, but examiners were disappointed that candidates were not able to demonstrate a reasonable level of understanding of basic tax concept.

Part (b)(ii) and (iii) required candidates to explain the tax treatments on the cost deduction, licensing income and disposal gain on the IPR under two different scenarios. Performance was also poor as most candidates simply relied upon s16(1) for all answers, without elaborating the reasoning. For licensing income, a majority of candidates relied upon s15(1)(b) to deem the licensing income as taxable on 30% basis and subject to withholding obligation. This illustrates that candidates failed to differentiate s14 and s15 implications in different perspectives. Moreover, some candidates gave confusing answers that income is taxable if cost is deductible, and vice versa. This is fundamentally wrong concept which should not be expected from a candidate on P6 level. As for Part (b)(iii), only a few candidates were able to address s16B concessionary deduction on R&D costs.

### Question Two

This 25-mark question covered the standard question on personal taxation covering salaries tax, property tax and personal assessment. Most candidates were able to score high marks on this question. The common mistakes found included:

- Goepfert principles were wrongly analysed to conclude the source of 'income' rather than 'employment'. Some candidates even jumped to conclude that due to the three principles being offshore, all income is offshore and non-taxable.
- 'visit' is wrongly defined to refer to a stay in Hong Kong not exceeding 60 days. Some candidates drew wrong conclusion that, since the number of days in Hong Kong was not exceeding 60, the stay is not counted as 'visit' and thus not taxable.
- Rental value of 4% was wrongly applied to the hotel accommodation
- Tranche B of share option was not analysed correctly as to whether and why it is taxable.
- Home loan interest was wrongly considered as applicable.
- Most candidates answered that home loan interest would only be deductible under personal assessment.
- Home loan interest was confused with loan interests on investment property
- Some candidates even refer to s16(1) for interest deduction
- No married person allowance or child allowance was given due to not being residing in Hong Kong
- 60 days are mixed up with 180/300 days as required for temporary resident

### Question Three

Being one of the three questions for choice under Section B, this 20-mark question was asking about stamp duty on transfer of Hong Kong stock and property. Most candidates were able to correctly explain the scope of charge, and the rates. Probably this is due to the fact that stamp duty has become a commonly examined topic in recent diets. However, same as the last diet, not all candidates have included the loan value in the stampable value for the share transfer. Some other candidates have treated the loan value to be subject to the highest ad valorem rate of 4.25%. Quite a few candidates have done the calculation wrong, which is purely due to carelessness. For part (b) on special stamp duty, performance was good in those candidates who obviously have well-prepared for this new tax rule. However, some others have not been able to demonstrate their knowledge, or have mistaken that special stamp duty would apply if only the property was sold within 2 years of acquisition. In the majority of cases, candidates have cited the effective date wrong. Part (c) on due diligence issue was average.

### Question Four

This question was asking about the basic objection requirements, advanced ruling system, determination of date of business commencement and deduction of pre-commencement expenditure. This question was the least attempted, and for those who attempted this question, performance was not satisfactory. This could possibly be explained by the common phenomenon that candidates tend to ignore topics relating to tax administration such as objection and advanced ruling. Date of commencement is usually a given fact rather than an open issue for discussion. While the suggested answer only remains as suggested position as to which date could possibly be accepted as date of business commencement, the argument remains open, and marks will be awarded for reasonable and sensible arguments. However, most candidates attempting this question were not able to score satisfactory marks.

### Question Five

Part (a) of this last 20-mark question under Section B was concerning fundamental concept of interest income taxability and interest expense deductibility. As mentioned above, performance was unexpectedly poor, in particular to the symmetrical treatments of interest income and expense. Moreover, some candidates have mistaken that the loan to subsidiary being financed from a bank loan would equate to an arrangement that there was a flow-back of interest under s16(2B). Candidates must ensure that fundamental tax concepts like taxability and deductibility are clear and well-understood. Part (b) asked about common tax principles surrounding change of accounting date. However, this was also poorly answered although this topic is a F6 level topic. Possible basis periods were incorrectly identified for each year of assessment, and those affected years of assessment caused by change of accounting date were also not correctly identified. For example, in most answers, basis period of 1.7.2013 to 30.6.2014 was used for YA 2013/14! This error was not simply relating to change of accounting date but more on the fundamental principle of ascertaining taxable basis period of assessment year under Hong Kong tax regime.