

Examiner's report

P6 Advanced Taxation (HKG)

June 2014



General Comments

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

Candidates performed particularly well on questions 1(a)(i)&(ii), 2(b)&(c) and 3(c). The questions candidates found most challenging were questions 1(b)(i)&(ii), 4(b) and 5(c). It is the general observation of examiners that candidates' performance was generally better for topics that have been examined in the past, such as source of income and deemed trading receipts as in Q1(a)(i)&(c), and salaries tax remuneration items as in Q2(b)&(c). Stamp duty, especially the recently introduced special stamp duty, was another commonly examined hot topic, and thus candidates were generally well-prepared for this for Q2(a). However, those questions that were less satisfactorily performed include loan interest income and expense (Q1(b)(i)&(ii)), deductibility of incorporation fee and MPF contributions (Q1(d)), deductibility of remuneration for staff on overseas secondment (Q3(a)), disposal and demolition of industrial building (Q4(b)), and employer's compliance obligation and IRD's recovery actions (Q5(b)&(c)). This phenomenon seemed to indicate that candidates spent excessive efforts on past papers but failed to grasp an adequate level of fundamental concept and knowledge, even on topics that were basic and straightforward. For example, for Q1(d) incorporation fee, a majority of candidates gave the answer that the fee was tax deductible as it was related to the business, without any attempt to consider the basic concept of capital versus revenue. Another example of disappointing performance is Q5(c) where candidates were required to explain the IRD's recovery actions but most answers were given on objections, holdover, s.70A claim, additional assessment and penalty. That said, as for recent topical issues such as special stamp duty, most candidates were able to demonstrate a basic understanding with some candidates even extending their answers to buyer's stamp duty and new ad valorem duty despite these are not yet legislated (thus scored no mark unfortunately).

Common issues found in candidate's answers are:

- Failing to read the question requirement carefully and therefore providing irrelevant answers which scored few if any marks. Typical example was Q3(a) asking about the deductibility of the staff remuneration from the employer's perspective rather than the principles leading to chargeability under salaries tax as most candidates had mistaken. Another typical example was Q5(c) asking about the IRD's recovery actions but most candidates gave answers on objections, appeals, holdover, s.70A claim, additional assessment and penalty.
- 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. Some candidates even provided contradicting answers for 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 different ways of fund-flow between group companies. Part (a) asked about the general taxability rule of the subsidy income as well as the transfer pricing principles. Most candidates were able to explain the two-limb concept under the basic scope of charge under s14, and the basic transfer pricing principles between associated enterprises. Those candidates who lost marks were mostly found to have only repeated the facts given in the question (even replicating word-to-word from the question) without relating to the tax law or concept. Part (b) was the most disappointing area where taxability of loan interest income and deductibility of loan interest expense were examined. These topics were most commonly found in past examinations but still candidates' performance was poor. A lot of candidates grossly 'linked' the interest income and expense together and explained that, if interest income was taxable, then interest expense was deductible; or vice versa. This was a significant conceptual mistake about the 'symmetry' of tax law. Candidates are advised to read the recent technical article uploaded to the ACCA website under Student Accountant, titled: *The pitfalls of interest deduction claims by individual taxpayers*. Some other candidates lost marks for explaining that the loan interest income received by HK-Co was not taxable due to the 1998 exemption order. Note that the exemption order does not apply to income received from non-financial institutions. Other candidates ignored the provision of credit test in determining the source of interest income but focused on the place of negotiating and concluding the loan contracts. On the loan interest expense deduction, not many candidates were able to analyse correctly the application of s.16(2)(c). Some other candidates simply gave one statement that no deduction would be granted since the loan was not used to generate taxable income, without noting that 3 marks were assigned to this part.

On Part (c) regarding the taxability of royalty income received by the overseas company, most candidates were able to explain that it was taxable in Hong Kong but did not give any supporting authority or reason. Most candidates could mention the 30% or 100% deemed profit basis but not all candidates could correctly explain under what circumstances the 100% basis would be enforced. Quite a number of candidates ignored s.15(1)(ba). On Part (d), candidates were asked to explain the tax treatments of three selected items: depreciation of computer system, incorporation fee and MPF contributions. This part was the one where examiners found candidates' performance most disappointing. For depreciation, a fair number of candidates only mentioned the 60% initial allowance and 30% annual allowance but not the deduction for prescribed fixed assets. Some other candidates mentioned about prescribed fixed asset but allowed a deduction at 30%. For incorporation fee, as mentioned above, most candidates claimed that it was deductible for the reason that it was related to the business, or it carried the same nature as business registration fee. Some other candidates claimed that this fee was pre-commencement expenses which were specifically allowed for deduction by the IRD by concession. Note that not all pre-commencement expenses are deductible. For MPF contributions, most candidates mixed up the profits tax deduction rules with the salaries tax assessability rules, by answering that only mandatory contribution was deductible and the maximum deduction was \$12,000 p.a. Lastly, on Part (d), candidates were required to give an estimated calculation of HK Co's HK profits tax liability. This required a short profits tax computation which could score 4 marks, but unfortunately, a lot of candidates gave a revised management account (in an income and expenditure format) rather than a profits tax computation. This was a technical mistake.

Question Two

This 25-mark question covered the standard topic of personal taxation covering stamp duty, home loan interest, share option/award, dependant parent allowance and low-interest loan from employers. Although most candidates were able to score relatively higher marks for this question, performance for Parts (d) and (e) was less satisfactory. For Part (a) on 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. In particular,

most candidates had mistaken that the 24-month requirement counted from the date of the current transaction. Moreover, some candidates obviously paid too much attention to giving answers on Head 2 (Hong Kong stock), assuming that the property-holding company was bought instead of the property. Most candidates lost marks on s.29 certificate which is a tax avoidance provision to counteract attempts to separate one transaction into two for the purpose of paying less stamp duty. Obviously, a lot of candidates did not pay attention to this provision and gave the answer that splitting the transaction to save stamp duty was effective and recommended. Some other candidates mixed up special stamp duty with buyer's stamp duty, or with the new ad valorem duty.

Other observations and common mistakes in Parts (b) to (e) were:

- Part (b) home loan interest – this was correctly mentioned but the maximum years were wrongly stated as 10 years instead of 15 years. A maximum deduction of \$150,000 was also incorrectly stated by most candidates. The same mistake was also found in past examinations and highlighted in past years' examiners' reports. Candidates are advised to read the examiners' reports to avoid making the same mistakes. Moreover, a majority of candidates mentioned that the home loan interest deduction could only be claimed under personal assessment or joint assessment. This was incorrect. Note that home loan interest is a concessionary deduction which is granted under salaries tax, personal assessment or joint assessment. Candidates obviously mixed up home loan interest with mortgage loan interest on leased property.
- Part (c) share option/award – most candidates were able to give correct answers on share option being exercised. However, for share award, candidates who lost marks gave wrong answers on the year of assessment in which the share award should be taxable. Some other candidates obviously mixed up the two.
- Part (d) dependent parent allowance (DPA) – most candidates were able to cite the criteria for claiming DPA but failed to explain whether, and how, the position would be different after the marriage. Not many candidates were able to focus on the key problem whether the payment could be considered as 'contribution' to the parents. Regarding the interest payment, most candidates were able to explain that home loan interest deduction was not granted but for the wrong reasons, such as because the parents were not a financial institution or the parents were not taxable on the loan interest. Some candidates wrongly answered that DPA could be apportioned before and after the marriage.
- Part (e) low-interest loan from employer – the most common mistake under this part was that home loan interest deduction was not granted for the wrong reasons that the interest was paid to a non-financial institution or to the employer. Note that in this case, home loan interest deduction could be granted but only if the property was mortgaged for the loan. Candidates correctly gave the answer that the savings in interest payment was not taxable but without giving any reasons.

Question Three

As one of the three optional questions in Section B, this 20-mark question was on a scenario where a resident individual was seconded to work in Malaysia. This question examined the candidates' understanding of the scope of charge for salaries tax under the exposure to two taxing jurisdictions, and their abilities to interpret the related provisions under the Malaysia-HK double taxation arrangement (DTA). Candidates were also examined on the profits tax deductibility position of the employer in respect of the remuneration paid to such staff on secondment. Part (a) asked about the profits tax deductibility of the remuneration and most candidates did not approach this part from the employer's perspective. Some candidates gave answers on the *Goepfert* principles, or combined parts (a) and (b) together by giving answers on the staff's Hong Kong salaries tax position. Some other candidates simply answered that the deductibility would depend on the source of employment or the salary was deductible to the employer for the reason that it was a Hong Kong-sourced employment and the salary was subject to salaries tax in Hong Kong. Again, this concept of 'symmetry' is wrong. For the recharge, only a few candidates were able to discuss the implication to the deductibility position under the recharge option.

Parts (b) and (c) were most well-performed in this question, as the scope of salaries tax charge had been the most commonly examined aspects in the past, and the interpretation of Article 16 of the DTA was examined before and was straightforward. Yet, the most common mistake was found on the definition of 'visitor' and eligibility for the 60-day rule. Quite a number of candidates overlooked that the resident staff was not a visitor and thus not eligible for the 60-day rule. Part (c) was most straightforward as candidates were only required to interpret the given conditions under Article 16 of the DTA according to the facts. However, candidates are reminded here that care should be exercised not to simply repeat what the Article says without relating it to the case.

Question 4

This question asked about the eligibility for industrial building allowance (IBA) and the implications arising from the disposal and demolition of a building. This was the question which was least attempted by candidates. For those candidates who attempted this question, performance was not satisfactory. It was disappointing to see that most candidates did not cite the 6 qualifying trades for IBA and explain them. Most candidates simply answered that the building could qualify for IBA without giving any reason. As for the calculation of IBA, most candidates could use 20% for initial allowance and 4% for annual allowance, but disappointingly, the 4% was calculated based on the reducing balance, and not the cost. Ascertainment of the qualifying expenditures used for calculating IBA or CBA was not satisfactory. Most candidates simply excluded the land cost from the consideration, instead of apportioning the profit element among the land and construction costs. Some other candidates had mistaken that only the construction cost could be used as the property was purchased from a property developer. The last part on the demolition of a building was poorly answered. Candidates could only mention balancing adjustment but did not attempt to address the implications to the tax treatment of interest payment and rental income.

Question 5

This question was on a termination payment, employer's compliance obligations on leaving employees and the IRD's recovery actions. As mentioned earlier, the last part on the IRD's recovery actions was the poorest-performed part as most candidates gave incorrect answers on objection, appeal, holdover, s.70A claim, additional assessment and penalty. The employer's compliance obligations on leaving staff were also not satisfactorily answered, in particular, the one-month notification period was incorrectly cited as after cessation instead of before cessation. Regarding the retention of money by an employer, a lot of candidates were not able to cite the one-month period, but answered that only the last month salary was retained until all tax was cleared. On Part (a) regarding general taxability principles applicable to the various types of termination payment, it was surprising to note that a lot of candidates had mistaken 'lump sum gratuity' to be 'retirement payment', and gave detailed answers on the calculation of proportionate benefit. Other candidates had only answered it was taxable or not, without explaining why.