Examiner's report

P6 Advanced Taxation (MLA)
December 2013

General Comments

The examination consisted of two compulsory questions and three optional questions. Section A contained two compulsory questions, one of which carried 35 marks (Question 1) and the other carried 25 marks (Question 2). Section B comprised three questions of 20 marks each, from which candidates were required to select two.

The vast majority of candidates attempted four questions and there was little evidence of time pressure. Where questions, or rather parts of questions, were left unanswered by candidates this appeared to be due to a lack of knowledge, as opposed to time pressure.

The technique chosen by most candidates was to start with Section A (which carried 60 per cent of the marks) and then move on to Section B.

Candidates generally performed well in question 1 but found the rest of the paper challenging. The questions that seem to have been found most challenging in the exam were Questions 2 and 5. It appears that candidates did not read the question well enough in both these cases, as was evident from the fact that the majority of candidates missed key parts of the scenario or did not address what was actually being asked.

Handwriting and layout of answers (especially in Questions 1 and 2) were generally of a satisfactory standard.

The following were common issues identified in candidates' answers:

- Poor time management between questions; some candidates wrote far too much for Question 1, at times considering irrelevant issues, which put them under time pressure to finish the remaining questions.

- Not reading the question requirement clearly or, at times, completely ignoring the question requirement and providing irrelevant answers which scored few, if any, marks. By way of example, the value shifting rules were mentioned frequently in Question 1 (a), the reduced rate of 15% in terms of the treaty was often completely ignored in Question 2 (despite being specifically mentioned in the facts) and often no reference to the Parent-Subsidiary Directive and Interest and Royalties Directive was found in Question 5, although the Question specifically asked candidates to consider the application of European Union ('EU') Directives.

- It is clear that a number of candidates do not have the depth of knowledge required to understand the intricacies of tax law.

- Candidates seem to confuse certain core principles in the exam, with the result that their answers often include fundamental mistakes. It is advisable that candidates only sit the P6 Paper once they feel very comfortable with the principles learnt at F6.

- It is clear from this paper that candidates were well prepared for Question 1 but not for the rest of the exam. While it is true that Question 1 contains 35 marks, it is <u>not</u> enough to just be prepared for this Question in order to pass the exam. There were many instances of students scoring very well in Question 1, but then scoring poorly in the remaining 3 questions they answered. Candidates need to have a thorough understanding of the course materials in order to pass the exam and cannot rely on studying a few select topics. The level of mastery in Question 1 should, however, be taken as an encouraging aspect of candidates' ability to learn tax law. Question 1 is generally considered the most difficult exam question at P6 and some candidates have mastered the topic. The same effort should be applied to mastering other areas.

Specific Comments

Question One

This 35 mark question mainly focused on issues relating to capital gains legislation and duty on documents legislation. Part (a), which carried 24 marks was based on plans to restructure the shareholding of Alfa Ltd, a consultancy firm which owns an office block. Part (b), which carried 7 marks, was based on the transfer of Mr Zammit's residence whether *inter vivos* or *causa mortis*.

Part (a) (carrying 24 marks) required candidates to advise Alfa Ltd on the income tax, duty on documents and transfers and value added tax ('VAT') implications in relation to the reorganisation. Two options were being considered: (i) Option A was an outright share transfer with one of the transfers being the transfer of a controlling interest; (ii) Option B involved an intra-group transfer of assets, which would be exempt for income tax and stamp duty purposes. Both transfers would not give rise to any VAT implications.

Most candidates performed well on this part of the question, identifying that there was the transfer of a controlling interest and applying the rules relative to such a transfer in order to determine the tax on capital gains in Option A, and identifying that in Option B, Alfa Ltd could benefit from the intra-group exemption, and the more stringent conditions imposed on property companies. However, many candidates lost precious marks by failing to state the obvious. There also appeared to be a common misunderstanding regarding the applicability of the value shifting rules. A number of candidates explained the application of the value shifting rules in either Option A or Option B despite there being no value shift in either option, but, rather, an outright transfer. This was either an example of "knowledge dumping", or a misunderstanding of core aspects of the syllabus, with the latter option being more likely.

Part (a) briefly touched upon VAT, carrying a few marks which very few candidates managed to score. The VAT part of the question was often completely omitted from candidates' answers. Candidates need to read the question well, and should ensure they answer all parts of the question. A similar issue has been identified in previous Examiner's Reports. This recurring issue should be addressed by candidates in order to ensure they show their thorough knowledge of the subject and obtain the maximum marks possible.

Professional marks were awarded to candidates who merited this with regards to the structure of their answer and format.

Part (b)(i), carrying four marks, considered the income tax implications of the transfer of an individual's own residence and a 60 square metre garage. The transfer of the residence was exempt, while the transfer of the garage was not as it was too large. Candidates generally performed fairly well, even though a number of candidates did not consider the conditions for the application of the exemption to the garage, thereby not gaining marks here.

Part (b)(ii), carrying three marks, considered the stamp duty implications of a *causa mortis* transfer. The question required candidates to identify that the *causa mortis* transfer was subject to stamp duty and identify the different rates applicable to the case at hand since Mr Zammit's daughter lived with her father. In general, candidates did not perform particularly well on this question due to confusion of the rules. The most common mistake was applying the stamp duty rates applicable to first-time buyers.

Question Two

This 25 mark question covered the topics of tax refunds, tax treaties, incentive legislation (and their interaction with the tax refund system) and exemptions. The Med Pharma group had a two-tier structure in Malta with Med Pharma (Malta) Ltd benefitting from incentive legislation. Under the terms of a double tax treaty, Med Pharma

(Malta) Ltd could benefit from a reduced rate of tax on distributed profits. Med Pharma (Malta) Ltd received trading profits, royalties and dividends from its subsidiaries.

Part (a)(i) asked candidates to comment on the tax implications for Med Pharma (Malta) Ltd. This required candidates to comment on the application of a 40% tax credit, the application of the reduced rate of tax in terms of the double tax treaty on all Med Pharma's (Malta) Ltd's profits and its interaction with the tax refund system, the application of the exemption on income derived from patents and the application of the participation exemption.

Generally, the availability of tax credits was not mentioned and; when this was mentioned, it was often mistakenly stated that the tax credit is deductible against the company's profits, instead of its tax charge. This may be due to a number of factors, including lack of knowledge of the incentive legislation, insufficient time spent reading the facts (the question specifically stated that the company benefitted from incentive legislation) and candidates being too focused on the main part of the question. As in Question 1, the interaction of different provisions generally resulted in candidates missing salient features.

Similar to comments on previous exam sittings, candidates generally did not demonstrate an understanding of the anti-avoidance provisions of the participation exemption. Many candidates seemed to only understand the condition related to the subsidiary being resident or incorporated in an EU member State or that it is subject to foreign tax of at least 15%, and did not show a proper understanding of what passive interest or royalties are.

A number of candidates did not identify that income derived from patents may be exempt from tax in Malta. Where this was identified, the conditions for the application of the exemption were rarely mentioned; this could be due to lack of knowledge or taking the obvious for granted – something that should be avoided in an exam. Furthermore, most candidates wrongly provided that the renting of immovable property from third parties required an allocation of profits to the immovable property account.

I re-iterate my comments from previous sessions that candidates should not be intimidated by the group structure in a question. They simply need to <u>read the facts well</u> and dissect the different income streams. Marks were lost by candidates failing to read the facts of the question carefully.

Part (a) (ii) required candidates to consider the taxation of Med Pharma (Malta) Holding Ltd including the interaction of the tax refund system with the reduced rate of tax. Candidates generally performed well in this part of the question apart from with respect to the interaction of the reduced rate with the tax refund system.

Part (b), carrying three marks, required candidates to carry out the tax computations for the scenario which, due to poor performance in Part (a)(i), was generally not well-answered.

Question Three

This 20 mark question related to the tax benefits which Mr Fribau, an EU national, could benefit from once he is employed as CEO of a fund management company. Candidates were required to advise Mr Fribau on the conditions for the Highly Qualified Persons Rules and the Investment Services Expatriates provisions and the relevant benefits of each. Given that these rules are mutually exclusive, candidates were expected to explain the benefits of one versus the benefits of the other. On the basis of the facts presented, the Investment Services Expatriate provisions were more beneficial to Mr Fribau.

Candidates generally performed well outlining the conditions required to benefit from the Highly Qualified Persons Rules, and the application of a reduced rate. However, many candidates lacked further detailed knowledge. By way of example, only a handful of candidates mentioned that when benefitting from the Highly Qualified Persons Rules Mr Fribau will not be entitled to any deductions, double tax relief or set off.

Generally, candidates' knowledge of the Investment Services Expatriate provisions was unsatisfactory. In many cases, this requirement was either completely omitted or candidates listed the conditions and benefits of other rules. It appears that the majority of candidates do not know these rules; in particular, candidates rarely stated that, for an expatriate, the application of one rule excluded the application of the other.

It appeared that there is confusion regarding the different rules available to expatriates taking up residence in Malta, whether to work in Malta or not. As stated above, a number of candidates provided the conditions and benefits of different rules, for example, the conditions and benefits of the High Net Worth Individual Rules were frequently mentioned as part of this question.

Question Four

Question 4, carrying 20 marks, was divided into four different scenarios dealing with the VAT place of supply rules. As a general rule, while candidates showed an understanding of the general place of supply rules, their understanding of the exceptions was somewhat mixed.

Part (a), carrying six marks, related to the purchase of a car from the United Kingdom by a Maltese individual. Candidates were required to consider the conditions for the application of the place of supply rules relevant to distance sales, and therefore needed to determine whether the car qualified as a new means of transport. However, most candidates only considered the general place of supply rules without considering the exception to the rule when there is a distance sale. As a result, the majority of candidates did not perform well on this part.

Part (b), carrying seven marks, related to two supplies between three taxable persons situated in three different European Union jurisdictions. Candidates were required to consider the conditions for the application of the simplification procedure for triangulations. Candidates generally performed better in this question, identifying that the facts resulted in the application of the simplification procedure. However, the majority of candidates did not venture into an analysis of the VAT implications in the chain of transactions thus not gaining all available marks.

Part (c), carrying three marks, related to the acquisition of an online subscription by an individual. Candidates were required to consider the place of supply rules with respect to electronic services provided to a non-taxable person. Candidates generally performed well on this question identifying that there was a supply of electronic services and the correct place of supply.

Part (d), carrying four marks, related to the tax implications of an insurance company (True Insurance) receiving services from outside Malta. Candidates were required to identify that an insurance company is exempt without credit, but in view of the receipt of services from outside Malta, the company may be required to register for VAT purposes in Malta. Candidates generally recognised that the insurance company was exempt without credit; however, most did not identify that the place of supply of the legal services was in Malta. This may have been because candidates erroneously assumed that True Insurance was not a taxable person for VAT purposes. In view of this mistake, most candidates did not consider the VAT registration requirements of True Insurance.

Question Five

Question 5, carrying 20 marks, related to the interaction between the EU Parent-Subsidiary Directive and the Interest and Royalty Directive on one hand and double tax treaties on the other. Candidates were required to consider the conditions for the application of both these Directives and the double tax treaties with respect to the distribution of dividends and payment of royalties by Fresh Living Ltd to its parent company Fresh Ltd, and the payment of a dividend to its other parent company Fresh Living Holding Ltd. Fresh Living Ltd and Fresh Ltd were both incorporated in the EU, while Fresh Living Holding Ltd was not.

With respect to the dividend income, the double tax treaty between the EU member States provided for a 0% withholding tax rate on dividend distributions to a parent company holding 25% or more of a company's shares, but a 15% withholding tax rate on dividend distributions in all other cases. On the other hand, under the terms of the Parent-Subsidiary Directive, the State in which the subsidiary is resident is restricted from imposing a withholding tax on dividend distributions by a subsidiary to a parent company holding 10% or more of the share capital, where both are incorporated in the EU. Furthermore, the Parent-Subsidiary Directive provides that the State in which the parent company is resident should not tax the dividends received by the parent company, or if taxed, it should grant an underlying tax credit for the tax suffered by the subsidiary on its corporate profits. Therefore with respect to the dividend distribution, this would have been exempt from withholding tax in State U, and would not be taxable in State E.

With respect to the royalty income, the Interest and Royalty Directive would not have applied as the holding threshold of 25% is not met. In this case, the provisions of the double tax treaty applied such that State U would be restricted from imposing a withholding tax.

Overall, candidates performed very poorly in this question. The question specifically required candidates to consider the application of the double tax treaties and EU Directives, but the majority of candidates did not even mention the EU Directives, limiting themselves to the application of the double tax treaties.

Where the Directives were mentioned, this was only done with a brief reference of the holding condition and part of the implications of the application of the Directive.

Candidates also demonstrated a poor knowledge of the provisions of a double tax treaty, with most candidates not stating that State U was restricted from imposing a withholding tax on the royalty payment under the terms of the double tax treaty but instead assuming that a withholding tax would be charged.