

Examiner's report

P6 Advanced Taxation (MLA)

June 2013



General Comments

The examination consisted of two compulsory questions and three optional questions from which two were to be chosen. Section A contained question 1 for 35 marks and question 2 for 25 marks. Section B comprised three questions of 20 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 as opposed to time pressure.

The approach chosen by most candidates in answering the questions was the recommended one: starting with section A questions (which carry 60 per cent of the marks) and then moving on to section B questions.

Candidates performed well on questions 1a(i), 1a(ii), 1b, 2a, 3a, 4a and 5a. The questions candidates found most challenging were questions 1a(iv), 2b, 3b, 4b, 5b and 5c. This was mainly due to two factors (i) candidates not demonstrating the ability to apply the concepts they have learnt to a new scenario so as to prove their understanding of core syllabus areas; and (ii) candidates failing to demonstrate their understanding of certain fundamental principles of the syllabus.

Handwriting and layout of answers (especially in questions 1 and 2) was generally of a good standard.

Common issues arose 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.
- Failing to read the question requirement carefully so providing irrelevant answers. By way of example, a number of candidates referred to the value shifting provisions or the intra-group exemption in question 1a(i) where this was not required, but then left the topics out in answering the questions which did require them to be explained.
- A number of candidates opted to leave out part of a question entirely. This mainly occurred in parts (b) in section A. Candidates should attempt every question.
- It is clear that a number of candidates simply rely on the notes provided to them without reading the law. Without reading it, candidates cannot understand the intricacies of tax law.
- Candidates seem to confuse certain core principles in the exam with the result that their answers often include basic mistakes. It is advisable that candidates sit for the P6 Paper only once they feel very comfortable with the principles they learnt at the Fundamentals level.

Specific Comments

Question One

This 35-mark question was based on a property owning company, Estate Ltd, and tested candidates' knowledge of capital gains and duty on documents issues. The shareholders of Estate Ltd required further funding and sought to introduce another shareholder into the structure. Candidates had to consider the different tax consequences of three different scenarios which were presented to them in question 1(a) and a further scenario in question 1(b).



Part (a)(i) for 12 marks required candidates to consider the income tax and stamp duty implications of an outright transfer of shares to the new prospective shareholder.

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. The best candidates remembered to mention the obvious points as well as discussing more complex issues. A minority of candidates failed to apply their understanding of the law to the case at hand, opting instead to explain irrelevant topics.

Candidates should ensure that they read the question carefully so as to understand what is expected of them; they should then identify and present the main issues they need to consider, while remembering the obvious points, such as the basis for calculating real value for duty purposes. A number of candidates made some fundamental mistakes in the calculation of the market value of Estates Ltd, excluding the share capital from the determination of the net asset value of the company.

This part required candidates to apply what they had learnt in a holistic manner, rather than defining the question as a capital gains question thereby excluding other topics from their analysis. A Ltd was a company incorporated outside Malta that was owned by an individual resident but not domiciled in Malta. The Income Tax Act provides an exemption for non-residents deriving gains from the transfer of shares in a Maltese company; however, this exemption is not applicable where the shares are held in a property company, which Estate Ltd qualified as. A small number of candidates are to be congratulated for considering this point, which is a fundamental principle of their syllabus.

Part (a)(ii) for 4 marks required candidates to consider the application of the value shifting rules to the scenario at hand. The vast majority of candidates identified the value shift and correctly explained the income tax and stamp duty implications of this scenario.

Part (a)(iii) for 6 marks required candidates to consider the specific rules with respect to the application of the intra-group exemption on the transfer of immovable property, the reasons why the exemption cannot be benefitted from and the consequences of its non-application. This question related to a recent amendment to the law of which candidates should have been aware, and most candidates identified that an intra-group exemption may apply.

A number of candidates identified that an intra-group exemption existed and concluded that it would not apply. Very good answers were produced by a number of candidates who went on to explain to the client the reason why the exemption would not apply, thereby proving that they know the conditions for its application.

Part (a)(iv) for 4 marks required candidates to consider the structure as a whole, to prove that they have a holistic understanding of tax law. Very few candidates gave adequate responses to this question which was surprising because most candidates knew of the concepts, such as the non-applicability of tax refunds to the fact that profits derived by Estate Ltd would be allocated to the immovable property account.

Professional marks were awarded to most candidates as the structure of their answer and format was of a good standard.

Part (b) for 5 marks required candidates to consider the income tax implications of the transfer of immovable property to a third party. Candidates were expected to show an understanding of the rules under Article 5A and the different opt-outs available in the case at hand.

The majority of the candidates showed an understanding of the different options available, and candidates generally performed well on this question, demonstrating a proper understanding of the opt outs to be considered.

Question Two

This 25-mark question was based on the tax implications of a group with various international operations and tested candidates' knowledge of the tax refund system and the participation exemption. Malta Ltd was the parent company of three companies with various interests; candidates had to consider the tax treatment of the different sources of income derived by the companies.

Part (a)(i) for 15 marks required candidates to consider the Maltese income tax treatment of the income derived by Cyprus Property Ltd and Trade Ltd, and the application of the tax refund system to them, as well as the tax treatment of dividends derived by Hold Ltd, mainly with respect to the application of the participation exemption and, where applicable, the application of the tax refund system.

Candidates' performance in this question varied. While a number of candidates performed very well, highlighting the main points required, it was clear that the majority of candidates are not clear as to the correct tax accounting, for example, that, in order for profits to be allocated to the immovable property account, the income must be derived from immovable property situated in Malta.

A number of candidates concluded (wrongly) that Malta Ltd could not benefit from the tax refund system on profits derived by Cyprus Property Ltd as this income was to be allocated to the immovable property account since it was derived from immovable property situated in Cyprus; consequently they did not consider the different options available to Cyprus Property Ltd.

On the other hand, candidates who correctly allocated the income to the foreign income account went on to explain the different options available to Cyprus Property Ltd. A number of candidates did very well to consider which of the different options provided the best solution.

A similar concern relates to the application of the anti-avoidance provisions of the participation exemption, with candidates seeming to understand the condition related to the subsidiary being resident or incorporated in an EU member state or that it was subject to foreign tax of at least 15%, without having a proper understanding of what passive interest or royalties are.

My advice to candidates with a question of this type is simply to dissect the different income streams, and not to be taken aback by the group's four level structure. The tax considerations were relatively straightforward for candidates who focused on what was required from them.

The answers to this question were generally well structured.

Part (a)(ii) for 6 marks required candidates to prepare tax computations of the Maltese tax payable by Cyprus Property Ltd, Hold Ltd and Trade Ltd, and calculate the tax refunds available to Malta Ltd.

Most candidates performed well on this part, although a number of candidates did not attempt it even though they had analysed the tax considerations in part (a)(i).

Part (b) for 4 marks required candidates to consider the tax treatment of different scenarios related to the reorganisation of the group. All scenarios resulted in no tax implications in Malta, which a few candidates did very well to point out.

The application of the exemption to capital gains derived by a non-resident from the transfer of shares in a Malta company that was not a property company was spotted by a number of candidates. This is one of the most important exemptions in our tax law.

Some candidates demonstrated their understanding that the participation exemption can apply with respect to the transfer of a domestic subsidiary and that the anti-avoidance provisions do not apply with respect to gains derived from the transfer of a subsidiary.

Question Three

This 20- mark question mainly considered the exemption from taxation of shares listed on the Malta Stock Exchange and the non-applicability of the exemption with respect to shares held prior to the shares being listed on the Malta Stock Exchange. The limitations to this exemption were introduced recently and caused quite a stir as it partially eliminated a long-standing exemption. A further question required candidates to consider the application of Article 73 of the Income Tax Act.

Part (a)(i) for 13 marks required candidates to explain the tax implications of the disposal of 3,500,000 shares in Memorable Hotels by Mr J, who was one of the original shareholders of the company and had acquired various shares at different stages.

Most candidates noted a number of the main points and picked up on the key issues. The majority of candidates correctly explained the limitations of the exemption to Mr J's scenario, the application of a reduced rate on the transfers, the means to determine the cost of acquisition and how to determine the capital gain. Some candidates are to be congratulated for correctly applying the last-in-first out basis to determine which shares were being transferred and the limit on the determination of the transfer price.

Part (a)(ii) for 3 marks required candidates to calculate the income tax payable by Mr J on the disposal of the 3,500,000 shares. Candidates' successful completion of this question was dependent on their understanding of the tax implications of the taxation of shares sold by an original shareholder.

Part (b) for 3 marks required candidates to consider the application of withholding tax in terms of Article 73 of the Income Tax Act with respect to the payment of income chargeable to tax in Malta to a person not resident in Malta.

The majority of candidates referred to the 35% rate which is applicable to companies without considering the rates applicable to individuals and to non-resident entertainers, suggesting gaps in their knowledge of the law.

Question Four

This 20-mark question may be divided into two. The first part considered the application of a tax treaty with respect to different sources of income derived by Mr X, a national of State X, who had been posted to work in Malta. The second part related to Mr P, who was taking up residence in Malta and would be deriving pension income arising outside Malta.

Part 4(a) for 12-marks asked candidates to consider the application of a tax treaty to the circumstances of Mr X who was taking up residence in Malta. Candidates were expected to consider the application of the tie-breaker rule to the facts of Mr X, an individual who was considered to be resident in Malta by the Maltese tax authorities given that he lived and worked in Malta and was also deemed to be resident in State X, where he still owned a house to which he returned at the weekends and, most importantly, where his wife and children lived.

A number of candidates did not consider the issue of Mr X being a dual-resident, and assumed that he was only resident in Malta and therefore taxable in Malta as a person who is resident but not domiciled in Malta.

The candidates who looked into the application of the tie-breaker rule generally understood it and explained it well. Mr X was tax resident in State X in terms of the tie-breaker rule, and the taxability or otherwise of all income derived by Mr X must be read in terms of the Malta-State X double tax treaty.

Candidates performed well with respect to the tax treaty issues relative to the employment income derived by Mr X from his employment activities carried out in Malta and a few did well to realise that, although Mr X received his salary from Company X in a Maltese bank account, Malta was restricted from taxing this employment in terms of the Malta-State X double tax treaty, which had precedence over Malta's jurisdiction to tax principles. The same comment applies with respect to director's fees received from Company Y. While candidates generally applied the treaty well, only a few realised that Malta was restricted from taxing the director's fees in terms of the Malta-State X double tax treaty.

Part (b)(i) for 4-marks required candidates to consider the taxation of pension income and the commutation of a pension arising outside Malta to a person who would be resident but not domiciled in Malta.

While most candidates interpreted the treaty correctly, giving exclusive taxing rights to the residence state, a few candidates are to be congratulated for realising that the commutation of a pension is exempt in Malta, even if received in Malta.

Most candidates remembered to advise Mr P on Malta's jurisdiction to tax principles with respect to a person resident but not domiciled in Malta.

Part (b)(ii) for 4 marks required candidates to consider the conditions for the application of the High Net Worth Individuals Rules and the benefits of these rules. Most candidates performed well on this question, and knew the different rules applicable to individuals taking up residence in Malta. A number of candidates provided the conditions for the application of the Highly Qualified Persons Rules, which were not relevant here.

Question Five

This 20-mark question considered different aspects of the Tax Accounts (Income Tax) Rules, the question may be divided into three: in the first part, candidates were to identify the tax account to which the different income sources would be allocated, in the second part, candidates were to consider the tax accounting issues relating to the Euro Set Group as well as identify mitigating alternatives, and the third part related to the election to have profits attributable directly to the immovable property account and its effects.

Part (a)(i) for 5 marks provided eight different scenarios with ten tax accounting allocations. Candidates were required to identify the tax account to which different sources of income would be allocated. Candidates generally performed well in this part, identifying the proper tax account through a reasoned understanding. Few candidates knew that the tax refund was allocated to the untaxed account.

Part (b)(i) for 8 marks required candidates to consider the effects of the indirect allocation of the annual market rent of €250 per square meter for property owned and used by a company, or for the use of immovable property owned by a related company for the purposes of its activities for no consideration or for a consideration of less than market value. The question also required candidates to consider the effects of the group transfer rules where the indirect allocation was not fully utilised in a company.

It appears that a number of candidates have understood the principles of the indirect allocation, as they explained the application of the group transfer rules and core principles, such as the definition of a related company. Often candidates simply showed the allocations to the tax accounts without providing the explanations which were required: the question asked candidates to 'advise'.

Part (b)(ii) for 3 marks required candidates to consider means of mitigating the group transfer rules problems the Euro Set Group faced. Candidates found this part challenging; some ignored the instruction not to consider rental of property as an option. Some candidates failed to identify that, with respect to the group transfer rules, companies are related if they have a common parent established in Malta.

Part (c) for 4-marks required candidates to consider the rules relative to the election in terms of Rule 9 of the Tax Accounts (Income Tax) Rules. Candidates were expected to explain the consequences of the election, the timing from when the election becomes effective and the effects the election has on the indirect allocation rules and related party transactions rules. Most candidates explained what the election entailed but few went on to considering further issues related to the election.