



Examiner's report

F6 (CHN) Taxation
June 2016

General Comments

There were two sections to the examination paper and all of the questions were compulsory. Section A consisted of 15 multiple choice questions (two marks each) which covered a broad range of syllabus topics. Section B had four questions worth 10 marks each and two longer questions worth 15 marks each. Section B questions test the candidates' understanding and application of tax knowledge in more depth.

In addition to the specific issues on each question, there are some general exam points that future candidates should be aware of:

- Take care to use the tax rate tables properly
- Try to state clearly which answers are for which sub-item (e.g. preparing calculations but not stating whether "taxable", "zero-rated" or "VAT exempt")
- Using "RMB000" when the numbers are 5-digit and 6-digit and resulting in errors, e.g. RMB123,450 became RMB12.345 (RMB000) Using the correct tax rate but using the wrong quick deduction factor
- Misreading numbers such as reading RMB876,000 as RMB76,000

The following paragraphs report on each section and focus on some of the key learning points.

Specific Comments

Section A

It was very pleasing to see that almost all candidates attempted all of the questions. Candidates preparing for the next examination of F6 are advised to work through the pilot paper and sample questions discussed here and to carefully review how each of the correct answers were derived. Section A questions aim to provide a broad coverage of the syllabus, and future candidates should aim to revise all areas of the F6 syllabus, rather than attempting to question spot. The following two questions are reviewed with the aim of giving future candidates an indication of the types of questions asked, guidance on dealing with exam questions and to provide a technical debrief on the topics covered by the specific questions selected.

Sample Questions for Discussion

Example 1

Ome Ltd is a UK resident company, which has a subsidiary company in China. In 2015, Ome Ltd had the following incomes:

- (1) Profit on the sale of goods to the China subsidiary**
- (2) Interest income from a loan made to the China subsidiary**
- (3) Dividend income from the China subsidiary**
- (4) Profit on the disposal of its equity interest in the China subsidiary**

Which of the above incomes are subject to China enterprise income tax (EIT)?

A. (1) and (4) only

- B. (2), (3) and (4) only
- C. (1), (2) and (3) only
- D. (1), (2), (3) and (4)

This question tested the scope of EIT of a non-resident enterprise.

A non-resident enterprise is subject to China EIT on income sourced from China. Item (1) is trading income which is considered as sourced from China if the trading activity is conducted in China (trading in China) where the current scenario is trading with China and it is not subject to China EIT.

Items (2) and (3) are passive income which the payer is a Chinese entity and these are China sourced incomes subject to 10% withholding tax (EIT). Item (4) is disposal of shares of a Chinese enterprise which is also China sourced taxed at 10% on gain.

Most of the candidates selected D which meant considering item (1) is also subject to enterprise income tax. The correct answers are items (2), (3) and (4) (i.e. B).

Example 2

Ready Ltd and Mr Mo jointly set up a partnership, Moready Co in Shanghai. They share profits equally. Mr Mo did not receive any salary from the partnership. Moready Co made a profit after tax adjustments of RMB1,500,000 in 2015.

What are the amounts of income tax payable by Ready Ltd and Mr Mo on the profits of the partnership in 2015?

- | | Ready Ltd | Mr Mo |
|----|-------------|------------|
| A. | RMB187,500; | RMB187,500 |
| B. | RMB187,500; | RMB233,050 |
| C. | RMB187,500; | RMB247,750 |
| D. | RMB247,775; | RMB247,775 |

This question tested the areas of calculating income tax under partnership. A partner who is a natural person pays individual income tax (IIT) under the category of entrepreneurs. The correct answer is RMB233,050 (750,000 – 42,000) x 35% - 14,750). However, almost the same number of candidates selected C, which means not deducting the allowance of RMB42,000 when calculating the IIT. In the tax rate table, it was stated clearly that "**Allowance per annum RMB42,000**".

Candidates should ensure that they use the information in tax tables to avoid making basic mistakes.

Section B

Question One

This 10-mark question covered the topics of transfer pricing and tax adjustments.

Part (a) for 4 marks was straight forward which required candidates to state the four methods (except for cost-plus) for transfer pricing adjustments. Anti-avoidance is an important subject in the world's tax administration and candidates from China are expected to have basic ideas in transfer pricing.

Part (b) for 6 marks was on transfer pricing adjustments and required candidates to calculate the revised profit after adjustments. Some candidates did not select the correct tax rates (25% or not starting the tax exemption period from 2010). It is recommended that future candidates have strong technical knowledge of:

- cost-plus (mark-up) method and adding the profit before adjustment or deducting the loss before adjustment;
- tax incentives that are allowed even after transfer pricing adjustments

Question Two

This 10 mark question required the calculation of customs duty, consumption tax and value added tax relating to import / export of goods.

Parts (a), (b) and (c) for 4 marks were reasonably straight forward. It is important that candidates can differentiate that consumption tax is tax inclusive and VAT is tax exclusive in order to avoid using the incorrect formulas were used in answering part (a) and (c).

The export VAT refund method of trading company is different from manufacturing company. Candidates are expected to know this difference in answer part (b) instead of using the "exempt, credit and refund" method for manufacturing companies.

Part (d) for 6 marks required calculating output and input VAT. Only a limited number of candidates could state that VAT was not credited but refunded by a trading company which exported goods from China (the export refund method).

Candidates' performance was fair on this question.

Question Three

This 10-mark question covered basic concepts of taxation and tax administration.

Parts (a) and (b) for 4 marks were about direct tax and indirect tax. These parts were fairly answered.

Parts (c), (d) and (e) for 6 marks were on tax administration. Parts (c) and (d) were well-answered. Candidate performance was not so strong in part (d)..

Most were able to identify that establishing an audit committee would improve the internal control environment, help with internal audit and assist in appointing or liaising with external auditors.

As is normal in F6, essay-type questions are the least popular amongst candidates.

Question Four

This 10-mark question covered the VAT on services (conversion of business tax to VAT). China started the conversion of business tax to VAT in 2012 and was fully converted from 1 May 2016 onwards (i.e. no more business tax).

It is important that candidates refer to the tax rate table which states clearly the tax rates. Some candidates used (1 – 17%) (which is always wrong since VAT is on top of the selling price). Some candidates found it difficult to differentiate the meaning of VAT inclusive and VAT exclusive. In addition, some candidates did not demonstrate that they are aware of the differences between "zero-rated" and "VAT exempt" which are fundamental VAT concepts. A few candidates correctly realised that depreciation should be calculated for equipment.

Candidates should avoid using gross profit (i.e. revenue minus cost) and then applying a VAT rate to calculate the VAT payable. Output VAT and input VAT should be calculated separately (one of the reasons is different tax rates). Candidates should also avoid calculating profit by using cash flow method, i.e. amount received minus the amount paid minus the VAT payable. This does not result in the correct answer when there is inventory or this relates to capital expenditure and fixed assets.

Candidates did not perform well on this question.

Question Five

This 15-mark question required calculation of individual income tax (IIT).

Part (a) for 5 marks required calculating IIT on a few items. A few candidates answered both "tax exempt" and "not subject to IIT"; or "tax exempt" but calculated the tax at the same time. Please be aware that credit will not be given for providing conflicting answers.

Candidates' performance in part (b) was subject to some common errors that future candidates can learn from:

- Treating all the allowances as tax exempt (while only housing allowance and meal allowance are temporarily tax exempt for expatriates)
- Not using RMB4800 as monthly allowance for expatriates (most used RMB3,500 and an extreme case used RMB4,500) while it was stated in the tax rate table that "Monthly personal allowance for a China local RMB3,500" "Additional allowance for expatriate employees RMB1,300"
- Not knowing that only one bonus can use the special formula to calculate IIT
- Find the correct tax rate for bonus ($\text{RMB}360,000 \div 12 = 30,000 \rightarrow 25\%$) but used $\text{RMB}30,000 \times 25\%$ instead of $\text{RMB}360,000$
- Using the correct tax rate but copied the wrong quick deduction factor from the tax rate table
- Using the wrong tax rate table

Part (c) for 4 marks was well-answered. that the majority of candidates were aware that there was special incentive to reduce the IIT rate to 10% on leasing of residential property.

Question Six

This 15-mark question was a typical enterprise income tax computation question. Future candidates are recommended to:

- Read the instructions clearly to avoid spending time in writing explanations that are not required
- Write the formulas used in order that some credit may be awarded for answers that contain careless mistakes (e.g. when copying numbers often one "0" more or one "0" less is written)
- State the applicable tax rate of 25% for calculating EIT
Compare (a) the lower of amount incurred x 60% and (b) sales x 0.5%; and the amount not deductible means the amount incurred minus the maximum deduction when calculating the deductible entertainment expenses, it is to find the maximum deduction.

EIT computation is a typical question which future candidates should practise for.

Part (b) for 2 marks required candidates to state the preferential treatments of two EIT incentives. Candidates should ensure that they read the requirement carefully and state the preferential treatment rather than selecting one incentive for the company.