

**THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN**

**EXAMINERS' COMMENTS**

**SUBJECT**

Advanced Taxation

**SESSION**

Final Examination - Winter 2007

**General comments:**

The overall performance in this paper was again very poor. It was seen that the students tried to answer according to the general understanding of the subject, and not according to the specific requirements of the question and the law.

**Question-wise comments:**

Q.1 Most of the students failed to understand the scenario presented in the question. This question was meant to test the knowledge in many areas of the law. The students generally failed to highlight the following critical aspects of taxation in their answers:

- That the presence of employees of the non-resident, for carrying out supervisory services would result in constituting a permanent establishment (PE) of the non-resident contractor.
- Income attributable to installation work and local purchase of the plant and machinery in Pakistan would be considered as Pakistan source income and would be taxable in Pakistan.
- Designing work and procurement of plant and machinery outside Pakistan could not be considered as Pakistan source income. Hence, it would not be taxable but exemption certificate from Commissioner of Income Tax would be required if the foreign contractors wants to avoid tax withholding thereon.
- The entire contract proceeds would have to be accounted for by the contractor notwithstanding that a part of it was directly payable to the sub-contractor.

Q.2 This question required proper and complete knowledge of the law relating to taxation of salary income of residents and non-residents. Majority of the answers showed that the students did not know how to put together various aspects of the law relevant in this regard. The main points were to judge the criterion for Pakistan and foreign source salary, identifying the timing of income chargeable to tax in Pakistan when a resident person is leaving Pakistan during the year and the allowability of tax credit on account of payment of foreign tax.

These points are discussed below:

- (a) Majority of the candidates treated the income received between January 07 to February 07 as foreign sourced relying on the fact that it was paid by the foreign employer (a group company). Very few candidates were able to point out that salary is Pakistan sourced if employment is exercised in Pakistan irrespective of where the amount is actually paid or received.

- (b) The students generally failed to point out that if Mr. Kashif returns to Pakistan before June 2007, the salary earned by him while being in Middle East, will also become taxable whereas if he returns after June 2007, it will not be taxable because if a resident person goes outside Pakistan in a tax year and remains abroad till the end of the tax year, the salary income earned outside Pakistan will not be taxable.
- (c) Very few candidates could correctly point out that though Mr. Kashif will be a non-resident for tax year 2008 but salary earned & received for exercising employment while being present in Pakistan was Pakistan sourced and hence subject to tax in Pakistan.
- (d) Very few students cared to discuss the tax credit that can be availed by Mr. Kashif on account of income tax paid in the foreign country.

Q.3 This question was well attempted by the majority of the students and many of them were also able to get full marks. However, there were few candidates who mixed up the concepts of "Group Relief" and "Group Taxation".

Q.4 It was a very straightforward and scoring question regarding refund of income tax. Surprisingly, very few students seemed to have studied Section 170 and 171 of ITO 2001 and did not manage to secure good marks.

Some of the common mistakes were as under:

- (a) Many students did not know that the company must file refund application in the prescribed form to the Commissioner of Income Tax. In the given scenario, it should be filed immediately after filing of income tax return since determination of refund date depends upon the date of filing of application.
- (b) Very few students knew that the refund order has to be issued by the Commissioner within 45 days of receipt of the refund application. Many of them only mentioned that the refund cheque shall be issued within three months from the date of refund order. Also, there was confusion among some students who mentioned that the refund cheque shall be issued within three months of the date of return.
- (c) Most of the students managed to convey that the compensation allowed to the tax payer is 6% per annum, if the period in which refund cheque is issued, exceeds three months as have been allowed by the Income Tax Ordinance, 1979.

Q.5 It was noted that most of the candidates had reasonable knowledge about the main issues which were tested in the question. However, many of them did not really understand the requirement of the question. They were required to discuss each issue so as to assess whether in that situation it would be better to have a branch or to have a subsidiary duly incorporated under the Companies Ordinance, 1984. They discussed the issues in a different perspective and therefore lost easy marks. Further details are given below:

**Business Income:** Very few candidates were able to point out that in either case the income will be taxed @ 35%.

**Head Office expense:** Majority of the candidates were able to correctly discuss the requirement of admissibility of the expense to the branch in the ratio of branch turnover to world turnover. However, they lost easy marks where they failed to mention that in case of an incorporated company, the expenditure would be admissible only where the same was incurred wholly and exclusively for the purpose of its business.

**Payment of Royalty/Fee for Technical Services:** Many of the students were able to declare correctly that in case of a branch these expenses will be inadmissible. However, when discussing the case of an incorporated company, many candidates were not clear in their minds about the admissibility of such expenses and tried to provide vague answers.

**Interest Payments:** The performance in this part was better and the students managed to secure good marks. The students generally knew that interest payments made by a branch to its head office are inadmissible and that payments by a company are subject to thin capitalisation rules.

**Remittance of profit:** The performance in this part was about par. Surprisingly, some students mentioned that remittance of profit was an admissible tax deduction against the profits of the branch. Many others failed to mention about the deductibility of tax at source, on dividends.

- Q.6 The question required computation of the amount which the taxation authorities can recover from the legal representative of a deceased person along with necessary explanations. Overwhelming majority of the examinees was aware of the fact that the tax authorities could only make a recovery out of the assets of the estate of the deceased person.

However, with the exception of few, the others could not really appreciate the fine point of assigning value to the respective assets. From the facts given in the question (i.e. sale of stock on February 1, 2007), it was quite apparent that assets were transmitted to the legal heirs on January 1, 2007 and accordingly were subjected to the valuation based on January 1 and not otherwise.

It also seems that most of the students were ignorant of the provisions of Section 75 (2) which provides that transmission of an asset by succession or under a will is treated as disposal of the asset by the deceased at the time the asset is transmitted and that as per section 77 the consideration received shall be the fair market value as determined at the time of disposal.

Further, any income on assets, subsequent to their transmission could only be accrued and owned by the heirs and not the deceased and hence the same could not form part of the recoverable amount.

Q.7 The requirement of the question was to compute the taxable income of the company and the tax payable by it, with the return of income. Students generally managed to attempt it well.

Some of the common mistakes made by many students were as under:

- Total taxable income was computed but Pakistan source income and foreign source income were not computed separately. Consequently the ratio for apportionment of expenditure was not calculated.
- The fact that losses incurred in deriving foreign source income can be carried forward for a maximum period of six years was not mentioned.
- Minimum tax on turnover was not calculated. It was necessary for deciding whether the company will be liable to normal tax or minimum tax.

Q.8 This question tested the basic concepts of sales tax and federal excise duty laws under specified situations. The responses to this question showed that the students generally do not comprehend the basics of the law before moving on to more advanced concepts.

The common mistakes made by the students can be summarized as under:

**Alpha**

- Sales tax for a third schedule item is calculated on the price exclusive of sales tax. Many students levied sales tax @ 15% on retail price.
- The students wrongly calculated federal excise duty (FED) on retail price of the product whereas FED was chargeable on retail price before sales tax.
- Income tax @ 3.5% was deductible by the distributor on price charged inclusive of all taxes and duties. Many students did not follow this rule.

**Bravo**

- A general error was made whereby sales tax was calculated before charging of FED.
- Another common error was made whereby both sales tax and FED was calculated on retail price per unit whereas it had to be charged on price to distributors.
- Income tax @ 3.5% was deductible by the distributor on price charged inclusive of all taxes and duties.

**Charlie**

- The students generally did not know that sales tax had to be charged on import value plus customs duty.
- Income tax is levied after levy of customs duty and sales tax. Surprising many students even at this level were unaware of this basic rule and could not calculate income tax payable at the import stage.

- Q.9 (a) It was the highest scoring question in the whole paper. The students were generally aware of the requirements of newly inserted Section 8B of the Sales Tax Act, 1990. However, many students failed to mention the rule related to non-corporate tax payers.
- (b) Part (i) and (ii) of the question were generally well answered. The students knew the requirements of Sections 7 and 62 of the Sales Tax Act, 1990 and managed to describe them adequately.

Part (iii) of the question related to sales tax on services. The examinees mostly answered by yes/no. They should have explained that sales tax on courier services is levied under the Provincial Sales Tax Ordinances and can be claimed as input tax provided it is incurred for the purposes of taxable supplies.

- Q.10 (a) The examinees were expected to mention the following three key points:
- Capital loss cannot be offset against normal business income and can only be offset against capital gains.
  - In case there are no capital gains in that particular year, the capital losses may be carried forward for offsetting against capital gains of the next six years.
  - If the transaction is on arm's length basis, there are no further tax implications even if the transaction is made with an associated company.

Very few of the examinees covered all the above points in a concise and clear manner.

- (b) This was a straight forward question for students who were aware of section 76(8) of the Sales Tax Act 1990. However, very few students were aware of the requirement and tried to answer using their general understanding of the subject.
- (c) This part tested the knowledge on taxability of intangibles. Generally the examinees were able to answer correctly that the intangibles become eligible for amortization once they are used for the purpose of the business and where the useful life is unascertainable, the amortization shall be allowed over a period of ten years.
- (d) The students generally could not arrive at the central theme of the question i.e. that this payment was Pakistan source, as per section 101(12) and subject to withholding tax. Due to non-deduction of withholding tax, the company will be liable to pay the applicable withholding tax itself as well as the additional tax thereon.

**(THE END)**