

ADIT Examiners' Reports from May 2006 examinations

Paper I: Principles of International Taxation

51 candidates sat this examination (as compared with 20 candidates last year). Each candidate, as required, answered four questions. The vast majority used the time available well and provided four complete answers.

Each of the questions on the examination paper attracted answers. The most popular question was question 2 (Article 5 and permanent establishments), which was answered by all but three candidates. The quality of the answers was variable. This was followed closely by questions 4 (jurisdiction to tax) and 5 (MAP and advance pricing agreements). I was particularly impressed by the answers to question 5 which were generally very well done. The least popular questions were questions 1 (influence of the OECD on international tax law) and 7 (exchange of information), neither of which were answered well.

It is fair to say that, generally, the standard of the scripts in this cohort was pleasing. The substantial increase in the number of candidates may have led to a drop in standards, but this proved not to be the case. In the event, 14 candidates secured a mark of 60% or more, and 36 candidates (70%) were awarded marks of 50% or more. The foundation of the performance of the candidates in these groups tended to be very sound/good answers to questions 2, 4 and 5, and in such cases where there was a weaker fourth answer this did not diminish the overall mark too drastically. Overall, therefore, I felt that many of the candidates performed creditably and exhibited a good understanding and appreciation of the subject.

Paper IIA: Advanced International Taxation – Primary jurisdiction – United Kingdom Option

General

The overall standard of the majority of the papers was very disappointing. Candidates have a wide choice of questions covering a wide range of relevant topics and a well prepared candidate should have been able to secure a pass mark comfortably. The evidence from many of the scripts was that very little preparation had been done as answers were often superficial and lacking in the level of detail which would be expected from advisers working in international tax on a regular basis.

Overall, attempts were lacking detailed knowledge even in areas that are clearly marked as a 3 in the syllabus and therefore where there is likely to be a detailed question in that area (eg, DTR). There was a lack of depth to most answers although a couple of candidates displayed reasonable detailed knowledge of entity characterisation and double tax relief. One reasonably answered area was the general treaty question regarding capital gains and allocation of taxing rights and

elimination of double taxation, perhaps reflecting a better understanding of general international tax principles rather than specific knowledge of the UK tax system.

Question 1

It is reasonable to expect that a transfer pricing related question will appear in an international tax examination and the examiner is expecting to see a strong understanding of United Kingdom and international transfer pricing principles. Only one quarter to candidates who attempted this question managed to achieve more than 50% of the available marks. The answers to the first part of the question, which looked at some detailed transactions, were often very superficial. Most candidates were at least able to mention most of the transfer pricing methodologies referred to in the OECD guidelines but proved quite unable to explain how these worked or the circumstances in which they might be suitable. Finally, the examiner was disappointed that so many candidates seemed to have very little idea on the subject of corresponding adjustments, either under a tax treaty or under domestic legislation in the case of United Kingdom/United Kingdom transfer pricing.

Question 2

This was a relatively unpopular question. The first part did in fact give candidates ample opportunity to discuss the United Kingdom taxation system as it relates to inbound activity in both breadth and depth. Both were lacking in most answers. Virtually no candidates discussed the rules for determining the profits of a permanent establishment in the United Kingdom. Most candidates at least made some reference to the relevance of a permanent establishment but made little effort to explain how the concept would actually be applied in the case of the M&C Consultancy Company.

When choosing questions, candidates were perhaps put off by the second part of this question as, if they had not studied customs duties at all, they were unlikely to score any marks. That was, regrettably, all too frequent an occurrence among those who had tackled the question. Some candidates sought to get round their absence of customs duty knowledge by discussing VAT instead, which did not attract marks.

Question 3

The majority of candidates knew something about domicile and were able to provide a reasonably explanation of the concept itself. The explanation of its importance in determining liability to tax tended often to the superficial but candidates generally scored at least a few marks for identifying some of the major points.

Few candidates showed any real level of understanding of the second part of question 3.

Question 4

This was a question of two halves. Answers to the first half were generally competent with most candidates exhibiting a reasonable understanding of the controlled foreign company provisions. The second half was generally poor with many candidates unable to name any case at all except Cadbury Schweppes which strictly failed to meet the requirements of the question as, at the time of the examination, it was merely an opinion of the advocate general and not a decision. European Court decisions are of fundamental importance in international taxation from a United Kingdom standpoint and it was extremely disappointing to see such widespread

ignorance of the European Court's activities from candidates who had been studying international taxation in preparation for this examination.

Question 5

This question involved two key aspects of UK international taxation, namely the characterisation of a foreign entity for UK tax purposes drawn from various principles established by UK case law (Memec and Dreyfus) and HMRC published guidance (tax bulletin), and the Avoidance Through Arbitrage rules.

The standard of responses was not as detailed as expected, although most candidates showed a good general awareness of entity characterisation. The responses on Arbitrage were disappointing (being mainly superficial in nature) particularly as this is a relatively new area of UK tax law that received significant media coverage over many months in 2005.

Question 6

This question required knowledge of the computational aspects of UK double tax relief and in particular the measure of Schedule D Case V income (grossing up by unrestricted creditable taxes), the application of the mixer cap and the calculation of eligible unrelieved foreign tax ("EUFT").

Whilst a couple of candidates demonstrated good knowledge of this area and achieved high marks as a result, the overall standard was low in an area that is clearly shown on the syllabus as requiring detailed knowledge including computational aspects.

Question 7

This question was treaty based and focused on the allocation of taxing rights for capital gains realised on a disposal of real property and methods for relieving double taxation, and a specific UK-US treaty situation that required knowledge of the limitation on benefits provision of the UK-US treaty.

The capital gains part of the question was generally answered well, possibly reflecting the fact that this was a question that was more general in nature in relation to international tax principles than UK specific, although a couple of candidates showed knowledge of the UK close company rules which was impressive.

The UK-US treaty part was generally answered poorly and very few candidates showed much knowledge of the treaty other than references to a qualified person including a UK listed company. Again, I expected more detailed knowledge of this particular treaty.

Paper II C: Advanced International Taxation – Primary jurisdiction – Hong Kong option

Question 1

This question tests students' ability in identifying tax issues by examination of accounts and tax computation. The issues on capital nature v. trading nature are examined. Also, the general deduction rule and various specific deduction rules, including that for interest expense, patent cost, and bad debts, have been covered. There was a lack of understanding of both the general deduction rule as well as most

of the specific deduction rules, the tax treatment on disposal of capital assets, particularly patent right and the rules in ascertaining taxability of interest income, including source rule, i.e. operation test and provision of credit test. Therefore, the effect of s.16(2) on taxability of interest income under the interest income exemption order were not explained.

Question 2

This question tests students' understanding on various issues on salaries tax, including charging scope (Hong Kong source v. non Hong Kong source employment), deduction of expense, deduction of personal allowances and concessionary deductions. Performance on this question was good.

Question 3

This question tests students' understanding on tax implication of non-Hong Kong residents doing business in Hong Kong. Students' overall performance is in the range of poor to only marginally acceptable. Students failed, to a large extent, to distinguish the differences between a fully-accredited agent v a subsidiary in the context of capital duty, PE, deduction of expense, home country taxation, and withholding tax and tax treaties.

Question 4

The performance on the question was good. The tax implications of different forms of processing operation in China and the issues/requirement involved in applying for a revised assessment through lodging an objection v making an s.70A claim were explained. However, that an employer's return is for reporting all payments made to employees, no matter whether the payment is taxable or not was misunderstood. So including items which are not taxable in an employer's return strictly does not render the return to be regarded as completed wrongly.

Question 5

The performance on the question was poor. The basic charging requirement that the transaction must be of a trading nature was not explained. There was no relevant discussion on the "badges of trade" and a failure to analyse the implication of the tax treaties in the context of Hong Kong tax law. Even though there is limitation of the tax rate imposed on the interest income derived by a Belgium/Thailand company, the limitation may not be applicable to the interest charged on trade debts resulted from direct sale to Hong Kong customers. This is because, for direct sale, the basic charging condition of carrying on business in Hong Kong cannot be met. This important point was not explained.

Question 7

Performance on this tax planning and anti-avoidance question was poor. The most important specific anti-avoidance provision attacking the sale and lease back transaction, i.e. s.39E was not applied. Also there was not much relevant discussion on s.16(1), the general deduction rules to the question, in the aspect whether the payment is excessive and hence "NOT to the extent" incurred in the production of assessable profits. There was a failure to identify the intended benefit that the tax plan is designed for, the application of the both general anti-avoidance rules and specific avoidance rules to the situation were therefore not discussed.

Paper III B: Principles of Corporate and International Taxation – Secondary jurisdiction – European Community option

The European Community paper proved more difficult than expected for most candidates with only a handful of candidates scoring high marks.

Problems appear to be – not writing enough material on questions to pick up easy marks; using the Van Raad book to simply copy out material without really relating that material to the examination question; failing to discuss cases; failing to cite cases; failing to cite the correct cases to support an argument. Overall, most candidates did poorly owing to lack of material being written in their exam scripts compared to the better students.

Question 1 concerning CFC legislation and *Cadbury Schweppes* was answered poorly despite the availability of the Advocate General's Opinion prior to the examination. There was little reference to secondary materials and barely any connection made to recent cases like *Marks and Spencer* which dealt with the tax avoidance issue.

Question 2 was attempted by 50% of candidates and only a handful did well. There was little effort made in discussing the main directives beyond naming them. Easy marks were available for a general discussion of each. The better candidates summarised the key points relating to each directive they mentioned. There was little reference to any of the Court's case law in the area of the directives.

Question 3 was generally answered well. Most candidates showed a good understanding of positive and negative integration and the roles of the institutions. The weaker scripts failed to discuss the roles of the institutions in detail. Many candidates simply named the institution and said little about it. Moreover, many candidates failed to discuss the cases in this area beyond naming them, throwing away easy marks secured by the top students.

Question 4 generated either very high scores or very low ones. Few candidates expressed a conclusion, for instance. The *D* case was either discussed very well or else quite poorly. As a significant case from 2005, one would have expected all candidates to be familiar with the facts, issues and holding of the Court – this was far from the case. The MFN issue in the case was noted by many candidates but rarely put into context. Candidates who scored highly on this question produced a 4 part Report with an introduction, a discussion of the *D* case, a discussion of *Manninen*, and a Conclusion. There was little reference to the considerable secondary materials available on the MFN topic.

Question 5 was attempted by most candidates and some scored generally good marks, but few scored high marks. Those that did made an effort to discuss each of the justifications in some detail rather than simply repeating the headings from the question. They related each justification to a case or two and discussed those cases also. *Marks and Spencer* was a key case from 2005 and should have been better prepared for by candidates.

Question 6 was attempted by only a few candidates and only one of those scored a high mark – the rest failed to discuss what was perhaps the easiest question on the paper, given that the Treaty provisions were available in Van Raad. The answers demonstrate the complete rift in terms of the quality of answers and highlight the lack of understanding of EC Tax Law generally as the EC Treaty is such a fundamental part of the syllabus. Without understanding the provisions of the EC Treaty that relate

to tax – how can any candidate understand EC Tax Law? Again, cases were almost absent from the answers to this question throwing away very easy marks to show general knowledge and relate the cases to provisions of the Treaty.

Question 7 was answered well by just one candidate. This was an easy question because there were a handful of cases that could have been discussed. Indeed, the *Bouanich* case should have made this a hot current topic for students given its significance. The fact that the GLO's also involved tax treaty issues should have alerted candidates to at least a few recent cases occurring in this area. Add to that the significance of the *D* case and the MFN issue and one can see that tax treaties and Community law were a live issue in 2005/2006.

Overall, the standard of answers was up on last year but still there are too many candidates failing this examination through lack of preparation. The better students have shown that the paper was not a difficult paper and that reasonable results can be achieved in the allotted time limit with access to Van Raad's book.

Clearly, candidates must be aware that structuring answers leads to more focused and interesting answers which generate higher scores. It is important to show the examiner knowledge. This cannot be achieved by writing two pages as an answer to a question in 45 minutes when the better candidates are writing six pages. Similarly, candidates who double-space and skip a line must remember that writing 6 pages with every second line blank is really only writing three pages! There was no evidence that time was a problem for most candidates – the better candidates this year produced far more knowledge and writing in the time allotted than the weaker students (who generally wrote two or three page answers). Like any examination, the more knowledge you show the examiner, the greater your chance of doing well in the examination.

Paper IIIC: Principles of Corporate and International Taxation – Secondary jurisdiction – United Kingdom option

This was the first sitting of the new Paper III UK Option with only one candidate sitting the paper. The level of knowledge shown by the candidate was in line with the required level expected and required. The intention with this paper is for a general knowledge of UK taxation as a secondary jurisdiction but from an international perspective. The candidate showed an ability and quality of answer in line with this level of expectation.

It is intended that the format, required level of knowledge and mix of UK and International aspects for future sittings will be in line with this paper and the specimen paper produced last year. Future candidates should review each of the questions set as a guide for the future.

The seven questions set can be summarised as:

Question 1

A general question requiring an understanding of the definition and factors affecting a company's residence for UK tax purposes. As with all areas of international taxation the principles of residence are a fundamental area of consideration.

Question 2

A question considering the UK implications of the disposal of a company or business. The key was to identify the differences between the two alternatives and to finally consider planning opportunities from an international emigration perspective.

Question 3

A business start up question requiring outline knowledge of the various structures available and the tax implications of each. A key requirement was to be able to compare and contrast each and therefore understand the differences.

Question 4

A general question requiring knowledge of the UK transfer pricing legislation, a core area for consideration in this type of exam paper. A textbook question giving an excellent opportunity for a well prepared candidate.

Question 5

Again a transfer pricing based question but with specific types of transaction for comment and consideration. Each of the four sections was intended to cover a different aspect.

Question 6

A question requiring an understanding of the differences between revenue and capital items. An outline knowledge of the capital allowances legislation was required. The second part considered the effect of the accounting treatment of various transactions on the taxation treatment.

Question 7

This question considered the international implications from a UK tax perspective on the movement of employees in UK and abroad.

As with all examinations marks are allocated for lay out and presentation.