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In this issue:

Hong Kong court clarifies relationship between unrealized gains and assessable profits

The Hong Kong Court of First Instance (CFI) issued its decision in *Nice Cheer Investment Limited v. Commissioner of Inland Revenue HCIA 8/2007* on 28 June 2011, ruling in favor of the taxpayer that its unrealized gains arising from the revaluation of trading securities that were recognized in accordance with ordinary accounting principles are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance (IRO), the general profits tax charging section.

The chargeability of such unrealized gains was not controversial until the Hong Kong Court of Final Appeal issued its far-reaching decision in 2000 in the *Secan* case. That court held: "Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the Ordinance, no further modifications are required or permitted." The *Secan* decision led to the Inland Revenue Department (IRD) issuing Departmental Interpretation and Practice Notes (DIPN) No. 40 (Revised) "Prepaid or Deferred Revenue Expenses" and DIPN No. 42 "Taxation of Financial Instruments and Taxation of Foreign Exchange Differences," the essence of which is that tax treatment should follow the treatment prescribed under the accounting rules unless the accounting rules are contrary to any provision of the tax statute; in other words, "tax follows accounting."

Based on the "tax follows accounting" principle, the IRD attempted to assess tax on the unrealized gains arising from the revaluation of listed securities of Nice Cheer. The CFI, however, concluded that the IRD incorrectly applied the *Secan* principle. The Commissioner of Inland Revenue (CIR) had placed too much emphasis on the commercial accounting rules and viewed the particular accounting treatment as conforming to the IRO. As a matter of law, however, the CFI interpreted the meaning of "profits" in section 14 of the IRO as real, not notional, profits. Unrealized gains arising from the revaluation of listed securities fall outside the intendment of section 14 and, hence, are not chargeable to tax in Hong Kong.

Facts and background of the case

Nice Cheer is a Hong Kong company that is principally engaged in investment trading of Hong Kong securities. The company prepared its financial statements in accordance with the prevailing generally accepted accounting principles and the financial statements in the relevant years gave a true and fair view of the company's affairs and profits. Specifically, Nice Cheer adopted Hong Kong Accounting Standard 39 (Financial Instruments: Recognition and Measurement (HKAS 39)) issued by the Hong Kong Institute of Certified Public Accountants (HKICPA) and applicable since 1 January 2005. Under HKAS 39, unrealized gains and losses arising from a revaluation of trading securities are treated as profits or losses in the income statement. However, in computing its profits tax liability, the company excluded the unrealized gains arising from the revaluation of trading securities in arriving at assessable profits, but claimed a deduction for the unrealized losses on trading securities at year end. The CIR took the position that the unrealized gains and losses arising from the revaluation of trading securities held at year-end should be respectively chargeable to tax and allowable as deductions for profits tax purposes.

Nice Cheer appealed the CIR's determination, and the CIR consented to a hearing and judgment by the CFI rather than the Board of Review. The issue before the CFI was whether unrealized or holding gains resulting from the revaluation of trading securities in Hong Kong at year end, which are determined in accordance with ordinary commercial accounting principles, are chargeable to profits tax.

Arguments of the parties

According to the taxpayer, unrealized gains arising from a revaluation do not constitute "profits" as meant in section 14 of the IRO because that provision refers to "actual" profits rather than notional profits. As such, profits could only be assessed when earned and realized. The taxpayer's argument thus hinged on the statutory construction of the meaning of the term "profits."

In contrast, the CIR based its argument on the *Secan* decision, contending that, under the statutory regime, the method for computing profits tax is that profits and losses must be reported in accordance with ordinary commercial accounting principles, i.e. the prevailing accounting standards and financial reporting standards as prescribed by the HKICPA, as modified to conform to the IRO. Because Nice Cheer prepared its financial statements according to prevailing accounting standards and recognized the holding gains arising from the revaluation of the listed securities, the assessment of profits tax on the unrealized gains was consistent with the IRO and was not a case of charging profits tax on notional or anticipated profits. That is, the CIR basically applied the "tax follows accounting" principle and placed particular importance on ordinary commercial accounting principles, but did not shed any light on their interpretation of the meaning of "profits" under section 14.

Decision of the CFI

The CFI held for the taxpayer in the case, ruling that unrealized gains from a revaluation are not taxable, whereas unrealized losses are deductible. The court agreed that ordinary commercial accounting principles are useful and important in ascertaining profits and losses, but their importance should not be over-emphasized. The court stressed that ordinary commercial accounting principles apply only when no statutory provision suggests otherwise. If statutory provisions are applicable, the interpretation of the statutory provision and jurisprudence interpreting the provision take precedence over ordinary commercial accounting principles. For example, since financial statements prepared in accordance with accounting standards record global income that should be recognized under the relevant income recognition rules for book purposes, due consideration must be given to exclude offshore profits based on the territorial concept of taxation in Hong Kong. In this manner, the correct approach in analyzing which profits are chargeable to tax must be decided on legal principles, particularly principles of statutory construction.

In reaching its decision, the CFI systematically examined all aspects of the intent of section 14, the main charging provision of profits tax, as well as the relevance and application of a principle established in the U.K. (in *Sharkey v. Wernher*) to the assessment of notional profits when a taxpayer's asset is changed from one category to another. In summary, the CFI reaffirmed that the charge on "profit" in section 14 is a charge on real profit (i.e. profit derived from trading or business activities), not notional profit (i.e. anticipated profit or gain from the revaluation of trading securities that the taxpayer never made). The court also reiterated that the *Sharkey v. Wernher* principle does not apply to Hong Kong (following previous Board of Review decisions and *Commissioner of Inland Revenue and Quitsubdue Ltd*).

The CFI rejected the CIR's arguments relating to the *Secan* principle, concluding that the CIR misinterpreted it without taking into account the intent of section 14. Thus, the CIR's argument that the taxpayer's unrealized gains resulting from a revaluation of unsold trading securities should be assessed on the amount based on ordinary commercial accounting principles and no modification is required by the IRO is incorrect.

Comments

Taxpayers and practitioners have generally welcomed the *Nice Cheer* decision, particularly in the context of DIPN No. 40 and DIPN No. 42, which seemed to indicate that the IRD has been taking a relatively aggressive position in dealing with issues involving "profits" derived from unrealized transactions.

The problem of assessing unrealized gains derived from unsold trading securities is not difficult to understand in the context of Hong Kong profits tax. For example, assume a taxpayer holds one trading asset – trading securities with a cost of HKD 100 that are worth HKD 130 at the end of Year 1. At Year 1 end, the company records an unrealized profit of HKD 30 in its income statement due to an increase in the fair value of the trading asset at the reporting date. The IRD would assess tax on the unrealized profit of HKD 30. When the taxpayer subsequently sells the trading asset at a loss for HKD 80 in Year 2, the taxpayer incurs a tax loss of HKD 50 (HKD 130 – HKD 80) that it is not able to carry back to the previous year of assessment, when, in fact, the taxpayer incurred an actual loss of HKD 20 (cost of HKD 100 less the sale proceeds HKD 80).

Apart from the above, we have identified the following issues that are worth discussing:

1. The treatment of unrealized losses from trading securities;
2. Applicability of the decision to foreign exchange transactions;
3. Applicability of the decision to financial instruments;
4. Correcting prior year assessments (under section 70A); and
5. Nonapplication of the *Sharkey v. Wernher* principle.

1. The treatment of unrealized losses from trading securities

The CFI ruled to exclude unrealized gains derived from unsold trading securities from profits tax, but at the same time allowed the taxpayer to claim unrealized losses on trading securities. Relying on the *Secan* principle, the IRD argued that losses are merely the mirror image of profits and must be ascertained in a like manner for tax purposes, and there was no reason why profits could not be anticipated while losses could. The CFI rebutted this argument for two reasons:

- There is no inconsistency in the tax treatment of unrealized gains and losses on trading securities. Section 14 qualifies the conditions on the scope of the charge on "profits" but not on "losses"; and
- A taxpayer would not obtain any genuine monetary benefit if it was allowed to claim unrealized losses on trading securities in the current year as long as the accounting rules have been applied consistently.

It is hard to subscribe to the CFI's position on this issue. If the charging conditions under section 14 only apply to profits but not losses, why can the IRD disallow offshore losses? Further, the principle in *Secan* that profits and losses should be treated in a like manner would appear to be a logical principle to follow. With respect to the treatment of losses, section 19D(1) of the IRO requires that the amount of losses incurred for any year of assessment be computed in like manner to assessable profits. Moreover, regarding the CFI's second reason, a taxpayer will obtain tax benefits if it is allowed to claim unrealized losses on trading securities in offsetting other profits of the current year. The taxpayer could enjoy a better cash flow in terms of a tax deferral.

2. Applicability of the decision to foreign exchange transactions

The *Nice Cheer* decision should not apply to foreign exchange transactions. Unrealized gains and losses relating to foreign exchange transactions are different from those in trading securities transactions because the underlying trading assets in the former are currencies (money), i.e. fungible assets that have a ready market and a value against the reporting currency. The "exit" value of the amount of foreign currency in terms of local dollars must be the value the currency has on the money market on the financial reporting date for unsettled foreign exchange dealings. It does not represent anticipated profits, but accrued profits valued at the financial reporting date. Therefore, unrealized exchange gains recorded at the financial reporting date are treated as profits and, hence, are taxable.

3. Applicability of the decision to financial instruments

Like trading securities, financial instruments (e.g. forward contracts and trading options) also are subject to fair value adjustments at the financial reporting date. Because financial instruments are, in general, like trading securities in that they are not freely exchangeable or replaceable (unlike currency), the *Nice Cheer* decision should apply and profits tax would be assessable only when the instruments are sold.

4. Correcting prior year assessments under section 70A

If an assessment was excessive because of an error or omission in a return or statement, section 70A of the IRO allows taxpayers to apply for correction of the assessment within the later of six years after the end of a year of assessment or six months after the date on which the relative notice of assessment was served. However, it is not likely that section 70A would be applicable to relevant assessments finalized before the decision in *Nice Cheer*. If an assessment was issued on the basis of, or in accordance with, general prevailing practice at the time the return or statement was made, no correction may be made under section 70A.

5. Nonapplication of the *Sharkey v. Wernher* principle

The *Sharkey v. Wernher* principle is generally applied when a taxpayer's intention for holding an asset is changed (from short-term to long-term, or vice versa) such that the fair market value of the asset at the time the intent is changed is taken into account in computing the taxpayer's assessable profits. The CFI concluded that the *Sharkey v. Wernher* principle does not apply in Hong Kong. It will be interesting to see whether the IRD will change its current assessing practice or issue written guidelines in this regard.

Conclusion

The CFI decision in *Nice Cheer* restores the correct "order" for computing profits tax, whereby ordinary commercial accounting principles prevail only to the extent they are not contrary to the statute. It is not correct to allow ordinary commercial accounting principles to take precedence over the statute or a judge's interpretation of the statute. However, there is some doubt as to whether the court's conclusion that a dichotomy in treatment between profits and losses for tax purposes is technically correct. It will be interesting to see whether the IRD will appeal the case to seek clarification from a higher court.

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Canada: Additional waiver form required for employer withholdings

The Canada Revenue Agency (CRA) recently introduced new Form R102-R, *Regulation 102 Waiver Application*, for use by a nonresident employee who will be exempt from tax in Canada under a tax treaty between the individual's country of residence and Canada. This form is in addition to the joint employer/employee waiver application, Form R102-J, *Regulation 102 Waiver Application – Joint Employer/Employee*.

Under the Canadian Income Tax Act, employers are required to withhold income tax at source from Canadian-source compensation related to services rendered in Canada that is paid to nonresident employees. The amount of withholding is determined in accordance with section 102 of the Income Tax Regulations (commonly referred to as "Reg. 102" withholdings). A tax treaty between Canada and the country of residence of a nonresident employee providing services in

Canada may provide for relief from Canadian tax. The employer, however, may only be relieved of the tax withholding obligation when a formal waiver is obtained from the CRA.

New rules for Reg. 102 waiver

Form R102-J should be used to apply for a waiver of tax required to be withheld in the following situations:

- If an employee is a resident of the U.S. and is expected to earn no more than CAD 10,000; and
- If an employee is a resident of another country with which Canada has concluded a tax treaty and is expected to earn no more than CAD 5,000.

New Form R102-R should be used by a nonresident employee providing employment services in Canada to apply for a waiver of tax required to be withheld if he/she satisfies other conditions for exemption pursuant to a tax treaty between Canada and the country of residence. Form R102-R should be completed and submitted 30 days before either the start of the employment services in Canada or the initial payment for the services.

If the employee is claiming a treaty exemption for remuneration to be paid by a nonresident employer and the amount is not borne by a permanent establishment of the nonresident employer in Canada, the employee must attach a written attestation to this effect from the employer or arrange for such attestation to be provided directly by the employer to the CRA office processing the waiver application. If the waiver application is approved, the CRA will issue a letter to the employer and employee authorizing the employer not to withhold tax on payments made to the employee. The effective date of the Form R102-R waiver will be the date on which the waiver application is approved.

Issues to consider

If the employee does not have a Social Insurance Number (SIN) and has a work permit, the employee must apply for a SIN from Service Canada. If the employee does not qualify for a SIN, he/she must apply for an Individual Tax Number (ITN) and must submit the ITN request at the time of the waiver application.

Even if a waiver from tax withholding is obtained, the payer of remuneration still has the obligation to provide the employee with a T4, *Statement of Remuneration Paid*, reporting the amounts paid in the calendar year by the end of February of the following year. Employers also are required to withhold and remit Canada Pension Plan (CPP) contributions and Employment Insurance (EI) premiums for each of their employees unless otherwise exempted. An exemption for CPP may be available based on a reciprocal agreement on social security between Canada and the employee's home country. An exemption for EI may be available if the unemployment insurance laws of the employee's home country require payment of premiums on the same employment income.

An approved waiver of withholding on amounts subject to Regulation 102 does not affect the requirement of a nonresident providing employment services in Canada to file a Canadian income tax return.

If the information presented in Form R102-R changes for any reason, the CRA must be informed immediately. Failure to do so may result in the waiver being rescinded and the withholding requirement reinstated.

We understand that the CRA may perceive Form R102-R to be a concession to employers from an administrative perspective. We are of the view that the CRA falls short on this objective, as the application must be filed either 30 days before the start of the work in Canada or 30 days before the initial payment. However, we believe that the introduction of this new form is aligned with the CRA's journey towards achieving higher taxpayer compliance.

Comments

Affected employers and employees should take the following into account:

- Employers must have a process for tracking their nonresident employees to ensure that they can comply with their Canadian tax withholding and reporting obligations.
- Employers should educate their nonresident employees about the requirement to apply for a SIN/ITN and the importance of obtaining a waiver from withholding.

- Question 12 on Form R102-R asks for a copy of the employment contract. This may be problematic for frequent business travelers or employees required to work in Canada without having an assignment agreement. Employers may consider providing a letter printed on company letterhead outlining the requirement for their employees to work in Canada and the related responsibilities as an alternative.
- Questions 14 and 15 on Form R102-R, which require disclosure of days in Canada, may be confusing for frequent business travelers. Employees may consider attaching a separate document to indicate their anticipated travel in and out of Canada.
- Question 17 on Form R102-R, which requires employees to disclose previous employment services in Canada, could be problematic if the employer was not complying with withholding requirements in the past. This question reflects the CRA's increased focus on identifying noncompliant taxpayers. Employers may consider using the Voluntary Disclosure Program to settle past years.
- As noted above, among the documents to be provided to the CRA is written attestation from the nonresident employer that remuneration to be paid is not borne by a PE of the nonresident employer in Canada. Since the waiver is required 30 days before the start of employment services in Canada or the initial payment, it appears that the CRA is not considering the "Services PE" rules under the Canada-U.S. tax treaty.
- In the past, if a nonresident employer had an affiliated entity in Canada, this Canadian entity was used as an agent to comply with the nonresident employer's reporting requirements on a T4 where treaty waivers were obtained. Further to discussions with the CRA, our understanding is that the CRA will no longer accept the agent option; instead, all nonresident employers will be forced to register with the CRA and obtain a Canadian Business Number and a CRA payroll account number. This may result in even more Canadian compliance obligations.

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Czech Republic:
Lower withholding tax on royalties paid to EEA companies

As from 1 January 2011, royalty payments made by a Czech resident to a qualifying related company in the EU, Iceland, Norway and Switzerland are exempt from withholding tax because the transition period under the EU Interest and Royalties Directive, under which the Czech Republic was allowed to levy a 10% tax, expired on 31 December 2010. To qualify for the exemption, the following conditions must be satisfied:

- The recipient obtains a ruling from the Czech tax authorities granting the exemption (the application must include prescribed information);
- The taxpayer and the recipient of the royalties must be directly related through capital for at least 24 consecutive months (the withholding tax exemption may be applied before expiration of the 24-month period, provided this condition is subsequently fulfilled);
- The recipient of the royalties must be the beneficial owner; and
- The royalties are not attributable to a permanent establishment in the Czech Republic or a third country.

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Germany:
Application of ECJ case law to U.S. residents rejected under friendship treaty

Germany's Federal Tax Court (BFH) has ruled that the principles of the European Court of Justice (ECJ) decision in the *Gerritse* case cannot be extended to U.S. residents based on the nondiscrimination article of the Germany-U.S. tax treaty or on the basis of the Treaty of Friendship, Commerce and Navigation (friendship treaty) between the two countries.

At issue before the BFH was whether the nondiscrimination articles of the Germany-U.S. tax treaty or the friendship treaty confer the same rights on a U.S. citizen residing in the U.S. who earned income from independent professional services provided in Germany as the basic freedoms in the Treaty on the Functioning of the European Union (TFEU, formerly the EC Treaty) confer in a similar situation to an EU citizen.

A U.S. resident partner of a law firm with a branch in Germany earned income from German sources in 2004 that was subject to the minimum tax rate of 25% at the time. In the *Gerritse* case, involving a comparable EU situation, the ECJ had decided on 12 June 2003 that the application of the minimum tax rate to an EU national infringed the freedom to provide services of the EC Treaty (now TFEU). (In *Gerritse*, a nonresident artist was taxed on the gross receipts for his performance (i.e. he was not allowed to deduct expenses incurred in relation to his performance) and a minimum tax rate of 25% applied to his earnings. The ECJ held that such gross basis taxation and the minimum tax rate violate the freedom to provide services if they apply only to nonresident taxpayers, whereas resident taxpayers are taxed on a net basis and are subject to a lower rate of tax due to the progressive rates.)

The BFH rejected the claimant's argument based on both the tax and friendship treaty. Article 24(1) of the tax treaty prohibits the contracting states from taxing nationals of the other state in a manner more burdensome than it would tax its own nationals in the same circumstances; the taxpayer could not rely on this article because he was discriminated against based on residence, not nationality. In this respect, the BFH did not follow ECJ jurisprudence that provisions referring to the (foreign) residence of a taxpayer constitute hidden discrimination that is prohibited under EU law in the same way as open discrimination on the grounds of nationality.

The BFH also held that the situation did not constitute discrimination within the meaning of article 24(2) of the Germany-U.S. tax treaty, according to which a contracting state may not tax a permanent establishment of an enterprise of the other state less favorably than enterprises of that state carrying on the same activities. Even if the rule also applied to professional services, the entire income of the U.S. taxpayer had to be taken into account when comparing his situation to a domestic taxpayer, which would mean that the comparable German taxpayer would not have been taxed at a higher tax rate.

Nor could the taxpayer rely on the nondiscrimination clause in article XI(1) of the friendship treaty because this rule (as in the case of article 24(1) of the tax treaty) refers to discrimination based on nationality.

Finally, the BFH held that the taxpayer could not rely on the most favored nation treatment (MFN) clause in article XI(3) of the friendship treaty. Although the minimum tax rate would not have been applicable to a comparable EU taxpayer due to the *Gerritse* decision, the BFH held that EU cases should be covered by the caveat to the MFN clause in article XI(5) of the friendship treaty. This provision allows each contracting state to extend specific tax advantages to nonresidents on the basis of reciprocity. The BFH held that the basic freedoms of the TFEU constitute such benefits on the basis of reciprocity; thus, the MFN clause was not applicable in the case.

By classifying the basic freedoms as specific tax advantages on the basis of reciprocity, the BFH confirms that it is not willing to extend the principles of ECJ case law to U.S. residents under a most favored nation argument. It can therefore be expected that the relevance of the friendship treaty in direct tax cases will decrease because it appears that the friendship treaty would not offer any significant additional protection as compared to the tax treaty. However, even though the taxpayer was unable to rely on the tax treaty in the case, the nondiscrimination article in the tax treaty may provide protection in other cases; its implications would have to be analyzed on a case-by-case basis if an argument based on the nondiscrimination clause is to be made.

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Germany: Amendment to anti-treaty shopping rule proposed

The German government recently submitted an amended draft version of the domestic anti-treaty shopping rule in section 50d paragraph 3 of the Income Tax Act to the European Commission, which – if enacted in the current form – likely will result in the termination of the infringement procedure initiated by the Commission in March 2010. However, the language in the draft leaves room for interpretation, and it is possible that the government may further clarify the wording of the proposed rule during the legislative process.

Background

Germany levies a 26.38% withholding tax (including the solidarity surcharge) on dividend distributions by a German corporation, although a lower rate frequently applies on distributions to foreign companies, either because the rate is reduced under a tax treaty or the distribution qualifies for the application of the EU Parent-Subsidiary Directive. Technically, the lower rate may be achieved by a refund of the withholding tax to the foreign recipient or by a (full or partial) exemption from withholding tax at the time of the distribution if an exemption certificate has been obtained. Relief from the full withholding tax, however, is subject to Germany's anti-treaty/anti-directive shopping rule in section 50d paragraph 3 of the Income Tax Act.

Under the current anti-treaty/anti-directive shopping rule, a foreign company that receives a payment subject to German withholding tax will be entitled to withholding tax relief only to the extent that (i) the company is owned by shareholders that would be entitled to a corresponding benefit under a tax treaty or an EU directive had they received the income directly; or (ii) if all of the following three tests are met:

- Business purpose test – There are economic or other relevant (i.e. nontax) reasons for the interposition of the foreign company;
- Gross receipts test – The foreign company generates more than 10% of its gross receipts from its genuine business activities; and
- Substance test – The foreign company has adequate business substance to engage in its trade or business and engages in general commerce (mere administrative functions, outsourced activities or activities carried out by related parties in the same jurisdiction are not taken into account in determining business substance).

In principle, the relief mechanism (i.e. refund or exemption), as well as the anti-treaty shopping rule, apply equally to royalty payments and to certain interest payments (payments on profit-participating loans or convertible bonds). The withholding tax rate may be limited in cases qualifying for the EU Interest and Royalties Directive (in particular, royalties) or under a treaty (royalties and interest). With the exception of profit-participating loans and convertible bonds, interest payments made on "regular" loans (including "regular" shareholder loans) are not subject to withholding tax. The anti-treaty shopping rule generally is mainly relevant for dividend payments since the full or partial exemption depends on the existence of a corporate shareholder resident in an EU or a treaty country.

Infringement procedure with respect to gross receipts test

In March 2010, the European Commission initiated an infringement procedure against Germany and formally requested that the anti-treaty shopping rule be amended. The Commission emphasized that it was not challenging the objective of the anti-abuse measure, but rather the disproportionate requirements imposed on foreign companies to prove, in particular, the existence of a "genuine economic activity" (gross receipts test).

Draft of amended anti-treaty shopping rule

If passed in its current form, the amended draft version of section 50d paragraph 3 could result in the termination of the infringement procedure. According to the draft, a foreign company that receives a payment subject to German withholding tax will be entitled to withholding tax relief to the extent (i) it is owned by shareholders that would be entitled to a corresponding benefit under a tax treaty or an EU directive had they received the income directly; or (ii) if the foreign company's gross receipts in the relevant year are generated from its genuine own business activities. If the foreign company fails both tests, the company would be entitled to withholding tax relief only if both of the following two additional requirements are met:

- Business purpose test – There are economic or other relevant (i.e. nontax) reasons for the interposition of the foreign company in relation to the mentioned receipts; and
- Substance test – The foreign company has adequate business substance to engage in its trade or business and does participate in general commerce.

In addition to the changes to the wording of section 50d paragraph 3, a new sentence would be added that would codify the tax authorities' view that the burden of proof would be on the foreign company to demonstrate that there are economic or other relevant (i.e. nontax) reasons and adequate business substance.

Consequences of proposed changes

The wording of the proposed amendment is ambiguous and leaves room for interpretation. Even though from a technical and historic perspective, the terms "gross receipts," "receipts" and "income" have different meanings, it appears they are used synonymously in the draft law. In practice, the issues relating to the language used in the proposed rule will become extremely relevant. Based on the actual wording of the draft and its explanations, the following tax consequences may ensue:

Example 1 – Assume a Luxembourg management holding company has three German subsidiaries, two of which are actively managed. All three subsidiaries distribute dividends to the Luxembourg holding company. The Luxembourg company has limited substance and is held by shareholders in the Cayman Islands.

- Dividend distributions from the two actively managed German subsidiaries should qualify for withholding tax relief provided it can be demonstrated that the Luxembourg entity acts as a true management holding company. This outcome would be based on an interpretation of the proposed amendment, according to which a foreign company that has treaty-protected shareholders or that earns income from its own business activity is entitled to relief.
- Dividend distributions from the German subsidiary that is not actively managed should qualify for withholding tax relief only if it can be demonstrated that there are business reasons for the interposition of the Luxembourg entity *and* there is sufficient substance in relation to the business purpose of the Luxembourg company.

Based on this interpretation, the situation for the actively managed subsidiaries should be similar to that under the current rule because such entities typically meet the gross receipts test (i.e. the dividends they receive qualify as "good income" for purposes of that test). Discussions with the tax authorities are likely to be ongoing and will focus on whether the activity of the management holding company is sufficient to qualify as a genuine own business activity. In the worst case, the tax authorities could argue that income not derived from own business activity taints the entire income of the nonresident holding company so that a withholding tax exemption would not be available for dividends distributed by any of the German subsidiaries. This restrictive view may be based on the ambiguous wording of the draft. Under the draft, a withholding tax exemption will be denied (only) *to the extent* there are nonresident shareholders that are not entitled to a comparative exemption; however, the second criterion for the denial ("the income is not derived from own business activity") lacks a specific reference that a withholding tax exemption will not be available *to the extent* it is not derived from own business activity. Thus, it may be argued that *any* income that is not derived from genuine own business activities is harmful. As it is doubtful that this is really the intention of the revised rule, the wording of the draft should be amended to eliminate this ambiguity.

Example 2 – A German company that is part of a multinational group develops patents and transfers them to a Swiss related party, which centrally manages the IP for the group. The Swiss company is directly held by the group parent company resident in Canada. The German company subsequently pays royalties to the Swiss company for which the Swiss company wants to obtain withholding tax relief (0% under the Germany-Switzerland treaty). The applicable treaty rate on royalties from Germany to Canada is 10%.

- The Swiss IP company is not held by shareholders that would qualify for a corresponding benefit and the royalties are not earned in connection with a genuine own business activity (according to the German tax authorities' view of what constitutes a genuine own business activity).
- The Swiss IP company, therefore, would only enjoy full withholding tax relief if it can show that there are business reasons for its interposition in relation to the royalties earned (e.g. because there are synergies from a centralized IP structure) and that it has sufficient substance for its activity as an IP management company. In all other cases, the 10% withholding tax rate under the treaty with Canada should apply.

For this group, the amendment would be an improvement because currently, withholding tax relief for royalties received by pure IP companies whose activity is deemed to generate passive income under the anti-treaty shopping rule would not be available because it usually would be impossible to meet the 10% of gross receipts from own business activities test without adding additional substance to these entities.

Example 3 – An operating entity in France holds shares in a German subsidiary. The German subsidiary is not actively managed by its French parent, but the parent is active in the same line of business and coordinates the distribution of the group's products on a worldwide basis. The French parent company wants to obtain withholding tax relief for dividends received from its German subsidiary. The French parent is held by the Japanese head of the group.

Alternatively, assume there are no business or other relations between the German subsidiary and its French parent.

- Based on the wording of the draft law, it is unclear whether the dividends received would qualify as receipts that result from own genuine business activity in the absence of a management holding activity in France.
- If the dividends were not deemed to be earned in connection with a genuine own business activity, the French parent company would have to show that there are business reasons for its interposition, as well as sufficient substance at its level.

In this case, the taxpayer's situation would remain unchanged or may potentially become worse as compared to the current situation.

Currently, the gross receipts test, the business purpose test and the substance test must be met. Based on the facts in the example, the gross receipts test would be met since the French parent company's active business should be sufficient to produce more than 10% of the total gross receipts. In addition, past experience has shown that in these situations the tax authorities often do not scrutinize closely the business purpose of the interposition of the holding company. Thus, it generally should be possible under current law to obtain withholding tax relief in the base case of Example 3 (e.g. because of the supporting nature of the parent company for the subsidiary's distribution) and, in many cases, in the alternative fact pattern as well.

Under the draft, "reasons for the interposition of the foreign company" will have to be proven "in relation to the mentioned receipts," i.e. presumably in relation to the dividend income. It remains to be seen whether the tax authorities will – with reference to the mere new wording – ask for nontax reasons for the interposition of the French company as a holding of the German subsidiary or whether it will be sufficient that the foreign and the German business complement each other. Regardless of which view will be supported in future, it appears unlikely that full withholding tax relief will be granted in the alternative fact pattern (with only a refund to the treaty rate with Japan instead).

Enactment

The amended version of the anti-treaty shopping/anti-directive shopping rule is likely to be enacted with the law by which the Directive on the EU Recovery of Tax Claims will be implemented into national law. It will become effective on 1 January 2012.

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India:
Tax information exchange provisions introduced

Measures included in the 2012 Indian budget are designed to discourage transactions with persons located in a country or jurisdiction that does not effectively exchange information with India. Under the new provisions, which are formulated as anti-avoidance rules, the central government will designate countries or territories for this purpose.

The salient features of the rules are as follows:

- All parties to a transaction entered into with a person in a designated jurisdiction will be deemed to be associated enterprises and the transaction will be subject to the transfer pricing rules. Moreover, the benefit of allowable variation between the arm's length price and the actual price will not apply to such transactions;

- No deductions will be allowed for payments made to a financial institution in a designated jurisdiction unless the Indian taxpayer furnishes an authorization to the designated income tax authority in prescribed form to obtain information from the institution;
- No other deductions for expenditure or allowances (including depreciation) arising from such transactions will be allowed unless the Indian taxpayer maintains prescribed documentation; the burden is on the taxpayer to demonstrate the source of receipt of money from a designated jurisdiction, in the absence of which the amount will be deemed to be income of the taxpayer; and
- Payments made to a person in a designated jurisdiction will be subject to a minimum withholding tax of 30% even if the actual withholding tax rate applicable to the income is lower than 30%.

The new rules apply as from 1 June 2011. Thus far, the government has not designated any countries or territories under this provision. However, it has signed tax information exchange agreements with some jurisdictions, including Bermuda, the Cayman Islands and the Isle of Man.

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Indonesia:
Implementing regulation on branch profits tax exemption

Indonesia's Director General of Taxation (DGT) has issued a regulation implementing an earlier Ministry of Finance regulation that expanded the exemption from the branch profits tax (PER 16, dated 6 June 2011, implementing PMK 14, dated 24 January 2011). Permanent establishments (PEs) and branches in Indonesia are required to pay a 20% branch profits tax (or lower treaty rate) on their after-tax profits unless the profits are reinvested in Indonesia.

The expanded exemption is available if all of a PE's after-tax income is reinvested in Indonesia in the form of:

- An equity participation as a founder or founding participant in a newly established company domiciled in Indonesia;
- An equity participation as a shareholder in an existing company established and domiciled in Indonesia;
- The purchase of fixed assets to be used by the PE to do business or conduct its activities in Indonesia; or
- Investment in the form of an intangible asset to be used by the PE to do business or conduct its activities in Indonesia.

(Previously, the exemption was available only where the after-tax profits were reinvested in an equity participation in a newly established Indonesian company.)

Where the profits are reinvested in a new company, that company must commence business activities in accordance with its deed of establishment within one year from the date of incorporation and the PE cannot transfer its participation within a two-year period from the start of commercial production. Where the profits are reinvested in an existing company, the company must have active business operations in Indonesia and the PE cannot transfer its participation for three years from the date the participation is acquired. Where the profits are reinvested in the acquisition of fixed or intangible assets, the PE may not transfer the assets within three years from the date of acquisition.

Further, the PE must submit prescribed information as an attachment to its annual corporate income tax return in the fiscal year in which the after-tax profits are earned and for the three fiscal years following the fiscal year in which those profits were earned. Information that must be disclosed includes the identity of the taxpayer (PE), details of the head office, the form and amount of the reinvestment; and the realized reinvestment amount in a new or existing company or acquisition of fixed or intangible assets should be reported in the returns for the three subsequent fiscal years. For investment in a new company, the PE must submit the information at the start of commercial production. If a PE does not submit the required information or the information is incomplete, the branch profits tax will be imposed on the after-tax income.

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Panama: Country now in compliance with OECD standards on EOI

The OECD announced on 6 July 2011 that Panama has been moved into the category of jurisdictions considered to have substantially implemented the internationally agreed tax standards on transparency and exchange of information, becoming the 39th jurisdiction to do so since the progress report was first issued in April 2009.

With a view to increasing its competitiveness in the international services sector, Panama launched an aggressive agenda in 2009 to implement tax treaties with OECD countries and other jurisdictions Panama considers strategic. The change in category was made possible based on the country's recently expanded treaty network: Panama has negotiated 14 double tax agreements (DTAs) and signed 11 agreements, including one additional tax information exchange agreement (TIEA) with the U.S., to meet the minimum 12 agreements needed to be removed from the OECD "gray list." Panama's signed agreements are as follows:

- Mexico (23 January 2010);
- Barbados (21 June 2010);
- Portugal (27 August 2010);
- Qatar (23 September 2010);
- Netherlands (6 October 2010);
- Luxemburg (7 October 2010);
- Spain (7 October 2010);
- Singapore (18 October 2010);
- South Korea (20 October 2010);
- Italy (30 December 2010);
- France (1 July 2011); and
- U.S. TIEA (30 November 2010).

Treaties that have been negotiated, but that still require signature, are those with Belgium, the Czech Republic and Ireland. As of 1 August 2011, the DTA with Mexico is the only one in effect (the treaty applies as from 1 January 2011). The DTA with Barbados entered into force on 18 February 2011 and will apply as from 1 January 2012, and the DTA with Spain entered into force on 25 July 2011 and will apply as from 25 October 2011. All of these treaties include exchange of tax information provisions.

Over the past two years, Panama has amended its domestic law so that DTAs and TIEAs can enter into effect after they have entered into force in accordance with the relevant treaty provisions. Further, transfer pricing rules, as well as rules on permanent establishments and fiscal residence, have been introduced. The transfer pricing rules adopt the arm's length principle and apply to transactions between related companies, but only when there is a tax treaty in force with the country where the related party is resident. To ensure that taxpayers comply with the transfer pricing rules, detailed documentation that supports an arm's length transfer price must be made available to the tax authorities in the form of a technical study. The study must include a sufficient analysis to enable a conclusion that transactions between the related parties comply with the arm's length principle and the methods established in the rules. In addition, specialized administrative entities within the tax administration have been created to handle international and tax information exchange issues.

Panama is aiming to further expand its treaty network; it is negotiating a DTA with Israel and is in discussions with Cyprus and Greece. Panama also has expressed an interest in negotiating agreements with Australia, Canada, Chile, Germany, Iceland, Liechtenstein, Norway, Switzerland and the U.K.

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In brief

European Union – The European Court of Justice will rule on whether the Netherlands has failed to fulfill its EU obligations by levying an exit tax on companies' transfers of assets to another Member State but not on such asset transfers within the Netherlands.

United States – The Large Business and International division of the Internal Revenue Service (IRS) issued a new directive 15 July 2011 on the application of the economic substance doctrine and the associated strict liability penalty. The directive provides guidance to IRS examiners and managers on when to seek approval from an IRS Director of Field Operations to impose the doctrine and the related strict liability penalty in an examination. It also provides that, until further guidance is issued, the application of the economic substance penalty will be limited to transactions that lack economic substance, and may not be imposed due to the application of any other "similar rule of law" or judicial doctrine (e.g. step transaction doctrine, substance over form or sham transactions).

Tax treaty round up

At the end of each month, the World Tax Advisor provides an update on recent tax treaty developments, with a focus on items that directly affect the withholding tax rates of the key jurisdictions covered by the Deloitte International Tax Source (DITS). Additional coverage may include stated negotiating priorities and other important tax treaty trends. For updates on tax information exchange agreements, visit our DITS special feature.
URL: http://www.dits.deloitte.com
URL: http://www.dits.deloitte.com/Administration/ManageHomePage/Popup.aspx?ChildPage=InfoExchange

Unless otherwise noted, the developments discussed are not yet in force.

Colombia-Switzerland – The 2007 treaty will enter into force on 11 September 2011 and will generally apply from 1 January 2012. When in effect, the treaty provides for a 0% rate on dividends paid to a company that holds at least 20% of the capital of the payer and 15% in all other cases. The withholding tax on interest and royalties will be 10%.

France-India – The 2008 social security agreement came into effect on 1 July 2011. The agreement applies to French and Indian nationals who are salaried employees or self-employed and to nationals who have been subject to the legislation of either of the contracting states. The agreement states that the employee can continue to be partially covered by his/her *original* social security regime for 60 months, and he/she will have the option to retain the social security regime in the home country only for pensions and invalidity. The employee will be subject to the contributions in the host country for health insurance, maternity, work accidents, family allowances, basic death insurance, solidarity contributions and unemployment.

Germany-United States – See article in this issue.
URL: http://newsletters.usdbriefs.com/2011/Tax/WTA/a110819_4.html

Hong Kong-Japan – The 2010 treaty and protocol entered into force on 14 August 2011 and will generally apply in Hong Kong from 1 April 2012 (1 January 2012 in Japan). When in effect, dividends will be subject to withholding tax at a rate of 5% if paid to a company that has owned directly or indirectly at least 10% of the voting shares of the company paying the dividends for the six-month period ending on the date on which entitlement to the dividends is determined (the 5% rate will not apply if the company paying the dividends is entitled to a deduction for dividends paid to its beneficiaries in computing its taxable income in Japan); otherwise, the rate will be 10%. The rate on interest will be 10% and that on royalties, 5%.

Hong Kong-Liechtenstein – The 2010 treaty and protocol entered into force on 8 July 2011 and will generally apply in Hong Kong from 1 April 2012 (1 January 2012 in Liechtenstein). When in effect, the treaty provides that dividends and interest will be exempt from withholding tax. The rate on royalties will be 3%.

Ireland-Armenia – When in effect, the treaty signed on 14 July 2011 provides that dividends will be exempt from withholding tax if paid to a company (other than a partnership) that holds directly at least 25% of the capital of the payer company (and has owned that holding for at least two years prior to any claim under the treaty), provided the receiving company, by the contracting state in which it is resident, is entirely relieved from tax by an exemption or would, but for the dividend exemption in the treaty, be entirely relieved by a credit (including a credit under treaty article 24(2)(b), by which Ireland grants a credit if the Irish resident directly or indirectly controls at least 5% of the voting power of the payer company) for tax paid in respect of the dividends by the payer company. The rate will be 5% if paid to a company (other than a partnership) that holds directly at least 10% of the capital of the company paying the dividends; otherwise, the rate will be 15%. Interest will be exempt (under an accompanying protocol) if paid in respect of a loan granted by a bank; otherwise, the rate will be 10%. The rate on royalties will be 5%.

Israel-Malta – When in effect, the treaty signed on 28 July 2011 provides that dividends paid by a company that is a resident of Israel will be exempt from withholding if paid to a company (other than a partnership or a real estate investment company) that holds directly at least 10% of the payer company's capital; otherwise, the rate will be 15%. Distributions by an Israeli real estate investment company, however, will be taxed according to the laws of Israel, but not to exceed a rate of 15% when paid to a resident of Malta that holds directly less than 10% of the paying company's capital. Malta tax on the gross amount of dividends paid to a beneficial owner resident in Israel may not exceed that chargeable on the profits from which the dividends are paid. The rate on interest will be 5% (with an exemption for corporate bonds traded on a stock exchange in the source state that are issued by a company that is a resident of the source state). Royalties will be exempt.

Italy-Moldova – The 2002 treaty entered into force on 14 July 2011 and will apply from 1 January 2012. Once in effect, the treaty provides for a withholding tax rate of 5% where dividends are paid to a company that holds at least 25% of the capital of the company paying the dividends; otherwise, the rate will be 15%. Interest and royalties will be taxed at a rate of 5%.

Japan-Saudi Arabia – The 2010 treaty will enter into force on 1 September 2011 and will apply from 1 January 2012. When in effect, dividends will be subject to withholding tax at a rate of 5% if the beneficial owner is a company that directly or indirectly holds at least 10% of the voting shares of the company paying the dividends for the period of 183 days ending on the date on which entitlement to the dividends is determined. In the case of Saudi Arabia as the source country, 10% of total issued shares (rather than voting shares) will also satisfy the ownership test; whereas Japan, as the source country, adds the additional requirement that the Japanese company paying the dividends cannot be entitled to a deduction for dividends paid to its beneficiaries in computing its taxable income in Japan. The rate on dividends will be 10% in all other cases. The rate on interest will be 10% (with an exemption for interest beneficially owned by a Japanese pension fund). Royalties will be subject to a 5% withholding tax rate if paid for the use of, or right to use, industrial, commercial or scientific equipment; otherwise, the rate will be 10%.

Korea-Peru – When in effect, the treaty signed on 7 July 2011 provides for a 10% withholding tax on dividends and a 15% rate on interest and royalties. The treaty also contains a most favored nation clause with respect to the withholding tax rates on dividend and interest income, under which more favorable provisions in any tax treaties that Peru enters into with other countries will be applied to Korean residents and vice versa.

Malaysia-Laos – The 2010 treaty entered into force on 23 February 2011 and will apply as from 1 January 2012. When in effect, dividends will be subject to withholding tax at a rate of 5% if paid to a company (other than a partnership) that holds directly at least 10% of the payer company's capital; otherwise, the rate will be 10%. The rate on interest and royalties will be 10%.

Malta-Turkey – When in effect, the treaty signed on 14 July 2011 provides for a 10% withholding tax where dividends are paid by a Turkish company to a Malta company provided the recipient company holds directly at least 25% of the capital of the payer company. The rate in all other cases will be 15%. Dividends paid by a Maltese company to a Turkish company will be exempt from tax in Malta that is chargeable on dividends, in addition to the tax chargeable in respect of the profits of the company. Further, Malta tax chargeable with respect to distributed profits of the company may not exceed 15% if the distributed profits consist of gains or profits earned in any year in respect of which that company is in receipt of a benefit under the measures regulating aid to industries in Malta as long as the recipient submits returns and accounts to the taxation authorities of Malta in respect of its income liable to Malta tax for the relevant year of assessment. The rate on interest and royalties will be 10%.

New Zealand-Chile – Under the most favored nation clause, the 10% withholding tax rate on royalties paid by a resident of New Zealand to a resident of Chile is reduced to 5%. The new reduced rate, announced on 12 August 2011, applies retroactively as from 1 May 2010.

New Zealand-Mexico – Under the most favored nation clause, the 15% withholding tax rate on dividends paid to a nonresident is reduced. The rate is 0% where the dividends are paid to a company that holds at least 80% of the voting power in the payer company for at least 12 months up to the date the dividends are declared. The principal class of shares of the recipient must be listed and regularly traded on a recognized stock exchange or be entitled to equivalent benefits in respect of such dividends under the treaty. A 5% rate applies where the dividends are paid to a company that holds at least 10% of the voting power in the payer company. The rate in all other cases is 15%. The new reduced rates, announced on 12 August 2011, apply retroactively as from 1 May 2010.

New Zealand-Turkey – The 2010 treaty entered into force on 28 July 2011 and will apply in New Zealand as from 1 January 2012 for withholding taxes and as from 1 April 2012 for other taxes. The treaty will apply in Turkey as from 1 January 2012. When in effect, the treaty provides for a 5% withholding tax on dividends paid to a company that holds directly at least 25% of the capital of the payer company (provided the dividends are exempt from tax in the other state); otherwise, the rate will be 15%. The rate on interest paid to a bank will be 10%; otherwise, the rate will be 15%. The rate on royalties will be 5%.

Panama – See article in this issue.
URL: http://newsletters.usdbriefs.com/2011/Tax/WTA/a110819_8.html

Singapore-Albania – The 2010 treaty entered into force on 19 July 2011 and will apply as from 1 January 2012. When in effect, dividends, interest and royalties will be subject to a withholding tax rate of 5%.

Spain-Panama – The 2010 treaty entered into force on 25 July 2011 and generally applies as from that date. Dividends are subject to a 5% withholding tax if paid to a company (other than a partnership) that holds directly at least 40% of the voting power of the payer company; and 10% in all other cases. The rate on interest and royalties is 5%.

Switzerland-Georgia – The 2010 treaty entered into force on 7 July 2011 and will generally apply from 1 January 2012. When in effect, dividends will be exempt if the beneficial owner is a company (other than a partnership) that directly holds at least 10% of the distributing company's capital; otherwise, the rate will be 10%. Interest and royalties will be exempt.

United Kingdom-Armenia – When in effect, the treaty signed on 13 July 2011 provides for a 5% withholding tax on dividends paid to a company that holds at least 25% of the capital of the payer company and has invested at least GBP 1 million in the capital of the payer company on the date the dividends are paid. A 15% rate will apply where dividends are paid out of income derived from immovable property by an investment vehicle that distributes such income on an annual basis and whose income from such property is exempt. The rate in all other cases will be 10%. The withholding tax rate on interest and royalties will be 5%.

Venezuela-United Arab Emirates – The 2010 treaty entered into force on 20 June 2011 and will apply as from 1 January 2012. When in effect, a 5% withholding tax will apply to dividends paid to a company (other than a partnership) that holds directly at least 10% of the capital of the payer company; otherwise, the rate will be 10%. A 10% rate will apply to interest and royalties.

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Brazil

New tax incentives announced

The government has published a package of measures to stimulate the competitiveness of national industry by encouraging technology innovation and domestic production and by boosting exports. [Issued: 9 August 2011]

URL: http://www.deloitte.com/view/en_GX/global/services/tax/international-tax/4d05030eb3fa1310VgnVCM1000001a56f00aRCRD.htm?id=us_email_Tax_WTA_081911

URL: http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Alerts/dtt_tax_alert_Brazil_090811.pdf?id=us_email_Tax_WTA_081911

United Kingdom

Courts rule on availability of double taxation relief

Two recent court decisions involve the availability of double taxation relief in the U.K., with the U.K. tax authorities prevailing in both cases. [Issued: 11 August 2011]

URL: http://www.deloitte.com/view/en_GX/global/services/tax/international-tax/7befc334039b1310VgnVCM3000001c56f00aRCRD.htm?id=us_email_Tax_WTA_081911

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