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France clarifies tax treatment of international employees' equity compensation

The French tax authorities published two sets of long-awaited regulations on the equity compensation of internationally mobile employees on 13 March 2012.

The first set, which was in draft form for many years, basically confirms the OECD position that taxation rights on equity compensation should be attributed to the country in which the employment activities are carried out during the vesting period ("OECD sourcing principles"). The second set of rules clarifies the procedure for applying new article 182 A ter of the French tax code, which imposes a withholding tax on income derived by nonresidents from French-source stock options and free share awards (restricted stock units or RSUs) as from 1 April 2011. Only a few paragraphs long, article 182 A ter was introduced in December 2010 and created uncertainties about the responsible withholding party and the basis for withholding. While the withholding tax is essentially in line with the tax legislation of many OECD countries, it represents a fundamental shift in the French approach to taxation of equity income realized by internationally mobile employees.

Background

Until publication of these new regulations, there was no specific provision establishing whether profits derived from employee share plans should be considered employment-related income for tax purposes.

There has been a long-standing debate in France about the taxation of equity awards in the hands of internationally mobile employees in the country – specifically, whether gains from the exercise of an award constitute capital gains or employment income, whether such gains are taxable in France, and, if so, the extent of taxation. The source of the uncertainty arguably lies largely in the domestic law treatment of those equity awards as "quasi-capital gains." From that perspective, it has seemed logical for many French taxpayers to regard the income as a capital gain and either fully taxable (if the individual in receipt of the award was a tax resident of France when he/she actually sold the relevant shares and derived the cash) or fully exempt (if the individual was nonresident).

Under French tax law, equity awards granted under *qualified plans* (as defined by French company law) benefit from favorable tax treatment if specific, substantive reporting and holding requirements are met. Basically, the tax on such

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awards is deferred until the individual sells the shares, with gains being taxed at flat rates. Further, the gains are exempt from the burdensome French social security charges and are subject to a lower flat social tax due from the employer at the time of grant. This favorable treatment also applies to stock options and free shares granted by non-French companies provided the awards are made under the same conditions as those that govern French qualified plans.

Until the 2010 Amended Finance Law (which introduced the new withholding tax mechanism), however, French tax law was silent on the taxation of stock option or RSU income derived by internationally mobile employees. In the absence of any legislation, it was up to the courts to resolve the issue of the qualification of gains arising from the exercise of options in such circumstances. The tax authorities and the courts, however, adopted differing and sometimes contradictory approaches in such cases, thus creating considerable uncertainty for employers and individuals alike.

The 2010 Finance Law provides that gains derived by a nonresident from the exercise of a stock option (the difference between the market value of the shares at the time of exercise and the exercise price) or RSUs (the market value of the shares at the time of delivery) will be taxed as employment income paid to a nonresident, that is, such gains will be subject to a withholding tax. According to new section 182 A ter of the tax code, tax must be withheld at source on French-source profits derived by a nonresident from share options, RSUs (whether or not qualified) and equity warrants (BSPCEs). The rate of the withholding tax can be as high as 50%. The code provision, however, did not define French-source profits, or specify how to determine such profits or whether, in certain circumstances, such profits were to be regarded as related to employment activity.

OECD sourcing principle now the rule

The regulations settle the debate over the taxation of equity awards in international mobility situations: it is now clear that France will apply OECD sourcing principles to determine taxation rights. That is, for purposes of the OECD model tax treaty, income derived from employee stock options is to be treated as an employment-related benefit taxable in the country in which employment was exercised (the country of source). The portion of income "sourced" to a particular country is determined as the proportion that the number of days during which employment was exercised in that country bears to the total number of days of employment activity from which the stock option is derived. Because stock options often represent a long-term incentive earned over a period of time, a number of countries may have taxation rights with respect to income if the employment activity to which it relates is carried out in different countries.

The OECD principles are effectively incompatible with the quasi-capital gains principle under French domestic law taxation of qualified plans. Most plans in France are qualified plans, so it is understandable that the tax treatment of qualified plans has driven the debate. This "quasi-capital gains" logic justifies a full exemption from French tax for gains derived from the exercise of stock options by nonresidents, irrespective of whether the gains relate to a period of activity in France. Conversely, the same logic leads to the full taxation (without tax treaty relief) of stock option income earned by French residents, even if such income is related to a professional activity performed outside France and is taxable in the foreign country concerned.

In practice, tax auditors and the courts have applied the OECD and "quasi-capital gains" approaches alternatively and inconsistently. The relative uncertainty created by the incompatibility of the two positions now can finally be considered resolved. The new regulations even go so far as to specifically require that the OECD sourcing principles apply to outstanding audits or tax litigation.

The "quasi-capital gains" approach was only strictly applicable to French qualified options granted before 20 June 2007 (it did not apply to qualified free share awards or nonqualified plans); nevertheless, this was the prevailing approach for both qualified and nonqualified plans. Even though the application of French domestic law could be overridden by a tax treaty, it was possible for France to continue to take its domestic "quasi-capital gains" approach because the Commentary to the OECD model treaty is not binding on treaties signed before the date of the Commentary concerned (in this case 16 June 2004).

The first set of regulations resolves the debate based on domestic law only; that is, income from both stock options and RSUs, whether or not qualified, constitutes compensation for employment even if the income is taxed under a special tax regime that in some respects treats the income as equivalent to capital gains. As a result, residents, who are taxable on their worldwide income, are eligible for treaty relief with respect to equity income taxable outside of France.

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Nonresidents are taxable in France on the French-source portion of their equity income. With respect to the latter, it is important to note that neither qualified options granted before 20 June 2007 nor BSPCEs are exempt from taxation in France when realized by nonresidents. The absence of any exemption for this category of equity awards is highlighted by the second set of regulations, which provides that the exemption for pre-20 June 2007 qualified options from the withholding tax does not otherwise affect the nature or taxation of the income.

Two points dealt with in the regulations merit particular attention: the determination of the reference period for sourcing and the actual sourcing calculation.

The definition of the reference period is largely influenced by the 2004 OECD report. While a facts and circumstances approach is retained to determine the period of professional services in consideration for which equity is awarded, there is an assumption that most equity awards are granted in consideration for future services. Accordingly, unless otherwise provided, the reference period for professional activity typically runs from the date of grant to the date of vesting, which in many cases is different from the date of the actual exercise of the option or the date of the share release. The equity income is, therefore, taxable in the country in which the professional activity is exercised by allocation to the reference period.

If, however, during the reference period, there is a period during which the employee exercises his/her activity in a country where the individual's income is not taxable under the provisions of a tax treaty (e.g. in the case of a short-term assignment to that country), the allocation is to be made as if, during that period, the employee exercised activity in the country in which he/she was taxable during that period.

It can be argued that this treatment would result in an over-reaching of French domestic law for nonresidents whose reference period consists, for example, of a period of French residence punctuated by business trips outside France. French domestic law seeks to tax only income related to an activity performed in France, and thus excludes income attributable to business trips outside the country. The regulation, however, would lead to the full taxation in France of equity income attributable to a reference period during which the employee was resident in France, including income related to an activity carried on outside France.

The reference period for purposes of the sourcing calculation is to be split according to the number of days worked in each country. There is no definition of a "work day" and, in particular, of a day in which an individual works in two countries. For practical purposes, the tax administration has adopted a calendar day approach, taking into account the period from the date on which the employee takes on an assignment in another country, including days not actually worked. The days not worked are to be taken into account in both the numerator and the denominator in the relevant calculation. If the employee worked during the same reference period in a number of countries, however, the income can be sourced according to the actual days worked. For this purpose, holidays, weekends and any other days not actually worked are not counted as work days for purposes of the calculation. While in many situations the pro rata result will be the same whether based on calendar or work days, there are situations in which the two calculations could produce different results. On the grounds that the purpose of the calculation measure is to allocate income to professional activity, it seems unreasonable to limit a pure work day approach to exceptional situations.

Withholding tax

As noted above, French-source equity income realized by nonresidents has been subject to a withholding tax since 1 April 2011. The new regulations supplement the sparse paragraphs of article 182 A ter by setting out the mechanics of the withholding obligation, as well as its scope, the taxable base, the rates, what constitutes a taxable event, the withholding agent and its responsibilities, filing/reporting obligations, penalties, and the interaction between withholding tax and the individual annual tax return reporting and refund procedures.

The withholding tax applies to all profits derived by nonresidents from employment-related share incentive plans, subject to two exceptions: for qualified options granted before 20 June 2007 and for gains derived from company savings plans. This represents a somewhat robust step for a country where withholding tax is the exception rather than the rule (France, for example, does not have a withholding tax mechanism for salary earned by resident individuals).

While specific types of income derived by a nonresident (i.e. salaries, directors' fees) are subject to an employer withholding tax obligation, qualified share plans are not within the scope of these rules. Therefore, before the new withholding rules

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came into effect, even when French-source qualified equity income realized by a nonresident was regarded as taxable in France, the responsibility for tax reporting and payment of tax lay solely with the employee.

Despite the clarification provided by the OECD sourcing principles, which resulted in the taxation in France of French-source equity gains realized by nonresidents, there was no mechanism to secure the collection of the relevant tax in the case of qualified plans. It is, therefore, clear that the objective of the new withholding tax rules is to ensure tax compliance and collection.

However, because the withholding tax is, in many respects, different from withholding taxes imposed in other OECD countries, compliance with the rules is challenging.

First, the party responsible for withholding, reporting and remitting tax to the French tax authorities is the plan administrator or broker, rather than the employer or the issuer. The French tax authorities will look at which entity delivers the sale proceeds or the shares to the employee/beneficiary of the share plan. The employer will have a withholding obligation only where it fully manages the plan internally (i.e. where shares are issued directly to the employee). Even the purchaser of shares may be responsible for withholding if shares from a qualified plan are sold person-to-person (i.e. when there is a transfer of share certificates outside of a bank). Further, the regulation clearly specifies the applicability of the withholding obligations to parties established outside France.

Second, although the administrator/broker is responsible for withholding/remitting the tax, the employer and the employee/beneficiary are responsible for communicating the necessary information to the withholding agent. If a company uses a broker or third-party plan administrator, it must communicate this information to enable it to process the tax withholding. Moreover, as from 2012, new reporting obligations for qualified plans (issued on 31 January 2012) require the employer or issuer to calculate the French-source portion of the gain, report this information to the tax administration and deliver a certificate to the withholding agent. More precisely, the new regulations specifically mention 30 April 2012 as the end of the transition period during which withholding agents are permitted to determine their obligations solely based on information provided by the employee/beneficiary of the award. Consequently, with effect from that date, employers and issuers must track the equity awards of their internationally mobile employees.

Third, the basis of the withholding tax is the same for qualified and non-qualified plans: gains derived from the exercise of a stock option (i.e. the difference between the fair market value of the shares at exercise and the exercise price) and RSU vestings (i.e. the value of the shares) apportioned to the French activity in accordance with the OECD sourcing rules. Although the regulations clearly disallow the deductibility of capital losses arising on the sale of shares obtained through these plans, given that the deduction is clearly linked to the definition of qualified plan taxable gains under domestic law, an argument could be made that the losses should be deductible.

The actual withholding system is detailed and complex but, in essence, withholding tax at progressive salary rates of 0%, 12% or 20% is applicable for a non-qualified plan or if the taxpayer opts for these rates for a qualified plan, in which case further income tax could be due based on annual ordinary progressive tax rates. The flat rates applicable to qualified equity income, not including CSG/CRDS surtaxes (which are not payable by nonresidents) are 18%, 19%, 30%, 41% or 50%, depending on the type of plan and the particular situation. The flat rates are, in principle, a final tax, except in some situations where the beneficiary can file a tax return claiming to have the income subject to ordinary progressive rates.

While the taxable basis is the same, the tax is actually triggered at different points depending on whether the plan is qualified or not. The triggering event for qualified plans is the sale of the relevant shares, whereas for non-qualified plans, it is the exercise of the option or the share release, respectively. The necessity of tracking shares that are sold will present challenges for administrators and brokers since the standard global system typically tracks only up to vesting or exercise.

While some non-French administrators have instituted share tracking for the purposes of complying with qualified plan holding periods, a withholding mechanism that comes into operation only when the shares are sold will present additional logistical challenges. It should be noted that when shares obtained through a qualified plan are transferred to a new bank, that new bank becomes the withholding agent and the old bank is required to deliver the information to the new bank so it can comply with its withholding obligations.

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Conclusion

The impact of the new regulations likely will be felt more in France than outside of France. While the regulation on OECD sourcing has been the topic of considerable debate in France, it follows a well-worn path in terms of global tendencies, and many non-French global companies already have or are in the process of implementing tracking systems for their mobile employees.

The second regulation clearly will require adjustments to existing processes, especially for qualified plans, because administrators will need to track shares until sale to allow them to withhold the tax triggered by the delivery of the shares. The tracking aspect, in addition to the specificities of tax rates, the filing options of beneficiaries and the fact that the administrator will file the tax directly with the tax authorities, will render compliance challenging. Noncompliance, of course, is punishable by both monetary and criminal penalties.

This material has been prepared by professionals in Taj, French tax and legal firm, member of Deloitte Touche Tohmatsu Limited

— Christina Melady (Paris)
Partner
Taj
cmelady@taj.fr

Costa Rica: Tax reforms rejected

In a decision issued on 10 April 2012, Costa Rica's Constitutional Supreme Court ruled that, due to significant and material errors in the legislative process that led to the National Congress pre-approving a proposed tax reform on 14 March, the reform measures are unconstitutional. Should the government wish to pursue the reform, the legislative process with have to start anew, which currently seems unlikely.

The reform included the following:

- Capital gains derived by Costa Rican residents would be subject to a 15% tax (3% for nonresidents) if the gains do not arise from the disposal of assets used in a normal trade or business. Under current law, capital gains are not subject to tax unless the gains arise from "habitual" transactions or the transfer of an asset subject to depreciation (or amortization in the case of intangibles).
- Foreign exchange gains and losses would be considered taxable/deductible for income tax purposes in the fiscal year in which they are realized. Existing law is unclear as to whether such gains are taxable or nontaxable income, with several cases pending before the national tax courts.
- Formal transfer pricing rules that follow the OECD guidelines would be introduced.
- Formal thin capitalization rules that include a 3:1 debt-to-equity ratio would be introduced. Costa Rica currently does not have any restrictions on interest deductions if interest rates on related party debt are in accordance with market standards.
- The double taxation relief rule would be abolished. The rule currently allows companies in certain countries (including Mexico and the U.S.) to obtain a 100% exemption from withholding tax on dividends, interest, royalties, commissions and insurance premiums.
- A 15% withholding tax on dividend distributions would be introduced for free trade zone companies that begin operations in 2015; currently, dividends are covered by tax holiday rules.
- The standard rate of VAT would increase from 13% to 14%, the list of exempt products would be significantly curtailed and the provision of services, with limited exceptions (i.e. certain cases of public transportation), would be brought within the scope of VAT.

The decision of the Constitutional Supreme Court means that existing rules will remain unchanged.

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— Rafael Gonzalez (San Jose)
Partner
Deloitte Costa Rica
rafgonzalez@deloitte.com

Sergio Chacon (New York)
Senior Manager
Deloitte Tax LLP
schaconbarantes@deloitte.com

Germany: BFH rules on set off of loss carryforwards

In a recently published decision, Germany's Federal Tax Court (BFH) stated its position on the deductibility of tax losses carried forward under the change-in-ownership rule, holding that existing loss carryforwards may be set off against profits generated in the year of a harmful change in ownership but before the change took place. The court's position deviates from tax administrative practice.

Under the change-in-ownership rule, a direct or indirect transfer to one acquirer (within a five-year period) of more than 25% (and up to 50%) of the shares in a company that has loss carryforwards results in a pro rata forfeiture of the loss carryforwards. A share transfer of more than 50% will result in the forfeiture of all available loss carryforwards.

According to the German tax authorities, where tax *losses* are incurred in the year of a harmful change-in-ownership, but before the change takes place, such losses will be forfeited. The Ministry of Finance, however, has taken a conflicting position to the effect that, where *profits* are generated in the year, but before the harmful change in ownership takes place, it will not be possible to offset such profits with existing tax loss carryforwards, such losses being forfeited because of the harmful share transfer.

According to the BFH, the aim of the change-in-ownership rule is to limit the deduction of tax loss carryforwards to profits realized *after* the harmful share transfer. However, and contrary to the Ministry of Finance's position, the change-in-ownership rule is not designed to limit the setoff of tax loss carryforwards against profits generated *before* the share transfer.

The BFH has clarified that neither the wording nor the meaning and purpose of the change-in-ownership rule justify the Ministry of Finance interpretation: the change-in-ownership rule is designed to disallow the setoff of prior tax loss carryforwards against profits generated in connection with a subsequent economic activity (i.e. the new economic identity of the company resulting from the share transfer).

Taxpayers should be aware, however, that the loss utilization still should be subject to the German minimum tax rules. Under the minimum tax rules, loss carryforwards may be set off against current year income up to EUR 1 million without restriction, but amounts exceeding EUR 1 million may be offset only to the extent of 60% of the excess over EUR 1 million (a potential exception from the minimum tax rules may apply for the years 2008 and 2009). By contrast, profits generated before a harmful change in ownership should not be affected by the rule, so they can be offset by existing loss carryforwards; any remaining loss carryforwards will then be forfeited due to the harmful share transfer.

— Katja Nakhai (Munich)
Director
Deloitte Germany
knakhai@deloitte.de

Sven Petersen (Munich)
Senior Manager
Deloitte Germany
svpetersen@deloitte.de

Paul Potocki (Munich)
Consultant
Deloitte Germany
papotocki@deloitte.de

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India:
Gains on sale of compulsory convertible debentures treated as interest

In a ruling dated 21 March 2012, India's Authority for Advance Rulings (AAR) held that gains from the sale of compulsorily convertible debentures (CCDs) would not be in the nature of capital gains and, therefore, would not be exempt from tax in India under the India-Mauritius tax treaty. The AAR concluded that the gains derived by a Mauritius company from the sale of the CCDs to an Indian company are taxable as interest in India under Indian tax law, as well as the treaty.

CCDs are quasi-debt instruments that must be converted into equity. They provide a tax efficient way of pushing down debt into India without being hit by the restrictions on debt under India's exchange control regulations.

The ruling involved a Mauritius tax resident (applicant) that invested in equity shares and zero interest-bearing CCDs issued by an Indian company, which were convertible into equity after six years. According to the securities subscription agreement, the applicant was granted a put option to sell a specified number of CCDs to "V Co," the parent company of the Indian entity. V Co was granted a call option to buy the CCDs from the Mauritius resident. Before the mandatory conversion of the CCDs, V Co exercised the call option and consequently the applicant proposed to sell the CCDs to V Co. The applicant asked the AAR to rule on whether the gains derived from the sale of the CCDs would be exempt from tax under the treaty as capital gains.

The AAR observed that a CCD creates or recognizes the existence of a debt and remains as such until the debt is repaid or discharged. The AAR referred to various clauses of the shareholders agreement and the securities subscription agreement, concluding that (i) the calculation of the purchase price is predetermined and almost entirely dependent on the period the investment is held; (ii) V Co acts as a guarantor of the investment made by the applicant in the Indian entity; (iii) the Indian entity is de facto under the control and management of V Co; and (iv) while the Indian entity and V Co are a subsidiary and parent company "on paper," under the facts of this case, the Indian subsidiary had no power to manage its own affairs, so that the two companies are effectively one and the same. Accordingly, the AAR concluded that the amount paid by V Co to the applicant is for the debt owned by the Indian entity to the applicant, so the appreciation in the value of the CCDs was in the nature of interest and not capital gains.

While advance rulings are binding only on the applicant, the ruling creates uncertainties for other taxpayers – particularly private equity investors – that have used the convertible debenture route to invest into India.

— Rajesh Gandhi (New York)
Client Service Executive
Deloitte Tax LLP
rajegandhi@deloitte.com

Thailand:
Corporate income tax exemption on dividends received in amalgamation

Royal Decree No. 534 grants a corporate income tax exemption for dividends paid by a company incorporated under Thai law that are received by the new amalgamated company or the transferee in the case of a transfer of a business as follows:

- A full exemption where
  - The recipient of the dividends is a company listed on the stock exchange of Thailand; or
  - The recipient of the dividends holds no less than 25% of the voting shares in the payer company with no direct or indirect cross shareholding.
- A 50% exemption where the recipient is not one of the above companies.

These exemptions are granted where the recipient company held the shares or investment units generating the dividends for not less than three months from the date the shares or investment units were acquired to the date the dividends were received, and for not less than three months after the date the dividend income is received. The period during which the shares or investment units were held by the former companies before the amalgamation or transfer are taken into account in determining whether the holding period is met.

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— Auyporn Tanlamai (Bangkok)
Partner
Deloitte Thailand
atanlamai@deloitte.com

In brief

Kazakhstan – A draft law presented to the lower chamber of parliament would simplify the registration and liquidation procedures for legal entities and the registration of branches and representative offices in Kazakhstan. Online registration procedures would be introduced, paper registration certificates would be replaced by electronic certificates and the country would move from a permission-based registration system to a notification system. The requirement that a certificate be obtained from the tax authorities when a company is established by another legal entity would be abolished and the number of documents required for a company liquidation would be reduced. The law is expected to be adopted shortly.

New Zealand – The government has released a consultation document setting out proposed changes to the New Zealand Emissions Trading Scheme (ETS). The proposed changes include a gradual phase out of the transition measures put in place for business and the introduction of more explicit powers for the government to auction New Zealand units within an overall cap and restrict the use of overseas units in the ETS. The consultation period will run until 11 May 2012.

United States – On 17 April 2012, the Treasury Department amended the final regulations requiring Form 1042-S reporting of bank deposit interest, expanding beyond Canadian residents the nonresident alien individuals (NRAs) whose receipts of interest on deposits maintained at U.S. offices of financial institutions must be reported by the payor, effective for interest paid on or after 1 January 2013. Unlike the 2011 proposed version of these amendments, the final version requires reporting only on payments to NRAs resident in countries with U.S. agreements relating to the exchange of tax information, and listed in a revenue procedure before the year of payment (although, at the payor's option, the payor may report on the deposit interest paid to all NRAs). The revenue procedure also will include a second list identifying the countries with which the Treasury Department and the Internal Revenue Service have determined that it is appropriate to have an automatic exchange relationship with respect to the information collected under these regulations. Revenue Procedure 2012-24 was issued 17 April 2012 in connection with these regulations, listing 87 countries with U.S. tax information exchange agreements, and listing Canada as the only country with which the U.S. will engage in the automatic exchange of deposit interest information collected.

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Finland
EBITDA-based limitation on related party interest proposed
The Ministry of Finance has issued a draft proposal that would limit the deduction of interest on related party loans to allow a full deduction for interest expense if the borrower has interest income, but the deduction of the excess amount would be limited to a maximum of 30% of profit before interest, tax, depreciation and amortization. [Issued: 16 April 2012]
URL: http://www.deloitte.com/view/en_GX/global/services/tax/international-tax/3bbb067b85bb6310VgnVCM1000001a56f00aRCRD.htm
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