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International Tax

World Tax Advisor

11 May 2012

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Key tax implications of Australian budget

The 2012-13 Australian budget was announced on 8 May 2012 and includes proposals to introduce a limited loss carryback, clarify the general anti-avoidance rule, increase the Managed Investment Trust withholding tax rate and eliminate the capital gains tax discount currently available to individual nonresidents.

The various budget announcements are expected to be introduced into the Parliament on a staggered basis. Some measures will be introduced into Parliament quite quickly, while other matters will be the subject of consultation and will not become draft law for some time. The government does not control either House of Parliament, which adds some complexity to the process of getting the measures passed by Parliament. Some of the key announcements are as follows:

Corporate tax

- The government has decided not to proceed with a cut to the corporate tax rate from 30% to 29%. This is projected to save AUD 4.76 billion, and the government has stated that it will focus these savings on other measures, such as the company loss carryback measures.

- The government will allow companies to claim refunds on prior year tax payments through the carryback of losses. As from 1 July 2012, companies will be able to carry back up to AUD 1 million of losses to get a refund for tax paid in the previous year. From 1 July 2013, the AUD 1 million loss carryback will apply for tax paid up to two years earlier. There is no apparent limit on the size of the taxpayer or the economic group that can benefit from these measures. However, the mechanics of how the refund is to work were not set out in the announcement.

- The government had previously announced an amendment (expansion) of the general anti-avoidance rule (Part IVA) with effect from 2 March 2012, and it confirmed its commitment to amend the rule to ensure the provision remains effective against tax avoidance schemes. The proposed amendment is intended to clarify the circumstances in which a taxpayer obtains a "tax benefit" in connection with a scheme, and follows several recent Federal Court decisions that found that the Commissioner of Taxation had incorrectly determined that the anti-avoidance rules should apply to remove the perceived "tax benefits." A common feature of the cases was that the

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taxpayers had choices about the manner in which they carried out business transactions, with the choices leading to different tax outcomes.

There is considerable uncertainty about the current operation of Part IVA because of the proposed retroactive nature of the amendment. This uncertainty will be felt most by taxpayers that undertake mergers, disposals, acquisitions and other transactions that may have different tax outcomes depending on how they are carried out. A cautious approach to the tax considerations will be necessary, and it can be expected that the Australian Taxation Office will keep a close eye on major transactions that occur in the period since the announcement was made.

- The government has proposed "more consistent tax treatment for bad debts between related parties irrespective of whether they are members of a tax consolidated group." Where a debt as between members of a tax consolidated group is bad, the transaction is disregarded due to tax consolidations. It is proposed that where the parties are related but not in the same tax consolidated group, a deduction for bad debts written off will not be available. This could affect group financing activities outside of tax consolidated groups, such as within non-wholly owned groups, stapled groups and involving nonresident debtors. The measure also will ensure that the gain to the debtor will not be subject to tax.

- The government has announced that it will clarify that limited recourse debt includes arrangements where the creditor's right to recover the debt is effectively limited to the financed asset or security provided. The measure will ensure that tax deductions are not available for capital expenditure on assets that have been financed by limited recourse debt to the extent the taxpayer is not effectively at risk for the expenditure and does not make an economic loss. No further details are available as yet.

- The Tax Breaks for Green Buildings Program, which was announced as part of the 2010 government election commitment, was intended to provide businesses that invest in eligible assets or capital works to improve the energy efficiency of their existing buildings with the ability to apply for a one-off bonus tax deduction of 50% of the cost of these improvements. This program was originally due to start on 1 July 2011, but was then deferred to 1 July 2012. The government has now announced that the program will no longer proceed due to the various incentives provided by the Clean Energy Future package.

Funds

- The Managed Investment Trust (MIT) withholding tax rate will be increased from 7.5% to 15% as from 1 July 2012. The two main categories of income/gain subject to MIT withholding are:

    - Net rental income, so this will increase the tax rate for property investments into Australia via a MIT structure; and
    - Gains on the disposal of Taxable Australian Property (TAP), including real property and 10% or greater interests in entities that are Australian land rich.

  Other income, such as dividends and interest, fall outside the MIT withholding regime and remain subject to existing dividend/interest withholding tax rules. Gains on the disposal of non-TAP (e.g. shares in non-Australian land-rich entities where a capital election has been made under the MIT rules) are not subject to MIT withholding, so should not be affected by the announcement.

- The government reiterated its commitment to a comprehensive/permanent Investment Manager Regime (IMR) from 1 July 2011; this is directed at hedge funds and is not expected to be of direct benefit to private equity funds.

- Currently, individual nonresidents of Australia who earn taxable Australian capital gains (including through certain funds) are eligible for the capital gains tax (CGT) discount – effectively, half rate taxation. The CGT discount will be removed for gains accruing after 8 May 2012, but remains available for gains accruing before that date where nonresidents choose to obtain a valuation as at that date.

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Not announced

- It had been expected that the thin capitalization rules would be tightened, but there was no announcement in the budget. The potential changes mooted included a reduction in the safe harbor debt ratio from 75% of relevant assets to 60% and the removal of the arm's length debt test. There is still a prospect that the thin capitalization rules will be tightened in due course.

- The budget did not elaborate on the expected timing of the proposed controlled foreign company or foreign accumulation fund reforms. These changes are not expected to be introduced before 1 July 2013.

- Finally, although there were no major new indirect tax measures announced, the government confirmed its increased focus on Goods and Services Tax compliance activities by allocating additional funds to the Australian Taxation Office for the 2014-15 and 2015-16 years.

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European Union:
ECJ rules on VAT treatment of supply of phone cards

The European Court of Justice (ECJ) ruled on 3 May 2012 in the *Lebara Limited* case that the supply of phone cards is a supply of telecommunication services. Consequently, phone cards sold to businesses in other EU member states are not subject to U.K. VAT because the businesses are required to account for VAT in their own member states.

Background

The case concerns the VAT treatment of the sale of phone cards by a U.K. company, Lebara, to businesses (Distributors) established in other EU member states. The Distributors then sold the cards to end-users and other businesses that would themselves sell the cards to end-users.

Lebara argued that it was not required to pay U.K. VAT on the sale of phone cards to Distributors on the grounds that it made a single supply of telecommunication services to Distributors established outside the U.K. The place of supply of telecommunication services was where the Distributors were established (outside the U.K.). Accordingly, the Distributors must account for VAT where they are established.

The U.K. tax authorities (HMRC) contended the phone cards were in the nature of vouchers. Therefore, Lebara made two supplies for VAT purposes: the first at the time of the initial sale of the phone cards to the Distributors and the second at the time the end-user redeemed the card. According to HMRC, Lebara should have paid VAT at the time of redemption.

The U.K. First-tier Tribunal referred the case to the ECJ, with the AG issuing a favorable opinion for Lebara in December 2011.

ECJ decision

The ECJ agreed with Lebara that the sale of the phone cards constituted a supply of telecommunication services to the Distributors. Therefore, the Distributors were required to account for VAT in their own member states. Further, Lebara did not make any supply to the end-users because it did not receive any payment.

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In reaching its decision, the ECJ made the following observations:

- A supply is taxable only if there is a reciprocal consideration. Since Lebara received only one payment (from the Distributors), it made one supply.
- Lebara's supply was in the nature of a telecommunication service as it related to the transmission of signals.
- The recipient of Lebara's supply was the Distributor because Lebara transferred to the Distributors all the necessary information and the infrastructure to make the phone calls.
- There was no direct link between Lebara and the end-users. The Distributors sold the phone cards to the end-users on their own account, Lebara did not know the identity of the end-users and the payment made by the end-users was not the same as the payment made by the Distributors to Lebara.

Implications

The ECJ's decision is a good reminder that complex VAT issues can be resolved by following the basic principles of VAT. In this case, it was clear to the court that, since Lebara received a single payment, there could only be one supply (and not two, as was alleged by HMRC).

Many telecom operators will welcome the decision as it ensures that VAT is accounted for on the value addition made at each stage of the supply chain. Phone card operators that have been accounting for VAT on cross-border sales may want to consider seeking the repayment of VAT. Some businesses, however, will find the decision disappointing since there is no guidance on the VAT treatment of vouchers. The U.K. rules on the VAT treatment of vouchers are complex and many had hoped that Lebara would clarify the application of the rules.

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India:
Proposed changes to 2012 Finance Bill aimed at alleviating concerns of investors

India's Finance Minister proposed a number of amendments to the 2012 Finance Bill on 7 May 2012 in an effort to alleviate the concerns of foreign investors. Originally announced on 16 March 2012, the 2012 Finance Bill contains a number of significant and far-reaching direct tax measures that could be a challenge for nonresident investors. Measures proposed in March include the taxation of indirect share transfers (effectively overruling the Indian Supreme Court's decision in the landmark *Vodafone* case) and the introduction of a general anti-avoidance rule (GAAR) (for a discussion of the original proposals, see the 23 March 2012 issue of the *World Tax Advisor*). The Finance Minister has now pulled back on some of these proposals, clarified their scope and added a few new measures.

The most controversial proposal in the 2012 Finance Bill is clearly the measure that would allow India to tax share transfers outside the country. This proposal arose out of a transaction by a telecommunications company (Vodafone) in which the Indian tax authorities tried to tax a transfer of shares by a Cayman Islands company to Vodafone of an overseas holding company that indirectly held the shares in an Indian company. After a protracted and contentious dispute between the tax authorities and the mobile phone carrier, the Indian Supreme Court ruled in January that the Indian tax authorities could not tax the capital gains derived by the Cayman Islands company on the sale of the shares because the transaction was structured as a deal between two foreign entities and involved the sale of shares of a third foreign entity. In the wake of the decision, the Indian government was expected to introduce rules that would allow India to tax cross-border transactions in which the underlying assets are located in India.

In the Finance Minister's presentation to Parliament on 7 May, he stood firm on the proposal to retroactively tax capital gains derived from the sale of assets located in India through the indirect transfer of shares abroad. This measure, which is characterized as a clarification of existing law, would have effect back to 1962. The Minister did confirm, however, that:

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- The measure will not override provisions in India's existing tax treaties, but will impact cases in which the transaction was routed through a low-tax or no tax country with which India does not have a tax treaty; and
- The amendment will not be used to reopen any cases in which assessment orders have been finalized. A policy circular will be issued in this regard.

General anti-avoidance rule

Significantly, the GAAR provisions would apply from financial year 2013-14 instead of 1 April 2012, as anticipated under the original bill. The amendments also would make it possible for taxpayers to request advance rulings on proposed arrangements. The presumption against the taxpayer in the original bill to the effect that any arrangement resulting in a tax benefit was undertaken with the main purpose of obtaining such benefit would be eliminated. Consequently, the tax authorities would need to demonstrate that one of the main purposes of an arrangement was to obtain a tax benefit and, as originally proposed, that the arrangement satisfies at least one of the following tests:

- It creates rights and obligations that are not normally created between parties dealing at arm's length;
- It results in the misuse or abuse of provisions in the tax law;
- It lacks or is deemed to lack commercial substance; or
- It is carried out in a manner that normally is not employed for *bona fide* reasons.

Special tax rate for nonresidents on transfer of unlisted securities

The Finance Minister has added a proposal to the original bill that would tax the long-term capital gains of foreign companies and other nonresidents on the sale of unlisted securities at the more favorable rate of 10% (plus the applicable surcharge and education cess) instead of the currently applicable 20% rate (plus the applicable surcharge and education cess). However, the base cost of such would not be indexed for inflation and would be calculated in rupees.

Tax neutrality in converting Indian branch of a foreign bank to a subsidiary

Under another new proposal, capital gains arising on the conversion into an Indian subsidiary of an Indian branch of a foreign bank carrying on a banking business in India would not be chargeable to tax. The Reserve Bank of India, however, will determine the framework of any intended conversion. Further, the treatment of unabsorbed depreciation, losses, tax credits and other tax items, as well as the conditions to be satisfied for the conversion to be tax neutral, will be notified by the central government. Failure to comply with these conditions would result in denial of tax neutral treatment or, if already granted, the benefit would be clawed back.

Special tax rate for overseas loans

Interest income of foreign companies and other nonresidents from loans made in a foreign currency from 1 July 2012 through 1 July 2015 under an agreement approved by India's central government would be taxable at a rate of 5% (plus applicable surcharge and education cess) instead of the currently applicable 20% (plus the surcharge and education cess). Under the original bill, the benefit of the lower rate was restricted to interest on borrowings by certain specified companies; the amended proposal would extend the benefit to interest on borrowings by all Indian companies. Moreover, interest paid on the issue of long-term infrastructure bonds would be eligible for this benefit.

Sale of unlisted equity shares under an IPO

The sale of unlisted equity shares under an offer for sale to the public included in an IPO where the shares are subsequently listed on a recognized stock exchange would be liable to Securities Transaction Tax at the rate of 0.2% of the sale price, payable by the seller. The seller would be exempt from long-term capital gains tax if the shares offered were held for more than 12 months. If the shares were held for 12 months or less, the seller would have to pay short-term capital gains tax at a rate of 15% (plus the applicable surcharge and education cess).

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Other proposals

- The minimum alternate tax provisions would not apply to life insurance companies retroactively from financial year 2000-01.
- The proposal that any resident having any asset (including a financial interest in any entity) or signing authority over any account located outside India would be required to furnish an income tax return, even if the person does not have taxable income, would be amended to exclude individuals who are not ordinarily resident in India.

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United States: Customs, EU Agree to Mutual Recognition for C-TPAT and AEO

On 4 May 2012, U.S. Customs and Border Protection and the EU reached a Mutual Recognition Decision between CBP's Customs-Trade Partnership Against Terrorism (C-TPAT) program and the EU's Authorized Economic Operator (AEO) program. The implementation date has not yet been announced.

Mutual recognition means that customs authorities for the U.S. and the EU will treat members of the other entity's trade partnership programs as it would its own members. This includes favorable consideration of an operator's membership for risk assessment, inspection or control purposes. In the event of an irregularity of a member authorized by the other customs authorities, those authorities can suspend the operator's membership treatment. The suspending authorities must inform its counterpart of the suspension.

Under the decision, the customs authorities also will exchange certain information electronically, including:

- Providing updates on the operation and development of their trade partnership programs in a timely manner;
- Engaging in mutually beneficial exchanges of information regarding supply chain security; and
- Facilitating interagency communication between CBP and the EU Taxation and Customs Union Directorate (TAXUD) regarding supply chain security.

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In brief

China – The State Administration of Taxation has issued a circular that provides detailed implementation guidance on the VAT treatment of zero-rated services in the VAT reform pilot program.

Ecuador – As from 1 January 2013, the electronic filing of tax returns will be mandatory for all taxpayers.

European Union – The EU recently strengthened its sanctions against Iran, adding new restrictions on business transactions carried out by persons who are resident in the EU or are considered an EU national and by companies operating in or incorporated in the EU. The new sanctions target a wide range of industries (such as oil and gas, petrochemicals, metals and mining, finance and insurance and freight forwarding) and expand the restrictions on transfers of dual-use items and other goods to and from Iran and targeted individuals and persons or entities acting on behalf of the Iranian government. These restrictions extend to activities such as the import, export and transport of listed items, technologies and services, in addition to less obvious transactions such as the indirect provision of financial services or brokering services that facilitate trade with Iran. The restrictions are complex and represent the increasing will of the EU to restrict trade with Iran, posing significant compliance risk for EU businesses in a variety of sectors. More changes may be on the horizon as Iran and

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Western states engage in intensified diplomacy ahead of a full EU (and U.S.) embargo on oil imports from Iran scheduled to take full effect in July 2012.

Iran – The standard VAT rate increased from 4% to 5% on 20 March 2012.

New Zealand – On 1 May 2012, the Taxation (International Investment and Remedial Matters) Bill passed its third reading and now awaits royal assent. This bill continues the reform of New Zealand's international tax rules by extending the active income exemption to non-portfolio foreign investment funds, as well as replacing the current grey list exemption with an exemption for Australian companies. There also are changes to the thin capitalization rules, a zero rate Approved Issuer Levy on certain bonds and various GST and remedial changes.

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No new alerts were issued this week. Be sure to refer to the archives to ensure that you are up to date on the most recent releases.

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