Banking on tax

Focusing on the core issues

Recent global developments in cash management

Recent global market fragility has heightened risk and cash management scrutiny at senior levels in multinational corporations. This has meant a focus on treasury systems and processes. Also, as Asia Pacific’s profile in global trade grows (both inbound by non-Asia Pacific groups and outbound by domestic groups) risk and cash management strategies specific to the region have also had to be developed and adopted.

In addition, multinational corporations face the even more complex challenge of securing treasury operations and processes connectivity between time zones, and particularly the visibility and control of both cash and management of foreign exchange risk. In consequence, selecting, operating and enhancing multinationals’ cash pooling structures are accelerating. Nevertheless, these developments are all within the framework of the product base and capabilities of the ‘provider’ banks.

In addition, reassessing the correct basis for pricing intra-group transactions has arisen from the tax authorities’ greater scrutiny of cash management structures.

Two recent tax cases demonstrate that the simplistic approach to allocating benefits from cash pooling structures among corporate participants may not be acceptable.

The first is a Norwegian case involving a notional cash pooling structure (ConocoPhillips Skadanavia AS and Norske ConocoPhillips AS v Oljeskattekontoret). Under such an arrangement, ownership of cash by participant companies does
not change and each corporate participant continues to have a debtor or creditor relationship with the provider bank. The bank may pay or receive interest from each participant based on the participant’s cash balance and then make a ‘true up’ payment at agreed intervals to the group (typically to the group treasury company) based on the aggregated group cash position of all participants. Alternatively, the bank may pay or receive interest to or from only one group member, based on the group aggregated cash position, with interest then paid to or from individual participant accounts at rates determined by the group treasury company.

The Conoco Group used LIBOR and LIBID spreads, applied uniformly across all participants, as the basis for the payments to and from individual participants. It was able to demonstrate that the interest earned by Norwegian participants with surplus cash was in excess of the return which could be received had the participants deposited cash with banks outside of the pooling agreement. The Conoco Group claimed that such spreads constituted a legitimate comparable uncontrolled price for transfer pricing purposes. This was rejected by the Norwegian court, which held that a ‘profit split’ basis for allocation of the benefit was the correct approach, given the significance of the bargaining power of the Norwegian companies with surplus cash to the pooling arrangement. Arm’s length rates should be established on the basis of true credit risk taken by each participant in surplus, with relative bargaining power determining profit allocation.

The conclusion reached was that there is no comparable uncontrolled price for pricing a cash pooling arrangement, as cash pools do not exist outside of a group situation.

Bottom line
As cross border and intra-time zone cash management structures become more common and sophisticated, competition for cash management mandates will increase between the banks. Demonstrating an awareness of tax risk for multinationals and being clear about the methodology and principles for acceptable transfer pricing policies should assist in helping clients achieve their cash management strategies.

Issue of Basel III compliant capital instruments by mutual ADIs
As part of the implementation of the Basel III capital adequacy framework in Australia, APRA issued Prudential Standard APS 111: Measurement of Capital (APS 111). The framework requires Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments to be written-off or converted into ordinary shares if relevant loss absorption or non-viability provisions are triggered. However conversion into ordinary shares is not possible for mutual ADIs due to their mutual corporate structure. Without further provisions mutually owned ADIs would not be able to issue these types of capital instruments and so potentially face a competitive disadvantage.

Amendments to APS 111
Following consultation with mutual ADIs and ASIC, APRA published draft amendments to APS 111 in October 2013. On 15 April 2014, the final amended APS 111 was released.

Under the amendments, APS 111 provides that an AT1 or T2 capital instrument issued by a mutual ADI will convert into ‘mutual equity interests’ in the issuing ADI if the loss absorption or non-viability provisions are triggered. On conversion, the mutual equity interests will be included in Common Equity Tier 1 (CET1) capital for capital adequacy purposes.

The mutual equity interest will need to comply with the same requirements as ordinary shares with two exceptions:
1. Mutual equity interest holders will share in any surplus of a failed mutual ADI up to the nominal value of the AT1 or T2 capital instrument prior to conversion.
2. The payment of dividends on the mutual equity interest and any other ‘investor shares’ (as referred to in Regulatory Guide 147 Mutuality – Financial Institutions) will be capped at 50 per cent of the issuer’s net profit for the annual period in which the distribution is made. Dividends must be payable only out of that period’s profits.

Mutual equity interests will not carry any voting rights other than as required under the Corporations Act.

A mutual ADI will need to obtain APRA’s approval to issue AT1 or T2 capital instruments that will be eligible for conversion into mutual equity interests.

**Potential difficulties with characterisation under the debt and equity tax rules**

From a tax perspective, unlike AT1 capital instruments, T2 capital instruments can potentially meet the requirements to be classified as a debt interest under the debt test contained in Division 974 of the Income Tax Assessment Act 1997 (ITAA 1997). This will enable interest paid under the terms of the T2 capital instrument to be tax deductible to the Issuer.

For a financial instrument to be characterised as debt for tax purposes, the issuer must have an effectively non-contingent obligation to repay an amount at least equal to the issue price. An obligation is ‘non-contingent’ if it is not contingent on any event, condition or situation (including the economic performance of the entity with the obligation), other than the ability or willingness of that entity to meet the obligation. There is a risk that a non-viability condition, as required for all compliant AT1 and T2 capital instruments under Attachment J to APS 111, could result in obligations under T2 capital instruments as being effectively contingent on the issuer’s solvency.

Regulations 974-135D, 974-135E and 974-135F of the Income Tax Assessment Regulations 1997 were gazetted to ensure that obligations under certain term subordinated notes, perpetual cumulative subordinated notes, and term cumulative subordinated notes issued by ADIs are not precluded from being effectively non-contingent obligations under Division 974 of the ITAA 1997 by certain capital adequacy, profitability, insolvency or non-viability conditions.

In particular, Regulation 974-135F requires that the non-viability condition attached to the T2 term subordinated notes must require the issuer to write-off the notes or convert the notes into ordinary shares.

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The current wording of the regulation does not consider conversion into mutual equity interests as now permitted under APS 111.

Given the different characteristics between mutual equity interests and ordinary shares, it may be difficult for T2 term subordinated notes issued by a mutual ADI, to satisfy the requirements of Regulation 974-135F and so satisfy the debt test.

Until these regulations are amended to reflect the recent changes to APS 111, the tax treatment of interest paid by mutual ADIs on T2 capital instruments that may convert into mutual equity interests in the event of non-viability of the mutual ADI is uncertain.

**Board of Taxation discussion paper on the review of the debt and equity tax rules**

The Board of Taxation’s (BoT) discussion paper ‘Review of the debt and equity tax rules’ released in March 2014 provides a comprehensive review of the debt and equity tax rules, and invites submissions on:

- Potential problems with the operation of the current law
- Where the debt and equity rules interact (or don’t interact) with other parts of the tax law
- Issues in compliance and administration
- Cross-border tax arbitrage opportunities that exist under the current law.

The key outcome of the discussion paper is to identify issues with significant practical implications for business or tax administrators and issues which involve significant risks to the revenue.
The BoT stated that its final report to Government due in March 2015 will be focused on addressing those significant practical issues.

More than 110 questions are raised by the BoT in the discussion paper, some of which relate to the following areas of the debt and equity rules:

- The term ‘financing arrangement’, which was thought to be relatively uncontroversial until the recent case of Blank v Commissioner of Taxation [2014] FCA 87. In this case, a distinction was drawn between raising capital for prudential purposes and raising finance for the purposes of Division 974
- The term ‘effectively non-contingent obligation’ used to identify a debt interest, is determined by pricing, terms and conditions, rather than an economic enquiry into all the facts and circumstances. Although limiting this test to the pricing, terms and conditions simplifies compliance, it has the potential to complicate outcomes for economically comparable instruments
- The ability and willingness to pay, and related issues such as solvency clauses, subordination clauses and non-recourse or limited recourse financing can create uncertainties, especially where differences in treatment do not result in an ‘effectively non-contingent obligation’
- Identifying the actual scheme prior to aggregating or disaggregating schemes is crucial to the debt and equity analysis and the impact of the ‘related scheme’ provisions
- Valuing cash flows in present value terms and calculating the benchmark rate of return can give rise to significant uncertainty
- There is significant uncertainty associated with the concepts of ‘designed to operate’ and to ‘fund a return to the ultimate recipient’ in section 974-80
- The uncertainty of applying section 974-80 to stapled structures
- How the debt and equity rules interact (or not) with other parts of the tax law. E.g. where flows of money are involved, the debt and equity rules apply (such as franking of distributions), however, where control is involved, voting and dividend/liquidation entitlements should determine characterisation (such as in the controlled foreign company rules).

The discussion paper provides an overview of the debt and equity rules in a number of modern economies, with Australia’s rules not replicated in any other jurisdiction. The discussion paper notes that this may give rise to international arbitrage opportunities for double deductions or deduction/no income pick-up on financing transactions.

The BoT noted the relationship of the OECD draft discussion paper on hybrid arrangements with the Australian debt and equity tax rules and raised some preliminary questions as to how the proposed OECD approach involving domestic law change would interact with existing Australian law.

Interested parties with transactions that are affected by uncertainties in the debt and equity rules should make representations to the BoT.

**GST and the use of credit cards outside Australia**

On 2 April 2014, the Commissioner of Taxation issued Draft Goods and Services Tax Determination GSTD 2014/D1 ‘Goods and Services Tax: in what circumstances is the supply of a credit card GST-free under paragraph (a) of item 4 in subsection 38-190(1) of the A New Tax System (Goods and Services Tax) Act 1999 (GST Act)’ (GSTD 2014/D1). Once finalised, GSTD 2014/D1 is intended to have retrospective and prospective effect.

In GSTD 2014/D1, the Commissioner expresses the view that the provision of a credit card facility is a supply of rights for GST purposes. On this basis, the provision of a credit card facility would fall within the scope of item 4 in subsection 38-190(1), which deals specifically with the treatment of the supply of rights for use outside Australia.

The Commissioner has previously expressed the view (e.g. in GSTR 2003/8) that it is the ‘intended’ use of the particular right that is relevant to making an assessment as to whether a right is for use ‘outside of Australia’. For a credit card facility, it must be intended that the cardholder will use the facility to undertake a transaction when they are physically outside Australia, provided the location is ‘integral’ to the relevant use of the credit card facility. In cases where the cardholder is required to be physically present to provide the card as payment, the location would be considered ‘integral’. For a transaction where the cardholder is not required to physically present the card (e.g. online payments), factors other than location would need to be considered.
The Commissioner accepts that it is not practical for card issuers to obtain evidence of each cardholder’s intended use.

Information such as past usage patterns of other similar cardholders and market research about usage patterns, and other reasonable methods, can be used to calculate the extent to which the facility is for use outside Australia.

**Impact of the Commissioner’s view**

In light of this interpretation as set out in GSTD 2014/D1, taxpayers should review existing processes and input tax credit apportionment methodologies to determine whether their current methodology needs to be adjusted. If a more conservative approach has been taken than that the Commissioner has proposed, there may be an opportunity to increase claims for input tax credits over historical and future periods.

The draft determination represents the Commissioner’s preliminary view. Taxpayers that seek to rely on GSTD 2014/D1 will only be provided with protection for interest and penalties if the Commissioner subsequently changes his view (i.e. the underlying tax amount would need to be repaid). As such, we recommend that any changes to methodologies should be finalised once the final determination is issued.

**OECD BEPS discussion draft on hybrid mismatch arrangements – the impact on additional Tier 1 capital needs further clarification**

As part of its ongoing base erosion and profit shifting project, the OECD released a discussion draft on 19 March 2014, which sets out various recommendations for the design of domestic rules to neutralise the effect of hybrid mismatch arrangements. The OECD is presently considering public comments on that draft and expects to release its final recommendations in September 2014.

**OECD recommendations for hybrid instrument mismatches**

The discussion draft identifies that certain undesirable tax outcomes arise from cross-border payments made under ‘hybrid’ financial instruments that are classified as debt for tax purposes in one jurisdiction and equity in another.

**The OECD is specifically concerned with ‘double non-taxation’ outcomes that arise when multinational groups make payments under financial instruments that are deductible in the payer’s jurisdiction but not included in income for tax purposes in the recipient’s jurisdiction.**

An example of such an arrangement might involve a redeemable preference share issued by an Australian company to its overseas parent. Where this share is classified as a debt interest for Australian tax purposes, dividends on it would generally be deductible in Australia. A mismatch would arise where the jurisdiction of the overseas parent company classifies the redeemable preference share as equity and allows a dividend exemption for the dividends. The discussion draft describes this result as a ‘deductible/non-inclusion’ mismatch.

To eliminate such a hybrid instrument mismatch, the discussion draft contains recommended ‘linking’ rules that countries should implement into their domestic tax law. The effect of these rules, once implemented, would be to neutralise hybrid mismatches.

The discussion paper suggests that the proposed hybrid instrument rules should generally not apply for certain widely-held issuances, although the discussion paper qualifies this by stating that the proposed rules could be applied where the hybrid instrument was entered into as part of a ‘structured arrangement’ (e.g. where the arrangement was engineered to exploit differences in tax treatment or marketed as a tax-advantaged product to investors that would benefit from the tax mismatch).

**Driving taxpayers away from the use of tax hybrids**

The discussion draft indicates that the OECD’s objective is to drive taxpayers away from the use of hybrid instruments that result in tax arbitrages. It states: “the rules are intended to drive taxpayers towards less complicated and more transparent tax structuring that is easier for jurisdictions to address with more orthodox
While this may be a laudable objective insofar as it relates to aggressive tax planning, it could conflict with regulatory requirements surrounding hybrid instruments issued by banks to comply with regulatory capital requirements.

The discussion draft includes a brief acknowledgement of the fact that financial institutions issue certain hybrid instruments to their parent companies in order to satisfy regulatory requirements – namely the Additional Tier 1 (AT1) capital requirements under Basel III. Instruments that satisfy the AT1 requirements are required by regulators to have both debt and equity-like features, which can result in different countries adopting differing treatments of AT1 instruments for tax purposes.

Given that the discussion draft acknowledges that “there are likely to be an increasing number of these [AT1] instruments issued intra-group to adhere to emerging regulatory practices”, we would expect the OECD to further consider whether hybrid instruments issued by financial institutions to satisfy regulatory capital requirements should be excluded from the scope of its proposed rules.

The OECD’s broad objective to drive taxpayers away from the use of hybrid instruments could conflict with the regulatory requirements for AT1 capital, especially given that AT1 instruments are issued by banks to satisfy regulatory capital requirements, not for tax planning purposes.

White Paper on tax reform

Prior to the last federal election, the Liberal Party stated that a Liberal Government would release the modelling behind the Henry Review ‘to enable an open discussion about the future of Australia’s tax system’. The Liberal Party also stated that it would then seek a second-term mandate for a further tax reform agenda by releasing a comprehensive White Paper on tax reform prior to the next federal election.

Few recommendations in the Henry Review have been implemented. Dr Henry was recently reported as saying that the Government’s long-promised White Paper on tax reform would have to be ‘deep and broad’ to make the tax system sufficiently robust to sustain government spending.

It is still not clear when the Government will deliver the terms of reference for the White Paper. Recent reports indicate that the terms of reference may still be some way off.

The following areas affecting the taxation of financial institutions are likely to be covered by the White Paper:

- A reduction of the company tax rate from 30% to 25%
- If there should be a trade-off between the corporate tax and the dividend imputation system and as financial institutions diversify their income sources from outside Australia, does the dividend imputation system still have the relevance it had in the 1980s? Are there more effective models that address the debt bias, but do not act as a disincentive for Australian multinationals investing offshore?
- At a state and federal level, ten taxes collect about 90% of the revenue. That leaves 115 other taxes to collect about 10% of the revenue. The reform of state taxes, in particular, requires a fundamental shift in thinking, presumably with reform to the GST system to compensate the states.
- With the abolition of the R&D incentive for major financial institutions, the White Paper should consider other incentives to stimulate innovation and similar investment.
- Retail funding of financial institutions in the form of an interest income exemption on deposits was previously considered, accepted, deferred then rejected. This should be reconsidered, with meaningful exemption levels.
- The phased reduction of interest withholding tax rates on borrowings by financial institutions from foreign institutions or offshore retail deposits was previously considered, accepted, deferred then rejected.
- An analysis of the deductibility of Additional Tier 1 funding instruments in various foreign jurisdictions to determine the competitive position of Australian based financial institutions that operate in overseas markets.
- The wealth businesses of financial institutions will be very interested in the taxation of retirement

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- An analysis of the deductibility of Additional Tier 1 funding instruments in various foreign jurisdictions to determine the competitive position of Australian based financial institutions that operate in overseas markets.
- The wealth businesses of financial institutions will be very interested in the taxation of retirement.
incomes, particularly the exemption from taxation of superannuation funds in the pension phase and the extension of the retirement age

- The proposal to split the ATO between administration and policing to ‘foster a more co-operative relationship between taxpayers and the ATO’.

**Bottom line**

To enable a meaningful debate and allow sufficient time for proper analysis, the term of reference for the White Paper should be released as a matter of importance, together with the modelling behind the Henry Review. The Henry Review, coupled with other recent finance reviews (e.g. the Johnson Report), already provide a solid base on which to launch the tax reform review through the White Paper.

**Australian IGA for FATCA signed and new entity account onboarding delayed**

**Australian IGA**

On 28 April 2014, the Australian and U.S. governments signed an intergovernmental agreement (IGA) to improve international tax compliance and to implement FATCA. Australian financial entities will be treated by the U.S. as complying with FATCA and so not subject to withholding until the IGA formally enters into force which is expected to be by 30 September 2015. See the IGA is available [here](#).

The Australian IGA is based on the model IGA released by the U.S. Treasury. The main differences between the two are the list of entities and accounts that are exempt or deemed to comply with FATCA. Listed in Annex II of the IGA these include:

- Australian retirement funds (including a superannuation entity defined in the *Superannuation Industry (Supervision) Act 1993*, pooled superannuation trusts defined in the *Income Tax Assessment Act 1997* (ITAA 1997) and certain entities wholly owned by such entities) are exempt from FATCA

- Excluded accounts include retirement and pension accounts, employee share schemes, FHSA, funeral policies and scholarship plans. However, a number of other accounts, such as children’s accounts, are not excluded

- Also in Annex II, the 98% of financial accounts test for a deemed compliant local entity includes accounts held by Australian or New Zealand residents.

The Memorandum of Understanding accompanying the IGA also contains:

- Clarification of reporting for securities registered in an Australian clearing and settlement facility

- Not-for-profit entities that are exempt from tax under Division 50 of the ITAA 1997 are to be treated as active non-financial foreign entities.

On 28 April 2014, the Australian Treasury also released exposure draft (ED) legislation and a draft explanatory memorandum (EM) to enact provisions to enable Australia to fulfil its reporting obligation under the IGA from 1 July 2014. The ED and EM are available [here](#). Submissions were due by 9 May 2014.

The ED is focused on reporting information to the ATO, record keeping and penalties for non-compliance with FATCA reporting under domestic legislation. Under the exposure draft:

- Reports would be required to be lodged with the ATO on a calendar year basis by 31 July of the following year

- The procedures for determining the information to be reported (including due diligence procedures for new and existing accounts) would be required to be in writing and retained for five years after the report is lodged with the ATO. The EM recommends that the procedures could be contained in broader internal guidelines or documents

- Any elections to use definitions or procedures in the U.S. FATCA regulations must be made before a report is lodged and will be evidenced by the written procedures and the way the report is prepared

- The approved form for reporting is yet to be determined.

**Significantly, draft guidance to address interpretation issues and address any gaps between the IGA and the US regulations has not yet been released.**
Notice 2014-33 – delay of FATCA compliant onboarding for new entity accounts and limited transition relief

On 2 May 2014, the U.S. Treasury and Internal Revenue Service released Notice 2014-33 that:

• Entity accounts opened after 30 June 2014 and before 1 January 2015 may be treated as pre-existing accounts. The 30 June 2016 deadline for remediation of pre-existing entity accounts will remain unchanged.
  - All new entity accounts opened between 1 July 2014 and 31 December 2014 will be subject to due diligence, as the $250,000 de minimis exception otherwise applicable under the due diligence rules for pre-existing accounts will not be available for new entity accounts opened in this period.
  - The U.S. Treasury intends to update the due diligence procedures described in Annex I of the Model 1 and Model 2 IGAs to incorporate due diligence procedures consistent with the notice as outlined above in future IGAs. An Australian entity will be permitted to adopt the revised due diligence procedures pursuant to the most-favoured nation provision in the Australian IGA, once an IGA with the revised procedures has been signed with another partner jurisdiction.
  - Importantly, onboarding procedures for new individual accounts are still required to be FATCA compliant from 1 July 2014.

• Relief for certain limited FFIs and branches which are subject to additional local law restrictions not currently contemplated in the U.S. FATCA regulations or are prohibited by their government from registering with the IRS.

• Reasonable explanation of foreign status.

• Modifications to the standards of knowledge rules in the U.S. FATCA regulations.

• The 2014 and 2015 calendar years will be regarded as a transition period for the purposes of IRS enforcement and administering the due diligence, reporting and withholding provisions under FATCA. In this transition period, the IRS will take into account the extent to which an entity has made efforts in good faith to comply with the requirements of FATCA, including identifying and facilitating the registration of each member of its expanded affiliated group. For Australian entities, the ATO will be responsible for enforcing FATCA under Australian legislation (i.e. under the provisions of the ED, if enacted).

Next steps

The signing of the IGA means that all Australian ‘financial institutions’ as defined in the IGA are required to consider the application of FATCA and, in many instances, comply with FATCA obligations which are phased in from 1 July 2014.

Accordingly, the focus for the period from now to 1 July 2014 should be on:

• Finalising entity classifications
• Reviewing and updating onboarding procedures for new account holders
• Extracting pre-existing account population.

Entity classifications

Australian entities have undertaken entity classifications referring to the terms of the model I IGA or the U.S. FATCA regulations. It is now time to review those classifications, confirm any elections to utilise definitions in the U.S. FATCA regulations, update and finalise the classifications and document the classifications and any choices made.

On finalisation of entity classifications, registration requirements and obligations for monitoring compliance with any deemed compliant conditions, updating onboarding, undertaking due diligence and preparing for reporting can be confirmed and scoped or changes finalised.

Updating onboarding procedures for new account holders

The 1 July 2014 start date for FATCA compliant onboarding of new individual accounts has not been delayed. Accordingly, Australian entities should review and update onboarding procedures for individuals with priority to meet this deadline.

In extending the deadline for FATCA-compliant onboarding of new entity accounts, the U.S. Treasury and IRS recognised the complexities involved in onboarding entity accounts in a manner that complies with the FATCA requirements. Given these complexities, Australian entities should use the additional time given to put in place updated procedures for onboarding entities, taking into account other expected changes to onboarding of entities (e.g. AML/KYC changes).

Extracting pre-existing accounts

Australian entities should also prepare to extract the population of accounts as at 30 June 2014 for which due diligence will be required.
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