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Tax Alert

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In this issue:

GST on Mortgagee Sales

OECD adds complexity and uncertainty to intangible property pricing

New Customs law to be implemented next year – how prepared is your business?

High Court provides guidance on shortfall penalties

Country-by-Country Reporting: What is your risk profile?

A snapshot of recent developments

GST on Mortgagee Sales

By Andrew Babbage and Hana Straight

The issue of whether you can recover GST on costs associated with mortgagee sales has recently had another twist, this time in the taxpayer's favour. Businesses that provide finance to other businesses and use the business-to-business ("B2B") GST zero rating of financial services provisions, can now recover the GST on costs associated with trying to recover any amounts owed, if those loans turn sour. While this has most relevance in the case of mortgagee sales, this taxpayer friendly change applies not just to sales of land but to all types of asset sales by a lender who has the power to enforce the debt, provided the original loan qualified for GST B2B zero rating treatment. Organisations that have previously had GST disallowed on mortgagee sale costs should re-examine the treatment they applied in the past and see if the GST can now be claimed under the newly published Inland Revenue position, both on a go-forward basis and also for historical costs.

It has been a long road to get to this result and we welcome Inland Revenue releasing this latest statement to clarify this issue, which is contained in the updated operational statement, [Operational Statement 17/01](). This now confirms that mortgagees who are subject to the

B2B financial services rules can claim an input tax deduction for costs associated with mortgagee sales. Positively, the operational statement allows impacted taxpayers to approach the Commissioner to claim back previous input tax credits that were not previously claimed.

The genesis for this change arose when Deloitte took the unusual step of seeking a binding ruling from Inland Revenue that put forward a position contrary to Inland Revenue's published interpretation statement which disallowed claims for GST on mortgagee costs. We took this approach on the basis that we considered ours to be the better interpretation and we recognised that binding rulings were required to be based solely on an assessment of the law, and not influenced by existing Inland Revenue policy.

Although private rulings are specific to a taxpayer, it is positive that Inland Revenue accepted the need to withdraw its existing interpretation statement and publish this update, once the contrary binding ruling was issued, given its relevance to other impacted businesses. The takeaway is that the binding ruling process can be a very useful tool to obtaining movement on technical issues, even if there are published Inland Revenue comments that disagree with the position being sought by the taxpayer.

For those interested in the technical details behind this GST issue, it is useful to look briefly at the underlying history, as there have been a number of earlier statements from Inland Revenue that initially sought to disallow the ability of anyone to claim back GST on mortgagee sales.

In 2004 Inland Revenue released an Operational Statement that considered whether a GST registered lender could recover GST on the costs associated with mortgagee sales. The Operational Statement concluded that a mortgagee was not entitled to claim input tax on costs associated with a mortgagee sale as the input tax was not incurred in the course or furtherance of a taxable activity. The rationale was that a mortgagee, by carrying on a lending activity, was making exempt supplies, being the provision of financial services. However, with a throwaway line, the statement signed off with the teaser that "*This is subject to the newly enacted section 11A(1)(q)...*".

Section 11A(1)(q) is more commonly known as the "B2B" provision and allows a lender to treat certain financial supplies as zero-rated supplies, where the borrower is making more than 75% taxable supplies, rather than being an exempt supply. This B2B provision meant that a lender, who loaned funds to a GST registered business, e.g. to a property developer, could treat the loan as a zero-rated supply rather than as an exempt financial service.

At face value, the reference to section 11(1)(q) in the Operational Statement meant B2B lenders could recover GST incurred in collecting loans from borrowers in default.

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However in practice Inland Revenue sought to disallow GST claimed on costs associated with mortgagee sales, although there was no other explicit Inland Revenue published comment on the interplay of the B2B rules and mortgagee costs.

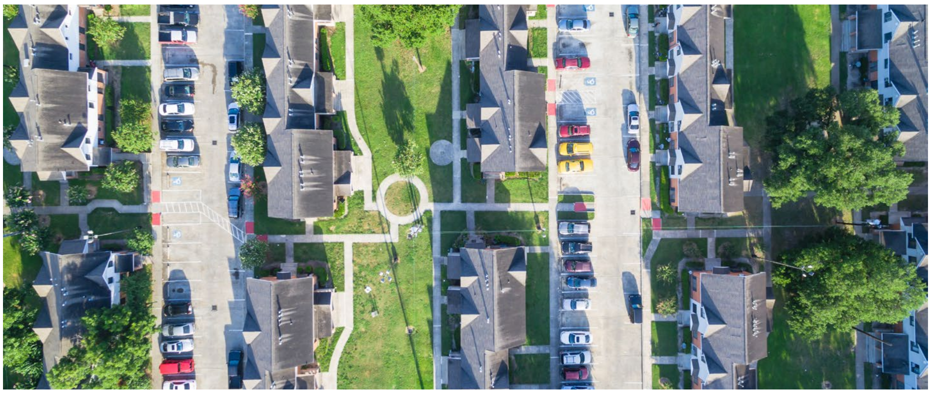
It was not until 2015 that Inland Revenue issued any further statement on this, concluding in Interpretation Statement 15/01 '*GST and the costs associated with mortgagee sales*' that a mortgagee was not entitled to recover GST on mortgagee sales costs, even if they had made an election into the B2B regime.

Following Deloitte's application, and an independent review by Crown Law, we were successful in obtaining the binding ruling for our client confirming the GST amounts could be claimed, resulting in Inland Revenue now updating its published position here.

For more information please contact your usual Deloitte advisor.

OECD adds complexity and uncertainty to intangible property pricing

By Bart de Gouw and Jennie Yao



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The new Transfer Pricing Guidelines (2017) on the arm's length principle will drive significant changes to current practices in relation to the transfer pricing outcomes for members of multinational enterprise (MNE) groups in respect of intangibles.

There are increased reporting requirements (in the form of the master file and the local file) in respect of ownership and exploitation of intangibles, and these transactions will be scrutinised by tax authorities in ever more detail.

The changes to the treatment of intangible property transfer pricing will have far-reaching consequences and apply broadly, as intangibles are widely defined. Intangible property can include things like marketing materials, branding, technical know-how and software, amongst other items.

If your business has valuable intangibles, now is the time to evaluate who carries out the important functions involved, assets used, and risks associated with the development, enhancement, maintenance, protection and exploitation (the so called "DEMPE functions") related to the intangibles, and review the legal contracts in place.

It is not enough to simply have legal contracts in place stating the ownership of the intangibles – contracts also need to clearly delineate the functions and risk allocations of the parties and ensure that the contracts are aligned with the actual performance and control the parties have in respect of the intangibles.

There are practical steps that companies can undertake to ensure that their intercompany transactions in respect of intangibles are appropriately documented and supported. The risk of not aligning profits associated with the transfer and use of intangibles with value creation (i.e. significant people functions) is the exposure of the transactions to challenge and potential reconstruction by some tax authorities.

Legal form vs. economic substance

The Transfer Pricing Guidelines recognise that payment for use of an intangible should be made to the party having the legal rights to such intangible. Intercompany contracts are a useful way to describe the roles, responsibilities, and rights of the relevant associated enterprises, and a way for the associated enterprises to express and agree their intentions. However, if the actual assumption or control of risk, and performance of the development, enhancement, maintenance, protection and exploitation functions in respect to the intangible differs from those stipulated in the contractual agreement, then the transactions must be assessed based on the actual activity carried out by the related parties (i.e. the economic substance rather than the legal form).

When a related party other than the legal owner participates in the development, enhancement, maintenance, protection and exploitation activities, provides funding, or assumes various risks, a separate transaction dealing with that activity must also be considered. In many MNE groups these activities may currently be treated as routine service arrangements (often with a routine cost plus return) with the intangible owner receiving the remainder of the profits derived from the intangible.

There is no intention under the new guidance to divert the income stream arising from use of the intangible away from the legal owner, but instead the guidance recognises that the legal owner has a transfer pricing obligation to pay for those activities that it does not perform. Under the guidance, a legal owner of intangible property who simply owns the intangible, but does not undertake or control the wider DEMPE functions, may only be entitled to a risk-adjusted or risk free return after compensating other members of the group for their respective contributions. In many cases such an approach is a marked change from current practice and may mean a party formerly thought of as a "service provider" would receive materially greater remuneration.

DEMPE functions and control

The guidelines acknowledge that the legal owner of the intangible does not need to be the one to carry out all the development, enhancement, maintenance, protection and exploitation functions itself and that independent parties do sometimes engage others to perform such functions. However, for an outsourced activity to be priced as an "outsourced service", the legal owner (or someone other than the service provider) should exercise control over its performance. Where the legal owner does not adequately control the outsourced activity, the party that in practice controls the outsourced activity should be appropriately compensated.

Companies will need to identify and obtain a deeper understanding of how value is created with respect to the development and exploitation of its significant marketing and technology intangibles. The functions performed, assets used and risks assumed in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles should be analysed in detail to ensure that associated enterprises are appropriately remunerated for their value-creating functions.

Step by step analysis

We have set out below steps for companies to follow in aligning their intangible transactions with the new OECD Guidelines.

1) Determine the cross border related - party transactions involving intangibles, and any legal contracts in place (e.g. software licence agreements, contract research and development agreements, sales and distribution agreements).

2) Identify the significant functions performed, assets used and risks assumed (including the control and capacity to fund those risks) in the development, enhancement, maintenance, protection and exploitation of the intangibles.

3) Compare the contractual allocation and the function and risk analysis to the actual activities performed by each entity in respect to the intangibles.

4) Determine the appropriate allocation of intangible returns among related parties following the functional analysis, and consider if any changes of profit allocation is required to align profits earned with value creation.

5) Appropriately document the important functions and risks and the parties assuming and controlling those functions and risks, including tracking significant intangible-creation activity in real time.

There are practical steps that companies can undertake to ensure that their intercompany transactions in respect of intangibles are appropriately documented and supported

Conclusion

The increased disclosure required under the OECD's master file and local file requirements will highlight any discrepancy between conduct and remuneration. The master file specifically provides for information to be disclosed in respect to intangible property of MNE groups.

Additionally, NZ Inland Revenue have released proposals to shift the burden of proof from Inland Revenue to the taxpayer in a dispute for years commencing on or after 1 July 2018, so this will require that MNEs pay far greater attention to substantiating their arrangements in both legal and economic terms.

It is important that companies ensure that profits associated with intangibles are appropriately allocated in accordance with value creation as any discrepancy may be challenged.

If you need advice in considering whether you comply with the new Transfer Pricing Guidelines, or you need assistance in documenting your intangible transactions or master or local file, contact your usual Deloitte advisor.

New Customs rules to be implemented next year – how prepared is your business?

By Jeanne du Buisson and Divya Pahwa

New Zealand Customs is in the process of refreshing the current Customs and Excise Act 1996 (CEA). The refresh of the CEA has been with a view to modernise many provisions to keep pace with technology and the digital era and shift the procedural provisions from the CEA to the delegated regulations. The new draft customs and excise bill is expected to be enacted in 2018. The draft customs and excise bill is available to be viewed here. New Zealand Customs are currently working through the detailed regulations that will contain the procedural provisions to be read with the new customs and excise bill.

Now is the right time for businesses to consider the impact of the proposed changes on their customs activities. Some of the more significant changes are discussed briefly below.

Valuation methods

The *transaction value valuation methodology* (being the *price paid* or *payable* for the imported goods) is the default method for valuing the goods imported for Customs purposes. This method can be used if there is a '*sale for export*', amongst other conditions, that results in the export of goods into New Zealand.

Currently it is possible to have more than one sale for export based on case law.

New Zealand Customs is proposing to define the term '**sold for export to New Zealand**' in the draft legislation as the "last sale of the goods occurring prior to the importation of the goods into New Zealand". This amendment is intended to take away the choice that is currently available to importers. There are however still complexities around what constitutes 'the last sale of goods'.

Provisional assessment

Currently, any change to the customs value of the goods declared at the time of import needs to be notified to New Zealand Customs through the voluntary disclosure process. The new draft rules now allow the importer to use a provisional assessment in certain situations if the importer contemplates that the price paid or payable at the time of import may change. This includes situations such as when royalty payments are made, when transfer pricing influences / changes the price, or when proceeds of the sale of goods after import accrue to the original exporter. The provisional assessment will be available only if certain conditions are met.

If the importer chooses not to use the provisional assessment scheme and later lodges a voluntary disclosure to disclose the adjustment to the customs value (even if only GST applies), then compensatory interest on any underpayments and penalties could potentially apply.

Replacing additional duty with a compensatory interest and late payment penalty system

Currently additional duty is a penalty imposed when a person does not pay enough duty or does not pay the duty

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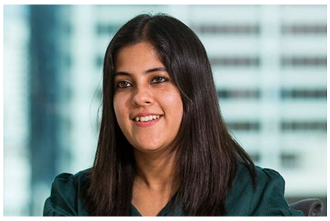

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on time. Additional duty is made up of an initial charge of 5 percent of the unpaid duty, followed by a monthly incremental charge of 2 percent. New Zealand Customs are aware that the incremental and compounding nature of additional duty can result in debts that are disproportionate to the offending, particularly when the debts are incurred over a long period of time.

It is intended that a compensatory interest and late payment penalty system would replace the existing additional duty provisions. Under the new draft legislation, compensatory interest (and potentially late payment penalties) will apply.

The new system in our view would be fairer and more proportionate for non-compliers. It has been designed to be broadly consistent with Inland Revenue's use-of-money interest scheme and its late payment penalty scheme.

Binding valuation ruling

Currently, only valuation advice can be obtained from New Zealand Customs in respect of any customs valuation issues which is not binding on New Zealand Customs or the applicant. The new draft customs rules will allow importers to obtain a binding ruling that will provide a higher level of comfort.

Excise related changes

- The new off-site storage rules, which are currently available only to the wine industry, will cover other alcohol manufacturers.

- New Zealand Customs have confirmed under the new draft legislation that the excise collection point for fuel will remain at the existing points, however a new excise collection point will be created at the gantry to capture increased volume from blending at tank farms.

Conclusion

New Zealand Customs are doing commendable work and have involved the stakeholders in the process, asking stakeholders for suggestions and feedback.

Various technical changes, including the provisional assessment scheme, will have a significant impact on businesses. There is a draft provision in the new legislation that requires the Chief Executive of New Zealand Customs to consult the Commissioner of Inland Revenue when considering an application to include provisional customs values that relate to a transfer pricing arrangement. There is an increased focus on the alignment of the customs value and transfer pricing value of goods that also need to be supported by up to date transfer pricing documentation.

Now is a good opportunity for businesses to consider the impact of the customs changes, especially on account of the new compensatory and late payment penalty regime that can be levied under the new legislation for non-compliance.

New Zealand Customs is proposing to define the term 'sold for export to New Zealand' in the draft legislation as the "last sale of the goods occurring prior to the importation of the goods into New Zealand". This amendment is intended to take away the choice that is currently available to importers

High Court provides guidance on shortfall penalties

By Emma Marr and April Wong

In what may seem like a purely capital-vs-revenue case, a closer look into the High Court case of *Easy Park Limited v Commissioner of Inland Revenue (Easy Park)* reveals valuable judicial commentary on the criteria that must be met for an "unacceptable" tax position shortfall penalty. *Easy Park* is interesting because it is not often that a court considers shortfall penalties and this decision provides some parameters for considering this particular penalty.

In some cases (as was the case in *Easy Park*), even where the tax position taken is incorrect in the Court's eyes and is contrary to the Commissioner's published view, a shortfall penalty may not be imposed

Shortfall penalties in a nutshell

Shortfall penalties are imposed where there is a shortfall in the amount of tax paid or an overstatement of a tax benefit, credit or advantage, calculated as a percentage of the tax shortfall. The level of penalty imposed depends on the severity of the behaviour that led to the shortfall. For example, where a taxpayer has failed to take reasonable care or has taken an unacceptable tax position, the penalty imposed is 20% of the tax shortfall. Where the taxpayer has taken an abusive tax position or has evaded their taxes, however, the penalty imposed is 100% or 150% of the tax shortfall respectively. Reductions can apply where no similar penalty has been previously imposed and for voluntary disclosure.

Background of the case

Easy Park Limited owned two commercial buildings in Wellington and derived its income from leasing out these buildings. Easy Park had received $1.1 million in exchange for the early surrender of one of the building's commercial leases. In its 2012 tax return filed, Easy Park did not declare this amount as income. Easy Park maintained the view that, contrary to the Inland Revenue's published view of lease surrender payments in a binding public ruling (BR Pub 09/06: Lease surrender payments received by a landlord – income tax treatment), the lease surrender payment it received was capital and not assessable for income tax. The Commissioner reassessed the amount as income to Easy Park and issued a tax assessment for $308,000. In addition to this, the Commissioner imposed a 10% shortfall penalty ($30,800) on Easy Park for taking an "unacceptable tax position". We assume in this case that the shortfall penalty was "reduced to 50% of the amount that would be payable by [Easy Park]" for previous good behaviour (section 141FB(2) of the Tax Administration Act 1994). The Commissioner took the view that, when "viewed objectively the tax position [taken by Easy Park] fails to meet the standard of being as likely as not to be correct" (section 141B of the Tax Administration Act 1994), due to Inland Revenue's position in BR Pub 09/06 and relevant case law.

In this particular case, the High Court agreed with the Commissioner that the lease surrender payment was income, however, on the question of shortfall penalties, Ellis J found that no shortfall penalty was warranted – even if the tax position taken by Easy Park was incorrect.

We note that this case was heard prior to a law change in 2013, which specifically provided for all lease inducement and lease surrender payments to be treated as taxable income. If the case was heard today, we would expect the ruling on the shortfall penalty point would be different, as the tax position taken would be directly contradictory to the legislation. Nevertheless, the comments on the decision not to impose a shortfall penalty are useful.

When is a tax position deemed to be "unacceptable"?

A shortfall penalty will be imposed where the taxpayer is deemed to have taken an "unacceptable tax position" in their tax return. This does not necessarily mean that a shortfall penalty will be imposed if the tax position taken is incorrect. If the tax position in question "can objectively be said to be one that, while wrong, could be argued on rational grounds to be right" (per Ellis J, citing *Walstern v Commissioner of Taxation* (2003) 138 FCR 1), shortfall penalties may not be imposed.

Ellis J found that shortfall penalties were not appropriate in this case as Easy Park had a reasonable and objective reason to conclude that lease surrender payments were capital – even if this tax position was in conflict with BR Pub 09/06 and relevant case law. Ellis J acknowledged that public rulings are not necessarily binding on taxpayers. Further, the capital/revenue distinction is not always easy to discern, and had it not been for the 2013 amendment to the law treating all lease surrender payments as assessable income, there were certainly situations where such payments could arguably have been capital receipts and therefore not taxable. In the present case, it was conceivable that Easy Park could have, when viewed objectively, regarded the payment as capital. As such, a shortfall penalty in this situation was not deemed to be appropriate.

Therefore, in some cases (as was the case in *Easy Park*), even where the tax position taken is incorrect in the Court's eyes and is contrary to the Commissioner's published view, a shortfall penalty may not be imposed. Arriving at the correct tax position can be a challenge at times given that the law is not always black and white. There is always the possibility that Inland Revenue may review a tax position, decide that it is incorrect and charge penalties and use of money interest on the tax shortfall. It is comforting to know that the Court provides some leeway where there is a good objective reason for a taxpayer to reach a certain tax position (even if incorrect).

Taxpayers do in some circumstances decide to file a tax return conservatively, taking the position that they will pay tax that they may not consider is technically payable, and then issue a notice of proposed adjustment (NOPA) to the Commissioner to request a re-assessment (i.e. reversal) of the tax position taken. This is not a process that Easy Park followed in this instance, however Ellis J made some brief comments on the practice anyway. She commented that a taxpayer filing and then immediately issuing a NOPA once the Commissioner has issued an assessment can be construed as "artificial" and "arguably dishonest" given that a taxpayer is expected to sign a tax return on the grounds that they believe it to be "true and correct".

This is an interesting observation. A NOPA is simply a process whereby a taxpayer proposes that a tax position may not be as declared in their return. It seems plausible to take that position, while equally believing the return to be true and correct (i.e. there is a possibility it may not be, and so that is what is tested by the taxpayer commencing a dispute process by issuing a NOPA). There are very few ways in which a taxpayer can achieve certainty on a less than straightforward/clear-cut tax position without high cost or high risk. Obtaining a ruling before filing can be a lengthy and expensive process. A taxpayer filing on the basis that tax is payable is not obtaining the benefit of having the tax sitting in their bank account while they wait to see if they got it right, so it seems entirely appropriate that if, in the end, the taxpayer and the Commissioner don't agree, the Commissioner should have no ability to impose penalties or use of money interest: there has been no tax shortfall. Parliament has given taxpayers the option of a taxpayer initiated NOPA to address uncertainty – while Inland Revenue may not necessarily welcome the prospect of disputes commenced by taxpayers, it does not appear unreasonable as an option to resolve the uncertainty, particularly if Inland Revenue is not out-of-pocket in the meantime.

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Country-by-Country Reporting: What is your risk profile?

By Bart de Gouw and Jennie Yao

Next year will be the first time tax authorities around the world will receive information on large MNE groups (greater than €750m revenues) with operations in their country, breaking down a group's revenue, profits, tax and other attributes by tax jurisdiction via Country-by-Country (CbC) Reporting. This information has never before been available to tax authorities in a consistent format and represents new opportunities for tax authorities to analyse a MNE group's business in ways that have not been possible before.

On 29 September 2017 the OECD released *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment* which supports countries in the handling of CbC Reports and provides guidance to tax authorities to make effective and appropriate use of the information they contain for the purposes of tax risk assessment.

The Handbook shows that CbC Reports can be a very important tool for tax authorities to detect and identify transfer pricing risk and other BEPS-related risk, and can be used alongside other information that tax authorities holds as a basis for further enquiries.

In particular, Annex 2 of the Handbook contains a table of the tax risk indicators that may be detected from the information contained in a MNE group's CbC Report. Examples are:

- IP is separated from related activities within a group;
- Jurisdictions with significant activities but low levels of profits (or losses);
- Information in a group's CbC Report that does not correspond with information previously provided by a constituent entity.

We note that this is not a comprehensive list of tax risk indicators that can be derived from a MNE Group's CbC Report, but illustrates the range of risk areas that can be uncovered. For a number of the risk indicators, example ratios have been included to suggest how the level of risk may be assessed.

With nine months to go until the first CbC Reports are exchanged, if your business is subject to CbC Reporting, now is the time to assess the group's tax risk profile using the indicators in the Handbook and consider what anomalies and potential risk indicators tax authorities may identify.

A copy of the Handbook can be found here.

If you need advice in considering the tax risk indicators that may be detected, or you need assistance in compiling your CbC Report, contact your usual Deloitte advisor.

The Handbook shows that CbC Reports can be a very important tool for tax authorities to detect and identify transfer pricing risk and other BEPS-related risk, and can be used alongside other information that tax authorities holds as a basis for further enquiries

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A snapshot of recent developments

Who will be eligible to use the accounting income method (AIM) for calculating provisional tax?

Inland Revenue has published some practical information on how the AIM method will operate from 1 April 2018. This is an alternative method of calculating provisional tax payments during the year, for taxpayers using approved accounting software meeting certain requirements. To choose AIM, it will be necessary for Inland Revenue to confirm if a taxpayer is eligible.

Key points to note about who is eligible to use AIM are as follows.

- To use AIM, taxpayers must opt in at the beginning of the tax year before the first payment is due (new provisional taxpayers can opt in at any time before their first instalment would be due)

- Taxpayers cannot use AIM in a transitional year. Partnerships, portfolio investment entities, superannuation funds, trusts, Māori authorities or taxpayers that derive FIF or CFC attributed income are also not allowed to use AIM.

The webpage also includes information on how approved accounting software will work out a taxpayer's AIM payments. A future Tax Alert article covering more details on AIM will be published closer to 1 April 2018. Watch this space.

QB 17/08: Are proceeds from the sale of gold bullion income?

On 21 September 2017, Inland Revenue released a finalised QWBA on whether the proceeds from the sale of gold bullion are income. This item concludes that, in most cases, gold purchased in bullion form will be purchased for the dominant purpose of disposal, so the amount derived on its disposal will be income. However, there are situations where the Commissioner may accept that the taxpayer's dominant purpose in acquiring gold bullion was to retain it for reasons other than eventual disposal. In this case, the onus is on the taxpayer to satisfactorily show this is the case.

Use of a valid electronic signature on documents provided to the Commissioner

Inland Revenue has released a Standard providing finalised guidance on when the use of electronic signatures on documentation and information provided to the Commissioner is permissible. In sum, Inland Revenue will accept an electronic signature on all documents and information that currently require a conventional signature, where this option is specified in the relevant document or associated guidelines. Taxpayers may use an electronic signature if they are using Inland Revenue's online services or are using software that complies with the requirements set out in the Standard.

Special Determination S54: Application of financial arrangement rules to Investors in the Lifetime Income Fund

Inland Revenue has released Special Determination S54: Application of financial arrangements rules to Investors in the Lifetime Income Fund. This determination specifically relates to the application of the financial arrangements rules in relation to investors in a Lifetime Income Fund, which is a managed investment scheme in which investors can invest their retirement savings in return for a stream of regular payments for the rest of their life.

General Determination DEP101: Tax Depreciation Rate for abrasive blasting booths (including media recovery/ recycling, dust extraction and ventilation systems)

Inland Revenue has finalised a depreciation determination for abrasive blasting booths (including media recovery / recycling, dust extraction and ventilation systems). The new estimated useful life is 12.5 years and the depreciation rates are 16% DV and 10.5% SL.

Business Tax Update – September 2017

The September 2017 edition of *Business Tax Update* has been published. The item covers due date reminders for PAYE (employer monthly schedule IR 348 and employer deduction form IR 345) and GST and FBT return and payment due date reminders for the periods ending 31 August 2017 and 30 September 2017 respectively. Other topics in this item include back-paid holiday pay, Common Reporting Standard due diligence and reporting obligations, the taxing of schedular payments made to contractors and myGST system enhancements.

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