Purchase price allocation

An officials' issues paper

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Purchase price allocation – an officials' issues paper

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CHAPTER 1

Introduction

1.1 Most sales of a business are mixed supplies, meaning they involve a mixture of revenue account property (for example, trading stock), depreciable property (for example, plant or machinery) and capital account property (for example, goodwill).[1] Another common example of a mixed supply is a sale of commercial property, which involves depreciable fit-out as well as non-depreciable land and buildings.

1.2 This issues paper discusses policy proposals to address income tax problems relating to mixed supplies where:

- two or more types of property are supplied in a single transaction; and
- the tax treatment of those types of property is not the same, for one or both of the parties.

1.3 One tax issue that arises is how to allocate the agreed purchase price among the assets transferred in a mixed supply. This allocation usually has little or no commercial significance but can have a material impact on the parties' tax obligations. Accordingly, it is not appropriate for the parties to determine the allocation without reference to market values.

1.4 In most cases, the Income Tax Act 2007 already explicitly requires the amount allocated to taxable assets in a mixed supply to be determined on the basis of market values. However, with the exception of the rules for trading stock, these rules do not explicitly require the seller and buyer to adopt the same allocation, that is, there is no general consistency requirement.

1.5 In many mixed supply transactions, the parties agree on an allocation which is based on market values and follow it in their tax returns. This is best practice, and the proposals in this issues paper are intended to encourage it. However, the Commissioner of Inland Revenue is aware of other practices which are not desirable, but which are difficult to deal with under the current provisions.

1.6 Buyers and sellers in some transactions are adopting different allocations for tax purposes, almost always to the detriment of the Government's revenue base. Sometimes these differences are based on different views of market values, where the parties have not agreed on an allocation.[2] Sometimes, one party files its tax return on the basis of an allocation explicitly agreed between the parties, while the other files on a different basis because the agreed allocation does not in its view represent market value.

1.7 In some cases, the parties agree to and both adopt an allocation which in the Commissioner's view is not based on market value. The parties may then take the

[1] Revenue account property is an asset that when sold would result in a taxable gain or deductible loss. Conversely, capital account property is an asset that when sold would result in a non-taxable, non-deductible capital gain or loss. Depreciable property is an asset whose market value is expected to decline in value over its economic life.

[2] In most cases the market value of an asset cannot be precisely determined, may be subject to debate between valuation experts, and falls within a range.

position that the Commissioner has no power to challenge the allocation, because it has been agreed between arm's length parties, or because there is no explicit market value rule for a buyer of depreciable property.

1.8 Officials consider that:

- in all cases allocations should be based on relative market values,[3] and the Commissioner must have the power to adjust an allocation (whether or not agreed) that is not so based. Officials believe that this is already the law, but for a purchaser of depreciable property, it could usefully be clarified;

- in a transaction which is a mixed supply for both parties, the parties should adopt the same allocation when filing their tax returns, and the Commissioner should be able to easily determine whether or not they have done so.

1.9 This issues paper:

- explains in more detail why the allocation of the price in a mixed supply is important for tax purposes;

- summarises the current law;

- explains the issues arising in practice under the current law; and

- proposes some solutions to those issues.

1.10 Feedback on the proposed solutions is invited, including any modifications to the proposals or solutions which may be preferable.

Summary of proposals

1.11 To increase taxpayer certainty, prevent vendors and purchasers from engaging in allocation practices that reduce tax revenue, and to minimise administrative costs, officials suggest the following rules for transactions where both vendor and purchaser treat the transaction as a mixed supply:

- that in all cases the vendor and purchaser be required to use the same allocation of the total purchase price to the different types of property;

- that this be achieved by a hierarchy of rules – if the parties:

  - agree on an allocation, both must file their returns using that allocation;

  - do not agree on an allocation, then:

    - the purchaser must use the vendor's allocation when filing its tax return. In this case, there would be a requirement for the vendor to disclose their allocation to the purchaser and the Commissioner within a specified period, for example, within three months of

[3] The amounts allocated still have to add up to the global purchase price, but the proportion of that purchase price allocated to a specific asset should be its market value relative to the total market value of all the assets being purchased.

when the assets are treated for tax purposes as disposed of by the vendor;

  - if the vendor fails to provide an allocation, the purchaser may make the allocation, in which case that allocation would be provided to the vendor and the Commissioner and would be required to be adopted by the vendor;

- that allocations must be based on relative market values, except possibly in the case of a non-agreed allocation to depreciable property, where depreciated cost or possibly original cost could be adopted instead;

- it may be appropriate to have a de minimis for these suggested changes.

1.12 It is expected that any amendments arising from these proposals will be included in a tax bill to be introduced in the first half of 2020.

How to make a submission

1.13 Submissions are invited on the proposals in this discussion document.

1.14 The closing date for submissions is **14 February 2020**.

1.15 Submissions can be made:

- by email to policy.webmaster@ird.govt.nz with "Purchase price allocation" in the subject line; or

- by post to:

  Purchase price allocation
  C/- Deputy Commissioner, Policy and Strategy
  Inland Revenue Department
  PO Box 2198
  Wellington 6140

1.16 Submissions should include a brief summary of the major points and recommendations. They should also indicate whether it is acceptable for officials from Inland Revenue to contact submitters to discuss the points raised, if required.

1.17 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission should clearly indicate if they consider any part of their submission should be withheld under the Act.

CHAPTER 2

Issues with mixed supplies and allocation of purchase price

2.1 The most common types of mixed supplies appear to be sales of land and buildings (both commercial and residential) and sales of businesses. A less common example is a sale of forestry land, where the bare land may be on capital account, but the timber is always on revenue account. Essentially, any time a person sells or buys, in a single transaction, two or more items with different tax treatments, there is a need for an allocation of the consideration between those items.

2.2 Although this allocation is required for income tax and often accounting purposes, it generally has no, or little, other commercial significance. It does not affect the amount payable, nor does it affect the manner or timing of the payment. It is therefore possible for the parties to agree it in their transaction documents, or to be silent about it.

2.3 The example illustrates the significance of the tax allocation.

Example

Suppose A Co has agreed to sell its business to B Co. The assets include land and buildings (all acquired after May 2010), fit-out and other depreciable property, receivables and trading stock. The purchase price for all of the assets on a going concern basis is $15 million. Assume for simplicity no liabilities are to be assumed by B Co so the consideration provided is limited to the cash price.

A Co is entitled to a deduction for the depreciated cost of its fit-out and other depreciable property, and the cost of its receivables and its trading stock. It will only be taxable on the portion of the sale price attributable to these items (in the case of depreciable property, up to the original cost of the property), and not the portion attributable to the land and buildings, or goodwill. Accordingly, the amount retained by A Co after tax will be twenty eight percent higher to the extent it is allocated to the land and buildings or goodwill than if it is allocated to the other items.

Suppose A Co believes that an appropriate allocation of the price is as set out in the following table. This table also shows the tax effect of the allocation for A Co.

	Allocation ($000)	A Co Cost* ($000)	A Co Profit ($000)	A Co Tax ($000)
Land and buildings	3,000	2,000	1,000	0
Depreciable property	6,000	6,000	0	0
Receivables	1,000	1,200	(200)	56
Trading stock	1,500	1,400	100	(28)
Goodwill	3,500	0	3,500	0
Total	**15,000**	**10,600**	**4,400**	**28**

* or tax book value, where relevant

B Co's position is generally the opposite of A Co's. The tax outcome of the transaction is less favourable for B Co as the amount allocated to the land and buildings and goodwill increases, because B Co can claim no deduction for those items. In other respects, their interests are not opposed. For example, B Co will be better off allocating the price to fast-moving trading stock than to depreciable assets, since the deduction for trading stock will be able to be claimed sooner than the deduction for the cost of depreciable assets. That allocation will therefore maximise the present value of its tax deduction. From A Co's perspective, the allocation between trading stock and depreciable property is generally irrelevant, since it will be taxable either way (unless the amount allocated to depreciable property exceeds its original cost).

Suppose then that B Co believes a greater amount should be allocated to depreciable property and receivables, and less to goodwill. If this allocation was required for A Co, the tax payable for A Co would be:

	Allocation ($000)	A Co Cost ($000)	A Co Profit ($000)	A Co Tax ($000)
Land and buildings	3,000	2,000	1,000	0
Depreciable property	9,000	6,000	3,000	(840)
Receivables	1,200	1,200	0	0
Trading stock	1,500	1,400	100	(28)
Goodwill	300	0	300	0
Total	**15,000**	**10,600**	**4,400**	**(868)**

This allocation would decrease A Co's after-tax return from the transaction by $896,000. It would increase B Co's after-tax return from the transaction by the present value of the additional deduction for depreciable property and trading stock. This will be less than $896,000, by reason of the time value of money reducing the value of the depreciation deductions.

Generalising from the example

2.4 Vendors are better off after tax if the global consideration in a mixed supply is allocated so that it is not taxable. This will generally mean allocating it to capital assets or goodwill, rather than to revenue account assets such as inventory, timber, patents or consumables. Of course, if all of the vendor's assets are on capital account, or they are all on revenue account, or if the vendor is tax exempt, there is no tax advantage to the vendor from the allocation.

2.5 Purchasers benefit if the consideration is allocated so that it is deductible as soon as possible. This will generally mean allocating it:

- first to revenue account assets such as trading stock which will be sold within a short period or to depreciable assets with a short depreciable life;
- then to revenue account assets which may be sold after a longer period or depreciable assets with a longer depreciable life;
- away from non-deductible items like land, buildings and goodwill.

2.6 It is generally assumed that the natural commercial tension between the parties ensures that in an arm's length sale, an agreed allocation, that must be followed for tax purposes, will reflect market values. The tax status of depreciable property means that this will not always be the case.

The special case of depreciable property

2.7 Depreciable property raises an additional issue. Consider the vendor's position first.

2.8 To the extent that the allocation does not exceed the cost price of the asset to the vendor, the vendor should view an allocation to a depreciable asset in the same category as an allocation to a revenue account asset, such as timber or trading stock. On sale, the vendor will be taxable on the amount allocated to the asset up to the amount of the original cost (with a deduction for any remaining undepreciated cost).

2.9 Any excess of the amount allocated over that original cost is not taxable to the vendor.[4] Accordingly, allocation to depreciable property in excess of the vendor's original cost has the same effect for the vendor as an allocation to land held on capital account or goodwill.

2.10 The purchaser's position is not bifurcated in this way. Provided the purchaser is not associated with the vendor, it will be entitled to a deduction over time for the whole of the consideration, including the amount that is not taxable to the vendor because it exceeds the vendor's original cost.

2.11 Accordingly, an allocation to a depreciable asset of an amount in excess of its original cost to the vendor gives a tax deduction to the purchaser at no cost to the vendor (to the extent of the excess above cost). It may be beneficial, for example, in the sale of land, buildings and fit-out, for the parties to allocate to the fit-out an amount more than the cost of the fit-out to the vendor, since that amount would be deductible to the purchaser and not taxable to the vendor.

2.12 In the example considered above, suppose that the original cost of the depreciable assets to the vendor was $8 million. If the vendor agrees to accept the purchaser's allocation of $9 million to that property, rather than insisting on its own $6 million valuation, the effect will be to:

- increase the vendor's income from sale by $2 million; and
- increase the purchaser's deductions by $3 million.

2.13 It is therefore likely that the $9 million allocation will result in less tax being paid overall than the $6 million allocation, though the benefit will accrue entirely to the purchaser and the cost will be incurred entirely by the vendor. It is possible that the vendor might be more willing to adopt the purchaser's allocation if the purchaser is prepared to share some of the benefit of the allocation in the form of an increased purchase price.

2.14 The possibility of depreciable property having a value greater than cost has increased considerably since fixed life intangible property and software became depreciable. Such property is often self-created, which tends to produce a very low cost-base due to a failure to accurately capitalise expenditure. However, it can have a very high value. The asymmetry between the vendor's treatment (on capital account, to the extent it exceeds cost) and the purchaser's (depreciable, sometimes over a relatively short period) means that the parties may have a common interest in overstating the amount allocated to such property.

2.15 There may also be other situations when the vendor is agreeable to accepting an allocation that is tax favourable for the purchaser because there are no implications for them, such as when the vendor is exempt from income tax.

[4] There is an exception for patents, where the whole amount payable is taxable to the vendor – see the Income Tax Act 2007 section CB 30.

Inconsistent allocations

2.16 The discussion to date assumes that only one allocation applies, to both the parties. However, if each party can adopt its own allocation, there is no tension. In the example, the vendor can treat itself as having sold depreciable property for $6 million, while the purchaser treats itself as having acquired the same property for $8 million. This is good for the vendor and purchaser, but not so good for the rest of the community, since the effect of the inconsistent allocations is that the sale of the property reduces total taxable income by $2 million over time.

Concluding remarks on the significance of allocation for tax

2.17 The discussion so far has made the point that while an allocation of the global consideration is of little or no commercial significance in most sales of business assets, the allocation adopted by a party in its tax return will often have tax consequences. Chapter 3 considers the law governing how an allocation should be made.

CHAPTER 3

Current law

3.1 Chapter 2 considered the commercial and tax significance of purchase price allocations. This chapter considers the legal constraints on allocations for tax purposes and the degree to which there is a requirement for consistent allocations.

Statute

3.2 Several provisions in the Income Tax Act 2007 require the amount allocated to taxable assets, by either or both of the vendor and purchaser, to be determined on the basis of market values.

Trading stock (broadly defined)

3.3 Section EB 24 applies to a person who sells trading stock along with other assets. It requires the amount apportioned to trading stock to reflect the respective market values of the trading stock and the other assets. It also treats the purchaser as adopting the allocation of the vendor. This ensures consistency in the allocation.

3.4 Trading stock for this purpose is broadly defined. It includes livestock, timber, anything acquired for the purpose of disposal, and land the sale of which is subject to tax. It does not include depreciable property or financial arrangements. With those exceptions, it seems to cover most if not all property the sale of which is subject to tax.

Depreciable property

3.5 Subsection EE 45(10) provides that an amount a person derives from the disposal of a depreciable item when that disposal occurs along with a disposal of other items (for example, in a sale of a business or a commercial property) is its market value. This requirement only applies to the vendor. Purchasers are entitled to claim depreciation for the cost of depreciable property, with no explicit statutory rule applying in the case of a mixed supply.

Financial arrangements

3.6 Sections EW 38 and EW 42 in the financial arrangements rules state that all disposals of financial arrangements for inadequate consideration are deemed to be for market value for the vendor and purchaser respectively. Therefore, neither party can allocate less than market value to financial arrangements in their tax returns. There is no explicit constraint on them allocating a greater amount, and no requirement for their allocation to be the same.

Case law

3.7 As a general proposition, taxpayers bear the onus of proof in relation to an allocation of the price in a mixed supply. There are a number of New Zealand cases dealing with such allocations:

- *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271. This case involved a single payment for the dual purpose of obtaining the employee's resignation and for a restrictive covenant. The question for the Court was whether the expenditure should properly be treated as deductible or on capital account. The case established a number of relevant apportionment principles:

  - The onus is on the taxpayer to justify an apportionment if challenged by the Commissioner.

  - Such a justification is likely to require some reference to market value.

  - The apportionment should be objective. Absolute precision/scientific process is not required, but there has to be sufficient evidence to justify a conclusion that a particular part is actually attributable to a particular item.

  - It is not a question of what a reasonable and prudent taxpayer would have expended; it is what this particular taxpayer in fact paid. This implies that under the current law the taxpayer is not free to adopt whatever value they please, even if there is no specific statutory requirement to use market values in the circumstances.

- *Rusk v CIR* (1986) 8 NZTC 5,128. This case involved a challenge by a taxpayer to the Commissioner's allocation of value to timber in a sale of forestry land by the taxpayer where the allocation of the price between land and timber was not agreed between the parties. The taxpayer was successful in arguing that the Commissioner's allocation gave too high a value to the timber, though the amount substituted by the Court appears to have been higher than that argued for by the taxpayer. It seems likely from the case that the value adopted by the purchaser was different from that approved by the Court.

- *Edge v CIR* [1958] NZLR 42. This case involved a mortgagee sale to the taxpayer of a farm as a going concern, with no agreed allocation of the purchase price. Included in the assets sold was livestock which had been valued a week before the sale at £6,471. The taxpayer sought to treat this amount as the purchase price of the stock. The Commissioner successfully challenged this, on the basis that the sale was at a discount, and the discount needed to be applied to the trading stock, just as it applied to the land and plant. Accordingly, the purchaser was only allowed a deduction for trading stock of £4,711.

- *Hansen v CIR* [1973] 1 NZLR 483. This case involved a sale of a farm as a going concern, where the parties had agreed an allocation of £27,750 to livestock. The purchaser nevertheless obtained a valuation of the livestock which showed a value of £82,645. The vendor returned £27,750 as income from sale of the livestock, but the Commissioner challenged this figure (under a predecessor to current section EB 24) on the basis that it was not market value. The Privy Council upheld the Commissioner's assessment that the vendor should be taxed on £82,645.

3.8 The *Hansen* case is particularly useful in demonstrating that in determining the sale value of the items sold in a mixed supply for tax purposes, an agreed allocation of a global price between arm's length parties is not accorded the same respect as a series of individual and independent sales of the same items.

Summary

3.9 There are statutory provisions for the allocation of the price in a mixed supply to trading stock, depreciable property and financial arrangements, requiring market values to be used by at least the vendor, and some requiring consistency between the vendor and purchaser. However, there is no consistency of rules across the asset categories.

3.10 Several principles have emerged from case law that highlight the important considerations in determining the validity of an allocation in relation to trading stock.

3.11 Although these principles are helpful, the lack of consistency in the statutory language has given rise to some problems in practice, as discussed in the next chapter. Officials therefore consider that the existing provisions alone cannot be relied on to achieve the desired policy outcomes.

Feedback

Officials seek feedback on:

- Whether this chapter correctly summarises the relevant law and practice.
- Are there relevant legal or practical considerations our summary has omitted?

CHAPTER 4

Issues arising in practice

4.1 In many mixed supplies the vendor and purchaser agree an allocation to depreciable property, financial arrangements and trading stock using relative market values and, follow it in their respective tax returns. Discussions with advisors suggest that this is best practice. Officials expect that it will become more common if the proposals in this paper are enacted.

4.2 However, there is also no doubt that this practice is far from universal. The parties may prefer not to agree an allocation, on the basis that this gives them freedom to make their own assessments of value, and scrutiny from the Commissioner is unlikely to occur or, if it does occur, to result in any adjustment even where there is inconsistency.

Inconsistent valuations

4.3 In some cases, for example, vendors treat depreciable fit-out as sold for its depreciated value, whereas purchasers treat it as acquired for a much higher value. In others the lower vendor valuation of depreciable property may result from the parties employing separate valuers. The difference in valuation of the fit-out is compensated for by the parties taking correspondingly different views on values for the land or building, which generally has no impact on tax.

4.4 In other instances, the Commissioner is aware of a purchaser in a mixed supply agreeing to an allocation, but then taking the view that the allocation should not be followed for tax purposes because it was much lower than indicated by relative market values the purchaser could point to (similar to the purchaser in the *Hansen* decision referred to above). Unless the purchaser seeks the Commissioner's guidance, this kind of behaviour is difficult for the Commissioner to detect, and almost certain again to lead to a loss of revenue, since the vendor will be relying on the agreed allocation. Resolving the inconsistency may be impossible if the vendor is liquidated after the sale takes place.

4.5 Where the vendor and purchaser adopt different allocations based on separate valuation advice it can be difficult for the Commissioner to resolve the difference, particularly given that outside of trading stock, there is no requirement for consistency of allocation. Even though the vendor's and purchaser's use of different valuations will almost always be to the detriment of the Revenue, it may be difficult for the Commissioner to determine which valuation to challenge or decide whether to challenge both. This is particularly true where the property is not frequently traded. For example, the *Hansen* and *Edge* decisions, where the Commissioner was successful in challenging an allocation to trading stock, both involved livestock for which reliable values were available. In *Rusk*, where the property at issue was timber, issues relating to the unique and non-fungible nature of standing timber and land were more significant, and the result of the case appears to have been a decision that meant the taxpayer vendor was treated as selling for a lower value than that adopted by the purchaser as the cost price of the trees.

4.6 Valuation is a matter of judgement, and in many mixed supplies, there will be a range of values for taxable property which can reasonably be said to be based on relative market values. So long as the parties each choose within this range, it may be difficult or impossible for the Commissioner to eliminate any gap and thus there is revenue leakage. The closer two valuations are to each other, the less inclined the Commissioner will be to expend resources on pursuing a challenge, and this will be especially true if two separate disputes are required.

Consistent valuations not within a market range

4.7 Generally, where two non-associated parties agree to an allocation and have opposing interests in the amounts allocated to different assets, the Commissioner will accept this is the product of natural tensions and represents market value. However, there have been instances when the Commissioner has not accepted that an agreed allocation is in line with market value. The *Hansen* decision makes it clear that when the property is trading stock, the Commissioner has power to challenge an agreed allocation on the basis it does not reflect market values. No law change seems to be required in this respect.

No explicit market value requirement for a purchaser of depreciable property

4.8 The argument is sometimes made that a purchaser of depreciable property in a mixed supply is not subject to a requirement to treat themselves as having acquired that property for an amount based on relative market values at all. This is on the basis that while section EE 45(10) explicitly requires the vendor to treat depreciable property disposed of with other assets as sold for its market value, there is no such provision applying to the purchaser. Using this argument, a purchaser might argue that it could rely on an inappropriately high allocation, based on agreement with the vendor.

Place of anti-avoidance rules

4.9 From a policy perspective, anti-avoidance provisions should not be relied on to address the issue. Such rules are a backstop to clear black-letter law. Amending the law creates more certainty than relying on anti-avoidance provisions as specific cases of avoidance need to be identified and the outcomes are subject to litigation uncertainty. Moreover, an anti-avoidance provision cannot be generally used to require parties to use the same allocations when the law does not require consistency other than in specific situations.

Feedback

Officials seek feedback on:

- The issues arising in practice set out in this chapter – in particular, whether there are aspects or issues that have not been taken into account.
- Whether there are any additional issues arising in practice with respect to purchase price allocations in mixed supplies.

CHAPTER 5

The proposed solutions

5.1 This chapter sets out the proposed solutions.

Policy framework

5.2 Officials' policy framework is that in all cases:

- allocations should be based on relative market values, and the Commissioner should have the power to adjust an allocation that is not so based; and

- the parties to a mixed supply should adopt the same allocation in their returns, and the Commissioner should be able to readily determine whether or not they have done so.

5.3 This framework is designed to both protect the revenue base and to be fair on the parties to the transaction. As noted in the previous chapters, these outcomes will not necessarily arise in the absence of specific legislative requirements.

Outline of proposals

5.4 Officials do not see any need to change the existing substantive rule for trading stock. This rule requires consistency between the vendor and purchaser and allows the vendor to determine the allocation. Obviously, the transaction documents can specify an agreed allocation. This rule covers all assets held on revenue account other than depreciable property and financial arrangements.

5.5 However, discussions with advisors suggest that it may well be necessary to provide some encouragement to purchasers to comply with the existing law in this respect. Many advisors seem unaware of the existence of section EB 24, and current practice in many cases appears to be that purchasers adopt their own allocations of a global price to trading stock with no regard to those adopted by the vendor.

5.6 To increase taxpayer certainty, prevent vendors and purchasers from engaging in allocation practices that adversely impact tax revenue, and minimise administrative costs, we propose to:

- extend this consistency requirement to depreciable property and financial arrangements;

- provide that purchasers are not entitled to claim any deduction for items acquired in a mixed supply unless they have either followed an agreed allocation or requested the vendor's allocation. If the vendor has not provided its allocation on a timely basis, then the purchaser may use its allocation, which must also be provided to and adopted by the vendor.

5.7 Prima facie, the vendor would use relative market values to determine the allocation to depreciable property and financial arrangements as with the trading stock rules.

Possible alternatives for depreciable property are to use the vendor's depreciated cost or original cost.

5.8 In all cases, the allocation should be able to be challenged by the Commissioner on the basis that it does not reflect relative market values. There is no need for a challenge by a taxpayer, since taxpayers can decline to enter into an agreement unless and until they are prepared to accept the outcome of the application of the proposed allocation rules to their transaction.

5.9 In the remainder of this chapter, we provide more detail about this proposal and how it might work. We also seek feedback on whether there is a better way to achieve consistency.

Agreed allocation

5.10 Agreed allocations are commonly adopted in asset sale agreements. The allocation may be specified in the agreement, either in specific figures or by way of a formula. Alternatively, the agreement may contain some mechanism for an allocation to be determined (for example, the use of a particular valuer, or some form of arbitration), either before or after the transaction has been agreed to or settled. Whatever mechanism is chosen, if parties agree on an allocation, we propose that the legislation specifically provide that they must follow that allocation in filing their tax returns. This will ensure consistent filing positions.

No agreed allocation

5.11 If there is no agreed allocation, the Income Tax Act 2007 already provides that the allocation to trading stock and depreciable property must be determined by the vendor on the basis of relative market values, and in the case of trading stock that it must be adopted by the purchaser.

5.12 We propose that this law be amended in a number of respects, in order to ensure that the consistency clearly envisaged in relation to trading stock is actually achieved, in relation to all of the taxable assets sold.

Allocation to depreciable property

5.13 For depreciable property, if there is no agreement as to market value, the treatment of trading stock suggests that the vendor should determine the market value, which the purchaser would be required to follow. However, it may be that the degree of uncertainty as to the market value of depreciable property is greater than it is with most forms of trading stock, and that as a result, leaving the valuation to the determination of the vendor is less acceptable.

5.14 In a situation where the parties are in fact negotiating the allocation, this concern does not seem to stand scrutiny. At the end of the day the allocation is about the post-tax value of the transaction, and any disagreement can be dealt with by an adjustment to price (for example, if the purchaser is concerned that the value allocated to trading stock or depreciable property is too low, it may reduce the price it is prepared to pay). However, in a situation where the parties have agreed the transaction without negotiating the allocation (which is likely to be less common

than it is now if there is an explicit consistency requirement), it is more likely that giving the allocation power to the vendor would put the vendor in a much better tax position than the purchaser.

5.15 If this is a concern, a possible alternative for depreciable property where the allocation is not agreed would be to treat it as sold for either its cost to the vendor, or its depreciated value to the vendor.

5.16 Treating the property as sold for original cost would give rise to full depreciation recapture income to the vendor, and depreciation for the purchaser based on the original cost of the depreciable property. It would thus be relatively vendor unfriendly but would ensure that there is no revenue loss from the transaction.

5.17 Treating the property as sold for its depreciated value would give rise to no depreciation recapture adjustment for the vendor. The transaction would have little or no effect on the depreciation claimed on the transacted assets – that is, the amount of depreciation claimed by the purchaser would be the same or similar to the amount the vendor would have claimed if the transaction had not occurred. This is a similar approach to that taken to a sale of depreciable assets between associated parties (section EE 40). The depreciated value would in most cases be a more accurate measure of the value of the assets than original cost, so might be seen as striking a more appropriate balance between the parties, particularly where they did not turn their minds to the allocation before agreeing on the transaction.

5.18 It is not intended that these three alternatives (vendor determination subject to a market value requirement, original cost or depreciated cost) should be optional in any way. Because they are intended to apply if the parties cannot agree, it would not be sensible for some choice to be able to be made between them. We propose that if the parties do not agree an allocation, there would be only one method for allocating the consideration to depreciable property.

5.19 Whichever method is chosen, the Commissioner would retain the ability to challenge a valuation on the basis that it does not reflect relative market values. The purpose of having a single method is to ensure consistent reporting positions, not to provide a safe harbour.

Allocation to financial arrangements

5.20 For financial arrangements, the value is likely to be within a relatively narrow range. It may therefore be appropriate to adopt the same approach as is taken for trading stock, that is, relative market value as determined by the vendor. It would not be appropriate to treat financial arrangements as sold for the amount outstanding, as this would not take into account the risk of default by the debtor.

Valuer appointed by Commissioner?

5.21 Some submitters suggested that the problem of vendor bias in transactions with no agreed allocation could be addressed by having the Commissioner appoint a valuer to determine the allocation. The cost of this would need to be borne by the parties.

5.22 Issues with this suggestion include:

- the potential difficulty in finding a qualified valuer prepared to provide a valuation. For some assets there is not a wide choice of valuers, and many may see a commercial conflict in acting in such cases;

- the risk of judicial review or other forms of litigation by a dissatisfied party;

- the need to create a legislative and administrative framework to deal with such a process; and

- the cost involved, in cases which may not merit a valuation.

5.23 Official's judgement is that in cases where the issue is sufficiently material for a valuation by the Commissioner to be justified, it is likely that the parties will have agreed their allocation.

Ensuring consistent allocations

5.24 As discussed above, a simple legislative requirement for consistent allocations does not seem to have been entirely effective in the case of trading stock. In order to ensure consistent allocations are actually adopted where there is no agreement between the parties, we propose the following process.

5.25 First, there should be a legislative requirement on the vendor to provide its allocation to the purchaser, with a copy to Inland Revenue. This allocation should have to be provided within a specified period, for example, within three months of the time when the assets are treated for tax purposes as disposed of by the vendor. This will give the vendor time to complete the allocation, and also give the purchaser time to use the allocation to complete its tax return for the year of the transaction.

5.26 It is necessary to make some provision for what happens if no allocation is provided. In that case, we suggest that the purchaser should first be required to request an allocation from the vendor. If no allocation is provided within a defined period from when the request is made, for example, one month, the purchaser would be entitled to make its own allocation on the basis of relative market values, and to provide that allocation to the vendor with a copy to the Commissioner. The purchaser and the vendor would then both be required to use that allocation. The purchaser would not be entitled to a deduction for any element of the purchase price unless and until it first requested an allocation from the vendor, and then (if no vendor allocation was provided) provided its allocation to the vendor and the Commissioner.

Contest rights

Contest by the Commissioner

5.27 If the Commissioner believes that an allocation does not reflect market values, the Commissioner may decide to issue a NOPA to whichever of the parties has an increased tax obligation as a result of the NOPA. No change is proposed with respect to this process. Suppose that the NOPA is issued to the vendor. If the result of the dispute were an increase in the amount allocated to depreciable property,

trading stock or financial instruments, the purchaser should be entitled to request an amended return reflecting that increased amount. Similarly, if the dispute were with the purchaser, the vendor would be entitled to request an amended assessment reflecting the benefit of any decrease in the amount allocated to taxable items. This should all be possible under existing law.

Contest by a party

5.28 There will be no need for contest rights if the parties have agreed to an allocation. Where there is no agreement, and the vendor makes the allocation, it is possible that the purchaser may believe that the allocation does not reflect market value. The question that arises is whether it is necessary to provide the purchaser with any right to contest that value, if the Commissioner does not wish to do so.

5.29 There is a strong argument that no such right is needed or appropriate. If the purchaser was concerned about the allocation, it would have ensured that it was agreed. By failing to require agreement, the purchaser has accepted that the vendor is entitled to make the allocation.

5.30 If some contest right is appropriate, there does not seem to be any need for it to involve the Commissioner. The Commissioner is, in this scenario, content to accept the vendor's allocation. However, she is not well placed to defend that allocation in a dispute process and will often be largely indifferent as to whether the purchaser's or the vendor's allocation is adopted, so long as one allocation only is adopted by both parties. Accordingly, officials propose that the parties to a mixed supply would not have the right to issue a NOPA challenging the allocation which is required to be adopted in their returns.

5.31 However, it may be appropriate for the legislation to provide for an implied term, which would give the non-allocating party a contractual right against the allocating party. For example, the allocating party could be under a duty to act reasonably in making its allocation. That would give the other party a right to claim damages against the allocating party for any additional tax payable by it as a result of an unreasonable allocation.

5.32 There is precedent for such an implied term in section LP 6 of the Income Tax Act 2007. When a company or unit trust pays a supplementary dividend, it is making a non-pro rata payment as between its foreign and its resident shareholders (or unitholders). Ordinarily, this might be a breach of company law, the terms of the shares or the terms of the trust. Section LP 6 approves the payment regardless of these obstacles, unless in the case of a company the constitution specifically over-rides the section.

5.33 In this case, the legislation would effectively give a non-allocating party who wished to dispute an allocation the right to do so directly with the allocating party, rather than with the Commissioner. The outcome if the non-allocating party is successful would not be a change to the tax positions, but a payment for damages.

5.34 If such a term were implied, thought would need to be given as to whether or not it could be over-ridden by agreement. If the objective of implying such a term is to give purchasers (in the usual case of a vendor allocation) some protection from unreasonable vendors, allowing an over-ride would allow that objective to be

defeated by vendors who insist on an over-ride. However, not allowing an over-ride would interfere more significantly with parties' freedom of contract.

De minimis

5.35 A concern that has been raised with requiring the purchaser to follow the vendor's allocation is that some purchasers may not be aware of this requirement at the time they enter into a transaction and assume instead that they will be able to determine the allocation themselves. This might be a concern if the purchaser paid more for the relevant assets than it would have were it aware of the consistency requirement. Ignorance of the proposed statutory consistency requirement would be more likely in lower value transactions.

5.36 On one view, whether or not the purchaser is aware of the rule is unimportant. The loss of tax revenue created by inconsistent allocations is the key issue. While low value transactions may give rise to a lower loss of revenue, there will be more of them. The vendor will need to make an allocation in any case, and there should be little additional cost in providing it to the purchaser. The current rule requiring the purchaser to follow the vendor's allocation in relation to trading stock does not have a de minimis.

5.37 Officials are of the view that it is unlikely that a purchaser sophisticated enough to factor the tax effect of an allocation into its determination of the purchase price would be unaware of a consistency requirement if one were introduced. Potentially relatively low value sale transactions are already subject to numerous special tax related requirements which vendors and purchasers are required to be aware of, such as:

- for residential property, the requirement on the vendor's agent to pay residential land withholding tax if the vendor is a non-resident and the land is not a main home (subpart RL of the Income Tax Act 2007); and
- for commercial property, the compulsory land zero rating rule in section 11(1)(mb) of the Goods and Services Tax Act 1985.

5.38 However, if there is a view that purchasers in low value transactions should be protected from an unexpected consistency requirement, the most obvious response is to adopt a de minimis. For example, mixed supplies where the total amount allocated by the purchaser to deductible or depreciable items is less than $50,000 could be excluded from the consistency requirement. This would not affect the obligation to allocate using relative market values.

Feedback

Officials seek feedback on any aspect of these proposals, but in particular on whether:

- a vendor should use relative market value, original cost or depreciated cost in making an allocation to depreciable property;
- there is a better way to achieve consistent allocations than that proposed, or what improvements could be made to the proposal;
- the proposal for an implied term giving a non-allocating party the right to contest an allocation is useful, and whether or not it should be able to be explicitly negated;
- a de minimis would be useful, on what basis, and at what level.

CHAPTER 6

Issues to consider

6.1 This chapter discusses a number of issues to consider alongside this proposal:

- The effect of the proposal on commercial behaviour.
- How the allocation should work in the case of a sale for a bargain price.
- How the allocation would work in the case of sales by way of auction or tender.
- The degree of consistency that should be required.
- Denial of a deduction for purchasers with no valid allocation.

Effect of the proposal on commercial behaviour

6.2 An issue raised by the proposal is whether it places an unacceptable amount of discretion in the hands of a vendor. A vendor might, for example, allocate an unduly high amount to land and goodwill, and unduly low amounts to trading stock and depreciable property (though as suggested above, it would be possible to require use of depreciated cost for depreciable property).

6.3 The obvious response is that purchasers who are concerned about this possibility can insist on an agreed allocation. An objection that may be made to this response is that it makes the allocation a point of potential disagreement, and that it is not appropriate for a requirement that exists purely for income tax purposes to potentially impede commercial transactions. In a competitive process, purchasers may not want to raise the allocation issue, for fear that it will make their bid less competitive.

6.4 Officials do not believe that this concern stands up to scrutiny. It is true that as compared to the current position, the proposal will make it much more likely that the parties to a mixed supply will want to discuss the allocation, though this will depend on the materiality of the issue. However, any disagreement as to the allocation can easily be dealt with by an adjustment to the price. Suppose for example that a potential purchaser takes the view that a vendor's allocation to depreciable property is too low. If the purchaser insists that the allocation be increased, the vendor can do so at no after-tax cost, by simply increasing its asking price, assuming that the allocation was material to the determination of that price.

6.5 The real problem is that under the current system where consistency is not required, the allocation issue is not dealt with. This allows the parties to a mixed supply to take inconsistent positions, to the benefit of themselves but the detriment of taxpayers as a whole. Requiring consistency will remove the tax subsidy that parties adopting inconsistent allocations currently enjoy. In marginal cases, this may mean that a transaction does not go ahead, because the seller and buyer cannot agree on a price in the absence of this tax subsidy. For example, a purchaser may be prepared to pay a certain price for a commercial building on the basis that it will be able to

claim depreciation based on a figure for fit-out which is 50% higher than the amount that will be returned by the vendor. If there is a requirement for consistency, the purchaser may reduce the price it is willing to pay, and the vendor may not accept that price. That does not seem an inappropriate outcome. The parties should not be able to use the tax system as a way to bridge the gap between the lowest price the vendor will accept and the highest price the buyer will pay.

Sales for a bargain price

6.6 It has sometimes been suggested that adopting an allocation based on relative market values is not appropriate in a situation where there is a fire sale. It is possible for goods to be sold between arm's length parties at a price that is below a normal market price.

6.7 Officials recognise that a straitened seller may agree to a price below arm's length. However, they do not agree that a test based on relative market values fails to recognise this possibility. For example, suppose a business is sold in fire sale circumstances for $400,000, where a more orderly sale of the individual components would have yielded $500,000. In that case, depending on the facts it may make sense for the relative market values to be determined by applying a twenty percent discount to all of the values taken into account in arriving at the $500,000 figure. Alternatively, there may be some items that are more liquid, and for which a lower or no discount is appropriate, with a higher discount on others.

6.8 *Edge* is a good example of such a case, where there was no difficulty in discounting the value of the trading stock to recognise the fact that it was sold in a mortgagee sale.

Auctions and tenders

6.9 Not all mixed supplies are a result of a negotiation process. For example, commercial property may be sold by way of auction or tender. It is important that any proposal can be integrated into these common methods of sale. Officials do not anticipate that this will present any significant difficulty.

6.10 Under current law, purchasers of a commercial property at auction or tender will usually not know, at the time they make a bid, precisely what the allocation to fit-out will be, as they will not have had the opportunity to undertake a sufficiently detailed inspection of the property. This lack of knowledge does not prevent transactions taking place – uncertainty as to the allocation to fit-out is just one of many uncertainties that any purchaser of property inevitably faces. There is no reason to think that if the allocation is determined by the vendor in accordance with relative market values, or in accordance with the vendor's depreciated cost, that the purchaser will be in a significantly worse position than it is in currently.

6.11 Nevertheless, if purchasers want more certainty about the allocation, it is likely that vendors seeking to maximise the price they can achieve will volunteer the necessary information as part of the selling materials. For example, they may specify that fit-out is estimated to constitute a certain percentage of the value of the property or may disclose the fit-out's depreciated value. Alternatively, the terms of the auction

or tender could provide for an allocation mechanism, for example, for the allocation to be undertaken by an agreed valuer after the winning bidder has been determined.

6.12 Submissions are sought as to whether the proposal is likely to cause any difficulties for commercial transactions, and if so, how it might be modified to address these.

Sales involving dealers or other revenue account holders

6.13 When the purchaser in a mixed supply is a dealer, acquiring the property with a dominant purpose[5] of resale, or otherwise holds the property on revenue account, prima facie there is no commercial tension in relation to the allocation. The revenue account purchaser is entitled to a deduction for the entire purchase price, so the consistency requirement is not relevant.

6.14 However, an issue arises when a revenue account purchaser acts as a conduit in a transaction that is, in reality, between two non-dealers. A specific anti-abuse rule may be required to ensure that the interposing of the revenue account purchaser is disregarded.

Degree of consistency

6.15 There is a question as to the degree of consistency required between the parties. For example, in a sale of a commercial building, would it be adequate to agree an allocation between land, building and fitout, without specifying the allocation between the specific different items of fit-out?

6.16 While agreement of this kind would be better than no agreement, it can still leave substantial scope for discrepancies. In particular, the vendor may allocate the price so that some depreciable items are sold for more than their cost so as to reduce depreciation recapture on other items. The purchaser may allocate the price in a different way, to items that depreciate at a faster rate. So long as the allocations are within a market value range, the discrepancy would not be able to be challenged.

6.17 Accordingly, officials suggest that to the extent that the vendor treats an item of property as a separate item for taxation purposes (mostly obviously, in a depreciation schedule, or in an IT system for recording financial arrangement income) the parties should be required to agree on the amount allocated to that item. This will not require any additional work for the vendor, since the vendor is separately identifying the item in any case and will have to allocate a portion of the consideration to it. It also should not require any additional work for the purchaser, who will have to set up its own records, or take over those of the vendor.

6.18 This approach should not preclude the purchaser taking a different approach from the vendor to the classification of depreciable items. The issue is not the classification of the items, but the amount of the purchase price allocated to them.

6.19 For example, suppose that a vendor of a commercial building has made no distinction for depreciation purposes between items A, B and C, treating them as a single asset depreciated at a single rate. However, the purchaser intends to split out

[5] Or, in the case of land, a purpose of resale.

item C, and depreciate it at a higher rate than items A and B. That should not be problematic in any way, so long as the total amount allocated by the purchaser to the three items is the same as the amount the vendor has allocated to them.

Denial of a deduction for purchasers who disregard the law

6.20 It appears that many advisors were not aware of the existence of section EB 24 and the requirement for a consistent allocation of trading stock between the vendor and purchaser in a mixed supply. Even where there is an existing legislative requirement for a consistent allocation, purchaser tax returns have in many cases been prepared simply on the basis of the purchaser's own allocation. This suggests a need to develop rules which not only require consistency as a matter of law but encourage voluntary compliance so far as possible.

6.21 We therefore consider there is a need for an explicit legislative rule that denies a purchaser in a mixed supply a deduction for any amount paid, unless that amount has been determined on the basis of the rules set out in this proposal. This means there would be no right to a deduction unless it was based on:

- an agreed allocation;
- in the absence of agreement, the allocation provided by the vendor, based either on the vendor's assessment of market value, or the vendor's original cost or depreciated value;
- only if the purchaser has requested the vendor's allocation and not received it, the purchaser's allocation – in which case the vendor would also be required to use the purchaser's allocation.

6.22 Such a rule would make it clear to those preparing tax returns that they need to actually obtain an allocation that ensures consistency and would enable them to make this requirement clear to their clients. It would also make it easier for the Commissioner to deal with situations where taxpayers have not attempted to comply with the law.

6.23 Such a rule would need to allow for the purchaser to claim a deduction in a later year once it has the vendor's allocation or has properly provided its own, and subject to continuity of ownership requirements.

Feedback

- Officials seek submissions on the issues discussed in this chapter, and whether there are any other issues that need to be considered in developing a proposal to require as much consistency as practicable between vendor and purchaser in mixed supply price allocations.

APPENDIX

Other countries' requirements

Australia

For tax and accounting reasons, the parties are encouraged by their advisors to agree in their sale and purchase agreement on an allocation of this price across the business assets being purchased/sold.

For tax purposes the amount allocated to the asset is generally the allocation agreed by the parties. This is generally acceptable to the tax authorities because it's recognised that there is a natural tension between the parties. There is an incentive for the vendor to allocate proceeds to CGT assets, and for the purchaser to maximise the amount allocated to plant and equipment which is depreciable.

However, the tax authorities can replace this allocation by a "market value consideration" under the market value substitution rule, if they do not consider the value to be a fair reflection of market value. This might arise, for example, if the parties are related. The Australian Tax Office has provided general guidance on assessing market value for various tax purposes.

If the parties cannot agree an allocation, they can apply to the Commissioner for Taxation for a private binding ruling on an acceptable market value.

Canada

In some cases, the sale and purchase agreement sets out the price for each asset, a value for the inventory and any goodwill. If there is no agreement then the purchaser has to determine how to allocate, and these amounts should coincide with the amounts the seller determined when reporting the sale. The amount allocated should be its fair market value.

While purchasers and sellers will have their own preferences as to how the purchase price is to be allocated, both parties must ensure that any allocation is reasonable and based on the actual value of the assets included in the deal.

Anti-avoidance rules in the Income Tax Act give the Canada Revenue Agency the authority to impose its own allocation of the purchase price such that the consideration paid is a reasonable reflection of the actual value in the circumstances. These are designed to overcome non-arms-length allocations.

Where there is genuine bargaining between the buyer and seller the CRA will accept the parties' allocation as prima facie proof that an allocation is reasonable. Accounting valuations may vary from allocations for tax purposes.

United States

Companies are required to complete a purchase price allocation for all transactions involving a change of control to determine the purchaser's basis and the seller's gain or loss. Section 1060 of the Internal Revenue Service (IRS) Code provides detailed procedures for

completing the allocation. This can vary from the accounting standards allocation through the exclusion of certain transaction costs, deferred taxes and accrued liabilities, and how assumed debt is measured.

For tax law the assumed value of the property transferred is fair market value which is defined as the price at which property would exchange between a willing buyer and willing seller. Where the parties have agreed the allocation, or their fair market value, they are bound to use it for tax purposes unless the IRS determines that such an allocation, or fair market value, is not appropriate.

There are prescriptive valuation requirements, such as when assets are acquired at bargain prices. For tax purposes the consideration paid is allocated amongst the net assets acquired based on a class system of asset categories in a process known as the residual method. If the aggregate purchase price allocable to a particular class of assets is less than the aggregate fair market value of the assets within the class (as would be the case with a bargain purchase), each asset in the class is allocated an amount in proportion to its fair market value, with nothing allocated to a junior class (goodwill is the most junior class).

United Kingdom

For tax purposes, it is necessary to apportion the total consideration of the transaction among the assets acquired. The parties to the transaction are encouraged by their advisers to specify the allocation in the sale and purchase agreement. That allocation is normally acceptable for tax purposes, provided it is commercially justifiable.

Two statutory rules impact on the allocation. The first stipulates that the open-market value of trading stock must be substituted in calculating the profits of the seller unless the purchaser acquires the stock for their own trade. The second requires that the purchaser's cost of acquisition and the seller's disposal proceeds for capital allowance purposes be calculated through a just apportionment of the total consideration. Since 1 April 2014 the buyer of a building that contains fixtures can only claim plant and machinery allowances if the expenditure is pooled before the sale. The seller and the buyer must either formally agree a value for fixtures within two years of transfer or start formal proceedings to agree the value within that time. If the two parties cannot agree an apportionment, either can apply to the first-tier tribunal to decide the value of the fixture(s).