



Tax policy report: Purchase price allocation

Date:	13 November 2019	Priority:	Medium
Security level:	Sensitive	Report number:	IR2019/554 T2019/3648

Action sought

	Action sought	Deadline
Minister of Finance	Agree to recommendations Note the contents of this report	28 November 2019
Minister of Revenue	Agree to recommendations and submit Cabinet paper to Cabinet Office by 10am 28 November 2019, for discussion at the Economic Development Committee's meeting on 4 December 2019.	28 November 2019

Contact for telephone discussion (if required)

Name	Position	Telephone
Jessica Rowe	Principal Advisor	s 9(2)(a)
Casey Plunket	Special Policy Advisor	

13 November 2019

Minister of Finance
Minister of Revenue

Purchase price allocation

Executive summary

1. This report seeks your approval to undertake public consultation, via an officials' issues paper, on possible changes to the tax legislation relating to how parties to a sale allocate the global price, for tax purposes, among the different assets being sold.
2. These changes are one of the revenue-raising measures that form part of a package of business-related tax initiatives in the Government's Tax Policy Work Programme. The package was discussed at the joint Ministers' meeting on 5 November 2019.
3. The changes are aimed at increasing the efficiency of the tax system and ensuring that sales of businesses and commercial property (in particular) do not lead to an inappropriate income tax reduction.
4. The Government is currently missing out on an estimated $\$9(2)(f)(iv)$ of tax revenue per annum as a result of a gap in the law that allows the buyer and seller to adopt different asset valuations for tax purposes in respect of the same sale transaction. This arbitrage can result in the seller treating the sale proceeds as largely non-taxable and the purchaser increasing the amount they treat as depreciable (or otherwise deductible).
5. The issues paper seeks feedback on this issue, and in particular, on a solution that, in broad terms, would require the vendor and purchaser to use the same allocation, based on market values. The paper proposes the idea of a de minimis threshold, to reduce compliance costs.
6. Under the proposal in the issues paper, if the two parties cannot agree on an allocation, the purchaser would be required to use the vendor's allocation. The vendor would be required to disclose their allocation to the purchaser, and if they did not do so on a timely basis, they would have to use the purchaser's allocation.
7. We have engaged with a variety of private sector stakeholders over the past 18 months with respect to this issue. We plan to meet again with the Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, and New Zealand Law Society prior to the issues paper's release to update them on progress.
8. If these changes are implemented as proposed in the issues paper, applying to transactions occurring on or after 1 April 2021, we estimate they will raise approximately $\$9(2)(f)(iv)$ over the forecast period. This revenue could be used to increase gross spending in Budget 2020 if final policy decisions to proceed are made by mid to late March 2020.
9. To meet this timeframe, we recommend that you obtain Cabinet's approval to release the issues paper in mid-December 2019 (before HYEPU on 11 December). We have attached a suggested draft Cabinet paper for Cabinet's Economic Development Committee's meeting on 4 December 2019, which would need to be submitted to Cabinet Office by 10am on Thursday 28 November 2019. This would allow the issues paper to be released before HYEPU – there is currently a specific fiscal risk for this proposal. If the issues paper were released after HYEPU, then the

disclosure of the specific fiscal risk at HYEPU would pre-empt the release of the issues paper.

10. Given the tight timeframe for achieving final decisions by the end of March, the draft Cabinet paper also seeks Cabinet’s approval to delegate to you the ability to make final decisions on this issue once feedback has been received.

Recommended action

11. We recommend that you:

- (a) **agree** to submit the attached draft Cabinet paper seeking Cabinet’s approval to release the issues paper on 10 December to Cabinet’s Economic Development Committee in time for its meeting on 4 December 2019;

Agreed/Not agreed

Agreed/Not agreed

- (b) **note** that if these changes were implemented for transactions occurring from 1 April 2021, they would raise approximately **s 9(2)(f)(iv)** over the forecast period;

Noted

Noted

- (c) **note** that final policy decisions would need to be made by the end of March 2020 for the estimated additional revenue to be able to be used to increase gross spending in Budget 2020.

Noted

Noted

Mark Vink
 Manager
 The Treasury

Casey Plunket
 Special Advisor
 Policy and Strategy, Inland Revenue

Hon Grant Robertson
 Minister of Finance
 / /2019

Hon Stuart Nash
 Minister of Revenue
 / /2019

Background

12. When a bundle of assets with different tax treatments is sold, both the vendor and the purchaser need to allocate the global price between the different assets to determine their tax results. Sales of businesses and commercial properties (land, buildings and fit out) tend to be the largest transactions of this kind. The allocation is important in determining the vendor's tax liability from the sale, and the purchaser's cost base for calculating depreciation and any taxable gains when they, in turn, come to sell the property.
13. Generally, the allocation must be based on market values, and there is case law that reinforces this, but there is no explicit requirement in tax law for the vendor and purchaser to use the same market values, except in relation to the trading stock component of a transaction. When trading stock is sold along with other assets, the vendor is required to apportion an amount to the trading stock that reflects its market price, and the purchaser is required to use that same apportionment. Trading stock is widely defined for this purpose, including anything produced, manufactured or acquired for the purpose of disposal, as well as livestock, timber, and land whose disposal would produce income.
14. While many purchasers and sellers agree an allocation, many do not as the vendor and purchaser have different incentives when trying to minimise their tax liabilities and benefits. If the parties adopt different allocations, there is generally foregone tax revenue. This issue, therefore, has been identified as a revenue integrity matter and the project is on the tax policy work programme. We have undertaken targeted engagement with key stakeholders on how to address this issue.
15. You have indicated a preference for this work to be progressed so that, if the Government decides to proceed with law reform in this area, the revenue raised could be used to increase gross spending in Budget 2020.
16. Officials reported to you on this issue in November 2018 (T2018/3398; IR2018/755 refers) but the project was put on hold at that time due to uncertainty around whether or not the taxation of capital gains would be extended. A comprehensive capital gains tax would have removed most of the opportunity for arbitrage between different tax treatments in the allocation of the purchase price and would have made the benefits of this project marginal.
17. Other countries have a variety of specific rules in the area of allocation, based on parties using market values, and requiring varying degrees of consistency.

Problem definition

18. Our starting policy framework is that, for revenue integrity reasons, the parties should be adopting the same allocation, based on market values. Generally throughout the Income Tax Act, sales are assumed to be at market value so that there is no transfer of value between the parties which could lead to a reduction in tax revenue. However, the law is currently deficient because, with the exception of trading stock, there is no explicit requirement for the parties to use the same valuation.
19. Since 'market value' is a range of values, both parties can adopt allocations that are quite different while claiming that their respective allocations are tethered to commercial prices. In many cases, the seller uses depreciated tax book values, arguing that they are reflective of market values, but avoiding any depreciation clawback (that is, the requirement to pay back depreciation deductions claimed in respect of an asset that has not, in fact, depreciated as fast as expected). The purchaser on the other hand often allocates a higher cost, to increase depreciation deductions.

20. The flexibility around what is a 'market value' enables the adoption of inconsistent allocations that minimise each party's tax liability and can only be challenged with considerable resource commitment from Inland Revenue. Inland Revenue incurs significant costs trying to match buyers and sellers, investigate their allocations, and obtain valuations to determine whether the parties' allocations can be challenged as not being in accordance with market values. Experience has shown that it can be very difficult to challenge even widely divergent allocations.
21. Inland Revenue's compliance work has uncovered a number of sizeable transactions, particularly in relation to commercial property, where there have been differences between the seller's and purchaser's valuations sometimes in the tens of millions of dollars. Differences were identified in nearly fifty percent of the investigated cases, amounting in total to around \$170 million. In some of these cases, settlements have been agreed. The remainder are either in dispute or have not yet been dealt with given resource constraints. There is no doubt that under current law, many of these discrepancies will not be able to be resolved.

Recommended solution

22. The issues paper seeks feedback on a rule that would require the parties' allocations to be consistent. If that consistency cannot be achieved through the parties reaching agreement, the purchaser would be required to use the vendor's allocation – or vice versa if the vendor does not notify the purchaser of their allocation within a reasonable period of time.
23. The allocations should also be based on market values. There is case law in this area which reinforces the requirement that market values should be used. Otherwise, there is an opportunity for one party to reduce its tax liability, and there may be no or inadequate compensating increase in the other party's tax liability given its tax status (for example, exempt or in loss), or because of differences in the (marginal) tax rates of the parties. Where a party obtains assets at a genuine bargain price then their relative market value is what is important.
24. Given the breadth of coverage (residential rental properties with chattels would be covered, for example), and to reduce compliance costs, the issues paper explores some options for a de minimis below which the new rules would not apply. The issues paper suggests, for example, that sales in which the total amount allocated by the purchaser to deductible or depreciable items is less than \$100,000, the transaction could be excluded from the consistency requirement.
25. For parties involved in transactions of significant value, implementing this approach should involve almost no additional cost, as they are already required to undertake an allocation. It should encourage them to agree on an allocation beforehand, in the sale and purchase agreement or otherwise.
26. When the assets involved are relatively minor, it seems that vendors have often been using the written down book value in their allocations, often to reduce compliance costs. The de minimis should allow that to continue where the revenue at stake is less significant.

Fiscal implications

27. If the proposals outlined in the issues paper were to be implemented exactly as proposed, we estimate that tax revenue would increase by approximately [REDACTED] s 9(2)(f)(iv) over the forecast period. This estimate is based on a sample of known cases, extrapolated out to the total estimated base of depreciable property sold with other assets. As it does not include financial arrangements or revenue from improved compliance with the trading stock rules, it is potentially conservative. However, it

should also be noted that the methodology to reach this number is complex and relies on a number of assumptions.

28. Any change to the design of the measure following consultation is likely to change these estimates.

Systems or technology impacts

29. The proposal does not give rise to significant operational or systems changes, and we consider that it would have low administrative costs for Inland Revenue.

Consultation

30. To test out the problem and possible solutions, we have engaged with a variety of private sector stakeholders over the past 18 months. Their involvement and cooperation will be important to the success of any policy change given their clients and members are those most likely to be affected.
31. We have advised stakeholders that their initial suggestion of an operational solution is not likely to be effective, which means that a legislative change seems necessary. Chartered Accountants Australia and New Zealand has acknowledged that the current law generally does not require consistency in allocations. A key private sector concern with any legislative change is that either the vendor or the purchaser might be given undue power, and that there would therefore be a negative impact on commercial transactions. Therefore, this issue, among others, is discussed in depth in the officials' issues paper. The recommended solution has included some safeguards to try to reduce these concerns.