# Hon Grant Robertson, Minister of Finance

# Hon Stuart Nash, Minister of Revenue

## Information Release

## Purchase price allocation decisions

## August 2020

### Availability

This information release is available on Inland Revenue's Tax Policy website at https://taxpolicy.ird.govt.nz/publications/2020-ir-cab-dev-20-min-0042/overview

### Documents in this information release

| # | Reference | Type | Title | Date |
|---|---|---|---|---|
| 1 | IR2020/094<br>T2020/351 | Tax policy report | Purchase price allocation: consultation and recommendations for legislative reform | 11 March 2020 |
| 2 | DEV-20-MIN-0042 | Minute | Oral item: Purchase price allocation: update on delegated policy decisions | 18 March 2020 |
| 3 | - | Supplementary analysis report | Purchase price allocation | 27 May 2020 |

### Additional information

The Minister of Finance and the Minister of Revenue were authorised to make final decisions following consultation (see the information release for DEV-19-SUB-0336: Purchase price allocation - release of officials' issues paper).

An oral update from the Ministers was provided to the Cabinet Economic Development Committee on 18 March 2020.

### Information withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act). Where this is the case, the relevant sections of the Act that would apply are identified. Where information is withheld, no public interest was identified that would outweigh the reasons for withholding it.

Sections of the Act under which information was withheld:

| | |
|---|---|
| 9(2)(a) | to protect the privacy of natural persons, including deceased people |

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POLICY AND STRATEGY

## Tax policy report: Purchase price allocation: Consultation and recommendations for legislative reform

| | | | |
|---|---|---|---|
| **Date:** | 11 March 2020 | **Priority:** | High |
| **Security level:** | In Confidence | **Report number:** | IR2020/094<br>T2020/351 |

## Action sought

| | Action sought | Deadline |
|---|---|---|
| Minister of Finance | **Agree** to recommendations | 23 March 2020 |
| Minister of Revenue | **Agree** to recommendations | 23 March 2020 |

## Contact for telephone discussion (if required)

| Name | Position | Telephone |
|---|---|---|
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11 March 2020

Minister of Finance
Minister of Revenue

## Purchase price allocation: Consultation and recommendations for legislative reform

### Executive summary

1. In December 2019, Cabinet agreed to release an issues paper seeking feedback on proposed new purchase price allocation rules (DEV-19-MIN-0336 refers). Cabinet delegated authority to the Minister of Finance and Minister of Revenue to make final policy decisions, to allow for decisions to be made in time to include the forecast revenue in Budget 2020. This report summarises the outcomes of consultation and seeks your approval to the final policy design of the purchase price allocation rules, to be achieved through legislative reforms.

### The problem definition

2. The purchase price allocation proposals are intended to address a tax issue that arises where a buyer and seller of business assets use different values for the assets sold. The value allocated to assets can reduce the amount of income tax paid by the parties to a transaction and the amount of revenue collected by the Government. Allowing parties to adopt different allocations is a risk to the integrity of the tax base.

3. The issues paper was released in December 2019 and outlined details of proposed purchase price allocation rules (T2019/3469, IR2019/554 refers). Broadly speaking, it proposed that parties be required to agree on consistent values for assets sold, and if they did not agree, the vendor would determine the value.

4. To ensure parties to transactions adopt consistent values, and to minimise the tax revenue currently lost due to inconsistent values, new rules are proposed.

### The proposed rules

5. The crux of the core proposal was that:

   - The buyer and seller would be required to use the same values for the assets sold.
   - If the parties agree on the values for the assets sold, both would have to file their tax returns using that allocation.
   - If the parties disagree, then the seller would have the power to determine the value of the assets sold.
   - If the seller does not do this within a specified timeframe, the buyer gets to choose the values of the assets.

### Submissions on the issues paper

6. There were twelve submissions from stakeholders, most of which agreed that parties to a transaction adopting different values was problematic, and that they

should be required to adopt consistent values. However, all submitters were against the proposal that the seller would have the power to determine the values if the parties do not agree, as this would allow the seller to have an unfair advantage during negotiations. Officials' response to submitters' concerns is outlined further in the report and the appendix.

## Recommended response to submissions: changes to the proposal

7. In response to this feedback, we recommend retaining the core proposal but making some significant design modifications that would address the concerns raised by submitters. The modifications we recommend are:

- A requirement that the seller must allocate use a minimum of the tax book value for all taxable assets when they are sold (in effect imposing a "floor" of tax book value for certain property). This would minimise the potential advantage to the seller that submitters were concerned about, by denying the seller additional deductions and providing some protection to the buyer.

- To reduce compliance costs, the rules would only apply to broad asset categories rather than to each individual asset.

- Changing the de minimis so that these rules only apply to sales with depreciable or deductible assets greater than $100,000, or where the total sale price is greater than $1 million. This will reduce compliance costs by ensuring that fewer sales come within the scope of the new rules.

- To provide more time for taxpayers to prepare, the new rules would apply from the earlier of three months after the date of enactment or 1 July 2021.

8. Officials consider the revised proposals strike an appropriate balance between competing considerations: minimising administrative and compliance costs, not interfering with the dynamics of commercial transactions, and ensuring the Government receives an appropriate amount of tax revenue.

## Fiscal implications and next steps

9. The proposals will raise tax revenue by an estimated $154 million over the current forecast period. This will be included in BEFU 2020 forecasts and will increase gross operating spending in Budget 2020. Note that this is less than the $210 million forecast in the Cabinet paper, because of further refinements to the assumptions underlying the calculations.

10. If you agree to the recommendations in this report, the proposed new rules will be included in a Supplementary Order Paper to the Taxation (Annual Rates for 2020—21, Feasibility Expenditure, and Remedial Matters) Bill scheduled to be introduced in April 2020. The Supplementary Order Paper would be released at the Finance and Expenditure Committee stage in time for submissions to be made on the proposed rules. This will provide us with another opportunity to make further refinements to the rules if necessary.

## Recommended action

11. Officials recommend that you:

(a) **Agree** that parties to a sale of assets with differing tax treatments should be required to adopt the same allocation of the total sale price to the various assets for tax purposes.

Agreed/Not agreed Agreed/Not agreed

(b) **Agree** that the allocation must be based on relative market values for all the assets.

Agreed/Not agreed Agreed/Not agreed

(c) **Agree** that if the parties do not agree an allocation, the seller chooses the allocation.

Agreed/Not agreed Agreed/Not agreed

(d) **Agree** that if the seller chooses the allocation, it must allocate at least tax book value to depreciable property and values to other taxable property such that the seller recognises no loss on the sale.

Agreed/Not agreed Agreed/Not agreed

(e) **Agree** that if the seller does not choose an allocation within a specified timeframe, the buyer can choose the allocation.

Agreed/Not agreed Agreed/Not agreed

(f) **Agree** that the Commissioner should be able to challenge an allocation if it does not reflect relative market values.

Agreed/Not agreed Agreed/Not agreed

(g) **Agree** that the above recommendations should be subject to de minimis exceptions to minimise compliance costs.

Agreed/Not agreed Agreed/Not agreed

(h) **Agree** that recommendations (a) to (g) apply to sale agreements entered into from the earlier of 1 July 2021 or three months after enactment.

Agreed/Not agreed Agreed/Not agreed

(i) **Note** that as a result of agreeing to recommendations (a) to (h), tax revenue is estimated to increase by $154 million over the current forecast period, as shown in the table below.

| | $m – increase/(decrease) | | | | |
|---|---|---|---|---|---|
| **Minister for Revenue**<br>**Vote Revenue** | **2019/20** | **2020/21** | **2021/22** | **2022/23** | **2023/24 & outyears** |
| Crown Revenue and Receipts:<br>Tax Revenue | - | - | 23.000 | 58.000 | 73.000 |
| **Total operating** | **-** | **-** | **23.000** | **58.000** | **73.000** |

Noted Noted

(j) **Note** that the revenue increase referred to in recommendation (i) will not increase allowances for Budget 2020, but can be used to increase total gross spending in Budget 2020.

Noted Noted

(k) **Note** that Cabinet (DEV-19-MIN-0336 refers) has previously delegated to the Minister of Revenue and the Minister of Finance the power to make final policy decisions.

Noted Noted

(l) **Agree** that the changes recommended above should be included in the Taxation (Annual Rates for 2020—21, Feasibility Expenditure, and Remedial Matters) Bill by way of a Supplementary Order Paper.

Agreed/Not agreed Agreed/Not agreed

(m) **Agree** to raise an oral item at DEV on 18 March to update Cabinet on your delegated policy decisions.

Agreed/Not agreed Agreed/Not agreed

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**Hon Grant Robertson**
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/ /2020

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/ /2020

## Purpose

12. This report seeks your approval to final policy design decisions of purchase price allocation rules and summarises stakeholder feedback and officials' response.

## Background

13. In December 2019, Cabinet agreed to release an issues paper which sought feedback on proposed purchase price allocation rules (DEV-19-MIN-0336 refers). The Minister of Finance and the Minister of Revenue were delegated the authority to make policy decisions to furtherance of the proposed changes.

14. When a bundle of assets with different tax treatments is sold (a 'mixed supply'), the parties are required to allocate the global price between the various assets to determine their tax position. We refer to the parties as the vendor and the purchaser. The allocation determines the vendor's tax liability from the sale, and the purchaser's cost base for calculating depreciation and any taxable gains when it, in turn, sells the property. The most common mixed supplies are sales of commercial property and going concern businesses (not including share sales).

15. While many vendors and purchasers agree an allocation, many do not, as the parties have divergent incentives in minimising their tax liabilities. Investigations into large commercial property transactions have revealed that some vendors and purchasers have been making substantially different allocations between depreciable property, revenue account assets, and capital account assets, resulting in an overall reduction in tax paid. Anecdotal evidence points to similar inconsistencies in sales of going concern businesses.

16. It is generally accepted among the tax advisory community as well as officials that consistency of allocations is a desirable outcome, at least in large transactions. Officials have undertaken targeted consultation with a number of stakeholders on this issue over several years, and recently consulted on policy proposals via an officials' issues paper.

## Problem definition

17. The current law requires parties to allocate market values to the assets. However, market value can be a range of possible values, and there is generally no legal requirement for the vendor and purchaser to use the same market values for tax purposes. This provides scope for both the vendor and purchaser to make allocations that are quite different, while justifying their values as being tethered to commercial prices. The ability for vendors and purchasers to adopt different allocations of a global price to different assets is undesirable because parties should adopt the same allocation for tax purposes (the Commissioner should not have to accept alternative facts), and not doing so constitutes a revenue integrity risk.

18. Given the current tax rules in this area, the incentive is for the vendor to allocate as little value as possible to depreciable property (such as building fit-out), and as much value as possible to non-taxable property (such as land). This helps the vendor minimise any repayment of the benefit of depreciation deductions (which is required when depreciable property is sold for more than its tax book value). The purchaser, however, is incentivised to maximise the value of any depreciable property and minimise the amount allocated to non-taxable property purchased, to maximise its depreciation deductions going forward.

19. It is resource intensive for Inland Revenue to investigate inconsistent allocations. Moreover, investigations can only deal with whether each party's allocation reflects market values — since market value is a range, they cannot enforce consistency. Discrepancies identified in a sample of investigations into large commercial property

transactions amount to around $133 million. Some of these cases have been resolved, while others remain in dispute or cannot be dealt with due to resource constraints. Under current law, many of these discrepancies will be impossible to eliminate.

***Example***

*A Co. has agreed to sell its assets to B Co. The assets include land and buildings (all non-depreciable), and fit-out and other depreciable property. The total purchase price is $90 million.*

*A Co. will only be taxable on the portion of the sale price attributable to depreciable property (up to the original cost of the property), and not the portion attributable to the land and buildings.*

*A Co. believes the appropriate allocation of the price is:*

| | *Allocation* | *A Co's Cost* | *A Co's Profit* | *A Co's Tax* |
|---|---|---|---|---|
| *Land and buildings* | *$30m* | *$20m* | *$10m* | *0 (as a capital gain)* |
| *Depreciable property* | *$60m* | *$60m* | *0* | *0* |

*In contrast, B Co. believes $20 million more should be allocated to depreciable property, and $20 million less to land and buildings. That is, the land and buildings would be $10 million and the depreciable property $80 million. This would increase B Co's tax deductions.*

*If they both adopt their separate allocations, A Co. pays no tax and B Co. gets additional depreciation deductions of up to $20m (a tax benefit of $5.6m given a company tax rate of 28%) over time.*

## Policy objective

20. The objective of the proposed reforms is to achieve a consistent allocation between both the vendor and the purchaser that reflects market values. Achieving this objective will improve revenue integrity, because parties will not be able to reduce their individual tax liabilities by allocating different values to the various assets in the transaction.

21. Vendors and purchasers will always take different views of the value of an asset; commercially, a vendor will not sell an item unless it thinks the item is worth less than the purchaser is willing to pay for it, and the purchaser will not buy the item unless it thinks the opposite. But the item is sold and bought for a single price, and that price is deemed to be the value of the item for both parties. Officials see no reason to disregard this principle where more than one asset is sold at a time. It is also clear that the value ascribed to an asset should fall within the range of values the wider market would ascribe to it.

22. Officials recognise that the proposed new purchase price allocation rules may be seen as a burden to transacting parties. We believe that the proposals (along with the design modifications we are recommending in response to submissions received) strike the right balance between achieving better revenue integrity while also minimising any additional compliance/administration costs and interference in commercial dynamics.

## Proposals

23. The core proposal we consulted on was that for transactions that involve mixed supplies:[1]

- In all cases, the vendor and purchaser would be required to use the same allocation of the total purchase price to different types of property.
- If the parties agree on an allocation, both would have to file their tax returns using that allocation.
- If the parties do not agree on an allocation, then the purchaser would have to use the vendor's allocation when filing its tax return, provided the vendor files its allocation with both Inland Revenue and the purchaser within a specified timeframe.
- If the vendor does not file its allocation within the specified timeframe, the purchaser would be required to file its allocation with Inland Revenue and the vendor. Both parties would then be required to follow the purchaser's allocation in their tax returns.
- The parties would not be able to dispute an agreed allocation, or allocations filed in accordance with the above process. The Commissioner would be able to dispute an allocation only if it does not reflect market values.
- A purchaser would not be entitled to a deduction for property acquired in a mixed supply until it has received or made an allocation pursuant to these requirements.

24. We recommend retaining the core proposal, but making some design modifications in response to stakeholder feedback.

## Stakeholder feedback

25. We received twelve submissions on the issues paper. These submissions were from Business NZ, Deloitte, Corporate Taxpayers Group, PwC, Bell Gully, the New Zealand Law Society, Russell McVeagh, nsaTax, Chapman Tripp, KPMG, Chartered Accountants Australia and New Zealand (CA ANZ) and EY.

26. Almost all submissions on the issues paper supported the proposition that parties to a mixed supply should adopt the same price allocation. Several advisors noted that they always advise their clients to agree an allocation, as it is considered best practice from a tax perspective.

27. A few submitters disagreed with the central premise that parties should always be required to agree on the value ascribed to an asset, as parties could legitimately take different views of its value.

28. Nearly all submitters objected to the proposals set out in the issues paper for legislative reform. Many felt that legislative measures were unnecessary or overly burdensome, and that the policy objectives could instead be achieved operationally through better enforcement of the existing law and the publication of additional guidance for businesses on price allocations.

[1] This is where a transaction involves a mixture of revenue account property (such as trading stock), depreciable property (such as plant or machinery), and capital account property (such as land or goodwill).

### Vendor allocation provides vendor an unfair advantage

29. Of particular concern to all submitters was the proposal to allow the vendor to determine the allocation in the event the parties could not agree, because this would give too much power to the vendor and thus disturb commercial dynamics. For example, vendors might force purchasers to accept unreasonable allocations. Some were concerned about how the rules would work in the context of auctions and tenders, where the price might be agreed without prior negotiation between the parties.

30. Submitters did not explain how it is that the existing provisions dealing with trading stock, which also require the purchaser to follow the vendor's allocation, are not already causing difficulties.

### Alternative approach suggested: Commissioner's allocation

31. Three submitters proposed that the Commissioner should be responsible for determining the allocation where parties cannot agree. If the Commissioner does not determine an allocation, then the inconsistency should stand. Five submitters were in favour of some version of the alternative approach proposed in the issues paper, that depreciable property should be treated as sold for tax book value if the parties do not agree an allocation. Some suggested that this kind of approach also apply to other forms of revenue account property. One submitter suggested the purchaser would be a more appropriate person to make a non-agreed allocation.

### Other concerns

32. Five submitters suggested that the proposals be limited to transactions involving commercial property, since these are the transactions that in practice seem to be most problematic.

33. Six submitters felt that the parties should be able to make allocations at an asset category level, rather than being required to make the allocation at a more granular, detailed level. The more detailed an allocation, the greater the compliance burden on taxpayers.

34. Eight submitters felt that the proposed de minimis ($50,000 of depreciable property) was too low, and suggested various alternative figures, ranging up to a $5 million transaction value. Two submitters suggested an additional de minimis for depreciable assets worth less than $10,000, under which the parties could allocate tax book value and be immune to challenge by the Commissioner. This was suggested to reduce compliance costs and provider greater certainty to taxpayers.

35. A more detailed summary of submissions received, and officials' responses to them, is provided in the appendix.

## Recommended response to stakeholder feedback

36. Officials recommend that the core proposal proceeds (refer to paragraph 24 above), with some design modifications to address many of the practical concerns expressed by submitters.

### Vendor allocation should not affect commercial dynamics

37. The most significant submission regarding the design of the proposal that officials disagree with is that the power to ensure the parties adopt consistent allocations should not be given to the vendor.

38. Officials do not agree that giving this power to the vendor will be problematic from a commercial perspective, especially with the design modifications we recommend be made in response to submissions.

39. An allocation will generally be agreed as part of the negotiation process. Even if the purchaser thinks the vendor's proposed allocation is unfavourable to it, the variance will often not be material to the price. If it is, the purchaser can factor that into its offer. This is not different from any other commercial issue in a sale and purchase negotiation.

40. If the purchaser does not turn its mind to the allocation before agreeing a price, that suggests that the allocation is not a material issue for it.

41. In auction or tender situations (usually relating to commercial property), vendors will be incentivised to provide information that will ensure the highest bid. If purchase price allocation is important, advance guidance as to the allocation to commercial fit-out should be able to be provided.

42. Our proposal to adopt the preference of a number of submitters to require a vendor to allocate at least tax book value to depreciable property (and possibly other taxable assets) will provide significant protection for purchasers against unreasonably low vendor allocations. This will reduce some of the advantage the vendor might have in being able to make an allocation should the parties be unable to agree on one during or after negotiations.

43. The existing provisions requiring purchasers to adopt vendor allocations to trading stock do not seem to be causing any problems. In addition, there are existing provisions (for example, those that relate to non-depreciable improvements to land) that require assets to be transferred at the vendor's tax book value. Anecdotal evidence from the private sector and Inland Revenue officials indicates that these provisions have not been problematic, and have successfully been applied in practice.

### Commissioner allocation a viable alternative but not recommended

44. Officials agree that requiring parties to file their inconsistent allocations, and then giving the Commissioner the power to choose between them, is possible in principle. However, it raises a number of concerns.

- It would place a burden on the Commissioner which she is not resourced to undertake. Choosing between rival valuations would either have to be done on an arbitrary basis or would require the acquisition of skilled resource.
- It would be less effective than vendor allocation in achieving consistency, since consistency would require intervention by the Commissioner on a timely basis.
- It would lead to more uncertainty than vendor allocation, since the time period the Commissioner would have within which to make an allocation would necessarily be a longer one than the vendor would have.
- It would be more likely to lead to disputes with the Commissioner, which can be expensive and time consuming. Disputes in this area are particularly difficult, because a decision in favour of one party usually has a negative effect on the other. For example, if a purchaser successfully challenges an allocation to depreciable property as being too low, consistency requires that the vendor adjusts its return also, generally with the result that more tax is payable by it. For this reason, it would be necessary to develop a process whereby both parties are engaged in any dispute, and information provided by one of them can be shared with the other. Current dispute rules would

need to be modified, which would involve cost and further uncertainty regarding the operation of those rules.

### Scope should not be limited to commercial property

45. Officials do not agree that the proposals should be limited to commercial property at this stage. Issues have arisen in the past in relation to other forms of depreciable property, and financial arrangements, which would continue to be unresolved if the proposal were limited as submitters suggest.

## Recommended design modifications

46. Officials believe that the following design modifications substantially address the concerns submitters had with allowing the vendor to make an allocation where the parties do not agree, without weakening the effectiveness of the proposals.

### Minimum of tax book value for vendor allocation

47. To address concerns raised by submitters regarding the vendor having an unfair advantage, we recommend adding in a new requirement where the parties have failed to come to an agreement and the vendor files an allocation.

48. Where the vendor makes an allocation, it will be required to make an allocation reflecting market value of the assets sold, subject to a requirement to allocate at least tax book value to depreciable property and financial arrangements, and possibly other categories of revenue account or amortisable assets.

### Significant modifications to the de minimis

49. The proposals include a de minimis, below which the new purchase price allocation rules would not apply. In the issues paper, we proposed that the de minimis would apply where the total amount allocated to deductible or depreciable items by the purchaser was less than $50,000.

50. In response to submissions that the de minimis should be based on a higher value, or based on the total value of the transaction, we recommend making significant modifications to the de minimis (although these modifications are not to the level requested by all submitters).

51. We recommend that taxpayers be able to satisfy the de minimis (so that the new rules do not apply) if:

- The total transaction value (including assumed liabilities) is less than $1 million; or
- The total amount the purchaser has allocated to deductible or depreciable items is less than $100,000.

52. In addition, we recommend another de minimis that applies to disputes, which would prevent the Commissioner challenging allocations made to certain low value depreciable property. This de minimis would apply where individual assets are valued at less than $10,000, the amount allocated is a value between the vendor's tax book value and original cost, and (if there are multiple identical assets) the total value of the assets is no more than $1 million.

### Allowing allocations to be made at a less granular/detailed level

53. In response to submissions, we recommend significantly reducing the level of detail required for an allocation. Instead of having to allocate amounts at an individual asset level, we recommend amending the proposals so that allocations can be made at a more global, asset category level.

54. This means an allocation would have to identify the amount allocated to trading stock, buildings, other depreciable property, and financial arrangements (there may be other less common categories of assets also requiring separate identification). Parties would be free to make a more detailed allocation if they wished to do so, but would not be required to.

### Delaying the effective date of the new rules

55. In response to submissions, we recommend the new purchase price allocation rules apply to transactions pursuant to binding agreements entered into more than three months after the rules are enacted. Provided the legislation containing these reforms is enacted by 31 March 2021 (which is what we are expecting), these proposals should apply from around 1 July 2020. This slightly deferred application date will provide businesses and advisors with more time to familiarise themselves with the new rules, and make changes to standard forms and practices as required.

## Risks

56. As suggested by submitters, there is a risk that the legislative reforms proposed might disrupt commercial negotiations more than officials anticipate. It is not certain how vendors and purchasers will behave in the face of stricter tax rules around purchase price allocation (though it should be noted that the proposal is already law in relation to trading stock sold in a sale of a business). Officials expect that the design modifications, such as the new tax book value floor and the more generous de minimis, that we are recommending be made in response to submissions should significantly reduce this risk. Officials recommend the rules be reviewed in 2024 to assess whether they have achieved the objective without having a disproportionate effect on market behaviour.

## Financial implications

57. The proposed purchase price allocation rules are estimated to increase tax revenue by $154 million over the current forecast period. Tax revenue will increase in the outyears and is expected to increase tax revenue by $100 million per annum once it is in full effect (expected in 2028/29). The fiscal impact can be shown in the table below, with a corresponding impact on the operating balance:

| | $m – increase/(decrease) | | | | |
|---|---|---|---|---|---|
| **Minister for Revenue**<br>**Vote Revenue** | **2019/20** | **2020/21** | **2021/22** | **2022/23** | **2023/24 & outyears** |
| Crown Revenue and Receipts:<br>Tax Revenue | - | - | 23.000 | 58.000 | 73.000 |
| **Total operating** | **-** | **-** | **23.000** | **58.000** | **73.000** |

58. The fiscal estimate is based on administrative data showing allocation discrepancies that were identified during investigations over recent years and applying assumptions to the rate of annual turnover of commercial property and other

tangible depreciable property. No account was taken of the effect of the proposals on depreciable intangible property or financial arrangements.

59. If the proposal is agreed to before Budget moratorium begins (30 March), the fiscal impact above will be included in BEFU 2020 and can be used to increase gross spending at Budget 2020.

## Administrative implications

60. Even with legislative rules to require consistency of allocations, the Commissioner will still need to be prepared to challenge an allocation if it does not reflect relative market values. This is already the case under the status quo, but will become more important if revenue loss is to be minimised.

61. Where the parties have not agreed an allocation, the vendor will be required to make its own allocation and notify both the purchaser and the Commissioner of it. This will give the Commissioner an opportunity to dispute the allocation if she wishes to.

62. The suggested de minimis is intended to exclude transactions in which any revenue at stake would be too small for the Commissioner to pursue. However, it will still be necessary for the Commissioner to monitor compliance with the new rules.

## Legislative mechanism and application date

63. Officials recommend that the amendments proposed in this report be included in the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill by way of a Supplementary Order Paper. We also recommend that the amendments, if adopted, take effect from the earlier of three months from the date of enactment of the Bill or 1 July 2020.

## Next steps

64. If you agree to the recommended proposals before 30 March 2020, the forecasted revenue increase will be included in Budget 2020.

65. The proposals could be introduced by way of a Supplementary Order Paper to the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill. We expect to report to Ministers with a draft Cabinet paper in May.

## Appendix – Analysis of submissions

66. An issues paper setting out the proposals was published in December 2019. Submissions on the paper were received from Business NZ, Deloitte, Corporate Taxpayers Group, PwC, Bell Gully, the New Zealand Law Society, Russell McVeagh, nsaTax, Chapman Tripp, KPMG, Chartered Accountants Australia and New Zealand (CA ANZ) and EY.

67. Below is a summary of the main submission points (some are italicised), and officials' responses to them.

### No need for legislative reform

68. *The revenue at stake does not justify the intrusive nature of the reform.*

Officials do not consider the proposals to be intrusive. They apply a similar rule to depreciable property and financial arrangements as currently applies to trading stock. The proposed rules have been designed to be as unintrusive as possible, while achieving the objective of preventing an unjustifiable loss of revenue. An allocation has to be made for tax purposes in any event. The only issue with the proposals is whether it is unduly burdensome to legislate rules requiring the parties to adopt consistent allocations, rather than leaving it to them to arrive at their allocations independently. Officials do not believe that it is, especially if the allocation is to broad asset classes, not individual items, and has a sensible de minimis.

69. *Issues can be dealt with by better enforcement of the law.*

The revenue loss caused by inconsistent allocations cannot be dealt with solely by better enforcement of the existing law. Experience over decades has shown difficulties in obtaining adequately robust valuation advice to challenge even larger inconsistencies. In smaller cases, the cost and effort of obtaining valuations and challenging allocations makes it uneconomic and well beyond the resources available to the Department. Officials note that a statement has already been published stating that allocation discrepancies will increase the risk of scrutiny. Anecdotally, this has not had an effect in significant parts of the market. More importantly, without legislative change, the Department is not able to require consistency — market value is a range, and so long as there is no consistency requirement, allocations can differ and still be entirely within the law.

70. *Market values are inherently uncertain and within a range, not a single figure.*

Perceptions of value always differ – an item will only be sold if the buyer is prepared to pay more for it than it is worth to the seller. Nevertheless, in a single asset transaction, there is only one price. Achieving the same "one price" outcome in a mixed transaction is precisely the reason why this reform is required — if parties are allowed to allocate a global price using their own perceptions of value, the tax system will suffer a loss which cannot be justified.

### Level of allocation too detailed

71. *In larger transactions, it may take an unduly long time for parties to agree on an allocation to all assets sold, such that otherwise efficient transactions might not take place.*

Officials accept that allocation of the purchase price down to the level of individual assets may be unduly time consuming in some cases. Officials are of the view that this would rarely be a problem in practice, as parties would develop business practices to deal with it. However, in response to submissions, we propose that it would be acceptable for the parties to reach agreement at the level of asset categories — trading stock, depreciable property, financial arrangements, and so on.

### Proposal favours the vendor

72. *Giving the vendor the power to determine the allocation if there is no agreement will unduly favour vendors.*

Officials do not agree that giving the power to make the allocation to the vendor if there is no agreement is problematic.

If the purchaser seeks an agreed allocation before committing to the transaction, it will be in the vendor's interest to propose an allocation, to maximise its after-tax return. If the vendor does not provide an allocation, the purchaser can either discount its price for uncertainty, or refuse to go ahead with the transaction. Once the purchaser knows what the proposed allocation is, it can adjust its price accordingly, if the allocation is not what it was expecting.

If the purchaser does not seek an agreed allocation before committing to the transaction, it is true that it has missed the opportunity to take the allocation into account in setting the price. Once the reform is in place, officials believe this is unlikely to happen in transactions of any size, as the purchaser will be properly advised, and purchase price allocation will be just one of many matters that advisors will ensure are dealt with in the process of negotiation. Even if it does happen, officials have modified the proposal so that in cases where there is no agreement, the vendor must allocate such amount to taxable assets as ensures that it does not make a loss on their sale. For example, depreciable assets bought for $100 and with a tax depreciated value of $30 must be treated as sold for at least $30. This is typically the treatment vendors already adopt. Vendors will also remain subject to the possibility of the Commissioner challenging an unreasonable allocation.

### Limit reform to commercial property

73. Several submitters suggested that limiting the reform to commercial property would be comparatively simple to implement and avoid a wide range of issues which would otherwise arise. Officials observe that significant discrepancies have also arisen in business sale transactions, and there does not seem to be any basis for drawing the proposed distinction.

### Use vendor's tax book value as default allocation for depreciable property

74. Several submitters supported allocating the vendor's tax book value to depreciable property in cases of no agreement, rather than allowing the vendor to determine the tax book value. This was an option on which officials sought feedback in the issues paper. The benefit of it is that it would put a limit on the extent to which the vendor could undervalue depreciable property.

75. On reflection, officials agree with these submitters that a tax book floor option should be adopted. This would mean that a vendor would have to allocate a minimum of tax book value to depreciable property, but could allocate more if it considered the value to be higher. Of course, it would not normally be incentivised to do so.

76. For practicality reasons, vendors usually use tax book value to make a market value-based allocation to depreciable property. It is a readily available value, and means there is no depreciation clawback (though there is no loss on disposal either). However, if the market value is clearly different from the tax book value, the Commissioner must reserve the right to challenge the allocation. Officials note that where the value of the depreciable property is relatively low, the Commissioner is very unlikely to challenge an allocation of tax book value.

### Agreement with proposals where parties have agreed an allocation

77. Submitters generally agreed with the proposal that where parties have agreed to an allocation, that allocation must be used by the parties when they file their returns. This support is welcome.

### Rules create a bias in favour of revenue account vendors and purchasers

78. Officials proposed that the rules would not apply to transactions involving revenue account vendors or purchasers, since these parties are indifferent to the allocation of the purchase price.

79. CTG submitted that this would add additional uncertainty and complexity to the rules as well as creating a bias towards these purchasers in a competitive bid process.

80. Officials agree that drawing the proposed distinction would create complexity and uncertainty. A party to a transaction will not know for certain whether its counterparty is transacting on revenue account. Although there is no benefit to applying the proposed rules to revenue account parties per se (because they are indifferent to the allocation):

    - There also seems to be no harm in doing so.
    - Doing so would avoid the need to make a distinction.

81. Officials do not agree that the rules would necessarily create a bias towards revenue account purchasers in a competitive bid process. For example, such purchasers are already at a disadvantage compared to a capital account purchaser, since they are taxable on all profits from sale of the transacted property.

### Proposal advantages foreign bidders

82. Foreign bidders will often acquire New Zealand assets through a New Zealand branch or subsidiary, in which case the proposed rules will determine their New Zealand tax treatment, just as they will for a New Zealand-owned acquirer. In a minority of cases, the cost of the assets may also be deductible or depreciable to a purchaser in another country. Some submitters argued that if the purchaser were entitled to a greater cost base in that country, then it would enjoy a tax benefit over other purchasers.

83. Officials do not think this submission is an obstacle to the proposal. The New Zealand tax system does not have any objective of trying to equalise the treatment of New Zealand and foreign purchasers in such a case, and it would be futile to attempt to do so.

### The proposal will lead to difficulties in auctions and tenders

84. Some submitters said that the proposal would make it difficult for purchasers to know their tax position when bidding in auctions or tenders.

85. Vendors in a mixed supply who are selling by way of auction or tender will have an interest in providing as much information to bidders regarding the allocation as possible, where the allocation has a material impact on the price. It is difficult to predict exactly how this will be achieved, but a number of mechanisms can be envisaged, and this does not seem to be an obstacle to the reform. Officials note the statement on page five of the Corporate Taxpayers Group submission that in commercial property auctions issues can be managed to ensure fair outcomes.

### Taxpayer allocations should only be challenged where there is clear evidence they are not at market value

86. Given her limited resources, the Commissioner does not challenge transactions that are within an arm’s length range. Absent clear evidence that an allocation is outside that range, it will not be challenged. If an allocation has been based on the application of an acceptable market value method, there is no basis for the Commissioner refusing to accept it — the legislation is not prescriptive about how market value should be determined. If the Commissioner forms the view that an allocation is outside a market value range, there is no case for an additional requirement that the reason for the allocation is fraud, sham or avoidance.

## De minimis

87. The issues paper proposed that the consistency requirement would not apply where the purchaser allocated less than $50,000 to deductible or depreciable items. Submitters generally said this was too low, and suggested de minimises ranging from $100,000 of depreciable/deductible assets to a $5 million total purchase price (suggested by a number of submitters).

88. Submitters also suggested that if the de minimis is based on the value of depreciable property, buildings should be excluded, since they depreciate at a rate of zero per cent. Officials agree that this would be the only logical approach.

89. Officials consider that the de minimis should be set at a total purchase price of $1 million or a total allocation to depreciable or deductible assets of $100,000, excluding buildings. Officials also recommend a de minimis for low-value depreciable assets. This de minimis would apply where individual assets are valued at less than $10,000, the amount allocated is a value between the vendor’s tax book value and original cost, and (if there are multiple identical assets) the total value of the assets is no more than $1 million. In these cases, the Commissioner would have no right to challenge the allocation.

DEV-20-MIN-0042

# Cabinet Economic Development Committee

## Minute of Decision

*This document contains information for the New Zealand Cabinet. It must be treated in confidence and handled in accordance with any security classification, or other endorsement. The information can only be released, including under the Official Information Act 1982, by persons with the appropriate authority.*

## Oral Item: Purchase Price Allocation: Update on Delegated Policy Decisions

| | |
|---|---|
| **Portfolio** | **Finance** |

On 18 March 2020, the Cabinet Economic Development Committee **noted** an update from the Minister of Finance and the Minister of Revenue on purchase price allocation.

Vivien Meek
Committee Secretary

**Present:**
Rt Hon Winston Peters
Hon Grant Robertson (Chair)
Hon Phil Twyford (part item)
Hon Dr Megan Woods
Hon David Parker (part item)
Hon Nanaia Mahuta (via phone)
Hon Stuart Nash
Hon Iain Lees-Galloway
Hon Jenny Salesa
Hon Damien O'Connor
Hon Shane Jones
Hon James Shaw
Hon Eugenie Sage

**Officials present from:**
Office of the Prime Minister
Officials Committee for DEV

**Hard-copy distribution:**
Minister of Finance

# Supplementary Analysis Report: Purchase Price Allocation

## Section 1: General information

### Purpose

Inland Revenue is solely responsible for the analysis and advice set out in this Supplementary Analysis Report (SAR), except as otherwise explicitly indicated.

The purpose of this report is to explain the policy rationale and development behind the "purchase price allocation" proposal contained in the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill, as a Regulatory Impact Assessment (RIA) was not required for the proposal. It is a modified version of the approach set out in an officials' issues paper – *Purchase price allocation* – which was released for public consultation in December 2019 with Cabinet's approval.

The issues paper functioned as an interim RIA when it was considered by Cabinet and a final RIA was not required as policy decisions were made by the Minister of Finance and Minister of Revenue under delegated authority from Cabinet. Therefore, this SAR has been produced to improve transparency and understanding of the policy as the amendments go through the legislative process.

### Key Limitations or Constraints on Analysis

A limitation on the analysis is the absence of precedent for the proposed approach in foreign jurisdictions. However, there is one instance of the approach in current New Zealand statute, and it appears to have worked without problem for many decades. Officials are confident that the approach will achieve the desired outcome, acknowledging that aside from the aforementioned instance, it is untried and therefore less certain.

### Responsible Manager (signature and date):

Casey Plunket
Special Policy Advisor
Policy and Strategy
Inland Revenue

27 May 2020

*To be completed by quality assurers:*

| |
|---|
| Quality Assurance Reviewing Agency: |
| Inland Revenue |
| Quality Assurance Assessment: |
| The Quality Assurance reviewer at Inland Revenue has reviewed the *Purchase Price Allocation* Supplementary Analysis Report prepared by Inland Revenue, and considers that the information and analysis summarised in the Supplementary Analysis Report meets the quality assurance criteria. |
| Reviewer Comments and Recommendations: |
| The reviewer's comments on earlier versions of this draft have been incorporated into the final version.  Although this SAR will not be presented to Cabinet it has still been reviewed consistent with the quality assurance framework. |

# Section 2: Problem definition and objectives

## 2.1 What is the policy problem or opportunity?

When business assets are bought or sold, they may be subject to different tax treatments. Some assets, such as land or goodwill[1], are generally held on capital account and are not taxable or deductible. Other assets, such as trading stock[2] and financial arrangements[3], are held on revenue account and are both taxable and immediately deductible. Still other assets – capital assets that are expected to decline in value over time ('depreciable property') – are only deductible over a number of years, in line with their estimated useful lives (if the asset is sold for more than its depreciated value, the excess deductions are clawed back as taxable income).

Parties to a sale of two or more assets with different tax treatments (a 'mixed supply') are required to allocate the total sale/purchase price between the various assets for tax purposes. The allocation determines the vendor's tax liability from the sale, and the purchaser's cost base for claiming deductions in the future. To correctly account for the business going forward, the owner must maintain a schedule for any depreciable assets – which have different depreciation rates – and a register of all the other assets, some of which may be bought or sold separately.

The policy problem is that currently, vendors and purchasers are able to adopt different price allocations that minimise their own tax liabilities, resulting in an overall loss to the revenue base. Moreover, in a small number of cases, parties have been found to adopt different allocations in their tax returns despite having agreed an allocation during the sale process.

The problem stems from the existing legal framework governing purchase price allocation. Under the Income Tax Act 2007, parties are generally required to ascribe market values to the assets transferred. But market value is a range rather than a single value and the parties are not required to use the same market values, other than for trading stock (the specific instance alluded to earlier where a rule akin to the proposed approach – discussed in the next section – is already used). There is also some doubt about how the law applies to a purchaser of depreciable property.  Consequently, the vendor can allocate lower amounts to depreciable property and financial arrangements, which are taxable, and higher amounts to non-taxable capital assets, to reduce its tax liability, while the purchaser can allocate higher amounts to depreciable property and financial arrangements in order to maximise its deductions over time.

Since the law does not require consistency, it is difficult for the Commissioner to challenge different allocations that are both based on market values, despite the result being a loss to the tax base. Investigations undertaken by Inland Revenue into a number of large commercial property transactions have revealed discrepancies between vendor and purchaser allocations resulting in overall revenue losses in the millions of dollars. Given the cost and uncertainty of disputes, these losses are often unable to be eliminated.  If the status quo continues, such outcomes are likely to recur.

[1] Any excess of the total sale price above the aggregate value of all the assets being sold, attributable to the established reputation of the business.

[2] Items bought and sold regularly in the course of a business, such as books in a bookstore.

[3] Arrangements under which a person receives money in exchange for providing money at a future time, such as loans.

Officials do not consider these discrepancies to be justifiable. In a normal commercial transaction, the vendor and purchaser will take different views of the value of an asset. The vendor will not sell the asset unless it thinks the asset is worth less than the purchaser is willing to pay for it, and the purchaser will not buy the asset unless it thinks the opposite. But the asset is sold and bought for a single price, and that price is the amount taken into account in the tax returns for both parties. There is no obvious reason to depart from this “single price” principle where multiple assets are sold together.

## 2.2 Who is affected and how?

The purchase price allocation amendments affect vendors and purchasers in mixed supplies – particularly those that do not agree an allocation under current law. Compliant parties to a sale are generally not opposed to alignment between sale and purchase prices but often do not support structured rules that increase compliance costs.

## 2.3 What are the objectives sought in relation to the identified problem?

The policy objective is to prevent revenue loss arising in mixed supplies – i.e. promote “revenue integrity” – while keeping any additional compliance and administration costs and disruption to natural commercial dynamics as small as possible.  Since the only way to prevent revenue loss is for the vendor and purchaser to use the same purchase price allocation, the  objective of revenue integrity can also be represented as “consistency”.

# Section 3: Options identification

## 3.1 What options have been considered?

- Option 1 – Status quo
- Option 2 – Party allocation (vendor first)
- Option 3 – Commissioner allocation
- Option 4 – Operational approach

Options 2 and 3 are the main legislative approaches considered by officials, and relate to how an allocation is made if the vendor and purchaser do not reach an agreement between themselves. Officials have always considered that if the parties agree an allocation, they should not be able to adopt separate, more favourable allocations in their tax returns. Officials have also been of the view that the allocation should always be based on relative market values (market values proportionate to the total purchase price) – in line with the current law – and that the Commissioner should  be able to challenge an allocation that she considers is not so based.

Other elements that did not differ between options 2 and 3 during policy development were:

- *Granularity of allocation:* parties should not be required to agree an allocation to every individual asset, but rather asset categories with unique tax treatments – e.g. depreciable property, buildings, land, revenue account property etc. While this may leave some scope for arbitrage between different write-down rates for depreciable property, for example, the compliance cost of working out and agreeing a value for every single asset might be unrealistic for many taxpayers.

- *Notification of allocation:* parties should be required to notify the Commissioner if they have not agreed an allocation.

- *De minimis:* transactions falling below certain value thresholds should not be subject to the consistency requirement for purchase price allocation, as the scope for tax manipulation is not great enough to present a material risk to the revenue base. The thresholds should be a total purchase price of $1 million, or an allocation to taxable property by the purchaser of $100,000.

Option 4 is the operational approach generally favoured by stakeholders.

The criteria against which the options were assessed are:

- *Compliance costs:* compliance costs for taxpayers should be minimised.

- *Administration costs:* administration costs for Inland Revenue should be minimised.

- *Neutrality*: the tax rules should not distort economic outcomes by incentivising business behaviours that do not make commercial sense, and are only adopted for tax reasons. They should not advantage one party over another.

**Option 1 – Status quo**

Vendors and purchasers can continue either to agree an allocation or to make their own separate allocations. The Commissioner can challenge allocations that she considers are not at market, but cannot require parties to adopt the same allocation. Revenue would continue to be lost where vendors and purchasers adopt separate allocations that minimise their own tax liabilities.

*Pros*

Parties would not have to change their behaviour, therefore compliance costs would be low.

*Cons*

There would likely be an ongoing substantial loss of revenue, meaning the objective of revenue integrity/consistency would not be achieved. Inland Revenue would continue to incur the administration costs associated with identifying inconsistent allocations through audit, and attempting to resolve inconsistencies without a legal basis to require resolution. Moreover, the status quo is not economically neutral, because parties adopting different allocations are relying on an effective subsidy from the revenue base to support their commercial transaction, when the transaction should stand on its own.

**Option 2 – Party allocation (vendor first)**

If the vendor and purchaser do not agree an allocation, they must step through a short sequence of rules that allow one of the parties to determine the allocation.

For two months after transfer of the property, the vendor is required to determine the allocation, and must notify the purchaser and the Commissioner of it. However, the vendor cannot allocate amounts to taxable property that result in an additional loss on the sale of that property (other than for part year depreciation).[4]

If the vendor fails to notify an allocation within the two-month window, the purchaser must determine the allocation, and notify the vendor and Commissioner of it. Whether the vendor or the purchaser determines the allocation, both parties must follow it in their tax returns. The allocation must be at market, and the Commissioner can challenge the allocation if she considers that it is not.

If neither party notifies an allocation, the vendor is treated as disposing of the assets for market value, and the purchaser is treated as acquiring the assets for nil consideration. The effect of this is that the purchaser is unable to claim any deductions in relation to the property until it has made an allocation. This incentivises the purchaser to make and notify an allocation, which is key to achieving consistency.

[4] The vendor will not be able to satisfy this rule if the total purchase price is lower than the vendor's aggregate carrying cost of the taxable property. In this case, therefore, the minimum allocation to taxable property will be its carrying value reduced (pro rata) in proportion to the difference between the aggregate carrying cost of the taxable property and the purchase price.

*Pros*

This option achieves the objective of revenue integrity/consistency by driving parties towards using a single allocation. It has low administration costs, as it is the parties who must allocate, not the Commissioner. Importantly, the parties will have much better knowledge of the transaction and the assets in it than the Commissioner, and are therefore better placed to make the allocation.

*Cons*

This option appears less neutral between the vendor and purchaser, as it allows the vendor to determine the allocation in the first instance. This may be perceived as unfair by some purchasers, or may be an additional source of tension in the negotiations, which could mean increased compliance costs. However, as the purchaser will be aware of the rule when negotiating the sale, an unfavourable or undisclosed vendor allocation could be answered by a reduced purchase price. Moreover, the vendor is constrained by not being able to allocate amounts to taxable property that would result in an additional loss.

**Option 3 – Commissioner allocation**

If the vendor and purchaser do not agree an allocation, they must request an allocation from the Commissioner. The Commissioner may choose the vendor's allocation, the purchaser's allocation, or any other allocation within a market value range. Both parties must then follow that allocation in their tax returns.

The Commissioner's allocation cannot be challenged. The Commissioner may or may not decide to seek an external valuation to determine the allocation.

*Pros*

This option ensures revenue integrity/consistency by driving parties towards using a single allocation. It has low compliance costs, because if the parties cannot agree, it is the Commissioner who determines the allocation. The uncertainty of what the Commissioner will decide to allocate also provides a strong incentive for both parties to reach an agreement between themselves. Since neither party is given the opportunity to allocate before the other, this option is relatively neutral in its impact on the commercial dynamic.

*Cons*

The administration costs of this option could be high. The Commissioner has to dedicate resources to making an allocation every time parties fail to agree one. To avoid costly disputes, the Commissioner's allocation has to be unchallengeable, but this is likely to be seen as unfair by aggrieved parties – particularly if the Commissioner's position is not supported by an independent valuation. This might lead to attempts to challenge an allocation regardless of any legal provisions, for example through judicial review.

**Option 4 – Operational approach**

The vendor and purchaser can continue either to agree an allocation or to make their own separate allocations. In the latter case, the parties are required to notify the Commissioner that they have not agreed, and to provide both the Commissioner and the other party with copies of their respective allocations. Penalties will apply to parties who are found not to have complied with this requirement.

If the Commissioner takes issue with one or both of the parties' allocations, she can enter into a dispute with both parties simultaneously, leveraging the associated costs as an incentive for the parties to agree an allocation.

The Commissioner will issue clear guidance to the effect that vendors and purchasers should agree a purchase price allocation or risk a dispute with the Commissioner. She will also clarify the existing legislative provisions governing allocations. There will be no other changes to the legislation.

*Pros*

This approach may be seen as more subtle and targeted at the concern area – a relatively small number of large transactions where there is deliberate and substantial tax planning. It may seem fairer to vendors and purchasers than enforced legislative rules, and more neutral on transactions.

*Cons*

The Commissioner cannot require the desired outcome of consistency, because there is no legal basis for her to do so. Parties may be deterred by the costs of dispute, but they may not, and then an operational approach is ineffective at resolving the revenue risk. The Commissioner has failed to achieve consistency in a number of real disputes, and it is unlikely that this would change simply through administrative guidance.

## 3.2 Which of these options is the proposed approach?

The proposed approach is option 2. Officials consider that it is the best option on balance, for the reasons outlined below.

*Legal foundation*

Option 2 provides a strong legal requirement for consistency, which does not currently exist. This enables the Commissioner to mandate consistency, not merely expect it. While the operational approach (option 4) may be seen as less intrusive, it is also likely not to lead to the desired outcome in some cases.

*Expertise*

Where the parties do not agree an allocation, it is better to keep the responsibility to allocate with the parties rather than transfer it to the Commissioner, because the parties are directly engaged in the transaction and have a much better understanding of the assets being sold, and their value. The Commissioner is detached from the transaction, has no particular valuation expertise, and is largely indifferent to what allocation is chosen provided it is a single allocation and is tethered to market values. An allocation determined by the Commissioner will be seen as at least as arbitrary – if not more arbitrary – than an allocation chosen by the vendor or the purchaser, and to avoid the possibility of costly disputes that would ultimately have to be funded by the Government, the Commissioner's determination has to be unchallengeable. Stakeholder feedback has indicated that this would not be popular.

*Neutrality*

The main criticism of the proposed approach is that it favours the vendor, since, if the parties do not agree an allocation before filing their returns, the vendor is given the power to determine it first. Thus, the vendor is not incentivised to agree an allocation, and the rules disrupt the neutrality of the commercial dynamic. However, officials consider that this concern is overstated for the reasons outlined below.

In the first place, if the allocation is important to the purchaser, the purchaser can insist on agreeing the allocation with the vendor as a condition of the deal. If the vendor is not prepared to agree the allocation, the purchaser may either refuse to go ahead with the transaction, or lower its price. These strategies operate as a counterbalance to the vendor's perceived advantage.

Even if the vendor gets the opportunity to determine the allocation, it is constrained by not being able to allocate amounts to taxable property that result in an additional loss. This means that the purchaser's cost basis for claiming deductions in the future cannot be lower than the vendor's basis would have been had the transaction not occurred. It also means that if the vendor considers the value of taxable property to be lower than its current carrying value, it is incentivised to agree an allocation with the purchaser to avoid paying more tax on the transaction than it thinks is appropriate. Thus, the ability for the vendor to determine the allocation is only advantageous if it thinks the taxable property is worth *more* than its carrying value. Probabilistically, it seems reasonable to assume  this might only be the case half of the time.

Finally, the Commissioner can challenge an allocation that she considers is not based on market values. If the amounts allocated by the vendor to taxable property are unjustifiably low (even taking into account the aforementioned constraint), and the transaction is sufficiently large, the Commissioner may intervene and substitute an allocation that is more favourable to the purchaser.

*Awareness of the rules*

Another related concern with the proposed approach is that parties may not turn their minds to the tax implications of the transaction until after the sale and purchase is completed, and then the vendor has the power to allocate. This may occur in multiple bid scenarios, or where parties are distressed.

If parties neglect to consider tax until filing their returns, then the result will be either that the purchaser must settle for the vendor's market values *or* the vendor for the purchaser's, if more than two months have elapsed since the property was transferred.  However, officials consider that this is unlikely to occur if the parties are well advised and the rules are signalled so that taxpayers and advisors are aware of them. Officials anticipate that taxpayers will adapt sale and purchase practices to ensure there is sufficient time for an allocation to be agreed before the transaction is completed. Moreover, for the reasons given in the previous section, officials do not think purchasers will be significantly disadvantaged by a vendor-determined allocation.

# Section 4: Impact Analysis (Proposed approach)

## 4.1 Summary table of costs and benefits

| **Affected parties** *(identify)* | **Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks | **Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts* |
|---|---|---|
| | | |
| Additional costs of proposed approach, compared to taking no action | | |
| *Regulated parties*<br>Vendors and purchasers in mixed supply transactions | Some vendors will pay more tax and some purchasers will claim lower deductions as a result of the new rules. The revenue estimate is based on data from commercial property transactions, extrapolated out to the total base of tangible property.<br>Possible compliance costs for vendors and purchasers associated with having to negotiate an agreed allocation, or to expedite an agreement that might otherwise have occurred after the sale. | Approximately $154 million of additional tax paid/collected over the forecast period (2021-24).<br>Low to medium |
| *Regulators*<br>Inland Revenue | | |
| Wider government | | |
| Other parties | | |
| **Total Monetised Cost** | | **Estimated $154 million over forecast period** |
| **Non-monetised costs** | | **Low to medium** |

| | | |
|---|---|---|
| Expected benefits of proposed approach, compared to taking no action | | |
| *Regulated parties*<br>Vendors and purchasers in mixed supply transactions | | |
| *Regulators*<br>Inland Revenue | Inconsistent allocations will not occur, or will be clearly in breach of the law, so able to be effectively challenged. | Medium |
| Wider government | An increase in revenue is expected. | Approximately $154 million of revenue gain over the forecast period (2021-24). |
| Other parties | | |
| **Total Monetised Benefit** | | **Estimated $154 million over forecast period** |
| **Non-monetised benefits** | | **Medium** |

### 4.2 What other impacts is this approach likely to have?

Some sale and purchase transactions may take longer as a result of a single allocation having to be used. This may place more pressure on some purchasers in multi-bid deals where there is competition with foreign purchasers that are not subject to the consistency rule. Officials note, however, that purchasers from different jurisdictions may be on an unequal footing already for a variety of reasons that are unrelated to purchase price allocation.

## Section 5: Stakeholder views

### 5.1 What do stakeholders think about the problem and the proposed solution?

Officials engaged in targeted consultation with the Corporate Taxpayers Group (CTG), Chartered Accountants Australia and New Zealand (CA ANZ), KPMG, PwC, Deloitte and Russell McVeagh, and an official's issues paper – *Purchase price allocation* – was released for public consultation in December 2019. Submissions on the issues paper were received from the above stakeholders as well as Business NZ, Bell Gully, the New Zealand Law Society, nsaTax, Chapman Tripp, and EY.

Almost all stakeholders support the proposition that parties to a mixed supply should adopt the same purchase price allocation. A number of advisors have noted that they always advise their clients to agree an allocation, as it is considered best practice from a tax perspective. However, clients do not always follow this advice.

A few stakeholders disagree with the central premise that parties should always be required to agree on the value ascribed to an asset, as parties could legitimately take different views of its value (officials acknowledge this reality but do not think it is a valid reason to treat the asset as being sold for two different values for tax purposes).

Nearly all stakeholders disagreed with the proposals set out in the issues paper for legislative reform. Many felt that legislative measures were unnecessary or overly burdensome, and that the policy objectives could instead be achieved operationally through better enforcement of the existing law and the publication of additional guidance for businesses on price allocations.

The strongest concern expressed by most stakeholders was that the approach set out in the issues paper gave too much power to the vendor, by allowing the vendor to determine the allocation if the parties could not reach agreement. Stakeholders were not convinced that the purchaser would always have the negotiating power to insist that the vendor agree an allocation with it, or that the parties would always turn their minds to tax during the negotiation, and once the transaction was completed, the purchaser would have no recourse.

In response to these concerns, officials made a significant modification to the proposal: the vendor cannot allocate amounts to taxable property (depreciable property, revenue account property, financial arrangements) that result in an additional loss on that property. Therefore, the vendor cannot, for example, allocate to an item of depreciable property an amount that is less than its adjusted tax value. This constraint protects the purchaser from an unreasonably low vendor allocation that may not be challenged by the Commissioner. It also means that the purchaser cannot end up with a lower cost basis for deductions than the vendor would have had if the transaction had not occurred. This enhances the neutrality of the rules.

The modification went some way to allaying stakeholder concerns, but stakeholders are still in disagreement with the proposals. The majority are of the view that legislation is unnecessary, and thus would not agree with the amendments in any form.  Officials explored the possibility of an operational solution early on, but determined that it would not be effective, as ultimately the Commissioner would have no legal basis on which to require the desired outcome of revenue integrity/consistency. Parties might choose to agree an allocation, but that is the case under the status quo, and the lack of an *obligation* for them to do so is the problem perpetuating the loss of revenue.

# Section 6: Implementation and operation

## 6.1 How will the new arrangements be given effect?

The new rules will be legislated via the Taxation (Annual Rates 2020-21, Feasibility Expenditure, and Remedial Matters) Bill, and will apply to agreements for the disposal and acquisition of property entered into on or after 1 April 2021. In conjunction with the enactment of the legislation, Inland Revenue will publish guidance on the new rules so that taxpayers and advisors are aware of them and have time to prepare. Officials note that the basic requirement for parties to make a purchase price allocation is not new, so a long lead-in period is not necessary.

For vendors and purchasers in mixed supplies that agree an allocation, nothing will be different, other than that they will now be obliged under income tax law to follow the agreed allocation in their tax returns (which happens in almost all cases in any event). For parties that do not agree an allocation before filing their returns, but determine that the transaction falls below at least one of the two de minimis thresholds – a $1 million transaction value or a $100,000 allocation to taxable property by the purchaser – nothing will be different. Officials envisage that these thresholds will exclude many rental property sales (as residential buildings cannot be depreciated by the purchaser and are therefore not counted towards the taxable property threshold), as well as some small business sales.

Where parties do not agree an allocation and both de minimis thresholds are exceeded, whichever party unilaterally allocates under the new rules will have to notify both the other party and the Commissioner of its allocation. This will tell the other party what values it must use to complete its tax return, and will give the Commissioner visibility of the allocation, so that she is in a position to ensure the other party follows it, and to challenge it if necessary. The notification procedures are set out in section 14 of the Tax Administration Act 1994.

Compliance with the new rules will be monitored through routine audit and through evaluation of any allocations notified to the Commissioner by the parties.

Overall, implementation risks are low, provided the rules are well-signalled, as they are intended to be.

# Section 7: Monitoring, evaluation and review

## 7.1 How will the impact of the new arrangements be monitored?

Officials will engage with the tax advisory community and Inland Revenue investigators again when the rules are in force to seek feedback on how the rules are working for vendors and purchasers.

Officials considered requiring all vendors and purchasers in mixed supplies to notify the Commissioner of their allocation, regardless of whether they agreed the allocation or not, however this would increase compliance costs for taxpayers and officials expect the monitoring methods outlined above to be sufficient.

## 7.2 When and how will the new arrangements be reviewed?

Policy officials maintain strong communication channels with stakeholders in the tax advisory community, and these stakeholders will be able to correspond with officials about the operation of the new rules at any time. If problems emerge, they will be dealt with either operationally, or by way of legislative amendment if needed.