

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):

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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 goodwill¹, are generally held on capital account and are not taxable or deductible. Other assets, such as trading stock² and financial arrangements³, 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
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Additional costs of proposed approach, compared to taking no action

<p><i>Regulated parties</i> Vendors and purchasers in mixed supply transactions</p>	<p>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.</p> <p>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.</p>	<p>Approximately \$154 million of additional tax paid/collected over the forecast period (2021-24).</p> <p>Low to medium</p>
<p><i>Regulators</i> Inland Revenue</p>		
<p>Wider government</p>		
<p>Other parties</p>		
<p>Total Monetised Cost</p>		<p>Estimated \$154 million over forecast period</p>
<p>Non-monetised costs</p>		<p>Low to medium</p>

Expected benefits of proposed approach, compared to taking no action

<p><i>Regulated parties</i> Vendors and purchasers in mixed supply transactions</p>		
<p><i>Regulators</i> Inland Revenue</p>	<p>Inconsistent allocations will not occur, or will be clearly in breach of the law, so able to be effectively challenged.</p>	<p>Medium</p>
<p>Wider government</p>	<p>An increase in revenue is expected.</p>	<p>Approximately \$154 million of revenue gain over the forecast period (2021-24).</p>
<p>Other parties</p>		
<p>Total Monetised Benefit</p>		<p>Estimated \$154 million over forecast period</p>
<p>Non-monetised benefits</p>		<p>Medium</p>

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.