

Hon Grant Robertson, Minister of Finance

Hon Stuart Nash, Minister of Revenue

Information Release

Purchase price allocation: release of officials' issues paper

January 2020

Availability

This information release is available on Inland Revenue's Tax Policy website at <http://taxpolicy.ird.govt.nz/publications/2020-ir-cab-dev-19-sub-0336/overview>.

Documents in this information release

1. IR2019/554 T2019/3648 – Tax policy report: Purchase price allocation (13 November 2019)
2. DEV-19-SUB-0336 – Cabinet paper: Purchase price allocation issues paper (4 December 2019)
3. DEV-19-MIN-0336 – Minute: Purchase price allocation: release of officials' issues paper (4 December 2019)

Additional information

The Cabinet paper was considered by the Economic Development Committee on 4 December 2019 and confirmed by Cabinet on 9 December 2019.

One attachment to the Cabinet paper is not included in this information release as it is publicly available:

- Purchase price allocation – an officials' issues paper (10 December 2019).

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
- 9(2)(f)(iv) to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

Copyright and licensing

Cabinet material and advice to Ministers from the Inland Revenue Department and other agencies are © Crown copyright but are licensed for re-use under the Creative Commons Attribution 4.0 International (CC BY 4.0) licence (<https://creativecommons.org/licenses/by/4.0/>).





POLICY AND STRATEGY


Tax policy report: Purchase price allocation

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

Action sought

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

Contact for telephone discussion (if required)

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

13 November 2019

Minister of Finance
Minister of Revenue

Purchase price allocation

Executive summary

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

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

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

Recommended action

11. We recommend that you:

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

Agreed/Not agreed

Agreed/Not agreed

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

Noted

Noted

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

Noted

Noted

Mark Vink
 Manager
 The Treasury

Casey Plunket
 Special Advisor
 Policy and Strategy, Inland Revenue

Hon Grant Robertson
 Minister of Finance
 / /2019

Hon Stuart Nash
 Minister of Revenue
 / /2019

Background

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

Problem definition

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

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

Recommended solution

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

Fiscal implications

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

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

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

Systems or technology impacts

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

Consultation

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

Sensitive

Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

PURCHASE PRICE ALLOCATION ISSUES PAPER

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to the release of an officials' issues paper, *Purchase price allocation*, for public consultation.

Executive Summary

2. In September, the Government announced two tax policy initiatives to support the Economic Plan – a law change to provide greater deductibility of feasibility and other currently non-deductible expenditure; and public consultation on options to relax the tax loss continuity rules and review the research and development tax loss cash out scheme introduced in 2016.
3. In approving these measures, Cabinet noted these initiatives were part of a package of proposed business-related tax initiatives in the Government's Tax Policy Work Programme, including some items that raise revenue (DEV-19-MIN-0255).
4. One of these items is the purchase price allocation initiative. This is an integrity measure which is aimed at increasing the efficiency of the tax system and ensuring that sales of businesses and commercial property (in particular) do not lead to an inappropriate income tax reduction. The integrity of the tax system was an important theme emphasised by the Tax Working Group and work in this area has been prioritised following the Group's final report.
5. A number of sizeable transactions, particularly in relation to commercial property, have been identified by Inland Revenue with differences between the seller's and the purchaser's allocations, sometimes in the tens of millions of dollars. This discrepancy is, in effect, an unintended subsidy from the government.
6. The government is currently missing out on an estimated s 9(2)(f)(iv) of tax revenue per annum, as a result of a gap in the law that allows the buyer and the seller to adopt different asset valuations for tax purposes in respect of the same sale transaction. This arbitrage can result in the seller treating the sale proceeds as non-taxable capital gains and the purchaser treating the purchase price as deductible/depreciable.
7. The issues paper seeks feedback on possible changes to the tax rules to correct this anomaly.

8. The purpose of these proposed changes is to reinforce the integrity of the tax system by requiring the buyer and the seller to ascribe the same value to the assets sold.
9. The estimated revenue raised by these changes (if they were to be adopted) is approximately s 9(2)(f)(iv) over the forecast period.
10. I am also seeking Cabinet's approval to delegate final policy decision-making to the Minister of Finance and the Minister of Revenue. This is to ensure the changes can be implemented for transactions occurring on or after 1 April 2021 and the revenue raised can be used to increase gross spending for Budget 2020, if we decide to proceed with changes to the law following public consultation.

Background

11. When a bundle of assets with different tax treatments is sold, both the vendor and the purchaser need to allocate the global price between the different assets to determine their tax treatment. Sales of businesses and commercial properties (land, buildings and fit out) tend to be the largest transactions of this kind, but sales of residential rental properties are also affected. The allocation is important in determining the vendor's tax liability from the sale, and the purchaser's cost base for calculating depreciation and any taxable gains when they in turn come to sell the property.
12. Generally, the allocation must be based on market values, and there is case law that reinforces this. However, there is no explicit requirement in tax law for the vendor and purchaser to use the same market values, except in relation to the trading stock component of a transaction. When trading stock is sold along with other assets, the vendor is required to apportion an amount to the trading stock that reflects its market price, and the purchaser is required to use that same apportionment. Trading stock is widely defined for this purpose, including anything produced, manufactured or acquired for the purpose of disposal, as well as livestock, timber, and land whose disposal would produce income. Anecdotally it appears that this requirement may not be well understood.

The issue

13. If the parties adopt different allocations, the result is usually a loss of tax revenue. This issue is on the tax policy work programme, and was referred to as part of a business tax package when Cabinet made a decision to proceed with the feasibility expenditure and loss continuity initiatives earlier in the year.

Analysis

14. For revenue integrity reasons, the parties should be using consistent valuations based on market values. Generally, throughout the Income Tax Act, sales are assumed to be at market value so that there is no transfer of value between the parties which could lead to a reduction in tax revenue.
15. In practice, consistent valuations are adopted in many cases. However, since market value is a range of values, parties are able to adopt allocations which are quite different, while both claiming that their allocations are tethered to commercial prices.

In many cases, the seller uses depreciated tax book values for depreciable assets, arguing that they are reflective of market values, but avoiding any depreciation clawback (that is, the requirement to pay back depreciation deductions claimed in respect of an assets that has not, in fact, depreciated as fast as expected). The purchaser on the other hand often allocates a higher cost to the same assets, to increase depreciation deductions.

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, i.e. 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.

-
16. The lack of an explicit requirement for the vendor and purchaser of a business to adopt a consistent allocation incentivises the parties not to agree on an allocation. Inland Revenue incurs significant costs trying to match buyers and sellers, investigate their allocations, and obtain valuations to determine whether the parties' allocations can be challenged as departing from market values. Where both parties have a valuation from a registered valuer, challenge is extremely difficult, even if the valuations are significantly different.
 17. Inland Revenue's compliance work has uncovered a number of sizeable transactions, particularly in relation to commercial property, where there have been differences between the seller's and purchaser's allocations to depreciable property sometimes in the tens of millions of dollars. Differences were identified in nearly fifty percent of the investigated cases, amounting in total to around \$130 million. In some of these cases, settlements have been agreed. The remainder are either in dispute or have not yet been dealt with given resource constraints. There is no doubt that under current law, many of these discrepancies will not be able to be resolved.

Issues paper proposal

18. To resolve these issues the issues paper seeks feedback on the following approach:
- In any transaction involving the sale of assets with different tax treatments, the vendor and purchaser would be required to use the same allocation of the total purchase price to the different types of assets.
 - If the two parties cannot agree an allocation, the purchaser must use the vendor's allocation. The vendor, before filing its tax return for the relevant income year, must disclose its allocation to the purchaser. If the vendor does not provide its allocation to the purchaser in a reasonable amount of time, the purchaser may prepare an allocation, which must then be used by the vendor.
 - The allocation should be based on relative market values or, possibly in relation to a vendor allocation, depreciated value or original cost in relation to depreciable property.
 - Given the breadth of coverage (rental properties would be covered, for example), and to reduce compliance costs, there could be a de minimis – e.g. sales in which the total amount allocated by the purchaser to deductible or depreciable items is less than \$100,000 could be excluded from the consistency requirement.

Consultation

19. The issue has been identified in investigations and disputes over a number of years. An organised programme of investigation into large commercial property transactions brought it into focus. The increased profile of the issue within Inland Revenue has flushed out further transactions, and it seems clear that there is a need for action of some kind.
20. To test out the problem and possible solutions, officials engaged with key stakeholders, in particular Chartered Accountants Australia and New Zealand, the Corporate Taxpayers Group, Russell McVeagh, PwC and KPMG. Their involvement and cooperation will be important to the success of any policy change given their clients and members are those most likely to be affected. While these stakeholders would prefer an operational solution, given the time and cost involved, and the need for consistency, officials have advised that a legislative change seems to be a better solution to this issue.

Financial Implications

21. There are no direct financial implications of this Cabinet paper.
22. If the proposals outlined in the issues paper were to be implemented exactly as proposed, this is estimated to increase tax revenue by approximately $s\ 9(2)(f)(iv)$ over the forecast period.
23. This estimate is based on a sample of known cases, extrapolated out to the total estimated base of depreciable property sold with other assets. As it does not include financial arrangements, or revenue from improved compliance with the trading stock

rules, it is potentially conservative. However, it should also be noted that the methodology to reach this number is complex and relies on a number of assumptions.

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

Systems and Administrative Implications

25. The proposal does not give rise to significant operational or systems changes and would have low administrative costs for Inland Revenue.

Legislative Implications

26. Implementing these proposals would require changes to the Income Tax Act 2007.
27. The issues paper indicates that any legislative changes resulting from the proposals put forward in the paper would be included in a tax bill in early-mid 2020.

Impact Analysis

28. The issues paper substitutes for a Regulatory Impact Assessment. Inland Revenue's Quality Assurance panel has reviewed the issues paper and confirms that it is likely to lead to effective consultation and to support the delivery of Regulatory Impact Analysis that supports subsequent decisions.

Human Rights

29. There are no human rights implications.

Gender Implications

30. There are no gender implications.

Disability Perspective

31. There are no disability implications.

Publicity

32. I will make an announcement on the issues paper at the time it is released. The proposals it contains are likely to be controversial in the tax advisory community.

Proactive Release

33. I propose to proactively release this Cabinet paper, associated minutes, and key advice papers, with appropriate redactions.

Recommendations

1. **agree** to the release of the attached issues paper on purchase price allocation, on 10 December 2019;

2. **authorise** the Minister of Revenue to approve any final technical amendments to the issues paper before its release;
3. **note** there are no direct financial implications of this Cabinet paper, however the changes suggested in the issues paper could raise approximately s 9(2)(f)(iv) over the forecast period;
4. **authorise** the Minister of Finance and the Minister of Revenue to make final policy decisions following consultation;
5. **note** that this Cabinet paper, the associated Cabinet minute, and key advice papers will be proactively released, with appropriate redactions.

Authorised for lodgement

Hon Stuart Nash
Minister of Revenue



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.

Purchase Price Allocation: Release of Officials' Issues Paper

Portfolio **Revenue**

On 4 December 2019, the Cabinet Economic Development Committee:

- 1 **agreed** to the release of the officials' issues paper on purchase price allocation (the issues paper), attached to the submission under DEV-19-SUB-0336, on 10 December 2019;
- 2 **authorised** the Minister of Revenue to approve any final technical amendments to the issues paper before its release;
- 3 **noted** that the changes suggested in the issues paper could raise approximately s 9(2)(f)(iv) over the forecast period;
- 4 **authorised** the Minister of Finance and the Minister of Revenue to make final policy decisions following the consultation.

Janine Harvey
Committee Secretary

Present:

Rt Hon Winston Peters
Hon Kelvin Davis
Hon Grant Robertson (Chair)
Hon David Parker
Hon Nanaia Mahuta
Hon Jenny Salesa
Hon Kris Faafoi
Hon Shane Jones
Hon Willie Jackson
Hon James Shaw
Hon Eugenie Sage

Officials present from:

Office of the Prime Minister
Officials Committee for DEV

Hard-copy distribution:

Minister of Revenue