

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.

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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