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Our ref: Purchase Price Allocation

Purchase Price Allocation
c/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
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Dear Madam

KPMG Submission - Purchase Price Allocation

KPMG is pleased to make a submission on the officials' issues paper "Purchase Price Allocation" (the "Issues Paper").

General Comments

We understand the issue arises because vendors and purchasers adopt different valuations in mixed supplies. The difference results in a mis-match of tax outcomes which Inland Revenue is motivated to try to resolve. This leaves vendors and purchasers in an uncertain position. Further, the ability of Inland Revenue to resolve this is unclear and practically may not be achievable (due to cost and the reality that market value is a range rather than a single number).

In principle, measures to provide certainty are sensible. However, any measures need to be practical and to not unduly interfere in the commercial negotiations.

Our experience

When advising on transactions of this nature, we encourage parties to agree the allocation of the purchase price between the various categories of assets. Where allocations have been agreed, our experience is that parties have not deviated from the agreed allocations when filing their income tax returns.

Where purchase price allocations have not been or cannot be agreed, independent market valuations will generally be obtained as a means of allocating the purchase price, as a matter of practice. This is then used as the basis for filing income tax returns. However, this has not precluded Inland Revenue scrutiny and, in some circumstances, Inland Revenue has obtained their own valuations as a basis to challenge the tax position.

This leaves taxpayers in a difficult situation, unable to obtain certainty on a mixed supply transaction where the allocation has not been agreed, even though they have acted in good faith in determining their tax position.

Given the above, we are supportive of a change that encourages parties to a mixed supply transaction to agree the allocation of the purchase price and using this allocation for tax purposes.

Submission

1. Allocation when parties agree

Where two independent parties are transacting mixed supply property, a natural tension exists between the two means that any allocation agreed by them represents market value. For this reason, we consider that the Commissioner should be required to accept that allocation.

Specifically, the mis-match that arises from different values and is the concern being addressed, does not arise. Any mis-match is due to the difference in character of the amounts (for example, a capital sale, a deductible acquisition) or the tax status of the parties. The difference is therefore systemic rather than due to the allocation values.

We appreciate there may be instances where one party is less concerned with the allocation. for instance, if one party is tax exempt or acquiring a building on revenue account. While this may lead to a non-market value allocation, we consider the Commissioner's existing tax avoidance powers should be sufficient to deal with any abuse of this process.

One of the key benefits to these proposals is that it provides certainty for taxpayers. Allowing the Commissioner to adjust agreed allocations undermines this certainty and may also discourage parties from agreeing an allocation if they know that the Commissioner has the ability to make any adjustment she considers necessary.

We agree with the requirement, that once agreed between the parties, these allocations must be followed in filing each party's tax return. This is essential for taxpayers to be comfortable that they have certainty filing their income tax returns based on agreed allocations.

2 Allocation when the parties do not agree

For commercial reasons, parties do not agree an allocation. Typically, this is due to time pressures or because parties are forced to deal with each other when the relationship has broken down.

However, subsequently, each party for its own tax and accounting position must determine an allocation. The point is that there are commercial requirements which force a post-acquisition allocation for both parties.

2.1 Vendor's allocation option

We have some concerns that allowing the vendor the first initial right to prepare the allocation if mutual agreement is not reached gives vendors additional power in any negotiations. This could lead to vendors stifling negotiations around the purchase price allocation to allow them to come up with an allocation which is favourable to them.

However, a clear structured approach to determine the allocation where parties do not agree will encourage the purchaser to agree the allocation, rather than having to accept the vendor's allocation. Further, arguably, as the vendor has to immediately pay tax on depreciation recovered income, this is fairer.

We consider that requiring the parties to treat depreciable property as sold for its original cost to the vendor is not appropriate. Based on our experience, depreciable property (other than buildings), is very infrequently valued at (or above) their original cost and, therefore, we consider this approach would not represent the commercial reality of the transaction.

We agree that in arriving at the allocations, vendors should be guided by relative market value. (This should prevent vendors from making unreasonable allocations which bind the purchaser.)

The issue, however, is what is an acceptable method for determining this value where an independent valuation has not been obtained? For simplicity, the rules could include a safe harbour, which applies where no valuation or other evidence of relative market values is obtained.

The safe harbour could treat any buildings as sold for their original cost, such that any historic depreciation is recovered by the vendor, and any other depreciable property as sold for its depreciated value. However, this is unprincipled. Officials work for the Tax Working Group confirmed that buildings do in fact depreciate. This means that the market value of a building can be below its cost.

Further, this safe harbour option still favours vendors over purchasers. Although, as noted in the Issues Paper, purchasers would factor this potential outcome into their negotiations, this does not allow them deductions consistent with their economic position. A much better result for the tax system is obtained if a purchaser is entitled to a deduction based on their economic cost.

Accordingly, although a vendor allocation approach provides some certainty and can be a proxy for market values, it is not the only possible solution and may not be ideal.

2.2 A disclosure to Commissioner option

Both parties will have to allocate the price to assets and liabilities for tax purposes at least. If both parties are required to disclose this to the Commissioner, the Commissioner can decide whether the parties have complied with the market value rules. If not, the Commissioner can seek to enforce those rules.

We see this option as encouraging the parties to agree as it is likely that the Commissioner would inquire further if the disclosures showed the values did not align in a way which caused her concern. Further, it does not provide either party with additional bargaining power.

From a timing perspective, the disclosures could be made via MyIR with the disclosure due within a fixed time after accounting decisions and allocations are made if this occurs before the income tax return is due. Otherwise, the disclosure would be required with the return.

2.3 Contest by a party

If a vendor allocation model is followed, careful consideration should be given to whether a purchaser can contest this.

The Issues Paper notes that, if the purchaser is concerned about the allocation it should ensure this is agreed with the vendor, and where this not possible, should factor any lost depreciation into the agreed price. This is theoretically correct but it is possible that either party will not be motivated to agree.

Given that the Commissioner would still be able to contest the allocation, the purchaser should be able to join that dispute as the natural consequence is they would be affected by the result of the Commissioner’s dispute with the vendor.

2.4 Our preference

Although we can see a case for a vendor allocation, we consider that this has the potential to interfere in the commercial transaction. We consider that a purchase price adjustment, in the absence of agreement, is a second best alternative as the tax consequences will not be transparent.

Implementing a rule that provides certainty for those that agree and requires disclosure for those that do not should be tried as a first step. If the Commissioner disagrees with an allocation made and that would affect the other party (as we assume it would), then the other party should have rights to be involved in any dispute.

3 Other matters

3.1 De minimis

In principle, the same approach (i.e. agreeing an allocation) should apply to all transactions. However, we agree that a de minimis may be helpful to reduce compliance costs for smaller transactions

3.2 Level of allocation

We consider that it should not be necessary for parties to agree an allocation for every single asset or category of depreciable property. We consider this would make negotiations unnecessarily complex. While we accept there may be some discrepancies between the ultimate allocation between categories of depreciable property by the vendor and purchaser, we consider the impact is likely to be minimal for the tax base.

In our view, agreeing a split between land, buildings and fit-out should be enough. We understand that the focus of the Issues Paper is to ensure that the total amount allocated to depreciable property (other than buildings), is the same as that included in the disposal calculation by the vendor. On that basis, the allocation between different categories of depreciable property should not be a cause for concern, even where this results in a discrepancy.

We understand that Officials want to avoid a situation where a vendor arbitrarily allocates all of the purchase price allocated to depreciable property to one category, resulting in a large non-taxable gain for that category and a depreciation loss for the others. However, in such situations, the Commissioner could use its tax avoidance powers as grounds for adjusting this allocation.

While we agree in principle that the vendor's allocation between categories of depreciable property should be based on relative market values, as noted above, this introduces some uncertainty as to how market value can be determined in the absence of obtaining an independent valuation. Again, for simplicity, we suggest the rules could include a safe harbour, whereby the purchase price allocated to depreciable property must be pro-rated against all categories of depreciable assets based on each category's original cost.

3.3 Types of transactions – a phased approach

The recently released cabinet papers focus on commercial property transactions. These deal with relatively confined asset classes – land, buildings, plant and equipment, fixtures and fittings.

Allocations are also required when businesses are sold. In that case, additional assets such as goodwill, customer lists as well as trading stock and liabilities are "acquired". The allocation exercise is less straight forward.

Consideration should be given to applying any rules to real property first to see if the rules are practical and achieving a desired effect. If the rules do work, they can then be extended to other property transactions.

3.4 Impact of accounting rules

For the purchaser, if the acquisition is a business combination, they are required to perform a fair value exercise. This restates the transaction from its legal form as the purchaser must ascribe fair value to assets and liabilities acquired and determines as a result whether goodwill arises or whether a bargain has been acquired. Further, different accounting consequences arise depending on what values are allocated to different assets. For example, intangible assets are typically amortised while goodwill is subject to impairment testing and expensed only if it is impaired.

The allocation may not be the same as the sale and purchase price or an agreed allocation in the sale and purchase agreement. This potentially causes differences between the allocations made for tax purposes. These differences are dealt with by the deferred tax accounting rules for financial reporting purposes. However, they may create a perception that the vendor and purchaser are taking different positions.

The Commissioner should consider whether taxpayers should document what they have done to track values and amounts from the sale and purchase agreement to their tax returns and financial statements. If she considers that would be helpful for taxpayers and Inland Revenue to show compliance, she should publish her view of what she would like to see on an inquiry by Inland Revenue.

Further information

If you would like to discuss our submission please contact us – John Cantin on 04 816 4518 or Rachel Piper on 09 363 3525 and we would be happy to cover any points raised in greater detail.

Yours sincerely

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