KPMG Tax Chat

Commercial Property Transactions - The Taxman is Watching You

"Big Brother is watching you" is a phrase made famous by George Orwell in his dystopian vision of the future outlined in his famous novel 1984. While the New Zealand of 2018 is a far cry from the bleak future suffered by the citizens of "Airstrip One", Orwell's vision of the ability of the Government to scrutinize the activities of its citizens proves increasingly prophetic.

This ability to scrutinize activities extends well into the tax sphere. Over the last twelve months Inland Revenue has been undertaking a project focused on matching up the allocation of the purchase price adopted by the purchaser and vendor on commercial property transactions.

This project has arisen because of a concern that the two parties to a transaction are taking different tax positions for the purposes of determining the sales proceeds for calculating depreciation recovery income/loss on disposal (for the vendor) vs the cost base for the purposes of calculating tax depreciation (for the purchaser), resulting in tax leakage.

It is relatively easy for Inland Revenue to identify the parties to property transactions (both through media articles and Land Information New Zealand records) and the requests we are seeing are for both parties to a transaction to provide details regarding the methodology they have used to allocate the purchase price to the component assets that have been transferred, as well as the support for this allocation.

Prior to the reduction in the depreciation rate on building structures (to zero percent from the beginning of the 2011/2012 income year) there was a natural tension between vendors and purchasers - the vendor preferred a higher allocation to land and a lower allocation to the building structure and building fit-out (to reduce depreciation recovery income), whereas the purchaser preferred a higher allocation to the building structure and building fit-out (to increase tax depreciation). Generally the parties either negotiated to a position that broadly gave them a similar allocation of purchase price, or arrived at a similar allocation amount for the land, with all other value being ascribed to depreciable items.

Post the reduction in the tax depreciation rate on building structures, the purchaser is less concerned with the amount allocated to building structure, however the vendor is still concerned with this if they have previously claimed tax depreciation which may be recovered on sale. Given that only building fit-out is depreciable, the purchaser is now very focused on ensuring that they have maximised the allocation of the purchase price to depreciable items.

Those of you who have negotiated the sale or purchase of a residential property will no doubt recall how protracted the negotiations are to agree on the purchase price, let alone then negotiating further to agree on the allocation of this amount between individual assets that are being transferred.

This means that the parties to the transaction generally agree the purchase price only, and then take their own positions to allocate this amount between land, building structure and fit-out. Inland Revenue's current information gathering project is focused on determining how different the positions taken by the vendor and purchaser actually are.

For instance, a vendor may take the position that the building fit-out has transferred at tax book value, resulting in no depreciation recovery income. Meanwhile, the purchaser has commissioned an independent valuation of the fit-out they have acquired, and may be allocating an amount to fit-out well in excess of the tax book value of the fit-out. In this situation Inland Revenue would be missing out on tax on depreciation recovery income, while tax depreciation is being calculated on a go-forward basis off a much higher cost base.

At this stage Inland Revenue has not published any guidance on how they expect the purchase price to be allocated in property transactions. However, anecdotally we understand that the Commissioner's view is that, without a supporting valuation to substantiate the allocation of the purchaser price to fit-out, taxpayers should not be taking the approach that the tax book value of the fit-out is the market value of the fit-out.

In the absence of any published guidance, we caution taxpayers to exercise sound judgement in allocating the purchase price in a property transaction. We recommend that:

— If possible the parties agree the allocation of the purchase price between land, building structure and building fit-out as part of the sale and purchase agreement.

— If it is not possible for the parties to agree the allocation in the sale and purchase agreement, subsequent to the transaction each party should engage an independent valuer (generally a specialist plant and machinery valuer) to determine an appropriate allocation of the purchaser price to support either the calculation of depreciation recovery income or a deductible loss on sale (from the vendor's perspective) and the cost allocation for the purposes of calculating tax depreciation (from the purchaser's perspective).

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