BusinessNZ
GROWING PROSPERITY AND POTENTIAL

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Purchase Price Allocation – An Officials' Issues Paper
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Sir/Madam

Re: Purchase Price Allocation Issues Paper

Background
I am writing to you regarding the Inland Revenue issues paper entitled *'Purchase Price Allocation'* (referred to as "the Paper").

Overall, BusinessNZ considers tax policy issues should be investigated where there is a persistent and significant problem that needs to be addressed. However, whether a reasonable solution can be found will depend on accurately identifying the problem, considering all possible solutions, and ensuring any unintended consequences are minimised as much as possible.

Therefore, while we support an investigation into purchase price allocation as it relates to tax, we are concerned that less prescriptive options for change have not first been considered. Our concern is that overly prescriptive rules will be introduced which place an excessive burden on businesses relative to the scale of the problem.

Identifying the problem and optimal solution
When submitting on any issue, BusinessNZ typically looks at the topic from a broad public policy perspective. This includes understanding the impediments and/or opportunities likely to result from any recommendations made, as well as how significant the identified problem is across New Zealand.

We have no issue with purchase price allocation being on the Government's policy agenda but it is important that proposed solutions to the perceived problem should not themselves be either overcomplicated or miss the mark in terms of intended focus. That, ultimately, would undo much of the good work put into finding a solution in the first place.

In setting the scene, chapter 3 of the Paper outlines a number of New Zealand cases dealing with purchase price allocations from which several principles have emerged highlighting what it is important to consider in determining the validity of an allocation in relation to trading stock. Yet, as paragraph 3.11 points out, there continue to be problems in practice.

Paragraph 4.1 of the Paper alludes to situations where vendors and purchasers agree to an allocation and follow it in their respective tax returns. This is generally considered best practice but the practice is far from universal.

Also, it is important to reiterate the point made in paragraph 4.6 of the Paper, namely that valuation is a matter of judgement. No matter what processes are introduced, there will also be a degree of subjectivity that can never be eliminated. We also acknowledge the fact that the closer two valuations are to each other, the less inclined the Commissioner will be to expend resources on pursuing a challenge.

However, the Paper provides little evidence of how common allocation problems are and whether there has been a significant increase in any tax mis-match over recent times. If difficulties were becoming prevalent across a sizeable number of commercial transactions, support for change would be stronger. But with no information available to make that determination, proposals seeking to change behaviour by making the parties in question agree on the matter need to be viewed with caution.

Who benefits?

When it comes to answering the question about who the proposed changes would actually benefit, from reading the Paper it is clear the primary benefactor would be government, not the private sector. Paragraph 1.6 points out that purchase price allocations between buyers and sellers are *"almost always to the detriment of the Government's revenue base"* and this seems to be the overriding reason for the change proposed. While the Paper later points out, in paragraph 5.3, that the proposed framework is designed both to protect the revenue base and to be fair on the parties to the transaction, its general flavour tends to suggest it is the loss of tax revenue that is the primary reason for what is proposed. This view is backed up by the statement in paragraph 5.36 that states clearly: "*the loss of tax revenue created by inconsistent allocations is the key issue*".

Placing additional compliance costs on the business community by way of further processes and practices begs the question as to what the net outcome will be for the economy. The additional compliance measures might ensure the scheme's broad objectives are achieved from a government perspective, but potentially at a greater cost to the private sector.

BusinessNZ concerns
Overall, BusinessNZ is concerned many will consider the legislative approach outlined in the Paper to be draconian. The proposals represent a sizeable shift when it comes to the impact of tax on any commercial deal, taking a number of unnecessary steps up the regulatory pyramid rather than identifying the next logical step in solving the perceived problem.

Both the vendor and purchaser may take very different views of the asset concerned, bringing into question how practical it will be for allocations to be acceptable to both parties. Moreover, there is the potential for certain parties to suffer significant angst due to the differences in bargaining power present in business negotiations. Under the current proposals, the vendor would be in a strong bargaining position, given that without an agreement, vendors can unilaterally allocate the price. Also, vendors would have a strong incentive not to agree a price leaving them in a position to choose the allocation that suits them best.

The process of buying and selling businesses is complex and the issues paper oversimplifies the impact of inserting complex tax rules into an already complex process. Ultimately, the introduction of these proposals would likely see many commercial deals not proceed, which would not, in our view, be conducive to optimal economic growth. Therefore, from our perspective, the solutions proposed will not best achieve the desired policy outcomes.

Administrative guidance, rather than prescriptive legislation
The Paper explicitly asks for feedback on whether there is a better way to achieve consistent allocations than those proposed. BusinessNZ believes that rather than introducing what we believe to be prescriptive legislation to solve what is only a perceived problem, it would be better to deal with the matter along the <u>administrative guidance route</u>.

This option is circled but not landed upon in the Paper. Paragraph 5.5 states that *"it may be necessary to provide some encouragement to purchasers to comply with the existing law in this respect. Many advisors seem unaware of the existence of section EB 24, and current practice in many cases appears to be that purchasers adopt their own allocations of a global price to trading stock with no regard to those adopted by the vendor"*.

In short, having IRD promote better visibility and awareness of the various sections of the Act that apply to market values for trading stock, depreciable property and financial arrangements would be a logical place to start in terms of next steps. Such a response would generally be welcomed and supported by the business community, with efforts to provide better guidance also finding business groups and representatives seeking to ensure others are aware of what constitutes best practice.

We would also like to point out that in practice, the commercial negotiations between the parties will usually result in depreciable property being allocated based on the vendor's tax written down value and trading stock at the vendor's carrying value. Those allocations should not unduly affect the Government's tax take if it is consistently applied. Therefore, the need for obtaining market valuations should really only apply to other/unusual revenue account property.

Overall, we accept it is often difficult to establish a balance between providing information that helps business and supplying information that poses further questions. However, it is often better that more pointed and prescriptive options are held over until such time as greater supportive guidance is given a chance to improve the (perceived) problem.

Primary recommendation: That IRD look to produce and circulate administrative guidance material as a first option to solving the problems identified with purchase price allocation.

Notwithstanding our primary recommendation above, if the Government were to proceed with the legislative approach outlined in the Paper, we would support a more restrictive option.

We note that the cabinet paper associated with the Paper noted in paragraph 21 of its executive summary that *"Inland Revenue's compliance work has uncovered a number of sizeable transactions, particularly in relation to commercial property, where there have been differences between seller's and purchaser's valuations sometimes in the tens of millions of dollars. Difference were identified in nearly fifty percent of the investigated cases, amounting in total to around $170 million"*. Therefore, rather than a wide legislative approach, we believe it may be preferable to concentrate any amendments on just commercial property transactions, given this is where most of the problem seems to lie. This also has the advantage of not having to deal with a myriad of complex issues associated with business sales.

Recommendation: That notwithstanding our primary recommendation above, if the Government were to proceed with the legislative approach, this be confined to commercial property transactions only.

Last, if IRD's proposals were to proceed, we agree that a de minimus threshold would be useful. However, the threshold would most likely need to be revised upwards from what is considered in the Paper ($50,000 of deductible or depreciable assets in paragraph 5.38 of the Paper). Given the additional compliance costs of the proposal, the de minimus should be set at least between $500k to $1m. This is because the threshold needs to weigh up the cost of obtaining valuations, as well as the time required to negotiate matters such as the allocation of value to particular assets. Also, the suggested provision of allocations to IRD within tight timeframes will have a compliance cost associated with it.

Recommendation: If the Government were to proceed with the legislative approach, any proposed de minimus is set at least between $500k to $1m.

Thank you for the opportunity to comment, and we look forward to hearing about any further developments.

Kind regards,

Steve Summers
Economist
BusinessNZ