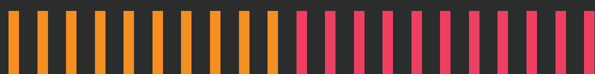
New Purchase Price Allocation (PPA) Rules in Practice:

what commercial property purchasers and vendors need to know



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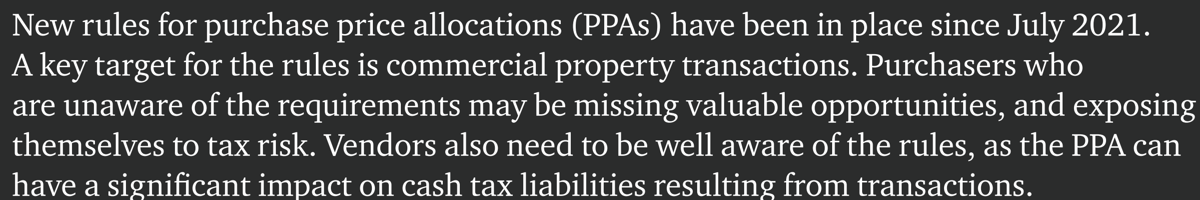


New rules for purchase price allocations (PPAs) have been in place since July 2021. A key target for the rules is commercial property transactions. Purchasers who are unaware of the requirements may be missing valuable opportunities, and exposing themselves to tax risk. Vendors also need to be well aware of the rules, as the PPA can have a significant impact on cash tax liabilities resulting from transactions.

The PPA rules were introduced to encourage a purchaser and vendor in a transaction to adopt consistent tax positions to reduce perceived harm to the tax base. In this article, we summarise the key trends we have observed since the new rules were introduced, and discuss opportunities as well as risk mitigation for both purchasers and vendors.

As the new PPA rules continue to become embedded in market practice, the importance of seeking appropriate expert advice early in a transaction should not be underestimated.

Key market trends

In practice, we are observing the following trends in the commercial property market:

- The most commonly-used form for property Sale & Purchase Agreements (SPAs), published by the Auckland District Law Society (ADLS), recommends that the contracting parties agree an allocation of the purchase price by incorporating their standard-form PPA Addendum into the SPA where the rules are relevant to both parties. Industry bodies, Inland Revenue and tax advisors have undertaken numerous educational initiatives, both on the rules themselves and on the PPA Addendum and how it should be used, and encourage tax advice to be sought.

- Despite these efforts, market awareness and understanding of the new rules is mixed. Many property owners, agents, lawyers, accountants and tax advisors are fully aware of the rules and their potential consequences from a tax and cashflow perspective. However, there are many market participants who are still not up to speed.

- Where the right professional advice is sought at the right time, transaction parties are achieving expected and agreed outcomes. However, where this is not the case, there are challenges and misunderstandings in relation to how the rules should apply, such as how specific a PPA has to be, how assets should be described, or what approach to take in more complex or non-standard third party sale transactions (e.g. multiple contracts, amalgamations, intra-group transactions, transfers of limited partnership interests, etc).

- PPAs are agreed at the time of execution of the SPA in many cases, particularly in higher-value transactions where the parties are well-advised. Practice in the market is varied as to whether the ADLS standard contractual provisions are adopted, or whether parties use their own version of a PPA clause in the contract.

- Where PPAs have been agreed, these often only split the purchase price between land and buildings, sometimes with an aggregate amount for building fit out. We have seen few instances where a detailed assessment of the various categories of fit out has been carried out at this stage.

- We have also seen instances where both parties have agreed to adopt the allocation assessed by a jointly appointed, suitably qualified, third party expert. The assessment is then made after execution of the SPA and typically prior to settlement, with both parties obliged to accept the valuation (in the absence of material error).

- In larger transactions, we also see cases where the parties 'agree to agree', with both parties taking separate advice, while committing to appoint a third party expert if an allocation ultimately cannot be agreed.

- Various practical challenges have been encountered when the parties do seek to negotiate agreement. A key issue is the availability or tidiness of information. Fixed asset registers are often not up to date, and in many instances it is not clear whether the landlord or tenant owns property fit out.

- In a significant portion of transactions, the parties have not agreed an allocation or a methodology for its assessment by the time the SPA is executed. We are observing a few variations of activity following SPA execution:

  - Non-compliance: The parties are simply unaware of the rules, and no allocation is being made at all. Where there is no agreed allocation, the next step is for the vendor (in the first instance) or the purchaser to do an allocation and notify the other party and Inland Revenue. However, we understand from Inland Revenue that they have received only a handful of notifications at this stage. This indicates a significant level of non-compliance with the rules.

  - Commissioning an independent PPA assessment: While the rules provide that the vendor has the first right to make an allocation that must be adopted by the purchaser, we find that it is often the purchaser that takes the steps to commission an independent assessment. This is more prevalent in instances where the purchaser is the more sophisticated of the two parties, in terms of property or tax expertise.

  - Subsequent agreement between the parties: We are aware of instances where parties have become aware of the rules following execution of a SPA or completion of the transaction. In some cases, the parties have reached subsequent agreement. This is a much more likely outcome in a related party context.

Let the buyer beware

Purchasers are most at risk of adverse tax outcomes if a PPA (or a mechanism to reach agreement on a PPA) is not agreed and included within the executed SPA. While it is possible to agree a PPA at any point after execution of a SPA until relevant tax returns are filed, the vendor is not incentivised, or obliged, to reach agreement if not required to do so by the SPA. Instead, a vendor can bind the purchaser to its own unilateral allocation if it is notified to Inland Revenue and the purchaser within three months of settlement of the transaction. This can lead to a purchaser's future depreciation deductions, and corresponding cash tax savings, being more restricted than expected by the vendor's allocation.

Purchasers also need to be mindful that until an allocation has been made (by agreement or by unilateral allocation), either before, during, or after the sales process, they are treated as having no tax base from which to claim annual deductions. Vendors have been given the 'upper hand' in having the first right under legislation to make an allocation, but purchasers can 'level the playing field' by being aware of the rules, raising the issue during the negotiation process, and ensuring they are contractually protected against being bound by the vendor's allocation by using the standard ADLS documentation or other appropriate contractual provisions.

Purchasers are particularly at risk in relation to auction sales because the vendor sets the sale terms. This method of sale was on the increase as the market peaked in late 2021/early 2022. While the sale price is not known in advance, in theory an estimate of the allocation could be made beforehand, based on an estimated sale price. The purchaser needs to exercise caution in forecasting any particular tax position for their new acquisition. Unless an agreeable allocation was prepared by the vendor prior to auction (unlikely in our experience), then it is difficult for the purchaser to ensure a beneficial outcome.

In a market of rising asset values, purchasers are also most at risk of missing a valuable opportunity to maximise future tax outcomes. Agreeing a PPA based on a vendor's tax written down values (which is very common practice), or agreeing broad categories of allocation to building and/or fit out without expert assistance (particularly between building and fit out), limits the timing and extent of the depreciation deductions a purchaser can claim during the subsequent period of ownership.

Vendors can also be at risk

Vendors are also at risk if they are not aware of their rights under the PPA rules. If the amount allocated to a particular asset exceeds the tax book value of the asset, this is likely to give the vendor an immediate tax cost. Vendors need to make sure they are aware of the consequences of an agreed PPA. Where there is no agreed PPA, vendors who are unaware of their right to have the first choice of allocation in the absence of agreement are at risk of a purchaser choosing an unfavourable allocation.

The importance of independent expert advice

We are starting to see a change in market dynamics - we've observed a sellers' market for the past few years. The relative bargaining power of parties now seems to be shifting to a more balanced position. With the recent re-opening of New Zealand's borders, we are already seeing an uptick in overseas buyers looking to increase their activity in the market, particularly in investment grade assets at the larger end of the scale. These buyers in particular are familiar with PPA requirements as they are common practice in other jurisdictions. As the PPA rules become more and more embedded, Inland Revenue will also be looking to ensure compliance with the new rules through investigative and other activity.

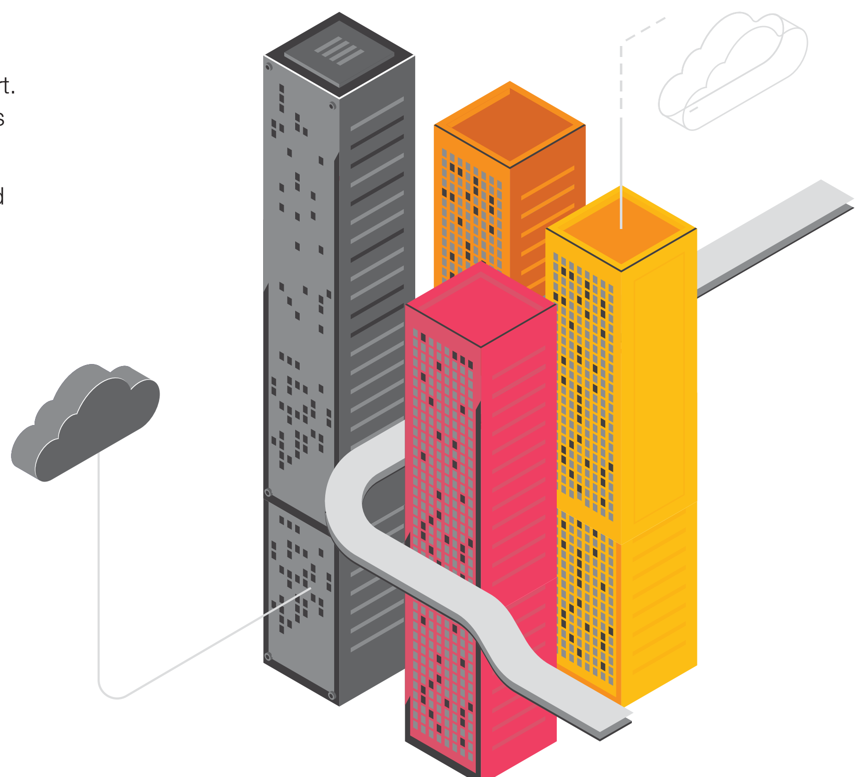
As the market shifts, it will become more important that allocations are supported by an independent assessment from a suitably qualified third party expert. The key benefits of parties to a transaction taking this approach are:

- providing an independent and market value-based mechanism for the parties to reach agreement
- giving greater certainty of the outcome for both parties
- ultimately reducing the risk of the IRD challenging the allocation made.

Particular situations where risk of not having an independent assessment is enhanced, are where the parties have different tax profiles, or where a purchase wishes to negotiate a PPA above the vendor's tax book values.

Property PPA format

A Property PPA from a suitably qualified third party expert will allocate the sale/purchase price of the property between the various asset categories, at market value. A best-practice allocation would include a market value assessment of the land and a detailed assessment of the breakdown of the improvements value between building structure and, typically, dozens of building fit out categories. This assessment is built up from a detailed estimation of the cost of individual improvements assets, to be proportionally applied to the overall price paid for improvements. A best-practice assessment of this manner requires a detailed knowledge of construction methods and costs from either a specialist property valuer, or perhaps more appropriately from an experienced quantity surveyor. It is also critical that the expert has a good understanding of the relevant tax laws, and in particular, what is considered 'building structure' and 'fit out' for tax purposes.



How to work effectively with the PPA rules

Purchasers have the most to gain by seeking independent PPA advice. We advise purchasers to confirm their PPA strategy, and raise the PPA, early in transaction negotiations. The rules advantage the vendor, so a purchaser needs to take action to even the balance early in the process. Purchasers should engage an independent PPA expert and tax advisor at the outset of transaction negotiations, and in advance of any allocation being agreed in an SPA. In our experience, if expert assistance is sought after a split between building and fit out is already agreed, there is often a missed opportunity for the purchaser to maximise value in the form of future tax savings.

If the vendor provides a proposed PPA to a purchaser, an independent expert can review any allocation commissioned by the other party and ensure that a full breakdown of all building fit out categories has been undertaken (in contrast to a simple land/building split). The allocation can then be modelled to forecast the annual depreciation deductions available to the new owner. The review by an independent expert can inform the negotiation process.

If the circumstances of the transaction mean that it is not possible to engage an independent PPA expert before a SPA is executed, our strong recommendation is that the SPA provides for a mechanism to agree a PPA following execution by commissioning an independent PPA expert, rather the purchaser than agreeing to a PPA that has been arrived at too quickly, or which is simply based on the vendor's tax book values. This approach may prove costly to the purchaser in future.

Vendors should consider engaging an independent PPA expert and a tax advisor at the commencement of any marketing campaign, to allow for modelling the tax and cash outcomes based upon a desired sale price, or for a pricing range. This will provide a forecast of any deprecation recovery exposure as a result of the transaction, and ensure the vendor is aware of the consequences of an agreed PPA. Ensuring the proposed PPA is within the range of market values is also important in case Inland Revenue challenge that a PPA does not represent market value (which may be the case if tax book values are used for the PPA).

The draft allocation could be provided to prospective purchasers during the sale process to facilitate negotiation. Once the sale is agreed, the PPA can be finalised for formal agreement with the purchaser. It may be advantageous for a vendor to allow a purchaser to raise the PPA in transaction negotiations – this will depend on the circumstances, the profile of the purchaser, and the relative bargaining power of the parties. If the purchaser does not do so, it is critical that the vendor notifies Inland Revenue and the purchaser of its allocation within three months of settlement.

Other market participants such as real estate agents and lawyers should ensure their clients are aware of the rules and their consequences, and recommend that they seek appropriate expert advice. Clients who receive a nasty shock or a call from Inland Revenue following the settlement of a transaction may take issue with their advisors in the first instance!

Summary of the New Rules

The new rules govern the way parties to a transaction must allocate a global transaction price across different classes of assets. The rules cover the situation where the transaction parties agree and allocation, and also provide a default mechanism if no agreement is reached. In both instances, the allocation must ascribe relative market values to the assets, and the Commissioner of Inland Revenue may require the parties to adopt a different allocation if she considers that the allocation does not reflect market value.

Where the vendor and purchaser have agreed and documented a purchase price allocation before filing their respective income tax returns, incorporating their tax position in relation to the transaction for the year in which the transaction occurs, section GC 20 of the Income Tax Act 2007 states that the parties must file in accordance with the agreed allocation. Agreement between the parties made within this timeframe will override any allocation made by the parties under the mechanisms outlined below.

Where the vendor and purchaser have not agreed an allocation before filing their tax position in relevant returns, section GC 21 contains three mechanisms to give an allocation for the parties to use these mechanisms are:

1. Vendor allocation

In the first instance, the vendor may determine the allocation. If the vendor notifies both the purchaser and the Commissioner of this allocation within three months of settlement, the parties will be bound by the allocation. Both parties must then file tax returns based on this allocation. The allocation chosen by the vendor for a particular asset must not be less than the vendor's tax book value of the asset.

2. Purchaser allocation

If the vendor fails to notify an allocation within the three-month timeframe, the opportunity to determine the purchase price allocation is transferred to the purchaser, who has a further three months to make their allocation. For the allocation to bind the vendor, the purchaser must notify the vendor and the Commissioner within the allocated timeframe. Both the vendor and purchaser are bound to file their tax returns based on that allocation. Other than the requirement for the allocation to reflect relative market values, there are no constraints on the purchaser's allocation.

3. If no allocation is made by the parties

If neither party makes an allocation within six months of the change of ownership in the assets occurring, the Commissioner may allocate the purchase price across the assets at what she considers to be "market value". The vendor and the purchaser are treated as disposing and acquiring the property for this deemed market value.

Until an allocation is made by one of the parties (and notified to the Commissioner) or made by the Commissioner (and notified to the parties), the purchaser will be treated as having no cost base in the assets acquired. Deductions disallowed as a result of this rule are intended to be deferred rather than denied.

The new rules will always apply where parties have agreed an allocation. However, parties will remain free to choose their own allocations if either (a) the total purchase price is less than $1m, or (b) the only property being disposed of is residential land together with its chattels, and the total consideration for them is less than $7.5m.

A de minimis will also apply to the Commissioner's ability to challenge an allocation. The Commissioner is unable to challenge item of depreciable property if:

- the original cost of the property is less than $10,000
- the total allocated amount for the item and for any identical property is less than $1m
- the allocated amount for the item is no greater than its original cost and no less than its tax book value.

For more information please see Tax Tips Alert: April 2021

How we can help

There is a lot to think about when entering into a transaction for commercial property, and the PPA may not be at the top of the list. The right approach to take in relation to agreeing (or not agreeing) a PPA will vary in different situations. Taking advantage of PwC's integrated Real Estate service offering can help you mitigate risk and maximise opportunities for value, and move the work from your desk to ours.

Our experts can provide an independent PPA assessment. Our tax advisers and lawyers can help you determine the best strategy for working with the PPA rules and negotiations. Please contact your usual PwC advisor, who can link you in with our team.

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