What are you leaving on the table? Why purchase price allocation can change the real value of a farm acquisition

For every farm transaction, the way price is allocated between land, buildings, plant and other assets can materially affect the parties' after-tax positions. Despite this, parties will sometimes spend days negotiating the final $50,000 of the purchase price and considerably less time considering an allocation that may have a much greater economic impact. That is value potentially left on the table.

Purchase price allocation, commonly referred to as PPA, is the process of dividing the total consideration among the different classes of assets being sold. For a dairy farm, those classes may include land, dwellings and farm buildings, the dairy shed, milking plant, irrigation equipment, pumps, effluent infrastructure, feed systems, silos, generators, other machinery and, in some transactions, trading stock.

Why the allocation matters

Different asset classes receive different income tax treatment.

Broadly, a purchaser will generally prefer more of the price to be attributed to assets that qualify for depreciation or other deductions so as to increase the purchaser's deductions following settlement.

The vendor will have the opposite preference. An allocation to depreciable assets can give rise to taxable depreciation recovery, whereas an allocation to non-depreciable land will not ordinarily have the same consequence.

The tension is therefore straightforward:

- the purchaser may favour a higher supportable allocation to depreciable plant and machinery;
- the vendor may favour a lower allocation to those assets and a higher allocation to land; and
- both parties must be able to support the allocation by reference to relative market values.

The allocation does not alter the amount paid on settlement. It can, however, alter the economic value that each party ultimately obtains from the transaction.

PPA is therefore not merely an accounting exercise undertaken after the commercial deal has been agreed. It is part of the commercial deal.

The statutory framework

New Zealand's PPA rules apply to agreements entered into from 1 July 2021 involving two or more classes of property with different income tax treatments. The principal rules are contained in ss GC 20 and GC 21 of the Income Tax Act 2007.

Where the parties agree an allocation and document it before either files the relevant income tax return, both must generally adopt that allocation for income tax purposes. The figures should reflect relative market values, and Inland Revenue may substitute market values if the agreed allocation is not supportable.

If the parties do not agree and the transaction falls within the statutory thresholds, the vendor has the first opportunity to determine the allocation. The vendor has three months from settlement to notify the purchaser and Inland Revenue. The vendor's allocation is subject to statutory constraints, including relevant market values and tax book values.

If the vendor does not act within that period, the purchaser has a further three months to determine and

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notify an allocation. If neither party acts, Inland Revenue may determine the allocation, and the purchaser may face a deferral of otherwise available deductions.

The statutory no-agreement process generally applies where the total purchase price is $1 million or more. However, where the only assets sold are residential land, including buildings and chattels, the applicable threshold is $7.5 million. Accordingly, the $1 million threshold will ordinarily apply to a dairy farm transaction.

Below those thresholds, the statutory no-agreement process does not apply. However, if the parties agree an allocation, they must generally use it for income tax purposes, and the allocation should reflect relative market values.

The rural complication: not every improvement is treated alike

Not all expenditure on a farm follows the same tax treatment. Items such as milking plant, pumps and movable irrigation equipment may be depreciable assets. Qualifying farmland improvements listed in Schedule 20 of the Income Tax Act, including certain expenditure on drainage, fencing, roads, tracks and irrigation works, are governed by a separate amortisation regime.

This creates a potential trap in the purchase price allocation.

In QB 25/22, Inland Revenue has confirmed that the PPA rules do not reset the tax book value of qualifying farmland improvements and listed horticultural plants. Where the purchaser continues to carry on a farming business on the land, it generally takes over the vendor's existing tax book values and continues the remaining amortisation deductions.

For example, the parties may allocate a substantial part of the purchase price to qualifying farm improvements based on their current market value. That allocation does not necessarily give the purchaser deductions based on the amount allocated. The purchaser's deductions may instead be limited to the vendor's remaining unamortised tax book value.

The practical message is that value in the allocation schedule is not always value for tax purposes. Before agreeing the allocation, the parties need to identify which assets are ordinary depreciable property, which are subject to the special farmland-improvement rules, and what tax book values the purchaser will actually inherit. Otherwise, they may spend time negotiating an allocation that does not produce the expected tax benefit.

Where transactions go wrong

Common problems include:

- leaving the allocation blank on the basis that the accountants will agree it after settlement;
- importing figures from a bank or general market valuation without checking whether the asset categories correspond with the relevant tax classes;
- attributing value to farmland improvements without establishing the vendor's remaining tax book values or the purchaser's actual amortisation entitlement;
- grouping plant with land or buildings when separate treatment is required;
- agreeing figures without retaining valuation evidence capable of supporting the relative market values; and
- negotiating the allocation separately from the price, GST treatment, warranties, condition of the plant and other commercial terms.

By the time these issues are referred to the parties' accountants, one or both parties may already have lost the commercial leverage needed to address them.

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How to protect the value in the deal

PPA should be considered before the agreement becomes unconditional, not after settlement.

A vendor selling a farm with material plant or infrastructure should understand its relevant tax book values before accepting an offer. A purchaser should identify the assets it expects to depreciate or amortise and test whether those expectations are supportable.

Where the values are material, the valuer should be instructed to provide asset values using categories that correspond with the proposed contractual and tax treatment. A valuation undertaken for lending purposes may not, without further work, provide the information required for PPA.

The agreement should then record either:

- a complete and supportable allocation; or
- a clear process and timetable for determining it before the relevant tax returns are filed.

If the parties' preferred allocations differ, the issue should be negotiated with an understanding of the after-tax consequences. That may involve reconsidering another component of the bargain rather than treating the allocation as an isolated accounting matter.

The essential point is that the trade-off should be identified and negotiated deliberately, not discovered after the deal has become unconditional.

The takeaway

The purchase price tells you what will be paid.

The allocation helps determine what each party will ultimately keep.

On a substantial farm transaction, treating PPA as an afterthought can mean leaving considerably more on the table than the amount fought over in the headline negotiation.

Want to know more?

If you have any questions, please contact our specialist Rural and agribusiness team.

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