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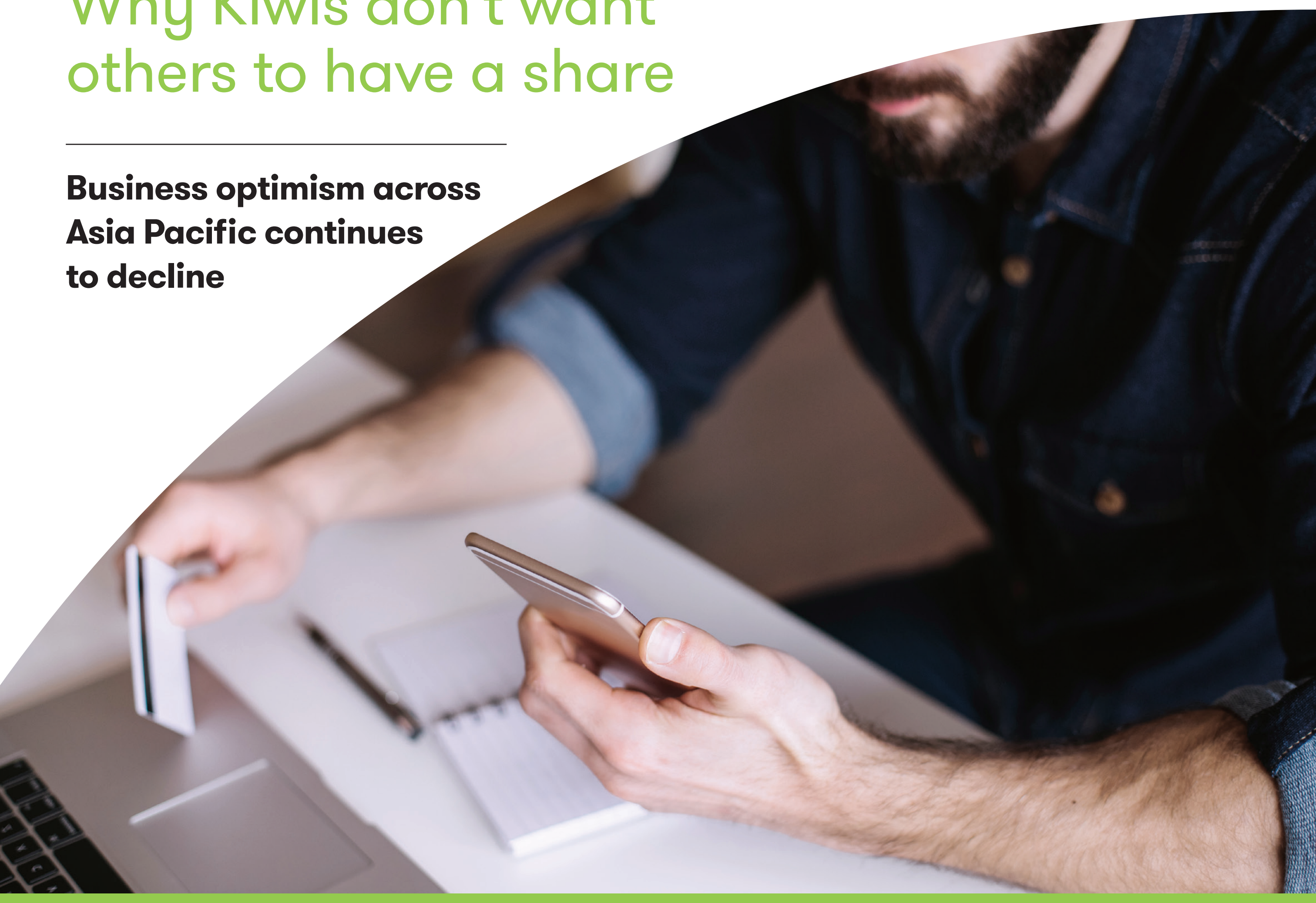
The tax empathy gap: Why Kiwis don't want others to have a share

Business optimism across Asia Pacific continues to decline



PLUS

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Business optimism across Asia Pacific continues to decline

Latest research from Grant Thornton International reveals that business optimism continues to decline amid swirling economic uncertainty.

Q1, 2019 optimism
55%

Q2, 2019 optimism
23%

Across the Asia Pacific region, optimism took a dive in Q2 2019 dropping to 23% from 55% percent in Q2 2018.

Currently, there is no shortage of ambiguity, both economic and political; Brexit, the OCR drop and a weak export demand from China are all contributing to a perceived poor outlook.

Although economic growth in New Zealand has been stable over the past year, it is projected to ease in 2020 as private consumption slows down, net immigration declines, and housing wealth gains dwindle.

Productivity growth has been weak as businesses face cost pressures, margin squeeze, regulation, and difficulty finding skilled labour.

Companies need to prepare for economic uncertainty and disruption by investing in technology and retaining talent.

Uncertainty is always a reality in business; the key is an ability to respond to change and to stay competitive.

There are ways of managing growth; smart operators will have strategies in place to deal with obstacles and jump on opportunities.

Technology can help expedite this; businesses who are investing in cloud technology and business intelligence are better equipped to respond to changes within their industries.

Automation and artificial intelligence can also limit skills shortages by getting people to focus on other valuable activities like building client relationships.

Even in the current labour market, organisations can maintain a leading edge by retaining talent.

A tight labour market creates rising wages and falling unemployment, which in turn helps to maintain consumer spending and creates some stability for economies.

It is sensible for businesses to think about how economic factors may impact them, but their mantra should be: ‘plan for disruption, aim for growth’.

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Why Kiwis don't want others to have a share

Unless we can find some way of taxing wealth as well as incomes, New Zealand is headed for an intergenerational economic meltdown.

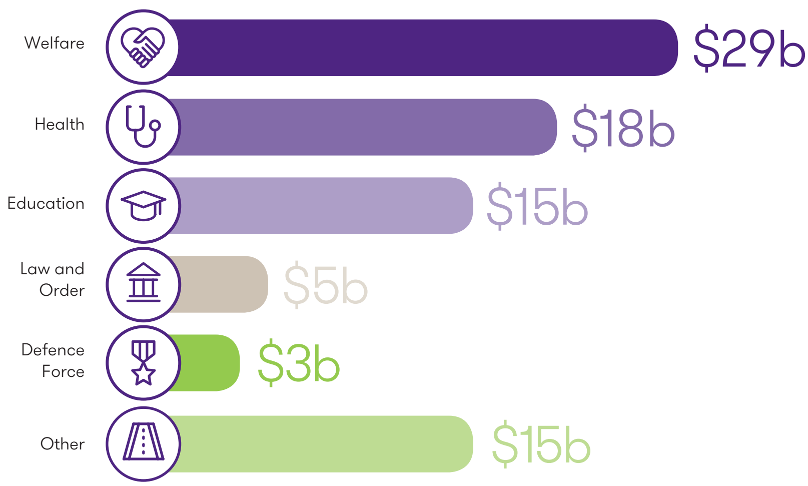
It's hard to get your head around how much money the government has. For example, a $95 million programme to train 3,280 new teachers over four years sounds great, but what does that mean and what proportion of the whole does it account for?

Instead of thinking of the $85 billion in tax the government will collect from us all this year, let's condense that down to $85 which the government will spend at the supermarket for the entire year. There are certain basics that have to be paid for. In the welfare aisle, it will spend about $29 on benefits, of which about $15 will be on national superannuation welfare's 800,000 or so recipients. Another non-negotiable is $18 on health. Then there's education $15 and $5 on law and order and the defence force $3, not to mention roads, railways and other essential infrastructure. Add in initiatives such as the Provincial Growth Fund $1 and very quickly there is not much left of the original $85.

Kiwis see the likes of universal superannuation and free healthcare as their birthright. Yet these same New Zealanders are known to wring their hands in outrage over social good spending such as Treaty of Waitangi claims. The fiscal reality is that two months of this year's superannuation payments would cover the last 20 years' worth of Treaty settlements.

There is a name for this emotional response to money. Mental accounting is the theory that people think of value in relative rather than absolute terms.

Stick with me because it explains a lot, and the recent extreme reaction to the government's plans for a capital gains tax (CGT) is a good example. The groundswell of opposition was so strong that it forced the Ardern administration to back away and



declare it now won't be happening on its watch. Similarly, successive governments have not dared to touch national super aside from intermittent attempts to tinker with the age of eligibility.

Groups such as residential landlords with a handful of rental properties were vehemently opposed to a CGT. Their arguments against it ranged from unfairness that their hard-won assets should be taken away through to 'I'm benefitting society by providing these homes to tenants'.

Some would say that their reaction demonstrates a gap in empathy and a failure to see the big picture. Because we don't tax wealth in New Zealand these landlords have had it good for a long time, and they are not looking back down the road at the younger people coming through who are struggling to buy a home in the country's overpriced property market.

The mental accounting theory works like this. You have five people who are entitled to a share of a profit pool. Think of my own profession where partners in an accountancy firm might get paid a base monthly salary and then divvy up the remaining profits each year based on their individual contributions. One person may be entitled to 50 cents, while the other four are in line for $5.

> We are relative in our behaviour rather than absolute. In short, we are jealous.

The person getting 50 cents is far more likely than those getting $5 to say, 'let's not allocate anything this year, I'd be happy if there was no bonus'. Even though they are giving up 50 cents, they would rather that other people don't get ten times as much. We are relative in our behaviour rather than absolute. In short, we are jealous.

If you think of this in terms of the CGT example, small-time landlords were aghast at the idea whereas commercial property developers and investors tended to view it as an inevitable cost of doing business.

At some point the tide is going to turn in New Zealand. We pay tax on what we earn, not on how wealthy we are. There is an unevenness in how we all chip in to pay for the likes of universal superannuation and free healthcare. PAYE earners remain an easy tax payer target, but many in this group struggle to pay their bills. Unlike many of our trading partners, New Zealand has no capital gains tax, wealth tax, death duty, stamp duty, or compulsory and tax incentivised retirement savings. The recent failure to introduce a CGT indicates this isn't going to change anytime soon.

If everyone keeps objecting to every version of a wealth tax, eventually we are going to run out of ways to raise money. With an ageing population and increasing immigration, we have a massive and growing queue of people whose pensions and healthcare will need to be paid for out of that $85. This is not a new concern. Treasury warned the government of this funding bubble in 2016, noting that the amount the government can spend isn't going to increase anywhere enough to match the much larger increase in the amount it will need to spend on health and superannuation.

With only $85 to spend we will need to whip out the credit card to pay short term bills. But longer term it's not a pretty picture.

The Tax Working Group's recommendations, including a CGT, were an attempt to create better social cohesion. Younger people are being left with the burden of funding the retirement bubble plus paying for their own education and trying to get on the property ladder. If nothing changes there will be a massive gap in economic wellness between the younger and older generations. Already we have one of the highest standards of living for retirees in the world, and yet we struggle to fund the upkeep of infrastructure, health and education, while nodding uniformly that universal super is a given.

If older people aren't prepared to share the pie around in a more even fashion while they're alive, perhaps it will have to be death duties.

It would be great to see the government introduce meaningful tax incentives to encourage personal retirement saving. But this type of change will directly hit the amount of tax collected from PAYE. It will mean the government collects less money to spend in the shorter term and will require longer term strategic thinking. Currently salaries are taxed in full before employee contributions are invested into Kiwisaver or similar schemes. Our close trading partners, including Australia, provide meaningful retirement savings tax incentives to individuals even though most of their retirement savings systems are compulsory. It's no coincidence that Australia's capital markets, it's infrastructure, and the independence of its citizens in their retirement years is much stronger than ours and nor is our dependence on their banks. Will any New Zealand government ever exhibit the thinking and political bravery required to move away from the current 'cash flow' model of short-term annual budgeting?

If nothing changes and we continue to hold our breath, then we will eventually get to a point where universal superannuation and healthcare services will need to be cut, or at least means tested. The population demographics and the size of our tax base don't compute in the longer term. If treasury was a little bolder and was prepared to roll the dice to encourage relative behaviours in the area of personal retirement savings through tax incentives, then it might give the politicians more courage to make change to improve the longer-term health and wellbeing of the economy.

The recent teacher strike is an indicator that the system and people are under pressure. It's easy to ignore this for a while and to focus on other national headlines such as resolving the inconvenience of Waiheke Island super gold card ferry congestion. But with so many of the benefits New Zealanders enjoy locked in socially, it may take an economic meltdown before politicians and voters are forced to make principled decisions to effect meaningful change. In the meantime, the protection of political capital seems to be the main concern across the board.

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We need to completely rethink what 'fairness' means when it comes to tax

Should the collection of taxes be the point at which we talk about fairness, or should fairness be part of a completely different conversation?

It's counter-intuitive, but when we talk about tax fairness we aren't really talking about tax. We're really talking about politics, economics and how we view the world. Tax is just the mechanism to deliver a predetermined outcome.

But is fairness an appropriate way of thinking about how the tax system should be designed? Can tax even be fair at all? The idea of who should pay what share is so heavily contested, that the question must always be – fair for whom? And there's a corollary to all of this, in that often targets of fairness campaigns get picked based on how easily they can be scapegoated as behaving in a way that people see as unfair.

Tax is based on fundamental principles that are thousands of years old. Historically we have always taxed things that can be seized, like bricks and mortar, for obvious reasons. Some, like anthropologist James C Scott from Yale University, have even theorised that we came to eat a lot of grain because, during the earliest development of agriculture a few thousand years ago, it was an easy type of produce for state makers to collect, as it stays above the ground, can be easily counted and matures all at the same time.

As a result, we came to organise our affairs around how the tax system works, in accordance with the letter of the law. No more, no less. But things like the evolution of digital value creation will completely upend all of that. Digitised businesses don't necessarily have to have a presence in a country to operate there. While multinationals with huge resources have dominated the conversation around this, digitisation of the economy isn't just for the big players –digital business models underpin multitudes of emerging businesses as well, and fragile lower margin startups.

When it comes to a new idea like the digital services tax, we are all playing catch up. These ways of creating value and wealth have existed for a long time, untaxed. That's a major reason why such a tax is now pitched more as a question of fairness than of revenue raising. After all, the revenue that actually gets raised will be negligible, at least in New Zealand. In a best-case scenario, it is expected to deliver about $80 million a year. But it hits targets like Google, Facebook, Amazon – companies who have built a reputation of being evil empires exploiting the ordinary consumer.

But can reforms like this actually be driven by fairness? Countries in Europe have come up with very blunt instruments for their digital services taxes; for example, France is pushing for 3% tax on turnover. But simply taxing 3% of turnover isn't a particularly good tax solution,

because it doesn't take into account how value is created, and what you're actually hoping to tax. It's widely seen as a bad tax, and it will take years to come up with a better solution. We should also be deeply wary of taking aim at big players of overseas origin for more tax, because we'll probably find tit for tat responses against our home-grown exporters.

As a tax advisor, I constantly hear an extraordinary amount of cynicism from my clients around digital services taxes, especially when they're pushed under the pretext of fairness. There's a huge uproar in corporate circles about such an approach, with claims they've been cast as characters in some great moral drama of tax. But everyone's perception of fairness in the tax system will always directly relate to their own interests.

Fundamentally, the agenda of tax fairness is misguided, and we should be deeply sceptical of the principles underpinning it. No one, since the dawn of civilization, ever wanted their grain taken away from them, and presenting the issue in the moral light of fairness is not going to change that.

The recent Tax Working Group (TWG) report was a classic example of the fairness play. It was fundamentally aimed at fairness as a concept, and how the system should be reformed to become 'more fair' – that was even part of the title of the report. But in looking at the treatment of Goods and Services Tax, the TWG had an opportunity to consider fairness of outcome as something that can be achieved through the tax system.

It's a widely acknowledged view that GST has unfair, regressive outcomes for those on lower incomes. If the TWG wanted to change outcomes on the basis of tax fairness, it was clear that something would have to be done about GST. We have the broadest GST system in the world at the moment, with 15% of absolutely everything consumed getting taxed. You may think it's a fair tax because it taxes everyone the same. But in terms of fairness of outcomes, it fails, because lower income earners see a much greater share of their income disappear into government coffers than those who can afford to save and invest.

Put simply, there is no such thing as a fair tax. So if we want to accomplish anything in building a better society, we should focus our efforts on delivering fairer outcomes and leave the tax collector to their duties, benevolent or not.

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Charitable sector at risk if standards removed

Now that submissions have closed for the Charities Act 2005 review, the Department of Internal Affairs is now charged with mission-critical task of reviewing basic registration requirements for New Zealand Charities.

There are 27,000 charities in New Zealand; they spend $17 billion and manage $58 billion in assets, so a basic level of standards is essential.

There are 27,000 charities in New Zealand; they spend $17 billion and manage $58 billion in assets, so a basic level of standards is essential.

The Department of Internal Affairs has questioned whether requirements associated with maintaining registration are actually working. These standard requirements include maintaining charitable purpose, annual reporting, financial reporting requirements, compliance requirements along with considerations around Governance of the charitable organisations. These serve as the safety measures to ensure transparency within the sector and when executed correctly, they function well and serve an important purpose.

The DIA discussion document states many small charities struggle to meet these standard reporting requirements. Current financial reporting is managed under a 4-tier system based on expenditure incurred in the previous two years. Fifty eight percent of tier 4 charities (those with under $125,000 in annual operating payments) successfully met the minimum reporting requirements in 2018 and only 50 percent of all charities filed their returns on time.

Although it might be tempting to do away with a minimum standard for smaller organisations, a better approach would be to further simplify the systems in place that are set up to expedite the reporting process for smaller entities. The reality is that every charity should be able to report how much money it has. Tier 4 reporting requirements are based on 'Simple Format Cash Reporting'; it's the most basic level of financial reporting possible and it would be reckless to lower the standards any further.

Kiwis are among the most generous people in the world when it comes to donating either the time or money they have spare to the causes that are important to them. There must be a basic standard to maintain public trust; removing this puts the whole charity sector at risk. If reporting isn't timely and transparent, then the level of trust the public has in the sector will be severely diminished

along with their investment in charitable organisations.

Another suggestion made in the discussion document is to challenge the level of reserves and spending funds available; however, there should not be a measure of maximum reserves or donation levels because:

1. there is no need for these measures if the organisation is maintaining transparency by adhering to their financial reporting requirements
2. a call on cash to make payments may result in non-cash assets being sold to raise cash funds for distribution
3. charities could be forced to make donations or payments for projects that otherwise wouldn't get funding
4. no other sector (with the exception of banking) is required to hold a minimum or maximum level of reserve
5. to maintain the sustainability of the organisation, it is better to be taking a longer-term view rather than pay out reserves in the short term; this will allow governance to undertake a set strategy and utilisation of funding in accordance with a long term strategy.

There are some limited advantages; the charitable spend would likely increase within the sector and there would be some tier 4 organisations encouraged to use a level of the substantial reserves that they have built up. For example, the top one hundred tier 4 charities have over $800 million in assets, and many are old trusts that have gathered reserves over time and now pay out very little to the community.

An area where standards could improve is governance structure, currently it is questionable whether some organisations' governance is fit for purpose. Many organisational founding documents haven't been reviewed in decades or modernised which means in some situations the people being elected do not have the expertise required for the governance position they hold.

An alternative change for Governance we would encourage is to reduce the number of board member positions in organisations. Often, we see clients with an excessive number of board members and streamlining the number of seats at the board table would enhance the Boards contribution to the organisation.

Another question posed in the DIA document is "Do you think the Australian governance standards could be adapted to work in New Zealand?" In Australia there are minimum standards charities must meet to remain charitable, operate lawfully, and be run in a way where they are answerable for their actions. A formal leadership structure for all charities would help build a governance resource with depth that can serve both individual organisations and the wider society.

For the charitable industry to have a sustainable future, we must take stock of what is working and what needs to change. This is an opportunity to create a governing document that will nurture a robust and dynamic charitable industry that New Zealanders can trust.

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For the charitable industry to have a sustainable future, we must take stock of what is working and what needs to change.

Why sustainability matters to your business

New Zealand businesses run the risk of falling out of step with the rest of the world if they fail to grasp the importance of transparency on not only financial matters, but also sustainability matters.

Quality and price points are no longer the only considerations that impact the public's perception of a company and the value of its brand. Failing to pursue sustainable business practices can swiftly damage the value of a brand. For example, when iconic confectionary company Cadbury admitted to using palm oil in their chocolate products, public pressure forced them to stop supporting the palm oil trade. Up until this point they had been one of the nation's most trusted brands which brought cashflow with it.

However, the rewards for companies that have truly embedded sustainability into their strategy and operations are significant. Selecting a sustainability reporting framework that will be fit for their purpose can be a real challenge for those charged with the governance of any organisation, be it in the private, public or not-for-profit sectors.

Indeed, there are a myriad of stainability framework options to choose from as evidenced in the External Reporting Board's recent publications on Extended External Reporting, but what is being done to make selecting them easier?

The Corporate Reporting Dialogue

The good news is there is a solution in the pipeline, and it's manifesting itself in an initiative known as the Corporate Reporting Dialogue (CRD).

In a nutshell, the CRD initiative provides a roadmap for any type of organisation to select a framework for reporting on sustainability matters. The CRD participants currently include the Carbon Disclosure Project, the Climate Disclosure Standards Board, the Financial Accounting Standards Board, the Global Reporting Initiative, the International Accounting Standards Board, the International Organization for Standardization, and the Sustainability Accounting Standards Board. In their different ways, all of these organisations are committed to driving better alignment of sustainability reporting frameworks; their most notable effort to date was their joint announcement of a Better Alignment Project at last year's World Congress of Accountants.

During this two-year project, the CRD participants will map their respective sustainability standards and frameworks to identify the commonalities and differences between them. They will also identify how non-financial metrics relate to financial outcomes and how this can be integrated in mainstream reports. An initial output of the Better Alignment Project is expected in Q3 2019 and will show the linkages between reporting frameworks of project participants. Once the project is completed, those who both prepare and use the reports will be able to better coordinate their approach and at the same time pave the way toward reporting on sustainability more consistently.

To remain relevant in the market place, organisations will need to select a sustainability reporting framework. In certain industries, more than one framework might need to be used to tell the full story of how it is addressing sustainability because using two frameworks can offer the different levels of transparency demanded from all its stakeholders.

As sustainability becomes more mainstream, integrated reporting will likely become a preferred business reporting framework for organisations because it can elegantly tie together the elements of traditional financial reporting, sustainability reporting, and governance reporting within a single presentation. Mercury Energy is a good local example of a company who selected integrated reporting to demonstrate how sustainable its operations are. In a sustainability statement included in its 2018 annual report, Mercury explained that to meet expectations of shareholders and investors, they set out their pillars and focus areas against the International Integrated Reporting Council's Framework. They said "' … this requires organizations to reflect on six capitals that are essential for value creation. The capitals: natural, social, social and relational, manufactured, intellectual, human and financial, also need to be considered from the perspective of minimising future risks to the business or value destruction.'"

By using integrated reporting, Mercury was able to map a close connection between their focus areas, their capitals and their sustainability. Indeed, their integrated report has now become a communication tool that effectively tells a unique company story of sustainability and the relative weightings given to the six pillars it is monitoring.

Sustainability is here to stay

Businesses need to view sustainability as a way of future proofing their operations rather than an afterthought or inconsequential administrative task. Consumers are becoming increasingly discerning and generally speaking, only choosing companies who they perceive are environmentally, socially and culturally responsible. If you have not already done so, now is the time that reporting on sustainability should become a higher priority within your organisation.

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Resolving disputes in share valuations: five things to consider

If you require a final binding opinion about the value of shares in your company, an expert determination of value is a common mechanism to achieve this.

Expert determination clauses are often found in standard company constitutions, and in many different forms of ownership agreement, including shareholder, JV and partnership agreements.

Engaging a business valuation specialist to deliver an expert determination provides a lot of flexibility, with the parties deciding all matters including the procedure, the expert and their role, and the way the decision might be enforceable. However, it is also this flexibility that can lead to a poor process – or the derailment of a good one - that at worst can mean a "final and binding" determination is overturned.

Based on our experience in expert determination valuation processes, both as determiner and as the expert appointed by one of the parties, here are five things to consider when seeking an expert determination on share value.

1 Choose your expert wisely.

Running a fair and transparent process is crucial to ensuring natural justice is observed, and a final and binding outcome obtained. This means the expert selected should be competent not only in valuation, but also in running an effective process – including understanding where their mandate starts and finishes. So, prospective experts should ideally be quizzed on both their valuation and previous expert determination credentials.

2 Allow enough time for the process.

Once the expert is agreed, a robust expert determination process requires a period of information gathering, party submissions and responses so the expert can then write their decision. Guided by the expert, the process should be conducted within an agreed 'reasonable' timeframe, to avoid both unnecessary delay and any time pressures that could compromise the process. This often takes longer than you might think. On average, allow 2-3 months for a robust process to be undertaken.

3 Make sure you know what you are getting.

During a high-profile case in New Zealand, one of the Defendant's arguments was that the valuer provided inadequate reasons to support their valuation. However, this argument failed - the court found neither the expert determination clauses nor the valuer's appointment terms placed

Dig deeper

For a white paper about the valuation of share interests under expert determination, contact Jay.

Jay regularly produces thought leadership and presents at business valuation conferences. Earlier this year, he was appointed to the committee of the Chartered Accountants Australia and New Zealand Business Valuation special interest group. The committee comprises some of the industry's most experienced valuation specialists. In addition to contributing submissions about business valuations, the committee develops and leads networking events like the annual Business Valuation Conference.

Jay is also sits on the Business Valuation Board of the International Valuation Standards Council (IVSC), the leading global valuation standard setter.

any obligation on the valuer to provide support for their valuation.

The simple message is that where parties wish to ensure the valuer gives reasons for their decision, as opposed to a certificate of value, an express term to that effect should be included in either the reference or appointment terms.

4 The experts' decision is likely to be difficult to overturn.

This is provided that the determination is carried out as required by the terms of the contract. For example, as also indicated by the case mentioned, should the contract specify the expert only to fix fair value, then the parties, in effect, entrust the expert "to carry out the valuation and agreed to be bound for the purposes of the share transfer by the fair value assessed in the exercise of the expert's independent skill and judgment, acting honestly and in good faith. If the valuation was carried out incompetently, the affected party would have a remedy against the expert but no right to resist the share transfer at the price fixed".

This suggests that should the parties agree that the valuer is to follow certain valuation principles, processes and procedures, they should include these in the reference terms. That might include, for example, whether a minority discount to the shares should apply to the valuation.

5 Who pays?

A dispute over how the expert's costs will be met is the last thing either party, and the expert, will appreciate at the end of the process. So, the reference or appointment terms should set out clearly the basis on which the expert's costs will be met. Many options are available, including costs to be met by the company, by shareholders in proportion to their holdings or equally. In our experience, a sensible approach is to allow for the expert to be guided by the parties' wishes regarding costs, but to have the final say on their allocation.

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