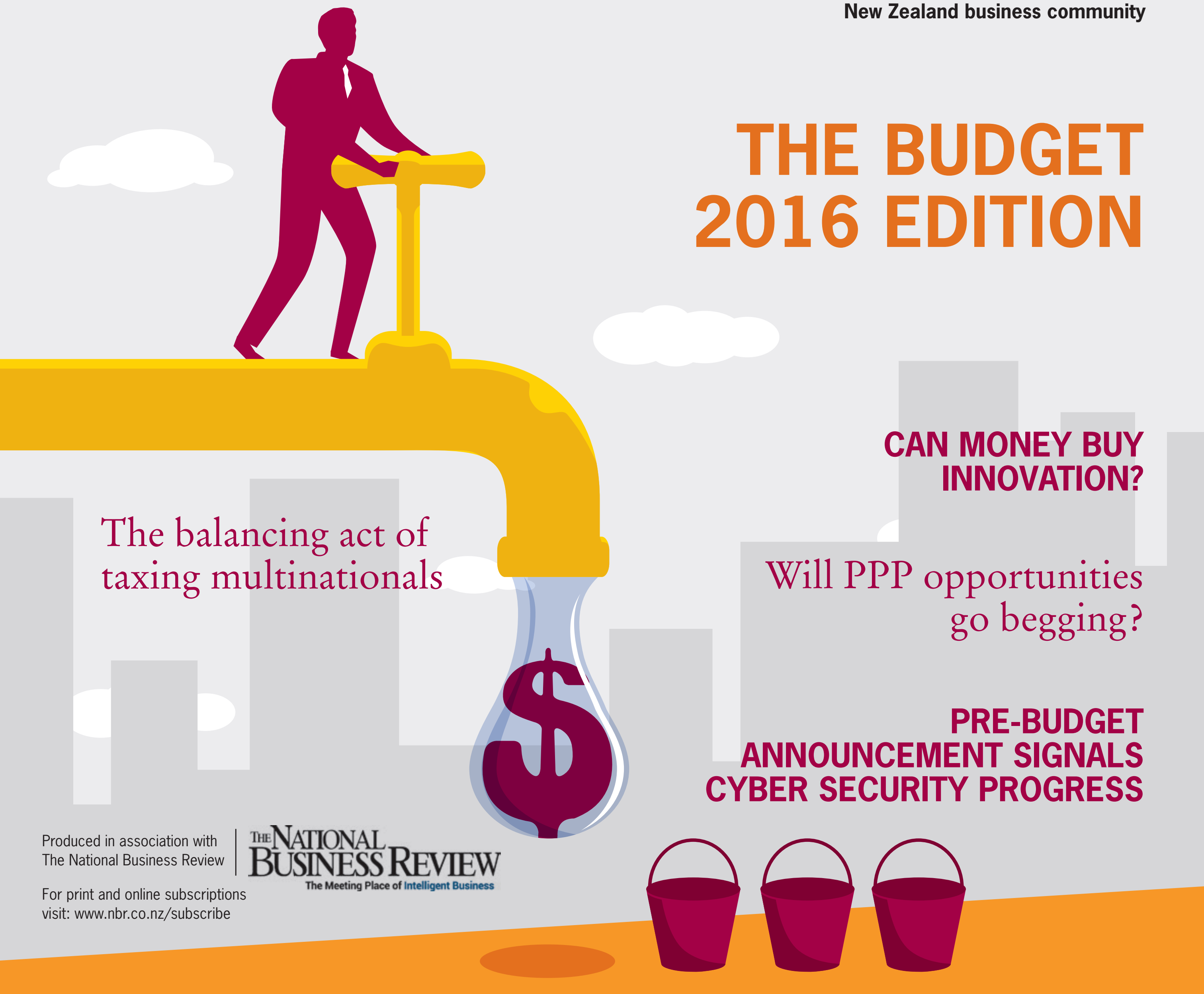
Business Adviser

Q2 2016 ISSUE 64

Commentary, opinion and intelligence for the New Zealand business community



THE BUDGET 2016 EDITION

CAN MONEY BUY INNOVATION?

The balancing act of taxing multinationals

Will PPP opportunities go begging?

PRE-BUDGET ANNOUNCEMENT SIGNALS CYBER SECURITY PROGRESS

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PLUS

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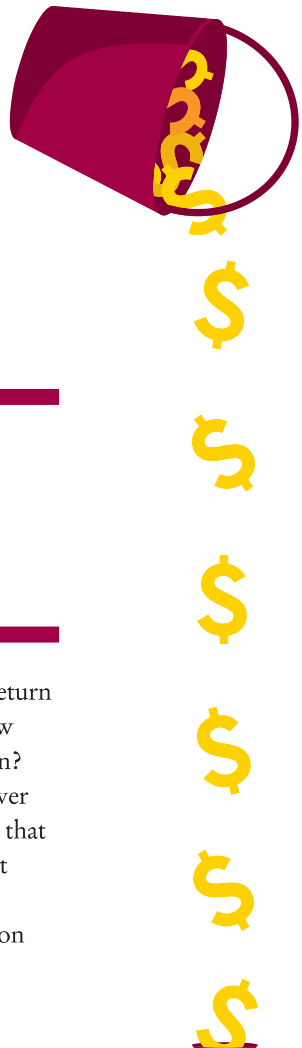
Can money buy innovation?



Innovation is crucial to the success of any organisation, or economy for that matter. So how can you grow innovation?

Budget 2015 saw a range of new funding for science and innovation initiatives. This included $80 million of growth grants to boost research and development (R&D) projects administered by Callaghan Innovation. The Government also reprioritised money to fund an international investment programme to attract multinational companies to undertake R&D in New Zealand.

All in, Government invested more than $1.5 billion in science and innovation in 2015/16. But is it enough?

Recently Science and Innovation Minister Steven Joyce announced a further $15 million in funding to accelerate the commercialisation of scientific research and to support start-up companies.

Government invested more than $1.5 billion in science and innovation in 2015/16. But is it enough?

Current policies will take time to deliver a return on investment, but is it even possible to grow New Zealand to be the 'go to' for innovation?

R&D is seen internationally as a key driver of economic growth and comparisons show that New Zealand has scope for more investment in R&D, especially by business. However, recent research conducted by Grant Thornton

shows that investment in R&D has fallen 14 per cent this year compared to last year. Despite business belief in the need for innovation, they do not appear willing to increase their investment into R&D.

The United States has Silicon Valley with its burgeoning population of the world's largest high-tech companies and startups; why can't New Zealand carve out its own niche around innovation?

We can. We have a unique environment and biodiversity, fast-growing knowledge-intensive sectors, and a distinctive and inventive culture. We typically embrace opportunities to absorb new ideas and to contribute to the global pool of knowledge.

Knowledge travels through people and the answer is to expand New Zealand's pool of smart capital by attracting innovators to New Zealand. We can do this by building an innovation ecosystem and connecting people. People already love New Zealand – and we are seen as great people to do business with.

With greater international engagement and a broader exchange of ideas, New Zealand businesses may be inspired to invest more into R&D activity and help drive growth in our economy.

New Zealand could also accelerate the commercialisation of innovation through partnership and collaboration. A great example is the partnership between Unitec and The Mind Lab. Over the past 12 months The Mind Lab has grown from one to eight training facilities. The scale of this growth is significant, and central to the expansion has been the collaboration between the two partners. Together the partnership has been prepared to take risks where, individually, they may well have passed the opportunity by.

Risk is a huge factor in innovation – larger organisations have the financial resources, but tend to be more cautious while smaller more agile businesses have an appetite for risk, but often lack the financial resources to see a project through. In all, funding for R&D is important to innovation, but partnership and collaboration are key.

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Will PPP opportunities go begging?

While public-private partnerships (PPPs) have been welcomed overseas, New Zealand is late to the party; the public is missing out on the infrastructure that could be provided, and the economy isn't benefitting from the stimulation PPPs create.

PPPs deliver on many fronts. The use of private sector capital frees up Government (or local government) cash flows, while private sector expertise ensures projects are best in class and built to private sector standards. Generally speaking, the private sector with its scrutiny on the use of capital, will deliver on-time and within budget. The asset generated provides a facility for public use, while returning an investment stream to the private sector partner. PPPs also stimulate the wider economy.

Back in 2007 the Vector Arena project brought together the Auckland City Council, Quay Park Asset Management and Mainzeal to deliver a facility that will be transferred back to ratepayers in 2047. In the meantime, the Auckland region can enjoy the benefits of a 12,000 seat, world-class, multi-purpose, all weather arena. And a new inner-city sports stadium for Auckland could create another perfect PPP opportunity – the deliverable this time being a completely different stadium in our largest city, with good transport links and great public access.

So why aren't we seeing more PPP solutions being delivered elsewhere in New Zealand?

Surely it's time for less debate and more action, given that the world is awash with capital looking for a home, and New Zealand needs more

This is where Budget 2016 could have an impact. The Government must articulate and actively promote the benefits of entering into PPPs because of the capital investment they deliver with no additional borrowing.

infrastructure. Hospitals, prisons, schools and roads all make sound PPPs because they can deliver a consistent return on investment over a 20 to 40 year period, and all are for the national good.

The issue in New Zealand may be insufficient experience with PPPs and not enough political engagement. If we're talking about business disruption and old models being no longer fit for purpose, PPP solutions have to be on the agenda and get more airplay.

This is where Budget 2016 could have an impact. The Government must articulate and actively promote the benefits of entering into PPPs because of the capital investment they deliver with no additional borrowing. With no mention of PPPs in the Budget speech since 2011, its time has come.

After seeing the success of the Hobsonville School PPP, the Ministry of Education has signalled its intent to create six new schools using PPPs (in Hamilton, Auckland and Christchurch). But the opportunities are far broader: think cross-harbour tunnels, rapid transit solutions, hospital research centres and those parts of the Christchurch rebuild that are still at concept stage.

The Budget challenge is for both the Government to identify the need, and for the private sector to embrace it.

As more PPPs are successfully undertaken, hurdles will diminish and the expertise in implementation will grow. In other countries, including the United Kingdom, PPP implementation is a specialism we simply aren't seeing in New Zealand.

And just in case you are interested – yes there is comprehensive accounting guidance in this area to ensure that the economic substance of any PPP arrangement is fairly stated.

While not strictly a PPP, the proposed cash injection from ACC and the Super Fund into NZ Post to enable Kiwibank to extend its lending was a smart redistribution of capital. And that's also the way PPPs should be assessed from a Government's perspective.

A win-win, you might say, much like a well-executed PPP.

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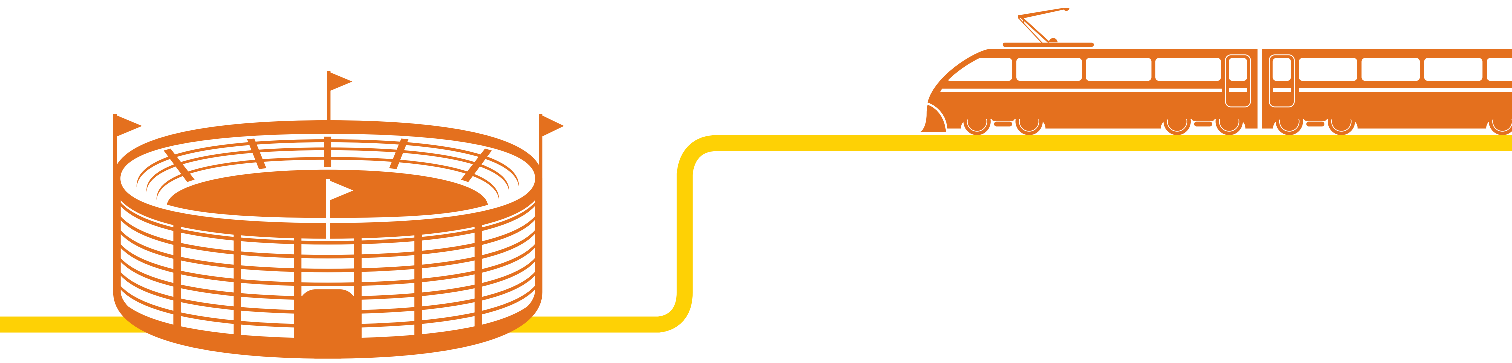

Pre-Budget announcement signals cyber security progress

At the recent Cyber Security Summit in Auckland, new measures including a national Computer Emergency Response Team (CERT) and a credentials scheme for business were announced. Like most new endeavours, the implementation will present a number of challenges and even more opportunities to build on these positive steps.

At the summit, Prime Minister John Key made a pre-Budget announcement confirming a $22 million investment in the CERT. Summit host, Minister for Communications, Amy Adams said the CERT would have an appointed public and private sector advisory board reporting directly to her. To enable a fast-start, the CERT will initially be housed within the Ministry of Business, Innovation & Employment. Minister Adams also confirmed that a cyber-credentials scheme would be up and running by the end of this year.

The CERT will rely on building trust with business to contribute information about their security breaches, with no mandatory reporting, and a business and public sector community capable of understanding and using this information. At the Cyber Security Summit, keynote speaker from Google, Richard Salgado, was among those who noted that while mandatory reporting occurs overseas, it isn't necessarily more effective. Anyone with a major bank account or user of a service is likely to be made aware of a breach. As Richard says, "it is more important to ask, what are you going to do about it?"

Many SMEs rely on outsourced technology support to secure their systems and data. Of course there are also variances in contracting service providers – when you don't know what good looks like, it isn't always easy to know what to look for. The next initiative the Government should pursue through future budgets is to support and fund certification processes that would help inform businesses who the best technology providers are.

In New Zealand, and many other parts of the world, we tend to focus on technology, systems and hardware. But a locked-down security environment is where we tend to see the worst behaviours – people will find ways to work around this; for example, your colleague who emails documents home, or the vendor who provides content on a USB plugged straight into your hardware.

Focusing purely on technology and systems will never be fully effective – organisations must also turn their attention to their people and the processes supporting them. Human error or "wetware" is still the biggest weaknesses in any cyber security defence. Education and understanding supports good systems in place – and growing the understanding and capability of cyber security would be a great Government investment. The more leadership teams understand and support security, the better and more likely their organisations are to improve their understanding and reaction to the changing threats. If we achieve this, then the information provided by a CERT would be well used.

We also can't rely on our physical isolation as a protective measure. That didn't work for the flightless bird that used to exist here … and it won't work for cyber security. New Zealand has an opportunity to not only catch up with the rest of the world but to actually become better when it comes to cyber security.

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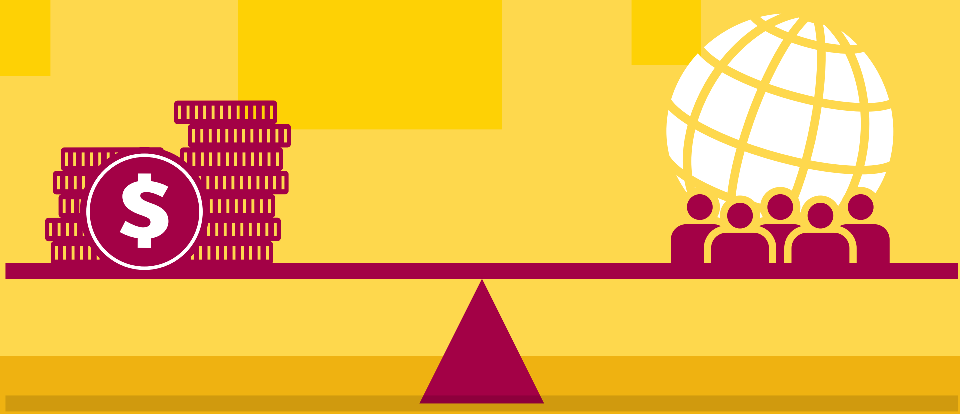
The balancing act of taxing multinationals

Inland Revenue is stepping up its campaign on ensuring small businesses meet their tax obligations, so naturally the finger once again points at multinationals to stump up the cash to meet theirs. After all, the tax revenue from multinationals has the potential to materially increase Government revenues. This requires a change in rules which should be definitively signalled in Budget 2016, rather than a continuation of the rhetoric surrounding the current measured progress being made toward possible rule changes.

However, there is a fine balancing act that the Government needs to maintain to ensure these changes deliver successful outcomes. Our export presence overseas needs to be treated fairly to encourage foreign and domestic business in New Zealand, and our robust voluntary tax compliance regime needs to remain solid. All taxpayers should feel that everyone is paying their fair share. These competing factors are critical to avoiding an inappropriate focus on a particular revenue stream and risk alienating or "cutting off" an important part of our economy.

The debate over an appropriate level of taxation being paid by multinationals is not a new one. After running a programme to revise the rules of international taxation for several years, the OECD released a detailed recommended action plan surrounding 15 key areas in October 2015. Countries all over the world are revisiting their domestic rules to address these recommendations, but everyone simply changing their rules simultaneously isn't that simple.

While global taxation principles share some common characteristics, there is no global uniformity. Tax also does not operate in isolation; it's just one economic lever to manage people, resources, and to fund operations. Politics also plays a major part in which tax policies are seen as acceptable, and to help attract foreign investment.



Kiwis are proud of their country, punching above their weight and their place on the international stage, but in reality, we are a small global player...

Australia and the United Kingdom have already broken ranks and implemented rules targeting the perceived rorting of their countries' taxes by certain multinationals. India and China's tax authorities have sought to achieve the same outcome through more aggressive policing. New Zealand, on the other hand, has implemented minor changes to date but has held back on more substantive initiatives that correspond with the OECD's programme. Our implementation will also be subject to the impact on the country's business and compliance costs, and the generic public consultation process.

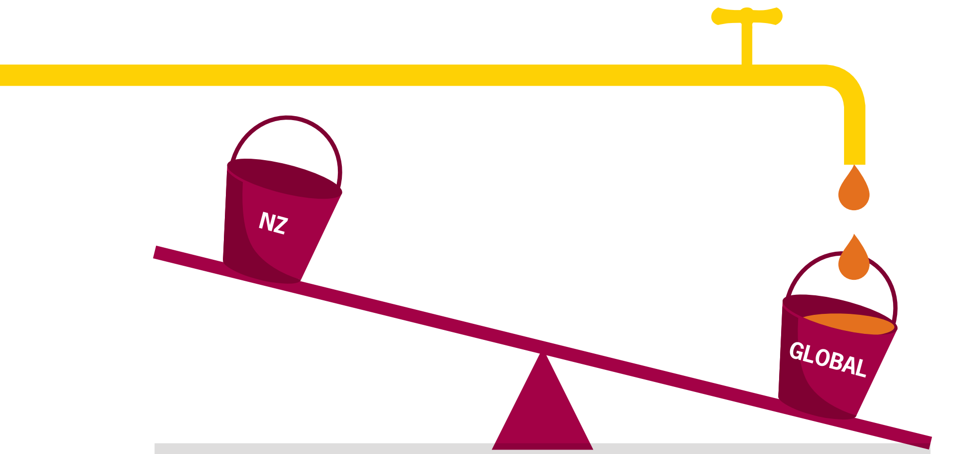
Caution is warranted by the Government, but it needs to actively do something so that New Zealand taxpayers do not remain aggrieved at the perceived inequality. The current tax proposals around global automatic information sharing - while to be commended as a necessary step in creating transparency between tax authorities - doesn't sit well with New Zealand taxpayers as affirmative action.

This measured approach recognises multinationals play a significant role in our economy. We need the foreign investment to grow and develop our domestic markets. We also need to ensure we are not considered heavy handed by other countries when our exporters seek to do business in their country.

Kiwis are proud of their country, punching above their weight and their place on the international stage, but in reality, we are a small global player, often lost in the roundings of global businesses. Special rules or treatment for multinationals can easily lead to the tap in New Zealand being firmly turned off. We're not that special in the eyes of the world, and that can have a significant impact on our economy, and the New Zealand customer experience.

We also shouldn't lose sight of the range of requirements tax authorities place on multinationals, which could be implemented without being seen as overly heavy handed. For example, compulsory contemporaneous transfer pricing documentation based on the New Zealand presence (rather than a global transfer pricing study), or annual transfer pricing policy disclosure could lift the focus on New Zealand tax principles, rather than the current practices of imposing world policies on New Zealand.

We can't afford to antagonise international businesses. Equally, New Zealand's tax system shouldn't be seen as a "soft touch" internationally. And most importantly, we need to ensure that New Zealand domestic taxpayers are treated fairly and that voluntary compliance is not compromised. Proactive and public implementation of enhanced rules on multinational business is required, and should be outlined in the Government's 2016 Budget rather than the current approach which will take some time to see the full light of day.



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No sweet taxes this year

Who would have thought that celebrity chefs could influence Governments to introduce new taxes? Jamie Oliver has publically lobbied the UK Government to do this, and was quick to claim credit when it introduced a two tier levy on soft drinks from 2018. Unsurprisingly, Mr Oliver quickly identified further potential television markets, including New Zealand, and has extended his call further afield.

Health Minister Jonathan Coleman has said that New Zealand will not follow suit at this stage, due to a lack of compelling evidence to support the effectiveness of such a tax. These comments have disappointed general practitioners. A recent poll in NZ Doctor revealed that nearly 70 per cent of GPs surveyed disagreed with Dr Coleman and 84 per cent believe a sugar tax should be introduced in this country. Earlier this month, 74 public health academics collaborated to demand that Government introduce a 20 per cent tax on sugary drinks in the 2016 Budget. This group is supported by organisations such as the Heart Foundation and Diabetes New Zealand.

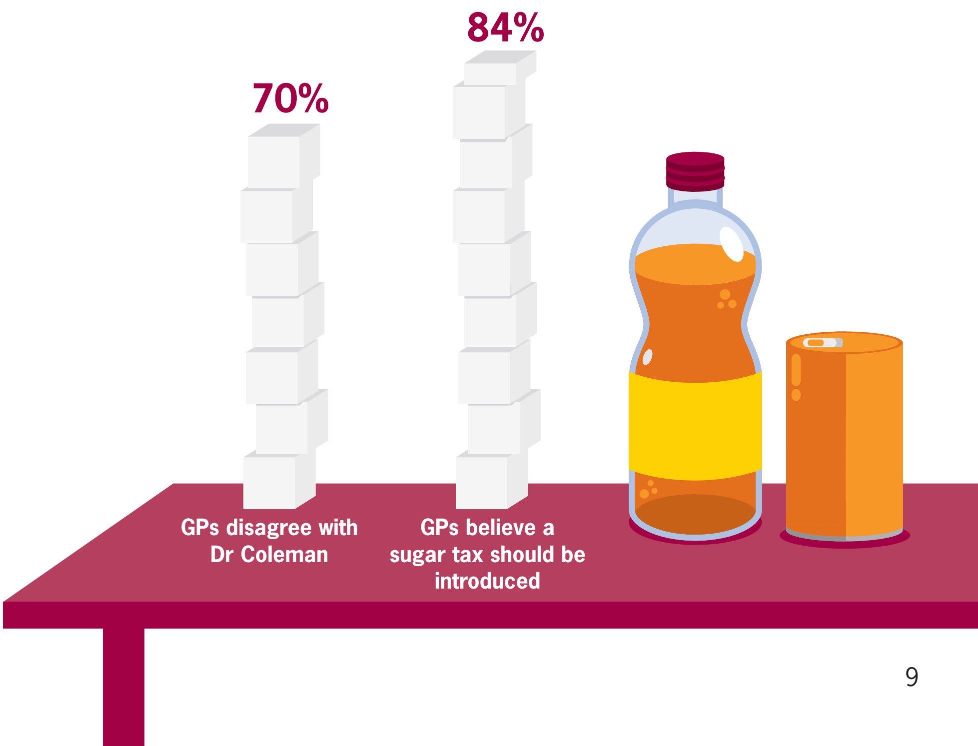
There is no doubting that that diets high in sugary foods have life changing health implications for many and this places pressure on the public health system. But we really have to ask ourselves if a sugar tax would actually change behaviours at consumer level.

If people truly crave these products, will they simply continue to buy them even if they do cost more? And will they sacrifice other important areas of their household budget causing other forms of deprivation?

If we look at other heavily regulated commodities in New Zealand, the answer to both questions is yes.

The Government's goal of making New Zealand smoke-free by 2025 includes annual 10 per cent tax hikes which started in 2010 and conclude this year. Since then, there's only been an incremental decline in the number of Kiwis who smoke monthly - 20 per cent in 2006/2007 to 17 per cent in 2014/2015. The daily smoking rate is virtually unchanged since the New Zealand 2013 Census, and remains at 15 per cent.

And what about the role advertising plays in the promotion of unhealthy products?



Modifying consumption behaviour requires more than financial disincentives.

In 1963 broadcasting authorities banned cigarette advertising on New Zealand television and radio; ten years later billboard and cinema advertising was banned. In 1974 the first health warning appeared cigarette packets, and in 2008, all tobacco companies were mandated to have graphic health warnings printed on all cigarette packages sold in New Zealand. These are some of the more significant initiatives among a whole raft of measures to discourage tobacco consumption.

In the more than half a century since the tax on cigarettes has skyrocketed and that first advertising ban was imposed, around 5,000 New Zealanders still die each year from smoking or exposure to second hand smoke – the equivalent of 13 people per day.

In the long term, modifying consumption behaviour requires more than financial disincentives. Education and increasing public knowledge levels are important tools. Schools have a key role in incorporating messages about healthy eating into the curriculum. Our devolved curriculum system gives schools the flexibility to teach subjects in ways that suit their students and community. We should encourage our schools to look to incorporate nutritional information into their curriculums. Several DHBs across the country have banned sugary drinks from sale at outlets within their premises. This is a good start to the public education process.

Consumers need to make informed choices about which products they consume rather than State directed decision making.

So it's unlikely we'll see a new sugar tax in the 2016 Budget. Despite heavy media coverage and opinion from a diverse group of pundits, it's a politically challenging tax to enforce, and of dubious policy value.

However, if the issue is not addressed at all, New Zealand taxpayers will be funding the ever burgeoning health system that is treating people with lifelong disease potentially caused by poor food choices.

Whatever the current view of Government, it is inevitable that politicians will need to formally address the issue. In the meantime, we can watch the sweet, or not so 'sweet as' results in the UK.

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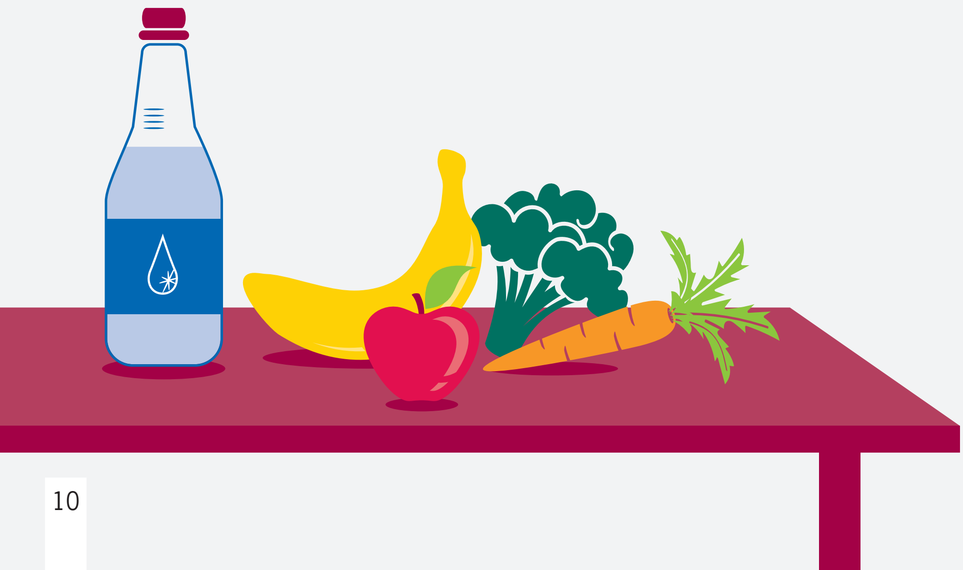

Time to iron out the wrinkles in aged care

Budget 2015 saw the Government allocate $76.1 million to help hospices expand palliative care services. While this is a solid start, more investment is needed to comprehensively change the way healthcare services are delivered to people 65+ in New Zealand.

We have an increasing proportion of people in older age groups and a declining number of children. This is a hot topic globally as several other countries are experiencing this phenomenon, but what will it mean for New Zealand?

In 2010, the Grant Thornton Aged Residential Care Service Review warned that by 2026 the over 65 population is expected to increase by 84 per cent, from 512,000 to 944,000 people. During this period the overall population is projected to grow by 20 percent, from 4.2 million to 5 million.

The report revealed that by 2026:

- between 12,000 and 20,000 people will require aged residential care
- new beds in the sector need to increase by 78-110 per cent to accommodate demand and to replace aging facilities
- the current operating profits from stand-alone residential care facilities will be insufficient to stimulate the required private sector investment
- the workforce needed to service the aged care sector must increase by 50 to 75 per cent.

The review also states that investment in the residential aged care sector requires significant planning and lead-in time to ensure that demand, supply and workforce models are established to meet these future challenges.

The research found that demand for rest homecare will begin to increase between 2012 and 2015 – so the time to act is well and truly upon us.

As a country, we need to recognise the need for more aged care services and funding to meet future demand. The current regulatory environment's influence on supply and demand needs to be reviewed and refocussed to support appropriate investment models of care.

Current trends in preference for alternative care will also continue into the future and need to be taken into consideration. For example, international literature suggests that informal care by family and friends is a viable option for someone with limited, but not severe, disability.

Pre-emptive strikes like United Future's proposal to provide free annual health checks for everyone over the age of 65 are well intended measures to maintain health and hence reduce demand for resources, but they simply won't stop the onslaught of those needing care in their twilight years; a 2014 costing update to the Grant Thornton Aged Residential Care Service Review reveals that two thirds of New Zealand facilities are over 20 years old and new supply has grown at just 1.2 per cent annum over the past five years (excluding Canterbury). The Ministry of Health's forecast models indicate that a severe shortage of supply will exist by 2022 if current growth rates don't pick up. Some providers have projected the shortfall to come as soon as 2018.

One of the priorities in the Government's 2016 Budget Policy Statement is to spend to achieve better outcomes for New Zealanders. Policy and funding needs to have an impact on investment levels so that New Zealand is prepared for the unprecedented number of older New Zealanders requiring support. After all, this is an issue that will ultimately affect all of us.

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Nest egg tax: a hands-off tax approach for super schemes

The introduction and success of KiwiSaver has undoubtedly helped New Zealanders save more effectively, but it won't be enough to ensure that participants in the scheme will be comfortable when they retire. People are living for longer and the status quo isn't going to cut it for future generations.

Many Kiwis are currently relying heavily on the value of their home (often their only key asset) and NZ Super to fund their retirement. The rapid rise in residential property values means that the ideal of owning a home is becoming a mere fantasy for many. Home ownership is at its lowest in 50 years at just under 65%, and it's expected to decline further.

To ensure future generations have sufficient investments to fund their retirement lifestyle, bold decisions are required in this year's budget and beyond.

A key area that deserves some serious attention is making employee contributions and investment income accrued within the fund exempt from tax.

This isn't outrageous in any sense of the word when you look at other countries' approaches to superannuation. Many countries offer tax incentives for retirement savings by exempting contributions, exempting investment income generated and taxing future payments – otherwise known as EET. It encourages active saving while significantly increasing an individual's nest egg.

New Zealand, on the other hand, opts for a TTE approach. Contributions are taxed on the way in and investment income is taxed as it is earned, while subsequent payments are exempt from further tax. To put the impact of these two regimes into context, consider the following: you invest $100 in a retirement fund for 50 years at 6% nominal return with a marginal rate of say, 30%. If tax doesn't accrue on the investment income and is only applied on withdrawal, the after tax result is $1,319. However, under New Zealand's current system, investment income is taxed as it is derived, but not on withdrawal; which reduces the amount to $782. This significant drop in ROI highlights the punitive nature of our current system.

Given the adverse tax outcome that the TTE approach delivers, there is no real surprise that those who have funds often invest them in the housing market. The generous tax treatment of housing relative to other investments compounds the housing problem and promotes investment in less productive areas of the economy.

Clearly an EET tax system would provide massive benefits for individuals. It would create greater wealth and less reliance on the state for assistance in later life. An increase in savings better employed would also lead to wider economic benefits such as greater access to capital, job creation and greater productivity, which in turn would reduce our reliance on overseas borrowing.

Of course there's an immediate cost as any decrease in taxes will reduce the revenue intake for the Government. It is unlikely that this cost could be replaced without generating the revenue from somewhere else.

There is no doubt that taxes distort decision making – so why not modify the tax system to encourage investment into more productive areas?

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