cutting through complexity

Joint Select Committee Inquiry

Family Business in Australia

31 October 2012

Private Enterprise
Riparian Plaza
71 Eagle Street
Brisbane Qld 4000

GPO Box 223
Brisbane Qld 4001
Australia

ABN: 51 194 660 183
Telephone: +61 7 3233 3111
Facsimile: +61 7 3233 3100
www.kpmg.com.au

Mr R Grant
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Email: corporations.joint@aph.gov.au

Our ref 29013721_1

Contact Bill Noye, 07 3233 3253

31 October 2012

By email

Dear Richard

Joint Select Committee Inquiry - Family Business in Australia

Background

KPMG's Private Enterprise practice has been working with family businesses for more than 100 years, helping them to navigate their challenges and determine a balance that suits their own unique family and business model. In addition to our tax, audit and accounting functions, we help our family business clients with a range of specialised business advisory services to support their long term success and inform current owners and the next generation of business owners and managers as to family business best practice.

Our client base includes a broad cross-section of some of the most successful and dynamic family businesses in Australia providing a significant contribution to the Australian economy via their output, tax contribution and employment and a significant contribution to Australia's social fabric and its community through their connectivity, longevity, philanthropy and values.

KPMG has a long and established relationship with Family Business Australia ("FBA") both at a National and State level and is currently, the FBA's National Gold Sponsor. KPMG supports the work of the FBA and endorses the comments made in their submission to the inquiry.

KPMG has sponsored six national Family Business Surveys dating from 2005 to 2011, and one Survey on the Next Generation of Family Business in 2010. In addition our annual Private Companies Survey, the latest of which was released earlier this year, has been developed for this audience since 2007.

KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity.

Liability limited by a scheme approved under Professional Standards Legislation.

KPMG's relationships with family business globally includes sponsorship of the Institute of Family Business in the UK and the Canadian firms' own Canadian Centre for Family Business, together with regional alliances with *Young Presidents' Organization* (YPO) and the pan-European umbrella federation *European Family Businesses-GEEF*.

Both in Australia and in Canada, KPMG has deliberately created a separate division catering to the needs of the private capital markets, entrepreneurs and wealth owners – KPMG's Private Enterprise and Enterprise divisions respectively.

More broadly, KPMG Canada and KPMG Europe also invest in significant research into the sector, enabling us to identify global contrasts and similarities.

Given our involvement in and focus on the family business sector, we welcome the opportunity to provide a submission to the Senate Committee inquiry into Family Business in Australia. We also would appreciate an opportunity to expand on our submission and provide deeper insights into the issues facing the sector in the planned public hearings.

Our submission is attached for your reference, should you have any questions please do not hesitate to contact me.

Yours faithfully

Bill Noye

Bill Noye
National Chairman - Family Business Services
KPMG Private Enterprise

KPMG

Contents

The key issues facing family business include ;

a) Management and equity succession, including planning, implementation and future governance;

b) Fostering of entrepreneurship and innovation within the business;

c) Recognition and support of the complexity facing families in business, as both owners and managers;

d) The conflict inherent in family and business ("the work/life balance"); and

e) How family businesses are funded.

The contribution of family business to Australia's economy may be debated as to its true quantum. Based on the limited research available it is clear that as a contributor to Australia's economy it is significant and vitally important, however it would seem largely unrecognised and unsupported by government policy. It is important that 'family businesses' are now recognised as significant contributors to the Australian economy.

The nature of family businesses and the complex inter-relationship between the family and how that informs the management of the business suggests that targeted policy responses and incentives based on the business activity itself may be less useful than a broad policy approach, designed to support the family in business as meaningful and significant contributors to Australia's business and social environment.

> "Family businesses must be seen not only in terms of assets but as a combination of property and values. That is, family businesses have implications that involve more than merely serving a financial purpose: they are means of sharing certain values and providing a service to the community in which they are integrated."[1]

The development of policy initiatives to support family business therefore need to be broader than simply offering specific relief from taxation for transfer of business interests or assets as part of succession planning, (although important and welcome), but include government departmental recognition as a separate portfolio building on the scope of the Minister for Small Business in each State and Territory and at the Federal level.

Such portfolio's key objective would be to create an environment that helps build resilient and durable family businesses through development of networks and initiatives targeted at helping families to develop family business 'best practice'. Such support may be offered by, for example, exploring research into the sector, helping to fund educational programmes for business owners and the next generation around strategy and planning, creating local forums for business owners.

Working in lock step with professional advisers and industry bodies such as FBA, the opportunity for the family business sector and the economy in general is to be able to build on the resilience and sustainability demonstrated by the sector in recent times for the benefit of the Australian economy as a whole.

[1] Tapies J – Ward J 'Family Owned business; a role model of values' Palgrave McMillan, 2008

Recommendations

Acknowledging the family business sector

- That the government adopt a formal definition for family business that enables policy initiatives to be developed that recognise the unique characteristic of family business owners as both the owners of equity/capital and managers of the business.
- That Federal and State governments recognise the contribution of family businesses by the development of separate portfolios and agencies focussed solely on the sustainability of family owned business rather than narrowly on "Small Business" alone.
- The government should encourage the development of academic research into family business and the formal development of professional education to support the long term sustainability of family businesses in Australia.

Dealing with succession

- To help support the long term stability and sustainability of family businesses, government should adopt policy measures that recognise the benefits of long term multi-generational ownership by specifically recognising that on succession whilst individual ownership may change the family's ownership does not.
- It is recommended that the CGT treatment for intergenerational transfers of interests in a business to family members (in life) should mirror the CGT treatment of an asset passing to a beneficiary through a deceased estate.
- Alternatively, the transfer of a family's ownership interest in a family business (as defined) to another member of the family should not be regarded as a change in ownership tantamount to a disposal.
- It is recommended that all family businesses have the ability to access the same stamp duty concessions when transferring their business to their next generation, and that the concessions are not limited to primary producers.

Funding family business

- It is recommended that government explore ways and means by which private capital markets may be encouraged to provide equity funding to support family business.

Taxation of family groups

There has been significant legislative changes over recent years around the taxation of trusts and private companies. This has increased the complexity and risk associated with tax administration of family groups and has resulted in increased compliance costs, increased operating costs and has unnecessarily complicated the way family group entities interact, operate retain profits and obtain funding. We believe Government should consider reviewing the taxation of trusts and family groups to reduce complexity, compliance risk, cost of compliance, cost of funding and provide more certainty and clarity.

1. The definition of 'family business'

We note the recommendation of FBA as regards the adoption of a formal definition for family business. As their submission explains, there is little consensus on the definition of what constitutes a family business.

At the heart of many family business definitions is the idea that there is family influence or control over both the ownership and the management of operations which continues by way of inheritance or succession. It is this lack of separation of ownership and management that defines the unique character of family business compared to those publically owned[2].

By implication this requires acceptance of three separate principles, the first is that there is an 'active' business or enterprise being undertaken, (as opposed to the collective ownership of a pool of 'passive' investment capital), secondly, that the business or enterprise has to be family owned, and the second is that there is "either the occurrence or anticipation that a younger family member has or will assume control of the business from an elder"[3].

As the following extract from the German Wittener Institute fur Familienunternehmenas a definition for family business suggests:

"*The term "family business" is used when:*
a company is owned wholly or partly by one family, several families or family associations and the latter have a determining influence on the development of the company based on entrepreneurial responsibility.

- *this responsibility of the business family or families is exercised by means of a management or supervisory function or both. The legal form and size of the company are irrelevant.*

The transgenerational aspect is essential to a family business. For this reason, it is strictly speaking only correct to refer to a company as a family business if the family is planning to hand down the company to its next generation. Start-ups and owner-managed companies are therefore not yet family businesses in their own right."

It should be noted that a family business may grow successfully to such an extent that it becomes publically owned with the family maintaining a "controlling" interest. In such cases the family may still see their involvement as being part of the "family business" despite the existence of outside shareholder influence.

It may be necessary to contemplate the continuation of the 'family business' as both a closely held 'private' entity and also a more widely 'held' public entity providing the organisation can demonstrate that there exists a significant level of family influence.

---

[2] It's the mix of pride, loyalty and entrepreneurial spirit that contributes to the belief that family businesses are a special breed. KPMG Canada solicited the views of 5117 members of business across Canada, asking them to describe the number one characteristic of family business. Having sense of ownership and identity ranked well ahead of any other characteristic. The next top characteristics identified were passion, team orientation and loyalty.

[3] Refer to Succession in Small and Family Business – thesis by Tamara Checkley prepared for the Canadian Association of Family Enterprises 2010 - pg 12 (quoting Fox, Nilihant and William 1996)

As an example, such a definition may include[4];

- The majority of votes/control are held directly or indirectly by the person who established or acquired the business, or their spouse, parents, child or child's direct heirs; and
- At least one representative of the family is involved in the management or administration of the business; and.
- In the case of a listed company, the person who established or acquired the firm, or their family, possesses 25% of the right to vote through their share capital, and that there is at least one family member on the board of the company.[5]

According to the European Commission[6]:

"A firm, of any size, is a family business if:

1. *the majority of decision-making rights is in the possession of the natural person(s) who established the firm, or in the possession of the natural person(s) who has/have acquired the share capital of the firm, or in the possession of their spouses, parents, child or children's direct heirs.*
2. *The majority of decision-making rights are indirect or direct.*
3. *At least one representative of the family or kin is formally involved in the governance of the firm.*
4. *Listed companies meet the definition of family enterprise if the person who established or acquired the firm (share capital) or their families or descendants possess 25 percent of the decision-making rights mandated by their share capital.*

This definition includes family firms which have not yet gone through the first generational transfer. It also covers sole proprietors and the self-employed (providing there is a legal entity which can be transferred)."

It is very important to note that "Family Business" does not mean "Small Business" to do so is a poor misconception and provides a misguided view of the sector and its needs.

Recommendation

That the government adopt a formal definition for family business that enables policy initiatives to be developed that recognise the unique characteristic of family business owners as both the owners of equity/capital and managers of the business. Having a focus on the 'ownership' of a business rather than the size of the business in formulating policy may help provide a better framework for family businesses to operate.

[4] Extract taken from Family Firm Institute- model and definition

[5] Recently applied in the research paper "Family Firm, A resilient Model for the 21st Century" – PwC Family Business survey

[6] First published on November 2009 in the Final Report of the Family Business Expert Group to the European Commission: Overview of family-business-relevant issues: research, networks, policy measures and existing studies

We note the comments made in the FBA submission and support the recommendations made to undertake more systematic research into the form and substance of family businesses.

The importance of conducting this research will be to understand the relative importance of family business (divided by reference to relative measures e.g. turnover, number of employees) as a function of GDP contribution and determine to what extent further policy support should be provided to family business by, for example, extending the tax relief offered to businesses whose turnover is less than $2 million per annum, to larger scale family businesses encouraging and supporting their continued succession.

The benefit of that research should then be applied towards broad based education for the family business sector and the professional advisers that can help support their long term sustainability. The FBA's adviser accreditation programme is an example of the kind of education programmes taught on the specific issues affecting family business.

Recommendation

The government should encourage the development of academic research into family business and the formal development of professional education to support the long term sustainability of family businesses in Australia.

The government should design and systematically collect data on the sector to better understand its significance and help support effective policy development to support family businesses.

3. The contribution of family business to the Australian economy, in terms of financial, social, employment, innovation and sustainability outcomes

The contribution of family businesses to the Australian economy has been estimated to be worth approximately $4.3 trillion, to the Australian economy. It is considered that over 65% of all businesses in Australia are family owned and that they employ over one half of the private workforce.[7]

The contribution of family businesses in Australia is not dissimilar to their impact globally. On average, family businesses create an estimated 70% to 90% of global GDP annually. [8] Specifically, Family Business in Europe represents:

- 50% of the European GDP
- 60% to 80% of all European Companies
- on average 40% to 50% of all jobs[9]

Aside from the financial benefits family businesses continue to offer the following broad benefits to the Australian economy. Of themselves, these benefits are not exclusive / or only accessed by Australian businesses but are generic and common to the sector globally.

- **Long term focus** providing stability and security to the local economy. Commonly, enlightened family businesses think about the state and nature of the business in the hands of future generations and encourage 'stewardship' thinking in both family members and non-family executives and staff;
- **Family businesses engender loyalty and trust** amongst the communities they operate including the work-force they employ and feel a greater sense of responsibility to maintaining relationships through business cycles;
- **Innovation and risk** in developing new initiatives operates to a higher level than publically owned businesses. Such innovation is typically the basis upon which the business was first created and should be further encouraged by way of incentives. Innovation also enables family businesses to generate new engines of growth and exploit their markets more dynamically than less nimble organisations. However, developing entrepreneurship in future generations is difficult and such innovation and risk taking is not easily funded by the private family business; and
- **Patience around the expected timing of a return on capital** provides stability and low mobility. It also helps ensure the financial stability of many family businesses who are necessarily funded not by debt, but through reinvestment of earnings and use of equity. It may also contribute to less volatile and more stable earnings as reflected in studies in the US[10]

Whilst less well understood at a National level, studies conducted into the impact of family businesses in South Australia have demonstrated that the continuation of successful family businesses creates long lasting economic impacts[11].

Further that their demise can result in broader costs to the community in which that business operates beyond the simple economic loss. What was recognised was that when business

---

[7] MGI Aust and RMIT survey – Family Business in Australia 2006

[8] Family Firm Institute, Inc http://www.ffi.org/?page=globaldatapoints

[9] Final report of the EU Expert Group, Overview of family-business-relevant issues: research

[10] In January 2010, McKinsey & Company reported family business provide healthy returns to shareholders, outperforming their non-family counterparts. From 1997 to 2009, a broad index of publicly traded family-influenced businesses in the USA and Western Europe, achieved total returns to shareholders two to three percentage points higher than those of the MSCI World, the S&P 500, and the MSCI Europe indexes. The five attributes of enduring family businesses, McKinsey Quarterly, McKinsey & Company, January 2010

[11] University of Adelaide – the cost of business closure to the SA economy

owners sell their business interests the capital transformation into a passively held form does not generate a future rate of return equivalent to that of the original business.

The impact of this economically could be significant as the 'baby boomer' generation retires. One estimate is that the value of wealth held by family businesses that is likely to be transferred over the next 10 years will be $3.5 trillion.

Despite recognition of their importance to the success of an economy, a significant number of family businesses fail to transition ownership and control successfully, due to several factors. Whilst, those factors include the effect of family dynamics, often it is a function of the legislative environment which does not encourage the implementation of planning for succession due to the tax imposts that may arise as a result of changes of ownership of equity or business assets, during the current owner's lifetime. (See later for further comments).

Recommendation

To help support the long term stability and sustainability of family businesses, government should consider adopting policy measures that recognise the benefits of long term multi-generational ownership by specifically recognising that on succession whilst individual ownership may change the family's ownership does not. This would help families plan for the most significant issue they face which is succession.

4. Structural, cultural, organisational, technological, geographical and governance challenges facing family business

The following table sets out the key challenges identified by participants in KPMG's Family Business Survey in 2011.

Of highest importance to the families surveyed[12] in 2011, maintaining family ownership and control of the business ranked as the issue posing the greatest challenge. Only 21.5% of families saw this issue as being of low or very low importance.

Issues of importance to family business	% where importance was Very High	% where importance was High	Total % rating the issue of High Importance
Maintaining family control	31%	30.5%	61.5%
Balancing family concerns and business interests	20%	39%	59%
Preparing and training a successor before succession takes place	23.5%	36%	59.5%
Maintaining a role for existing senior family members	11.5%	29.5%	41%
Selecting a successor	15.5%	22.5%	38%

From the responses it is clear that the most significant challenge that family businesses face is the interaction of family component with the business component and the 'flow-on' cultural and organisational difficulties that can arise if these are not properly acknowledged and systematically managed.

This suggests that the main reason why family businesses fail is a 'failure to effectively and thoughtfully communicate' and finding the time to develop strategic planning involving multiple generations of the family, when faced with the day to day demands of the business itself.

The failure to communicate typically revolves around the question of the future management and control of the business e.g. the capacity of the current owners to step aside, the confidence of the current generation in the ability of the next generation, the dilemma of moving from a dictatorship to a democratic environment.

The prospect of dealing with this challenge may in part explain the survey's finding as regards business owners' future succession plans, which suggested that 59% would consider selling their business if approached by a genuine buyer.

[12] In the 2011 Survey conducted between April and May 2011, 658 family enterprises were surveyed. http://www.kpmg.com/au/en/services/private-enterprise/family-business/pages/default.aspx

The contrast, between the thoughts of business owners in recognition of what is important to a family business and how they react to that challenge and the thoughts of the next generation, can be illustrated by the findings of an earlier survey[13] of next generation family members working for their family business.

The survey's findings found the participants to be overwhelmingly positive[14] about the prospect of working for the family business into the future and taking on the challenge of leadership.

Recommendation

That Federal and State governments recognise the contribution of family businesses by considering the development of separate portfolios and agencies focussed solely on the sustainability of family owned business rather than narrowly as is currently the case on "Small Business."

[13] KPMG and Family Business Australia – Survey of the Next Generation of Family Business

[14] Nearly two thirds of survey respondents said that being in the family business is "where they always wanted to be".

5. The role of family trusts in facilitating family business

The main operating entity employed by family business is a private company. For reasons associated with asset protection and maintaining the family's long-term ownership and control of that capital, many families may own their equity in a business (the shares in the company) through a discretionary trust structure.

Typically, therefore, the control and legal ownership rests with the trustee of the trust which acts on behalf of the beneficiaries of the trust.

Such trusts may also act as the owner of the business premises through which the business is conducted thus providing the family with a greater level of asset protection than if the property were to be owned by the business directly.

The trust structure offers flexibility to the owners as regards the use of working capital by enabling them to reinvest the 'after–tax' profits of the business without having to issue equity to the person to whom such profits have been distributed, such profits being effectively retained by the business to fund future growth.

The sense that the trust structure may be applied for the purposes of indefinite deferral of taxation has led revenue authorities to follow a firm line on compliance based on increasingly complex and less efficient tax legislation. Over recent years increasingly complex legislation around the taxation of family trusts has resulted in a significant increase in compliance costs, compliance risk and uncertainty. There is a clear need for government to simplify the taxation trusts and family groups.

Division 6 of Part III of the *Income Tax Assessment Act 1936*

It is recognised that the income tax provisions governing the taxation of trust income are currently subject to reform and will be rewritten into the Income Tax Assessment Act 1997. As such, we have not made any comments concerning the current Division 6 provisions within our submission.

Division 7A

Most family groups use family trusts in their structures, typically together with a company. This structure however is too often subject to the overreaching impact of Division 7A of the *Income Tax Assessment Act 1936,* making it easy for the family group to inadvertently fall foul of it and suffer significant implications, despite the fact that there is no mischief.

The concept that underlies Division 7A is simple; companies should not make tax free distributions of profits to its shareholders (or associates).

Unfortunately, it was exactly that simplicity that led to the demise of the antecedent "anti-avoidance" mechanism to prevent this from occurring, in section 108, and on this basis, whilst Division 7A is clearly aimed at a well understood "mischief" the provisions are in many cases drafted without reference to an avoidance motive.

The result of this is that the Division was drafted as the ultimate in "black letter law" – setting out the taxing events that arise and the limited number of exclusions from them. As a consequence, family groups are left with a set of self executing provisions that not only fail to deal with the perceived mischief in a number of instances, but have become the bane of many innocent commercial or family transactions.

The failure by the Government to appropriately deal with the 'perceived mischief' has resulted in the need for ongoing band-aid amendments to close 'loop-holes' as they are identified. Overall, the capture of innocent commercial or family transactions has resulted in potential time-bombs for family groups together with their advisers and insurers.

Application of Division 7A

A classic example of Division 7A incorrectly applying to a business transaction arises when a family group arranges for its family company to lend money to its family trust, generally for cash flow reasons. Whilst the funds have been utilised by the trust to conduct its business operations and there has been no 'mischief' in the law (that is, no money has been pulled out by the individuals) Division 7A is still triggered. This creates an unnecessary compliance and cash flow burden on the family, particularly if they are required to enter into a 'complying Division 7A loan agreement' with minimal annual repayments.

A taxpayer then has the choice to enter into a complying written loan agreement, with terms of 7 years (for an unsecured loan) or 25 years (for a secured loan) using the prescribed benchmark interest rate. Consequently, a loan that is unable to be secured must be repaid over a tight timeframe of 7 years which places pressure on the family group to meet these excessive cash flow demands. This is particularly a burden for families as they are subjected to repayments for a loan which is higher then what they would ordinarily be subjected to under a commercial loan.

More recently the introduction of *Taxation Ruling TR 2010/3* and *Practice Statement PS LA 2010/14* has had a noticeable and substantial impact on family and privately owned businesses. This guidance introduced by the ATO, has further tightened the relationship between trusts and its corporate beneficiaries, increasing the situations which bring them within the realm of Division 7A. The ATO has done so by firmly stating that loans between the trust and a company are caught by Division 7A and furthermore that unpaid distributions by a trust to a corporate beneficiary will also generally be treated as loans. The only exception is if the unpaid distribution is maintained separately from the other assets of the trust (that is using a sub-trust arrangement). In practice, this option is not often adopted due to the administrative burden placed on family and privately owned businesses.

Prior to the publication of the above ATO guidance, it was common practice for trusts to distribute profits to companies as any profits retained in the trust would be taxed at the top marginal rate by the trustee as opposed to distributing to companies that are capped at the tax rate of 30%. However, distributing to beneficiaries did not mean that the trust was also required to pay the profit to the company immediately. It instead enabled the trust to retain the profit and reinvest the funds in its business or use the profits to invest in new capital expenditure to facilitate the business' growth.

Now under the current approach, any unpaid distributions are generally treated as loans which would be caught by Division 7A. Division 7A requires that a Loan Agreement be entered into between the trust and the company if there is a loan in existence and that the loan is to be repaid to the company with interest over a period of time. This requires unnecessary administrative costs for family and privately owned businesses to ensure that loan agreements are set in place and to ensure these agreements are complied with. Furthermore, if the trust failed to comply with this agreement, then there is the potential for additional significant tax costs resulting in the discretionary trust model being an ineffective tool for tax purposes.

Family and privately owned businesses also may not have assets in liquid form (such as cash), in order to fund the Division 7A minimum loan repayments. Therefore in practice, the loan would typically be required to be repaid by way of the company paying a fully franked dividend to its shareholders. This again may result in particular individual shareholders being subject to additional top up tax.

To further complicate matters, the ATO ruling has been much criticised, and there is considerable uncertainty as to its correctness. There are also many complexities surrounding the existing unpaid present entitlement rules in Subdivision EA of Division 7A and its interaction with the ruling. Whilst the ATO was to participate in a test case to resolve some of these uncertainties, none have yet commenced and taxpayers are therefore faced with an ongoing period of considerable uncertainty. This is clearly unsatisfactory.

As a result of these complexities, many taxpayers have taken the approach that they are practically forced to comply due to the penal consequences of not complying with the ATO view, notwithstanding the doubts about the correctness of the same.

In summary, the original intent of Division 7A was to be an integrity provision that was aimed at ensuring loans that were in substance distributions of profit from companies to individuals, were caught within these provisions. Hence, Division 7A required that these loans be repaid or a loan agreement with minimum repayments be executed. However, unpaid present entitlements to a company from a trust are not an arrangement to disguise the distribution of profits to its family members.

As outlined above, the funds retained in the trust are used to fund the business operations and facilitate the business' growth. Additionally, prior to the above ATO guidance, unpaid present entitlements to companies ensured that the trust funds were still taxed at 30%. This placed them on commercial footing with other businesses that chose to operate under a private company structure.

There are very few instances where the trust uses the unpaid present entitlement for non-business purposes (such as the repayment of personal debt). Accordingly it is strongly recommended that the rules be amended so that the majority of family and privately owned businesses are not penalised for the small minority. Other specific purpose tests may be included to catch the minority who are seeking access at an individual level, to amounts taxed at the company rate.

Commissioner's Discretion under Section 109RB

Section 109RB was introduced under Tax Laws Amendment (2007 Measures No. 3) Act 2007 to bestow upon the Commissioner the discretion to either disregard a deemed dividend or allow it to be franked if the deemed dividend arose from an 'honest mistake' or 'inadvertent omission' by the taxpayer. The discretion retrospectively applies from the 2001-02 income year and is subject to certain conditions being satisfied. Under this section, the taxpayer must apply to the Commissioner to exercise his discretion if the deemed dividend arose after 1 July 2001 (assuming that no corrective action was taken before 30 June 2008 per PSLA 2007/20).

According to paragraph 1.33 of the Explanatory Memorandum to Tax Laws Amendment (2007 Measures no. 3) Bill 2007[15], assessing whether something constitutes an honest mistake or an inadvertent omission is an objective test which must be determined by reference to all the circumstances of the individual situation. This is particularly the case since neither term is defined in section 109ZD or elsewhere in either of the tax assessment acts.

[15] Being the amending legislation which introduced the Commissioner's discretion under section 109RB.

The Commissioner's views of section 109RB are set out in PS LA 2007/20 and PS LA 2011/29, which take a narrow view in terms of the circumstances where an 'honest mistake' or 'inadvertent omission' has occurred and hence where his discretion can be exercised. In short, the Commissioner seems adamant that a situation where a taxpayer is ignorant of the operation of Division 7A is unlikely to amount to an honest mistake or inadvertent omission. The Commissioner, we think incorrectly, draws a significant distinction between circumstances where taxpayers took incorrect advice from their tax advisers as opposed to situations where taxpayers relied upon their tax advisers to point out tax associated issues and as a result, did not to take any specific advice or undertake any action in connection with Division 7A (presumably on the basis because they did not know they even had an issue).

Whilst the introduction of the Commissioner's discretion clearly indicates that the Government and ATO alike acknowledge how confusing Division 7A actually is, the bar is set far too high in terms of what the Commissioner determines what is considered to be an 'honest mistake' or 'inadvertent omission', resulting in two unacceptable consequences:

1) The taxpayer does not apply for relief under this provision due to the probability that the Commissioner may make an unfavourable determination, regardless of the fact that a third party is likely to deem the situation to be as a result of an 'honest mistake' or 'inadvertent omission'.
2) The taxpayer incurs significant expenditure to prepare a private ruling application (likely to be through their tax agent) to the Commissioner to seek his discretion, knowing that there is only a small probability that the taxpayer's circumstances may exceed the high threshold.

This demonstrates that section 109RB, whilst so hardly fought for by those involved in order to bring some semblance of reality into Division 7A, has been rendered redundant by the Commissioner's approach.

Small Business Capital Gains Tax ("CGT") concessions

The Small Business CGT concessions were introduced by the Federal Treasurer on 21 September 1999. The intention was to remove impediments to efficient asset management, improve capital mobility, reduce complexity and compliance costs and overall, make Australia's CGT regime internationally competitive.

There is a significant benefit to small businesses and their owners if they fall within these concessions under Division 152 of the *Income Tax Assessment Act 1997.* However, the tests to determine whether a taxpayer is eligible are extremely complex and have received much criticism due to their lack of fairness.

Due to the complexity of these provisions, many small business owners do not understand the provisions, resulting in them making uninformed and costly decisions. Alternatively, any informed decision will come at the expense of sizeable professional costs. We have summarised some of the alternative scenarios that we believe taxpayers are currently faced with:

a) The taxpayer incurs significant professional fees to ensure they understand these provisions and their ability to access these concessions (best case scenario); or
b) The taxpayer incurs significant professional fees and after doing so, it is concluded that the taxpayer is unlikely to qualify due to the number of hurdles that must be satisfied. It is extremely difficult for a decision to be made upfront as each step is complex and must be carefully assessed and considered; or
c) The taxpayer cannot afford to pay for the associated professional fees, and as such, the taxpayer may voluntarily choose to forgo their ability to access these favourable concessions; or

d) The taxpayer may misinterpret one (or more) of these provisions when determining their eligibility. This is the worst case scenario and is likely to result in shortfall tax together with penalties and interest charges imposed by the ATO in the event of a review.

The extent of complexity is evidenced by the number of recent cases which address the application of the small business CGT concessions, and more specifically, the ability for a taxpayer to access the Maximum Net Asset Value Test (one of the basic conditions). These cases include, but are not limited to, Byrne Hotels[16] case, White's[17] case and Bell's case[18].

The outcome in Bell's case demonstrates our fourth point above. We note that although it was not specifically stated in the judgment, the capital gain in question was in excess of $6 million and the disallowance of the provisions caused a tax shortfall of approximately $1.4 million, penalties of $350,000 and 4 years of interest totalling about $2.6 million. A significant price to pay for a taxpayer that was trying to understand and adopt the correct approach within the law.

The taxpayer in Bell's case had a common structure to most family businesses. That is, the taxpayer controlled a family trust which owned units in a unit trust which in turn, conducted a successful business. Alternatively to this structure, we also typically see a family trust owning shares in a company. The commonality in Bell's structure creates concern for other family businesses that they may too fall foul to these provisions.

Recent cases plus ATO audit action point to the reality that unfortunately taxpayers and even in instances, their advisers, are struggling to properly understand and apply even the more basic tests of the provisions (for example how must a liability relate to an asset as in Bell's case).

Recommendation

It is strongly recommended that the Government rewrite the small business CGT concession provisions such that the intention of the law can finally be achieved.

[16] **FC of T v BYRNE HOTELS QLD PTY LTD 2012 ATC**

[17] WHITE & ANOR v FC of T 2012 ATC

[18] BELL v FC of T 2012 ATC

Other CGT considerations

Trusts (and indeed other entities) who do not qualify for the small business CGT concessions are not entitled to any form of CGT rollover where assets are disposed of, and the proceeds are reinvested in business assets. This potential CGT liability may therefore distort decisions as to whether to dispose of inefficient business assets. Further, it provides no incentive to reinvest the proceeds of asset sales in business assets.

It is recommended that consideration be given to introducing rollover relief similar to that provided under Sub division 152-E of the *Income Tax Assessment Act 1997* for all taxpayers.

Succession Planning

Central to all family businesses is the need for control to remain within the family and to have a mechanism in place that is sufficient to allow for the next generation to take over the family business. Family businesses are united when it comes to their desire for a simpler and more supportive tax regime, particularly with respect to CGT and inheritance tax. All too often the value created by each generation is almost wiped out by the substantial tax that is imposed when transferring the business to the next generation.

CGT implications

Assuming a unit trust model, although we note the same issue would arise with a company, the transfer of a business may be dealt with by leaving the units to the next generation on death, or transfer ownership of the business whilst the parents still have ownership.

Under the first scenario, there will be no CGT consequences where an asset passes to a beneficiary. However, with the increase in Australia's ageing population, it is likely there will be a misalignment between the need for the transition to the next generation to occur and the actual testamentary disposition of the asset.

As such, transferring a business to the next generation would preferably take place as an inter vivos disposition. Generally this transfer will give rise to CGT and the transferor will be deemed to receive market value as the capital proceeds where the actual consideration is less than market value. Alternatively, if the next generation is to be given partial ownership, then the trust may choose to issue new units at nominal value to their children and the parents retain their existing interest. In this instance there is no disposal of an asset under CGT event A1, however there may be value shifting implications. That is, there may be a deemed capital gain to the parents and a corresponding uplift in the cost base of the children's units.

Similarly to the above CGT consequences for individuals, transferring the ownership of assets owned by a discretionary trust to a new discretionary trust will also trigger CGT. Arguably there was previously relief available under the former provisions which allowed trust cloning, however these have now been repealed.

We note that the CGT consequences create an unnecessary cash flow burden to family groups when looking to transition their business. So much so, that the tax consequences may outweigh the benefits and the parents may instead choose to dispose of their interests to third parties, or alternatively do nothing.

Recommendation

In order to encourage the long term sustainability of family businesses, it is recommended that the CGT treatment for intergenerational transfers of interests in a business to their family members should mirror the CGT treatment of an asset passing to a beneficiary through a deceased estate.

Alternatively, the transfer of a family's ownership interest in a family business (as defined) to another member of the family should not be regarded as a change in ownership tantamount to a disposal.

Stamp duty implications

In the absence of specific exemptions or concessions, stamp duty is a major impediment to the intergenerational transfers of family businesses. Transfers of land or other business assets attract duty at rates up to 7.25% of the greater of the GST inclusive consideration and the unencumbered value of the assets.

In addition, some jurisdictions impose duty on the transfers of shares or units in private companies and unit trusts respectively, which can attract duty at rates up to 7.25% of the underlying land and goods or other business assets held in the entity. This duty alone (i.e. ignoring CGT) creates a significant cash flow burden on families wishing to transition the ownership of their business to their children.

We note that the very essence of the family business is, of course, that it has and will continue to be, passed from one generation to the next. However, the moment of transition (and the years planning up to it) can make or break the firm's future success if not executed at the appropriate time. Should the older generation choose to defer the transition as a result of the cash flow burden, then this choice may be at a cost to the businesses growth.

Similarly to the CGT implications above, generally the distribution of assets from a deceased estate is either exempt from duty or subject to nominal duty in the applicable jurisdiction. To encourage the growth of family businesses, one would think that it would be more effective to adopt a tax regime that fostered the intergenerational transfer of family businesses, as opposed to any tax benefits only being available after the former leadership has deceased. Even at the point, the business may be ready to be further passed to the say, the third generation.

Furthermore, we recognise that it is important for there to be tax relief for the transfer of family farms or primary productions between family members. However, why is it that the concessions are only limited to this industry, when other industries (for example manufacturing and retail and wholesale trade) are also subject to considerable economic factors?

Recommendation

It is recommended that all family businesses have the ability to access the same stamp duty concessions when transferring their business to their next generation, and that the concessions are not limited to primary producers.

Other ancillary issues

- **Trustee beneficiary statements**

Since the 2009 income year, closely held trusts are subject to additional reporting requirements to the ATO. The main purpose of these requirements is to ensure that the trustee of a 'closely held trust' with a trustee beneficiary advises the Commissioner of the trust beneficiaries of the net income and tax-preferred amounts of the trust. These rules allow the Commissioner to check whether the assessable income of the trustee beneficiaries correctly includes any required share of that net income, and whether the net assets of those beneficiaries reflect the receipt of the tax-preferred amounts.

However, the ATO's data matching is at the significant expense of the taxpayer who is required to understand new complex legislation and complete further schedules within their tax return (increasing professional costs). Further if the trustee fails to satisfy the reporting requirements, trustee beneficiary non-disclosure tax is imposed at a penalty rate of the top marginal rate plus Medicare levy on the untaxed part of the share of the net income.

Whilst certain trusts are excluded from the closely held trust measures (such as complying superannuation funds, family trusts or trusts whose income or capital is fully owned by family members and/or family trusts), in many instances businesses may operate through a discretionary trust which have not made a family trust election or are jointly operated by two families, thus tipping them into these complex provisions.

Recommendation

It is suggested that the Government consider whether the cost to taxpayers of complying with these rules is disproportionate to the benefit to the revenue from data matching. If so, it is recommended that these rules be revoked.

- **Family trust elections**

It is submitted that the family trust rules have created a great deal of confusion and unintended non compliance since their introduction. It is recognised that the election has a role to play in preventing trafficking of losses and franking credits. In the vast majority of cases however, there is no attempt to traffic losses or franking credits, but taxpayers are denied the benefit of those losses or credits because they made no election, an inappropriate election or an otherwise appropriate election from the wrong date.

It is further recognised that there have been attempts to create some flexibility in changing nominated individuals and the ability to make elections to vary or revoke the family trust election, however these amendments are limited and have merely added to the confusion of the family trust rules.

Making a family trust election to simplify some of the tax law measures for families, also come at further price - the family trust distribution tax regime. This not only penalises family businesses if they wish to make a one off distribution to a member outside the family group (for example to a key employee), however it also inhibits commercial decisions. That is, there are limited situations, if any, for a family trust to allocate interests in the trust to deserving outsiders such as key employees of a unit trust, or potential capital contributors.

Recommendation

It is recommended that the family trust election rules be amended to allow revocation or amendment of elections, where there is no attempt to traffic losses or franking credits.

6. Access to and the cost of finance and insurance for family business

Family businesses are usually funded through three sources, self and family, by way of loan and equity, reinvested earnings and borrowing from banks. The latter being the option used when the first two are exhausted. As the scale of the business increases, so those choices as regards third party funding increase but as a general rule, family businesses are prudent and conservative borrowers of funds.

The fact that family businesses are prudent and conservative has helped such businesses continue over the long term. However, in the absence of sufficient liquidity (caused in part by the desire to continue to reinvest earnings back into the business), the capacity to fund business transitions may be hampered as the next generation of owners cannot access funds to subsidise the current owners for the transfer of their interest.

This leads to a delay in the next generation of management being involved in the business, as the owners cannot financially afford to retire in the absence of funding and may cause the business to suffer.

Dependent upon the nature of the structure under which the business is undertaken, this funding is often sourced by the business on behalf of the family owners which may then create unintended costs and consequences for the owners. Some of these consequences were mentioned above.

Encouraging family businesses to plan for transition both at the level of the business succession but also at the level of the owners would be important. Such encouragement could be given, for example, by way of enhanced tax relief for;

- transfers of interests in family businesses between family members (as previously recommended);
- creation of separate shareholding and equity rights that enable equity holders to swap their control rights and create preferred equity participation rights; and
- deferred compensation arrangements (family earn outs).

Many family businesses may also benefit from access to a broader range of funding models including those offered by private equity and venture capitalists rather than simple debt based financing. Such funding could be encouraged by offering incentives to invest in family businesses to owners of private capital through providing preferential CGT rates on disposal of equity interests.

Recommendation

It is recommended that family businesses be encouraged to develop and grow through developing;

- ***models that support 'stewardship' of interests by helping retiring owners realise the value of their investment in line with their family's overall needs without incurring significant tax cost; and***
- ***new funding models to support family business through broader access to private capital markets***

7. Family business responses to the challenges of the GFC and post GFC resilience

In KPMG's 2012 Private Companies Survey, over half of our 546 respondents identified themselves as family businesses. Family business respondents reported the three biggest challenges over the last 12 months as being consumer confidence, business confidence and competitor activity and 36 percent reported negative revenue growth over the last 12 months.

However, demonstrating the resilience of these family businesses, 87 percent advised they expected to achieve revenue growth over the next 12 months. Forty five percent of family business respondents expressed intentions for major investment plans and of these, fifty percent advised they would be sourcing additional funding from banks. Key focus areas for the next 12 months will be customer satisfaction, supplier contracts and finding alternative or additional revenue opportunities.

The primary issues for these, often medium-sized, but well run organisations, revolve around three main themes, preserving cash, growth and changing governance. As they tend to take the longer term view; interested in growing the family wealth and having a different set of strategic goals compared to non-family owned private companies, their long term economic contribution is significant, and will be increasingly so. For many family businesses the ability to plan long term can give them a huge competitive edge, allowing them to be more innovative than the corporate sector. In addition, the agility in which a well-run family business can take decisions quickly means that many are in a better position than the corporate sector to ride out economic downturns, and some are actively acquiring other companies that are doing less well.

A strong focus towards cash reserves are also qualities that will continue to give traditional family businesses a genuine competitive edge in the marketplace as the global economy recovers.