Institute of Chartered Accountants Australia

13 November 2012

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

By email: corporations.joint@aph.gov.au

Dear Sir/Madam,

Inquiry into family business in Australia

The Institute of Chartered Accountants Australia (the Institute) is the professional body representing more than 70,000 business leaders and professional accountants in Australia and abroad. Chartered Accountants play a leading role as advisors to Australian business, including small and medium enterprises (SMEs) and family businesses.

The Institute welcomes the opportunity to contribute to the Inquiry into Family Business in Australia being conducted by the Parliamentary Joint Committee on Corporations and Financial Services (the Committee). We note the terms of reference for the inquiry, as follows:

1. The definition of "family business"
2. The availability and reliability of information and statistics about family business in Australia
3. The contribution of family business to the Australian economy, in terms of financial, social, employment, innovation and sustainability outcomes
4. Structural, cultural, organisational, technological, geographical, and governance challenges facing family business
5. The role of family trusts in facilitating family business
6. Access to and the cost of finance and insurance for family business
7. Family business responses to the challenges of the GFC and post GFC resilience

We believe that this is a timely inquiry into the subject of family business in Australia, particularly given the demographic issues facing the family business sector and the broader changes shaping the nature of "family" in our society.

Our submission offers several specific short term policy recommendations for the Committee to consider in relation to the terms of reference, but overall we recommend that the family business subject area be given greater recognition by government in regard to both data collection and policy consideration.

1. <u>The definition of family business</u>

The Institute notes that there is no single agreed definition of "family business".

Whilst most family businesses are SMEs and share many of their characteristics and challenges, nonetheless not all family businesses are SMEs. Further, irrespective of the definition of family business that is used, there is general consensus that family businesses have characteristics that are not necessarily shared with other SMEs.

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Essentially these different characteristics are those that result from overlaying the complexity of the "family" onto business ownership, operation and control. As discussed below, this consideration and involvement of family can result in more risk averse behavior by family business than by similar counterpart businesses.

Some of the academic literature cites as a defining feature of family business an intention to retain family succession in the ownership of the business. Whilst the issue of succession is a key issue for family business, we note research (see below) that shows that a majority of family businesses in Australia would consider selling their business if approached. Accordingly, a desire to maintain a business though successive generations of the family should not be the defining feature of a "family business" (particularly given the need, in our view, to facilitate transfers of equity to non-family members to maintain dynamic family businesses – see below).

Whilst the desire to determine a universal definition of "family business" is understandable from government's point of view, the risk in doing so is that businesses that might have the look and feel of a family business could be excluded by the application of a strict definition.

The Institute of Chartered Accountants Australia encourages further dialogue with stakeholders to agree a workable definition of family business, if a single definition is needed.

2. The availability and reliability of information and statistics about family business in Australia

The Institute notes that the Australian Bureau of Statistics (ABS) does not currently collect information on family business, though it has included questions relating to family firms in past data collections. Accordingly there is no authoritative statistical resource available on family business and its economic contribution in Australia.

To our knowledge the most comprehensive information on family business in Australia is contained in the longitudinal series undertaken by RMIT University dating back to 1995 and funded in recent years with the backing of MGI Australia.

Given the value of this series in illuminating information on family business in Australia, we consider this would be a useful base on which to build should government seek more detailed information, noting the ABS's current budget constraints.

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

Definitional issues and the absence of ABS information make it difficult to illustrate with comprehensive data the contribution of family business to the Australian economy.

To show the potential scale to which family business does contribute however, in comparative terms the Family Business Institute in the USA in 2007 estimated that there were 24 million family businesses in the United States, employing 82 million people or 62% of the workforce and accounting for 89% of the business tax returns.

The absence of formal data collection on family business makes it difficult to accurately estimate the contribution of family business to the Australian economy in terms of GDP contribution, employment numbers, financial turnover etc.

The MGI Australian Family and Private Business Survey in 2006 estimated the wealth of Australian family business to be $4.3 trillion, up from $3.6 trillion in 2003. This suggests both the scale and growth potential of the sector in Australia.

There would appear to be little information on innovation and sustainability practices within family business. The influence and involvement of younger generations ought to suggest both the capacity and willingness to innovate on the part of family business and an awareness of sustainable business practices.

Anecdotally the social aspect of family business is complex. Whilst a family business is able to leverage family strengths for positive business outcomes, the converse is also true – that business can place additional strains on family relationships. This factor is key to understanding the sector.

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

There are a number of specific issues facing family owned businesses in Australia that require policy deliberation.

In relation to governance, some specific issues for family businesses are:

- The operation of the so-called 50 shareholder rule. The 50 shareholder rule under section 113 of the Corporations Act 2001 requires corporations with more than 50 non-employed members to become unlisted public companies. Larger and older family businesses may have more than 50 non-employed members and the requirement for these businesses to restructure as unlisted public companies imposes administrative costs for questionable benefit. The Institute of Chartered Accountants Australia supports calls from other family business stakeholders to increase from 50 to 100 the number of non-employed members required before requiring a corporation to become an unlisted public company. We note that the Committee made this recommendation in 2008 but that recommendation has never been acted upon.

- Effective corporate governance is an issue facing family businesses. The 2010 MGI Australian Family and Private Business Survey reports that over 57% of family businesses do not have a formal Board of Directors, and of those that do, the overwhelming majority do not have non-family directors. The concern is that more time is spent running the day to day business than on strategic planning for the business, often meaning that the business's growth potential remains untapped. The requirements on directors imposed under the Corporations Act 2001 are seen as a disincentive to having more than the statutory minimum number of directors and consequently the lack of formal boards.

It is generally recognised that, with the retirement of the baby boomer generation, succession planning has become, and will continue to be, a key issue for family business.

Many family businesses, especially those in the SME sector, have little depth of management and the retention/attraction of key managers is critical for the successful transition of the business from the current owner/manager.

Providing equity to managers can be an effective measure to attract and/or retain those managers who are key to the smooth transition of the business. It is often difficult for SMEs to attract quality managers in competition with public companies which are able to offer attractive employee share plans as part of a remuneration package.

Providing shares to an employee in an SME is usually seen more as a means of aligning the long term goals of the business with those of the employee rather than being a component of a remuneration package. This is because shares in a private company are not liquid. Even if the shareholding was not subject to specific forfeiture provisions it is unlikely to be able to be converted to cash unless the other shareholders want to acquire it, or there is an exit event for the entire business or a trigger event occurs under a shareholders' agreement, such as cessation of employment with business.

Because of this lack of liquidity, paying full value for equity in an SME is not attractive to employees who have no certainty as to when, or if, they will be able to realise that value or indeed any value. It is therefore often both desired and deemed necessary for SME owners to gift or discount equity to key managers. However the taxation impediments to this often mean that equity is not provided or is provided through complex, cumbersome arrangements in order not to fall foul of the current taxation provisions.

Division 83A of ITAA97 operates to tax employees upfront on the value of any discount they are allowed on the provision of shares. This tax may only be deferred if the arrangement is structured so that:-

- there is a real risk that the shares will be forfeited, or
- the shares are acquired under a salary sacrifice arrangement and the employee receives no more than $5,000 worth of shares per annum.

The tax will be deferred until the earliest of:-

- the time when there is no real risk that the employee will forfeit the shares and there are no genuine restrictions preventing disposal;
- when the employee ceases the employment; or
- seven years after the employee acquired the shares.

Importantly deferral is only available where at least 75% of all of the permanent employees of the employer who have completed at least 3 years service are entitled to acquire shares.

This requirement that the shares be broadly available effectively means that deferral is not available where shares are offered only to key employees, which will generally be the position where shares are provided to one or a few managers for succession planning purposes.

It is noted that the requirement for shares to be broadly available does not apply to rights to acquire a beneficial interest in a share. However the issue of options, and other arrangements in respect of rights, are generally arrangements that are not well understood by SMEs and are too difficult for most of them to deal with.

The provisions of Division 83A actively deter SME owners from providing discounted shares as part of their succession planning, when it is one of the most effective means of ensuring the continuity and commitment of key managers.

A solution would be to insert into Subdivision 83A-C an exemption for SMEs from the broad availability requirements contained in Subsection 83A-105(2). This would mean that SME owners would not have to offer shares to at least 75% of employees in order to defer the taxing point on the issue of discounted shares to key employees.

The definition of SME for this purpose should encompass businesses which characteristically have insufficient depth of management to ensure long term viability of the business. It is suggested that the definition be limited to companies with an aggregated group turnover of no more than $35 million per annum. Larger companies could generally be expected to inherently have a sufficient depth of management to survive a succession event.

Division 83A also provides that deferral is only available where the employee has a shareholding of 5% or less. It is submitted that this percentage is too low to provide a worthwhile succession planning mechanism for SMEs, especially where equity succession takes place progressively. A more meaningful requirement would be for the shareholding to be a minority holding. Once a majority holding is obtained, the succession has essentially taken place and the employee is then in a better position to be able to realise the value of the shares.

The maximum deferral period of 7 years contained in Division 83A should be extended for SMEs, as generally the opportunity to realise the shares in an SME is extremely limited. Therefore it would be reasonable for the deferral to extend to the earlier of

- a realisation event,
- termination of employment (which usually involves disposal of the shares); and
- obtaining a majority shareholding.

The capital gains tax provisions should also be amended to provide an exemption from the operation of the direct value shifting rules in Division 725 of ITAA97 for the holders of ‘down interests’ where the employee will be presently, or in the future, subject to tax under Division 83A.

As it stands, where shares are issued at a discount to employees, the employees will be subject to tax under Division 83A and the current shareholder(s) may be subject to tax in respect of CGT event K8, determined under Division 725, in relation to the same amount.

The exclusion from FBT for discounted shares issued under an employee share scheme to which Subdivisions 83A-B or 83A-C applies would consequently be extended to include shares provided under the proposed Division 83A succession planning deferral in Subdivisions 83A-C.

5. The role of family trusts in facilitating family business

Whilst the majority of family businesses are structured as private companies, discretionary trusts are commonly used for legitimate purposes by family businesses, including to protect assets and for succession planning purposes.

The transfer of ownership of a family business to other family members can incur both capital gains tax (CGT) and stamp duty costs. Unlike the sale of a business to a third party, transfer of ownership of a business to other family members will not necessarily generate cash proceeds and hence tax impositions can draw down needed business capital. Given the majority of family business owners are aged over 50, in the next decade it is to be expected that significant numbers of family businesses will be sold or transferred (or wound up). To maintain the viability of the family business sector consideration needs to be given to ways to enable the legitimate inter-generational transfer of businesses without tax imposts constituting a significant drain on the sector's resources and growth potential.

One of the means open to family business to transfer business assets without triggering a CGT event was the practice of trust cloning. Normally a CGT event happens when an asset is transferred to a trust, but prior to the abolition of the trust cloning exception from 1 November 2008 no event was taken to have occurred where an asset was transferred between trusts where the beneficiaries and terms of both trusts were the same. Circumstances where trust cloning could be used included when a trustee wished to rearrange the holding of business assets held in one trust to more properly align different business assets with different business activities, or when a trustee of a trust holding both business and non-business assets wanted to protect the non business assets from future risk by transferring them to a separate trust. Trust cloning facilitated succession planning, allowing effective control of assets to be passed between trusts, often within a family group, without triggering a CGT liability.

However, tax cloning was also perceived to be a tax avoidance strategy and was abolished by the Federal Government with effect from 1 November 2008.

The Institute acknowledges that the trust cloning exception was too wide and needed to be narrowed to protect the CGT base. However, we believe that the exception should not have been abolished entirely and should instead have been replaced with narrower provisions, with appropriate integrity measures, to preserve the use of trust cloning for legitimate business purposes (including asset and business protection, business restructuring and succession planning).

The Institute recommends that the Committee give consideration to the merits of reinstating a narrower version of the previous tax cloning exception to CGT events E1 and E2.

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

Research and anecdotal information indicates that family businesses tend to be more risk averse and desire to retain greater control over their business affairs than non-family businesses. This is reflected in their appetites for credit, with greater use of bank finance and lower use of external sources of equity finance.

Like many SMEs, family businesses' ability to access bank finance is often dependent on their ability to offer real property as security.

Usually it is the value of these assets that determines access to capital, not the success or viability of the business.

Business finance has been difficult to access for many businesses, with banks in the current economic environment tightening eligibility requirements.

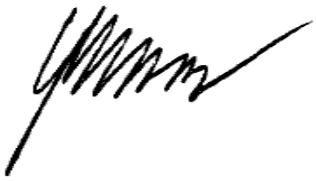
Similarly, whilst interest rates have been reduced five times in the past 12 months by the Reserve Bank, these rate cuts have not been passed on in full to either mortgage holders or business customers.

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

As above, the post GFC environment has posed challenges for family business as it has for many other forms of business in the economy. Sluggish demand, a high exchange rate and restricted access to business finance have all impacted on family business.

Accordingly the 2010 MGI Australian Family and Private Business Survey reports businesses cutting costs, deferring the hiring of staff, postponing expansion plans and reviewing product and service lines.

Yours sincerely



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