Deloitte Private

Family Business in Australia

Submission to the Parliamentary Joint Committee on Corporations and Financial Services

31 October 2012

Deloitte Private

Deloitte Private Pty Ltd
ACN 120 167 455

550 Bourke Street
Melbourne VIC 3000
GPO Box 78
Melbourne VIC 3001 Australia

DX 111
Tel: +61 (0) 3 9671 7000
Fax: +61 (0) 3 9671 7001
www.deloitte.com.au

31 October 2012

Mr Richard 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

Dear Richard,

SENATE COMMITTEE INQUIRY INTO FAMILY BUSINESS IN AUSTRALIA

Thank you for the opportunity to make a submission to the Senate Committee's important inquiry into Family Business in Australia.

Since 1993, Deloitte Private, a specialist group within Deloitte, has focused on serving the needs of Australian private businesses and the family groups who own them. Our 91 partners and 900 team members nationally represent a unique offering. We are the Big Four's only accounting, tax, audit and advisory services provider dedicated to serving family groups and privately owned Australian businesses.

We believe we have the necessary expertise, combined with our status as one of the leading advisors to private businesses, to respond to the Senate Committee on key aspects of family business as outlined in the key terms of reference.

Given our experience, we believe we are best placed to provide a more detailed response on the following aspects of the terms of reference (as well as covering the other aspects to a lesser extent):

- Recommended mechanisms for succession planning for family business
- The taxation of trusts and the role of trusts in facilitating family business
- How we define 'family business'.

We enclose our response to the above points and the other terms of reference as outlined by the inquiry.

We would appreciate the opportunity to discuss our submission in more detail at the public hearing in November/December 2012.

If you have any questions or require clarification on any aspect of this submission please feel free to contact

Yours sincerely

DAVID HILL
NATIONAL MANAGING PARTNER
DIRECTOR, DELOITTE PRIVATE PTY LIMITED

Contents

Executive summary

Family Business is Private Business

We define a family business as a business owned and managed by family members. This definition encompasses many privately owned, controlled and operated enterprises in Australia.

Deloitte Private recommends the Government request the ABS to consider developing criteria to categorise family businesses, small businesses and private businesses to facilitate more specific and detailed analysis.

Adequacy of existing statistical information

Based on our research, information on Australian family businesses is scarce. The ABS and other sources do not appear to have concise or comprehensive data on this sector.

Deloitte Private recommends that the ABS designs its data capture to enable separate reporting on the family business sector.

Economic contribution of family business

The world is experiencing a decade of unprecedented and rapid change as a result:

- disruptive technologies
- climate change and environmental concerns
- ageing populations
- globalisation
- economic uncertainty; and
- a global shift from 'West' to 'East'

Despite this volatility, Australian family businesses have demonstrated agility, flexibility and resilience and continued to be innovative and productive. As a result, family businesses are major contributors to the Australian economy with an estimated wealth of $4.3 trillion[1] and turnover up to approximately $1 billion per annum.

On a global scale, the Australian economy is currently lagging in innovation and productivity. Family businesses and their philanthropic arms present a real opportunity to change this. Developing progressive policies and initiatives to promote family businesses in their pursuit of commercialisation opportunities will be of high importance. This submission highlights the continuing need for the Australian Government to actively encourage investment in innovation, productivity and sustainability.

Deloitte Private recommends:

- **Reforms which will improve transparency and further reduce red-tape for NFPs**
- **NFPs and private investors partnering with Government via the introduction of social benefit bonds to engage in social projects in a way that is sustainable and delivers results**
- **Government policies which incentivise innovation and commercialisation in Australia**
- **The Government encourage sustainable family business practices.**

[1] Family Business Australia. 2012, 'Is Government Overlooking The Interests Of family Businesses?': http://www.fambiz.org.au/documents/MediaRelease-FamilyBusinessMinister.pdf

Challenges facing family business

The key challenges Australian family businesses face today are:

- Succession planning. Our ageing population necessitates sound succession planning. Failing to effectively manage succession means business transitions will stall productivity and erode wealth. The key to succession is managing the interactions between family and business issues. Educating and engaging the next generation is also key.
- Attracting and retaining talent
- Cost of compliance with both state and federal laws and regulations
- Continuing innovation
- Cost and access to funding due to commercial banks significantly reducing their level of lending, particularly to family businesses, since the GFC. Fluctuations in asset valuations and the unprecedented volatility during and post the GFC have also reduced investor confidence and restricted the ability for family businesses to raise equity funding.

Deloitte Private recommends:

- **Enhanced Government support for family succession processes**
- **Relevant training for next generation business owners**
- **Reduction of compliance costs**
- **Government undertakes a review of the regulatory framework to stimulate investment in and the financing of family businesses**
- **As part of this review, the Government may consider tax incentives or changes to regulations regarding debt and equity funding for small businesses.**

The role of family trusts

Recent changes to trust legislation have increased complexities and risks associated with trust tax compliance. We recommend consideration be given to structural reform of the taxation of trusts and family groups to create certainty and simplicity. Recent changes have caused frustration for family businesses and potentially reduced their competitiveness relative to businesses with alternate structures such as public companies.

We recommend that the current examination of the approach to the taxation of trusts be extended to include the family business group, with consideration being given to a tax consolidation regime for family groups and/or introduction of a family group tax unit. Variations of such rules are used in many countries to support and encourage family business.

Deloitte Private recommends consideration be given to structural reform of the taxation of trusts and the Government's scope be expanded to the taxation of family groups to create certainty and simplicity.

1. Definition of 'family business'

"Family Business is Private Business" Deloitte Private

We define a family business as a business owned and managed by family members. This definition applies to many privately owned, controlled and operated enterprises in Australia. Private businesses are operated through a variety of structures, e.g. sole traders, partnerships, trusts and private companies.

Private business is unique in that the owners are often the managers and operators of the business. This differs from public corporations, which often have many private and institutional shareholders, where ownership is offered to the general public and decision-making and management is outsourced to employees overseen by a board of directors appointed by the shareholders.

The key difference which makes private and therefore family businesses unique is that every decision made by a private business directly affects the welfare and wealth of the family or families who own the business and the ability of the business to support the family members now and in future generations.

The dynamics of a family business can be complicated. Organisations that are family owned face personal and family issues as well as day-to-day business concerns, which often impact on interpersonal relationships among family members.

Deloitte Private has a strong heritage of working with many of Australia's leading family businesses. We understand the dynamics of a family business. This has enabled us to guide family businesses through a myriad of events such as succession planning, generational change, tax restructures, wealth management and exit strategies.

Deloitte Private recommends the Government request the ABS to consider developing criteria to categorise family businesses, small businesses and private businesses to facilitate more specific and detailed analysis.

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

"Information is scarce. As far as formal information goes, the ABS has a number of sources that can inform on the size of the sector but nothing concise or comprehensive" David Rumbens, *Partner*, Deloitte Access Economics

Data collected by the Australian Bureau of Statistics (ABS) in relation to family business in Australia is available. However, the breadth, depth and frequency of relevant studies is limited. The ABS data tells us something about the income derived from owner-businesses in Australia and employment at the owner-business level. However, little is available regarding the extent to which family businesses contribute to Australia's GDP, employment and other economic indicators.

Studies are occasionally undertaken by various interest groups such as Family Business Australia, Universities and other private organisations. However, data is limited in terms of sample size and respondents.

We reviewed studies available from the ABS and Australian Taxation Office (ATO) statistics and found data available on household income, household expenditure, employment and business counts, which was somewhat aligned to family business. However, the studies did not provide enough recent data to properly drive policy decisions that support family business. For example, ABS study *6361.0 Employment Arrangements, Retirement and Superannuation, Australia*, tells us that of 10.3 million people employed in 2007, 19% were owner managers. The study was last commissioned in 2007 with the previous release in 2000.

1321.0 Small Business in Australia, 2001 tells us that 3.6 million people were employed in small business during 2000-01. However, family business in Australia is far more than small business. These studies don't tell us about the current state of affairs or how many people are actually employed by family business. They don't inform us on the need to support family business with their employment issues.

Numerous ABS studies refer to small business or segregate data by business size. However, this type of reporting does not identify the contribution of family businesses that are anything but small; those private and family enterprises that are often turning over in the hundreds of millions of dollars. We therefore question whether this important segment is measured in sufficient detail.

Deloitte Private recommends that the ABS designs its data capture to enable separate reporting on the family business sector.

3. The contribution of family business to the Australian economy

Social outcomes

The contribution family business makes to our society takes many forms – in sustainable and ethical business practices, funding of community projects and activities of private foundations in addition to the not-for-profit sector and good old fashioned philanthropy.

Debate in recent times has focused on the level of giving in Australia compared with other countries such as the US and UK, particularly among wealthy Australians. However, in some ways the culture of giving in Australia is still in its infancy – the US and UK have a long established history of philanthropy, dating back hundreds of years when the first philanthropic trusts were established.

The establishment of the Prescribed Private Fund (now the Private Ancillary Fund) model a decade ago has seen vast growth in the level of giving in Australia. Today there are close to 1,000 private ancillary funds established in Australia, holding over $2 billion in corpus[2].

Many of Australia's prominent family businesses today have private ancillary funds. Establishing a private foundation means the family can control how their philanthropic wealth is directed; to actively support the social causes they are most passionate about; and to create an enduring legacy for the family.

For example, The Bennelong Foundation, established by Jeff Chapman and Carena Shankar of the Bennelong Group, has made grants of over $6.5 million in the 10 years since it was established in 2002. In addition to the financial support given to various areas of the community, private foundations also foster a culture of social responsibility and giving by involving the wider business in community projects. Employees of the Bennelong Group are involved in the work of the Foundation in a number of ways, from deciding where grants should be made to volunteering and in-kind support.

Importantly, private foundations also transfer a culture of philanthropy to the next generation of family business owners and educate them on the value of philanthropy. Foundations are evolving to accommodate the social interests of the next generation. A number of our clients who have established foundations encourage next generation family members to sit on the board and have input into issues relevant to young Australians.

While not included in our definition of family business, not-for-profit (NFP) organisations are nevertheless closely tied to family business in terms of the support for the NFP sector through private ancillary funds and other philanthropic vehicles. Whilst we recognise that there are a number of reforms taking place in the NFP sector, we consider further reforms are needed to enable and encourage the support of family business. Reforms should improve transparency and further reduce red-tape. Consideration should also be given to alternative models.

Both Governments and family business will demand more from the NFP sector for their "return on investment". With resources limited, projects need to deliver better outcomes and innovation and collaboration will be critical to their success. One model which addresses these needs and is undoubtedly a part of the NFP landscape in the future is the concept of Social Benefit Bonds; a form of social finance which is revolutionising social policy internationally.

Social benefit bonds are a contract whereby the Government agrees to pay for improved social outcomes that result in public sector savings. They promise to deliver better results with reduced financial risk to the taxpayer.

[2] *Philanthropy Australia*

The mechanics of social benefit bonds are as follows: an intermediary (e.g. a NFP organisation) enters into a bond with the Government. The NFP raises funds from private investors (who may be both socially-minded and profit-motivated). The working capital is used to implement innovative solutions to social problems. The government pays out on the bonds based on an agreed rate of return for improved social outcomes.

Social benefit bonds address the increasing pressure on public finances and shifts the risk from the Government and taxpayers to the investors. They are outcome-driven and promote innovation and collaboration. They better align NFPs with family business by promoting efficiency and more strategic direction. In our view, social benefit bonds present an opportunity for Governments, NFPs and family businesses to invest and engage in social projects in a way that is sustainable and delivers real results.

Employment outcomes

The ABS published the following statistics in the 2007 study *6361.0 - Employment Arrangements, Retirement and Superannuation, Australia:*

Of 10.3 million employed people:

- 60% were employees (excluding owner-managers of incorporated enterprises) with paid leave entitlements
- 20% were employees (excluding owner-managers of incorporated enterprises) with no paid leave entitlements
- 7% were owner managers of incorporated enterprises
- 12% were owner managers of unincorporated enterprises.

We note that this study addressed the makeup of the workforce; employment arrangements, work and caring, retirement and retirement intentions and superannuation rather than addressing the contribution to employment by family businesses.

It has been estimated that family businesses comprise 70% of all Australian businesses. However, the lack of empirical evidence to substantiate this means we can only estimate employment levels. Based on the presumption family business employs a significant proportion of the workforce, the prosperity of family businesses is critical to the Australian workforce. For example, Visy group a large Australian family business provides employment for approximately 5,000 people across every state in Australia[3].

Innovation outcomes

Australian Innovation Performance - Current State of Play

In 2009-10 the Australian Government's budget for innovation was $8.58 billion[4]. This included science, education, infrastructure and the National Broadband Network. The investment clearly acknowledges the importance of innovation to our economy. Despite this large investment, Australia's innovation performance has lagged behind other first world nations and we have failed to compete with our Asia Pacific counter parts. In the last year alone, Australia has slipped from fifth to eighteenth in the World Economic Forum's Global Competitive Index[5].

[3] 2011 Visy E–report "Noteworthy Achievements"

[4] Department of Industry, Innovation, Science, Research and Tertiary Education – Powering Ideas Report

[5] Department of Industry, Innovation, Science, Research and Tertiary Education – Powering Ideas Report

Innovation is key to Australia's future. As a nation, we are capable of finding solutions to global challenges such as sustainability, climate change, disease, an ageing population and the digital future. With products such as Cochlear's bionic ear, the anti-cancer vaccine (Gardasil), wireless networking technology, Google maps and CSIRO's polymer bank notes, we have proven our innovative capability.

We have an opportunity to be world leaders in innovation. Our investment and focus should boost innovation, commercialisation and skills development within family businesses. Family businesses have a signification impact on the Australian economy and are major contributors to our innovation record, productivity and capability. With 70% of Australian businesses commonly classified as family businesses, the success or otherwise of family businesses is vital to the future of the Australian economy and society.

Within the Australian workforce, estimates show the cost of disengagement is more than $39 billion in lost productivity6. For Australia as a whole, just one percentage point gain in efficiency adds $14 billion to the productive power of the nation7. To this end, investment by government that delivers progressive policy to enable innovation, commercialisation and above all, develops the nation's productivity, will lead to a healthy economy which enhances the lifestyle we treasure.

Innovation is critical to lifting per capita incomes and community living standards. Too many of our innovations are being commercialised overseas[8], which impacts our ability to create new jobs, new industries and improve our standard of living.

Leading the way – innovative business models and strategies

Innovation in new products and services, business models, technologies and supply chain management are front of mind for family businesses. Family businesses also focus on their ability to implement innovative customer-centric strategies, rather than competing and seeking to gain market share through strategies purely focused on purchasing power and price.

Market trends worldwide purely indicate a purchasing power and a decline in the retail sector. Since the GFC, this industry has experienced difficult economic times, however, many family businesses in Australia have bucked the trend. Through innovations to capture the change in social power, consumer behaviour and the impact of digital and disruptive technologies, Australian family businesses have been able to create new customer segments for their businesses.

This is demonstrated by four Australian family businesses, which exemplify innovation and productivity.

Catchoftheday.com.au, Bing Lee Electronics, Jimmy Possum and Christie Park Safe had the insight to use their understanding of consumer behaviour and innovative strategies to create customer loyalty and gain market share, while many large retailers battle with declining revenues, profits and productivity. Their success can be attributed to their ability to develop and deploy innovative business models, supply chain strategies, products/services and digital technologies. Their success can also be linked to their commitment to foster an innovative culture and maintain their entrepreneurial roots.

Research has shown that consumers are more likely to buy products from family businesses, believing family companies supply products they can trust[9]. Family businesses are seen as having a long-term commitment to the communities in which they operate.

[6] Building the lucky country, where is your next worker? Deloitte

[7] Building the lucky country, where is your next worker? Deloitte

[8] Powering ideas; An innovation agenda for the 21st century (www.innovation.gov.au/innovation/.../poweringideasexecutivesummary)

[9] An Intuito Peartree Report, August 2010, Australian Consumer Attitudes to Family Businesses

Case Studies

Catchoftheday.com.au[10] was started in 2006 by two brothers, who had the insight to predict a change in consumer behaviour and harness the disruptive technologies of the online shopping phenomenon. On average, Catchoftheday.com.au sells one item every three seconds, 24/7. Web traffic to their site has pushed them to become the number one Australian shopping site, with 14.73% of all retail traffic. The only retail website with higher Australian traffic is Amazon.com. Catchoftheday.com.au has spent nothing on traditional marketing, instead using the power of social media and crowd sourcing to market their business.

Their innovative business model and supply chain enables Catchoftheday.com.au to deploy high volumes of products quicker than any major retailer. During a recent interview, the brothers were asked about their success. Their response: "We foster a culture of innovation by creating a very innovative working environment."

Bing Lee Electronics[11] has second and third generation family members working in their stores and is supported by an online store. Bing Lee Electronics has created an innovative supply chain, forging strong relationships with suppliers and business partners and boosting their ability to stock the latest technologies prior to other retailers.

The business has a simple philosophy - put the customers first and treat everybody with respect. As they state on their website, "Our people are our family, our suppliers are our family, and we like to think our customers are part of the family as well."

Bing Lee Electronics receives more than 85% of its business from repeat or referred customers.

Jimmy Possum[12] is Australia's largest producer of furniture manufactured from recycled timbers. This family business had the insight to recognise the social change and increasingly ethical consciousness of customers purchasing products constructed using sustainable materials and practices.

Jimmy Possum has a commitment to the community and the environment and has deployed an innovative marketing strategy. This commitment has enabled Jimmy Possum to diversify its product range and open further stores.

Christie Park Safe[13] is a third generation family business which began as a regional electrical engineering and contracting company. They provide safe, innovative and high quality products for the leisure and tourism industry in Australia and globally. Christie Park Safe's competitive advantage lies in its innovative manufacturing practices, allowing flexibility in design to produce innovative products.

The commonality between these family businesses is their entrepreneurial beginnings and their ability to sustain an innovative culture despite challenging economic times.

Opportunities - Government can play a key role

Awareness

The Australian government has already implemented many innovation initiatives and grant programs. More can be done to create awareness and engagement with these initiatives to ensure their relevance and support for family businesses.

---

[10] http://www.youtube.com/watch?feature=player_embedded&v=SRjYn9AHLOU
- Simply brilliant, Peter Switzer - The Australian
- Welcome to the Rich list club, James Thomson - Smart Company
- 10 ways to foster innovation in your company, Kosmas Smyrnios - Smart Company

[11] www.binglee.com.au

[12] https://www.jimmypossum.com.au

[13] www.christieparksafe.com.au

Commercialisation

Enhancing policies and initiatives which support a culture of prototyping and trial and error testing will help stimulate commercialisation within the Australian market. There is a need for creative funding solutions and incentives, including greater access to Venture Capital and social co-investment structures.

Collaboration

Through frameworks and programs, Government can provide support to family businesses and enable collaboration and co-design. Providing opportunities and access to the 'best of breed' from around the world through family business forums will increase community involvement and help shape the nation's future.

Skill and Capability development

In focussing on developing the capabilities and skills of our nation's workforce, it is important to provide a system which can capture existing knowledge and share/socialise lessons learnt.

Research and Development

There is an opportunity to increase R&D investment and reform tax incentives to ensure relevance to family businesses.

Sustainability and climate change

There are a number of climate change initiatives already in place which could be reformed to ensure relevance to family business. These include Enterprise Connect, Clean Business Australia, Clean Energy, Green Car Innovation Fund, Global Carbon Capture, Storage Institute, Climate Change Action Fund and Climate Ready.

Sustainability outcomes

Businesses are evolving in a world increasingly conscious of the quality and availability of natural resources, the health and wellbeing of their employees and the importance of vibrant community networks. Proactive organisations are increasingly taking factors such as these into account and integrating sustainable practices into their business strategy to enhance revenue, margins and brand value and to underpin the long term viability of their business.

At present, the uptake of such activities by Australian business is generally concentrated among high profile, publicly-listed organisations despite the potential for other market segments to equally respond to these opportunities.

The family business sector is a significant contributor to the Australian economy with the potential to play a key role in creating a more sustainable Australia. This raises two questions:

1. What, if anything, are family businesses doing in response to the push for the development of a more sustainable economy?
2. What role can Government play in fostering a more sustainability-focused family business sector?

Below is an overview of the way family businesses are interpreting and responding to the concept of sustainability. The need for increased Government investment in this area to foster a greater uptake of sustainability initiatives by family businesses has also been considered.

Family Businesses and Sustainability: Current state of play

A sustainability focus may take many angles depending on the nature of the business but generally encompasses the environment, community, workplace and marketplace. Aspects of sustainable business practices currently adopted by business include:

- Increasing the energy efficiency of operations
- Examining the environmental and ethical performance of the supply chain
- Creating robust health and safety protocols to protect the wellbeing of employees and contractors
- Meeting environmental performance targets and regulatory obligations
- Investing in the communities in which the business operates.

The current uptake of sustainability initiatives among family businesses varies considerably. At one end of the spectrum there are a relatively small number of large private businesses capitalising on the opportunities presented by sustainability.

For example, Visy, one of the world's leading paper, packaging and recycling companies, is taking responsibility for their products after they have fulfilled their initial purpose, by running collection and recycling services across Australia and New Zealand.

Grocon, the largest privately owned development, construction and investment management company in Australia, is committed to innovating and using sustainable technologies such as Pixelcrete (green concrete) in developments to facilitate a low carbon future.

At the other end of the spectrum, many family businesses lack a similar level of commitment to the concept of sustainability. This is usually a result of management's inability to connect the 'value' of sustainability initiatives with the underlying profit and growth objectives of the company. As a consequence, some family businesses are of the view that it is the responsibility of Government and the high profile publicly-listed organisations to ensure the future sustainability of Australia's economy.

However, it is important to recognise the many family businesses who interpret the concept of sustainability as interlinked with the notions of philanthropy and social justice. This in turn affects the approach family businesses take to 'giving back' to the community, whereby personal and family participation in their philanthropic activities stems from successful business activities, rather than the business itself being a vehicle for positive change in society.

Therefore, for many private business owners, sustainability is currently interpreted through the lens of their philanthropic activities rather than through the corporate entity. Companies such as Visy and Grocon appear to be exceptions rather than the norm at present as they undertake philanthropic activities and practice sustainability through their businesses.

Government: a key role to play

While the uptake of sustainability initiatives is relatively low among family businesses, the introduction of Government policy and regulation, such as the Carbon Tax legislation, is directly or indirectly affecting a number of family businesses through increased costs across their supply chains. In response, astute managers are keeping a close eye on costs and are looking to improve the resource efficiency of their business operations.

In this area specifically, the Government is supporting business via the funding available under the Australian Government's $32 billion Clean Energy Future package to support development of energy efficiency and low emission initiatives by business.

In light of the above, there is a key role for Government to play in fostering a greater uptake of sustainability initiatives across the family business sector. This could include:

- Promoting awareness of the opportunities presented by sustainable business practices across the family business sector
- Establishing an interactive family business forum for the exchange of sustainability ideas and better practice, including the production of better practice manuals and standards
- The Government looking internally to ensure members of their own supply chains are adhering to sustainable business practices.

The family business sector has the potential to play a significant role in transitioning Australia to a more sustainable future. However, for business owners to invest in these areas the link between the 'value' and contribution of sustainability to business profitability, growth and cashflow needs to be more clearly articulated – Government and forward thinking private business can lead the charge.

Deloitte Private recommends:

- **Reforms which will improve transparency and further reduce red-tape for NFPs**
- **NFPs and private investors partnering with Government via the introduction of social benefit bonds to engage in social projects in a way that is sustainable and delivers results**
- **Government policies which incentivise innovation and commercialisation in Australia**
- **The Government encourage sustainable family business practices.**

4. Challenges facing family business

Structural and geographical

Many Australian family businesses have benefited from expansion interstate and overseas. For others, the perceived risks and regulatory challenges associated with entering new markets has meant such opportunities are not pursued.

A range of regulatory requirements across Australia as well as the ever present staffing and operational challenges, are just some of the issues that discourage Australian family businesses from pursuing growth and expansion opportunities. The increasing connectivity and globalisation of the Australian economy is providing a new wave of opportunities for Australian businesses. However, like the experiences faced by business seeking to expand interstate, there are a range of challenges which need to be understood and managed before Australian family businesses are able to fully grasp these opportunities. Fortunately, the lessons learnt and observations made can serve as a template to support Australian family businesses seeking to access international markets.

Regulatory challenges

Each Australian state has its own regulatory environment, which can be challenging and complex for family business to navigate. Compounded by different state based taxes, the time and resources family businesses require to manage these requirements presents a significant burden and diversion from core business operations. For example, a large private hospitality business operating in two states will pay two levels of payroll tax, be subject to different statutory insurance schemes and require different state based operational permits and licences.

All forms of government recognise this challenge yet, in many cases, the response has only added complexity. For example, many areas of Government have increasingly moved to online platforms to engage with business. However, this has not happened in an integrated or consistent manner. In Victoria, for example, a small business operating in the health sector could potentially interact and transact with a number of different government agencies across multiple systems and account authentications and still be unsure of whether they are meeting their compliance requirements.

Operational and staffing challenges

Family businesses must maximise efficiency to be financially sustainable. For many, efficiency is often unaddressed. Many businesses lack the time, knowledge and resources to invest in the development of the requisite systems, procedures and processes to support efficient and effective operations and thus the core operational knowledge remains resident in the ‘heads’ of key staff members.

This key person(s) dependency can be a significant constraint on intra-state growth and expansion as the capacity to transfer knowledge of key processes and operational requirements is constrained.

Interstate and/or international expansion exacerbates this challenge. The likelihood of successful replication of business operations in another jurisdiction is limited without supporting processes and knowledge. Many family businesses are constrained in their capacity to access the advice they need to develop a more sophisticated business operation because of the cost of that advice or the lack of access to such advice.

While governments have sought to provide assistance to family businesses through a range of education and development programs, these are usually state-based and focused on local business and economic outcomes rather than assisting these businesses expand interstate or overseas. Further, the information and advice offered is, of necessity, generic and broad based rather than specific to an individual business.

Potential government response

The increasing digitisation of the economy provides Australian governments with a strong foundation to improve policy delivery mechanisms and thereby help Australian family businesses overcome the challenges associated with operating in multiple jurisdictions.

Business is now demanding streamlined interaction with, and support from government. The application of business-centric principles are able to support this. As with citizen-centric models of government interaction (such as e-health), the digitisation of the economy provides government with the opportunity to place business at the ‘centre’ of its service delivery through the development of new and innovative approaches to service delivery.

Technology platforms which link delivery of government services through a single integrated channel will enable business to readily access the information and advice they require, when they require it.

Appropriately designed technology solutions are capable of enabling government to remove many of the challenges faced by family business operating across multiple geographies.

The effective use of technology will enable government to assist family businesses grow and expand into new markets and geographies. Well-designed technology solutions could provide Australian family businesses with a streamlined, single point of access to a range of online information, replacing the current inconsistent, duplicated and potentially confusing modes of government support. Such technology-based solutions would increase business satisfaction with government service delivery and help to facilitate increased participation of Australian family businesses in the global economy by enabling easy access to the relevant information in a cost effective and timely manner.

Cultural and organisational

It is generally accepted that family owned and operated businesses outperform their corporate counterparts over the long run. Reasons for this are diverse and include:

- Sources of growth funding that avoid giving up equity are preferred. Family businesses often resist diluting ownership of the business for short term gain
- Family businesses are run ‘leaner and meaner’ (historically lower salaries, lower dividends and a lower cost base). Given the skills shortages in a number of industries some family businesses are consequently facing recruitment and retention challenges
- Owners will accept more modest growth and longer term returns to ensure the sustainability of their business rather than relentlessly strive for short term results
- Culturally, family business owners are in it for the long term. They want to ensure their wealth is sustained over many generations
- Families put their ‘heart and soul’ into their business. The family business becomes an extension of the family unit and themselves as individuals. The business is a conduit for transmitting family values across generations. This unique competitive advantage is very difficult to replicate
- Often the way family businesses are run is an extension of how the family runs. Everyone implicitly understands and aligns with the strength of the family culture. If you fit with the culture you add value and stay. If you don’t, it is not long before you leave or are removed
- Family businesses often have strong business and/or personal networks and supply chains built up over many years of working in their particular industry. These relationships and mutual support networks help family businesses withstand market and financial turbulence

Deloitte Private has witnessed over many years the diverse challenges family businesses face from internal and external sources.

Children of family business owners are sometimes reluctant to move into the family business because they don’t want to experience the pressures they have witnessed first-hand from their parents.

Family businesses experience increasing generational diversity which impacts generational transfer of both the business and the wealth created. The business founder often regards the business as a key vehicle for passing on family values and maintaining the family ‘brand’ or identity.

If succeeding generations don’t measure up to the values demanded by the founder, the family business owner can ‘rule from the grave’, which can have disastrous effects on the family dynamics and the sustainability of the business and wealth created. Contrary to popular opinion, succession is often most challenging between the 1st and 2nd generations.

Managing expectations of family members is a big challenge for family owned and managed businesses. Sadly, family businesses rarely have formal documentation outlining family policies, succession rules or dispute resolution mechanisms. This can lead to emotional distress, lower productivity and unnecessary tax and legal burdens.

Expectations of merit-based remuneration and promotion policies are also often ill-considered in family businesses. This can cause angst not only for the children (who usually occupy senior positions) but also for non-family members who generally have no transparency over the remuneration family members receive. This can have very damaging effects from an employee engagement and productivity perspective.

Human resource practices are also generally not documented or poorly documented. For example, many of our family business clients do not have position descriptions, leading to a lack of clarity regarding roles and responsibilities.

Technological

Australia’s family owned businesses often punch above their weight from a service and supply chain perspective due to their agility, often enabled by the smart use of technology. Most family business owners view technology as a way to overcome barriers to growth and as a means to help them achieve their strategic priorities.

Advanced analytic technologies for example can help family businesses identify high-value customers and opportunities to obtain more revenue from them. They also help family businesses set prices for goods and services in an economy where consumers are increasingly price sensitive.

Applications such as customer relationship management (CRM) and social media can improve marketing and sales efforts. Family businesses across all industries are increasingly looking to deliver new products and services that are technology-based.

Despite this, many small to medium family businesses still face challenges accessing technology solutions and providers. For many family businesses, technology investments are viewed as too expensive, leading many family businesses to settle for systems that offer fewer features or vendors that provide weaker support.

In the absence of a strategic technology plan, many have made tactical and low cost investments in disparate technology systems that require significant investment to rectify or replace. This is usually compounded by limited in-house IT skills and limited access to technology professionals.

The rapid adoption of Internet-based social networking has been transforming politics and social norms on a global scale for the past decade. Many small family businesses face the challenge of accessing the right advice about how best to adopt and embrace social media.

At Deloitte Private, we believe the digital revolution presents a great opportunity for family businesses given their agility and relative ability to easily and readily embrace new technologies and ways of working. For example, the advent of cloud computing and the use of social media has changed the competitive landscape and provided opportunities for family businesses to react faster and gain a competitive advantage over larger, less agile enterprises.

By improving productivity, technology also helps family businesses offset the impact of slower economic growth and rising materials and personnel costs on operating margins. Many are also using technology to capture higher-value customers, boost revenue per customer and improve customer loyalty.

Deloitte recently published the second paper in our *Building the Lucky Country* series, entitled 'Digital Disruption - Short Fuse, Big Bang'. In this paper we look at how Australian companies and the economy as a whole is being disrupted by digital innovation.

We consider both the scale of the residual impact of digital – what we call the 'bang' – and how soon those industries will be affected – the length of the 'fuse'. An important point to note is that digital disruption is in fact a whole of business issue not a technology issue and is driving fundamental shifts in our business landscape and traditional business models. While not a technology issue, technological responses are available.

Lack of technology planning

One of the key challenges facing family businesses is a lack of strategic technology planning. Many have made tactical or low-cost investments in disparate technology systems that often results in significant spend to fix or replace. This type of investment also demands resources due to workarounds or duplicate data input, process inefficiencies as well as the proliferation of spreadsheeting.

The needs of a family business also change with growth. The needs the family business had as a start-up for example, will be markedly different from those after one or two years of growth. Many technology investments are made at the start of a business lifestyle or in response to current needs without due consideration of future requirements. This can lead to sunk costs and require system replacements in future.

Having a strategic technology plan to guide and ensure technology investments are made with the long term in view, can future proof technology investment for family businesses.

How cloud computing can assist family businesses

One of the most visible elements of digital disruption is the proliferation of cloud-based solutions. Interest in cloud computing and Software as a Service (SaaS) has risen sharply among family businesses because it allows them to reduce their overheads while broadening their access to technology resources. The impact of the 'cloud' on business applications has been more immediate for many family businesses with many vendors replacing traditional enterprise resource planning (ERP) systems with cloud based offerings, eliminating the need to purchase more costly desktop systems.

The impact and benefits of such cloud based solutions on small family businesses are real and tangible today. Cloud computing allows these organisations to scale their solutions with more manageable investment, keeping IT staffing/overheads to a minimum as the company continues to grow. Family businesses have the opportunity to react faster than large enterprises often burdened with legacy systems and great bureaucracy. Cloud based solutions allow family businesses to readily tap into external resources on a needs basis in support of rapid innovation without the need for significant long term investments.

Social Media is having an immediate impact on family businesses

The Internet has become an all-pervasive means for connecting people, with social networks at the core of the ecosystem. The rapid adoption of Internet-based social networking has transformed politics and social norms globally during the past decade. The challenge for family businesses seeking to harness the power of social media is to get the right advice and overcome their fears of adoption.

Social media now accounts for 25% of all Internet page views in major markets[14]. With social networking sites, such as Facebook and Twitter, family businesses can use social media to increase their voice and connect with broader audiences. These sites alone can drive high customer engagement and revenue for minimal marketing dollars.

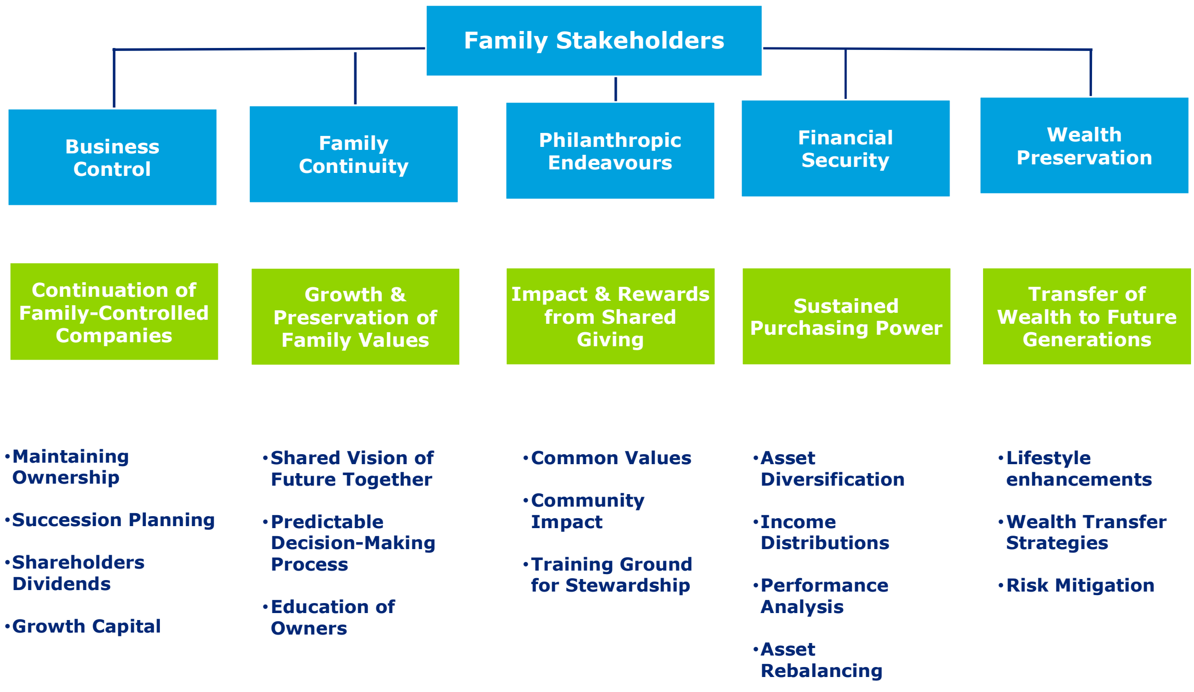
Via social media, customers can become brand ambassadors and loyal employees can amplify an organisation's efforts. Deloitte Private has worked consistently with family businesses in the retail sector to advise on the effective use of these channels to promote their products and services or promote special offers, which can drive traffic back to their physical or online stores, increasing revenues and raising brand awareness.

The use of social media sites such as Twitter and Facebook can also help family businesses develop new markets both locally and internationally. For example, a Sydney-based company allows customers to design their own shoes online and have them delivered from the factory to their door. This small family business now ships to destinations around the world and very effectively uses social media to run competitions and let people show off their designs as a thank you to encourage customer creativity.

Governance and succession planning

Succession issues facing family business

The following diagram summarises the typical issues affecting stakeholders in family businesses and the actions required to ensure these issues are successfully mitigated to preserve family wealth for future generations.



Educating the next generation of family members

Deloitte Private believe educating the next generation of family members is the key to ensuring the successful transition of family businesses to future generations. In the majority of our Client Service Assessment interviews, the patriarchs/matriarchs of our family business clients ask us whether we have a program to educate their next generation. They advise us they don't feel ready to hand over their business because they don't believe their children are ready to manage and grow it.

It is important that the next generation is engaged in a formal education program that prepares them for their future roles and responsibilities as business owners.

[14] "Deloitte Online – Social Media Study dated 2011"

Imagine you have built a successful business empire through many years of hard work. You decide to retire and place the enterprise in the hands of new management but they have little understanding of the company's products, goals, history, values or mission. There is great likelihood a business would not survive under these conditions and realistically you would not trust these people with your hard earned wealth. Unfortunately this is the prospect patriarchs/matriarchs of family owned businesses face if they do not prepare the next generation for the responsibilities that lie ahead.

Building an education program requires every family member to complete basic financial education and gain an understanding of the legal responsibilities conferred on them by the legal structure. This teaches them how to make competent decisions in tandem with their financial advisors.

Next generation family members require the following attitudes to successfully undertake the succession process:

- Belief in the future of the family
- Preservation of the family history and legacy
- Clear definitions of family and identified roles for family members
- Belief in the benefits of keeping the wealth together
- Development of entrepreneurial spirit in future generations
- Self-awareness of each other's limitations and the willingness and ability to employ external complementary skill-sets into the organisation.

How should a family business prepare for succession?

Families need to clarify the qualities, educational requirements, work experience and expectations they have of the next generation. They also need to consider what support they will provide, i.e. a number of our clients have found using an independent mentor to work with next generation family members is very helpful as the mentor is able to provide objective feedback free of family bias and unclouded by family issues.

It is also important to clarify who the next generation will report to, how they will be compensated and the performance criteria they will be measured on.

It is critical these expectations are articulated from the outset and the measures are as objective as possible.

Outside experience

Some of our clients insist family members must gain outside experience before being allowed to have a role in the family business, which gives family members an opportunity to prove themselves free of actual or perceived nepotism. They can then join the business with more to offer, having gained confidence and self-esteem from working in and proving themselves in an independent organisation.

Formal polices

Often a written contract of employment is required to clarify:

- Roles and responsibilities
- Remuneration, entitlements and performance bonuses
- Clear targets and feedback mechanisms.

Challenges facing the next generation include:

- Sibling competition, e.g. where all children want to be CEO of the business
- Parental expectations which can lead to feelings of unworthiness
- Inequality, both emotional and monetary, which can lead to conflict and unresolved issues among family members.

Responsible ownership

Responsible ownership is normally neglected as part of the education of the next generation as it is often assumed the next generation understands shareholder values. It is important the next generation understands the values and strategic direction of the business as well as basic financial concepts and that policies are in place regarding decision making, communication, managing differences of opinion and team building.

It is important family values are articulated and aligned so the next generation can bond and grow as a cohesive ownership group. Owners who view their role as part of a larger family legacy are able to see the value of planning and are thereby more likely to accomplish their goals.

"Succession is a process not an event" Peter Pagonis, *Senior Client Service Partner,* Deloitte Private

Family Governance – Getting it right from the outset

Families in business face a number of interpersonal dynamics that need to be managed. We believe that before a family starts the succession process they must ensure their values are aligned, interpersonal issues are tabled and resolved and they are all in agreement on how they want to work together in the future. If conflicts do arise within families they can destroy the business.

Family Dynamics – Effect on governance

Family dynamics are the greatest risk to the success of a family business and the preservation of family wealth for future generations. Often families do not put a plan in place capable of dealing with the conflicting needs of the family. This can lead to animosity among family members and may lead to the dissolution of the business and loss of family wealth.

Common causes of conflict among family members include:

- Inequality and perceived inequality amongst the next generation
- Spouses working in the business
- Marriage break down
- Poor communication among family members
- Salary and wages – family members working in the business vs. those not working in the business
- Distributions – capital and income.

We regard family values and family rules as the core of the family office and the foundation for the preservation of the business and the wealth it creates for future generations. A family must get this right first. It gives families the chance to correct inequalities of the past and agree the rules the family will live by in the future.

Often the greatest cause of family conflict relates to inequalities in the past and present. These need to be resolved and corrected before the family can work together in the future.

A documented agreement, often termed a 'Family Constitution', forms the basis for family decisions and operates to keep the family issues out of the family office/family business boardroom. Similarly, the family office/family business rules should be removed from other private family matters.

The purpose of the family going through this process is primarily to transition the family wealth and/or business to the next generation while the owner is still alive to avoid family conflict and the wealth being split up post the owner's passing.

"Managing the interactions between family issues and business decisions is the biggest challenge" David Smorgon, OAM

A number of our clients also create a family office separate to the trading business. A family office is concerned with asset allocation strategy, investment strategy, reporting, debt policy and other pertinent decisions.

A family starts a family office to govern the existing operational assets (business) and the non-operating assets (property and other passive assets owned by the family). Other reasons for establishing a family office may include investing the cash generated from a liquidity event such as the sale of a family business, a significant inheritance and/or cash flows from a trading business. The purpose of the family office is to preserve and protect the family wealth for current and future generations.

Governance – Creating a Family Board

Many of our clients have established a family board to provide governance between the family and family business and assist families improve communication, transparency, accountability and harmony. The family board effectively serves as a board of directors for the family.

The family board's key function is to protect the growth, development and welfare of the family and to provide family members with a regular, structured forum to make agreements, communicate and decide on the appropriate roles for the family members.

Typically, we recommend the family board have at least one independent member to act as a mediator if family issues arise and to serve as a mentor to the next generation.

We also generally recommend the family board comprises bloodline family members only apart from independents, i.e. spouses of the next generation should generally not be on the board as this can lead to unnecessary conflict arising from self-interest, which is not in the best interests of the family unit as a whole.

Due to the fiduciary duties of directors, many of our clients appoint advisors to their family boards rather than directors. This is a way of attracting skilled people to the family board without having to pay significant directors fees. An advisory board consists of a panel of external advisors who act purely in an advisory capacity to the directors. They are not appointed as directors and therefore are not entitled to vote on directors' resolutions. It is important that the external advisors act solely in an advisory capacity. They should not act in a manner that would see them deemed to be directors or officers of a company. Otherwise, they may be as liable as those who have been officially appointed to these positions.

Roles and Responsibilities

An advisory board can assist the family board in a number of areas:

- Providing access to skills and experience the family board may not otherwise posses
- Providing access to networks
- Acting as ambassadors for the business
- Offering mentoring and other support for successors
- Adding objectivity to decisions affecting family members, such as identifying successors
- Helping to determine salaries and measure performance of family members
- Helping with the hiring of family members
- Termination of the employment of family members
- Dealing with conflict between family members e.g. when a member of the next generation is transitioning into the CEO position and the owner is transitioning out of the business.

The best time to implement a family board is early in the succession planning process to provide the successors with the guidance and support they will need in the future.

When considering the composition of a family board, a board purely comprised of family members should be avoided. Even when all the shareholders are family members they should not automatically be entitled to a seat on the board. The board should principally comprise individuals with the skills needed to govern the business.

For a medium sized family business a board would ideally include all, or most, of the following:

- The current CEO
- The nominated successor when that individual reaches a senior management position (although it may be preferable for the successor to attend as an observer until they are appropriately prepared for a formal directorship)
- An external non-executive director with financial skills
- An external non-executive director with corporate governance experience
- One or two representatives of the family chosen by the shareholders, at a family meeting or by the family council
- Other external non-executive directors with high level specialist skills the business needs but cannot justify employing, e.g. sales and marketing expertise
- Executive directors with key senior roles in the business.

Deloitte Private recommends:

- **Enhanced Government support for family succession processes**
- **Relevant training for next generation business owners**
- **Reduction of compliance costs**

5. The role of family trusts in facilitating family business

"Trusts remain as the dominant vehicle chosen by family businesses with sufficient investment assets to justify compliance costs. The flexibility and flow-through effect of trusts from a legal and taxation perspective is appealing to families who face known but profound changes in circumstances over their life-cycle yet still desire succession certainty and simplicity, while maintaining profitable businesses".
David Pring, *Partner*, Deloitte Private

The taxation of trusts has long been an area of focus by the ATO. The tax law's acceptance of the unique nature of trusts creates various opportunities for exploitation of differing tax rates, and therefore this focus is understandable. However the methods used to address the issues have side-effects for the well-intentioned majority of family businesses who use trusts.

An example of such measures can be found in recent changes in the approach to unpaid present entitlements of corporate beneficiaries where physical fund transfers are required to avoid anti-avoidance rules applying and a dividend being deemed to be paid to a family member. Such a measure appears unnecessary for an unpaid trust distribution to a corporate beneficiary when the funds are maintained within the family business.

On 21 November 2011, the Assistant Treasurer released an initial consultation paper, *Modernising the taxation of trust income — options for reform*. A further consultation paper was issued on 23 October 2012, calling for submissions on methods of taxing trust income. In addition on 18 May 2012, the Assistant Treasurer announced that the Board of Taxation would undertake a post-implementation review of Division 7A reporting back by 30 June 2013. These consultations are welcome and will deal with some of the issues facing family business.

The ATO is in a difficult position in interpreting legislation that is complex and this difficulty can create an atmosphere of confrontation between the ATO and family business taxpayers. It is hoped that legislative reforms or clear and solid announcements are made in 2013 to provide greater clarity for the ATO and family groups.

Recent taxation changes have significantly increased the risks and costs for family businesses. Examples include integrity measures aimed at controlling unpaid present entitlements, the use of dividend access shares and the announced intention to potentially apply Part IVA to family arrangements. The increasingly complex and onerous tests ultimately decrease family business competitiveness against other business structures, including public companies.

Structural reform measures should consider a tax consolidation regime appropriate for family business groups to allow a similar environment available to corporate groups. A consolidation regime for family business entities could accept that funds maintained within the business (regardless of entity) would be taxed at the corporate rate with funds taken from the business be taxed at the individual level[15]. This would completely remove the need for many of the integrity measures such as the Division 7A provisions dealing with trust loans and unpaid present entitlements.

Further, consideration should be given to treating a family group as a single tax unit[16]. Tax systems that accept family group tax units are in place in a number of western nations including the USA and currently being debated in Canada and New Zealand. It is acknowledged that implementation of such a scheme is not without complication.

It is argued that fundamental tax reform is required to achieve equity between family groups, simplicity for both taxpayers to comply with and for the ATO to administer and greater certainty for family businesses in managing their affairs.

Objectives of family businesses and mechanisms commonly utilised

A typical family business comprises a corporate operating entity owned by a discretionary trust with both family members and a corporate entity as beneficiaries. For family groups the equity in the corporate operating entity is often their primary investment asset. A trust structure is regularly selected to hold significant long-term investments of family groups for asset protection and succession planning purposes.

A trust allows distributions of income from these investments to change over time to reflect the changing requirements of individual family members and to provide simple and more certain succession planning and inter-generational wealth distribution while maintaining limited liability and a single ownership structure.

For example, the eldest child of a family group may be expected to take over the operations of a family business in several years' time in return for a proportion of profits. However, it is not desirable for capital ownership to be transferred until after the current owner's death. Further, the extent of that child's involvement in the business is not known at various stages in the lifecycle of the business.

A trust provides a very simple alternative to multiple transfers of equity and the associated Capital Gains Tax (CGT) events and compliance costs that would otherwise arise. Further, the flow-through treatment of trusts replicates individual ownership, which is appealing for holding capital assets due to benefits such as the CGT general discount.

The use of a corporate operating entity is often necessary for a range of practical commercial reasons including the limitation of liability and satisfaction of industry-specific regulatory requirements. Prudent asset protection involves distribution of retained profits out of an entity engaged in potentially risky activities. Further, the ability to manage dividend distributions is reduced where the operating corporate entity is not 100% controlled, e.g. where business partners are involved or employees hold shares.

As such, it is common for the corporate operating entity to pay out dividends to a trust. The funding requirements of the business, however, usually require these distributions to be reinvested back into the corporate entity by way of loan.

The expectation of dividends being paid to the trust creates the need for a corporate beneficiary to hold funds outside of individual ownership as well as to avoid higher individual tax rates being applied to distributions where the physical funds are re-invested into the business. It is therefore common for family businesses to establish a corporate beneficiary to receive the distributions.

---

[15] This has been debated in the past and recommended by the Ralph Report. The "slice approach" to the taxation of trusts proposed in the Ralph Report faced industry objection at the time. We believe it should be re-addressed in light of current circumstances and the taxation integrity measures focussed on trusts.

[16] The concept of a single family tax unit and the resultant spreading of income amongst family members is in line with recommendations of the Henry Review with respect to the progressive marginal tax system to allow for fluctuations in income over a household's lifecycle.

Numerous variations on the above structure are used by family businesses to reflect their specific circumstances although the primary themes remain as does the desire for profits used to fund growth in a business to be taxed at a corporate rate.

Changing Division 7A rules attempt to limit the risk that funds used for private purposes are taxed at the corporate rate. The application of these rules within family groups can lead to additional costs, uncertainty and a perception of inequity.

A cohesive structure for the taxation of family groups would ideally allow for profits contributed back into a business to be excluded from individual tax rate treatment and provide a simple process for calculating group tax payable. Alternatively the introduction of a family tax unit concept would provide the ability to pool income (with or without the use of trusts).

A complex system for the taxation of family groups

The current complex system results in a high level of activity by the ATO in administering the system. This can be frustrating for family businesses which have to divert resources away from the business to deal with compliance issues. Of concern to family groups are recent changes to taxation rules and increased ATO activity around unpaid present entitlements, Division 7A, and dividend access shares.

As referred to above, the current approach to unpaid present entitlement provisions can have the apparently unnecessary effect of actually transferring cash to beneficiaries from existing trust asset holdings. This can create undesirable outcomes such as the realisation of assets and the application of CGT to what would otherwise be unrealised assets.

Failure to satisfy the particular tests set out in the legislation can result in undesirable taxation outcomes despite the cash ultimately being desired to be maintained in the business to support growth. It is therefore generally necessary for families to engage external advisors to utilise a trust structure that does not expose them to such risks. By contrast, if the family group were to be considered then all intra-group transactions could essentially be ignored, vastly simplifying compliance requirements as has been enjoyed by corporate groups who have entered the consolidation regime.

The complexity and regularly changing nature of integrity measures applicable to trusts and family businesses overall, has increased compliance costs significantly, with a higher proportionate burden falling on small businesses[17].

The Government's review of the taxation of trust income and the Board of Taxation's review of Division 7A recognises the complexity and importance of these issues. While each review is welcome, it is hoped that future changes to the rules are made with a holistic perspective and address the approach of taxation of family groups at a structural level rather than the isolated analysis of specific tax mechanisms.

Recommended policy changes

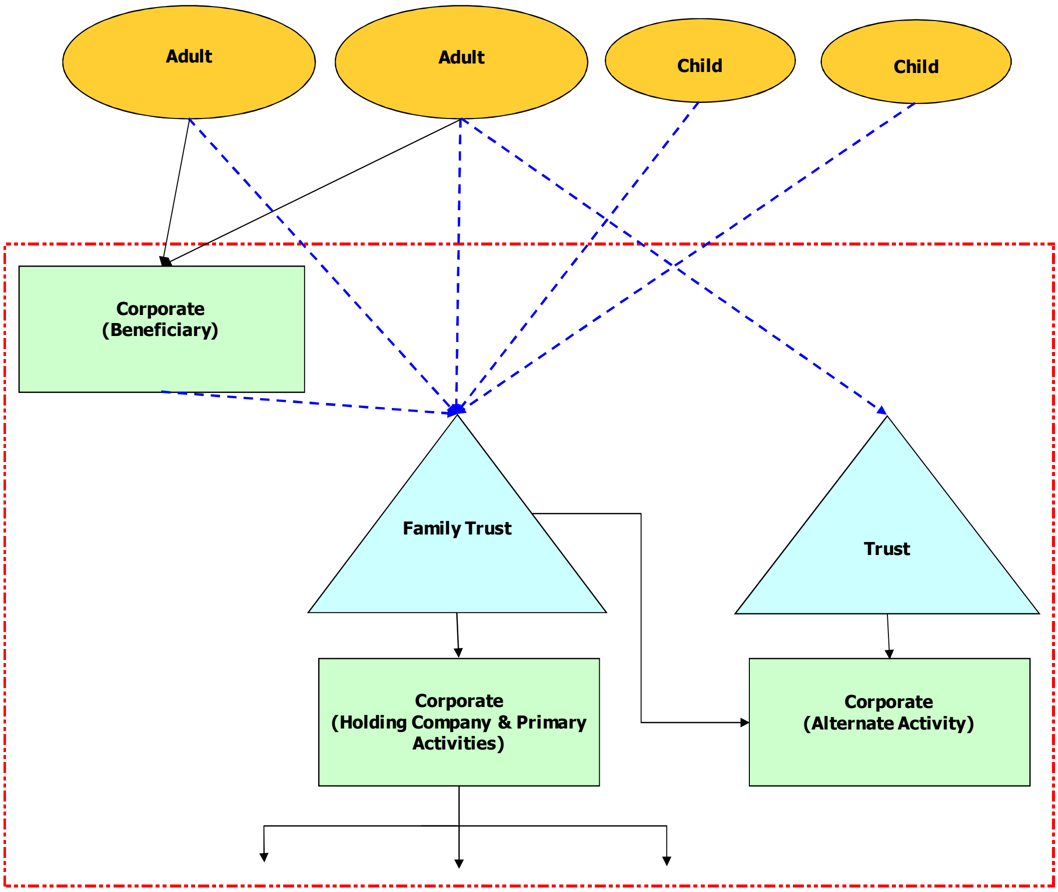
It could be argued that the taxation of a family group at an aggregate level would remove many of the issues associated with the regulation of trust taxation. Such a move would ideally involve greater alignment between corporate and individual taxation rates without undue loss of national revenue.

Alternatively, an approach that offers tax consolidation of family business groups, including trusts, would effectively eliminate the need for many of the integrity measures around transactions with other business entities involving equity and loans. Corporate groups have long been granted this concession and the associated simplification of taxation consequences of transactions would be welcomed by family groups.

Such policy changes could be achieved without disturbing the current flow through nature of trusts to allow the current taxation treatment of both income and capital gains to remain.

[17] As identified, for example, by the Board of Taxation ('Scoping study of small business tax compliance costs. A report to the Treasurer' December 2007) and the OECD Centre for Tax Policy and Administration ('SME Tax Compliance and Simplification' 2007, note for a 'Roundtable Discussion' at the 1st Meeting of the *Working Group on Taxation* of the SEE Investment Committee where it is identified that increased compliance costs associated with self-employed individuals as compared with employees is non-neutral and therefore discourages the creation of small business.

By way of explanation, we provide a diagrammatic representation of a common family group:



NB: A typical corporate group shown above may have multiple subsidiaries, represented above simply by downward arrows.

Through consolidation of family group entities, intragroup transactions could effectively be ignored as the family group would be treated as a single entity, eliminating the need for many of the existing integrity measures.

The report of the Ralph Committee argued for neutrality of tax treatment of similar activities carried on by different entities. Various other reports have made recommendations along similar lines including the more recent Henry Report and its recommendations designed to create greater simplicity and certainty at a fundamental level. Such a regime has led to more complex rules.

We would welcome the steps by the government to create an equitable environment for family businesses in a similar way that tax consolidation provided a simpler environment for corporate groups in Australia. A simpler system would be easier and more certain for the government, the ATO and family business owners.

International comparisons

Trusts remain a dominant vehicle for holding family group assets in other major economies. In the UK, while 2006 laws in respect of inheritance tax have diminished the attraction of trusts, trusts or other flow-through vehicles remain acceptable for income splitting, asset protection and succession planning. The USA also supports flow-through vehicles by allowing a company to elect to be treated as such ("S Corporations") and US trusts are widely used for estate administration, asset protection and generational fiduciary planning.

The family group tax unit concept has precedent in foreign countries such as the "married filing jointly" status afforded to family groups in the US and other similar systems in France, Germany, Belgium, Greece, Luxemburg, the Netherlands, Portugal, Switzerland, Iceland, Ireland, Norway, Poland and Spain. These systems could serve as a model for an Australian approach. Implementation of such systems is being considered in various other countries, notably Canada and New Zealand.

The international experience would support consideration of alternatives to the structural approach to the taxation of family groups (and trusts) currently taken in Australia.

Deloitte Private recommends consideration be given to structural reform of the taxation of trusts and the Government's scope be expanded to the taxation of family groups to create certainty and simplicity.

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

Financing challenges faced by Australian family businesses

Family businesses have faced challenging conditions in the period since the GFC in accessing affordable financing.

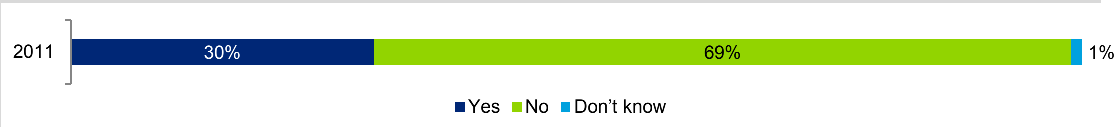
In this section we focus on the following key issues:

- Business lending by the major banks
- Accessing bank lending
- Capital raising and funding partners.

Business lending by the major banks

Commercial banks have significantly reduced their lending since the GFC, particularly to small-to-medium businesses in which family businesses predominate. This has meant that it has been harder for family businesses to source finance. In a recent survey on small businesses, CPA Australia found that only 30% of small businesses currently have a business loan, demonstrating that these businesses are funded from other sources.

Small business access to finance
Question asked to a selection of small businesses with less than 20 staff:
Do you currently have any business loans?

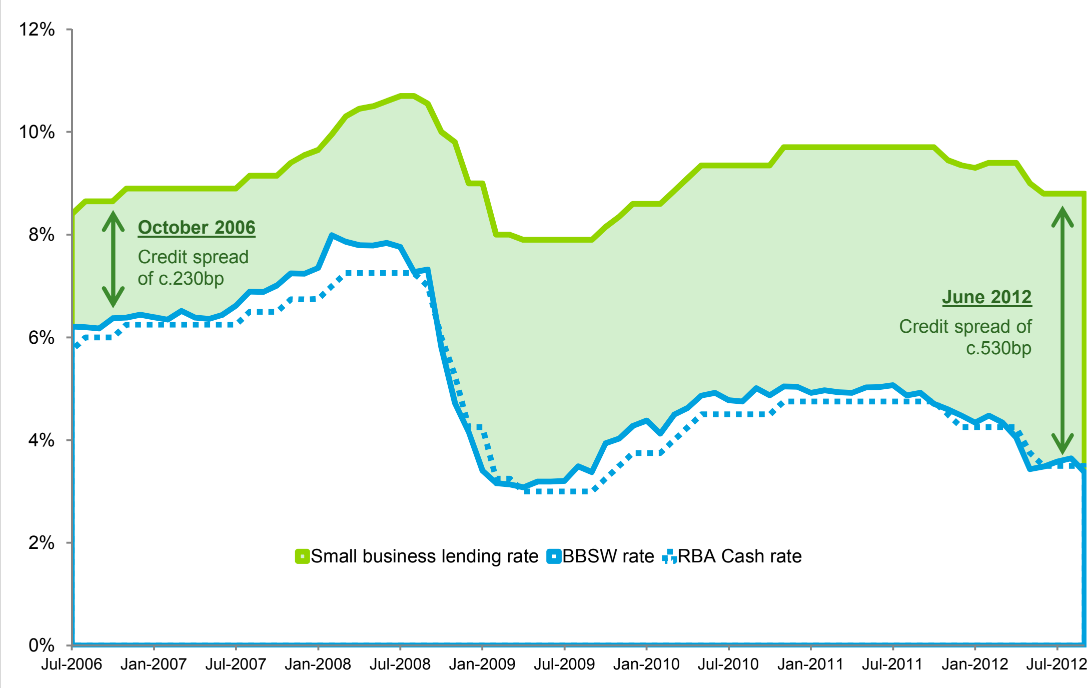


Source: The CPA Australia Asia-Pacific Small Business Survey 2011

Furthermore, funding costs for Australian banks have been rising since mid-2007 due to higher costs for long-term wholesale funding, attracting deposits and changes in funding mix. As a result, notwithstanding significantly lower Reserve Bank of Australia (RBA) cash rates and bank bill swap (BBSW) rates since the onset of the GFC, credit spreads have significantly increased from those of five years ago.

While the BBSW rate has reduced, the small business lending rate has remained relatively unchanged from July 2006 to September 2012 leaving the spread wider and borrowing effectively more expensive.

Evolution of BBSW and small business lending rates since July 2006



Source: RBA, Reuters

This is expected to be further impacted by the introduction of Basel III which will come into force from 1 January 2013 and be fully implemented by 1 January 2019. Mark Joiner, NAB Chief Financial Officer, has been quoted as saying the ability of Australian banks to grow their lending books will be constrained by Basel III.

"As a consequence, banks under pressure to reduce their capital burden under Basel III may well look first to reduce higher risk-weighted assets, including SME loans and advances."[18]

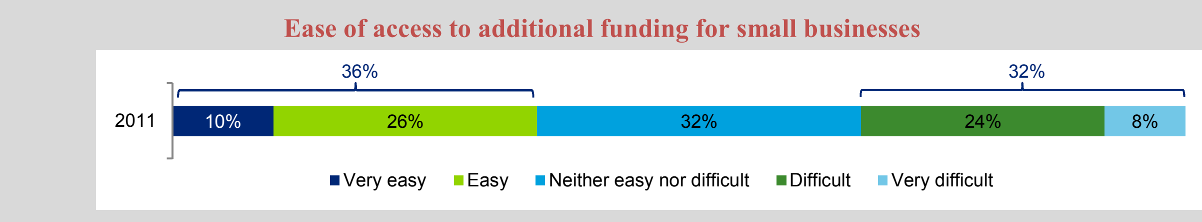
"According to the German Bundesverband Mittelständische Wirtschaft, the implementation of Basel III alone would lower the SME credit volume and would lead to a widening in the interest rate spread."[18]

Accessing bank lending

In addition to the cost barrier, many family businesses have difficulty accessing bank funding. According to the results of the abovementioned CPA survey on small businesses, 32% of small businesses seeking additional financing in 2011 found it difficult or very difficult. 70% of small businesses that expected to borrow in the 2010 survey thought it would be difficult or very difficult to borrow.

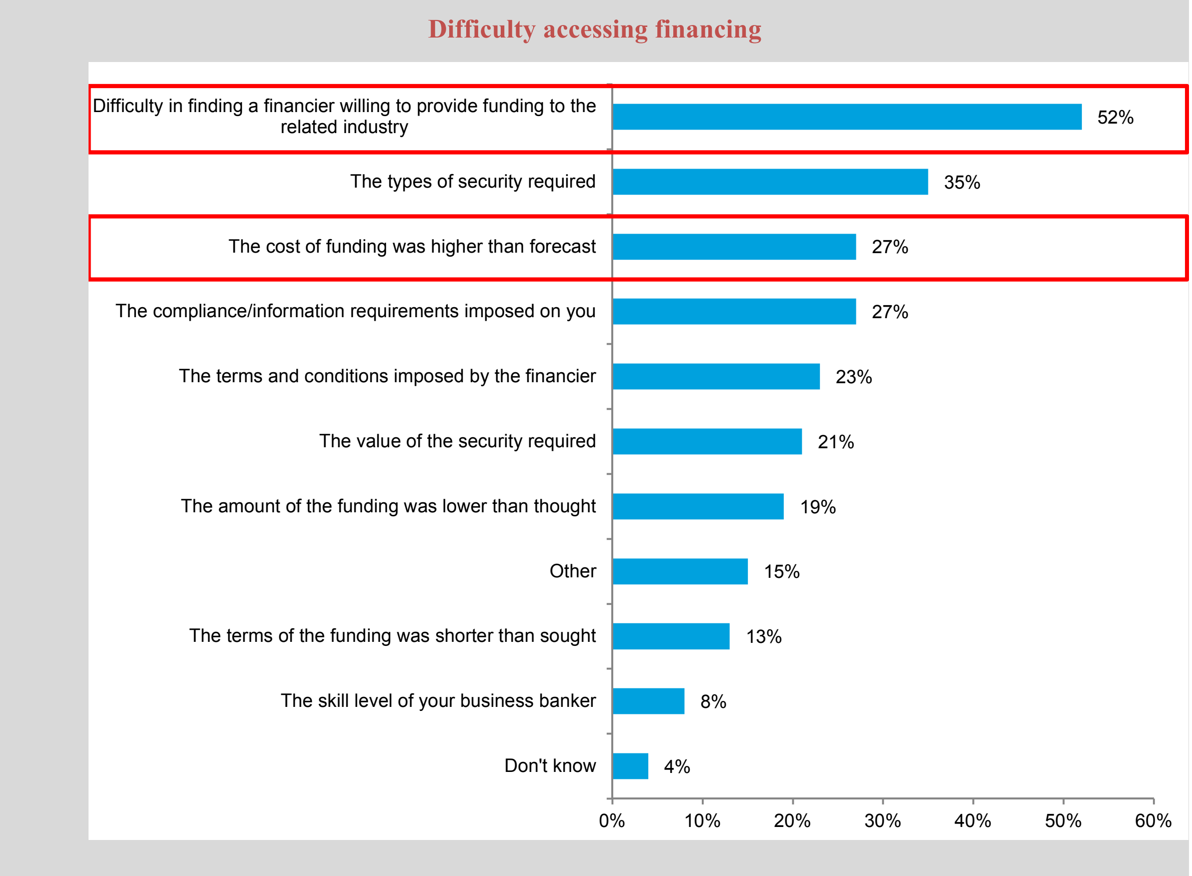
---

[18] *Institute of International Finance*
– Specific impacts of regulatory change on end-users-Initial Report, October 2012



Source: The CPA Australia Asia-Pacific Small Business Survey 2011

As shown in the CPA survey, the commonly cited difficulty in accessing bank funding related to the willingness of the financiers to provide the funding.



Source: The CPA Australia Asia-Pacific Small Business Survey 2011

Other factors include the reluctance of financiers to provide cashflow based loans to small and medium sized enterprises, which includes many family businesses. Consequently, a family business' ability to fund its growth potential is often constrained by the security available to be offered. Many family businesses are reluctant to provide security and therefore face a funding squeeze when seeking to financing their growth potential.

Capital raising and financing partners

The pronounced impact on asset valuations and unprecedented volatility associated with the GFC have affected investor confidence and therefore reduced the ability for family businesses to raise equity capital without significantly diluting their ownership.

Australian private equity firms, which could be valuable sources of equity capital for family businesses, are generally focused on larger and more mature businesses to maximise their return on investment in the current economic environment. The majority of private equity firms look for opportunities to write equity cheques starting at $10m - $20m which, combined with the leverage associated with such transactions makes the overall capital investment too large for many family businesses. Unfortunately, a very limited number of funded and active venture capital firms operate in Australia.

An additional hurdle to raising private equity funds for family businesses is the mechanism by which private equity investors realise their return on their investment. Private equity firms generally strive to achieve cash on cash returns of three times their investment in three to five years. Such an investment horizon and growth imperative (often coupled with a more aggressive debt appetite) is often not aligned with the goals and objectives of the family members.

Combined, these financing challenges have provided an unfavourable environment for family businesses to access debt and equity capital that is not expensive to procure or significantly dilutes existing ownership, neither outcome being desirable to many family business owners, hereby limiting their ability to grow through lack of funding.

Who fills the gap?

Due to the hurdles faced by family business in raising debt and equity capital, family businesses often resort to high cost products such as debtor financing, working capital loans and where accessible, cash flow lending. This can result in much of the cash flow generated by the business being applied to servicing the business' high cost financing rather than being reinvested for growth.

High net worth individuals or business angels do invest in other family businesses; however, in more recent times these investors have been less attracted to what are perceived to be higher risk investments following significant reductions in their personal wealth due to property and share market falls.

Deloitte Private recommends:

- **Government undertakes a review of the regulatory framework to stimulate investment in and financing of family businesses.**
- **As part of this review, the Government may consider tax incentives or changes to regulations regarding debt and equity funding for small businesses.**

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

There is very little data to make an informed response to this term of reference. The only data available is *ABS Report: 8165 Counts of Australian Business*. However, that report has only been published since 2007. It gives some idea of the relative survival rates of owner-managed businesses vs. incorporated businesses but not much else.

Our anecdotal view, however, is that Australian family businesses remain a critical and resilient part of the Australian economy. Their commitment to sustainable business practices, their focus on the longer term and their relative agility has and will continue to ensure they make a significant contribution to the ongoing success of Australia's economy, our society and the communities in which we live.

At Deloitte Private, we're proud to serve many of Australia's leading family businesses and together with them applaud the Government's commitment to a greater focus on this under-represented by vital component of the Australian business landscape.

Deloitte Private recommends a survey be conducted of an adequate sample of family businesses who have prospered or declined during or post the GFC to identify and learn from the common reasons for their relative success or failure.

The next step

Thank you for reviewing this submission.

We greatly appreciate your consideration of our submission and trust that the information set out in this document has provided you with a greater insight into the operation of family business in Australia and the challenges they face. We would welcome the opportunity to discuss our views with you in person.

Deloitte Private Pty Ltd
550 Bourke Street
Melbourne, Victoria
Australia
Tel: +61 (0) 3 9671 7000
Fax: +61 (0) 3 9671 7001
www.deloitte.com.au