Chapter 7

Legislative and common law frameworks – further challenges affecting Australian family companies

7.1 The *Corporations Act 2001* and the *Income Tax Assessment Act 1997* impose certain rules on the allocation of shares within a company. Family businesses trading under a company structure raised concerns about various rules affecting share allocation.

7.2 This chapter considers three challenges raised by family businesses. First, submitters argued that the restriction in section 113 of the *Corporations Act 2001* on the number of shareholders in a proprietary company undermines the effective administration of a family business. Second, submitters also questioned the rules regarding employee share schemes in Division 83A of the *Income Tax Assessment Act 1997*. Third, it was noted that family values may not easily align with more traditional concepts of corporate values. Accordingly, it was submitted that this can affect family companies' approach to engaging with corporate management structures such as boards of directors.

Section 113 of the *Corporations Act 2001*

7.3 As part of its 2008 report for its inquiry into 'the engagement and participation of shareholders in the corporate governance of companies in which they are part owners' (the 2008 shareholder inquiry),[1] the committee recommended that 'the government should amend section 113 of the Corporations Act to raise the limit for shareholders in a proprietary company to 100'.[2] The committee's recommendation responded to concerns that the corporate governance requirements under the Corporations Act may impede small, closely held, entities from incorporating. As the committee noted in its report:

> [t]he thrust of this disquiet is that the one size fits all approach best suited to regulating large financial entities is not necessarily suitable for small businesses without a diverse group of equity investors to protect.[3]

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1 Parliamentary Joint Committee on Corporations and Financial Services, *Better shareholders – Better company: Shareholder engagement and participation in Australia*, June 2008, p. 1.

2 Parliamentary Joint Committee on Corporations and Financial Services, *Better shareholders – Better company: Shareholder engagement and participation in Australia*, Recommendation 10, 2008, p. 35.

3 Parliamentary Joint Committee on Corporations and Financial Services, *Better shareholders – Better company: Shareholder engagement and participation in Australia*, 2008, p. 35.

7.4 Section 113 of the Corporations Act limits the number of non-employee shareholders in proprietary companies. A company with in excess of 50 non-employee shareholders is by virtue of section 113 required to incorporate. As the committee noted in its 2008 report, evidence before the committee included representations of Family Business Australia that family companies in existence for successive generations could inadvertently exceed this limit and, accordingly, be required to incorporate.[4] Family Business Australia advised that to avoid the automatic reconstitution of the business from a proprietary company to a public company, family businesses adopt inefficient governance practices. These practices can include minimum shareholding limits, joint share ownership and beneficial ownership, and 'no dividend' or 'low dividend' policies. Family Business Australia further advised that such arrangements can lead to family conflict and reduce the company's access to finance. For the 2005 shareholder inquiry, Family Business Australia concluded that section 113 leads to 'shareholder oppression: oppression by exclusion'.[5]

7.5 Similar concerns were raised by family business representatives during the committee's current inquiry. Family Business Australia reiterated its concerns with the effect of section 113, outlining two objections with the non-employee shareholder limit. First, Family Business Australia challenged the policy basis for the 50 non-employee shareholder cap:

> It is understood that the '50 shareholder rule'...is intended to protect the interests of those 'passive' shareholders. It not only unnecessarily duplicates other forms of legislative protection provided to such stakeholders, but represents a simplistic approach to that objective which adds considerable cost with, in most cases, little or no benefit to those it is designed to protect.[6]

7.6 MGI Australasia concurred with this view, also challenging the policy basis for the non-employee shareholder cap:

> We also agree with the observation of Family Business Australia that this legislation is unnecessary in that there are adequate remedies already available elsewhere in corporate laws to protect minority shareholders. It is our observation that the current law is able to be easily circumvented by those firms that do not wish to be burdened by the cost of a public company and therefore the provision has little practical use.[7]

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4 Parliamentary Joint Committee on Corporations and Financial Services, *Better shareholders – Better company: Shareholder engagement and participation in Australia*, 2008, pp 34–35; citing Mr Christopher Johnston, Family Business Australia, *Committee Hansard*, 15 April 2008, pp 36–37.

5 Family Business Australia, *Submission 3 - Submission to the 2008 'Better shareholders – Better company' inquiry*, p. 7.

6 Family Business Australia, *Submission 2*, p. 5.

7 MGI Australasia, *Submission 9*, p. 4.

7.7 Second, the committee was again advised that the 50 non-employee shareholder limit compromises the governance practices of an 'increasing number' of family businesses:

> FBA reiterates its objection to this provision, in respect of which anecdotal evidence indicates that increasing numbers of family businesses which are aware of the consequences of ownership by more than 50 shareholders adopt a range of shareholding arrangements to keep the share register below 50 non–employed owners. Examples of such strategies include: minimum shareholding limits and otherwise independent shareholdings being held jointly under various ownership, or beneficial ownership structures.[8]

7.8 As the statement indicates, the committee was informed that the 50 non–employee shareholder limit adversely affects a significant proportion of the family business sector. Family Business Australia put forward that it 'is an issue that most larger family businesses would concur with'.[9] MGI Australasia noted that approximately 11 per cent of family businesses reach the third or subsequent generations, a figure which it was submitted is significant.[10] While not estimating the proportion of family businesses affected, Mr William Noye, National Leader, Family Business Services, KPMG, provided the example of Coopers Brewery which has approximately '183 shareholders in [the] family group.'[11] In support of expanding the 50 non-employee shareholder limit, Mr Noye submitted that '[i]t is important to be able to cater for broader family groups.'[12]

7.9 The theme of supporting successful multigenerational family businesses was commonly put forward as a key reason for amending section 113. MGI Australasia noted that '[a]s family businesses progress through the generations the number of shareholders not employed in the business grows.'[13] MGI Australasia implied that section 113 operates to penalise highly successful family businesses:

> Such businesses, by virtue of their longevity, are often the larger family enterprises. It is such businesses that are often caught by the so-called 50 shareholder rule…section 113 of the Corporations Act 2001…requires corporations with more than 50 non-employed members to become unlisted public companies. This places unnecessary administrative costs on such enterprises.[14]

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8 Family Business Australia, *Submission 2*, p. 5.

9 Mrs Philippa Taylor, Chief Executive Officer, *Committee Hansard*, 14 November 2012, p. 35.

10 MGI Australasia, *Submission 9*, p. 4.

11 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 11.

12 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 11.

13 MGI Australasia, *Submission 9*, p. 4.

14 MGI Australasia, *Submission 9*, p. 4.

7.10 Similarly, the Institute of Chartered Accountants Australia submitted:

> [l]arger 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.[15]

7.11 The 50 shareholder restriction in section 113 of the Corporations Act was not broadly raised by family business owners. However, where raised, the submissions of family business representatives reflected family business owners' concerns. Mr Stephen Sampson, Director, Lionel Sampson Sadleirs Group, supported an increase to the 50 non–employee shareholder cap. Mr Sampson advised that enacting the committee's 2008 recommendation 'would be incredibly helpful' as it would assist family businesses to respond to governance challenges.[16] Mr Graham Henderson, Director, Family Business Australia, and managing director of a 63-year-old third-generation family business, supported the increase of the 50 non-employee shareholder limit, stating that 'small or medium businesses–SMEs–certainly need more than 50 shareholders.'[17]

The government's response to the committee's 2008 report

7.12 The government has not provided a formal response to the committee's 2008 report. Rather, on 6 July 2011, the government advised the Speaker of the House of Representatives that '[t]he government does not intend to respond to the report because of the time elapsed since the report was tabled'.[18]

7.13 During the 2008 shareholder inquiry, Treasury advised that companies with more than 50 shareholders have a sufficiently diverse ownership base to justify the greater governance requirements that apply where companies incorporate. It was further noted that large proprietary companies have similar reporting obligations to listed public companies. As Treasury submitted:

> [t]he regulatory regime established for proprietary companies is based on the principle that these companies have a relatively non-disperse shareholder base. For this reason, the Corporations Act requires proprietary companies to have less than 50 non-employee shareholders. Companies with a wider shareholder base, for example listed or other public companies, face greater issues in providing effective oversight and control of company management. In order to address these issues, the

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15 Institute of Chartered Accountants Australia, *Submission 25*, p. 3.

16 Mr Stephen Sampson, Director, Lionel Sampson Sadleirs Group, *Committee Hansard*, 7 February 2013, p. 18.

17 Mr Graham Henderson, Director, Family Business Australia, *Committee Hansard*, 14 November 2012, p. 38.

18 Government responses to parliamentary committee reports, *Response to the schedule tabled by the Speaker of the House of Representatives on 25 November 2010*, circulated by the Leader of the House, the Hon. Anthony Albanese MP, 6 July 2011, p. 3.

> Corporations Act places greater governance requirements on companies with more disperse ownership.[19]

7.14 Accordingly, Treasury did not accept that there was a compelling rationale for amending section 113.[20] It was further noted that few stakeholders have raised concerns with its operation and effect:

> The requirement for proprietary companies to have no more than 50 non-employee shareholders existed when Australia first adopted a national regime for corporate regulation in 1982. Since this time, Treasury has received very few comments from stakeholders in relation to this requirement. The requirement was reviewed as part of the Corporations Law Simplification Program in 1994. This included stakeholder consultation on whether there should be a restriction of the number of non-employee shareholders in proprietary companies, and if so, what should be set as the maximum number. Following this review, a decision was made not to amend the existing requirement.[21]

7.15 Five years on, in evidence submitted for the committee's family business inquiry, Treasury affirmed the advice previously given during the committee's 2008 shareholder inquiry. The committee was advised that 'the views that were expressed at the time…are consistent with the views which we would hold today on the issue'.[22]

7.16 Treasury confirmed that the increased reporting obligations on companies with a diverse stakeholder base are intended to protect the integrity of Australia's financial system:

> The principle behind the limit goes to the heart of how the Corporations Act seeks to address the agency issue which can arise when control of the company is exercised on a day-to-day basis as distinct from by specialist management and as distinct from the owners of the company. The Corporations Act has developed a framework to address that…mainly through imposing levels of disclosure upon the company. Those levels of disclosure vary between proprietary companies and public companies–listed and unlisted. Section 113 limits at 50 non–employee shareholders, and the principle behind that is that the more diffuse and the greater the

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19 Treasury, *Submission 40 – Submission to the 2008 'Better shareholders – Better company' inquiry*, p. 1.

20 Treasury, *Submission 40 – Submission to the 2008 'Better shareholders – Better company' inquiry*, p. 1; as cited in Parliamentary Joint Committee on Corporations and Financial Services, *Better shareholders – Better company: Shareholder engagement and participation in Australia*, 2008, p. 35.

21 Treasury, *Submission 40 - Submission to the 2008 'Better shareholders – Better company' inquiry*, p. 1.

22 Mr David Woods, General Manager, Corporations and Capital Markets Division, Treasury, *Committee Hansard*, 13 November 2012, p. 13.

number of shareholders on the registry, the greater is the potential for the agency problems to arise.[23]

7.17 Further, Treasury officials reiterated that the reporting obligations applying to larger proprietary companies are similar to incorporated companies. Although it acknowledged that the 50 shareholder limit is 'an arbitrary line in the sand', Treasury maintained its previous advice that the Department had 'received very few representations from small businesses and family businesses' about the effect of section 113. Accordingly, it was submitted that 'it is not clear how great the benefits would be of raising the cap'.[24] Importantly, however, Treasury advised the committee that '[i]f there was a problem, and people came to talk to us, we would be happy to revisit the issue'.[25]

Committee view

7.18 In electing to inquire into the operation of the family business sector in Australia, the committee determined to establish whether Australia's marketplace appropriately accommodates family businesses. Evidence before the committee demonstrates that section 113 of the Corporations Act is an example of a general corporations law policy that does not correlate with the specific needs and operational realities of family businesses. The effect of section 113 for larger, multigenerational family business further demonstrates the need for government, and policymakers more broadly, to proactively engage with the family business sector.

7.19 The committee acknowledges Treasury's advice that the limit on non-employee shareholders imposed by section 113 is an integrity measure. However, in the context of family businesses, the committee questions the relevance of Treasury's advice that the more diffuse and the greater the number of shareholders on the registry, the greater is the potential for the agency problems to arise. Where the non-employee shareholders are members of the same family, supporting the same business objectives, it is not clear that these agency problems will be present.

7.20 The committee appreciates Treasury's advice that the Department has received few representations about the effect of section 113 on family businesses, or, indeed, small businesses. However, the evidence currently before the committee mirrors that which the committee obtained about section 113 during its 2008 shareholder inquiry. The time has come for government to consider whether the policy rationale behind section 113 is applicable in the family business context.

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23 Mr David Woods, General Manager, Corporations and Capital Markets Division, Treasury, *Committee Hansard*, 13 November 2012, p. 13.

24 Mr David Woods, General Manager, Corporations and Capital Markets Division, Treasury, *Committee Hansard*, 13 November 2012, p. 13.

25 Mr David Woods, General Manager, Corporations and Capital Markets Division, Treasury, *Committee Hansard*, 13 November 2012, p. 14.

7.21 A theme that has emerged throughout this inquiry is the need for the family business sector to assume a more active presence in policy and legislative development. The committee encourages family business representatives to collectively approach government to provide necessary advice about the sector, its operational successes and its needs going forward.

7.22 To this end, the committee recommends that Treasury officials meet with representatives of the family business sector to explore the effect of section 113, and whether the policy rationale for the 50 shareholder limit is applicable for family businesses. The government's response to this report should detail the consultation process, the issues raised, and the measures that the government proposes to actively support larger, multigenerational family businesses to respond to the non-employee shareholder limit. It is incumbent on family businesses to advise Treasury of the number of family businesses that have exceeded, or are actively taking steps to avoid exceeding, the 50 shareholder limit.

Recommendation 16

7.23 The committee recommends that the Department of the Treasury consult with representatives of the family business sector about the effect of section 113 of the *Corporations Act 2001* on large, multigenerational family businesses.

7.24 The committee considers that it would be appropriate for the Australian Bureau of Statistics to collect data on the effect of section 113 on Australian businesses, including family businesses.

Recommendation 17

7.25 The committee recommends that the Australian Bureau of Statistics collect data on the effect of section 113 of the *Corporations Act 2001* on Australian businesses.

Division 83A of the *Income Tax Assessment Act 1997*

7.26 Family business advisors MGI Australasia and the Institute of Chartered Accountants Australia argued that the rules in Division 83A of the *Income Tax Assessment Act 1997* (the 1997 Act) that regulate employee share schemes disadvantage small and medium sized family businesses trading under a company structure.[26]

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26 Institute of Chartered Accountants Australia, *Submission 25*, pp 3–5; MGI Australasia, *Submission 9*, pp 5–6.

7.27 Employee share schemes provide employees shares, or the opportunity to acquire shares, in the company for which they work.[27] The Australian Taxation Office (the ATO) defines employee share schemes as:

> a scheme under which shares, stapled securities and rights (including options) to acquire shares or securities in the company are provided to its employees (including current, past or prospective employees and their associates) in relation to their employment.[28]

7.28 Employees' entitlements under employee share schemes are taken into account by the ATO for tax purposes. Division 83A of the 1997 Act establishes the rules that determine the taxation arrangements for employees' entitlements under employee share schemes. Division 83A was inserted in 2009 by the *Tax Laws Amendment (2009 Budget Measures No. 2) Act 2009*, which received Royal Assent on 14 December 2009. Division 83A replaced Division 13A of the *Income Tax Assessment Act 1936* (the 1936 Act), which was introduced in 1974. The rules in Division 83A were intended to address concerns that Division 13A of the 1936 Act was open to misuse and did not effectively prevent tax avoidance.[29] As Treasury informed the committee, the 2009 changes to the regulation of employee share schemes:

> were designed to better target eligibility for the concessions to employees to improve fairness and the integrity of the tax system. The changes improve horizontal equity in the tax system by treating different forms of remuneration more equally.[30]

7.29 As noted in the Explanatory Memorandum (EM) to the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, the taxation arrangements established in Division 83A are intended to strike an appropriate balance between ensuring that all remuneration received, regardless of its form, is subject to taxation, and encouraging business productivity and the retention of appropriately qualified staff:

> [T]he employee share scheme tax rules…specifically aim to improve the alignment of employee and employer interests. In recognition of the economic benefits derived from employee share scheme arrangements, the rules provide tax concessions for employees participating in employee share schemes. Tax support is provided on the grounds that aligning the

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27 Australian Securities and Investments Commission and MoneySmart, *Employee share schemes*, https://www.moneysmart.gov.au/investing/shares/employee-share-schemes (accessed 1 February 2013).

28 Australian Taxation Office, *Employee share schemes – guide for employees*, http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&menuid=0&doc=/content/00224640.htm&page=4&H4 (accessed 1 February 2013).

29 The Hon Wayne Swan MP, Treasurer, 'Better targeting the employee share scheme tax concessions', Media release, 12 May 2009.

30 Treasury, *Submission 26*, p. 1.

> interests of employees and employers, encourages positive working relationships, boosts productivity through greater employee involvement in the business, reduces staff turnover and encourages good corporate governance.[31]

7.30 This intention is given legislative force by section 83A.5 of the 1997 Act, which provides that the objects of Division 83A are:

- to ensure that benefits provided to employees under employee share schemes are subject to income tax at the employees' marginal rates under income tax law (instead of being subject to fringe benefits tax law); and
- to increase the extent to which the interests of employees are aligned with those of their employers, by providing a tax concession to encourage lower and middle income earners to acquire shares under such schemes.[32]

7.31 Accordingly, Division 83A establishes four categories of employee share schemes, namely:

- taxed-upfront scheme – not eligible for reduction (default tax position);
- taxed-upfront scheme – eligible for reduction;
- tax-deferred scheme – salary sacrifice; and
- tax-deferred scheme – real risk of forfeiture.[33]

7.32 The Institute of Chartered Accountants Australia provided the following explanation of the tax concessions available under Division 83A:

> 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:
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> - 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.[34]

7.33 The Institute further explained that Division 83A defers but does not waive tax liabilities:

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31 Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, paragraphs 1.84–1.86.

32 *Income Tax Assessment Act 1997*, s. 83A.5.

33 Australian Taxation Office, *Employee share schemes – guide for employees*, http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&menuid=0&doc=/content/00224640.htm&page=4&H4 (accessed 1 February 2013).

34 Institute of Chartered Accountants Australia, *Submission 25*, p. 4.

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.[35]

7.34 To access the concessions in Division 83A, employee share schemes must satisfy a number of preconditions. These include that the employee share scheme is non-discriminatory. A scheme satisfies this requirement if shares are offered to at least 75 per cent of the company's employees.[36] This requirement was carried over from the rules under the former Division 13A of the 1936 Act.[37] As Treasury explained, the 75 per cent rule does not apply to employee share schemes that only offer rights, that is, options, in the company.[38] Additionally, an employee may not hold more than five per cent of the company's shares, or be in a position to cast, or to control the casting of, more than five per cent of the maximum number of votes that might be cast at the company's general meetings.[39] As the Board of Taxation has commented, the requirements:

> aim to ensure, among other things, that participation in the scheme is widely available to employees, and that the concessions cannot be accessed by shareholders who are effectively able to exert control over the company's operations.[40]

Employee share schemes and executive remuneration

7.35 The Institute of Chartered Accountants Australia argued that for private family companies employee share schemes are primarily used to promote company loyalty, rather than to increase remuneration provided to executive employees:

> 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.[41]

7.36 However, employee share schemes are considered an essential recruitment tool for family businesses seeking to attract senior management personnel.[42] The

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35 Institute of Chartered Accountants Australia, *Submission 25*, p. 4.

36 *Income Tax Assessment Act 1997*, ss. 83A.35(6).

37 *Income Tax Assessment Act 1936*, s. 139CD.

38 Treasury, answer to question on notice, 4 February 2013 (received 8 February 2013).

39 *Income Tax Assessment Act 1997*, ss. 83A.35(9).

40 Board of Taxation, *Review into elements of the taxation of employee share scheme arrangements*, February 2010, p. 5.

41 Institute of Chartered Accountants Australia, *Submission 25*, p. 3.

Institute of Chartered Accountants Australia submitted that the judicious use of employee share schemes 'is about giving employees and employers in the family business the best opportunity they have…to ensure that the business can survive into the future.'[43]

7.37 However, the committee was advised that it is difficult for family companies and their employees to access the tax concessions under Division 83A. It was submitted that the requirements to access the tax concessions do not reflect the structure and financial arrangements of family companies. In particular, concerns were raised with the rules in Division 83A that require employee share schemes to be available to a broad range of employees. The Institute of Chartered Accountants Australia submitted that the requirement for employee share schemes to be non-discriminatory is at odds with the strategic use of employee shares to attract senior management personnel:

> 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 are 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.[44]

7.38 MGI Australasia concurred with this view, arguing that Division 83A limits the opportunities available to family businesses to attract external expertise:

> According to the 2010 MGI survey around one third of family business owners believe that the current CEO is likely to be succeeded by a non-family member. The attraction and retention of suitably skilled outside managers is therefore key to the success of that transition.
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> Attracting and retaining skilled and experienced successors is a critical component in the transitioning of family businesses from the current baby boomer owner-operators. Providing attractively-priced equity in order to achieve this is currently discouraged by Division 83A.[45]

7.39 To this end, the Institute of Chartered Accountants Australia recommended that Division 83A be amended to 'exempt SMEs from the broad availability requirements'. It was submitted that SMEs should be defined as 'businesses which characteristically have insufficient depth of management to ensure long-term viability

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42 Institute of Chartered Accountants Australia, *Submission 25*, p. 4; MGI Australasia, *Submission 9*, p. 6.

43 Mr Yasser El-Ansary, General Manager, Leadership and Quality, Institute of Chartered Accountants Australia, *Committee Hansard*, 14 November 2012, p. 19.

44 Institute of Chartered Accountants Australia, *Submission 25*, p. 4.

45 MGI Australasia, *Submission 9*, p. 6.

of the business' and 'with an aggregated group turnover of no more than $35 million per annum.'[46]

7.40 Treasury disputed the view that employee share schemes should be targeted towards executive management positions. Treasury argued that employee share schemes are not an appropriate means of fostering company loyalty:

> The interests of senior executives and directors of companies, including those working for family businesses, should already be strongly aligned with the interests of shareholders and therefore there is no productivity benefit that would arise by extending additional tax concessions to shares issued at a discount to such persons.[47]

7.41 Additionally, it was noted that providing employee share schemes to only a select proportion of employees would create disparity within the company. As Treasury submitted,'[a]llowing executives to defer the taxation point would provide a concession to a select group that was not extended to the majority of employees.'[48] Further, Treasury questioned the integrity of offering employee share schemes to only employees in senior management positions. Treasury advised that 'the 75 per cent requirement ensures the ESS [employee share scheme] tax concessions are not inappropriately accessed by those in control of the company.'[49]

7.42 In response to proposals to exempt a particular class of business from the 75 per cent requirement, Treasury informed the committee that 'it would be difficult to define "family business" to provide an exemption from the 75 per cent requirement, in a way that would robustly ring-fence particular types of companies.' It was further contended that the isolation of a particular category of Australian business in the manner recommended by family business representatives 'could also compromise the integrity of the ESS [employee share scheme] tax regime as a whole, potentially creating situations of inequity and increasing risk of tax avoidance'.[50]

Previous inquiries

7.43 The issue of whether employee share schemes can appropriately be used as a form of executive remuneration was the subject of previous inquiry. In 2009, the Productivity Commission examined 'the current Australian regulatory framework around remuneration of directors and executives, as it applies to companies which are disclosing entities regulated under the *Corporations Act 2001*.'[51] As the

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46 Institute of Chartered Accountants Australia, *Submission 25*, p. 4.

47 Treasury, *Submission 26*, p. 1.

48 Treasury, *Submission 26*, p. 1.

49 Treasury, answer to question on notice, 4 February 2013 (received 8 February 2013).

50 Treasury, answer to question on notice, 4 February 2013 (received 8 February 2013).

51 Productivity Commission, *Executive remuneration in Australia: Productivity Commission inquiry report*, Report No. 49, Terms of Reference, 19 December 2009, p. iv.

Productivity Commission noted, the 2009 amendments to the regulatory framework for employee share schemes restricted executive employees' access to the tax concessions.[52] Prior to 2009, the tax concessions applying to employee share schemes could be accessed by all employees regardless of their salary. In contrast, Division 83A limits the tax concession to taxpayers with an adjusted taxable income of less than $180 000.[53]

7.44 The EM to the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009 indicates the policy reasons for the introduction of a ceiling on the salary levels of eligible employees. As stated in the EM, the tax concessions under Division 83A are intended to be available only to lower and middle income earners.[54] Executives appear to be outside the contemplated scope of the tax concessions under Division 83A. As the Productivity Commission noted:

> [t]he taxation provisions for employee share schemes are not specifically designed for executives and must apply to all Australian employees. Furthermore, the concessions that enable deferral of tax for equity-based payments are targeted towards schemes to encourage broad employee share ownership.[55]

7.45 The Productivity Commission did not recommend that the $180 000 salary limit be increased. However, the Productivity Commission did recommend that the 2009 changes to the regulation of employee share schemes be reviewed as part of a broader review into corporate governance arrangements. The Productivity Commission further recommended that the review be undertaken no later than five years from the introduction of any new measures arising out of the Productivity Commission's report.[56]

Suitability of Division 83A for family companies – liquidity requirements

7.46 Family business advisors further submitted that Division 83A effectively discriminates between public companies and private family companies. MGI Australasia advised that '[f]amily businesses are at a great disadvantage competing with large enterprises, which offer discounted equity that can be market traded and/or structured to gain tax deferral.'[57]

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52 Productivity Commission, *Executive remuneration in Australia: Productivity Commission inquiry report*, Report No. 49, 2009, p. 328.

53 *Income Tax Assessment Act 1997*, s. 83A.35.

54 Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, paragraph 1.117.

55 Productivity Commission, *Executive remuneration in Australia: Productivity Commission inquiry report*, Report No. 49, 2009, p. 341.

56 Productivity Commission, *Executive remuneration in Australia: Productivity Commission inquiry report*, Report No. 49, 2009, Recommendation 17, p. xli.

57 MGI Australasia, *Submission 9*, p. 6.

7.47 It was noted that, compared with public companies, shares in a private company are not liquid.[58] Accordingly, tax is levied on benefits that cannot easily be realised. The Institute of Chartered Accountants Australia argued:

> [t]his acts as a deterrent to family businesses providing discounted equity to successors, because it results in tax on a 'benefit' that may take decades to convert into cash. Unlike shares in a public company, shares and family business are highly illiquid.[59]

7.48 It was submitted that it is necessary for employees of private family companies to access the tax concessions under Division 83A. As the Institute of Chartered Accountants stated:

> 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 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.[60]

7.49 Treasury disputed the view that legislative amendment is necessary to support family businesses to access tax concessions under Division 83A. In response to liquidity concerns raised by submitters, Treasury advised that liquidity 'is an issue that is not unique to family businesses and is faced by many other companies (for example smaller listed companies).'[61] Treasury also reiterated the accepted taxation principle that '[t]he economic value embodied in employee share schemes and rights is equivalent to any other form of employee compensation and should generally be taxed in the same manner.'[62]

Previous inquiries

7.50 The argument that access to tax concessions under Division 83A is necessary to support 'cash-strapped' companies was considered in 2009 by the Board of

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58 Institute of Chartered Accountants Australia, *Submission 25*, p. 3.

59 Institute of Chartered Accountants Australia, *Submission 25*, p. 5.

60 Institute of Chartered Accountants Australia, *Submission 25*, p. 3.

61 Treasury, *Submission 26*, p. 1.

62 Treasury, answer to question on notice, 4 February 2013 (received 8 February 2013).

Taxation.[63] The Board acknowledged that there is some merit to the argument. However, the Board ultimately concluded that relaxing the current restrictions was unviable:

> The Board agrees that there is some merit to the argument that the existing restrictions that operate to limit access to the existing employee share scheme tax concessions tend to operate particularly onerously on these types of companies.
>
> However, the Board considers that due to the largely disparate nature of these types of companies there is a fundamental difficulty in attempting to define which entities should be eligible to access any relaxed restrictions. The Board considers that in light of the significant integrity concerns to the operation of the employee share scheme provisions created by the inability to adequately ring-fence eligibility, any relaxation of the current restrictions is not a viable alternative.[64]

Additional matters: The five per cent cap on the percentage of company shares held and the maximum seven year deferral period

7.51 Concern was also raised with the restriction on the percentage of company shares that an employee may hold in order to be eligible to access tax concessions under Division 83A. The Institute of Chartered Accountants Australia submitted that the five per cent limit is 'too low to provide a worthwhile succession planning mechanism'.[65] It was argued that a 'minority holding' test would be more appropriate for family companies:

> [A] more meaningful requirement would be for the shareholding to be a minority holding. Once 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.

7.52 However, it is evident that there is a disconnect between the policy intent underlying Division 83A and the use of employee share schemes by companies within the family business sector. As noted in the EM to the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, the five per cent requirement reflects the policy of aligning employee interests with company interests. As the EM notes, it was not

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63 Senator the Hon Nick Sherry, Assistant Treasurer, 'Details of further industry consultation on employee share schemes tax reforms', Media release No. 017, 24 July 2009. In considering the terms of reference to inquire into 'whether shares and rights under an employee share scheme at a start-up, R&D or speculative focused company should have separate tax deferral arrangements', the Board of Taxation noted the attraction of employee share schemes for 'cash-strapped' companies - Board of Taxation, *Review into elements of the taxation of employee share scheme arrangements*, February 2010, p. ix.

64 Board of Taxation, *Review into elements of the taxation of employee share scheme arrangements*, February 2010, p. ix.

65 Institute of Chartered Accountants Australia, *Submission 25*, p. 4.

considered necessary to provide tax incentives to align the company's interests with the interests of employees who hold more than five per cent of the company's shares:

> This provision encourages the benefits of the employee share scheme to be spread widely among employees. The concession is intended to encourage employees with small or no ownership in their employer to take up an interest in the company. It is considered that if one employee owns more than 5 per cent of the voting rights, interests between the company and that shareholder are already aligned, and no tax concession is appropriate or warranted.[66]

7.53 The EM casts further doubt on the appropriateness of using employee shares as a mechanism to facilitate change of company ownership:

> Further, this acts as an integrity rule that prevents taxpayers from misapplying the concession in order to buy a business or indirectly access company profits through the employee share scheme rules. The concession is intended to apply in respect of the employee/employer relationship and not in relation to the company/shareholder relationship.[67]

7.54 It was further submitted that 'the maximum deferral period of seven years contained in Division 83A should be extended for SMEs, as generally the opportunity to realise shares in an SME is extremely limited'. The Institute of Chartered Accountants put forward that the deferral period for SMEs, including relevant family companies, should be 'extended to the earlier of a realisation event, termination of employment…and obtaining a majority shareholding.'[68]

7.55 Prior to 2009, Division 13A of the 1936 Act authorised tax liabilities incurred under employee share schemes to be deferred for a maximum of 10 years. With the introduction of the 2009 amendments, this timeframe was reduced to seven years.[69] Concerns with the introduction of a seven year maximum deferral period were raised at the time of consultation on the exposure draft legislation.[70] In response, the EM to the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009 states:

> The deferral period is limited by the ESS deferred taxing points to ensure fairness, [to] continue to align the interests of the employer and employee,

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66 Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, paragraph 1.134.

67 Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, paragraph 1.135.

68 Institute of Chartered Accountants Australia, *Submission 25*, p. 4.

69 Senator the Hon Nick Sherry, 'Taxation of employee share schemes', Media release No. 011, 1 July 2009.

70 See, for example, CPA Australia, *Submission re reform of the taxation of employee share schemes*, http://archive.treasury.gov.au/documents/1573/PDF/CPA_Australia.PDF (accessed 8 February 2013).

> and [to] preserve the integrity of the tax system by preventing unlimited deferral of tax on employment remuneration.[71]

7.56 While some submitters to the Exposure Draft consultation process raised concerns with the reduction of the maximum deferral period, others accepted the reduction as a revenue raisings measure.[72] The seven year deferral period is not included in Treasury's summary of the key matters raised during the consultation process.[73]

Committee view

7.57 On the basis of evidence before the committee, it is clear that there is tension between the preferred use of employee share schemes by family companies and the policy rationale underpinning Division 83A. In authorising the enactment of the Division 83A framework, Parliament intended to foster the productivity benefits that can be gained where employees have a personal stake in the success and profitability of their employer. Division 83A was not intended to facilitate management handovers or ownership transfers. Indeed, utilising Division 83A for these purposes attempts to re-engineer the operation and purpose of employee share schemes and the Division 83A tax concessions.

7.58 The committee notes the Productivity Commission's recommendation that the operation of Division 83A be reviewed. The committee also notes that the Board of Taxation's inquiry into the effect of Division 83A on 'cash-strapped' companies did not expressly include family businesses. Therefore, the committee considers that as part of a broader process of actively engaging with the family business sector, Treasury should review the challenges encountered by family businesses in recruiting executives and advise the government about whether the employee share scheme framework should be adjusted to support family businesses in their recruitment endeavours.

Recommendation 18

7.59 The committee recommends that the Department of the Treasury review the evidence gathered through the committee's inquiry into the family business sector in Australia and consider consulting the stakeholders identified through this inquiry about the sector's concerns about the effect of Division 83A of the

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71 Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, paragraph 1.191.

72 See, for example, PricewaterhouseCoopers, *Submission: Reform of the taxation of employee share schemes*, http://archive.treasury.gov.au/documents/1573/PDF/PriceWaterhouseCoopers.pdf (accessed 8 February 2013).

73 Treasury, *Employee share schemes: Summary of consultation process*, http://archive.treasury.gov.au/documents/1559/PDF/ESS_consultation_summary.pdf (accessed 8 February 2013).

***Income Tax Assessment Act 1997* on their capacity to engage suitably qualified executives. Treasury should advise government about whether appropriate support can be provided, whether through amendments to Division 83A or other mechanisms, to address the challenges faced.**

Family businesses, directors and directors' duties

7.60 The committee was informed that family values can affect a family business' management structure and financial operations. As David Hill, National Managing Director of Deloitte Private, noted, family values may not reflect corporate values:

> Corporates often are challenged by taking decisions based on quarterly reporting cycles—very short-term decisions designed to…report a profit. Family businesses do not think that way; they think of the longer term because of their legacy, their values and their reputation.[74]

7.61 For family businesses trading under a corporate structure, family values can impact corporate practice. Notably, the committee's attention was drawn to the composition and use of boards of directors.

7.62 As MGI Australasia has advised, formal boards assist companies to increase accountability, improve decisions making and planning without compromising privacy.[75] However, family businesses have shown a reluctance to engage more than the statutory minimum number of directors. MGI explained that the lack of formal boards is a result of family businesses' reluctance to engage more than the minimum amount of directors in order to maintain a certain level of asset protection and to minimise the liability of the family business.[76]

7.63 As a solution, MGI Australasia Ltd recommended in their submission that a separate class of directors should be created to encourage the adoption of separate formal boards. This sub class of director would not be subject to the liabilities that a standard director would be exposed to:

> [A]dditional persons should be able to act as actual or defacto directors without being subject to all the personal risks applied under the Corporations Law…as long as at least one member of the family business remains fully liable.[77]

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74 Mr David Hill, National Managing Director of Deloitte Private, *Committee Hansard*, 14 November 2012, p. 8.

75 MGI Australasia Ltd, *From the dining room to the board room – Family business in focus: The MGI Australian Family and Private Business Survey 2010,* July 2010, p. 7.

76 MGI Australasia Ltd, *Submission 9,* p. 5.

77 MGI Australasia Ltd, *Submission 9,* p. 5.

7.64 The submission suggested that this new category of a director could be named an 'associate director'.[78]

7.65 Reports into this issue have offered other reasons for family businesses only engaging the minimum amount of directors, separate to asset protection and the reduction in risk of liabilities. The MGI Australian Family and Private Business Survey 2010 stated that 'the main reasons provided for the lack of non-family, non-executive directors on the Board were: desire to retain privacy 52.5%...and skills required at Board level exist in-house 29.0%'[79].

7.66 Deloitte Private recommended a different approach to solve this issue—the creation of an advisory board. An advisory board would consist of a panel of external advisors who would aid directors. The advisors would not be considered directors, as they would not be entitled to vote on directors' resolutions, they would not receive directors' fees and they would hold only an advisory function. This would absolve the board of advisors of any liability.[80]

7.67 The duties of directors set out in the Corporations Act reflect the necessity of protecting investors.[81] It is expected that directors will uphold the highest of standards in the interests of investors and act with the degree of care and diligence that a reasonable person would exercise in their position.[82] The same standards apply for a director of a family business. In addition, a director owes fiduciary duties to their company. The director cannot have a conflict of interest and must act in the interest of the company.[83] After the Centro civil penalty case, the Australian Securities and Investments Commission (ASIC) explained that 'the role of a director is significant as their actions may have a profound effect on the community'.[84] Accordingly, ASIC has

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78 MGI Australasia Ltd, *Submission 9,* p. 5.

79 MGI Australasia Ltd, *From the dining room to the board room—Family business in focus: The MGI Australian Family and Private Business Survey 2010,* July 2010, p. 14.

80 Deloitte Private, *Submission 16,* p. 19.

81 *Corporations Act 2001,* Part 2D.1.

82 *Corporations Act 2001*, s180.

83 *Corporations Act 2001,* s182.

84 Australian Securities and Investments Commission, 'Decision in Centro civil penalty case', Media release 11-125MR, 27 June 2011, http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/11-125MR%20Decision%20in%20Centro%20civil%20penalty%20case?opendocument (accessed 19 February 2013)

also previously warned against directors heeding the advice of others without question.[85]

Committee view

7.68 As ASIC has recognised, directors are seen as the 'gatekeepers' of the Australian markets. [86] A director's duty is to act in the interest of the company, regardless of whether it is a public or family business. The committee notes that directors can be useful to family businesses in non-traditional ways, such as resolving family business conflicts.[87] Though family businesses will only tend to engage the minimum number of directors, those directors are responsible for ensuring the company functions in compliance with the Corporations Act.[88]

7.69 The committee believes there is no policy justification for the recommended change to add associate directors to the Corporations Act. A change such as the inclusion of associate directors could have unintended consequences in the broader Corporations Act, radically changing its framework while potentially affecting the general quality of directors' duties.

7.70 The suggestion for an advisory board for family business raises concerns for the committee. There is an inherent danger in directors relying uncritically on advisors, as the actions directors take can have a significant impact on shareholders, employees and the wider community. This danger was made evident by the Federal Court of Australia's decision in the Centro civil penalty case.[89]

7.71 The committee notes the hesitance of family businesses to engage more than the minimum number of directors. However, this uncertainty seems to be born of a discord between corporate and family values and a perceived need to keep the majority of the family business' decisions within the family, rather than a desire to

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85 Australian Securities and Investments Commission, 'Decision in Centro civil penalty case', Media release 11-125MR, 27 June 2011, http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/11-125MR%20Decision%20in%20Centro%20civil%20penalty%20case?opendocument (accessed 19 February 2013)

86 Australian Securities and Investments Commission, 'Decision in Centro Civil Penalty Case', Media release 11 – 125MR, 27 June 2011.

87 KPMG, *Stewards: Moving forward, moving onward – KPMG and Family Business Australia's Family Business Survey 2011,* 2011, p. 11.

88 Australian Securities and Investments Commission, *Your company and the law,* Information Sheet No. 79, http://www.asic.gov.au/asic/asic.nsf/byheadline/Your+company+and+the+law (accessed 19 February 2013).

89 Australian Securities and Investments Commission, 'Decision in Centro civil penalty case', Media release 11-125MR, 27 June 2011, http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/11-125MR%20Decision%20in%20Centro%20civil%20penalty%20case?opendocument (accessed 19 February 2013).

maintain a certain level of asset protection and to minimise the liability of the family business.

Recommendation 19

7.72 The committee recommends that the Australian Securities and Investments Commission consult with family businesses to gauge their understanding of the *Corporations Act 2001*, in particular directors' duties and liabilities, and work with Family Business Australia and other interested organisations that represent family businesses to disseminate information through education and training. Information could also be usefully provided in plain terms on the MoneySmart website.