

A few reflections on the current state of play for not-for-profit taxation arrangements

by Dale Pinto, CTA, David Gilchrist and Annette Morgan, CTA, Curtin University

Abstract: In its Budget handed down in May 2011, the federal government announced proposed new taxation arrangements covering the not-for-profit sector in Australia. The government explained that these arrangements were largely made in response to recent court cases pertaining to the taxation status of not-for-profit organisations (NFPs), with regard to trading income in particular. Currently, NFPs enjoy a range of tax concessions at the federal and state/territory level based on a relatively complex set of legislated and regulated arrangements. In utilising these concessions, NFPs can obtain a range of benefits for themselves and their employees. However, with the proposed new tax arrangements, these concessions can be at risk if NFPs do not understand the key changes and what they mean. In this article, the authors reflect on the current state of play in relation to not-for-profit tax arrangements and recent announcements by the government in relation to these concessions. In examining the government announcements, the article seeks to look to the future and take a preliminary view of the likely outcomes for NFPs.

Introduction

The governance, financial reporting and performance frameworks of not-for-profit organisations (NFPs) have been at the centre of debate in Australia for at least a decade. Arguably, the most recent spate of discussion flowed out of the establishment of the Productivity Commission's report into the contribution of the not-for-profit sector in Australia.¹ A number of reports before and since that report was published in 2010 have influenced the development of changes in the regulatory regimes affecting NFPs. The ensuing discussion has extended to encompass a number of topics and served to increase awareness in Australia of the sector's existence and various roles, and has also meant that the attention of the federal and state/territory governments has been piqued. Issues such as the legislative arrangements surrounding charitable collections, the establishment of the Standard Chart of Accounts and the Australian Charities and Not-for-profits Commission, and various other inter-related initiatives have, arguably, been the result of this ongoing discussion at the national level. The sole focus of this article relates to the income taxation arrangements applicable to NFPs which the federal government proposes to change. The government's proposed changes to the income tax arrangements for NFPs may well stem from both the recommendations of the Henry Review² and the *Word Investments Ltd* case³ and, given their

importance, this article shall consider both of these elements prior to considering the likely effects for NFPs. However, these changes should also be considered in the light of the broader regulatory changes taking place.

The current taxation arrangements are provided in summary terms in Table 1. Briefly reviewing this table, readers will note that the current arrangements are both complex and numerous. Those organisations included in this table are only the most common types. There are others that are affected but which are not discussed here because it would make the article somewhat unwieldy and would possibly detract from the central purpose of discussing the main issues for the most common types of NFPs. Table 1 has been extracted from the Henry Review² and illustrates the various NFPs and the tax concessions that are available to them, as well as the value of benefits provided.

Certain non-government NFPs are also eligible for the concessions described above.

This article is arranged in four sections. Section 2 will consider the likely trigger points for change in terms of the federal government's original 2011 Budget announcement and identify some of the causes and frameworks for this reform. Section 3 will provide a brief analysis in relation to these concessions, and section 4 will provide concluding remarks.

Trigger points for change

The NFP sector has been a focus of a number of national discussions over the last decade or so. Reports have been published relatively recently by the Senate Economics Committee, the Productivity Commission and the Industrial Commission. These reports have focused on governance, mission centricity, and regulatory and supervisory regimes for the sector. They have also sought to provide recommendations regarding nationalising and tightening the regulatory regime, as well as instituting a number of frameworks that have been established in other jurisdictions — most notably, the United Kingdom's Charities Commission. Additionally, a number of key issues have arisen over the last couple of years which have prompted the government to consider reforms to the NFP sector, or the "third sector" as it is sometimes called. Predominantly, these discussions have focused on matters other than taxation arrangements. However, taxation arrangements for NFPs have also come under scrutiny. For instance, the business sector has called on the government to provide a level playing field in relation to the benefits that can be provided by NFPs to their employees under the FBT regime, compared to those that the business sector can provide in the same commercial activities.

Seymour has outlined other areas of concern which may be adding to the

impetus to reform this sector. She notes that people may be discomforted by the ability of clubs to make large profits from poker machines which are then used to subsidise cheap meals and alcohol for their members (Seymour 2011).⁴ There may also be concerns regarding the use of donations for purposes other than charitable relief, such as political lobbying, in the light of the *Aid Watch* case.⁵ Finally, there are concerns regarding what can be considered reasonable costs for the running of a charity. That is, concerns regarding the extent to which charitable income (usually donated) is applied to the mission of the organisation rather than its administration.

More immediately, the key triggers for change in the taxation area were the recommendations made in the Henry Review and the High Court decision in the *Word Investments Ltd* case³ which examined the ability of NFPs to use tax concessions on commercial profits. The Henry Review was undertaken by the then Secretary of the Treasury, Mr Ken Henry.

Its result was a wide-ranging report that, in essence, was developed after a review of the Australian taxation arrangements and it made recommendations related to all facets of taxation administration in this country. Importantly, the report discussed the NFP sector and made recommendations that were widely considered. Indeed, the Henry Report states that: "The system of concessions is complex and does not appropriately reflect current community values about the merit and social worth of activities. The complexity of these concessions is exacerbated by the opaque and inconsistent regulatory arrangements for the NFP sector".⁶ In all, the report made four recommendations relevant to the NFP sector — described in the report as recommendations 41 to 44 which are briefly discussed below.

Recommendation 41 made by the review reinforced previous calls for the establishment of a national charities commission which would be empowered to monitor, regulate and provide advice

to NFPs. An appropriation for this Commission (now the Australian Charities and Not-for-profits Commission) was included in the 2011 federal Budget. Recommendation 43 suggested the removal of the concessions granted under the FBT legislation and replacing them with direct government funding. The review found that an unfair advantage was provided to NFPs as they could undertake commercial activities and could offer salary packages at a lower cost than could be offered by their direct for-profit competitors. Direct government funding would mean that NFPs would apply for funding for any specific projects or to assist with the cost of recruiting specialist staff. Interestingly, of the four recommendations made relevant to the NFP sector, this was the only recommendation not subsequently taken up by the federal government or at least developed further.

Recommendation 44 was in relation to the principle of mutuality for those NFPs whose income is generated mainly from the

Table 1: Main tax concessions for common types of NFPs

	Value (\$m) (2008-09)	Charities	Public benevolent institutions and health promotion charities	Deductible gift recipients	NFP and public hospitals, and public ambulance services
Income tax exemption	The value of the concessions cannot be quantified	Yes	Yes	–	Yes
GST concessions	The value of the concessions cannot be quantified	Yes	Yes	Yes	Charities only
FBT exemption (\$17,000)	260	–	–	–	Yes
FBT exemption (\$30,000)	715	–	Yes	–	–
FBT rebate	20	Charitable institutions only	–	–	–
Deductible gifts	1,090	–	Yes	Yes	Yes

The following are important points to note when reviewing Table 1:

- (1) entities may have more than one status (for example, a charity could also be a deductible gift recipient);
- (2) there are over 11,000 public benevolent institutions in Australia, including organisations such as Anglicare Australia Inc, Australian Federation of Disability Organisations Ltd, Australian Red Cross Society, Parents, Families and Friends of Lesbians and Gays Inc, Refugee Council of Australia Inc, and Society of St Vincent de Paul Pty Ltd;
- (3) many NFPs are taxable, but are entitled to special rules for calculating taxable income and lodging income tax returns, and they are able to access special rates of tax; and
- (4) income tax exempt entities that do not meet the broad definition of an NFP such as municipal corporations, local governing bodies, constitutionally protected funds and public authorities constituted under Australian law are not discussed in this section.

areas of gaming, catering, entertainment and hospitality, but exempt from income tax. The review considered that the income from those sources should be taxed at a concessional tax above a certain threshold. However, the tax position of smaller clubs would be mitigated by the introduction of a threshold, with exemptions for those with commercial activities at levels below the threshold not required to pay tax.

Importantly, from the point of view of the focus for this article, recommendation 42 suggested that categories of NFPs that currently receive income tax or GST concessions should retain these concessions. Not-for-profit organisations should be permitted to apply their income tax concessions to their commercial activities. This recommendation was put relatively simply but seems to run contrary to the subsequent arrangements proposed by the federal government in its 2011 Budget.

The government's response to the recommendations on 2 May 2010 was to reject making any changes to the tax system that might harm the NFP sector, including removing the benefit of tax concessions and changing income tax arrangements for clubs. Since the review, the government has acted more definitely as a result of the *Word* case.

The issue of charitable entities using tax concessions for engaging in commercial activities has always been a contentious issue in Australia. In essence, the ATO has considered that, if the purpose of an NFP is to carry on a commercial enterprise to generate surpluses, the purpose is not charitable and concessions should not be applicable.

However, NFPs were able to carry out such commercial activities to make profits where:

- the commercial activity was being carried out in a way that was charitable;
- the commercial operations were merely incidental to the carrying out of the charitable purpose; or
- it did so by charging fees for charitable services.

In recent times, the courts have had the opportunity to provide some clarification in this matter and the outcome of the *Word* case was stated to be particularly important in the ATO's decision to seek more substantial and definite arrangements.⁷ In this case, the taxpayer, Word Investments Ltd (*Word*), was set up

by members of Wycliffe Bible Translators Australia (*Wycliffe*) which was itself endorsed by the ATO as an income tax exempt charity. *Wycliffe* is a missionary organisation seeking to spread the Christian religion through translating the Bible for use in developing countries. *Word's* memorandum of association includes charitable objectives but also business-related objectives. Its sole activities involve accepting funds from the public for investment and carrying on a funeral services business, the profits being distributed to *Wycliffe* and other Christian organisations.

Word applied to the Commissioner for endorsement as being exempt from income tax on the grounds that it is a "charitable institution" under the *Income Tax Assessment Act 1997* (Cth) (ITAA97). The Commissioner rejected the application on the basis that *Word's* money-generating purposes were not incidental to the religious purposes, but instead were independent purposes. The taxpayer was successful in the first instance and this decision was affirmed on appeal to the Full Federal Court. The Commissioner was granted special leave to appeal to the High Court. The High Court upheld the earlier decision made by the Full Federal Court in a 4–1 majority that the business was not merely incidental or ancillary to *Word's* religious purpose. "Word endeavoured to make a profit, but only in aid of its charitable purposes", the majority of the judgment said. In essence, as a result of this case, the outcome for NFPs is that they can raise money through commercial activities and not be subject to a 30% tax rate so long as the acts of charity remain the motive for making the profit.⁸

Following this case, the ATO issued a draft ruling⁹ which updated its previous ruling following the *Word* decision. The draft ruling (subsequently finalised as TR 2011/4) provides the following view on the commercial activities of charitable organisations, stating:⁹

"An institution undertaking commercial or business-like activities can still be charitable if:

- the sole purpose of the institution is charitable and it carries on a commercial enterprise to generate surpluses in order to further that charitable purpose. For example, in *Word Investments* the High Court accepted that a company had the charitable purpose of advancing religion even though it carried on an investment business and a funeral business. The High Court concluded that the company

carried out its business activities to further its charitable purpose, rather than as an end in itself. The fact that the activities undertaken by the institution were not intrinsically charitable did not affect the characterisation of the institution as charitable;

- the commercial operations are merely incidental to the carrying out of the charitable purpose. Examples from the cases are a home for neglected boys that also provided training through its farm and the promotion of temperance through the running of a canteen;
- the activities undertaken by the institution are themselves intrinsically charitable but are being carried on in a way that is commercial. Examples from the cases are the preparation and sale of law reports, the manufacture and sale of animal vaccines, and providing cremations services; or
- the institution holds passive investments to receive a market return to further its charitable purposes."

This outcome was not in line with the expectations of government and the inclusion of the income tax changes in the 2011 federal Budget was as a direct result of the failure of this case. As such, the government responded to the High Court decision with its own agenda of reforms to ensure that NFPs will only receive tax concessions if profits made from commercial activities are given back to be used for charitable purposes. Indeed, the government made an election promise to reform Australia's NFP sector to deliver smarter regulations, reduce red tape, and improve the transparency and accountability of the sector. In relation to income tax, major reform commenced with the announcements made on Budget night and the release of a consultation paper, *Better targeting of non-for-profit tax concession*,⁶ a few weeks later.

The government announced in the 2011-12 Budget that it would adjust arrangements for the tax concessions provided to NFP entities to ensure that they are targeted only at those activities that directly further an NFP's altruistic purposes.¹⁰ The reforms are designed to ensure that income tax concessions will only apply to profits generated by the unrelated commercial activities of NFPs, if those profits are directed to the NFP's charitable purposes. Therefore, tax will be imposed on those commercial activity profits that are not directed back to the organisation, and the concessions granted under FBT, GST and deductible gift recipient status will also no longer be accessible. The new reforms

Celebrating 70 years

supporting the tax profession

Last month, we related the founding of the Institute in a special anniversary edition. This month, we look at the Institute's history during the booming 1950s and 1960s, as it begins to take the shape of the organisation we know today.

1950s

After a long period of depression and war, the 1950s marked the beginning of a period of economic strength. In Australia, the government and the country's tax landscape were largely stable and there were low levels of unemployment.

Things were looking up, and Australia was beginning to make an appearance on the world stage with a wave of European migration, the Queen's visit in 1954, and the Olympics held in Melbourne in 1956.

The Tax Institute was incorporated as a company limited by guarantee in the Australian Capital Territory on 15 July 1952, and by 1953, membership had grown to a respectable 1,275. The first membership committee was formed in 1953, along with the legislation and service committee, a publicity committee and a tax administration committee.

Since its inception, the Institute was actively involved in organising submissions to Treasury for the betterment of the tax system. In 1950, the Institute was invited to discuss with the newly formed Commonwealth Committee on Taxation any suggested amendments to the Commonwealth Income Tax Assessment Act.

Some of the Institute's suggestions were later adopted, including the merging into one levy of social services contribution and income tax, the reversion to a system of treating concessional allowances for dependants, medical, dental and optical expenses, life insurance premiums, rates on non-income-producing property and gifts, by way of a direct deduction from a taxpayer's assessable income (instead of by way of rebate as previously) and the replacement of the former closely

graduated scale of rates by a system of "stepped" rates applicable to various brackets of income.

Despite only occasional success, the valuable contributions and dedication by committee volunteers and tax experts meant that advocating for change to benefit the tax-paying public continued well into the 1950s and 1960s and beyond.

The 1950s also marked the expansion of the Institute's education offerings, with the first national convention held in Katoomba in 1954, with 47 attendees. Attendees participated in games of bowls, golf and tennis. The convention became an annual event, moving to Bowral in the late 1950s and 113 delegates attending by 1960.

1960s

As the 1960s began, the Liberal Party remained in government and made few changes to the tax system. Decimal currency was introduced in 1966 and the economy continued to boom, with the mining sector growing from the lifting of restrictions on iron ore exports.

Institute membership also continued to grow, reaching 2,000 members part way through the decade, and the first state conventions were held around the country.

The 1960s also marked the birth of *Taxation in Australia*, with the journal replacing traditional circulars and memorandums in September 1963. By the end of the decade, the journal was at 32 pages and featured news, reports of changes in tax legislation, and articles by some of the best and brightest in the profession — sound familiar?

QUEENSLAND PLATINUM JUBILEE CELEBRATIONS



VOICES FROM HISTORY



Sharyn Long is a Chartered Tax Adviser, and has been a member of the Institute for 27 years. A long-time presenter and volunteer at Tax Institute events, we sat down with Sharyn at the Perth national convention to talk about her memories of the Institute.

Sharyn Long, CTA, Managing Partner, Sharyn Long Chartered Accountants

What have some of the highlights of your time as a member been?

The first time I presented at the national convention in Melbourne years ago, it was the most people I had ever spoken to.

The launch of the education program that allows candidates to achieve their qualifications in tax — this was a great initiative and we have put a number of our staff through the program, with great results.

I've gained a number of long-standing loyal clients from my involvement with the Institute.

How has the Institute helped shaped the profession over the years?

I specialise in superannuation and, while this is now a mainstream area

for many accounting firms, that hasn't always been the case.

I've also given many presentations for the Institute, including at several national conventions, over the years — these forums have helped me to develop my technical knowledge, as well as my presentation skills.

Do you have a message for the Institute and its members on the 70th anniversary?

Without a doubt, the Institute has played a critical role in the development of tax professionals in Australia — congratulations on reaching 70.

were to commence on 1 July 2011 and to apply only to new unrelated commercial activities that commenced after 7.30 pm AEST on 10 May 2011. However, the federal government subsequently delayed their implementation until 1 July 2012, and in January 2013, announced a further delay for the commencement of the measures which will now apply from 1 July 2014. The stated reason for this further delay is to allow for further consultation and engagement with the sector, which is sensible, especially given the concerns that have been raised in relation to these proposals.

According to the government, the reasons behind these reforms are as follows:¹⁰

- to ensure that government assistance is directed to supporting the altruistic activities of NFPs;
- to ensure that the community assets of NFPs are protected from unnecessary commercial risks; and
- to ensure that there is a level playing field for all small, large and NFP businesses in Australia.

The government has stated that the reforms are not meant to affect NFPs carrying on small-scale or low-risk activities, such as school fetes or the truly Aussie fundraiser, the lamington drive.

Another important announcement in the 2011-12 Budget was the establishment of the Australian Charities and Not-for-profits Commission, which was intended to become operational on 1 July 2012. However, its establishment was then delayed until 1 October 2012. The Commission will initially be responsible for determining charitable, public benevolent institution and other NFP status for all Commonwealth purposes, providing education and support to the sector, implementing a “report-once, use-often” general reporting framework for charities, as well as establishing a public information portal by 1 July 2013.

As part of this NFP taxation and regulatory reform package, the government has implemented a statutory definition of “charity” with the passing of the *Charities Act 2013* in June 2013. The definition will take effect from 1 January 2014 and specifies that, to be a charity, an entity must:

- be not for profit;
- have charitable purposes; and
- the charitable purposes must be for the public benefit.

The proposed definition recognises that a charity may have incidental or ancillary purposes which are not charitable but which further the charitable purposes.

The Act lists categories of charitable purpose which include, among other things, advancing health and education and promoting and protecting human rights. There is presumption of public benefit for the purposes of relieving poverty, advancing education, advancing religion, and the relief of illness or the needs of the aged.

To date, there has been no such legislated definition, while the current definition has been based on common law. It is arguable that the need for a statutory definition of “charity” is long overdue, and the recent case *Bicycle Victoria Inc and FCT*,¹¹ heard in the Administrative Appeals Tribunal, showed just how complex our laws relating to determining charitable status have become. The case also illustrates the difficulty for taxpayers trying to implement the laws. In the case, the taxpayer attempted to be treated as:

- (1) a deductible gift recipient for the operation of a fund, an authority or an institution under s 30-120(a) ITAA97;
- (2) an income tax exempt charity under s 50-110 ITAA97;
- (3) a health promotion charity under s 123D of the *Fringe Benefits Tax Assessment Act 1986* (Cth); and
- (4) a charitable institution under s 176-1 of the *A New Tax System (Goods and Services Act) 1999* (Cth) (GSTA).

The Commissioner refused the application and the taxpayers appealed to the AAT. The AAT found that, for two of the applications, the applicant met the necessary requirements to be recognised as a charity. First, they were entitled to be endorsed as an income tax exempt charity under s 50-110 ITAA97 on the basis that *Bicycle Victoria Inc* is a charitable institution as described in s 50-5 ITAA97. Second, they were entitled to be endorsed as a charitable institution under s 176-1 GSTA. But, on the other hand, they were not accepted as being a charity for deductible gift recipient or health promotion charity purposes.

Once a statutory definition of charity is implemented within the legislation, there may be hope for greater clarity and certainty to enable the mitigation of issues like those in the abovementioned case.

Apart from the complexities of the law in this area, the government also seems

to be concerned with the identification and abuse of income tax exempt entities and deductible gift recipients, with the Assistant Treasurer, the Hon. Bill Shorten, releasing for public consultation an exposure draft of legislation titled “‘In Australia’ special conditions for tax concession entities”.¹²

The abstract states that:

- income tax exempt entities generally must be operated principally in Australia and for the broad benefit of the Australian community; and
- deductible gift recipients generally must be operated solely in Australia and for the broad benefit of the Australian community.”

The purpose of the legislation is described in the exposure draft as:

“Restating the ‘in Australia’ special conditions will provide support to the anti-avoidance measures in the tax law which limit income tax exempt entities expending money offshore and ensure tax supported funds remain in Australia.

The ‘in Australia’ special conditions provide additional measures to address possible abuse of not-for-profit entities for the purposes of money laundering and terrorist financing and ensure the proper operation of not-for-profit entities, their use of public donations and funds, and the protection of their assets.”

As the government has an intensive approach to the anti-avoidance measures in relation to other types of taxpayers (examples include its “Wickenby Project” and high wealth individuals program), it is not surprising that its focus on the third sector also takes into account anti-avoidance behaviour. At the same time, it is regrettable that some charities and NFPs are being set up and used for inappropriate reasons and are non-compliant taxpayers, rather than being for the charitable purpose of assisting those in need. Arguably, the actions of these organisations unfortunately make the legislation proposed by the government necessary, but it is those who do not abuse the system that generally are affected and incur the additional costs of complying.

Another noteworthy government proposal involved a Bill that was introduced by Senator Nick Xenophon in May 2010 (the *Tax Laws Amendment (Public Benefit Test) Bill 2010*), which was subsequently referred to a Senate inquiry and then lapsed at the end of parliament in September 2010. The purpose of the Bill was to amend the tax laws to require that religious and charitable institutions meet a public

benefit test to justify their exemption from taxation. This Bill was introduced by the Senator in response to claims that certain charities which received tax exempt status were abusing the concessions that were meant to be for those charities whose aims and activities are in the interests of the community and for the benefit of the public. Under this Bill, a public benefit test would be based on the following key principles:

- there must be an identifiable benefit arising from the aims and activities of an entity;
- the benefit must be balanced against any detriment or harm; and
- the benefit must be to the public or a significant section of the public, and not merely to individuals with a material connection to the entity.

This proposal is another example of the government's perceptions regarding the problems in this area and serves to highlight some remedies that have been considered.

Though the Public Benefit Test Bill 2010 did not eventually proceed, the statutory definition of a "charity" contained in

the *Charities Act 2013* includes a public benefit test. When applying this test, Australia could usefully draw on the experiences of the UK which has a Charity Commission with (as one of its main roles) the responsibility of administering the public benefit test to ensure that this test is applied in the way intended, that is, to target a small minority who might seek to abuse the NFP concessions available, rather than adversely affecting all charities.

Although these reforms seem to address the NFP sector as a whole, some of them target specific areas. It may be argued that the public benefit proposals introduced by Senator Xenophon appear to be focused on non-conservative types of cults and religions, while the measures proposed by the Assistant Treasurer's exposure draft legislation, "In Australia' special conditions for tax concession entities", address those who undertake money laundering or illegal activities. The July 2011 exposure draft on the new regulatory framework for public ancillary funds may arguably be seen to be ensuring that trustees act honestly. Against the background of these proposals, the question remains as to how these reforms

are affecting the thousands of other charities and NFPs that exist.

Analysis of the government's reforms

Chapter 2 of the *Better targeting of not-for-profit tax concessions* consultation paper⁶ sets out the government's policy intent for the reforms within the NFP sector. It is worthwhile to review these intentions and to consider whether they meet the criteria of a good tax system, namely, simplicity, neutrality, equity, efficiency and certainty.

The government's central intention can be summarised by the following paragraphs contained in point 2.1 of the paper:

"34 The reforms are intended to encourage altruistic entities to direct profits generated by unrelated commercial activities back to their altruistic purposes. The reforms will also ensure a level playing field between small, large and NFP commercial activities.

38 Income tax exempt entities will begin to pay income tax on profits from unrelated commercial activities that are not directed back to their altruistic purpose. The intent is to ensure that the focus of the entity remains the altruistic purpose, promoting efficient use of resources for altruistic purposes and lessening business risk to altruistic assets from unprofitable commercial activities."

There has been some commentary on the consultation paper since its release in May 2011. O'Flynn states that "[i]t foreshadows a significantly increased compliance burden for NFPs that undertake commercial activities, and there is a potential tax burden".¹³ This is because NFPs will now need to determine or seek advice on whether their activities are unrelated commercial activities, and this may be a time-consuming and costly exercise which many small NFPs will especially find difficult due to the lack of resources or funds needed to seek such advice.

Encouragingly, in the 2013-14 federal Budget, the forward estimates incorporate a small-scale threshold of \$250,000 of annual accounting revenue. Unrelated commercial activities under this threshold would be exempt from income tax under the measure. The threshold was the subject of public consultation in a discussion paper released in May 2011, and will also be subject to further public consultation.

Another problem with the government's intentions (as outlined in the paper) is that definitions and their overall policies are vague and this could create uncertainty



THE TAX INSTITUTE
THE MARK OF EXPERTISE

TAXLINE

TaxLine is a free research service provided to members of The Tax Institute.

The Tax Institute has one of the most extensive tax libraries in Australia. With TaxLine, you've not only got access to this unique collection of Australian and international tax material, but also to our expert team who will scour these wide-ranging and up-to-date resources to find the information you're after.

It's like having your own virtual research team.

0448P_07/13

Find out more at taxinstitute.com.au/member-centre/taxline

for the NFP sector. Many of the smaller organisations may not be able to correctly determine which of their activities could be regarded as being commercial and which non-commercial, as the scope of unrelated commercial activities has yet to be determined. Additionally, the identification of commercial profits is only the first step. There is no clarity as to when such profits need to be utilised in the mission-centric activities of the organisation. For instance, can the profits be applied the following year? Can you save year-on-year profits and apply them to a capital project some considerable time after they are generated?

establish new entities in order to undertake the commercial activities, and the associated costs of maintaining the entities for accounting, taxation and legal purposes. Uncertainty and complexity could also arise due to the proposed reforms. For example, current structures of NFPs may need to be reviewed and possibly restructured. New tax rules may need to be introduced and this in itself causes complexity in relation to the interpretation of legislation. O'Flynn's discussion paper also raises these concerns. He believes that the each of three options for taxing commercial

providing their much-needed services. The effect of the proposal might be to take money that is currently available for other services, or the imposition of higher taxes on other entities, to fund the extra costs of helping charities.

Sadiq and Richardson deal with issues raised by imposing tax reform on charities and other NFPs and the considered areas of a good tax system.¹⁵ They raise the point that there is an argument being put forward that charities are rorting the system, yet they are unable to find any concrete evidence of this and question the reasons for the reforms being proposed. They also address areas such as the perceived unfairness of the playing field between commercial sectors and the NFPs, and state that "any taxation policy limiting the availability of those concessions should be grounded in sound taxation policy pertaining to the fundamental principles of an ideal taxation regime rather than what could be considered principles of, for example, trade practices laws which are generally concerned with competitive behaviour".¹⁵

The authors agree with many of the comments made by Sadiq and Richardson and contend that the tax system should not be used as the lever to fix perceived problems unless, and only if, there is clear and conclusive evidence that a problem exists. As one of the government's main roles is to maintain a fair, equitable, simple and efficient tax system, this can be jeopardised by constantly using the tax system to overcome issues that the government considers needs attention.

Finally, a recent survey (the Not-for-profit tax concession survey 2013) by accounting firm BDO highlighted three concerns that NFPs still have with the proposed changes:

- any proposals to lift the deductibility threshold of donations from \$2 to \$25 as has been proposed would cause problems for many NFPs, as more than 25% of all donations received by NFPs surveyed were under \$25;
- proposed changes to the FBT concessions which apply to NFPs would likely have significant implications for NFPs to compete with the private sector for talented staff; and
- any changes to the franking credit rules to limit refundable franking credits being received by NFPs would also likely have a detrimental impact on their operations.

“One thing is for sure: time will tell whether the proposed changes will have their desired policy effect.”

The changes could cause similar problems even for large NFPs, such as universities. It is uncertain whether the activities of university bookshops, research centres, childcare centres and clinics would fall within the ambit of the rules. In a submission made on behalf of 15 universities, Ernst & Young said that a move to deny deductible gift recipient status to any university-related entity would be "draconian and inequitable".¹⁴

The options outlined in the paper for the taxing of commercial activities are:

- option 1 – unrelated commercial activities could be undertaken through a separate entity which would be taxed equivalently to other commercial entities in Australia;
- option 2 – unrelated commercial activities could be undertaken by a separate entity, and profits retained in the entity at the end of the year would be taxed; or
- option 3 – NFP entities could undertake related activities within the NFP entity.

Unfortunately, all three methods bring uncertainty, complexity and increased costs for NFPs and this means that proposals arguably do not comport with the principles of a good tax system (as noted above). There may be increased costs due to the perceived need to

activities will create different problems, but the general consensus is that they are all complex, will be costly and will ensure difficulty both in terms of administration and interpretation.

The government also needs to consider whether the reforms will result in equity for all concerned. The government argues that it is attempting to fix the uneven playing field that now exists between the commercial sector and the NFP sector, in order to allow everyone to be treated equitably under the tax system (that is, to pay tax on commercial activities and restrict the FBT concessions available to employees of the NFP sector). There may also be some unintended "swings and roundabouts" that need consideration. For example, if these reforms are passed and the NFP sector loses the right to use tax concessions, having to pay income tax, the government will have collected revenue on the one hand, but on the other will need to provide more funding to the NFP sector to allow the entities to continue to provide their services to those who need them. It may well be that the funding required will far outweigh the revenue collected, given the cost of collection and policing. So this raises the issue of whether the proposals are fair and equitable to all of Australia, when many may be satisfied with how the system already works now, with NFPs effectively funding their own activities and

Conclusion

It is becoming increasingly clear that the government is determined to reform NFP tax concessions by “better targeting” them as outlined in their consultation paper.

The then Assistant Treasurer, the Hon. Bill Shorten, said in his media release dated 27 May 2011 that:¹⁰

“By better targeting tax concessions in the not-for-profit sector, the government is encouraging charities to direct profits generated by unrelated commercial activities back to their charity’s altruistic purposes.”

Others may argue that this reform was only introduced to close a perceived loophole created by the *Word* case and that, rather than encouraging NFPs to return profits from commercial activities to their charitable ones, the government is actually forcing them to do so, as the tax concessions they receive actually assist them in offering their services to the Australian community and, without these concessions, they may not be able to exist. It is a delicate balance that the government must seek to find in this important sector.

The last 12 months have seen many discussions on the third sector, with the government releasing the Henry Review, the Productivity Commission’s report on the contributions made by the not-for-profit sector, the Senate Economics Committee’s Tax Laws Amendment (Public Benefit Test) Bill 2010, the High Court’s decision in *Aid/Watch*, as well as other cases (including *Word* and *Bicycles Victoria Inc*), and the Treasury’s *Scoping study for a national not-for-profit regulator*.¹⁶ Given the plethora of papers, it would not be wrong to say that the NFP sector is a focal point for the government and that many changes are looming for them once legislation is passed. The main players in the sector need to start preparing themselves for these changes, and those on the fringes who provide legal, accounting and taxation advice also need to keep a close eye on these reforms and discussions and be prepared for when the charities and NFPs start knocking on their doors, looking for advice.

Unfortunately, some of the entities that will be affected by these reforms will be the smaller charities and NFPs which do not have the same financial capacity as larger organisations and thus will rely heavily on the willingness of professionals to assist them on a voluntary basis. As many of the voluntary providers are local accountants or lawyers who may not be experts on

the tax requirements that affect NFPs, the government must ensure that any reforms are widely publicised and that education programs are put in place for both the NFPs at all levels and the professional advisers.

At the time of writing this article, none of the announced government taxation reforms were enshrined in legislation, though subsequently some of the measures have been enacted. The majority of the reforms have been put out for public consultation and it is of utmost importance that the major stakeholders in the NFP sector continue to have their say on how these reforms will affect them and their operations, so that the government has a clear understanding of the practical issues that many NFPs will face when these measures take effect.

An area of concern could be that many smaller players in this sector will not be heard, and yet these reforms will cause them more problems rather than easing the pressures that they have now. It will also be interesting to see whether those who offer their services to these smaller organisations for little or no cost will remain so charitably inclined, given the seemingly more complex issues that will arise with these reforms.

The government has stated that it wants to encourage the act of giving (donations) by the Australian community to those who can use the funds to help people in need, but if the reforms are introduced without taking into account the smaller charities and NFPs, they just might find that there are a lot less charities and organisations around to provide the much-needed support. The ultimate losers in all this may be the people who require the assistance of those organisations.

One thing is for sure: time will tell whether the proposed changes will have their desired policy effect. What is clear enough from recent dialogue on this, including the findings of the Not-for-profit tax concession survey 2013, is that any reforms should be meaningful and not just undertaken for the sake of reform.

Professor Dale Pinto, CTA
Curtin Law School
Curtin University

Fellow
Taxation Law and Policy Research Institute
Monash University

Professor David Gilchrist
School of Accounting
Curtin University

Annette Morgan, CTA
Curtin Law School
Curtin University

References

- 1 Commonwealth of Australia, *Contribution of the not-for-profit sector*, Productivity Commission research report, January 2010.
- 2 Commonwealth of Australia, *Australia’s future tax system: report to the Treasurer*, Part one: overview, December 2009, at 44 (the Henry Review).
- 3 *FCT v Word Investments Ltd* 2008 ATC ¶120-072.
- 4 E Seymour, *Re-thinking regulation of the charitable sector in Australia*, The Australian Law Teachers Association Conference, Brisbane, July 2011.
- 5 *Aid/Watch Incorporated v FCT* [2010] HCA 42.
- 6 Commonwealth of Australia, *Better targeting of not-for-profit tax concessions*, consultation paper, 27 May 2011.
- 7 T Dyson, *Tax exemptions and concessions for mutuals, charities and other non-profit bodies*, The Tax Institute’s 25th National Convention, Melbourne, March 2010.
- 8 J Mather, “Sidelines come under ATO gaze”, *Australian Financial Review*, 30 May 2011.
- 9 Australian Taxation Office, TR 2011/D2, 11 May 2011.
- 10 B Shorten, *Next stage for not-for-profit reforms announced*, press release, no. 083, 10 May 2011.
- 11 *Bicycle Victoria Inc and FCT* [2011] AATA 444.
- 12 Assistant Treasurer, *‘In Australia’ special conditions for tax concession entities*, exposure draft, 2011.
- 13 S O’Flynn, “The Budget’s not-for-profit changes: a start, but there are issues”, pt 1, 24, *Thomson Reuters Weekly Tax Bulletin*, para 886.
- 14 J Mather, “Fears grow over shake-up of tax on donations”, *Australian Financial Review*, 22 August 2011.
- 15 K Sadiq and C Richardson, “Tax concessions for charities: competitive neutrality, the tax base and ‘public goods’ choice”, *Australian Tax Forum*, vol 25(4), p 113.
- 16 Australian Treasury, *Scoping study for a national not-for-profit regulator*, January 2011. Available from www.treasury.gov.au.