
The Current State of Play Relating to Not-for-profit Tax Concessions in Australia and a Glimpse of What May Lie Ahead for These Concessions

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Abstract

There are an estimated 600 000 not-for-profit organisations in Australia, contributing around \$43 billion to GDP per annum and employing close to 1 million people. They provide a range of assistance within the community and rely heavily on the government and community support to help fund their activities.

The paper examines the concessions which are available under the Australian taxation regime for not-for-profit organisations ('NFPOs'). All businesses engaged either directly or indirectly with these organisations should have an understanding of the concessions that are available. As a result of utilising these concessions there can be significant tax savings and the ability to offer attractive salary packages to employees of these organisations. As well as examining the current state of play, this article will also discuss recent announcements by the government in relation to the commercial activities of NFPOs and their ability to access these concessions. In examining the government announcements, the paper will seek to look to the future and take a preliminary view of what really lies ahead for the many not-for-profit organisations in light the new regime for a better targeting of not-for-profit tax concessions that is being planned by the government following the 2011 Federal Budget and the subsequent release on 27 May 2011 of its Consultation Paper on this issue.

Introduction

In Australia, approximately 600 000 not-for-profit organisations ('NFPOs') employ almost 1 million people and contribute around \$43 billion to GDP per annum.¹ Many of these organisations provide a variety of assistance to those within the community who need help. They rely heavily on government and community support to help fund their activities. One of the main forms of government support is tax concessions.

The following table extracted from the Henry Report² illustrates the various NFPOs and the tax concessions that are available to them as well as the value of benefits provided:

¹ The Hon Bill Shorten MP, 'Passing Round The Hat For Change: This Labor Government And The Not-For-Profit Sector' (Speech delivered at the National Press Club, Canberra, 27 May 2011).

² Commonwealth, *Australia's Future Tax System: Report to the Treasurer, December 2009: Part One - Overview* (2009) 44. The table was based upon information drawn from: Australian Taxation Office (2007), *Tax Basics for Non-Profit Organisations: An Overview of Tax Issues Relating to Non-Profit Organisations Including Charities, Clubs, Societies and Organisations* (NAT 7966-05.2007, Canberra) <<http://www.ato.gov.au/content/downloads/NPO33609n7966.pdf>>; The Treasury (2008) *Tax Expenditures Statement 2008*, Commonwealth of Australia, Canberra.

Table 5.2: Main Tax Concessions for Major Types of NFPOs (a)

	Value (\$m) (2008-09)	Charities	Public benevolent institutions (b) and health promotion charities	Deductible gift recipients	NFP and public hospitals, and public ambulance services
Income tax exemption (c)(d)	*	Yes	Yes	-	Yes
GST concessions	*	Yes	Yes	Yes	Charities only
FBT exemption (\$17,000)	260	-	-	-	Yes
FBT exemption (\$30,000)	715	-	Yes	-	-
FBT rebate (e)	20	Charitable institutions only	-	-	-
Deductible gifts	1,090	-	Yes	Yes	Yes

- a) Entities may have more than one status (for example, a charity could also be a deductible gift recipient).
- b) 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.
- c) Many NFPOs are taxable, but are entitled to special rules for calculating taxable income and lodging income tax returns and are able to access special rates of tax.
- d) Income tax exempt entities that do not meet the broad definition of an NFPO such as municipal corporations, local governing bodies, constitutionally protected funds and public authorities constituted under Australian law are not discussed in this section.
- e) Certain non-government NFPOs are eligible for this concession.

* The value of the concession cannot be quantified.

The following sections will briefly review the concessions and the requirements necessary to be considered an NFPO for taxation purposes. The paper will then consider what the future might hold for NFPOs after the recent announcements in the 2011/12 Federal Budget and the subsequent release of a consultation paper by the government aimed at better targeting of NFPO tax concessions.³ The government’s new position may stem from both the recommendations of the Henry Review and the *Word Investments Ltd Case*.⁴

³ Commonwealth, *Better targeting of not-for-profit tax concessions*, Consultation Paper, 27 May 2011.

⁴*FACT v Word Investments Limited* 2008 ATC 20-072 (‘*Word Investments*’).

Types of NFPOs for Tax Purposes

There are various types of NFPOs but the main ones that benefit from the tax concessions are summarised below.⁵

Charity

According to the Australian Taxation Office (‘ATO’), a charity has the following characteristics:

- It is an entity that is also a trust fund or an institution;
- It exists for the public benefit or relief of poverty;
- Its purposes are charitable ...;

⁵ Australian Taxation Office, above n 2. What follows on this point is based on this source.

- It is non-profit;
- Its sole purpose is charitable.

Purposes will be considered charitable if they benefit the community or a section of it through various activities such as relief of poverty, sickness or the needs of the aged, the advancement of education, and the advancement of religion, to name a few.

Charitable Institution

A charitable institution is an institution that has the advancement or promotion of a charitable cause as its sole purpose..

Public Benevolent Institutions ('PBIs')

PBIs are non-profit institutions aimed at delivering direct relief in cases of poverty, sickness, suffering, distress, misfortune, disability or helplessness. The ATO cites the following characteristics of a PBI:

- It is set up for needs that require benevolent relief;
- It relieves those needs by directly providing services to people suffering them;
- It is carried on for the public benefit;
- It is non-profit;
- It is an institution;
- Its dominant purpose is providing benevolent relief.

Health Promotion Charity

Health promotion charities are non-profit charitable institutions whose principal activities consist of promoting the prevention or control of human diseases.

Charitable Fund

A charitable fund is established under an instrument of trust or a will in order to carry out a charitable purpose.

Income tax exempt funds

An income tax exempt fund is a non-charitable fund endorsed by the ATO so that it can access income tax

exemption. These funds are established to provide money, property or benefits to income tax exempt deductible gift recipients ('DGRs'), or in order to establish DGRs.

Other non-profit organisations

Other non-profit organisations include sporting clubs, community services groups and recreational clubs. The ATO accepts an organisation as non-profit if its constitution or governing documents prevent the distribution of profits or assets in a way that would benefit of members, either while the organisation is operating or on its winding up.

Concessions⁶

Concessions fall into four main areas of taxation. In order to access concessions, all DGRs, income tax exempt funds and charities must be endorsed, and all other NFPOs can self-assess their eligibility.

Income Tax

Income tax exemptions are provided to NFPOs whose purposes are broadly beneficial to the wider Australian community. Most NFPOs require endorsement.

Subdivision 50-A of the *Income Tax Assessment Act 1997* ('ITAA 97') lists various income tax exempt entities, and the legislation basically states that 'the ordinary income and statutory income is exempt from income tax'.

Non-exempt NFPOs do not pay income tax on the first \$416 of taxable income but are liable for any amounts that exceed this threshold. This concession is to ensure that small NFPOs do not incur extra costs when having to deal with managing their tax affairs.

Refunds of franking credits are also available to endorsed income tax exempt entities and DGRs where

⁶ Productivity Commission, *Contribution of the Not-for-Profit Sector*, Research Report (2010). What follows is based on this source.

they meet the necessary criteria, the main criterion being that they have an Australian Business Number ('ABN').

GST

NFPOs have a higher registration threshold than other enterprises, this being \$150,000 compared to \$75,000. They may choose to register if their turnover is less than the compulsory threshold in order to claim GST back on incurred expenditures, but they will also need to charge GST on any supplies they make.

Donations to NFPOs which are voluntary and have no material benefit are not subject to GST.

Charities and DGRs receive many GST concessions including the ability to make GST-free supplies under certain circumstances, including the sale of second hand goods and the ability to treat some fundraising events as input-taxed.

FBT

Sections 57A and 65J of the *Fringe Benefits Tax Assessment Act 1986* ('FBTAA 86') provide for FBT concessions available to certain NFPOs. Public benevolent institutions ('PBIs') and health promotion charities are provided with a \$30,000 capped FBT exemption per employee and public and NFP hospitals are eligible for an exemption of \$17,000 per employee. Other endorsed charities are entitled to have their FBT liability reduced by a rebate of 48% of the gross FBT payable, subject to the capping rules.

Deductible Gifts

Deductible gift recipients ('DGRs') are entitled to receive income tax deductible gifts. DGRs are either endorsed by the ATO or listed by name in the legislation.

The ATO cites the following as the characteristics of a gift:⁷

- There is a transfer of money or property;
- The transfer is made voluntarily;
- The transfer arises by way of benefaction;
- No material benefit is received by the donor.

Because NFPOs rely heavily on community support via donations, the ability to claim a tax deduction greatly increases the likelihood of the community support for the NFPOs. In the ten years to 2007-08, donations claimed by individuals increased by an average annual rate of 14.4% to reach \$2.34 billion. This resulted in a \$810 million reduction in tax revenues.⁸

Trigger Points for Change

A number of key issues have arisen over the last couple of years which have prompted the government consider reforms to the NFPO sector, or the 'third sector' as it is sometimes called.

The business sector has called upon the government to provide an even playing field in relation to the benefits that can be provided by NFPOs to their employees under the FBT regime, compared to those that the business sector can provide in the same commercial activities.

Seymour⁹ has recently outlined other areas of concern which may be adding to the impetus to reform charities and the NFPO sector. She notes that people may be discomfited by the ability of clubs to make large profits from poker machines¹⁰ which are then used to subsidise

⁷ Australian Tax Office, above n 2, 30.

⁸ Ibid 1.

⁹ Elen Seymour, 'Re-thinking Regulation of the Charitable Sector in Australia' (Paper presented at the Australian Law Teachers Association (ALTA) Conference, Brisbane, July 2011).

¹⁰ It should be noted that poker machines in Western Australia are principally limited to the Burswood Casino and are not as widespread as they are in other states of Australia.

cheap meals and alcohol for their members. 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.¹¹ And finally, there are concerns regarding what can be considered reasonable costs for the running of a charity.

Other key points were the recommendations made in the Henry Review and the recent High Court decision in *Word Investments Ltd* on the ability of NFPOs to use tax concessions on commercial profits.

Both of these areas are discussed in the following section, and comments regarding other trigger points will be discussed in more detail later under the heading of Government Reform.

Henry Review Recommendations Relating to NFPOs

The Henry Review 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 section.’¹²

Among its recommendations, the Review suggested the establishment of a national charities commission which would be empowered to monitor, regulate and provide advice to not-for-profit organisations.

Another recommendation included removing the concessions granted under the FBT legislation and replacing them with direct government funding. The Review found that an unfair advantage was provided to NFPOs who could undertake commercial activities and could offer salary packages at a lower cost than could be offered by their direct competitors. Direct government funding would mean that NFPOs would apply for

funding for any specific projects or to assist with the cost of recruiting specialist staff.

The final recommendation was in relation to the principal of mutuality for those NFPOs whose income is generated mainly from the 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.

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 not-for-profit sector, including removing the benefit of tax concessions and changing income tax arrangements for clubs. The government did not accept or reject the recommendation to remove the income tax and GST concessions against the commercial income of the organisation.

Since the review, the government has acted on some of these recommendations in a more direct way.

Word Investment Ltd Case

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

However, NFPOs were able to carry out 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.

¹¹ *Aid/Watch Incorporated v Commissioner of Taxation* [2010] HC 42.

¹² Commonwealth, above n 2, 43.

In recent times the courts have had the opportunity to provide some clarification in this matter. The following is a summary of the *Word Investments Ltd* case.¹³

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 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*. The Commissioner rejected the application on the basis that Word's money generating purposes were not incidental to the religious purposes, but were instead independent purposes. The taxpayer was successful at 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 judgment said. The outcome for NFPOs 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.¹⁴

The ATO recently issued a draft ruling¹⁵ which updates its previous ruling following the *Word Investments Ltd* decision. The draft ruling provides the following view on the commercial activities of charitable organisations, stating:¹⁶

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 Ltd* 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 purposes, rather than as an end in itself. The fact that the activities undertaken by the institution were not intrinsically charitable and 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 cases are the preparation and sale of law reports, the manufacture and sale of animal vaccines, and provided cremations services; or

The institution holds passive investments to receive a market return to further its charitable purposes.

Again the government has responded to the High Court decision with its own agenda of reforms to ensure that

¹³ See Teresa Dyson, 'Tax Exemptions and Concessions for Mutuals, Charities and Other Non-Profit Bodies' (Paper presented at the 25th National Convention TIA National Divisions, Melbourne, March 2010). What follows on this point is based on this source.

¹⁴ Joanna Mather, 'Sidelines Come Under ATO Gaze', *Education, Australian Financial Review* (Melbourne), 30 May 2011.

¹⁵ Australian Taxation Office, *Draft Taxation Ruling: Income Tax and Fringe Benefits Tax*, TR 2011/D2, 11 May 2011.

¹⁶ *Ibid* 12.

NFPOs will only receive tax concessions if profits made from commercial activities are given back to be used for the charitable purposes. These reforms will now be examined.

Government Reform

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, and they have now started to deliver on that promise. Major reform commenced with the announcements made on Budget night and the release of a consultation paper on 'Better targeting of non-for-profit tax concession'¹⁷ a few weeks later.

The government announced in the 2011-12 Budget that it will reform the tax concessions provided to NFP entities to ensure they are targeted only at those activities that directly further an NFPO's altruistic purposes.¹⁸ The reforms are designed to ensure that income tax concessions will only apply to profits generated by the unrelated commercial activities of NFPOs, if they are directed to the NFPO'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 DGR will no longer be accessible. The new reforms, if passed into law, will commence on 1 July 2011 and will apply at this stage only to new unrelated commercial activities that commenced after 7.30 pm (AEST) on 10 May 2011.

The reasons behind these reforms are as follows:¹⁹

- Government assistance is directed to supporting the altruistic activities of NFPOs;
- The community assets of NFPOs are protected from unnecessary commercial risks; and

- 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 NFPOs 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 will become operational on 1 July 2012. The Commission will initially be responsible for determining charitable, PBI 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, and establishing a public information portal by 1 July 2013.

As part of the NFP reform package, the government also intends to implement a statutory definition of 'charity' to take effect from 1 July 2013. To date there has been no such definition, and 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*,²⁰ heard in the Administrative Appeals Tribunal (AAT), 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:

- a) A DGR for the operation of a fund, authority or institution under s 30-120(a) of the *ITAA 1997*;
- b) An income tax exempt charity under s 50-110 of the *ITAA 1997*;

¹⁷ Ibid 2.

¹⁸ Bill Shorten, 'Next Stage for Not-For-Profit Reforms Announced' (Press Release, No. 083, 10 May 2011).

¹⁹ Ibid 2.

²⁰ *Bicycle Victoria Inc and FCT* AAT Case (2011) AATA 444.

- c) A health promotion charity under s 123D of the *FBTAA*;
- d) A charitable institution under s 176-1 of the *New Tax System (Goods and Services Act) 1999 (Cth) ('GST Act')*.

The Commissioner refused the application and the taxpayers appealed to the AAT. The AAT found that for two of the applications they did indeed meet the necessary requirements to be recognised as a charity. Firstly, they were entitled to be endorsed as an income tax exempt charity under s 50-110 of the *ITAA 1997* on the basis that Bicycle Victoria Inc. is a charitable institution as described in s 50-5 of the *ITAA 1997*. Secondly, they were entitled to be endorsed as a charitable institution under s 176-1 of the *GST Act*. But on the other hand they were not accepted as being a charity for DGR or health promotion charity purposes.

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

Apart from the complexities of the laws in this area, the government also seems to be concerned with the location and abuse of income tax exempt entities and DGR, with The Assistant Treasurer, Bill Shorten, releasing for public consultation an exposure draft of legislation titled “‘In Australia’ Special Conditions for Tax Concession Entities”.²¹

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 being their Wickenby Project and High Wealth Individuals program,²² it is not surprising that their focus on the third sector also takes into account anti-avoidance behaviour. At the same time, it is regrettable that some charities and NFPOs 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. 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 additional costs of complying.

Another noteworthy government proposal involved a Bill that was introduced by Senator N Xenophon in May 2010, the Tax Laws Amendment (Public Benefit Test) Bill 2010,²³ which was subsequently referred to a Senate inquiry. 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

²¹ Assistant Treasurer, *Exposure Draft ‘In Australia’ Special Conditions for Tax Concession Entities*, 2011.

²² Details of these programs are available from the ATO website <<http://www.ato.gov.au>>.

²³ Tax Laws Amendment (Public Benefit Test) Bill 2010.

response to claims that certain charities who 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 upon 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.

Although this Bill has not passed into law at the time of writing it is another example of the government's perceptions regarding the problems in this area that need to be remedied. Australia could draw upon the experiences of the United Kingdom, which has a Charity Commission with as one of its main roles the responsibility of administering the public benefit test. However, it might still be the case that the introduction of such changes to target a small minority perceived to be abusing the concessions awarded to them will in turn affect all charities.

More recently, the Assistant Treasurer, the Hon Bill Shorten, released an exposure draft of legislation and draft guidelines²⁴ for a new regulatory framework for public ancillary funds. According to the Gillard government, reform is needed to improve governance and accountability relating to these funds, and to bring them into line with private ancillary funds.

Under the reforms the Treasurer will have the power to make legislative guidelines to establish and maintain

public ancillary funds. The Commissioner of Taxation will also have the power to impose administrative penalties on trustees who fail to comply with the guidelines and to remove or suspend trustees or non-complying funds. This could become part of the role of the new Australian Charities and Not-for-Profit Commission when it is established.

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 Nick Xenophon appear to be focused on non-conservative types of cults and religions, while the measures proposed by the Assistant Treasurer's exposure draft of 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 NFPOs that exist.

The authors accept that the introduction of the new Australian Charities and Not-for-Profits Commission and a statutory definition of charities will be of benefit to the sector. But given that the introduction dates are not in the near future, there is some uncertainty in the current environment.

Analysis of the Government's Reforms

Chapter 2 of the 'Better Targeting of Not-for-Profit Tax Concessions' Consultation Paper²⁵ 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.

²⁴ Bill Shorten, 'Changes to the way Philanthropic Funds are Managed' (Press Release, No. 113, 14 July 2011).

²⁵ Commonwealth, above n 3.

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'Flynn²⁶ states that: 'It foreshadows a significantly increased compliance burden for NFPs that undertake commercial activities, and there is a potential tax burden.'

This is because not-for-profit entities 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.

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 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.

The changes could cause similar problems even for large not-for-profit organisations such as universities. It is uncertain whether the activities of university bookshops, research centres, childcare centres and clinics would fall within the ambit of proposed rules. In a submission made on behalf of 15 universities, Ernst & Young said a move to deny DGR status to any university-related entity would be 'draconian and inequitable.'²⁷

The options outlined in the paper for 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 NFPOs and this means that proposals arguably do not comport with the principles of a good tax system as noted above. There will conceivably be increased costs due to the need to 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 NFPOs may need to be reviewed and possibly restructured. New tax rules may need to be introduced and this in itself causes complexity issues in relation to how to interpret the legislation.

²⁶ Stephen O'Flynn, 'The Budget's Not-for-Profit Changes: A Start, But There Are Issues – Part 1' (2011) 24 *Thomson Reuters Weekly Tax Bulletin* para 886.

²⁷ As cited in Joanna Mather, 'Fears Grow Over Shake-up of Tax on Donations', *Education, Australian Financial Review* (Melbourne), 22 August 2011, 27.

O'Flynn's discussion paper raises the same concerns as noted above. He believes that each of three options for taxing the commercial activities will create different problems, but the general consensus is that they are all complex, will be costly and will give difficulties 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 taxation system (that is, to pay tax on commercial activities and restrict the FBT concessions available to employees of the NFP sector). But at the end of the day, if these reforms are passed and the NFP sector lose the right to use tax concession and have to pay income tax, the government will have on the one hand collected revenue, 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 suggested that the funding required will far outweigh the revenue collected. So this raises the issue of whether the proposals are fair and equitable to all Australia, when many may be satisfied with how the system already works now, with NFPOs effectively funding their own activities and providing their much-needed services. The effect of the proposal might be to take money available for other services, or even impose higher taxes on other entities to fund the extra costs of helping charities.

A paper written by Sadiq and Richardson²⁸ deals with issues raised by imposing tax reform on charities and other NFPOs and the considered areas of a good tax system. They raise the point that there is an argument being put forward that charities are rorting the system,

²⁸ Kerrie Sadiq and Catherine Richardson, 'Tax Concessions for Charities: Competitive Neutrality, the Tax Base and "Public Goods" Choice' (2010) 25(4) *Australian Tax Forum* 113.

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 NFPOs, 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.'²⁹

The authors agree with many of the comments made by Sadiq and Richardson and contend that the taxation system should not be used as the tinkering mechanism to fix the 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.

Conclusions

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 Assistant Treasurer, the Hon Bill Shorten, said in his Media Release dated 27 May 2011 that: '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'.³⁰

Others may argue that this reform was only introduced to close a perceived loophole created by *Word Investments Ltd* and that rather than encouraging NFPOs to return profits from commercial activities to their charitable ones, the government is actually forcing

²⁹ Ibid 114.

³⁰ Shorten, above n 16, 1.

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 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 Investment Ltd* and *Bicycles Victoria Inc*, the Attorney General's discussion paper on improving the integrity of public ancillary funds and the Treasury's 'Scoping Study for a National Not-for-Profit Regulator'.³¹ 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 NFPOs start knocking on their doors, looking for advice.

Unfortunately some of those entities that will be affected by these reforms will be the smaller charities and not-for-profit organisations 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 taxation requirements that affect NFPOs, the government must ensure that any reforms are widely publicised and that education

programs are put in place for both the NFPOs at all levels and the professional advisors.

At the time of writing this article, nothing discussed above in relation to government reforms has been enshrined in legislation and therefore we cannot say with 100% certainty that all of the proposed measures will be forthcoming for the NFP sector. 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 have their say on how these reforms will affect them and their operations, as it is easier to make amendments to proposed laws rather than trying to amend them once they are legislated. Once reforms are legislated, it may be that governments move onto their next projects and are reluctant to give up their time to fix inadequate laws.

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 they have now. It will also be interesting to see whether the 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 Gillard government states 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 NFPOs 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. In the meantime, and in light of the current Federal

³¹ Australian Treasury, *Scoping Study for a Not-for-Profit Regulator*, January 2011, available from <<http://www.treasury.gov.au>>.

government composition, the passing of legislation for any changes in this area will undoubtedly not be all smooth sailing.