THE TAX INSTITUTE

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Dear Sir/Madam

Consultation Paper: Better targeting of not-for-profit tax concessions

The Tax Institute is pleased to provide our submission in response to Treasury's Consultation Paper entitled "Better targeting of not-for-profit tax concessions" ("**Consultation Paper**"), and thank you for the extension of time granted to us within which to lodge this submission.

We note that The Tax Institute makes the following submission on behalf of our members in the tax profession, as Australia's leading professional association in tax. In the interests of full disclosure, we note that while The Tax Institute is also registered as a charitable institution under item 1.1 of section 50-5 of the *Income Tax Assessment Act 1997*, we do not make this submission in that capacity.

The Tax Institute supports the Government's policy underpinning the Budget announcement that was the impetus for this Consultation Paper. As tax concessions for not-for-profit entities ("**NFPs**") are effectively subsidised by other taxpayers, the better targeting of these concessions is welcomed by NFPs, as well as the balance of our members and the wider tax community.

Our submission below sets out the broad parameters along which, in our view, the proposed policy change should be implemented. While we support the Government's policy aims, we urge Treasury to take into consideration the compliance burden that will be imposed by the implementation of this policy on those NFPs that are not in breach of the spirit of either the current or proposed laws.

The overwhelming majority of NFPs are conscientious in their efforts to comply with the letter and spirit of the laws bestowing the NFP concessions, and already invest considerable resources in their compliance efforts. As such, it is essential that any further policy changes not impose any greater compliance burden than absolutely necessary so that NFPs are able to direct as much of their scarce resources towards their altruistic activities as possible, rather than towards compliance activities.

Our submission does not address all of the questions posed in the Consultation Paper. However, where specific questions are addressed, we have noted the relevant question for ease of reference.

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Overview

In addition to the above, we also welcome the Government's initiatives to:

- set up a Australian Charities and Not-for-profits Commission (the "**Commission**") to "determin[e] 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; and establishing a public information portal"[1]; and

- introduce a statutory definition of 'charity' applicable across all Commonwealth agencies from 1 July 2013[2].

In our view, in the longer term, policy decisions as to which entities are entitled to access NFP concessions should be made with reference to the statutory definition of 'charity', and broader consideration of the entities that are considered to each be a NFP entity. Specifically, entities that carry on significant commercial operations within the NFP entity should not, by definition be NFP entities, and should therefore not be permitted to access the NFP concessions. Such an approach does not differ vastly from the existing law on this issue.

The Commission (once set up) should be responsible for ensuring adherence to this definition, so that the Commission can consider the circumstances and applicable sanctions for any NFP that carries on activities within the NFP entity that constitute "unrelated commercial activities". Any non-compliance with the law should therefore be dealt with via these channels.

As a result, the amendments proposed in the Consultation Paper will in the longer term, constitute a sanctioned method by which NFPs may actively carry on fund raising activities, rather than as a detterent to carrying on commercial activities. These reforms, when considered in light of the other announced reforms in this sector should not be relied on to ensure adequate governance of the activities of NFPs, but should instead be part of the structure pursuant to which the taxation of NFPs is appropriately determined.

This method of implementation is consistent with our broader goals in relation to tax reform i.e. towards a tax system that is simple to understand, equitable in application and certain in effect. These goals are also consistent with the recommendations of the *Australia's Future Tax System Review* panel.

We note that the benefits stemming from the implementation of this policy will be realised only in the longer term after the other announced NFP reforms have been implemented, and the transitional period had ended, as the implementation of this policy is likely to lead to increased compliance costs for NFPs during the transitional period.

However, if the Government proceeds with the implementation of this policy via amendments as canvassed in the Consultation Paper, in our view Option 1 (amended as set out below) is most likely to achieve the Government's aims while minimising compliance costs for NFPs, for the following reasons:

- Option 1 will allow little difference in tax treatment between active investment in a company that is a separate entity in which the NFP carries on its "unrelated" commercial activities, and passive investment in an unrelated company (such as a listed public company) and will

[1] Assistant Treasurer's Press Release dated 27 May 2011 entitled "Next stage for not-for-profit reforms announced".

[2] Assistant Treasurer's Press Release dated 10 May 2011 entitled "Making it easier for charities to help those who need it".

therefore encourage competitive neutrality between potential forms of investment. In order to ensure this outcome, it may be necessary to extend franking refund eligibility to those NFPs currently not eligible for franking credit refunds;

- Option 1 will allow flexibility/choice to NFPs in relation to the type of entity in which to conduct their segregated activities; and

- Option 1 will allow these proposed changes to be implemented with the benefit of reliance on concepts developed in relation to other areas of taxation law (such as the imputation system in relation to companies, and the taxation of trusts) (consultation question 5).

It should be noted that the implementation of this option must allow for the option of carrying on segregated activities via a trust structure in order to gain access to flow through tax treatment and minimise cash flow disruptions or impact (i.e. only that share of the net income of the trust that corresponds to the trust income to which no beneficiary is presently entitled should be taxed in the hands of the trustee, and the trustee's tax liability (if relevant) should be calculated at the end of the income year).

Should this option not be available, the proposed reforms may result in NFPs expressing a preference for investing in unrelated commercial enterprises in order to minimise compliance costs, potentially resulting in greater risk exposure for the underlying invested capital of NFPs.

In this regard, we envisage that while the broader rewrite of trust laws expected to be undertaken in late 2011 will affect the operation of this option, the basic parameters of that review as set out in the Assistant Treasurer's press release of 2 June 2011 (entitled "Increased Certainty for Trusts"), will be equally applicable in this context so that any rewrite of Division 6 of the *Income Tax Assessment Act 1936* will not alter the flow-through tax treatment currently available to trusts.

On this basis, we envisage that Option 1 where the NFP's segregated activities are conducted through a trust will be similar in operation to Option 2 as set out in the Consultation Paper.

It is also necessary to consider whether the policy underpinning these measures requires all profits from the segregated activities to be taxed, or whether a *de minimus* rule will also be applicable in this circumstance to excuse minor retained profits from taxation. In this regard, we note that it may not be prudent to require all of the retained profits of a NFP to be utilised in fulfilling the entity's objects in each income year in order to access the tax concessions. In order to ensure adequate resources in economically challenging times, encourage self-sufficiency and reduce reliance on debt funding it may be more desirable to encourage a degree of profit retention.

We also note that our comments below relate to the application of income tax concessions in relation to NFPs that undertake segregated activities. It is not clear to us from the Consultation Paper whether any activities undertaken in the separate entity will also not be permitted to access the Fringe Benefits Tax ('**FBT'**) or Goods and Services Tax ("**GST**") concessions that are currently available to many NFPs. For example, where one employee provides services to both the NFP entity, and the separate entity that undertakes segregated activities, it is unclear to us whether the fringe benefits provided to that employee will need to be apportioned so that the NFP's FBT concessions are only available in respect of benefits provided to that employee by the NFP entity. We recommend that this issue be clarified before this measure is enacted.

As referred to above, the implementation of this policy will only yield benefits in the longer term, once the remaining announced NFP reforms have been implemented. In the shorter term, and most certainly through the transitional period, it is likely that compliance costs for NFPs will rise significantly. This is because, even if the measure is implemented as outlined in this submission:

- NFPs will be required to repeatedly test whether they have undertaken any "new activities" during the income year that would cause the new rules to apply to the NFP's activities. Any activities that fall within the current rules will be maintained in their current form (even if the activities may have otherwise organically evolved) in order to ensure the benefit of the tax treatment under the current rules. While we make no comment in relation to the manner in which such new activities should be identified, we note that the use of the 'same business test' in the context of utilisation of prior year losses has created significant compliance difficulties and therefore may not be the preferred model.

- If the NFP has undertaken new activities, or if the NFP has continued to undertake activities that are required to be segregated, the NFP will be required to apply the *de minimus* rule to determine whether the entity is required to restructure its affairs in order to comply with the new rules.

- If action is required to be taken for the first time to move segregated activities to a separate entity, such action is likely to result in significant ongoing compliance costs in relation to the compliance activities of two separate entities, as well as the costs of migration of the activity (such as for example, stamp duty on any land that is required to be transferred to the new entity for which an exemption is not granted).

As a result, assistance should be provided by the Government to NFPs in meeting these compliance costs where possible (consultation questions 7 and 8).

Our submission broadly addresses the following issues:

- What activities should be required to be segregated in a separate entity in order to effect the Government's policy aims (consultation question 1)?

- What is the distinction between an active and passive investment for these purposes?

- How should small-scale activities be defined (consultation questions 2 and 3)?

Segregated activities

In our view, the Government's policy aims, as well as the policy underpinning the Consultation Paper is in fact not to prevent NFPs from carrying on activities other than in pursuit of its charitable objects (as this is already prevented by existing law), but instead to prevent NFPs from retaining profits generated by undertaking segregated activities. Specifically, we note the Assistant Treasurer's comment in his press release of 10 May 2011 that "NFP entities will pay income tax on profits from their unrelated commercial activities that are not directed back to their altruistic purpose, that is, the earnings they retain in their commercial undertaking."

<u>Unrelated commercial activities</u>

Under current laws, all of the activities of an NFP must be carried on in pursuit of its charitable objects. In this regard we note that the case of *Word Investments*[3] established, in our view appropriately, that a fundraising activity where the funds raised are utilised in pursuit of the NFP's charitable objects constitutes an activity carried on in furtherance of the NFP's charitable objects.

[3] (2008) 236 CLR 204

As such, the distinction between activities that are related or unrelated to this purpose is unhelpful, as this distinction more appropriately addresses whether the NFP is complying with its own objects (and is therefore a question of compliance, rather than classification).

If a NFP acts outside its objects by carrying on activities other than for its charitable purposes, that NFP should be appropriately sanctioned by the Commission once it is set-up, and by the ATO in the meantime.

As such, in order to implement the policy underpinning the announced measure, we recommend abandoning the notion of defining what activities are "related" to an entity's charitable purpose and instead focussing on whether the activity in question is a fundraising activity or not, so that activities that have a primary or dominant purpose of raising funds are required to be carried on in the separate entity.

Such a construct would be consistent with the policy objectives underpinning this proposed change i.e. to "encourage altruistic entities to direct profits generated by unrelated commercial activities back to their altruistic purposes", and would alleviate the need to consider whether the activities that have led to the raising of funds are "related" or "unrelated" to the NFP's charitable objects.

Where fundraising activities are carried on in a charitable manner, are undertaken merely to promote the activities of the charity or constitute "minor" fundraising activities, such activities should be properly defined as exclusions to the primary rule that fund raising activities should be carried on in a separate entity.

<u>Earnings retained</u>

It is unclear to us from the Consultation Paper what it means to "retain" earnings in this context.

Specifically, it is unclear whether such earnings or profits need to be distributed by:

- income year end (a proposition we consider to be unreasonable since most entities only generate accounts for an income year just passed in the months following the end of the income year); or

- during the income year following the income year in which the profits were generated.

We recommend that this issue be resolved prior to the implementation of this measure.

We also recommend that a *de minimus* test apply to such retention, so that a percentage of profits generated during an income year may be retained within the separate entity indefinitely without being subject to tax. This is because it is not in the best interests of either NFPs or society more broadly for NFP entities to be entirely dependent on either debt funding or earnings from passive investments in times of decreased earnings or for the purposes of expansion or investment in the NFP's activities. A degree of self-sufficiency by NFPs will, in our view, be in the best interests of such entities and the taxpayer community more broadly.

Active vs passive activities

The Consultation Paper appears to contain an inherent assumption that "commercial activities" must be active in nature, and that passive investments by NFPs should retain their current treatment i.e. be permitted to be accrued within the bounds of the charitable entity (paragraph 37 of the Consultation Paper).

In our view this approach creates a peculiar and unnecessary dichotomy that will encourage passive rather than active investment by NFPs. Where "commercial activities" are carried on by

NFPs, these activities represent an effort by the NFP to raise funds for the purposes of its charitable activities, an effort that is ultimately similar in nature to investment in external ventures or vehicles.

As such, in order to maintain competitive neutrality between these potential forms of investment, their tax treatment should be as far identical as possible. For this purpose we recommend that all fund raising activities (subject to the exclusions referred to above) be required to be carried out in the separate entity.

This is because not all potential investments in external ventures will be carried on in a type of entity in which the NFP is permitted to carry on its fund raising activities. By way of example, it is unclear to us that if the law is amended so that an NFP's "commercial activities" are required to be carried on in a separate entity, whether a minority interest taken by the NFP in a partnership that is carrying on a business will be required to be carried on in the separate entity. However, if the proposal in this submission is adopted, all such activities will need to be carried on in the separate entity, regardless of the nature of the NFP's involvement in the commerical activity.

Ultimately, clarity of these rules will assist in reducing the compliance costs borne by NFPs.

De minimus rule and other exceptions

As noted above, a number of types of fund raising activities should be permitted to be carried on outside the 'separate entity', specifically where fundraising activities are"

- carried out in a way that was charitable;
- the fund raising activities are merely incidental to the carrying out of the charitable purpose;
- the NFP charges fees for the service; or
- "small-scale" fundraising activities.

Of these exemptions, in our view the first three should be constructed and applied in the same manner as in the ATO's now withdrawn TR 2005/21. These first three exemptions are essential to ensure that NFPs that undertake fund raising activities, where those activities are not intended to be a major part of their operations are not burdened with the compliance cost of setting up and maintaining a separate entity.

In order to provide certainty to NFPs seeking to comply with these rules, it is essential that multiple and detailed examples of "fund raising" activities carried on that fall within these first three exemptions are included in the Explanatory Memorandum to the Bill that introduces these measures.

The fourth exemption, a *de minimus* rule, is essential to ensure that minor fund raising activities are not caught by these measures. The Government's aim to introduce such an exemption is set out in the Assistant Treasurer's Press Release on 27 May 2011 and at paragraph 36 of the Consultation Paper. It is essential that this exemption be constructed appropriately in order to minimize compliance costs to NFPs of these measures.

Specifically, we recommend that the relevant *de minimus* test:

- Be designed as a threshold test that is applicable in relation to a NFP, rather than an activity or series of activities (consultation question 10). This will ensure that the relevant test is easy (and relatively low cost) to apply. NFPs will typically be required to apply such a test only once a year in relation to all their activities, rather than separately in relation to each activity or series of activities.

- Be applied on a prospective basis. Any requirement to apply the test on a retrospective basis would impose unnecessarily onerous compliance costs.

- Be applied by averaging the relevant inputs over a number of income years (as is currently the case in relation to the application of the test to determine if an entity is a small business entity, or subject to the thin capitalization provisions). Such an averaging mechanism will ensure that a NFP that has an unusual result in one income year is not adversely affected by being subject to the requirements to conduct its fund raising activities in a separate entity either in the current or future income years unless the relevant change in inputs is sustained.

Transitional arrangements

We strongly urge the development of transitional arrangements in close consultation with the NFPs that will be affected by these reforms in order to minimise compliance costs.

While we make no specific recommendations in this regard, we note broadly that longer transitional periods typically allow for a more strategic transition into a new paradigm of regulation. In this instance, a longer transitional period will allow NFPs to review the activities of their organisation, undertake an orderly migration of any activity required to be moved into a separate entity and allow time to recruit appropriate and sufficient staff to manage both the transition and the separate entity if necessary.

We note broadly that the retrospective application of these announced but not as yet enacted measures, especially when considered in light of other proposed reforms in this sector, are likely to cause an unnecessary degree of uncertainty in relation to the tax treatment of activities of NFPs.

While we acknowledge that these measures are not due to apply to the current activities of NFPs for a period of time, it is our view that such retrospective application reduces the available time to NFPs to prepare for the changes or plan their ongoing activities.

In addition, a start date of 1 July 2011 is likely to encourage NFPs to maintain (without any organic growth or evolution) those activities that are 'grandfathered' in under the current rules, even if such activities would have otherwise been altered, resulting in scope for inefficient resource allocation and/or market distortions.

Conversely, a later start date will allow NFPs that may have otherwise fallen foul of the revised rules to restructure their activities or to dispose of businesses that would otherwise constitute segregated activities prior to commencement, and will therefore encourage voluntary compliance with the new rules.

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Should you have any queries with respect to any of the matters raised above, please do not hesitate to contact me on (02) 8223 0011 or The Tax Institute's Tax Counsel, Deepti Paton on (02) 8223 0044.

Yours sincerely

Peter Murray
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