# Submission to the Treasury, *Better Targeting of Tax Concessions* (Consultation Paper, 27 may 2011)

# By the Not-for-Profit Project, University of Melbourne Law School

# Introduction

The University of Melbourne Law School’s Not-for-Profit Project is a three-year research project funded by the Australian Research Council which began in 2010. This project will be the first comprehensive Australian analysis of the legal definition, taxation, and regulation of not-for-profit organisations. Further information on the project and its members is attached to this submission as Appendix A.

We welcome this opportunity to contribute to the Treasury’s work. One of the aspects that we are examining in our research project is the taxation of business income and general treatment of commercial activities of not-for-profits (NFPs). We attach a draft Working Paper on the taxation of business income as Appendix B. This draft examines the policy and legal context and specific design issues, and this submission is informed by this work. We note that our work in this respect is ongoing, and that we would welcome the opportunity to continue discussions with Treasury at a later date.

There are a number of questions of policy and principle as to the overall merits of taxing the business income of NFPs. However, since the Consultation Paper invites questions only on issues of design in respect of the government’s announced policy, this submission does not address in detail the overall policy question. It also deals only with the first six consultation questions set out in the Consultation Paper, as the sector is better placed to address questions of transition. In line with our Project’s mission of addressing policy issues through first principles, however, we make some introductory remarks about the rationales for such a tax.

# RATIONALES FOR THE TAX

The Consultation Paper expressed four rationales for the tax: targeting concessions used for the purpose of the exemption; lessening financial risk for charities; competitive neutrality; and protecting charities from ‘mission drift’.

The stated rationale for taxing business income of charities will necessarily guide and shape the design of the tax. It is therefore desirable to comment briefly on these posited rationales.

Of the four posited rationales, we suggest that the first is the strongest rationale for the proposed tax. That is, the main rationale for taxing business income of NFPs is to ensure that the subsidies provided through tax (and other) concessions for NFPs are appropriately targeted to the main charitable or other activities for public benefit that have been defined as eligible for those government subsidies. As such, this should be the guiding rationale for any such tax.

There are significant difficulties in using such a tax to ensure competitive neutrality, especially across widely varying industries. This conclusion was supported by the Henry Review as well as inquiries by the Productivity Commission and its forerunner, the Industry Commission, and is supported also by economic analyses of the unrelated business income tax (UBIT) in the US. The difficulties with using the competitive neutrality argument to sustain the tax include:

* Comparing NFP with government and private providers is inherently difficult, because of the need to compare the different objectives of the organisations and to include in the balance the public benefit provided by NFPs;
* Comparisons need to take into account disadvantages suffered by NFPs including limited access to equity capital;
* Comparisons need to consider the degree of true ‘competition’ between those in the same broad field, for example whether the NFPs are serving clients or consumers who are otherwise under-served;
* Competitive neutrality is affected by many economic factors specific to particular industries that cannot be readily or practically incorporated into a tax on business income;
* The principle of competitive neutrality provides no justification for distinguishing between ‘related’ and ‘unrelated’ activity, and in some circumstances taxing business income may decrease competitive neutrality in some sectors because of a disincentive to engage in unrelated businesses; and
* There is insufficient evidence that distortions in competitive neutrality arise in any significant way across the whole sector rather than in particular parts.

The Project accepts that engaging in businesses may pose financial risks to NFPs and their stakeholders and may give rise to ‘mission drift’ and that these are substantive concerns. However, these are regulatory risks that are highly fact and context-specific, and are better addressed in terms of governance and overall regulation. In light of the Budget’s welcome announcement of a national regulator, we believe that these factors should be addressed through the guidance and oversight of the regulator rather than through a tax.

A tax on business income is insensitive both to the financial risk posed to the NFP (which is, in any event, regulated to some degree by the imposition of duties on board members of NFPs) and to the risk of mission drift. The only logical way in which such a tax will reduce such risk is by acting as a disincentive to engage in business, which the Consultation Paper states is not the policy intent of the proposal.

A final comment in respect of the rationale for a tax on unrelated business income of NFPs concerns the treatment of retained or reinvested profits. In the commercial world, for a business to become established and be successful, it will generally be the case that any profits generated in early years are reinvested in the business or may be used to pay down loans used as start-up capital. It appears that the proposed tax on unrelated business income will apply to reinvested profits. As a result, businesses of tax-exempts will be placed on a level playing field with taxable businesses.

However, in contrast to the situation for many taxable businesses, profits distributed from the business to tax-exempt NFPs (either actually distributed out of the business entity to the exempt NFP, or simply applied to the eligible charitable purpose) will be free of tax. This may create an incentive for NFPs to distribute more business profits than is commercially sensible, rather than reinvesting them in the business to ensure its long term growth or sustainability. The Consultation Paper does not address this issue directly; we raise it here simply to draw it to attention of the Treasury.

# Scope of ‘Related’ business

1. What should be the scope of a related business, unrelated business, primary purpose or non-primary purpose test?

If the rationale of the tax is to confine the tax concessions to the purposes for which they were granted (namely, the public benefit delivered by NFPs), then logically the ultimate distinction is between resources that are directed towards those purposes, and resources that are not. We welcome in this respect the intention of the policy to retain tax exemption for profits that are directed back to the NFPs’ purposes. However, this raises an important issue of design—namely, the purpose of distinguishing between ‘related’ and ‘unrelated’ businesses.

We note that in New Zealand the test is simply whether ‘business income’ is applied to the charitable purposes of the organisation (in New Zealand), without any further criteria of ‘relatedness’. Clearly the policy outcome is similar to that intended by the Australian proposal, namely that the tax concessions are used only to support charitable purposes, and indeed this test seems logical in relation to the rationale for the tax. For example, while a museum gift shop is clearly a ‘related’ business, it would be difficult to justify the exemption of its profits in the event that those profits were not redirected to the (charitable) purposes of a museum.

Eliminating the ‘relatedness’ test would have the major advantage of ease of administration for the tax and/or regulatory authority and for NFPs. In those jurisdictions that use a ‘related’ test, including the US and Canada, one of the key criticisms has been the vagueness of the qualitative ‘related’ test and the complexity of the definition. This creates uncertainty and complexity and can impose a wholly disproportionate administrative burden. For example, the US definition would require art museum gift shops to account separately for items that do not promote art. A real question might arise whether museum shops that sell high-quality design objects are in fact ‘promoting design’ in a way that is related to their exempt purpose or not.

This level of complexity and fine detail could act as a real disincentive to engage in business, could foster “creative” accounting or line-drawing by NFPs, and could even have perverse effects by encouraging NFPs to integrate unrelated businesses closely into their core charitable purpose in order to claim the business is ‘related’. Moreover, policing such a qualitative test may well have disproportionate administrative costs especially as it is unlikely that this tax will generate substantial revenues.

While the question in the Consultation Paper uses the term ‘related business’ and ‘primary purpose’ apparently interchangeably, there is potential for confusion in these terms. A primary purpose activity is merely an activity which is carried out for the charitable or tax-exempt purposes of the NFP.

As the attached draft Working Paper describes, there are two main forms of ‘primary purpose’ activity. The first is where the activity itself is part of the ‘core business’ of the tax-exempt purpose—for example, a hospital provides health services or a private school provides educational services. The second is where the activity is used as a core means of achieving the charitable purpose—for example, running a restaurant to train the disadvantaged in hospitality. The United Kingdom refers to the latter as ‘beneficiary (main) unusual’ trading.

The terminology of ‘related’ business to refer to these types of trading is potentially misleading, since the business itself is core to the charitable or tax-exempt purposes. The terminology of related business is more apt to cover what is also sometimes called ‘ancillary or incidental’ trading, with the usual examples being car parks for hospitals and museum gift shops or cafes. These activities indirectly further the tax-exempt purposes of the entity, not only because they raise income but also because they facilitate the use of the primary service. Another form of ancillary or incidental trading may be where the charitable or tax-exempt activity generates a saleable product or service as a by-product. Analogous to this, although sometimes treated as a separate category, is the use of excess capacity of infrastructure such as church halls. However, the term ‘related’ business is also used to cover other activities which are principally conventional fundraising vehicles, such as volunteer-run bingos, cake stalls, second hand shops, or the sale of greeting cards or charity-branded merchandise.

An alternative to simply removing the relatedness test would be to identify the types of activities that would continue to be exempt in statute, regulations or guidance in terms that are more analytically rigorous than the confused ‘relatedness’ test. To begin with, one could follow the New Zealand example and specify that passive investments and occasional fundraising events are not ‘businesses’ for the purposes of the tax. This would provide clarity and certainty. Secondly, it could be provided that the following were not taxable businesses:

1. ‘Core businesses’: Businesses that are engaged in necessarily in the course of achieving the tax-exempt purposes of the entity;
2. ‘Core activities’: Businesses that are engaged in order to achieve the tax-exempt purposes of the entity;
3. ‘Ancillary businesses’: Businesses that facilitate the provision of a tax-exempt service;
4. ‘By-products’: Businesses that involve the incidental sale of products produced in core businesses and core activities or the use of excess capacity of infrastructure used in core businesses and core activities.

Third, the legislation could additionally exempt a range of conventional fundraising activities, including: second hand shops; the sale of items promoting the charity; the sale of greeting cards; the use of licensed lotteries and gaming activities; and business sponsorships.

The advantage of the above approach is both analytical clarity and greater certainty. The use of terminology such as ‘related’ and ‘primary purpose’ can be misleading and confusing, because it encompasses a range of analytically separate categories. In our view, a clearer test would be to focus on whether the business is conducted primarily to raise funds for other activities or primarily to further the tax-exempt activities and purposes. Conventional fundraising activities are exempted because they do not raise real competitive concerns, because of their traditional significance to the sector, and because it is expedient to exempt them, but it is stretching the natural sense of the term to call them ‘related’.

The treatment of ‘mixed’ trades also needs to be considered. One example given by the US Internal Revenue Service is of a ‘school handicraft shop’, where goods produced in a handicraft school are sold together with those of other artisans. The approach of the US would require distinguishing between these two streams (similar to its distinction between art-related products in a museum gift shop and other items). The UK has recently adopted a rule also requiring ‘mixed trades’ to be treated as separate trades. This seems to greatly increase the administrative complexity of a regime without a commensurate benefit. It may be easier and less burdensome to adopt the earlier UK approach of applying the taxation treatment applicable to the dominant part of the trade.

# Small-scale Threshold

1. Should there be a small-scale threshold, and if so, what would be the appropriate threshold?
2. Is there an alternative principle that could be used to provide a small-scale or low-risk activity exemption?

The Project welcomes the policy intent to exempt certain small-scale activities. This is justified on the regulatory principle of proportionality, both in terms of the compliance burden imposed on NFPs and in terms of the administrative burden of government monitoring small-scale activities.

The appropriate threshold figure itself is best set in consultation with the sector itself and relevant accounting professionals. The principle employed in the UK of both an absolute cap and an alternative percentage limit, subject to a maximum cap, seems sensible, adjusted to the circumstances of the Australian sector.

As we discuss in the draft Working Paper, it may be worth exploring whether a threshold could be set that is in harmony with existing reporting obligations to reduce the compliance and administrative burden. For example, the registration threshold for GST is $150,000 for NFPs, and a new tiered structure for reporting under the *Corporations Act* for companies limited by guarantee distinguishes between those with revenue of less and more than $250,000 for the purposes of reporting.

We note that the question is concerned with ‘small-scale’ or ‘low-risk’ activity. Analytically, these are not separate, although clearly the smaller the business the less overall financial risk would be incurred. However, as stated earlier, the concern with financial risk is in our view a regulatory and prudential issue rather than a taxation issue. Consequently, we recommend that this rule or threshold refer only to ‘small-scale’ activity and not refer to the issue of risk.

## Exempting Profits Directed Back to the NFP

1. Would there be any unintended consequences resulting from any of these options?
2. Which option do you prefer and why?
3. Would we need to proceed with more than one option?

The Consultation Paper discusses three options for retaining tax exemptions for profits directed back to the NFP: (1) refund of franking credits; (2) separate taxation; and (3) separate accounting.

*Option 1: A separate taxable entity; refund of franking credits, deductible donations or other deductions*

The current tax law already contains a number of ways in which a business activity of a NFP that is conducted in a separate taxable entity may ensure that profits distributed to the tax-exempt NFP are not subject to tax. It is submitted that all of these options should remain in the current tax law.

One way is for a tax-deductible donation to be made by the taxable business entity to the tax-exempt entity. This requires, of course, that the recipient NFP be a deductible gift recipient (DGR) and, for example, carry on activities ‘in Australia’.

Another way is for profits subject to company tax in a taxable business corporation to be distributed as dividends to an eligible charity or NFP which can claim a refund of franking credits on the distributed taxed profits. Under current law, there are restrictions on the recipient entities eligible for refundable franking credits but generally endorsed charities and DGRs are eligible.

Yet another way for a taxable business entity to provide funds, legitimately, to a tax-exempt NFP could be for it to enter into a commercial arrangement with the NFP. For example, a NFP may own real estate, such as a shop. A separate legal entity, such as a proprietary company, owned by or connected to the NFP, may operate a business in the shop. The business entity may pay market rent to the NFP, which would be legitimately tax-deductible to the business entity, thereby reducing its taxable profit. The rent would be passive income from property for the NFP and legitimately tax-exempt in the NFP’s hands. Such an arrangement, subject to general anti-avoidance or tax integrity constraints, may be legitimately entered into by a tax-exempt NFP even if it is not a DGR or otherwise eligible charity.

Limits of the current regime for taxable donations or refundable franking credits are:

* Limits to eligible recipient entities (which must have DGR or eligible charitable status)
* The requirement to distribute profits in order for them to be free of tax.

Where business activities are small, it is unlikely that they will be conducted in a separate legal entity such as a proprietary company. However, as we discuss in our draft Working Paper, it is highly likely that prudential and pragmatic factors would compel most NFPs to conduct businesses of substance in separate taxable entities. This appears to be reflected in the empirical evidence of the *Finding Australia’s Social Enterprises* study, discussed in the draft Working Paper, which found that more than 90% of the social enterprises it studied were carried on in a separate taxable entity.

Nonetheless, it is possible that the above limits on tax-exemption of business profits are constraining some NFPs from establishing a separate legal entity for conduct of their business activities. The *Word Investments* case may have removed those limits. In particular, in light of the Treasury’s stated concern about financial risk and governance in the NFP sector, it is suggested that the Treasury could explore further how it might extend the definition of eligible recipient entities for receipt of a franking credit refund from distributed taxed profits of a business subsidiary. A reform that broadened the list of eligible recipient shareholder entities might encourage NFPs with (relatively) smaller business activities to establish a separate legal entity for those activities, which could improve transparency in respect of business or non-business activities.

*Separate taxation*

We agree with the Consultation Paper that the second option is unduly complex to implement and administer, particularly given our expectation that relatively few entities will ultimately be affected by this tax. Establishing a new set of rules for taxation of a particular form of entity, and in relation to profits retained or distributed, could lead to significant unintended consequences and complexities, and is unnecessary to achieve the outcomes intended by the Treasury from this reform

*Separate accounting*

We submit that there is merit in the Treasury considering the simpler New Zealand option which provides that the income of NFPs is exempt *to the extent* that it is applied to the exempt purposes.

Applying this approach, a NFP would have to account separately for the business and provide financial statements showing how that money was applied to charitable purposes. In our view, this would not be unduly burdensome since in a well-governed NFP business inputs and outputs should already be accounted for separately and general NFP reporting obligations should require an indication of how monies are directed to eligible purposes or other activities.

As noted above, most businesses of any substantial size will in any event be conducted in a separate entity. However, mandating a separate entity for business activity over a minimum threshold could cause significant difficulties for some NFPs. For example, if employees of a NFP spend some of their time, or expertise, working for the business activity and some working towards the NFP charitable purpose, this approach could require those persons to be separately contracted or employed by the business entity, adding significantly to complexity. This may also carry with it significant flow-on consequences in terms of federal and state law, for example in relation to employment regulation, workers compensation, fringe benefits tax and payroll taxation.

If the Treasury intends the above separate employment or similar consequences to follow from its proposal to tax “unrelated” business income, we submit that this would require significant further research and consultation, both to establish whether it is really necessary to do this, and to establish how this is to be achieved.

It is submitted that allowing NFPs to carry on business activity within the tax-exempt entity itself, but requiring separate accounting of business income not directed to the exempt purpose, accords with the mainstream taxation approach in most other countries. Very few countries legally prohibit the carrying on of businesses within the entity itself. Some countries which have done so have been forced to temper their approach because such a prohibition could only be enforced through the draconian step of removing the tax-exempt status of the entity itself, making such a prohibition difficult to enforce. South Africa, for example, changed its approach to require taxation of business income conducted by the entity instead of prohibiting the conduct of such business. While Canada continues to prohibit the carrying on of unrelated businesses, it has introduced a regime of intermediate sanctions to deal with the draconian nature of the sanction. We believe that the South African compromise is preferable to the Canadian approach, since an intermediate sanctions regime is unduly punitive and complicated, particularly when there is no real evidence of a practical problem.

In our view, the United Kingdom’s approach is philosophically preferable. The UK approach does not prohibit an NFP from conducting a business directly. However, the guidance given by its tax authority and charity regulators is that the issue of financial risk is a matter which directors must consider when establishing a business as part of its duty to consider the best interests of the NFP, so that the issue is treated as one of corporate governance, rather than through taxation. Further, the guidance also indicates that there are other practical advantages to establishing a subsidiary. With the creation of a national regulator, we submit that a permissive approach, coupled with appropriate guidance from a regulator, is preferable, since the issue of financial risk is ultimately highly fact and context-dependent and should be considered in light of all the circumstances of the NFP.

We note the concerns in the Consultation Paper that the third option of accounting separately for business profits not directed to the charitable purpose would not protect the assets of the NFP entity, would not provide transparency as to how taxpayer money was being utilised, and would divide the NFP focus between the NFP activities and the unrelated commercial activities. However, it is submitted that these are issues that are better addressed in the comprehensive regulation of NFPs rather than through the blunt measure of a tax policy that is not logically designed to be sensitive to these issues.

The other stated concerns appear overrated. The concerns as to higher compliance costs on the NFP would itself be a factor that would encourage the NFP to create a taxable entity, and is clearly something that an NFP would assess for itself. Mandating a separate legal entity would be likely to generate significant additional compliance costs, as suggested above, in relation to both reporting for the entity and managing employee and other aspects of the NFP. Again, as noted, our expectation is that since most businesses that are likely to be subject to the tax are in any event in the form of a separate taxable entity, it would not be unduly complex to administer. We are unaware of any particular difficulties the New Zealand revenue authority has found in this regard.

The Consultation Paper also raises an issue as regards application of GST in respect of separate accounting. It is agreed that GST currently applies on a business entity basis (rather than an activity basis). It is submitted that where a NFP is of a sufficient scale that it would benefit from claiming a refund of input credits in respect of services or goods that it acquires in conduct of its business activity, that NFP should proceed to establish the business activity in a separate legal entity. However, the NFP should have the option of conducting its business activity within the same entity, and not claim input credits, if that is, overall, a better approach for it taking into account the scale of the business activity, the NFP, and services/goods acquired by it.

## Conclusion

We hope the above remarks will be useful. Please feel free to contact us if you wish to discuss any matters further, or would like access to any of the material to which we have referred. Our contact details are listed in Appendix A. We look forward to engaging further with Treasury as our work progresses on this project.

# Appendix A: Not-for-Profit Project, Melbourne Law School

A group of academics from the University of Melbourne Law School is undertaking the first comprehensive and comparative investigation of the definition, regulation, and taxation of the not-for-profit sector in Australia (the Not-for-Profit Project). The Australian Research Council is funding this project for three years, beginning in 2010. The project aims to identify and analyse opportunities to strengthen the sector and make proposals that seek to maximise the sector’s capacity to contribute to the important work of social inclusion and to the economic life of the nation. In particular, the project aims to generate new proposals for the definition, regulation and taxation of the not-for-profit sector that reflect a proper understanding of the distinctions between the sector, government, and business.

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More information on the project can be found on the website of the [Melbourne Law School Tax Group Not-for-Profit Project](http://www.tax.law.unimelb.edu.au/index.cfm?objectid=053E24C1-B048-8204-A721A46DFB996924&flushcache=1&showdraft=1).