

# PilchConnect submission to the Treasury Consultation Paper:

Better targeting of NFP tax concessions

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## Endorsements

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# 1. Executive Summary

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PilchConnect welcomes the opportunity to respond to the Treasury's consultation paper on better targeting of not-for-profit tax concessions (**Consultation Paper**). This Consultation Paper comes at a time of other significant announcements by the Federal Government, as part of a broader reform agenda aimed at reducing red tape, streamlining regulatory requirements and improving transparency and accountability of the not-for-profit (**NFP**) sector. PilchConnect applauds the Government for its reform agenda, particularly the recent commitment to the establishment of the Australian Charities and Not-for-Profits Commission (**ACNC**) by July 2012.

The Consultation Paper sets out proposed reforms to current taxation arrangements to ensure that tax concessions are used appropriately to further NFPs' altruistic purposes. PilchConnect agrees in principle that NFP tax concessions must be appropriately targeted, however we have some concern that the proposed tax arrangements would be difficult to implement effectively, and may result in increased regulatory complexity and compliance burden for the NFP sector without requisite justification. We consider it imperative that any reforms to tax concessions, such as those proposed in the Consultation Paper, are thoroughly scrutinised by Government to ensure they are consistent with its broader NFP reform agenda for smarter regulation of the NFP sector, are evidence-based, and are the most appropriate mechanism to achieve the desired policy outcomes.

With the Government's broader policy context in mind, a summary of PilchConnect's views on the Consultation Paper is below:

- ▶ While we agree that NFP tax concessions should be targeted to ensure that NFPs' surplus funds (profits) from business activities are directed to furthering the organisation's altruistic purposes, we consider that some of the rationales underpinning the proposed reforms are better suited to other regulatory approaches (including, for example, tasking the new ACNC to provide guidance and support to NFPs on governance issues, and introducing a statutory definition of charity), rather than by introducing a tax on unrelated business income. In our view there is little evidence to support the proposition that such a tax is either necessary or the best way to achieve a number of the policy objectives identified in the Consultation Paper.
- ▶ If the test is to be based on a distinction between 'related' and 'unrelated' business activities, this framework will need to be very clearly defined, and expressed in simple language. Regulatory complexity and confusion are real barriers for NFPs and there is a risk that the proposed reforms will cause NFPs to refrain from engaging in legitimate (and innovative) commercial activities for fear of non-compliance with laws that are difficult to understand and apply.
- ▶ A small-scale threshold would be an essential part of any new tax arrangements. Such a threshold would reduce regulatory complexity for small NFPs and ensure compliance costs are proportionate to risk. We suggest that the threshold test should be harmonised with existing regulatory thresholds for NFPs, such as for example the 'top tier' of companies limited by guarantee (annual revenue over \$1m), and it would also be necessary to assess the size of an NFPs unrelated business income.
- ▶ Of the 3 options presented in the Consultation Paper, we consider option 3 offers the easiest mechanism for implementation. We also note that many larger NFPs currently choose to conduct unrelated business in a separate entity (option 1) without a mandatory requirement to do so. Prohibiting NFPs from conducting unrelated business in the same entity has caused difficulties (and attracted criticism) in other jurisdictions, and we urge caution with this approach.

- ▶ There is a need to ensure NFPs are adequately informed and appropriately educated about any reform to tax concessions, and have time to make any necessary changes to their business activities. Potentially, and depending on the scope of reform, any new reporting requirements could be implemented in tandem with new processes required by the new ACNC's public information portal.
- ▶ We urge the Government to conduct further consultation with the sector once submissions to this Consultation Paper have been considered, and before any final reforms are implemented.

This submission does not propose to address all the questions posed in the Consultation Paper. Our comments are focussed on overarching issues and aspects which we consider will affect our key client base (that is, small-to-medium NFP organisations with 'public interest' objectives).

## 2. About PILCH and PilchConnect

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### 2.1 PILCH

PILCH is a leading Victorian not-for-profit organisation. It is committed to furthering the public interest, improving access to justice and protecting human rights by facilitating the provision of pro bono legal services and undertaking law reform, policy work and legal education. In carrying out its mission, PILCH seeks to:

- ▶ address disadvantage and marginalisation in the community;
- ▶ effect structural change to address injustice; and
- ▶ foster a strong pro bono culture in Victoria; and, increase the pro bono capacity of the legal profession.

### 2.2 PilchConnect

PilchConnect is PILCH's specialist legal service for Victorian not-for-profit community organisations (NFPs). PilchConnect's focus is on providing legal help to NFPs that work with marginalised or disadvantaged Victorians. Our legal services for NFPs include free and low cost legal information (via our webportal at [www.pilchconnect.org.au](http://www.pilchconnect.org.au)), legal training, and legal advice and referral of eligible NFPs to PILCH member law firms for pro bono assistance. PilchConnect also engages in law reform and advocacy work on systemic issues about the regulation of the NFP sector. Our submission work is based on empirical evidence and practical examples drawn from our legal inquiry, advice and case work.

## 3. Background and policy context

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This is an important time of regulatory reform for Australia's not-for-profit (**NFP**) sector. The Federal Government has recently announced a number of key initiatives aimed at strengthening the NFP sector, including in particular:

- ▶ establishment of the Australian Charities and Not-for-Profits Commission (**ACNC**), to commence on 1 July 2012, and
- ▶ introduction of a statutory definition of charity based on the recommendations of the 2001 Report of the Inquiry into the Definition of Charities and Related Organisations (**Charity Definition Inquiry**) and incorporating the High Court decision in *Aid/Watch Inc v Commission of Taxation* (**Aid/Watch**).

PilchConnect welcomes these announcements – and broadly the Government's commitment to reforms which aim to reduce regulatory complexity for NFPs, streamline reporting requirements and enhance productivity and innovation in the sector. These commitments are consistent with recommendations of the numerous inquiries and reviews conducted over the last 15 years<sup>1</sup> which have highlighted the need for NFP regulatory reform.

We submit that the Consultation Paper must be viewed in the context of the Government's overarching NFP reform agenda. While PilchConnect supports the Government's aim of ensuring tax concessions are appropriately targeted, in our view any taxation reforms must serve the Government's commitment to smarter NFP regulation, and not exacerbate NFP regulatory complexity without providing real improvements to the current system. On the information provided in the Consultation Paper, we consider implementation of the proposed new taxation arrangements may result in increased complexity and compliance burdens for NFPs, without clear regulatory advantages or public benefits.

### 3.1 Rationales for reform evident in the Consultation Paper

It is important to consider the rationales underpinning the design of the reforms to assess whether the proposed measures represent the most appropriate approach to achieving the desired policy objectives.

There are a number of rationales for reform evident in the Consultation Paper, including:

- ▶ ensuring that tax-exempt NFPs maintain focus on their altruistic purposes and direct any profits (surplus) from commercial activities back into furthering those purposes,
- ▶ reducing the risk to altruistic assets from unprofitable commercial activities, and
- ▶ creating a 'level playing field' for all small, large and NFP businesses (in other words, to maintain a level of competitive neutrality).

PilchConnect supports the policy intent underlying the first of these rationales. Tax concessions are available to NFPs because there is a recognised 'public benefit' in the purposes they serve. As these concessions ultimately reduce the potential scope of the national revenue base, it is appropriate that measures be taken to ensure that commercial organisations are not able to 'masquerade' as tax-exempt NFPs in order to avoid

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<sup>1</sup> See especially Productivity Commission, *Research Report on the Contribution of the Not-for-Profit Sector* (2010) (**Productivity Commission Report**), Treasury and Australia's Future Tax System Review Panel, *Australia's Future Tax System—Final Report* (2010) (**Henry Review**), Charity Definition Inquiry, Industry Commission, *Charitable Organisations in Australia* (1995) (**Industry Commission Report**).

paying proper taxes. We agree therefore that income tax concessions should be available where it is clear that profits derived from an NFP's business activities are directed back to advancing the organisation's altruistic purposes.<sup>2</sup>

Unfortunately the Consultation Paper does not provide clear evidence of how widespread the inappropriate use of business income by tax-exempt NFPs is, or how much potential lost tax revenue it represents. It is therefore difficult to assess whether the proposed reforms are a necessary and appropriate response to the problem sought to be addressed. However we submit that if the Government is concerned that some NFPs can access tax concessions but do not have appropriately altruistic purposes, this issue is better addressed by way of a statutory definition of charity (and/or a broader discussion of the scope of available NFP tax concessions), rather than by introducing a tax on business activities of otherwise tax-exempt organisations. Imposing a tax on NFPs' business income would do little to encourage NFPs to build business opportunities to support their altruistic purposes; rather it would inhibit commercial innovation by the sector and may also lead to poor NFP business practices, as organisations may feel compelled to spend the profits of business activities rather than sensibly retaining a portion of this income for contingencies and future investment.

As the NFP landscape evolves, it is clear that many organisations are placing greater importance on a diverse funding source rather than placing full reliance on philanthropic donations. For example, in Victoria, the *Associations Incorporation Amendment Act 2010* (Vic) will repeal the historical prohibition on trading by Victorian incorporated associations, acknowledging that 'in practice, governments, both state and federal, actively encourage many incorporated associations to take on new trading activities.'<sup>3</sup> Any uncertainty as to the tax treatment of commercial activities amongst NFPs has the potential to limit an organisation's willingness to explore trading activities as a potential fundraising source.

The second and third rationales are, in our view, less compelling than the first.

With regard to the second (reducing financial risk to assets), we acknowledge there is a risk that NFPs may engage in unprofitable commercial activities, with the result that the organisation's assets may be affected. However we are not convinced that imposing a tax on NFP business income is an effective mechanism to address this risk. We note that neither the Productivity Commission Report nor other inquiries into the NFP sector have identified financial risk to charitable assets caused by NFP business activities as an area warranting regulatory reform. In our view the problem identified here is essentially one of governance. There are existing legal rules which apply in this context – eg, if an NFP is running an unprofitable business with significant risk to assets, the board/directors of that NFP are arguably failing in their legal duty to act in the organisation's best interests and/or for proper purposes. Legal sanctions apply to a breach of this duty. We submit a more targeted approach to mitigating risk associated with NFP business activities would be the provision of relevant guidance and support to help NFPs understand their legal obligations and implement effective governance and risk management. This could be achieved through initiatives undertaken by the new ACNC as well as by sector-based support services.

With regard to the third rationale (creating a level playing field), we acknowledge that tax-exempt status is a benefit enjoyed by NFPs that is not available to for-profit businesses, but the advantages it brings are offset by other market factors such as reduced access to equity capital, and there are a range of contextual factors which make it difficult to accurately and appropriately compare for-profit and NFP business domains. There are also important motivational differences between a business conducted purely for individual gain and one that operates for altruistic purposes. We note there is a significant body of literature identifying both theoretical and practical problems with taxing unrelated NFP business income as a means of addressing

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<sup>2</sup> See the Treasury Consultation Paper, p 3.

<sup>3</sup> *Associations Incorporation Amendment Bill (Vic)*, Second Reading Speech, 26 May 2010.



competitive neutrality concerns<sup>4</sup> and the Productivity Commission, Henry Review and Industry Commission all recommended against the introduction of a tax on unrelated business income of NFPs. We are also concerned that the proposed implementation of the tax (ie, applicable to unrelated business activities commenced after 7:30pm on 10 May 2011) gives an unfair advantage to NFPs that were operating, and can continue to operate, unrelated business ventures prior to the night of the budget announcement.

## 4. Scope of proposed reforms

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At PilchConnect, a large part of our current work involves assisting NFPs that are struggling to understand the current NFP taxation system and requirements of tax concessions. They have limited resources, are often run entirely by volunteers, with little access to legal and financial management services. They are often keen to comply with regulatory obligations, but need help to understand how to do so. As the ATO itself has noted, there is a high level of voluntary compliance in the NFP sector – and non-compliance is usually due to a lack of knowledge about compliance obligations than with deliberate tax avoidance.<sup>5</sup> **It is critical that any reforms to NFP tax concessions are implemented in a way which is responsive to, appropriate for, and respectful of, the NFP sector.** Reforms which require NFPs to have a sophisticated understanding of complicated definitions and apply vague or legalistic tests will not further the Government's agenda of smarter regulation and reduced compliance burden for NFPs.

The Consultation Paper provides examples of situations where the proposed tax would *not* apply, and activities that it would *not* affect, but in our view it is not clear precisely what the proposed tax *would* capture (and what the expected benefits of this would be). There also appears to be some uncertainty as to whether the proposed tax would apply a test based on an organisation's *activities*, or the *purposes* to which income generated by those activities is put (or a combination of both). On one hand, the Consultation Paper confirms that NFPs will not be subjected to income tax if the profits from business activities are directed back to the organisation's altruistic purposes, apparently even if the activities are 'unrelated'; on the other hand, it posits a test which defines 'related' and/or 'unrelated' activity, which suggests a need to delineate between the two.

We note that in jurisdictions where a 'relatedness' test currently applies (eg USA and Canada), there has been much criticism of the complex definitions and vagueness of the regulatory regime. We have concerns that if such a test were implemented in Australia, the definitional work involved in assessing unrelated/related business income, and the qualitative judgements in establishing whether an activity is sufficiently related to an organisation's purposes, would cause significant confusion for NFPs. Such a regime could stifle innovation in the sector and act as a disincentive to NFPs legitimately seeking to attain financial self-sufficiency through diverse commercial activities (particularly relevant for social enterprises). Regulatory complexity and confusion are real barriers to participation and innovation by NFPs. We submit that any test based on a 'related' and 'unrelated' distinction would need to be very clearly defined, expressed in simple language, and accompanied by appropriate information and educational resources for NFPs.

We also note that if the tax were to be applied only to 'unrelated' commercial activities, it would fail to address risks associated with 'related' business activities conducted by NFPs (which would also appear to

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<sup>4</sup> See, for example, the economic analysis in the Industry Commission Report and Henry Review and for an excellent discussion of this issue, we refer the Treasury to the submission of the University of Melbourne Law School's Not-for-Profit Project to this Consultation Paper.

<sup>5</sup> The ATO 2008/2009 Compliance Program report states (p63): "Non-profit organisations show a strong desire to get it right, but often have a low level of knowledge about how the tax and superannuation systems work. Where compliance issues arise, they are mainly due to mistakes or a lack of knowledge." See ATO 2008/2009 Compliance Program, available at [http://www.ato.gov.au/content/downloads/COR\\_0015516\\_CP0809.pdf](http://www.ato.gov.au/content/downloads/COR_0015516_CP0809.pdf).

be of concern, based on some rationales evident in the Consultation Paper). The Industry Commission noted this limitation in rejecting the introduction of an unrelated business income tax for NFPs in its 1995 report.<sup>6</sup>

## 5. Small-scale threshold

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If the proposed tax is implemented, a small-scale threshold would be an essential feature of the new taxation arrangements. A threshold would help to ensure the increased compliance burden associated with the new tax was proportionate to the risk involved, and it would also reduce the complexity of administration of the regime.

The small-scale threshold should be based on the scale of an NFP's activities, rather than on whether the NFP undertakes certain 'low risk' activities (such as lamington drives). Ideally the threshold should dovetail with existing regulatory thresholds applicable to NFPs to minimise additional compliance burden. One option would be to harmonise the threshold with the three-tiered reporting structure for companies limited by guarantee under the *Corporations Act 2001* (Cth).<sup>7</sup> Another could be to harmonise with GST registration requirements (ie. turnover of \$150,000 or more). Yet another could be to harmonise the threshold with the ATO's eligibility test for small business concessions (turnover of over \$2m).<sup>8</sup>

The small-scale threshold may need further consideration at a later stage (ie when more detail of the proposed tax is known), however we consider that organisations under the 'top tier' of corporations reporting (ie. annual turnover of over \$1m) should be exempt from unrelated business income tax. Over that initial threshold, it would then be necessary to determine what level of unrelated business income should incur liability to pay income tax. Our preliminary view is that an organisation with over \$1m of unrelated business income could be required to pay tax on that amount. This approach would ensure that any significant business activities by NFPs (and major risk to tax revenue) would be captured by the new arrangements, while smaller NFPs would have assurance that they can continue to carry out fundraising activities without restriction.

## 6. Options for implementation

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We reiterate our view that the policy rationales underpinning the proposed reforms would be more appropriately addressed through other measures, such as strengthened governance processes (eg guidance issued by the ACNC) and a statutory definition of charity. That said, we offer the following points on the 3 options canvassed in the Consultation Paper:

- ▶ In our view, options 1 and 2 (which require an NFP to set up a separate entity to conduct unrelated business) would impose a high compliance burden on affected NFPs and significantly increase the complexity of taxation arrangements. We are not convinced such high compliance costs and complexity are warranted given the scope and evidence of the problem to be addressed.

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<sup>6</sup> See Industry Commission Report at 310.

<sup>7</sup> In Victoria, reforms to the *Associations Incorporation Act 1981* (Vic) which are expected to commence in July 2012 will introduce a similar three tier reporting structure for incorporated associations. The 'top tier' applies to organisations with annual revenue of more than \$1m.

<sup>8</sup> See ATO *Guide to Small Business Concessions – Eligibility*, available at [www.ato.gov.au/businesses/content.aspx?doc=/content/00231250.htm&page=2&H2](http://www.ato.gov.au/businesses/content.aspx?doc=/content/00231250.htm&page=2&H2).

- ▶ Requiring unrelated business activities to be carried out in a separate entity may create difficulties for enforcement. If NFPs are required to carry out unrelated business in a separate entity, and an NFP is found to be contravening that requirement, the obvious enforcement option is to revoke the organisation's tax-exempt status. This may have serious ramifications for the NFP – consequences which may significantly outweigh the gravity of the contravention. This has been problematic in other countries<sup>9</sup> and we urge caution in relation to mandating this option.
- ▶ Many larger NFPs already find it more convenient and prudent to conduct unrelated business activities in a separate legal entity (ie. Option 1). Indeed we note the Consultation Paper's comment (page 13) that this occurs in the US, even though there is no requirement to conduct unrelated business activities in a separate entity. If the Treasury's preferred approach is for NFPs to operate commercial activities in a separate entity, there are incentive-based actions which can be taken to encourage NFPs to do so, rather than mandating that organisations must establish a separate entity in order to conduct unrelated business activities.
- ▶ Of the options canvassed, Option 3 offers the simplest mechanism for implementation. In our view, a requirement that NFPs account separately for unrelated/related business activities would be achievable (especially if the new tax rules applied only to larger NFPs over the small-scale threshold) as NFPs already report financial information to regulators and many also report on how funds are directed (eg, for acquittals of grants). However we appreciate that this option would still involve considerable complexity, including dealing with GST and FBT implications of tax-exempt and taxable activities of the one entity.
- ▶ There is no evidence provided in the Consultation Paper to support the Treasury's assertion that if Option 3 were implemented, an NFP's focus would be divided between the NFP activities and the unrelated commercial activities. If a tax-exempt NFP is not operating within the scope of its purposes, there are existing legal mechanisms (eg. duties imposed on NFP directors/board members) that could provide a sanction in this situation. The ACNC could assist in this regard by providing guidance to NFPs on governance and financial management issues. Sector-based support organisations and 'intermediaries' (such as PilchConnect) can also provide advice and assistance to NFPs to help them understand their legal obligations. This would be a more supportive, less 'policing' approach to achieving the desired policy objectives evident in the Consultation Paper.
- ▶ In our view all the options canvassed in the Consultation Paper would involve considerable complexity of administration and compliance.

## 7. Transitional issues

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PilchConnect does not intend to respond in depth to the remaining questions in the Consultation Paper, however we wish to highlight some key points arising from the issues discussed, which we think may affect our key client base (ie, small-medium NFPs with public interest objectives):

- ▶ the transitional arrangements should allow sufficient time for organisations to be able to implement any new requirements. We note the ACNC's public information portal is due to be operational by mid 2013 – potentially, any new requirements and/or reporting obligations with respect to NFP business activities could commence in tandem with the new ACNC reporting obligations,

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<sup>9</sup> See further the discussion of overseas jurisdictions referred to in the submission of the University of Melbourne Law School Not-for-Profit Project to this Consultation Paper.

- ▶ any reforms need to be accompanied by timely, practical and high quality information resources for NFPs,
- ▶ the Government should support sector-based services and ‘intermediaries’ that can provide advice and assistance to NFPs and support them with transition to, and implementation of, any new taxation rules, and
- ▶ further consultations should be undertaken with the sector after the issues raised by submissions to the Consultation Paper have been considered by Government.

## 8. Conclusion

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Thank you for the opportunity to provide comments on the Treasury’s Consultation Paper on better targeting NFP tax concessions. In conclusion we wish to reiterate our support for the Federal Government’s recent action on NFP regulatory reform, and urge the Government to ensure any reforms to NFP tax concessions arising from the proposals in the Consultation Paper are consistent with the spirit of that policy agenda, and strengthen the NFP sector by delivering smarter regulation, streamlining regulatory systems and reducing red tape for NFPs.

We would be happy to provide further comments on request. Our contact details are on the inside cover of this submission.