

19 August 2011

Manager
Philanthropy and Exemptions Unit
Personal and Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: NFPReform@treasury.gov.au

Dear Sir / Madam,

'In Australia' Special Conditions for Tax Concession Entities

We wish to respond to the Treasury's Exposure Draft of the Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No.1) (2011) (**Exposure Draft**), as explained by the accompanying Explanatory Material, 'Restating the 'in Australia' special conditions for tax concession entities' (**Explanatory Material**).

This letter does not propose to address exhaustively all issues arising from the Exposure Draft, rather we intend to bring to the attention of the Treasury particular concerns that we have regarding the impact that the draft legislation may have on small not-for-profit (**NFP**) organisations, and refer the Treasury to the submission prepared by the University of Melbourne Law School's Not-for-Profit Project (**Melbourne University**) for a fuller discussion of these and other salient issues arising from the proposed reforms.

PilchConnect endorses the recommendations put forward by Melbourne University in its submission, and strongly urges the Treasury to have due regard to the matters raised in Melbourne University's response to the Exposure Draft. **In particular, we urge the Treasury:**

- (a) not to proceed with the introduction of a new definition of 'not-for-profit entity';**
- (b) not to proceed with proposed s 50-50(3) (requirement to operate consistently with rules and purposes) or the repeal of s 50-75 (regarding gifts and government grants); and**
- (c) to delay the introduction of proposed legislation while the issues raised above can be resolved and further explained to the sector.**

About PilchConnect

PilchConnect is a community legal service that supports NFP organisations, and is one of six services operated by the Public Interest Law Clearing House (Vic) Inc (**PILCH**). PilchConnect provides free and low cost legal information, training, and advice for NFPs, and is able to match eligible Victorian public interest NFPs with PILCH member law firms to receive free legal assistance on complex legal issues. 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. Our service is unique within Australia.

Our submission

The Exposure Draft comes at a time of other significant proposed reforms to regulatory and taxation arrangements for NFPs. These include the Government's proposals to alter the NFP taxation treatment of unrelated business income, as canvassed in the Treasury's recent 'Better targeting of not-for-profit tax concessions' consultation paper¹ (**UBIT consultation paper**), as well as the establishment of the Australian Charities and Not-for-profits Commission (**ACNC**) and introduction of a statutory definition of charity. It is important to note that the Government has committed to wide-ranging NFP regulatory reform, with the aim of delivering smarter regulation for the sector, removing regulatory complexity and duplication, and reducing red tape for NFPs. We applaud these overarching policy objectives and urge that they be at the forefront of assessing the suitability of any proposed reforms, including the Exposure Draft proposals.

Given the backdrop of extensive reform in the NFP arena, we are concerned that the Explanatory Material does not provide a sufficient explanation or justification for what we believe will be the wide-reaching implications of the Exposure Draft should it be enacted in its current form. In particular, we are concerned that some key implications of the proposed reforms are down-played (and at times conveyed in a misleading way). As a result of this lack of clarity, we are also concerned that many NFPs will not have submitted a response to the Exposure Draft as they are unaware of the serious consequences both for them, and the sector as a whole.

To elaborate on our concerns, we refer the Treasury to Melbourne University's submission to the Exposure Draft and further highlight the following issues below in this letter:

- concerns regarding the policy rationale for the proposed reforms
- the inappropriateness of the introduction of a statutory definition of 'not-for-profit entity'
- difficulties with the 'principally in Australia' test for income tax exempt entities
- difficulties with the 'solely in Australia' test for DGRs
- difficulties with the restrictions on donations by exempt entities and DGRs
- the inappropriateness of the introduction of s 50-50(3)
- removal of the exception for certain gifts and grants
- process issues concerning NFP consultation on the proposed reforms.

1. Policy concerns

The Exposure Draft seeks to implement consolidated and standardised provisions that clearly articulate the 'in Australia' special conditions linked to various exempt entities. While PilchConnect supports measures to improve consistency and clarity of laws relating to NFPs generally, we are concerned that the Exposure Draft goes well beyond merely 'restating' and 'clarifying' the existing legal position and would impose additional and unwarranted restrictions on NFPs without a robust policy justification for change.

¹ Treasury, *Better Targeting of NFP tax concessions* (Consultation Paper, 27 May 2011) <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2056>

We refer the Treasury to Melbourne University's submission and note that:

- there are important issues of principle involved in the concept of the 'in Australia' requirement in a globalised world that are not adequately addressed in the Explanatory Material;
- the stated rationale for the 'in Australia' requirement (and legislative history of provisions) in the Explanatory Material is misleading in a number of respects;
- no evidence has been offered to support the assertion that money laundering, tax avoidance and terrorist financing are systemic issues in the sector or that these risks warrant this legislative response; and
- there is, therefore, a real question as to whether the proposed new 'in Australia' restrictions are necessary to achieve the stated purposes, especially in light of the lack of evidence provided of the problem to be addressed, and also the pending establishment of the ACNC.

We are concerned that the Exposure Draft would impose some of the highest barriers to cross-border philanthropy in the developed world. We urge the Government to consider the impact of these proposed reforms on its commitment to strengthening the sector, encouraging innovation and reducing compliance burden – in our view there is a significant risk that the Exposure Draft reforms will work against the Government's broader reform objectives.

2. Definition of 'not for profit entity'

Of primary concern is the proposed definition of 'not-for-profit entity'² in the Exposure Draft. We urge the Treasury not to proceed with its introduction. The consequences detailed in Melbourne University submission³ should be noted, in particular that the proposed reform would materially alter the generally accepted (and widely used) definition of 'not-for-profit' by:

- extending the scope of both the purpose and non-distribution requirements beyond members to include other (undefined) 'particular entities', including owners;
- removing the critical word 'individual' before that of 'members' in the requirement of 'purpose';
- altering the purpose requirement by introducing a focus on carrying on 'activities'; and
- removing the requirement that the organisation must have a non-distribution clause in its constitution.

² Sch 1 item 7 of the Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No. 1) Exposure Draft 2011 states that **not-for-profit entity** is an entity that:

- does not carry on its activities for the purposes of profit or gain for particular entities, including its owners or members, either while it is operating or upon winding up; and
- does not distribute its profits or assets to particular entities, including its owners or members, either while it is operating or upon winding up.

³ Not-for-Profit Project, University of Melbourne Law School, Submission to the Treasury 'In Australia Special Conditions for Tax Concession Entities (Exposure Draft, 4 July 2011), 3.

The lack of a clear definition of ‘particular entity’ is especially concerning given the potentially wide reaching consequences. PilchConnect assists many small, volunteer-run organisations who individually lack the necessary resources to independently achieve outcomes that impact their particular sector as a whole. To leverage their impact and contribution and enhance their sustainability, many of these small organisations elect to join a peak body. A peak body (for example, for community service organisations) quintessentially operates for the benefit of its members – who are themselves NFP organisations. Currently, a peak body is not precluded from operating for the gain or benefit of its members (who are charitable entities) or entities furthering the charitable purposes of the peak body itself. However, the proposed definition would seemingly limit the ability of a peak body to carry on its activities for the purposes of profit or gain for ‘particular entities’ – which, if broadly interpreted, may include the small NFPs that form its membership.

With draft legislation for the ACNC imminent, we recommend that a more appropriate time to canvass a new definition of an NFP is via the ACNC regulatory framework. We note that the Exposure Draft specifies that the definition of a NFP entity ‘is to be disregarded for a period of 12 months from Royal Assent in respect of any not-for-profit entity that is adversely impacted by the measure.’⁴ The inclusion of this transitional provision suggests that (even in the Government’s opinion) the introduction of this definition is somewhat premature and could have unintended adverse consequences. Putting the burden on individual groups to prove an adverse impact will be time consuming for them and the Australian Taxation Office / ACNC; it will add to red tape and the increase the compliance burden.

In light of the far-reaching, serious and seemingly unintended consequences of this aspect of the Exposure Draft, PilchConnect endorses the recommendation made by Melbourne University:

The current legislative definitions of ‘non-profit’ in Commonwealth legislation⁵ should be used as the standard definition. This language has already been judicially considered and is used consistently across Commonwealth legislation and in most state and territory legislation.

3. Income tax exempt entities – ‘principally’ in Australia test

Under the Exposure Draft, in order to maintain tax exempt status an entity must operate principally in Australia and pursue its purposes principally in Australia.⁶ While we agree with the general approach proposed, PilchConnect is concerned that vagueness in the wording of the proposed test may in fact add to uncertainty surrounding these requirements and inhibit reasonable and legitimate engagement by NFPs with overseas organisations and institutions.

The Exposure Draft states that ‘principally’ means mainly or chiefly, and less than 50 per cent is not considered principally. Further, the Explanatory Material states that:

‘while no one factor is conclusive, in determining whether an entity is ‘operating in Australia’ and ‘pursing its purposes principally in Australia’ **the Commissioner is expected to consider all surrounding circumstances**

⁴Treasury, *Restating the “in Australia” Special Conditions for Tax Concession Entities* (Exposure Draft, Explanatory Material, 4 July 2011) <<http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2053>>, [1.02].

⁵ See Melbourne University’s submission for details.

⁶ *Ibid*, [1.47]

including factors such as where the entity incurs its expenditure; where it undertakes its activities; where the entity's property is located; where the entity is managed from; where the entity is resident or located, where its employees are located; and who is directly and indirectly benefiting from its activities.⁷

Many organisations that PilchConnect assists are small volunteer-run NFPs, with no employees and no property. We are concerned that this approach may cause NFPs to adopt an unduly cautious approach or even abandon any overseas activities for fear of falling foul of the requirement – where a test is based on ‘all surrounding circumstances’ and a non-exhaustive list of ‘factors’, it can be difficult to assess where they can legitimately draw the line. Many organisations may also find the list of factors lacking in relevance to their operations (for example, there is no reference to volunteers).

A failure by an entity covered by the proposed section 50-50(1) to comply with the special conditions ‘at all times’ will result in a loss of entitlement to their exempt status. Given this very serious consequence for any failure to strictly comply with the requirements, it is essential that definitive guidelines about how to comply with the new provisions are provided in language that is appropriate to NFPs. In our view the Exposure Draft lacks the necessary clarity and detail for NFPs (particularly smaller and start-up groups) to confidently determine whether their activities will fall within the requirements.

4. Deductible gift recipients – ‘solely’ in Australia test

The Exposure Draft proposes to introduce a new stricter test for DGRs – that is, they must operate and pursue their purposes ‘solely’ in Australia. We do not support the introduction of this stricter test, for the reasons explored in Melbourne University’s submission. Critically, the new conditions impose significantly more restrictive conditions for DGRs that limit the extent of their operations, purposes and beneficiaries. We are concerned that the scope and potential impact of these changes is not sufficiently clear in the Explanatory Materials, and refer the Treasury to Melbourne University’s comments on this point.

At PilchConnect, many of our clients are DGRs (or those seeking DGR status) and many are working with international partners, would like to leverage opportunities that arise overseas, or are seeking international cooperation on global issues that impact on Australians (for example, environmental issues). Increasingly, international engagement and participation are vital to an NFP’s ability to further its purposes. NFPs are not immune from our contemporary globalising world, nor in our view should they be required to disengage from the international context to retain tax status. Indeed for some organisations, engaging in activities outside Australia is an essential part of what they do in, and the benefits they provide to, Australia – for example, a research body may conduct clinical trials overseas, and a cultural organisation may perform at international festivals – these organisations benefit Australia even while an important part of their activities are conducted overseas.

Given the relatively recent introduction of the ‘in Australia’ requirement for DGRs, and the original intention of the relevant provisions (as explained in Melbourne University’s submission), we think there is a good argument that the requirement should be made more liberal, rather than stricter, to accommodate our 21st century experience. However, even if it is accepted that there is a contemporary need for a stricter test, in our view the Exposure Draft goes beyond what is needed to achieve the intended policy objective and will create significant unintended barriers to participation and innovation by DGR entities.

⁷ Treasury, *Explanatory Material*, above n 5, [1.48]

PilchConnect endorses Melbourne University's recommendation that:

... the Treasury consult further on the implications of this changed threshold on the activities of DGRs. If the Government continues to adopt this policy position, we consider that the 'solely' threshold should be liberalised to ensure that NFPs can continue to engage globally.

5. Donation restrictions on income tax exempt entities and DGRs

The Exposure Draft proposes to impose a new requirement on income tax exempt entities that would prohibit them from donating money to any other entity, unless that other entity is also an income exempt entity. (This is in addition to the core test that requires an entity to operate and pursue its purposes principally in Australia.) Similarly, entities endorsed as DGRs are only permitted to donate to other endorsed DGR entities.

The Explanatory Material frames this new requirement for income tax exempt entities as restating this element of the test with the aim of ensuring that entities cannot pursue their purposes by merely passing funds to other entities (hence reversing this aspect of the High Court's decision in *Word Investments*). However we consider the implications of this additional requirement are more far reaching. In this regard we refer the Treasury to Melbourne University's submission and further emphasise that:

- the proposed approach goes beyond what would be required to ensure that income tax exempt entities and DGRs donate to other entities that are 'in Australia' and not overseas (assuming this is the intended policy aim) by additionally requiring them to have the requisite tax status;
- there are many reasons why an NFP may not access income tax exemption and/or DGR endorsement, even though they would be eligible for such concessions (for example, they do not have sufficient know-how and resources to apply for endorsement); and
- there is an inconsistency between the restrictions on donation types for exempt entities (that is, cannot donate money) and DGRs (that is, cannot donate money or property).

At PilchConnect, we receive many enquiries from small NFP organisations that are likely to be eligible for endorsement as a tax concession charity and/or DGR, but which do not have the expertise, level of understanding or resources to apply for these tax concessions. Often NFPs come to us for assistance because they have applied for endorsement and been rejected, and with the help of a pro bono lawyer, many of them are supported to make relevant (technical) changes and successfully re-apply for endorsement. We also note that some NFPs do not (and do not wish to) solicit gifts from the public and so have no interest in being endorsed as a DGR; and others are not yet at a stage where tax exemption or deductibility of gifts is a priority area (this is often the case for small 'start-up' groups).

Under the proposed new rules, an income tax exempt entity or DGR would be prohibited from donating to any NFP that did not have the same tax status as itself, even if such donations would be squarely within the donating organisation's purposes and the recipient of the donation is in Australia. In our view this situation would act as a significant barrier to the NFP sector 'helping itself' and would have particularly onerous consequences for start-up organisations and local grassroots groups that often rely on donations to get up and running (even so that they themselves can apply for tax concessions).

For the above reasons we encourage the Treasury to give due consideration to the submission prepared by Melbourne University on this issue and we endorse its recommendation that:

If the Government continues to adopt this policy position, it should consider allowing income tax exempt entities and DGRs to give money to entities that, to the best of the donor's knowledge, themselves operate and pursue their purposes principally in Australia. The Government should also allow DGRs to donate money to income tax exempt entities as well as DGRs.

6. Special condition – requirement to operate in manner consistent with rules/purpose

The Exposure Draft proposes the introduction of a new provision (s 50-50(3)) which would require NFPs to 'comply with all the requirements in its governing rules' and 'use its income and assets solely to pursue the purposes for which it was established' in order to satisfy the special conditions of eligibility for income tax exemption.

While PilchConnect supports measures that encourage NFPs to comply with their governing rules and pursue their purposes, we consider the requirement as currently drafted is unwarranted and its consequences draconian. We refer the Treasury to the submission of Melbourne University and note in particular that:

- the consequences of a breach of this provision are severe: a minor breach of the governing rules of an organisation is seemingly enough to strip an exempt entity of its tax exempt status. No mention is made in the Exposure Draft of avenues for organisations to rectify this breach. Nor is any mention made to the proposed enforcement of this additional requirement;
- it is foreseeable that small, volunteer-run organisations may inadvertently breach the rules and face what appear to be disproportionately harsh penalties for what may be a minor breach;
- the rationale supporting the inclusion of this special condition is entirely unclear. Without elaborating on the 'inappropriate conduct' referred to, the Explanatory Material suggests that this new 'special condition' is a response to difficulties experienced by the Tax Office because "inappropriate conduct' [by NFPs] may not always manifest pursuit of an alternate purpose but nonetheless should result in entity no longer being entitled to endorsement.'⁸ No further explanation is provided and there are no examples of the kind of conduct sought to be captured by this new provision; and
- in our view, the underlying policy issue to be addressed here is one of NFP governance and this is a matter more appropriately addressed in legislation on the role and functions of the new ACNC, rather than in legislation purporting to amend the 'in Australia' requirements for tax concessions.

At PilchConnect, a large part of our current work involves assisting NFPs that are struggling to understand the 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 usually keen to comply with taxation obligations, but need help to understand how to do so. As the ATO itself has noted,

⁸ Treasury, *Explanatory Material*, above n 5, [1.71]

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 rather than deliberate tax avoidance.⁹ It is critical therefore that NFPs be supported to comply with their obligations, rather than placed under constant ‘threat’ of having their tax status revoked. We submit that the proposed mechanism in the Exposure Draft is not the best way to support good governance or address ‘inappropriate conduct’ within the NFP sector.

Given the potential consequences of this additional requirement, and the lack of solid policy underpinnings, we endorse Melbourne University’s recommendation that:

Proposed s 50-50(3) should not be included in the forthcoming Bill.

7. Removal of exception for certain gifts and grants

The Exposure Draft proposes no equivalent of the current s 50-75 of the *Income Tax Assessment Act 1997* (Cth) which excludes gifts and government grants from the calculation of whether an entity is operating principally in Australia and pursuing its purposes principally in Australia. We draw the Treasury’s attention to Melbourne University’s concerns about the repeal of this provision (in particular its potential impact on organisations receiving government grants), and the lack of reference to the repeal of this section in the Explanatory Material. PilchConnect endorses Melbourne University’s recommendation that:

The Government reconsider the repeal of s 50-75 or, in the alternative, clearly explain the intended effect of the repeal in the accompanying Explanatory Memorandum.

8. Process issues with this consultation

We wish to comment on the Government’s approach to consultation on these reforms. The Government has formally committed to working with the sector on reforms affecting NFPs through the National Compact, *Working Together*. In order to adequately consult with the NFP sector, other approaches may need to be taken by Government to obtain feedback from groups that are directly affected but that are unable or ill-equipped to write a formal submission to Government, especially within the timeframe provided. Consideration should be given to other modes of consultation with the sector such as focus groups and roundtables.

Further, the Exposure Draft covers highly technical issues on which there should at least be proper and more targeted consultation with charity law experts (practitioners and academics). Given their potential impact and, as the transitional arrangements suggest, likely (unintended) adverse consequences, these are reforms that should be reviewed by the Taxation Board of Review to ensure the draft legislation adequately reflects (what should be) more clearly articulated policy objectives.

We are particularly concerned that this Exposure Draft proposes substantial and far-reaching changes to the law, on the basis of information in the accompanying Explanatory Material which is at times inaccurate, and which we believe understates the true nature and implications of the reforms. We also find there to be a very tenuous connection between some changes proposed in the Exposure Draft and the issue of an ‘in

⁹ The ATO 2008/2009 Compliance Program report states (p 63): “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.

Australia' requirement, particularly the proposed definition of 'not-for-profit', and, like Melbourne University, are concerned that the actual scope of the Exposure Draft will not be obvious to many NFPs, which may mean (even if they have the expertise and capacity) they have not responded.

Conclusion

In conclusion we urge the Treasury:

- not to proceed with the introduction of a new definition of 'not-for-profit entity';
- not to proceed with proposed s 50-50(3) (regarding operating consistently with rules and purposes) or the repeal of s 50-75 (regarding gifts and government grants); and
- to delay the introduction of proposed legislation while the issues raised above can be resolved and further explained to the sector.

We thank the Treasury for the opportunity to respond to the Exposure Draft and would be happy to elaborate on any of the issues raised in this letter upon request. Our contact details are below.

A handwritten signature in blue ink, appearing to read "Juanita Pope", with a long horizontal flourish extending to the right.

Juanita Pope
Senior Lawyer

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