



2011-12 Federal Budget

Not-for-profit sector reform initiatives

Overview

The 2011-12 Federal Budget contains a reform package for the not-for-profit sector which has the potential to visit upon the sector a similar level of confusion, administrative uncertainty, and compliance cost as was experienced with the tax concessions endorsement process in the early 2000's.

On the positive side, the foreshadowed changes can be seen as completing the unfinished work of earlier Enquiry Committees, and in that regard the developments will be welcomed by many. Some scepticism may be appropriate however, given the failure of earlier reform attempts to accommodate the diversity of circumstances existing within the not-for-profit sector, and the difficulty in finding

solutions which have universal application. It remains to be seen whether this reform package will prevail, and if so to what extent the powerful not-for-profit sector can modify the final legislation.

The three initiatives which are considered in more detail below:

- 1. Tax concessions: eligibility withdrawn for "unrelated commercial activities"**
- 2. Enactment of a statutory definition of "charity"**
- 3. Establishment of a new regulator - Australian Charities and Not-for-profits Commission (ACNC).**

Both the first and second measures can be seen as revenue raisers. The first measure will directly reduce "tax expenditures" by restricting access to tax concession status. The second measure will indirectly raise revenue by denying charitable status to certain bodies which currently enjoy it (e.g. advocacy groups), after which they will be likely to lose their access to tax concessions.

What is the scope of the not-for-profit sector?

The not-for-profit sector is a little like the dog; everyone knows a not-for-profit when they come across it, but no-one can satisfactorily define it. In its 2010 Review into the not-for-profit sector, the Productivity Commission spent many pages explaining why there was no single comprehensive definition of the sector; the sector is simply too diverse, and in any event the composition of the sector would vary depending upon the changing perspective brought to bear on the sector.

In the publicly available material released so far by the Government, the terms "charity" and "not-for-profit entity" seem to be used interchangeably, or at least indiscriminately. It is possible to predict some of the entities that will be covered by the reform measures, but it is not possible, as presently informed, to be certain about those at the margin. All bodies which are charities or public benevolent institutions, will be affected. Not-for-profit hospitals and child care centres will be caught.

But what about the broad range of community service organisations which may or may not come within the current common law definition of “charitable body” but which clearly lack the altruism gene?

What about sporting clubs, leagues clubs, shared interest associations, mutual societies and fraternities, not-for-profit schools and educational institutes, professional association bodies, and so on?

Exactly who will be required to register with the ACNC will be a critical threshold issue. If covered by the ACNC, there will be in many cases duplicate reporting requirements.

The impact of the proposed changes to available tax concessions will also be of critical interest to all. Any entity which is a “charity” to any extent, and which has unrelated commercial activities, is on notice of change. But what if another body, which is a not-for-profit but not a charity, has unrelated commercial activities - will this be affected?

Setting working boundaries will be an early task for the Implementation Taskforce.

Tax Concessions

At the Federal tax level, there are concessions available to eligible not-for-profits in connection with:

- Income tax;
- Fringe benefits tax; and
- Goods and services tax.

In differing circumstances, some or all of these concessions may come under review with the possibility of future access being denied. Assistant Treasurer Bill Shorten explained the motivation for the changes thus:

“The Government strongly supports the provision of welfare, education, sports, arts, worship, culture and community services provided by NFP’s through access to significant tax concessions. But the Government believes it is important that charities use their tax concessions only to assist disadvantaged people and not

for unrelated commercial activities. The Government’s reforms will encourage charities to direct profits generated by unrelated commercial activities back to their charity’s altruistic purposes.”

Four points warrant mention. The first is that all references in the press release are to “charities”, not to the broader grouping of not-for-profit entities. Tax concessions currently extend to all eligible not-for-profit entities, not just charities. Are non-charities not at risk? The Budget papers take a different approach, and refer to not-for-profits”. We think this correctly reflects the Government’s target market, so all not-for-profits, whether charities or not, which currently access any tax concessions, are affected and need to plan for change.

Second, the proposed changes target the “unrelated commercial activities” of not-for-profit organisations. Government has drawn a division drawn between:

- Commercial activities which are unrelated to an entity’s altruistic purpose (to be targeted); and
- Commercial activities which are integral in delivering the entity’s altruistic charter (i.e. related commercial activities: not to be targeted).

The “new” regime will apply from 1 July 2011, but initially only to unrelated commercial activities that first commence after Budget Night (10 May 2011). The new regime will be rolled-out to apply to all NFP unrelated commercial activities, but only after an as-yet unspecified transition period. Consultation is promised, but “.... with the intention of phasing [the tax concessions] out over time”. So, the Government’s intent is clear - it is not a matter of “if”, but rather a matter of “when”.

The third point is that FBT and GST tax concessions will be denied unconditionally to unrelated commercial activities of not-for-profit-entities, where those activities are not integral to the delivery of a body’s altruistic purpose. The income tax

concession may remain available for such entities, but only if the net funds generated are released from the business working capital, and actually spent in pursuing the body’s altruistic purposes.

Where a not-for-profit entity pursues its altruistic purposes in a commercial manner (i.e. related commercial activities) then the new regime will not apply, and the body’s entitlements to tax concessions will be unaffected. Examples of such unaffected bodies are: NFP hospitals, NFP child care centres, and businesses which provide meaningful work for disabled persons. Without doubt, the setting of this boundary is going to be a flashpoint during the consultation process.

The fourth point is to observe that the Assistant Treasurer specifically refers to a charity’s “altruistic purpose”. The present common law definition of “charity” does not require the presence of altruism; clearly, this will change with the introduction of the proposed statutory definition - see further below.

The table on the following page summarises the proposed changes to the eligibility for tax concessions.

Small scale and low-risk unrelated commercial activities will not be affected by the reforms. Examples of these “carve outs” are small - lamington drive fundraisers, school fetes and the leasing out of church halls.

Competitive Neutrality Issues

Taxpaying business’ which compete with tax advantaged not-for-profit organisations carrying on similar commercial activities have complained for many years about the “free kick” given to the not-for-profits. This absence of a “level playing field” translates into the economic concept of “competitive neutrality”. This was one of the issues reviewed by the Productivity Commission in its 2010 Report on the “Contribution of the Not-for-profit Sector”.

Tax concessions	New activities commenced post 10 May 2011 Date of effect: 1 July 2011		Existing activities Date of effect: to be advised, but after a transition period	
	Commercial activities related to altruistic purpose	Unrelated commercial activities	Commercial activities related to altruistic purpose	Unrelated commercial activities
Income tax	No effect	Available only if funds used for altruistic purposes	No effect	Available only if funds used for altruistic purposes
FBT	No effect	Not available	No effect	To be phased out
GST	No effect	Not available	No effect	To be phased out

Perhaps unexpectedly, the Enquiry did not find tax concessions to be highly distortionary, and this was reflected in the issue not featuring highly in the Report's recommendations. The high level findings were as follows:

"On balance, income tax exemptions are not distortionary as not-for-profits have an incentive to maximise returns on their commercial activities that they then put towards achieving their community purpose.

Input taxes, in particular payroll tax and FBT concessions, can confer a significant advantage to eligible organisations by reducing their employment costs. They can also distort decisions on the allocation of funds between capital and labour.

In principle, concessions are distortionary whenever an eligible organisation is in competition with a for-profit provider, or not-for-profit not eligible for concessions.

In practice, only a few areas pose a concern. These include not-for-profit hospitals and public hospitals which have a significant competitive advantage over for-profit hospitals."

The reform measures proposed by the Federal Government and summarised in the table above, can be seen to reflect the Productivity Commission's findings, at least to some extent. The reform proposals would permit income tax concessions to remain available for a not-for-profit entities unrelated commercial activities, provided the profit-generated cash is released and spent on advancing the body's charitable

aims. The Productivity Commission found little distortion flowed from income tax concessions.

But the input taxes were found to have a greater distortionary effect, and so the Government proposes to withdraw these concessions (FBT and GST) for unrelated commercial activities of not-for-profit entities.

This is so whether or not the profits from these unrelated commercial activities are applied for the body's charitable purposes.

But it is to be noted that the Productivity Commission's examples of the greatest distortionary effect - not-for-profit hospitals and public hospitals - will not be affected by the Government's proposed reforms, as their "commercial activities" directly serve their altruistic purpose. (At least, that is our view based on the currently available information.)

(The Productivity Commission also raised concerns about payroll tax concessions. We are surprised at this finding, because payroll tax concessions are usually targeted to only charitable bodies, and then only those employees directly involved in charitable activities. But that was the finding. Initially, the Government's reforms are aimed at the Federal tax concessions. However, with the medium term aim of achieving "harmonisation" across all the States, it may be expected pay-roll tax concessions will eventually come under review. This could occur sooner rather than later, particularly if the Federal Government makes all the running, and the State Governments can jump into the slipstream and increase their revenue take, with minimal political pain or risk.)

All not-for-profits should review each of their activities, and identify any which may fall within the classification of "unrelated commercial activities". (If in doubt, take the broader assessment rather than the narrower assessment!) Then the business model should be reviewed for the likely impacts should tax concessions be lost. The potential loss of the income tax concession will have a more immediate and obvious effect, and will be easier to model. But the loss of FBT concessions will result in the complete review of employee remuneration arrangements, and the loss of GST concessions will increase the effective selling price to consumers of goods and services. The effects of the FBT and GST changes are likely to be more fundamental for affected not-for-profits, and more problematic to model.

Whilst these changes will only occur over a "transitional period", early scenario planning will inform the positions not-for-profits may want to adopt during the consultation period.

Of course, if there are any "new" unrelated commercial activities which are in advanced planning, but were not in the market place before 10 May 2011, then urgent review measures are required.

The identification of "unrelated commercial activities" first requires an accurate assessment of:

- The not-for-profits purposes; and
- Those activities which are (sufficiently) related to the achievement of those purposes.

Having completed that internal survey, it should be possible to identify the body's "unrelated commercial activities". This will be easier in some cases than in others. A commercial printing and binding business carried on within a not-for-profit group's stand-alone subsidiary company could easily be seen as an "unrelated commercial activity". On the other hand, providing subsidised hostel accommodation to homeless people from within the not-for-profit entity would not be an "unrelated commercial activity". But the middle ground will be full of difficult examples, and it can be expected the consultation process will attract much discussion (argument) around these boundary issues.

Principle of Mutuality

The Government's announcements have so far made no reference to the principle of mutuality, which is a central element for many not-for-profits. It remains to be seen whether this will be picked up by the ACNC, or whether this omission is intentional and the new regulator will not take responsibility for not-for-profits which carry on activities largely with their members (e.g. clubs, associations and mutuals). This goes to the central issue of the coverage anticipated for the ACNC.

Statutory definition of charity

The Government proposes to enact a statutory definition of the term "charity", building on the recommendations from the 2001 Charities Review. The current definition of "charity" is based on common law conceptions, which can change over time (reflecting moving community values, and potentially to the Government's financial disadvantage) and which does not require the presence of any altruistic element.

Following the release of the 2001 Charities Review, the then Treasurer (Peter Costello) proposed a statutory definition for "charity", but following extensive community consultation, the proposal did not proceed. It proved "too difficult" to settle on a definition which would accommodate the disparate circumstances of the not-for-profit sector,

and (presumably) the pragmatic decision was reached that there was more to lose than to gain in pushing a reform which was deeply unpopular with a wide body of the sector. This occurred in 2003 and 2004; one could assume the Federal bureaucracy will be alive to this history, so either there must now be a significant shift of political will, or the Government is considering a different approach to the definition. Time will tell. For those who took part in the earlier "consultation", it may be prudent to retrieve the relevant papers from archival storage in anticipation of a "return to the future".

At this point, the Government has given no indication of its drafting intent, other than to note the definition will draw on the work of the 2001 Review. That Review recommended the definition of "charity" be drafted to incorporate the following characteristics:

- A non-for-profit entity;
- That has a dominant purpose/s that are:
 - Charitable;
 - Altruistic; and
 - For the public benefit.

This simple formulation was translated into the following draft definition: a charity is a body "...that:

- (a) Is a not-for-profit entity; and
- (b) Has a dominant purpose that:
 - (i) Is charitable; and
 - (ii) ...is for the public benefit; and
- (c) Does not engage in activities that do not further, or are not in aid of its dominant purpose; and
- (d) Does not have a disqualifying purpose; and
- (e) Does not engage in, and has not engaged in, conduct (or an omission to engage in conduct) that constitutes a serious offence; and
- (f) Is not an individual, a partnership, a political party, superannuation fund or a government body."

"Charitable purpose" was defined in turn to be a reference to any of the following purposes:

- (a) The advancement of health;
- (b) The advancement of education;
- (c) The advancement of social or community welfare;
- (d) The advancement of religion;
- (e) The advancement of culture;
- (f) The advancement of the natural environment;
- (g) Any other purpose that is beneficial to the community."

(This earlier proposed definition was based on the existing common law meaning; the element of "altruism" was not included, contrary to the Review's recommendation.)

Whilst different bodies may have taken exception to different aspects of the proposed definition, there were two major hurdles of general concern: lack of certainty about whether it could be said that all an entity's activities furthered its dominant purpose; and that none of an entity's activities fell within a disqualifying purpose.

"Advocacy" was one disqualifying purpose, and a significant number of charities, including large and well-known and respected bodies, feared a loss of charitable status by merely commenting on government policy.

In the end, Mr Costello decided not to proceed with the proposed definition as "...the draft legislation does not achieve the level of clarity and certainty that was intended to be brought to the charitable sector."

No doubt Assistant Treasurer Shorten will want to avoid a similar result, but the present Government has the same objective in mind - at least to some extent - and that is to deny charitable status to advocacy or lobby groups. In a 2010 High Court decision, a non-government organisation which monitored the application of overseas aid, and actively campaigned in respect of foreign-aid related matters, was held to be charitable body, notwithstanding it did not provide any aid itself: *Aid/watch Incorporated Ltd v FCT*.

Those who fail to learn the lessons of the past are condemned to repeat them (with apologies to Santyana). It remains to be seen how good the Government's grasp of recent political history is.

One group of not-for-profits which appears to be particularly vulnerable is those which are closely involved in the delivery of Government funded service programs. These not-for-profits have been protected by the High Court decision in the Bayside litigation, but their exempt status must be doubtful if the definition of charity is changed to include the element of altruism, and even more so if the "links to Government" issue is addressed in the modified definition.

Establishment of a sector regulator - ACNC

The Government has voted funding to establish a new independent statutory agency to regulate all aspects of the not-for-profit sector. It is to be called the Australian Charities and Not-for-profits Commission (ACNC), and will be in place by 1 July 2012. In the interim, the section within the Australian Tax Office which currently determines charitable status applications for not-for-profit organisations, will be "structurally separated" in anticipation of becoming part of the ACNC. The actual administration of tax concessions will remain within the Tax Office. When established, the ACNC ".....will have sole responsibility for determining charitable, public benevolent institution, and other

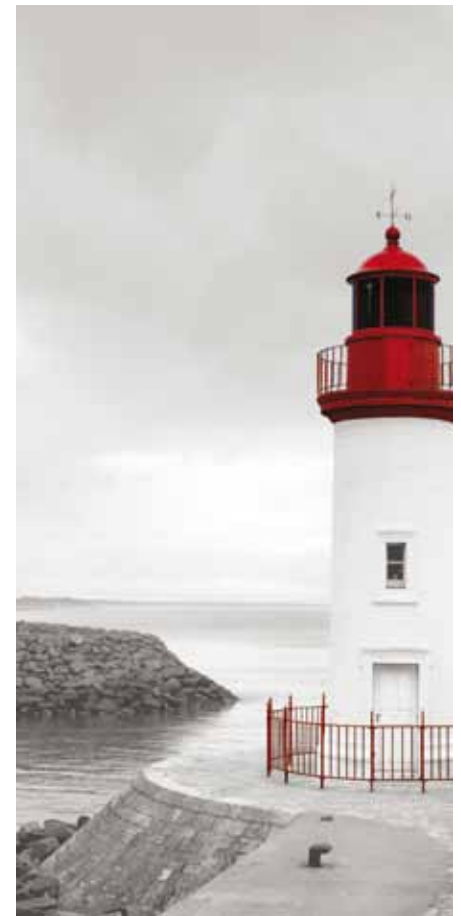
not-for-profit status for all Commonwealth purposes. The ACNC will also initially be responsible for providing education and support to the sector; implementing a "report once, use-often" general reporting framework for charities; and implementing a public information portal by 1 July 2010".

The ACNC will have jurisdiction, at least initially, over all not-for-profits in respect of Federal tax concessions only. However, the Government will enter negotiations with all State Governments with the aim of harmonising definitions, and in time, it could be expected the eligibility for all State tax concessions (e.g. pay-roll and land tax) will be determined by reference to the Federal statutory definition of "charity".

Apart from its role in administering access to tax concessions, the ACNC will have a major role in collecting data across the not-for-profit sector. In its 2010 Report, the Productivity Commission made numerous recommendations around the establishment of single sector regulator; the collection of financial and other data; and the analysis of that data to better understand the real value of the contribution made by the sector. At the risk of being accused of "crying wolf", there is merit in not-for-profit Board's and management teams revisiting the Productivity Commission Report: the performance levels assumed within the Report are likely to present challenges for some bodies, and generally, a need to upgrade finance and reporting capabilities.

The Government reform announcement also foreshadows further reviews into different aspects of the not-for-profit sector, including the future of companies limited by guarantee; fundraising; and appropriate governance obligations for not-for-profit organisations. These matters (amongst many others) were raised by the Productivity Commission in its Report.

With this proposed "reform agenda", the not-for-profit sector can look forward to a very lively decade ahead.



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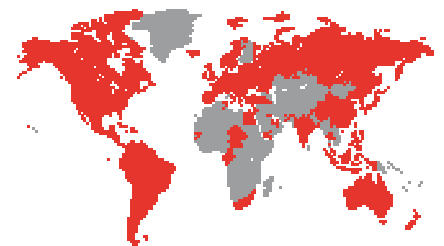
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