Not-for-Profit Tax Concession Working Group *Consultation Paper, November 2012*

Submission by the South Pacific Division of the Seventh-day Adventist Church

Rodney Brady

Chief Financial Officer

South Pacific Division of the SDA Church

Locked Bag 2014

Wahroonga 2076, NSW

Phone: (02) 9847-3333

rbrady@adventist.org.au

To the

NFP Sector Tax Concession Working Group Secretariat

The Treasury

Langton Crescent

PARKES ACT 2600

Email: NFPReform@treasury.gov.au

Executive Summary

The Church welcomes the opportunity to engage in dialogue with the Committee on the important subject of a fairer tax treatment for religion and charity.

Our response is in a format with specific responses to questions along with supporting appendices to support the reasons for our response. The many questions and issues a response has been sought on require much more detailed information for the questions and issues.

The responses are being made in the context of current taxation legislation. The significant *Unrelated Business Income Tax* legislation is yet to be made public. When its proposed contents are released our response to some questions may change materially. Not all questions have been answered.

The Organisation

The South Pacific Division of the Seventh-day Adventist Church is the regional coordinating office for the Church. Its territory includes Australia, New Zealand, Papua New Guinea and other South Pacific countries as far east as French Polynesia. Within this geographic area are various constituent bodies of different legal and administrative status.

The activities of the Church in Australia in this region include the ecclesiastical functions of the Churches; K-12 schools; tertiary education facilities; Aboriginal education facilities and health programs; aged care facilities; the promotion of health and wellness through the different activities of Church including hospitals and Sanitarium Health and Wellbeing; printing and publishing; Christian book shops; national and international welfare, development and aid agencies; second hand shops.

The Church welcomes the opportunity to engage in dialogue with the Panel on the important subject of tax and a fairer tax treatment for religion and charity.

Overall Response

We believe the Government has been right to recognize the role that charities can play in reducing excessive reliance on government social services. We further believe that religion and charity are fundamental pillars of civil society.

This submission should therefore be seen as consistent with, and embracing the logic of, previous government initiatives and putting them within a holistic approach to charity as part of the fundamental social and economic infrastructure of this nation.

Income tax "concessions" for charity have been in Australia's tax laws from their inception. These concessions can be traced back, like many other things, to the United Kingdom.

The anomaly in existing law is that is allows tax deductibility for gifts to cultural organizations, such as cathedral choirs, but not for gifts to religion per se. Yet religion lies at the centre of both Western culture and the legal concept of charity. The discrimination against those charities not currently eligible for deductible gift recipient (DGR) status has no logical justification.

- The *Income Tax Assessment Act 1915* allowed deductions for gifts to "public charitable

institutions". This concept went back to the New South Wales *Land and Income Tax Assessment Act of 1895*, and was then judicially understood as embracing religious institutions.

- The restriction in 1928 of deductibility only to gifts to "public benevolent institutions" instead of "public charitable institutions" was an unfortunate mis-reading and narrowing of both the then existing law and the original intention of Parliament in enacting the 1915 deduction

The word "concession" is perhaps unfortunate. In its common usage, especially by treasury officials or some academic writers, it has acquired a pejorative tone implying that a concession is really an unjustified allowance for human weakness or illogical public sentiment. However, its original sense meant a justified allowance for the circumstances of the particular case.

A key thrust of this submission is that income tax "concessions" for charity are a proper, necessary and entirely logical part of any income tax system and are only to be understood as "concessions" in the strict sense that they are necessary allowances to integrate an income tax into the circumstances of a pre-existing civil society where charities already exist.

The idea that tax concessions for charities are "subsidies" or "tax expenditures" is one which has deplorably infected much writing on the subject. It has no real basis other than assertion. Nonetheless, because of its influence, the logical defects of this viewpoint are subjected to closer scrutiny in *Appendix E* below.

This submission argues that it is logical, appropriate and in accordance with accepted political and economic theory that all income of all charities be exempt, whether from investments or business or donations and that donations to charity, whether in cash or property, should be tax-deductible.

Accordingly, the income tax law should be amended so that all tax-exempt charities are included as deductible gift recipients. With the establishment of the ACNC Australia should follow the New Zealand model which established a Charities regulator then gave a rebate to individuals that donated to registered charities. This was a positive benefit to the charitable sector as a trade-off for greater regulation.

GST and fringe benefits tax changes have created major administrative costs for charities. The sector is now heavily regulated and faces the prospect of duplicated regulation by a charities commission. All these administrative costs create overheads which eat into funds which should be directed to charitable activity. If a charity has passed all the existing administrative requirements imposed by government and is seen to be *bona fide*, it is reasonable for government to accept that a charity should not have to incur further wasteful administrative costs in maintaining separate deductible gift funds: the tax-exempt charity should be recognized directly as being a deductible gift recipient.

As Parliaments grapple with the problem of re-invigorating civil society, fostering self-responsibility, mutual obligation and community partnerships, the time has come to recognize the moral and practical value of charity in building morally responsible citizens and self-reliant communities. Pre-tertiary education in all schools, for example, can benefit from more active parental support and involvement. **Enacting deductibility for gifts to charities and to "public charitable funds" is a key step towards a flourishing and resilient Australian civil society.**

RESPONSE TO SELECTED QUESTIONS

Question 5.
Should other types of NFPs also be able to claim a refund of franking credits?

We submit, yes. **The current refundable franking credit system should be expanded to include all income tax exempt entities and deductible gift recipients as such is consistent with the original intent of the franking credit regime** to:

- Provide a 'fairer outcome'
- Ensure consistency of approach, ensuring institutions are taxed at their applicable tax rate on dividend income, determined in accordance with their wider tax status, which in the case of charities, is exempt or deductible.

The Paper notes that 'perhaps the tax expenditure could be used in a way that benefits a broad range of entities.' For the reasons given in the additional information below, this submission agrees with that proposition. To ensure consistency of approach and avoid effective taxation of certain charities that are otherwise exempt (as is currently occurring for those charities that cannot meet the criteria stated in Division 270-115), an entity that satisfies one or both of income tax exempt status or deductible gift recipient status should be the criteria against which eligibility to claim a refund of franking credits is measured. Consistency of application will have the effect of reducing complexity and a consequential increase in compliance.

Question 6.
Should the ability of tax exempt charities and DGRs to receive refunds for franking credits be limited?

We submit, no. **To remove the regime would be:**

- **to render exempt institutions as taxpayers**. **This is inconsistent with their endorsement as exempt from the payment of income tax or deductible**, and the wider policy intent of the exemption regimes under Divisions 30 and 50 of the ITAA.
- **to reiterate the concerns of the Industry Commission expressed in 1995, to reintroduce a system that leads to:**
    - **a less efficient use of financial resources by charities; and**
    - **produces a distortionary effect on the behaviour of charitable organisations**.

Question 7
Should the ATO endorsement framework be extended to include NFP entities other than charities seeking tax exemption?

No. In fact, the endorsement framework is an unnecessary excrescence upon the income tax law. Under a self-assessment framework, taxpayers are free to assess their own position and, if in doubt, may seek a binding ruling from the Commissioner which is open to review by the Court. Given that there are severe penalties for getting a self-assessment of exempt status wrong and the Commissioner is bound in any case to grant legitimate requests for endorsement, it would simplify things to remove the endorsement framework altogether and let entities approach the Commissioner directly for private rulings if they think necessary.

Question 8
Should the income tax exemptions for State, Territory and local government bodies be simplified and consolidated into the ITAA 1997? Which entities should be included?

There are fundamental constitutional problems in taxing the Crown in right of the States or their subordinate Crown entities. **A blanket exemption is therefore appropriate**. The necessary exemption of local government which often works alongside charities, e.g. in disaster relief, emphasizes the need for charities to receive the same tax treatment as government, namely, non-taxation.

Question9
Should the threshold for income tax exemptions for taxable NFP clubs, associations and societies be increased? What would a suitable level be for an updated threshold?

No comment, other than to say that it is confusing to lump in miscellaneous not-for-profit entities with charities. Mutuality rests on a different principle to charity exemption. As for an updated threshold, there is no need for any threshold, given that a taxable NFP could always declare a trust of its income for exclusively charitable purposes and achieve exemption.

Question 10
Please outline any other suggestions you have to improve the fairness, simplicity and effectiveness of the income tax exemption regime, having regard to the terms of reference.

Exemption should mean that charities are subject to non-taxation in all respects (like governments), not just exempt from income tax.

There are inconstancies in the treatment of charities between the Commonwealth and Sates that need to be reviewed. There are numerous inconstancies between charitable organisations and their activities with regards to the application of Fringe Benefits Tax, Payroll tax and DGR status.

- The treatment of Education at tertiary and K-12 levels is one example. K-12 schools are exempt from payroll tax but don't have DGR status. Whereas Universities can have DGR status but pay payroll tax.

Question 11
Should all charities be DGRs? Should some entities that are charities (for example, those for the advancement of religion, charitable child care services, and primary and secondary education) be excluded?

Yes.

An omission in the Consultation Paper on past recommendations is reference to the 2000 *Inquiry into the Definition of Charities and Related Organisations* and the 2009 *Australia's future tax system* reports that both supported extending tax deductibility to all Charities.

If an entity is a charity, it is eligible for income tax exemption. If it is eligible for income tax exemption, property income may be streamed to it (through trusts, to take one example). The equivalent of deductibility is therefore available to those would otherwise have received the

property income. The deduction for gifts to deductible gift recipients simply puts wage and salary earners who cannot alienate *ex ante* their non-property wage or salary income from personal exertion on the same basis as those with property or business income.

There is no reason to discriminate against religion, child care or primary and secondary education provided by charitable bodies. Such discrimination is illogical in that charity fundamentally arises from the religion and the two have always been intertwined. Prior to the Christianisation of the Roman Empire there was no general concept of charity. As charity embraces what assists other human beings in mind, body and spirit there is no reason to discriminate against primary and secondary education. Universities are public charities and quite properly deductible gift recipients (DGRs) and it would be discriminatory to include tertiary education while leaving out primary and secondary education.

If the idea of deductibility for all charities is wrong, the government should be able to explain to the community why it is wrong? The electorate needs to be told why schools or churches are *less* worthy than animal welfare, choir societies, community radio stations, environmental organisations etc, etc. Reforms must be made so that gifts to charities or to public charitable funds to support the work of bona fide registered charities are included as deductible gift recipients.

Question 12
Based on your response to Q11, should charities endorsed as DGRs be allowed to use DGRs funds to provide religious services, charitable child care services, and primary and secondary education?

If all charities are endorsed as deductible gift recipients there is no need to have separate DGR funds for religion, child-care services or primary and secondary education.

Question 13
Would DGR endorsement at the entity level with restrictions based on activity address the behavioral distortions in Australia's DGR framework? Could unintended consequences follow from this approach?

It is impossible to split religion from charity. Charity comes from the commandment to love your neighbour as yourself. For nearly 2000 years the Christian Church has fostered the relief of poverty, the caring for widows and orphans, the promotion of hospitals, the education of the young as part of its wider mission. Be it the Catholic Knights of St John aiding the sick, the Sisters of Charity establishing hospitals, the Anglican public schools or Adventist hospitals, all Christian denominations accept charity as a religious duty. A true principles-based solution is to accept all charitable activity as having a common religious source and treating it as all equally deductible.

Question 14
If DGR status is extended to all endorsed charities, should this reform be implemented in stages (for example, over a period of years) in line with the PC's recommendations, or should it be implemented in some other way?

For administrative ease and to ease the burden of increased regulation it should be done immediately because it is an existing distortion. The revenue cost of $120 million per annum is minor in context of the total Commonwealth Budget.

Question 15
Would a fixed tax offset deliver fairer outcomes? Would a fixed tax offset be more complex than the current system? Would a fixed tax offset be as effective as the current system in terms of recognising giving?

A deduction system is appropriate because it is a logical method of recognizing voluntary income transfers. A deduction system shows that the income initially earned by, or attributed to, person X is not really being enjoyed privately by X but is being allocated to some other person or socially useful purpose. That income ceases to be the income of X and is the income of the charity rather than of X.

By contrast, a fixed tax offset system may penalize or subsidize income transfers to charities. To the extent that a fixed tax offset is higher than the marginal tax rate of the donor it can be seen as a subsidy and to the extent that it is less than the marginal rate of the donor there is a tax penalty on transferring income to charity. Fundamentally the system of deductibility is nothing more than recognising that A's income is no longer A's income but is the income of B, the charity serving a public purpose.

There is an argument for adding a subsidy to gifts to charity but it is not a tax-neutrality argument. The argument is that such a subsidy offsets a bias in favour of public rather than private redistribution or meeting of social needs. That bias is created by the fact that the administrative costs of government programmes are met by taxes and therefore government programmes start with zero real overhead costs.

Question 16
Would having a two tiered tax offset encourage giving by higher income earners?

A two-tiered tax system such as the Canadian system with gifts over $200 getting a tax offset at the highest marginal rate could encourage some greater giving by some higher income earners. However, **the deduction system is strictly neutral whereas a tax offset in excess of the marginal tax rate of the donor is, to the extent of the excess, a subsidy** (which can be justified on non-tax grounds). In any case it should be remembered that many higher income earners have businesses or trusts through which they can make charitable payments or distributions, for example, as a deductible business expense advertising with or sponsorship of charities or as a distribution of trust income to the charity.

Question 17
What other strategies would encourage giving to DGRs, especially by high income earners?

The main thing is to **avoid creating barriers, by ensuring the tax system does not tax income or assets transferred to charities whether by imposing income tax, capital gains tax or stamp duty on the income or asset transferred.**

Question 18
Should testamentary giving be encouraged through tax concessions and what mechanisms could be considered to address simplicity, integrity and effectiveness issues?

All gifts to charities of appreciated property should be free from capital gains tax and State stamp

duty. There is a current distortion whereby a testator has a peculiar incentive to sell appreciated property on his deathbed to a charity and make a corresponding gift of the proceeds by endorsing the sale cheque back to the chosen charity. Similarly a testamentary trust could sell appreciated property and distribute the cost base and capital gain tax free to a charity. Yet a direct gift of the appreciated property under the will may attract capital gains tax.

Testamentary gifts should also be allowed to be claimed as deductions by the estate and carried forward as offsets against future estate income

The tax trap for testamentary gifts to charity inevitably creates problems with wills making gifts to charity. It sets up a situation where litigation becomes likely between beneficiaries and the charity if, for example, the tax on the charitable bequest is construed as a testamentary expense to be paid for out of residual assets. The neutral treatment would be to treat all gifts to tax-exempt charities as exempt from capital gains tax and stamp duty.

Question 19
Would a clearing house linked to the ACN Register be beneficial for the sector and public?

It is hard to see any need for this. The Tax Office already has a huge administrative burden administering lost superannuation accounts. One suspects it would not be volunteering for more non-tax work. Most people who are donors to charities have a reasonably clear idea of what charity they wish to give to and have few problems in finding out how to do it.

Question 20
Are there any barriers which could prohibit the wider adoption of workplace giving programs in Australia? Is there anything the Working Group could recommend to help increase workplace giving in Australia?

As a long-term career employment continues to erode with declining security of employment, workplace giving will face greater barriers. Only large employers are willing to undertake the cost of running such programs for an increasingly transient workforce. Employers are entitled to claim as general business expenses all amounts expended setting up a workplace giving programmes, given the goodwill thereby attracted to their business. **It is hard to see that more can easily be done.**

Question 21
Do valuation requirements and costs restrict the donation of property? What could be done to improve the requirements?

A valuation will always be required for a gift of property where it is sought to obtain an income tax deduction for the whole value of the gift. In these circumstances, **it is hard to see that much can be done.**

By contrast, a valuation should not be required where all that is sought is to exclude any gain on the property being included as a taxable capital gain.

To illustrate, suppose a donor has paid $100 for an item of property. Suppose its real value is now $500 but he values it at $1,000. If the whole amount is deductible his over-valuation gives him an extra tax deduction of $500 to claim against his other income. But if the capital gain is simply exempt, the over-valuation avails him nothing as the exemption simply offsets a higher capital gain on the higher valuation.

At the State level an important issue is whether donations of property are exempt from stamp duty. All gifts of property to charities should be exempt from both stamp duty and capital gains tax.

Question 22
Is there a need to review and simplify the integrity rules?

Once it is accepted that a gift must be a real gift, there would seem to be little need for further inquiry. **The case law seems quite capable of dealing with this issue**.

Question 23
Are there additional barriers relevant to increasing charitable giving by corporations and corporate foundations? Is there anything the Working Group could recommend to help increase charitable giving by corporations and corporate foundations?

Corporations are advantaged as compared to individuals because they can often claim (indeed usually claim) corporate giving as a tax deduction, the expense being made for a business purpose. Individuals who are not in business are not allowed to claim deductions for charitable giving on the same basis.

Question 24
Are the public fund requirements, currently administered by the ATO, either inadequate or unnecessarily onerous?

Public fund requirements seem to be quite unnecessary. Many charities simply have to go through the rigmarole of setting up a specified public fund which in turn is later drawn upon the purposes of the charity. It creates a system of double accounting for gifts which is inherently a waste of scarce charitable administrative resources.

Question 25
Are there any possible unintended consequences from eliminating the public fund requirements for entities that have been registered by the ACNC?

It is hard to see what consequences there could be, other than a gain in efficiency.

Question 26
Should the threshold for deductible gifts be increased from $2 to $25 (or to some other amount)?

In theory, there should be no threshold for deductible gifts to charity as the principle behind deductibility is that that amount of money (no matter how large or small) is no longer part of the income of the donor. In practice, a threshold amount has been set to simplify administration. Most donors expect a receipt so the administrative work is already done. Receipts are usually sought for a note (i.e. $5 and up) rather than a coin. Whether or not donors keep receipts is not known. Without knowing how many people claim for smaller amounts it is difficult to answer this question. **From a practical perspective $5 may be an appropriate level for today's environment**.

Question 27
Outline any other suggestions you have to improve the fairness, simplicity and effectiveness of the DGR regime, having regard to the terms of reference.

Universal exemption of charity and universal deductibility should be accepted as tax design norms.

Umbrella public charitable funds should be permitted to be eligible for DGR status where they only distribute to tax-exempt charities.

We note that deductions are available for gifts to cultural and philanthropic funds. An easy way to start implementing deductibility of gifts to charity therefore seems to be to place "public charitable funds" alongside these existing classes.

This would allow charities to work together to set up umbrella charitable funds rather than having each and every charity having to apply separately for deductible gift recipient status (which may not be even possible for some closed endowed charities.)

The precedent in Australia was the Elizabethan theatre Trust which used to collect gifts for the arts prior to the register of cultural organizations. In the USA, an example would be United Way, which encourages workplace giving and shares donations among member charities.

Allowing charities to pool resources through umbrella "public charitable funds" would thus help minimize private and public sector administrative costs while achieving the essential objective of treating all charities as equally eligible for deductible gifts.

A "public charitable fund" could be defined as a fund -

- held on trust for exclusively charitable purposes;
- which solicits contributions from the public;
- which makes public its annual audited accounts;
- the trustees of which are appointed by one or more income tax exempt charities;
- and which distributes its income and contributions made to it solely to one or more income tax exempt charities.

Further, large gifts should be allowed to be carried forward as deductions against income of future income years.

APPENDIX A

Supporting Information to questions on Income Tax Exemption and Franking Credits.

Our submission is based on the following details and background information leads us to the answers given to the questions put in the Paper concerning refundable franking credits.

Drawing firstly upon the original policy imperatives underpinning the refundable franking credit regime and an analysis of the effect of limitations upon the current regime we have concluded that:

a. That the current refundable franking credit system should be expanded to include all income tax exempt entities and deductible gift recipients; and,
b. That the ability of tax exempt charities and DGRs to receive refunds for franking credits should not be limited.

Brief Outline of Current System

The imputation system ensures that shareholders who have received income in the form of dividend receive the benefit of the tax paid by the company paying the dividend. Through the 'Gross up and credit' approach, tax paid by a company is imputed to its shareholders to avoid double taxation (in both the hands of the company and the hands of the shareholder). If an entity receives a franked distribution directly, and the distribution is not passed on to another entity, the amount of the franking credit on the distribution will be included in the assessable income of the entity (i.e. the entity's assessable income will be 'grossed-up') and the entity will be entitled to a tax offset equal to the amount of the franking credit. Harris notes that the franking credit provisions can be seen as a component of a global effort to avoid double economic taxation. [1]

Whilst the provisions have adopted several differing iterations since their introduction in 2000, they are currently enshrined in Subdivision 207-E of the *Income Tax Assessment Act 1997* (Cth) (ITAA). As noted in the Paper, 'refunds of franking credits are only available to a limited number of NFPs',[2] being those institutions which satisfy the criteria listed at section 207-115 of the ITAA.

1. Policy History

Both questions put by the Working Group in Section 1.5 of the Paper invite consideration of the ongoing suitability of the refundable franking credit system as it applies to charities today. It is therefore considered that an analysis of the original policy imperatives underpinning the current regime would be helpful. The current regime is essentially a compendium of recommendations put by the 1995 Industry Commission Inquiry into charitable organisations and the August 1998 Howard Government pre-election plan for a New Tax System. These proposals ultimately found their legislative fulfilment in the passage of the *New Business Tax System (Miscellaneous) Bill 1999* (Cth).

1.1 Industry Commission 1995 Report Charitable Organisations in Australia

[1] 'Stapled Stock: Are Australian dividend streaming provisions too wide?' *Australian Tax Review*, Peter A Harris, 1993, 22 AT Rev 239 at 240.
[2] http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Tax-concessions-for-the-not-for-profit-sector, Paper, paragraph 25.

In its 1995 Report on *Charitable Organisations in Australia*,[3] the Industry Commission emphasised the distortionary effect of the pre-refundable franking credits tax regime upon the activity of charities:

> Some participants submitted that Australia's dividend imputation system has unintended consequences for some CSWOs (Community Social Welfare Organisations). These arise because the CSWO cannot use tax credits to offset other taxation liabilities. Black Dawson Waldron Solicitors explained that:
>
> > For a non-taxable recipient, the system imposes the corporate rate of 33 per cent on the profits of a company distributed to a zero rate taxpayer. For an exempt CSWO, the investment decision is complicated because fully franked dividends carry no credit or benefit for the underlying corporate tax. Consequently, CSWO investment is often biased towards high yielding interest bearing debt and unfranked dividends. (sub. 445, p. 9)
>
> The Sunshine Foundation (sub 634) argued that one effect of the dividend imputation system was that charitable trusts and foundations had less money available for charitable purposes.
>
> The Commission recognises that the dividend imputation system in Australia may bias the investment decisions of tax-exempt bodies. As CSWOs are tax-exempt, they may favour investments in shares offering unfranked rather than franked dividends. Similarly, a CSWO may prefer other forms of business ownership than publicly listed shares. This **may result in a less efficient use of financial resources** by CSWOs.

In light of these findings the Commission made the following recommendation:

> Recommendation 12.8
>
> The Commonwealth Treasury should conduct a review to determine the most cost effective way of **removing any distortions** faced by Community Social Welfare Organisations due to the dividend imputation system in Australia.

For our current purposes, we conclude that the report highlighted two principle concerns with the pre-refundable franking credit regime:

1. The distortionary effect on the behaviour of charitable organisations; and
2. The resulting 'less efficient use' of financial resources by charities.

If one accepts the concerns of the Industry Commission, one must also accept that the concerns highlighted continue to apply to those charities that cannot take benefit from the current provisions allowing refundable franking credits to charities because they do not fulfil the criteria found at section 207-115 of the ITAA.

2.2 Howard Government Pre-election Plan for a New Tax System

[3] Commonwealth of Australia, Industry Commission, *Charitable Organisations in Australia Report No. 45*, Melbourne, AGPS, 16 June 1995.

In 1998 the Howard Government made clear that its election proposal to adopt a refundable franking credits regime was driven by a desire for a 'fairer outcome'.

> The refunds of excess franking credits would provide a fairer outcome for low income people in a way consistent with the original objectives of the full imputation system. The overall tax paid on profit distributed by a company or trust to low income resident individuals would reflect their marginal tax rates. They would not be disadvantaged simply because tax was first paid on the profit by the company or trust.[4]

The overarching rationale was that persons should pay tax consistent with the obligations attaching to their total income in order to obtain, first, an equitable outcome and, second, an outcome that was consistent with the otherwise applicable tax regime for the individual. The Howard Government's Plan therefore concluded that refundable franking credits 'would ensure that the imputation system operates as it should – imposing overall tax on distributed profits at the marginal tax rates of resident individual taxpayers.'[5] The arguments for equitable treatment and consistency of approach underpinning the refundable franking credit regime as made for individual taxpayers, as a matter of logical extension, apply equally to exempt institutions.

This focus on fairness and consistency was again reiterated in the 1999 Explanatory Memorandum to the *New Business Tax System (Miscellaneous) Bill 1999*:

> the current treatment means that low-income earners and certain other taxpayers may pay tax on dividend income at a rate higher than their marginal tax rate. This is because the company distributing the dividends may have already paid tax (at the company rate) on profits before distributing them as dividends.[6]

The explanatory memorandum makes clear that 'this is because the measure is aimed at ensuring that taxpayers are taxed at their marginal tax rate on dividend income.'[7]

Subsequently the Treasurer Peter Costello announced on 13 April 2000:

> **Refunding Excess Imputation Credits to Charities**
>
> The Government has decided that it will legislate to refund excess imputation credits to registered charitable and gift deductible organisations.
>
> From 1 July 2000, certain charities will be entitled to claim refunds of imputation credits attached to all distributions received directly, such as dividends from companies, or through a trust.
>
> The Government's announcement will provide a significant financial boost (around $50 million annually) to charities and they will therefore be in a position to provide more services and assistance to their beneficiaries.

[4] Commonwealth Government of Australia, *Tax Reform not a new tax: a new tax system (August 1998)* <http://archive.treasury.gov.au/documents/167/PDF/Whitepaper.pdf> at p 115.
[5] Ibid at 117.
[6] Explanatory Memorandum, New Business Tax System (Miscellaneous) Bill 1999 (Cth) at 17.
[7] Ibid at 19.

> This measure will be legislated as an amendment to the New Business Tax System (Miscellaneous) Bill 1999 (currently before the Senate) which contains provisions refunding such credits to individuals and superannuation funds.

The reforms were introduced to remove the unintended outcome that charities in receipt of a dividend would effectively pay tax on the amount paid. This was inconsistent with, first, the wider policy intent underpinning the refundable franking credit regime and, most importantly, the endorsement of the charity as exempt from the payment of income tax.

3. The Effect of Limiting the Refundable Franking Credit Provisions Upon Exempt Institutions

Question 6 of the Paper asks 'Should the ability of tax exempt charities and DGRs to receive refunds for franking credits be limited?' The question invites consideration of the effect of the removal of that ability for an exempt institution. Such a removal posits that, although an institution is eligible for exemption from income tax, the entity would receive the dividend after tax has been deducted from that stream of income. Professor Ann O'Connell has noted:

> Prior to 1 July 2000 a charity receiving dividends from the holding company share effectively bore the tax paid by the company. That is, because the charity did not pay tax, it could not claim a credit for the tax already paid by the company that was available to other shareholders and such credits were non-refundable. [8]

Love further notes:

> Prior to 1 July 2000, resident tax-exempt organisations were not entitled to a refund of the underlying tax paid by the company on their dividend investments. The imputation credits paid to these organisations were lost because of their tax-exempt status as they could not use the benefits of offsetting the imputation credits against other income subject to tax.
>
> Effectively, tax-exempt organisations were subject to underlying tax on their dividend income when received either directly through a company or indirectly through a trust. This tax treatment resulted in different benefits being derived when funds were invested in share portfolios and real properties (such as land and buildings) even though the pre-tax values of these investments may have been the same. This meant that share portfolios were not a tax effective form of investments for tax-exempt organisations.[9]

Therefore it may be firstly observed that removing or limiting the ability to claim refundable franking credits renders the exempt institution a taxpayer, to the effective extent of the removal, or limitation. This is inconsistent with the endorsement of the institution as either deductible or exempt from the payment of income tax. It is inconsistent with the provisions of Divisions 30 and 50 of the ITAA, as may apply. This is inconsistent with the current system, which logically maintains the net tax position of income paid to a charity. This would return exempt institutions to the pre 1 July 2000 position, as helpfully outlined by Love:

[8] Ann O'Connell, "Tax Issues for Charities in the New Millennium", *Deakin Law Review* (2002) 7(1) 131.
[9] Love, Nathalie, 2001, "Refund of Imputation Credits", Working Paper No. PONC103, The Program on Nonprofit Corporations, Queensland University of Technology at 15.

> 'Prior to 1 July 2000, tax-exempt organisations could not offset imputation credits to reduce an income tax liability, as they are exempt from income tax on all their income. As tax-exempt organisations could not access the benefits associated with the underlying tax already paid by the company, they were in effect paying tax on their dividend income at the company rate of tax.'[10]

In considering the question from the view of the taxpayer, it is to be noted that where the company franks a dividend (i.e. pays tax on a dividend) it is effectively paying tax on behalf of the taxpayer. In the absence of an ability to claim refundable franking credits, the taxpayer would be liable to pay tax on the dividend it receives. It is also to be noted that, when the above policy imperatives are considered, it appears difficult to justify a withholding of the exemption to income tax exempt entities and deductible gift recipients. To do so infringes the original intent behind the legislation to provide a 'fairer' system that ensures persons pay tax at their applicable rates.

[10] Love, above n 9 at 3.

APPENDIX B

Comments on the NFP Sector tax Concession Working Group discussion paper

Page 8 note 2

The concept of tax expenditures is inherently flawed as it is based on a non-neutral paradigm in the first place. Further the costing based on unchanged taxpayer behaviour necessarily overstates the cost of the so-called "tax expenditure".

Page 9

Income tax exemption and refundable franking credits are hardly tax concessions, since they are part of the design of normative income tax system.

The three rationales advanced for providing "tax concessions" to the not-for-profit sector do not do justice to the case.

The third rationale comes closest but fails to do justice to the public choice argument that charities are as legitimate, or more so, than governments as instruments for providing public goods. Competitive neutrality in terms of social organisation requires that they not be taxed at all (like governments which are never truly taxed).

Page 10

The attempt by William Gladstone to remove the income tax exemption for charities led to the greatest deputation ever received in the history of Parliament, led by the Duke of Cambridge. Gladstone found himself completely abandoned by his Parliamentary colleagues. Their common-sense and deeper understanding prevailed over his limited *ceteris paribus* reasoning.

Competitive neutrality in the case of charities is a question of comparing them with governments, not with businesses.

Page 11

At paragraph 2, it is asserted that, in the absence of exemption, charities would be subject to tax on their incomes, usually as companies or trusts.

This is not correct. For a start, if charities are considered as "businesses", logically their distributed income would be treated as tax deductible, being necessarily incurred in carrying on their "business" (a consideration which illustrates the futility of treating charities as businesses). Further, some charities would be able to claim the benefit of tax treaties through their parent charities overseas and, at least one, the Catholic Church, could potentially claim sovereign immunity.

Page 12

The exemptions for charities were always meant to be wide and the separate listing of ecclesiastical

or educational institutions was, strictly speaking, largely redundant.

Page 13

The heads of charity going back to Pemsel's case can be traced further back past the statute of Elizabeth to mediaeval law and the prevailing religious concept of charity. This was the basis on which the US Courts recognized charity law as part of pre-existing common law even though the Statute of Elizabeth was repealed by some States after 1784 in its operation as a British statute.

Page 14 paragraph 23

The cash refund of franking credits is not a tax concession but the logical conclusion of the imputation system because it traces income through to its ultimate recipient. It is necessary to ensure that dividend income received by charities is tax exempt on the same basis as, for example, income distributions from property trusts (where no tax is withheld at source).

Page 15

Paragraph 24

There should be no concern about refunds of franking credits. The table itself seems to illustrate that franking credits are responsive to economic conditions before and after the global financial crisis.

Page 17 option 1.3

Given the lack of efficiency and the increased compliance burdens, it would be better to eliminate the endorsement framework altogether.

Page 18

The cost of $910 million for tax deductible contributions is trivial in relation to government spending and GDP. If anything, it shows the bias in existing social arrangements against voluntary redistribution.

Page 18 paragraph 40

The provision for tax deductibility of gifts to public charitable institutions in the *Income Tax Assessment Act 1915* was in the very first Commonwealth income tax legislation. It followed discussion of exemption for public charitable institutions in the *Land Tax Assessment Act* and the *Estate Duty Assessment Act*. It is clear, as explained in Appendix 5, that the deduction was intended to embrace all gifts to all legal charities. This interpretation was upheld in *Chesterman's case* before the Privy Council. After that case, the Federal Parliament was induced by a misrepresentation as to the nature of the pre-existing law to restrict tax deductibility to a narrower class of public benevolent institutions. The history of this matter is set out in more detail in Appendix 5.

Page 19

Paragraph 46

The categories of welfare and rights, environmental organisations, and international affairs have muddied the waters, in so far as many of these entities are not charitable and may represent advocacy groups rather than charitable activities.

Paragraph 47

"Public benevolent institutions" were a statutory creature introduced into the law after the Treasury (wrongly) persuaded the Parliament that Parliament's original intent in 1915 had not been to extend tax deductibility for gifts to all charities. This was a misrepresentation of the previous law and its intent but Treasury had indeed intended to reduce the scope of deductibility.

Page 21 Note 13

The restrictiveness of the term "public benevolent institution" was intended by Treasury at the time it was introduced. However it ran contrary to the intention of the Parliament in 1915 and, as the note admits, has subsequently created its own anomalies.

Page 22 Para 62

The Productivity Commission recommendation in favour of extending DGR status to all tax endorse charities is rational, given of the findings of the 1995 Industry Commission inquiry and subsequent inquiries. It recognises that if an entity is endorsed for tax exemption it is logical to recognise it for tax deductibility. Tax deductibility only extends to wage and salary income earners the same opportunities that holders of business and property income may have to divert their income to charities in the first place. Owners of business and property income *do not need tax deductibility* in order to achieve the equivalent of deductibility by alienating or directing the income entitlement in the first place to a charity. Denial of tax deductibility is discriminatory and penalises wage and salary earners only.

Page 22 paragraph 63

Higher income earners often do not need tax deductibility to achieve the equivalent of a tax deduction because they can set up their own charitable funds or trusts to divert property or business income before they derive it. In that sense, it is misleading to talk about "the benefit" received by a higher income earner from a system of tax deductibility which many higher income earners with property income would not need in the first place.

Page 22 paragraph 64

It is not correct to describe a tax deduction system as regressive. When account is taken of the *total* tax burden relative to the *total* income the system is still progressive even after allowing for recognition of income transfers to charity. It is incorrect to look at *incremental* equity: one must look at total "equity" (even assuming that graduated income tax is equitable, for argument's sake).

Page 23 paragraph 68

It is logical to extend DGR status to all endorsed charities as recommended by the Productivity Commission.

Paragraph 70

The last sentence recognises that charities are more like government than commercial entities and therefore the appropriate comparison in terms of competitive neutrality is to compare charities to government.

Paragraph 72

Many bodies such as public art galleries, public museums, public libraries and public hospitals started off in their origins as charities and came under the auspices of governments and government legislation in order to put them on a firmer footing. They should be treated as tax-exempt and tax deductible entities because, like charities remaining as such, they exist to serve public needs, like government itself.

Page 24 Paragraph 74

It is absurd to talk about charitable schools as providing significant private benefits while ignoring the fact that selective State schools equally provide private benefits. To do so is to create a bias in favour of public redistribution towards private benefit as opposed to voluntary redistribution. As for the question of integrity issues and fees versus voluntary donations, this statement is legal nonsense because the law already makes clear distinctions between gifts and payments for services.

Paragraph 75

Trying to differentiate the public benefit of charities from their private benefit becomes ludicrous when one considers that poverty alleviation charities, if treated this way, would be regarded as providing private taxable benefits to their impoverished beneficiaries.

Paragraph 76

The assertion in the first sentence is merely that – an assertion. Many people benefit privately from public expenditures, such as new high schools or roads but no one regards the provision of private benefits from public expenditure as an "integrity problem". As for the statement that there is an integrity problem in relation to the provision of religious services, the statement is misconceived in that religion is not a service. Quite the contrary, religion is the worship of the Creator by the created.

Paragraph 77

Why correcting a structural dysfunction in the income tax system should be offset from savings and the removal of sector "concessions" is not logically explained.

Page 78

There is no logic to excluding any kind of charity from tax deductible status.

Page 25

Paragraph 82

It is absurd to try to divide up charity, especially since tax-exempt funds for religion, child-care

services, and education could always get tax-exempt income distributions. It is also noted that it is absurd to discriminate between primary secondary education on the one hand versus tertiary education on the other hand, where universities are eligible DGRs.

Paragraph 83

It is absurd to try to separate religion from charity as religion is the foundation or *fons et origo* of charity. It is equally absurd that a school building funds are eligible for tax deductibility but not gifts to education generally. This is as silly as the idea that a building education revolution that invests in bricks is more relevant to education than the actual quality of the teaching a child gets, whether in a hot classroom with chalk or in an air-conditioned room with computers. It is a “thick as a brick” to confound education with buildings.

Paragraph 85

The tax deduction for donations to deductible gift recipients is unnecessary for corporate deductions claimed as business expenses and unnecessary for those who can divert business or property income via trusts to exempt charities. The tax deduction for donations to deductible gift recipients is fundamentally a proper benefit to wage and salary earners, putting them in the same position as other taxpayers.

Page 26

Paragraph 86

It is not correct to say the tax deduction mechanism is regressive. It is necessary to look at the total amount of tax relative to the total amount of income. One cannot look at regressivity in terms of incremental amounts. It is the total effect of the whole system which counts. (“Disposal” should read “disposable”).

Paragraph 89

The description of an offset system as "fair" is an unsupported value judgement. It is not unfair if one thinks of a deduction merely as an income transfer mechanism like a deed of covenant or an alienation of income mechanism such as a trust distribution.

Page 27 Paragraph 98

The treatment of testamentary gifts is not logical, given that a well advised testator can always create a testamentary trust which diverts income from various assets and their sale towards chosen charities.

Page 28 Paragraph 99

It is an interesting non-neutrality created by the tax system that a tax deduction is available to the energetic donor who makes a *donatio mortis causa* and writes a cheque on his deathbed but not to the forgetful testator who leaves the gift to pass under his will.

Page 28 Paragraph 101

It is possible to achieve the equivalent of a charitable remainder trust under Australian tax law.

Paragraph 102

Any assertions as to tax avoidance opportunities should be spelt out.

Page 29

It would appear to be a waste of time to create a clearinghouse for donations to DGRs at a time when the ATO is stressed administering lost superannuation accounts et cetera.

Page 31 Option 2.9

Yes it would be simpler to eliminate the public fund requirements. They appear to be unnecessary and to create a system of double counting.

Page 32 Option 2.1

All charities should be eligible for endorsement as a DGR entity. This would create neutrality between charities and create neutrality for wage and salary earners versus owners of business or property income who do not need tax deductibility to achieve its equivalent effect.

Page 33

Details should be provided as to alleged tax avoidance opportunities.

APPENDIX C

Deductibility of Gifts to Charity: A reprise

Overview

- Charity, like governments, serves public purposes. Charities have enjoyed the favour of the law since the Middle Ages because they are as much a part of the social fabric as any public institution. The law of charity has always had a public benefit test.

- Unlike governments, charities do not raise funds by taxation but through donations and their own investment or trading income.

- But just as governments cannot be, and are not, taxed (which would be self-contradictory), so charities, as public-serving bodies, should not be either. Unlike commercial companies, charities do not exist to pay dividends to private owners but to serve the public benefit. Their donations, income and funds are reserved for public benefit. Any comparison for a "level playing field" in tax terms has to be with government itself.

- Since charities do not tax, and must rely on voluntary donations, the least that any tax system can do is free these funds from taxation by allowing deductibility and exemption to charities on a consistent basis. This is largely done in the USA and UK.

- The Federal Government has commendably broadened deductibility for philanthropic gifts of property and has encouraged employers to offer payroll deduction for deductible gifts.

- It is consistent with this approach for deductible status to be recognized for all charitable gifts. This would remove anomalies so that gifts to churches would be on the same basis as the many other charities they sponsor and support. General gifts to primary and secondary education would be on the same basis as gifts to school building funds and universities.

- Non-discriminatory tax treatment for all charities would be consistent with the recognition by the Inquiry into the definition of charity that the general concept of charity remains relevant to Australian society.

- Using charity as a unifying concept for tax deductibility and tax exemption has administrative clarity and even-handedness. Charities cannot be political. The public benefit test for charity allows a plurality of worthwhile causes in a liberal democratic society while insisting that mere lobbying or political advocacy are not charitable.

- There are sound economic benefits from general exemption and deductibility for charity. Economic efficiency is improved as increased donations enable charities to complement public spending in meeting society's welfare needs more sensitively and efficiently. At a time when governments of all political persuasions recognize the merit of public-private

partnerships and encouraging self-sufficiency (eg through superannuation tax deductions), it is logical to put deductibility and exemption for charities on a common basis.

- Contrary to what is sometimes said, tax exemptions or deductibility for charities do not involve unjustified tax concessions or "tax expenditures" or departures from competitive neutrality. A "tax expenditure" can only be defined against a neutral tax system and competitive neutrality can only be defined when "all other things are equal". It is actually necessary to give exemptions or deductibility to charities to ensure neutrality towards non-commercial, non-government altruism.

The meaning and history of charity

While some would argue that the existing legal definition of charity is a "horse and buggy" definition which has not been updated since the statute of Elizabeth of 1601, this is merely an assertion which must be tested against history, experience and reflection.

The UK Nathan Report (1952, p 31) recognized "For practical purposes the Courts have for many years accepted the classification of charities and made by Lord Macnaghten in the Pemsel case as a restatement of the preamble in modern terms. The passage in Lord Macnaghten's speech in that case runs as follows; –

> "'Charity' in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any one of the preceding heads".
>
> He added "the trusts last referred to are not the less charitable in the eye of the law, because incidentally they benefit the rich as well as the poor, as indeed, every charity that deserves the name must do either directly or indirectly".

There are two points of major importance to note in Lord Macnaghten's definition. First, that the definition was not closed; as Bradshaw (1983) documents, there is a wide range of charitable objects which could come into the definition depending on social conditions and the emergence of new areas of need; for example pyschotherapy in marriage counselling was unknown in the 19th century and its emergence illustrates the value of research and education in serving real human needs. Second, Lord Macnaghten was well aware that charities benefited - and should benefit - all social classes.

One also notes that religion was central to the definition; this is not surprising as charity in Western culture springs from the concept of Christian charity and good works. Thus universities, schools, hospitals and poor relief by monasteries in pre-Reformation Europe were all Church activities. This tradition largely continued after the Reformation and universities such as Harvard and Princeton were founded as theological seminaries much as Oxford and Cambridge had been founded before.

That the traditional English definition of charity clearly owes much to the Christian religion is emphasized by legal history. As Dal Pont (2000, p 44) notes, the mediaeval Church was the main agency sponsoring all kinds of charitable activity before the Reformation. From early times, gifts to

charity were fostered by the Ecclesiastical Courts and by the courts of Chancery (the Chancellor was an always an ecclesiastic until Sir Thomas More). As the Nathan Report (1952, p 16) notes " Indeed, in the absence of expressed directions in wills it was understood that the residue should be expended on pious and charitable works." There were, of course, ancient examples of philanthropy: for example, Plato bequeathed his Academy to his successors with an endowment of productive land, the Ptolemies endowed the library of Alexandria and the younger Pliny a school in his native town.[11]

Despite these ancient examples of philanthropy, the ancient world had not been particularly solicitous of the ignorant or the poor. Slavery, destitution and ignorance were usually regarded as the fate awarded the common man by the gods. The Christian concept that all men were equal in the sight of the creator was quite novel. Aristotle himself had said that some men were born to the slaves. The Roman republic drew clear distinctions between plebeians and patricians, freedman and slaves. The Christian idea that it was laudable for an educated upper-class person to mix with slaves or freemen and seek to educate their children or tend their sick was novel: individual bonds there might be between master and servant, but there was no general concept of inherent equality.

This religious concept of the inherent worth of each and every individual has profoundly influenced Western civilisation. Western European civilisation since the conversion of the Roman Empire, has held to the ideal, if not the practice, that each and every person is precious and that charity, (which at base means love), consists of aiding persons in mind, body and soul. Hence charity was never confined to aiding the poor, it naturally and always extended to instructing the young and ignorant and aiding the sick, be they rich or poor.

Interestingly, modern concepts of human rights of man are rooted in the same religious convictions which established charity in Western civilisation.

Nor should it be forgotten that other great religions and civilizations have recognized the importance of almsgiving or scholarship. As the Nathan Report noted (1952, p 7, para 34) "Historically, it is the religious motive which has been primarily responsible for widening the bounds of good neighbourliness and the obligation to meet human need. Though frequently neglected in practice, such tenets lay at the heart of the more ethical religions of the past, as well as of the great living religions of today. The command to love one's neighbour as oneself goes back to the earlier days of Judaism. The extension of that command without qualification, 'There is neither Greek nor Jew, circumcision nor uncircumcised, Barbarian, Scythian, bond nor free', was part of the motive force of primitive Christianity. The obligation of almsgiving is emphasised in the Koran and Buddhism and Hinduism are deeply imbued with a sense of the oneness of mankind." For example, in Islam is to be found the *waqf*, an institution governed by religious sanction and which resembles a combination of a family trust and a charitable trust.[12]

---

[11] Kutner (1970, p 16)

[12] Kutner (1970, p 18). It is interesting that the support of one's family as a moral duty is placed together with the duty of charity.

It is important to note that, whether in its religious or secular form, the concept of charity arises from the concept of the natural worth of the individual human being rather than from any utilitarian calculus, which perhaps explains why economic analysis based on wealth-maximizing behaviour has not been notably successful in analysing charity as an economic reality. The philosophical background of modern welfare economics rests on neo-utilitarianism and the utility maximising behaviour of individuals and has difficulty dealing with concepts such as altruism, voluntary gifting of income or moral duty.[13]

Most economic modelling essentially ignores the voluntary redistribution of income or the voluntary provision of social services or social goods, including the most precious social good of all - the mutual trust and confidence of members of society in each other.

Charity, resting as it does on different philosophical foundations, cannot be easily fitted - if at all - into models of utility maximising market exchange or social choice by rational self-interested individuals. Simple economic models of identical, adult, producers and consumers, with perfect information and fixed preferences, living in a world of atomistic exchange can shed little light on the social or economic reality of charity. Such models take certain social facts for granted, often without realizing that they are doing so.

Yet just because altruism and charity are not easily modelled by economists does not mean they are of no socio-economic importance or should not be considered in the formation of taxation policy.

Indeed, the importance of religion and charity for economic or civil society can hardly be overstated. Every day, it is religion which binds people on oath in the Courts of this country. How would governments collect taxes or administer laws if citizens did not obey the commandment not to lie? What would Budgets be like if people were told marriage vows meant nothing and there was no obligation to render unto Caesar what is Caesar's? The Courts and the administration of justice do not depend on force and coercion so much as the voluntary obedience of citizens which rests, for many, upon the moral habits arising from their religious upbringing.

It is instructive that the first President of a modern liberal democratic society, George Washington declared in his farewell address of 1796 that "Of all the dispositions and habits which lead to political prosperity, religion and morality are indispensable supports. In vain would that man claim the tribute of patriotism, who should labor to subvert these great pillars of human happiness, these firmest props of the duties of men and citizens. The mere politician, equally with the pious man, ought to respect and to cherish them. A volume could not trace all their connections with private and public felicity. Let it simply be asked Where is the security for property, for reputation, for life, if the sense of religious obligation desert the oaths which are the instruments of investigation in courts of justice ? And let us with caution indulge the supposition that morality can be maintained without religion. Whatever may be conceded to the influence of refined education on minds of peculiar structure, reason and experience both forbid us to expect that national morality can prevail in exclusion of religious principle.

---

[13] But Adam Smith, the father of economics, was *not* a narrow utilitarian in his thinking and fully recognized benevolence and sympathy in his theory of morality.

It is substantially true that virtue or morality is a necessary spring of popular government. The rule, indeed, extends with more or less force to every species of free government. Who that is a sincere friend to it can look with indifference upon attempts to shake the foundation of the fabric?"

The United States recognizes the separate, yet co-ordinate, positions of state and religion by allowing full deductibility of all charitable gifts (including to religion, which is the wellspring of charity) and tax exemption for all kinds of philanthropy. Deferred gifts of property and securities are also allowed.

What happens when charity ceases to exist?

It is commonplace today for people to admire the strength and vitality of US non-profit institutions and their role in US culture, education and healthcare. The American colonies took a liberal view of charity. Indeed, Massachusetts and Pennsylvania led the way by incorporating in their first post-colonial constitutions express recognition and encouragement of charitable purposes including the encouragement of public and private educational institutions.

But the United States furnishes another, and even more valuable lesson, for those who might argue for restricting or taxing charities. In 1819 in the case of *Philadelphia Baptist Association v. Hart's Executors*, the United States Supreme Court struck down a charitable bequest on the basis that the court's jurisdiction in charity cases originated in the Statute of Charitable Uses which had been repealed by the Virginia legislature in 1792. The result was that, in the United States, charitable gifts, other than to incorporated bodies, failed and many grasping heirs gained what had been intended for charity. By the 1830s, Virginia itself was seeking to reverse the anti-social effect of the Hart decision by both judicial and legislative action to try to save charitable gifts, including for educational purposes.

Fortunately, the American experiment in eliminating general charitable bequests was reversed by the Supreme Court in a famous case which vindicated the validity of the will which established the Girard School for orphans in Philadelphia. With the benefit of the publication in 1827 by an English Records Commission of unreported Chancery cases dating from the Middle Ages, the United States Supreme Court was able to acknowledge that the law of charity rested on case law rather than statutory foundations and dated well before the Statute of Charitable Uses of Elizabeth.[14]

Curiously, in New York, the State Supreme Court continued to hold that charitable trusts had been abolished by a specific State codification of 1829 which had abolished all uses and trusts of land except those specifically authorised. In 1891, the failure of a legacy of almost $4 million left by Governor Tilden to found a free library in New York City led to a public reaction against the ban on charitable trusts culminating in the passage of the "Tilden Act" in 1893 which declared that charitable trusts should thereafter be valid. Subsequent amendments restored the entire doctrine of charitable trusts to New York .

[14] A fascinating account of the 1819-1844 American experiment in abolishing charitable trusts is set out in Miller (1961)

The American experience dramatically illustrates the value of charity and the potential loss to the community if charities ceased to exist or were taxed out of existence.

Political theory

In common with the United States of America and United Kingdom, Australia has inherited the common law and its associated concept of representative government. It is implicit in our theory of political society that the citizen is not the property of the state and that there are pre-existing natural institutions and natural rights. As the 17th-century philosopher John Locke argued in his *Two Treatises on Government*, Parliaments do not come as legislators to a clean slate. The common law, with its associated law of charities, has existed for hundreds of years and many charities in this country are older than either the Commonwealth or its income tax legislation.

Essentially, it should be recognized, as the Americans have recognized, that charity forms an essential part of the social fabric which binds society together. Only Communist or extreme Socialist regimes would take the view that there should be nothing between the State and the individual and that there is no role for intermediating social structures such as family and charity. Indeed, one of the greatest problems in re-creating full civil societies in Eastern Europe has been the over-dominance of society by government to the exclusion of voluntary associations and charities.

Pre-existing civil institutions such as the family and charities serve social needs just as much as governments. Wise legislators have always recognised this and have followed a principle of subsidiarity which seeks to respect and acknowledge the separate and pre-existing roles of other social institutions. No Federal Government, for example, could ever seriously contemplate taking over roles of families, churches and State, local and municipal governments and even the most centralised of foreign nations have found devolution a practical necessity.

Turning more particularly to those civil institutions serving collective needs, these usually constitute local government bodies or charities. Practical respect for these other civil institutions is reflected in the principle that state and local governments and charities are not subject to Federal income tax. Just as one level of government should not frustrate another, so governments should respect the role of charities as equally legitimate institutions serving social needs.

Economic theory

Public choice theory in economics points to the notion that governments are like clubs in the sense that they can provide members of society with services beyond an individual's capacity. For example, social security systems can be explained as forms of collective or mutual insurance (at least in their origins).

But governments, unlike clubs, have coercive taxation powers. Taxation is designed to redistribute funds from private individuals to public purposes (eg education) or towards needy individuals.

Charities do much the same thing. Charity, by legal definition, exists for the public benefit and redistributes income from donors towards its purposes which include the relief of poverty and the advancement of education.

The difference is that charities achieve their public purposes through voluntary gifts and endowments, not through taxation.

As economists (and most other people) know, taxation usually creates economic distortions and disincentives. Taxation always involves economic costs. Hence there is a strong economic presumption in favour of meeting social needs through voluntary funding of charities before resort to public provision through taxation.

This observation furnishes a central economic argument (complementing the political theory argument of subsidiarity) in favour of general tax exemption and tax deductibility for charities.

Tax deductions for charity allow a kind of "free market" in letting taxpayers get the overall pattern of social welfare, broadly defined, which they wish. Some people prefer to support art museums, some prefer overseas aid, some prefer schools but all are given a free choice. It is a commonly accepted view that society works more harmoniously and efficiently when people are able to express their personal decentralized economic choices instead of being subject to the centrally commanded economic decisions of bureaucracies. This economic efficiency argument parallels the argument that a liberal democratic society recognizes pluralism and differences in preferences as natural and to be expected. Such a society looks for ways to foster its citizens' initiatives in every area of public improvement and tax deductions for charity are just one example of such creative pluralism at work.

The definition of charity is appropriate as recognising things which it is in the public interest to undertake. These voluntary forms of meeting community needs should not be impeded or "crowded out" by public sector taxation and expenditure systems. Taxation is a form of economic penalty. Why penalise the voluntary allocation by individuals or businesses of their income towards meeting socially worthwhile needs?

(Parallel economic arguments are often used - and accepted - in relation to even merely private expenditures. For example, tax concessions are given for superannuation contributions and health insurance premiums because government has a legitimate vested interest in ensuring less dependency on taxpayer funded age pension or hospital systems.)

Income taxation theory

Turning from the more abstract political and economic theory arguments in favour of general exemption and deductibility for charities, it is worth noting more precisely how the theory of personal income taxation itself points to general exemption and deductibility.

Henry Simons, the Chicago economist, in his oft-cited book *Personal Income Taxation,* argued that income was consumption plus accumulation. On this definition, it is logical (though unrecognized by Simons) to allow deductibility of charitable gifts since income transferred to a charity is not available for a taxpayer's personal consumption or as in addition to personal wealth. For example, under the United Kingdom tax system, the principle of recognizing income transfers has historically been achieved by allowing deduction of moneys paid under a covenant of gift. In Australia, for example, the tax system recognizes income transfers where a contribution made to a superannuation fund is deducted from the income of the contributor and treated as the income of the fund instead.

The basic idea behind income tax is that individuals should be taxed on the income *they actually enjoy themselves* rather than simply on income received. Any logical income tax system requires that income be taxed once, and once only, and in the hands of the ultimate beneficial recipient. Recognizing income transfers to charity is consistent with this principle of tracing income to the ultimate recipient.

This basic principle is recognized with business or investment income but not with wage or salary income. For example, taxpayers with property or business income can already enjoyed the equivalent of tax deductibility for their charitable contributions simply by making a charity a beneficiary of partnership or trust distributions or of company dividends.

Furthermore, many businesses claim deductions for charitable gifts under the ordinary business deduction provision on the basis that sponsoring charity and being seen to be a good corporate citizen is a legitimate business expense. But a wage or salary earner cannot claim a business deduction for such charitable gifts.

The result is that the present limitations on general tax deductibility for gifts to charity discriminates against wage and salary earners who want to make gifts from their income to charities which may be tax-exempt but do not have tax-deductible status. For example, an employed computer consultant cannot deduct a gift to his or her church but a self employed computer consultant operating through a partnership or trust can do so by arranging a distribution from the business entity. This is an unfortunate discrimination since corporate charitable giving is necessarily limited by the obligation of directors to make profits for shareholders rather than give money away to charity. There is a real need to ensure that giving by the person in the street is not discouraged. The existing anomaly and inequity can be removed by treating all tax-exempt charities as deductible gift recipients.

It is really quite anomalous that churches, as tax-exempt charities, are excluded from deductible gift status. Religion is the *fons et origo,* the fountain and source, of charity. It is precisely because charity in Western civilization finds its origins in the Christian gospels, that religion has always stood within the legal heads of charity. The historical origins of charity in religious conviction, and the continuing relevance of that belief in the activities of the Churches across a range of activities from schools, to hospitals, to welfare, to drug rehabilitation, to marriage counselling - across the whole range of human need - mean that charity in all its forms must be dealt with consistently for tax purposes. Many donors to churches take it for granted churches will use funds for a range of charitable purposes.

Conclusion

It has been recognized for years that it is anomalous that not all tax-exempt charities are deductible gift recipients and that it is illogical, for example, that a general gift to a university is deductible but a gift to a school or church is not. It has also been recognized as inequitable that a high-income taxpayer can gift pre-tax income through a trust or business to a charity but a wage or salary earner cannot.

Religious and other tax-exempt charities should be included as deductible gift recipients. There is every reason of logic and policy for doing so. If a charity is exempt on its income (as it should be) then transfers of income to it should be equally deductible.

APPENDIX D

Previous reports on Income Tax treatment of Charities

Asprey Report 1975

The 1975 Asprey Report, arising from the review of taxation in Australia by the Taxation Review Committee (the Asprey Committee), examined the taxation treatment of charities as part of its comprehensive taxation policy review.

While the Committee was perhaps overly influenced by the then novel terminology of "tax expenditures" or "tax subsidies", it did not, in fact, recommend removal of tax concessions for charities, recognising instead that these could be justified and that there were problems for charities.

The Asprey Report recognised there was a lack of uniformity between tax exempt and deductible status for charities and that one of the chief problems was that deductibility did not extend to religious bodies.

The Asprey Report discussed tax concessions and various types of subsidies, concluding that "charities are non-profit organisations with little or no income apart from investment income." The exemption of investment income of a charity "can be justified as flowing from the encouragement to donors to give to charities" while the deduction system for gifts should be retained in the absence of any evidence to assuage fears of reduced giving if it were to be altered.

Industry Commission 1995

A major aspect of the 1995 Industry Commission report on charities was their tax treatment.

The terms of reference of the Inquiry specifically requested the Industry Commission to report on "the appropriateness of the present taxation treatment of charitable organizations".

The Industry Commission report on charities was, from a tax viewpoint, in some respects a pleasant surprise.

The Industry Commission recognized in 1995 that:

- the tax exemption of charities is not an unfair commercial advantage;
- the exemption of unrelated business income does not lead to unfair competition with commercial competitors, since it would not be rational for a charity not to maximize its profits for its charitable purposes;
- the restrictions on tax deductibility to public benevolent institutions is discriminatory as regards other charities;

- tax deductions should not be capped; and
- the capital gains tax on assets bequeathed to charity is irrational and should be repealed.

We have used the term "charity" although, strictly speaking, the Commission's terms of reference limited it to charities in the social welfare field. But the Commission's recommendations cannot be so limited, given the close links between various kinds of charity.

It was particularly notable that the Industry Commission steered away from any suggestions for restricting the tax exemption or tax deductibility of donations to charities. This is perhaps one of the few occasions where an inquiry within a Treasurer's portfolio has recommended maintenance or extension of what Treasury describes (usually with a pejorative tone) as "tax concessions" or "tax expenditures".

Report of the Inquiry into the Definition of Charities

The Inquiry into the Definition of Charities in 2001 discussed the issue of the tax treatment of charities as it pertained to competitive neutrality. The Committee rejected the argument that the income tax exemption for charities caused unfair competition with for-profit organisations.

The Inquiry recommended some extension of the concept of charity (eg to recognize more fully cultural, environmental and human rights purposes) and accepted that religion properly remained within the primary heads of charity.

The Report of the Inquiry recognised that:

- For-profit business organisations can raise money in capital markets by issuing shares and by entering loan agreements. Not-for-profits are not able to raise money in the capital markets through equity or debt.
- Not-for-profits must rely on government grants, donations, or funds generated by their commercial activities Thus, the Inquiry did *not* accept the notion that charities have an unfair advantage over for-profit organizations.
- The "unfair competition" argument was weak because charities do not have income in the sense used in the taxation laws: charities do not have profits to distribute to shareholders or members. The funds of not-for-profits are devoted to the provision of services.
- Since charities cannot raise equity or debt in capital markets, generating a surplus from commercial activities was the only way to get reserves to undertake capital works or long-term commitments.
- Tax exemption did not give unfair advantage to not-for-profits, given their limited scope for fund-raising.

- Competitive neutrality should not be a factor in defining a charity: “It would be inappropriate for th definition of a charity to change because other sectors of society engage in activities previously undertaken only by charities...if they (charities) retain their characteristics of being not-for-profit and with a dominant purpose that is charitable, altruistic and for the public benefit.”

- Commercial activities are acceptable when not conducted for the profit or gain of any particular person or group of persons. If the dominant purpose of the organisation is charitable, then any other purposes must further the dominant purpose, or be in aid of it, or be ancillary or incidental to the charitable purpose.

- Charities are compelled to find innovative ways to raise funds: “Conducting commercial enterprises as a fundraising operation can be an important, at times essential, element in enabling a charity to achieve its charitable purpose.” The Government itself sought to foster partnerships between the community and for-profit sectors.

Summary Outcome

No independent inquiry into the income tax treatment of charities has recommended either restriction or removal of tax exemption for charity, nor recommended abolition of deductions. On the contrary, anomalies have been recognized including the problem of exempt, but non-deductible, religious charities. Further, the Inquiry into the definition of charities has found that the definition of charity should be somewhat less narrow in certain respects.

APPENDIX E

Arguments raised against Tax "Concessions" for Charities

The "Tax Expenditure" Argument against Charities

The question which has been raised from time to time is whether charities and their donors deserve the so-called "tax concessions" they enjoy. Should these tax "concessions" be replaced by direct Budget funded grants to secure a more efficient and publicly accountable outcome for the "assistance" given hitherto by tax concessions?

It has been the received bureaucratic wisdom that efficiency and equity will be improved if so-called disguised "tax subsidies" for charities are replaced by direct Budget grants. But does it really make sense that centralized decision-making is superior to decentralized decision-making by donors and the charities they support? Are large bureaucracies more sensitive to community needs and aspirations where people live? If centralized, departmental, decision-making has been abandoned for public economic enterprises, why should we expect it to work better at the more complex, social and inter-personal level on which charities operate?

The Concept of a Tax Expenditure

Any argument for replacing tax assistance with direct subsidies has to start with the assumption that tax exemptions for charities and tax deductions for charitable gifts are indeed subsidies. The jargon is that they are tax expenditures - a handout of public money through tax concessions.

Richard Krever argues "In effect, the *Income Tax Assessment Act* consists of two separate systems. The first is the revenue raising system based on a neutral revenue raising tax base. The second is an expenditure programme. This part of the Act has nothing to do with collecting revenue. Rather, it is the spending side of the tax system, the short cut for direct expenditures."[15]

In this statement, Krever states that many provisions of the *Income Tax Assessment Act* (ITAA) are tax expenditures. Put simply, a tax expenditure exists whenever the government assists any activity or person through a concession or allowance in the tax system which deviates from a neutral or benchmark system, instead of using budgetary outlays. The tax expenditure concept is a mode of analysis - a tool for identifying and accounting for disguised expenditures, whatever their purpose. As Treasury in its 1986 Tax Expenditures Statement puts it, tax "concessions reduce or delay the receipt of taxation revenue and... represent a call on the Budget similar to direct outlays. Because their effects on the Budget and on beneficiaries are comparable in many respects to the effects of direct outlays, and because the benefits provided by many of the concessions could conceivably be

[15] Richard Krever "Structure and Policy of Australian Income Taxation" in Krever, Richard (ed.) *Australian Taxation: Principles and Practice* (1987) p 10. Krever was later a consultant to the ATO in relation to its submission to the Inquiry into the Definition of Charity.

provided alternatively by direct expenditures, such concessions have come to be referred to as 'tax expenditures'."

The tax expenditure concept was first promoted in the United States by Stanley Surrey and has been copied in other countries including Australia, Canada and the UK.

The Importance of a Benchmark for Defining Tax Expenditures

Since a tax expenditure is *defined* as a deviation from a benchmark or neutral (which may not be the same thing) tax system, it is first necessary to define and examine the benchmark tax system before one can see whether anything is a tax expenditure or not.

The choice of the benchmark income tax system requires decisions as to what is the normal treatment to be adopted for many aspects of the system, including:

1. The rate scale (including the tax-free threshold):

   Is the tax-free threshold a "tax subsidy"? Generally, the legislated income tax rate scale is taken as a given benchmark.

2. The treatment of entities such as partnerships, trusts or companies:

   Should entity income be taxed twice or taxed only where it ends up? Before 1982 the "double taxation" of company dividends received by individuals was treated as part of the benchmark tax system: in 1988 the imputation system was treated as the benchmark and hence credits for franked dividends are not treated as tax expenditures. This example of a change in the Treasury definition of a "tax expenditure" shows how the term all depends on one's prior assumptions. It is now accepted that the proper conceptual benchmark is that all income should be allocated to persons before imposing tax. Artificial entities do not pay tax - people do. Thus income is allocated through these entities and taxed in the hands of the ultimate beneficiary.

3. The nature of income:

   Henry Simons defined personal income as consumption plus accumulation. If by consumption we mean the flow of satisfactions we receive from goods and services, should we count as income the benefit of public amenities such as parks or gardens? If we do not count these as income when provided by the public sector should we count them as income to the public when provided by charitable trusts? Generally the view is taken that income does not embrace public goods available to all such as defence or national parks etc.

4. The treatment of private income transfers, that is, voluntary private income redistribution:

   Generally, it is accepted that property income can be diverted to another person or charity but not wage or salary income. This may be questioned. Who is the proper taxpayer? - the person who drives the income or the person who gets to actually enjoy the goods and services yielded by its spending? On Henry Simons' view, logically applied, one should tax

income in the hands of the person who *gets to enjoy it*, unless one is willing to argue that giving money away is spending it. It is crucial to decide whether income tax should be levied on income gross or net of private income redistribution.

All these assumptions are relevant to the correct tax treatment of charities.

The Benchmark should be Neutral

One point to be observed is that the benchmark tax system should be a neutral tax system. If one can demonstrate that the chosen benchmark is not neutral, then the whole rhetoric of a "level playing field" falls to the ground with a heavy thud. After all, if one chosen non-neutral tax system is good enough for a benchmark, why not any of a thousand other non-neutral alternatives, including a few tilted in favour of the taxpayers?

History of the "Tax Expenditure" Concept

The tax expenditure concept was pioneered in the USA by Professor Stanley Surrey of the Harvard Law School. While in the US Treasury, Surrey was struck by how often lobbyists succeeded in getting by way of tax concession what they could not get by direct appropriation. The result was his book *Pathways to Tax Reform*, which pushed the idea that tax cuts across the board could be financed by wiping out tax expenditures. However, to be fair to Professor Surrey, many of the tax provisions he attacked were the result of Congressional "logrolling" and could not be justified on any reasonable tax principles. But not all were so devoid of merit and other scholars did not necessarily accept his ideas wholesale.

The tax expenditure concept was first used in Australia by the 1973 Coombs task force on continuing expenditure policies of previous government which was commissioned by the incoming Whitlam Labour Government. That report noted tax expenditures such as tax relief for life assurance premiums and low rates of tax on life fund earnings. (The subsequent decline in national saving and increased age pension dependency led the later Hawke Government to promote use of superannuation tax concessions).

Subsequently in 1982 the House of Representatives produced a Committee report recommending that Treasury prepare a list and costing of Australian tax expenditures. Treasury were only too happy to do so. Since 1986, the annual tax expenditures statement has appeared. Notwithstanding some cautions in the introduction, this list is usually seen as a list of tax concessions Treasury would prefer to see removed.

The list includes tax concessions for charity notably income tax exemption for charities and deductibility of gifts to a restricted set of charities and other causes. By no means all charities are eligible for deductibility. Religion, in particular, is discriminated against as are schools compared to universities.

Pros and Cons of Tax Expenditures

The major criticism of tax expenditures is that they have a perverse "upside-down effect", which undermines the redistributive function of a progressive tax system since the level of benefit can depend on the taxpayer's level of income. Moreover, those without taxable incomes are denied any benefit from tax expenditures.

Also, taxpayers may alter their behaviour in an economically inefficient way in exploiting a tax expenditure largely to avoid tax. The generous tax deductions for investment in Australian films may be an example. Finally, tax expenditures are not subject to the same Budgetary controls as direct Government outlays. Such arguments are often used to suggest that tax deductions should be replaced by tax rebates or credits at a fixed rate or by direct subsidy schemes such as matching grants.

On the other side, tax expenditures have been defended on the following grounds. Treasury in 1986 admitted "In some cases the intention may be to ensure equitable tax treatment for taxpayers in particular circumstances." Examples could be the tax threshold and family tax benefits.

It has been argued that the decentralised way in which tax expenditure decisions are made - by taxpayers rather than the Government - is an advantage because individual taxpayers' spending preferences are better accommodated than would be possible via a central bureaucracy. Also, without the need for bureaucratic review, tax expenditures may be cheaper to administer. Professor Martin Feldstein of Harvard University (later Chairman of President Reagan's Council of Economic Advisers) also argued that a tax expenditure may be successful in stimulating greater overall public and private spending on socially worthwhile activities such as charities.[16]

Because tax expenditures cover such a disparate range of activities, the arguments for or against will vary in strength from case to case. As Treasury officially conceded in its 1986 tax expenditures statement "The inclusion of a particular item in a list of tax expenditures should not be taken to imply a judgement on the merit of its place in the tax system."(original emphasis). Similarly, the House of Representatives Committee concluded that "Each current or proposed taxation expenditure must be examined on its merits."

The Policy Bias

Unfortunately, qualifications are seldom read. The listing of tax expenditures of itself suggests to most people that these tax subsidies so-called should be replaced by direct expenditures. This policy bias has recently been made even more evident by the rewriting of the gift provisions of the income tax law to group them by Budgetary functional expenditure categories.

[16] Professor Feldstein's views stimulated a lot of empirical research in the USA which tended to suggest that tax deductions for charity do lift the overall level of giving.

A critique of the conventional tax expenditure analysis

We have seen that the benchmark tax system should be neutral. This raises the question whether it is neutral for an income tax to ignore voluntary redistribution of income. Should tax be levied on income prior to voluntary redistribution? Business income is taxed net of distributions to creditors and expenses - is it logical to tax individuals without regard to inwards or outwards income transfers?

The public sector is *only one way* for society to meet its welfare needs. Charity is more ancient and, some would say, more honourable. If the public sector finances redistribution through taxes, it is given an advantage compared to private redistribution unless the tax-transfer system recognizes voluntary redistribution. It is *not neutral* for a tax system to ignore voluntary redistribution.

In a pluralistic society, why should not a thousand flowers be allowed to bloom? If maximizing social welfare means recognizing voter preferences, why should they not be undisturbed in promoting those charitable endeavours which most appeal to them? It is after all a test of charity that it be for the public benefit. If people are willing to give money for museums, welfare, hospitals etc there is no efficiency loss to the economy when contrasted with the alternative of tax-financed expenditure on such institutions. Tax concessions for charity are part of an efficient neutral benchmark tax system if one accepts that a neutral tax system should tax private incomes where it finds them.

One has to remember what an income tax is about. Income tax is a tax on persons according to their income. Institutions don't pay tax, people do - hence charities, companies etc should be exempt from income tax. On this reasoning, <u>the income tax exemption for charities is not a tax expenditure at all.</u>

If one wants to impose income tax on charity, it should be imposed on the beneficiaries not the charity, just as in the case of normal private trusts. So, if it likes, Treasury should tax the beneficiaries, tax the homeless, the sick, the poor, the helpless, aged and bereft.

Obviously, this might seem a pointless exercise since many of the beneficiaries will be under the tax threshold. In other cases, no concept of income emerges. After all, if government funded research on AIDS does not generate a taxable income to individuals, why should similar research undertaken by private charities be seen as generating taxable income to the community?

It follows that one can reject, even on tax theoretical grounds, the notion that the tax exemption for charities is a departure from a neutral benchmark.

As for tax deductible gifts to charities, one can also question whether these represent tax expenditures.

- First, a business can often claim a business expense deduction for a gift to charity on the basis that it is a promotional expense incurred in gaining public goodwill. No one suggests that such a deduction is a tax expenditure. It is part of the design of the benchmark tax system. Yet why should business taxpayers be better able to support their favoured charities than wage and salary earners?

- Second, what is income? Is income what you earn or control or what you get to enjoy? Henry Simons said income is consumption plus accumulation. But as Professors Oldman and Andrews point out, that means you should tax gifts of income to the recipient, not the donor - you should trace it through to the final consumer of the income. (It is interesting that the Treasury tax expenditures statement does not address this question though the statement claims to follow the Simons concept of income).

- Third, there is absurd arbitrariness in declaring deductibility of charitable gifts as a "tax expenditure" when it is not a tax expenditure for property or business income to be diverted via a trust to a charity. Yet it is supposedly a "tax expenditure" for a poor PAYE taxpayer wanting to contribute to St Vincent de Paul or the Smith Family or the Adventist Church? A neutral benchmark tax system would treat income from personal exertion no worse than property income. Why is it a "tax expenditure" to allow wage and salary income the same treatment for gifts to charity as is available to property income?

Some may argue that charitable deductions are a "tax expenditure" because what should be taxed is the ability to control the disposal of income not its actual enjoyment. But that is not how any income tax system is really designed. If it were so, and the power to dispose of income was a critical marker of a benchmark tax system, then Treasury should be taxing the directors of public companies on the whole of their companies' profits since it is they who have the power to declare a dividend. Similarly discretionary trustees would be taxed on the income of the trusts they control even though they may be excluded from any benefit. Shareholders and beneficiaries would pay no tax, just as children pay no tax on the after-tax income doled out to them as pocket money by parents. Apart from the obvious injustice, this criterion creates absurdities. Presumably no tax would be paid on dividends from companies with foreign directors. Professors Oldman and Andrews are right in noting that when it comes to income transfers, the usual benchmark income tax system is hopelessly flawed.

To drive the point home, consider a gift of all a taxpayer's income to the Commonwealth. The taxpayer is still subject to tax on it unless the gift is for purposes of defence. This is a strange benchmark for a tax system. Even the Emperor Caligula was content to take everything offered by his subjects without taxing them for the privilege of making their donations to the fisc. Logically, gifts of income to government should be deductible and, if that is so, gifts to charities should be treated the same way.

It is thus very hard to accept the oft-repeated but unreflective view that deductibility for charitable gifts represents a tax subsidy.

Conclusion

George Orwell realized that to control language is to control thought. Terms such as "tax expenditure", "tax subsidy" and "tax assistance" are loaded with implicit value judgments. But one needs to examine the underlying benchmark tax system, before making a judgement on what is really a subsidy. The tax expenditure concept has been used as a convenient crutch for those who

wish to argue that all tax exemptions are subsidies and *a priori* less efficient than direct outlays. It is a great pity that the misguided analogy of "tax subsidies" or "tax expenditures" has often been used as a substitute for real thought. There are, in truth, strong reasons of equity and efficiency which justify exemptions and deductions for charity in terms of tax theory itself.

At its deepest philosophical level, jurisprudence scholars might well question an apparently implicit totalitarian assumption underneath the "tax expenditure" concept. Lower tax rates can be seen as "tax subsidies" just as much as any tax deduction, so any tax rate less than 100% must, by the same logic, be seen as a "tax subsidy". It is almost as if all the revenue of a country belongs to the Treasury and it is a "concession" that anyone is left with anything to feed and clothe themselves and their families. This is a view of normative tax policy totally contrary to the tradition of English law. It has always been for the Crown to justify its appropriation of any subject's property, and not for the subject to justify his retaining his own property.

The "competitive neutrality" argument against charities

Unfair competition?

Businesses sometimes complain that tax concessions for charities results in "unfair competition". For example, St Vincent de Paul shops are accused of taking shopping dollars away from Woolworths or school canteens accused of taking money away from McDonalds.

Hence, it is argued tax should be imposed on the unrelated business income of charities (assuming, of course, that such a concept can be intelligently defined).

But, as the Industry Commission recognized, this argument is quite shallow. Presumably, a charity running a business is as keen to maximize its profits as anyone else. The more it maximizes profits, the more revenue it can apply to its charitable purposes. Indeed, it has more reason to maximize pre-tax profits - it gets to keep the lot. Why should it give away its tax exemption to customers of a business it runs?

From a practical point of view, the concept of taxing a charity's business income is hopelessly unwieldy. What if a charity lends to its business at a rate of interest varying with profits? What if its interest is as a partner or as a beneficiary in a private trust? There is enough verbiage in the tax law without adding more. Yet that is the inevitable effect of trying to draw an artificial separation of a charity's income into business and non-business income.

At a strictly logical level, the "unfair competition" argument does not hold up. Does it mean that nobody should ever do anything cheaply or voluntarily for someone else if it would adversely affect a commercial trader's profits? Are mothers working voluntarily in school canteens "unfair competition" against KFC? On this logic, Parliament would need to pass laws banning mothers from cooking for their children at home instead of taking them to McDonald's every day.

Presumably, no one takes the argument this far. But, as the Industry Commission recognised in 1995, the argument still makes no sense when applied more narrowly to the tax exemption for

business income of charities. If charities are deriving business income from arm's-length activities, they have as much reason to maximise their income from that business as anyone else would have. Just as other differently taxed entities, such as foreign investors or superannuation funds, still seek to maximise the returns from their investments or businesses, so do charities.

Why would charity forego income from its business or investment activities in order to subsidise arm's-length customers rather than and get as much money as it can to carry out its charitable purposes, be they relieving poverty, educational, health-related or religious?

Parliament recognised there is no force in this argument put forward by commercial interests when it legislated, quite properly, to ensure that any tax on the profits of a company distributed to charity is refunded through imputation credits.

At a deeper level, the argument for commercial competitive neutrality completely misses the point that tax exemptions or deductions for charity are actually neutral in the first place. They are available to everyone, including any business. If a Big W, for example, wanted to enjoy the same tax concessions as a charity, it is very easy. All shareholders have to do is decide they no longer want any dividends and vote to declare a charitable trust for the public benefit over all future profits of the business. Many companies do in fact take advantage of tax deductible charitable donations to either their own foundations or two other charities.

What is a level playing field?

The reality is that all sorts of entities, with all sorts of tax treatment, do compete from time to time. Having a "level playing field" does not mean that all players must weigh or be exactly the same height. Co-operatives, families, large corporations, small partnerships or trusts, and foreign-owned corporations may all compete in the one market: yet all have different tax treatments, with their advantages and disadvantages. I may mend my clothes at home, replace them from St Vincent de Paul or buy at a small retail shop down the street or go to Target or order from overseas over the Internet. Each of these choices has different tax consequences but no one argues that home production, sole traders, partnerships, trusts, co-operatives and foreign and domestic companies should all be taxed the same: it is simply not possible, even if it were desirable (which it is not, as recognized by the government's rejection of a common entity tax system).

The danger of false "level playing field" arguments is highlighted when one notes that, in actual fact, charities face some disadvantages in carrying on a business compared, for example, to branches of multinationals. Charities must fund their activities solely through retained earnings or gifts with possibly some borrowing. Charities cannot raise funds through equity, they cannot remit profits offshore through transfer payments or intellectual property licensing or thin capitalization. Charities operate domestically and all their revenues are re-invested in Australian jobs and in providing benefits for the Australian community. A business activity conducted on behalf of an Australian charity may still produce much more overall tax revenue and economic benefit for the Australian community (through onshore economic multiplier effects) than a similar business conducted by a branch or subsidiary of a foreign multinational.

Ensuring ethical competition

Competitive markets are not always ethical or moral. A perfect market in economic theory requires perfect knowledge on the part of consumers. Often consumers do not have such perfect knowledge, especially where the side-effects of a product or the necessity of a service cannot be easily checked. In such situations, there can be a temptation for purely profit-centred producers to "cut corners" or behave unethically (e.g. medical over-servicing or selling food of no nutritional value filled up with cheap sweetening and additives).

While legislation is often used to prevent market abuses, it can never be a complete solution and the integrity of the market ultimately depends on the integrity of the market participants. Participation by charities in some markets may help set standards of market integrity. It is understandable that some commercial providers tempted to cut corners might chafe at competition from a charity which holds to certain ethical standards as part of its mission, but it can hardly be said that competition in this way is "unfair".

Charitable activity in areas such as health can thus act as a check on moral hazard through excessive commercial motivation where the recipient of a service is unable to ascertain whether the provision of a service is necessary. For example, given that the price people would be willing to pay for life is almost infinite, market mechanisms can break down. There are moral temptations for a profit-maximizing supplier of medical or hospital care to over-service an ignorant or desperate patient. It is in cases such as this that charitable provision can act as an ethical conscience for suppliers of services generally by setting publicly observed standards of good professional practice.

As a matter of historical fact, precisely because trust is required in certain activities such as health, charities were well-established before the entry of commercial "for profit" providers.

REFERENCES

Andrews, William D (1972) *Personal Deductions in an Ideal Income Tax* **Harvard Law Review** Vol 86, No 2, December 1972, pp 309-385

(Asprey) Taxation Review Committee (1975) *Full Report* (Asprey Report), Australian Government Publishing Service, Canberra, January 1975

Bradshaw, F M (1983) *The Law of Charitable Trusts in Australia*, Butterworths, Sydney

Charitable Trusts Committee, (Rt Hon Lord Nathan, Chairman) UK Parliament (1952) *Report of the Committee on the Law and Practice relating to Charitable Trusts* (Nathan Report), Cmd. 8710, December, London, Her Majesty's Stationery Office

Commonwealth Treasury (various years) *Tax Expenditures Statement*, Canberra

Coombs, Dr H C (Chairman) (1973) *Review of the Continuing Expenditure Policies of Previous Government: Report of the Task Force*, Canberra, June

Cox, James (1992) *Private Welfare*, Centre for Independent Studies, Sydney

Dal Pont, Gino (2000) *Charity Law in Australia and New Zealand*, Oxford University Press, Melbourne

Goodman, John C and Nicholas, Alistair J (1990) *Voluntary Welfare: A Greater Role for Private Charities*, Centre for Independent Studies, Sydney

Industry Commission (1995) *Charitable Organisations in Australia*, Report No. 45, 16 June, Canberra

Krever, Richard and Kewley, Gretchen, editors, (1991) *Charities ad Philanthropic Organisations: Reforming the Tax Subsidy and Regulatory Regimes*, Australian Tax Research Foundation, Sydney

Kutner, Luis (1970) *Legal Aspects of Charitable Trusts and Foundations*, CCH, Chicago

Miller, Howard S (1961) *The Legal Foundations of American Philanthropy 1776 – 1844*,

State Historical Society of Wisconsin, Madison

Sheppard, The Hon Ian AO, QC (Charirman) (2000) *Report of the Inquiry into the Definition of Charities and Related Organisations*, Canberra, June 2001

Simons, Henry (1938) *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*, University of Chicago Press, 1938

Smith, Adam (1759) *The Theory of Moral Sentiments*, Liberty Press edition, Indianapolis, 1976

Surrey, Stanley S (1973) *Pathways to Tax Reform: the Concept of Tax Expenditures*, Harvard University Press, Cambridge, Massachusetts

APPENDIX F

Tax and Charity

To understand the original intent of "tax concessions" for charity, it is necessary to go back to a pre-income tax world. When Pitt the Younger introduced the income tax in 1798, it was introduced into a society where charitable foundations such as endowments for university colleges or religious institutions had been in existence for centuries. The rationale for tax exemption for charities was thus simply to leave undisturbed socially valuable institutions which were regarded as no less legitimate than government itself.

Thus it is conceptually wrong to speak of "tax concessions" for charity, if by that phrase is meant some indulgence or Treasury handout as opposed to a proper and necessary adjustment to the circumstances of the case. For example, it is not correct to say "The Australian (that is, the Commonwealth) Government... provided around $4 billion of quantifiable support to the NFP sector by way of tax concessions.." (Discussion Paper p 8). To put the matter that way is to make some undisclosed pre-suppositions, viz, that a neutral and proper tax system would not include such tax concessions and that the Federal Government supports charities rather than their donors. Merely not getting in the way of voluntary re-distribution is not the same thing as supporting it.

Hence, it is necessary to start by asking:

1. how a neutral income tax system should treat voluntary income re-distribution; and

2. how should a neutral tax system treat public bodies or charities?

Voluntary re-distribution

Most income tax theorists never think of voluntary re-distribution and income transfers, any more than most of us look at our feet. Yet the question of voluntary re-distribution goes to the heart of income tax theory. If the Henry Simons view of so-called comprehensive income taxation is adopted with closer analysis, there would be massive double taxation. A person who earned income would be taxed on it, even if he gave the income to his wife or to a charity. They in turn would have to include that income transfer as their income (to be taxed or not according to their status). The truth is that Simons never dealt with income transfers in a logically satisfactory way and did not fully explore his implicit assumptions about income transfers. This failure still bedevils thinking on the subject.

Fortunately, legislatures have not been so foolish as tax theorists and have always understood that *earning* income may not be the same thing as *enjoying* that income. For example, in the UK from the earliest times voluntary income transfers were recognized in the tax system where made under a legally binding deed of covenant and taxpayers were allowed to deduct amounts of income deemed necessary to support spouses or dependent children or adults. The Australian colonies adopted similar approaches which were inherited in Sir Robert Garran's 1915 Federal Income Tax Assessment Act.

The neutral approach to voluntary income re-distribution is to recognize it rather than try to pretend it does not exist and ignoring it. A neutral personal income taxation system would seek to identify and tax the *ultimate* recipient who *enjoys* the income rather than taxing the person or entity which *initially earns* it. This, of course, is the reason why trusts and partnerships are not taxed on their

income and why franking credits are provided to shareholders of companies. In each case, the object is to trace the income through to the ultimate recipient. What seems to be forgotten is that the same logic dictates that voluntary re-distribution through income transfers should likewise be recognized in the tax system.

Once this is recognized, it is seen that where an individual transfers some of his income to another person or to a public body or a charity, it should no longer be treated as the donor's income but that of the recipient entity. For example, if a taxpayer makes a gift of his income to Federal, State or local government, that should be treated as their income, not his, and likewise if the gift is to a charity. Any income tax system which does not recognize voluntary re-distribution where it occurs is fundamentally a non-neutral tax system with respect to re-distribution and should not be regarded as a proper norm.

Should public bodies or charities be taxed?

According to John Locke and Thomas Jefferson, governments derive their powers from the consent of the governed. This is true both of monarchical governments where the Coronation oath embodies an acceptance of obligations by the sovereign to the governed in exchange for their fealty and true of democratic or republican governments where those elected are chosen as representatives of the sovereign people who retain the sovereign power to abolish the governments they have created.

Public bodies such as constituent States of a Federation, their subordinate municipal or semi-government bodies are equally set up by the people for their own collective benefit. The Federal Government, notwithstanding the misleading term "Australian Government", is not the sole government of this country.

Governments are created to provide public goods and promote the general welfare of society. But so too are charities. Before governments provided schools, churches did. Before governments provided hospitals, churches did. Before governments provided widows pensions, benevolent societies and charitable funds aided widows and orphans. Governments are historically latecomers on the scene. Charities are as equally legitimate as governments as a means for society to meet its desire for the provision of social goods. Historically, the emergence of charity can be traced back to the Gospels and the emergence of the Church as the sole surviving social institution after the collapse of the Roman Empire.

In England, prior to the Reformation, the ecclesiastical lands comprised about one-third of the land of the kingdom and were devoted to maintain religious houses, churches, universities, schools and hospitals. The statute of Elizabeth on charities was at its root a codification of pre-existing law and, like the Elizabethan poor law, was designed to restore some of the social infrastructure destroyed by the unwise polices of Henry VIII (who had given away so much seized church lands to his favourites and fortunately died before he could carry out his plan to dissolve the endowments of the Oxford and Cambridge colleges).

Once it is recognized that charities, by definition, serve public purposes the only possible tax treatment is pure exemption. They should be no more subject to tax than government itself.

This principle is not confounded by apparent cases where governments may seemingly "tax themselves" as in government departments being obliged to pay goods and services tax (GST) or fringe benefits tax (FBT). In economic truth, governments do not – and cannot - pay tax: their unfortunate taxpayers pay the tax for them.

Accordingly, to impose tax on a charity in a vain pursuit of some chimerical claim of competitive neutrality is to ignore a fundamental non-neutrality – charities cannot recoup taxes levied on them from "taxpayers"; they are dependent on their endowed income and their donors, neither of which can be augmented by fiat. The proper application of neutrality is to treat charities as tax exempt on the same basis as governments and other public bodies.

This submission first provides answers to specific questions raised in the Discussion Paper. The Appendices provide further information on the tax arguments for exemption and deductibility for charities and history as to past inquiries and legislative policy.

APPENDIX G

Legislative history of deductibility of Gifts to Charity

The History

There is legislative precedent for a policy of deductibility of gifts to charity. The original 1915 legislation allowed deductibility of gifts to "public charitable institutions".

That this was, in fact, the clear intention of the Parliament which introduced the 1915 income tax can be extracted from both the history of judicial consideration of previous NSW tax legislation and the relevant Federal Parliamentary debates.

Income Tax Assessment Act 1915

The Act provided both exemptions and deductions for charities and gifts to charities in the following sections.

"11. The following incomes, revenues, and funds shall be exempt from income tax:--
……
(d) the income of a religious, scientific, charitable or public educational institution…"
……

"18. In calculating the taxable income of a taxpayer the total income derived by the taxpayer shall be taken as a basis, and from it there shall be deducted –
……
(h) gifts exceeding Twenty pounds each to *public charitable institutions* in Australia …"

New South Wales judicial precedents

It is noteworthy that in New South Wales the *Land and Income Assessment Act 1895* had exempted in s 11(v) "Lands occupied or used exclusively for or in connection with …. benevolent institutions, *public charitable purposes*…." while s 17(v) exempted the "incomes and revenues of all ecclesiastical, *charitable* and educational *institutions of a public character…*"

It was decided that a body of trustees of funds for stipends of clergy were an "institution" within the meaning of s 17(v), see *Re Robert Atkins as Public Officer for the Church of England Property Trust* Court of Review, 30 September, 1901, Murray DCJ.

It was also decided in *Trustees of St Mark's Glebe v Commissioner of Taxation* [1900] 21 NSWLR 308 that lands held by church trustees under a trust authorized by statute were held for "public charitable purposes."

The relevance of the New South Wales case law becomes apparent when it is realized that the New South Wales *Land and Income Tax Assessment Act of 1895* was introduced in the Legislative Council by Dr Andrew Garran, father of Sir Robert Garran, a New South Wales lawyer, and a draftsman of both the Commonwealth Constitution and the 1915 Federal

Income Tax Assessment Act.

High Court decision in Swinburne's case

Unfortunately, the High Court in *Swinburne v FCT* (1920) 27 CLR 377 looked neither at the previous New South Wales cases nor the Parliamentary debates and decided that "public charitable institution" should not be construed in its normal legal sense but narrowly as confined to the relief of persons in necessitous or helpless circumstances. The Swinburne Technical College was thus held not to be a "public charitable institution".

High Court decision in Chesterman's case

In 1923, in *Chesterman v FCT* (1923) 32 CLR 362, the High Court also decided, in a 3-2 decision, that a narrow approach should be adopted to construing "charitable purposes" in an estate duty exemption. Again there was no reference to the original Parliamentary debates (it must be emphasized that at this time Courts were not expected to refer to such debates to ascertain legislative intention.)

Privy Council decision in Chesterman's case

Not surprisingly, in the subsequent appeal to the Privy Council, *Chesterman v FCT* (1925) 37 CLR 317, the Privy Council in a very short decision based on the usual principles of stutatoty interpretation, restored the interpretation of "charitable" in its normal legal sense in the taxing statute. The decision obviously also undermined any judicial support for the restrictive administrative approach previously taken to the income tax deduction for "public charitable institutions". (Subsequent decisions, both in the Privy Council and the High Court further demonstrate that the decision in *Swinburne's Case* was misconceived and that "public charitable institution" should have been given its normal legal meaning.)

Income Tax Assessment Act 1927

Sadly, the tax authorities did not take kindly to charity and persuaded the Treasurer, Earle Page, to introduce amendments to ensure that "public charitable institution" was re-defined restrictively. As noted in the Report of the 2001 Inquiry into the Definition of Charities (Chapter 29, p 243-244), the result was that "public charitable institution" was narrowed to focus on the idea of a "public benevolent institution" and the relief of poverty or distress and later disappeared altogether in the 1936 Act.

But what neither that Inquiry (the best and most comprehensive on the subject) nor any previous inquiry has looked at was the fundamental question of "What did Parliament did intend in 1915"? In particular, the fact that the High Court was restricted in its use of Parliamentary debates in the 1920s has meant that, so far as we can discover, no one has gone back to examine this question and everyone has accepted the view of successive tax administrators that deductibility of gifts to public charities generally was never intended by Parliament.

What did Parliament intend in 1915?

Our researches have shown that it is more than arguable the Federal Parliament in 1915 did intend just what it said - that gifts to "public charitable institutions" should be deductible and that, in doing so, Parliament accepted that "charitable" had its normal legal meaning and was not restricted to the

relief of poverty or distress.

We abstract below relevant material from the New South Wales Parliamentary debates and then from the Federal Parliamentary debates.

Given the history of the debates from the *Land Tax Assessment Act 1910*, through the *Estate Duty Assessment Act 1914* to the *Income Tax Assessment Act 1915*, it seems clear enough that:

- Parliament *did* understand and intend to use the word "charitable" in its normal legal meaning and did *not* intend to limit it to some popular notion of poverty relief: and

- Parliament accepted established English and New South Wales case law on what constituted "public charitable purposes" or "public charitable institution" or a "public charity".

As was made clear in *Ashfield Municipal Council v Joyce and Others* [1976] 1 NSWLR 455 at 465, "charity" and "public charity" are virtually synonymous or, at most, "public" merely emphasizes the width of the class to be benefited. Their Lordships also noted in that case that the meaning of "public charity" had been judicially considered in 1885 and 1915, while the High Court had subsequently conceded that the narrow view of "public charitable institution" taken in *Swinburne's Case* could not be considered correct.

A "public charity":

- might be established under some general or specific Act of a Parliament (the St Mark's case); or

- be a charity raising funds by public subscription (the Home of Hope case); or

- be privately endowed, but benefiting a wide section of the public.

It would not, for example, matter if the "public" charity raised fees (eg a non-profit school) because those fees were not available for the private gain of any person.

Whatever "public charitable institution" meant in 1915, one thing is clear. As the case law stood, the *1915 Income Tax Assessment Act* should have been understood to embrace deductions for gifts to churches and schools. Churches and schools are - and have always been - unquestionably "public charitable institutions".

Parliament's intention in 1915 was thus –

- To exempt *all* charities; and, in addition,

- To allow deductible gifts to *public charities*.

New South Wales Land and Income Assessment Bill 1895 (Legislative Council debate 29 October 1895)

The New South Wales Legislative Assembly debated the exemptions to land tax assessment. The debate centred on how to best describe the types of land and the organizations owning such land

which were to be exempted from tax.

The exemptions were wide, far wider than public benevolent institutions alone, and included: "Lands occupied or used exclusively for, or in connection with, *public pounds, public hospitals, benevolent institutions, public charitable purposes, churches, chapels for public worship, universities, affiliated colleges, mechanic's institutes and schools of arts....."*

There was no question that lands owned and occupied by churches and devoted to charitable purposes were to be exempt.

Debate centred on whether or not organizations that charged for services should be included in the exemption. At the heart of the debate was consideration of the meaning of "public" and whether a private, or privately funded, as opposed to public organization (thought the precise meaning of "public" in this instance was by no means clear), could be considered a not for profit organization that conferred benefits on the community.

Hon T Dalton moved to include the words "whether supported wholly or partly by grants from the consolidated revenue fund or not and which are not a source of profit or gain" following the word "hospitals". He wished to make a distinction between public and private hospitals, wishing to encourage as much as possible benevolent people in giving land for hospitals and if they were carried on without profit, they should not be taxed. (p. 2068)

Hon H C Dangar stated that all schools which were held by trustees and not for the purposes of profit but bona fide for the purpose of education should be exempt. (p. 2069)

Hon R E O'Connor stated that the general policy of the Bill seemed to be to exempt everything of a public character from which the public derived benefit yl by way of education or by way of comfort in the shape of nursing, and so on. (p. 2069)

He moved an amendment to exempt lands on which public or denominational schools stood and said that there are denominational schools which supply education and the denominations had to pay tax to the general revenue to support the public schools and that these denominational schools conferred a great benefit on the community. (p. 2069)

Hon L F Heydon said that land used for various public and charitable purposes was exempt from taxation, and in the nineteenth century, with our zeal for education, we ought to be prepared to exempt the land of these educational institutions. (p. 2070)

Land Tax Assessment Bill 1910 (Commonwealth) Hansard debate of 28 September 1910, House of Representatives

In his second reading speech, the Prime Minister, Mr Fisher set out the exemptions to land tax in Clause 12 which included "charitable or public educational institutions....religious bodies, public libraries, show grounds, public cemeteries, public gardens....."(p. 1543)

Clause 12 actually exempted land owned by a "*public charitable* or public educational *institution.*...." and "all land, owned by a religious society, the proceeds whereof are devoted to the support of the aged or infirm clergy or ministers of the society or their widows or children; all land owned by any person or society and used or occupied by that person or society solely as a site for–a place of worship for a religious society, or a place of residence for any clergy or ministers or order of a religious society; a charitable or educational institution not carried on for pecuniary profit...." (p. 3863)

Comment:

> *In the excerpts below, the debate centred on removing the word "public" before the word "charitable" and what the word "public" actually meant and how it modified the concept of what was considered "charitable". There was concern that use of the word "public" before "charitable" would unnecessarily narrow the range of exemptions while Parliament wished to exempt a wide range of charities, including religious and educational institutions:*

Mr Glynn: *"*The amendment which I now propose will bring within the exemptions institutions which are charitable, but which are not public in the sense of being controlled by the State. I have in mind various benevolent institutions, some under religions bodies, for the purpose of helping the weak and unfortunate, and finding new ways of life for them. If the word 'public' be retained, these societies will be excluded from the exemptions; and I am sure every honourable member wishes that those legitimate efforts of benevolent people, and the public through their subscriptions shall receive the same recognition as institutions that have to rely on the State for what should come from benevolence." (p. 3870)

Mr Glynn: "We ought to encourage everything that will lead to the development of charity, promote mutual assistance, and ultimately realize, perhaps, that truly Christian state in which man recognises, through the benevolence of his neighbour, that he is one with him." (p. 3870)

Mr Hughes: " ...the land owned by any person or society, and is used exclusively as a site for a charitable or educational institution not carried on for pecuniary profit is already exempt, as well as public charitable and educational institutions." (p. 3870)

Mr Roberts: "...the clause exempts the sites of all charitable institutions, whether public or not. The question raised by the amendment is whether the lands held by an educational or charitable institution apart from the site on which its buildings are erected shall be exempted from taxation." (p. 3870)

Comment:

> *In the following excerpts, the members debated whether the words "not for pecuniary profit" were sufficient to safeguard the exemption if the word "public" were removed from "education":*

Mr Roberts: "If the word "public" is used before "educational institutions" there will be grave doubt as to whether the lands of certain institutions....will be exempt, because those institutions charge fees to students, although both the proceeds of their lands and the fees are used solely for educational purposes, no person receiving any profit from them." (p. 3871)

Comment:

> *Below, the nature of "pecuniary profit" was examined and it was asked whether even these words should be omitted so as not to jeopardise exemptions for schools that charge fees:*

Mr Groom: "It is very difficult to obtain a satisfactory definition of the word ('public')..... the difficulty is to determine whether by the mere act of charging fees the privilege of being a "public" institution is not destroyed. I think that the Committee desires to preserve from taxation all charitable and educational institutions that are substantially intended for the benefit of the community generally, notwithstanding that they may be limited to specific denominations or persons, provided that they are not carried on by some individual fr his own personal profit." (p. 3872)

Mr Bruce Smith: I think we are all anxious to provide that where one of these institutions (that come within the exemption provisions) so invests its money as to derive a profit in the shape of interest....that investment shall not, in itself, constitute it a profit-making concern." (p 3872).

Comment:

> *In the following excerpts, the width of "public charitable purpose" in the context of the receipt of fees was discussed. New South Wales case law and particularly Pemsel's Case were canvassed. Mr Hughes appears to misconstrue the "public versus private" debate as centering on whether fees are received by an organization. He does not appear to advert to the notion that "public" might relate to the types of objects which may be defined as charities. Mr Glynn points out that the object of the charity, not whether it receives fees, is the crucial determinant of charitable status at law.*

Mr Hughes: "The words 'public charitable or public educational institution' are by no means unambiguous and the decisions that have been given under the land income tax law of New South Wales unfortunately do not make the position clear. They deal with public charitable, rather than public educational, purposes.....*The question is what is a charity? According to the technical legal meaning, it covers a very wide field, and would not appear to be at all limited by the popular meaning of the term, but it seems to be generally admitted that there must be some public purpose. It need not be a public purpose in which the whole community share and its benefits may be restricted to a comparatively small proportion of the community. It may be for the relief of poverty, for the advancement of religion, or for other purposes beneficial to the community. It has been laid down in the New South Wales Courts that the words 'public charitable purposes' have a special and more limited meaning*, *and are not to be construed in their technical, acquired, and even legal sense, although they go pretty far even there.* For instance, in a case decided under the Municipalities Act in New South Wales,'benevolent institution' was held to include St. Martha's Industrial Home, conducted by the Sisters of the Order of St. Joseph as a home for destitute and orphan girls. The institution received a substantial sum form fees and sale of work, but not enough to cover the expense of carrying it on, and the deficiency was made good, and somewhat more than made good, by voluntary subscriptions. Similarly, a refuge supported by donations, and carried on in a building used for private worship, was held to be a benevolent institution. The same thing applies to the Home of Hope, a very well-known institution in our State, where evidently they live on something more than hope*. I submit there is no necessity to leave out the word 'public' before the word 'charitable'. 'Public charitable purposes' is a term sufficiently wide to cover the whole field of charity, and if 'public' were struck out, I doubt very much whether anything could be construed to be a charity that did not effect a public purpose."* (p 3873, italics added)

Mr Bruce Smith: "There was a case in New South Wales where a charity school was held not to come under 'charitable institutions' because fees were received...." (p.3873)

Mr Hughes: *"*I am anxious to exempt every charitable institution that is properly charitable....The New South Wales and New Zealand Acts speak of public charitable purposes. The South Australian Act and the Victorian Bill do not use the word 'public'. *I do not want to refuse the amendment without the best of reasons and I confess that there appear to be conflicting authorities... (*p. 3873, italics added)

Mr Glynn: "*There is a leading English case, Pensel (sic) v The Commissioner of Taxes...which defines what the Privy Council considered was meant by charities....I think it has been decided that the receipt of fees is not the essential difference between what is and what is not a charity. It is the object of the application of the moneys that determines the charity, and common sense will follow in the line of judicial decision on that point. If an institution can further its own objects, which must be*

charitable, by the receipt of fees, so long as those fees are only applied to the maintenance or development of the institution it still retains its essential character as a charitable institution" (pp. 3873-3874, italics added)

Comment:

> *The following excerpt again shows that the primary concern of Members was the receipt of fees by charitable organizations as possibly negating their tax exempt status in the Bill, should the word "public" be retained. The receipt of fees has never been essential to the definition of "charity" and appears to be a red herring in the debate.*

Mr Roberts: "I understand that so far as the word 'public' before 'charitable' is concerned, the Attorney-General desires to look into the matter in view of the suggestions which have been made, and I should not like anything to be done when there is some disagreement, because it may subsequently be found that we are unanimous on the point...." (p. 3874*)*

Mr Roberts: My only fear is that if the word "public" be allowed to remain before the word "charitable" it may govern the word "educational". (p. *3875)*

Mr Roberts: I wish to bring to the notice of the Attorney-General a charity known as the Adelaide Workmen's Homes which I am not sure can be called a public charitable institution, though its land should, in my opinion, be exempt from taxation. A large sum was left by a gentleman to trustees for the building of homes for indigent workmen. I hope that the Attorney-General will consider the advisability of exempting all lands of that, and similar institutions." (p. 3875)

Mr Hughes: "If the word 'public' before the word charitable is taken out of the clause, the lands of these institutions will be exempt from taxation; but if the word remains, those lands will have to be exempted in set terms or by some other words.*"* (p. 3875)

Mr. Groom moved an amendment: exempting "all lands owned by or in trust for any religious society the proceeds whereof are devoted to the payment of the stipends of the clergy ministers catechists or teachers of the religious society, or to building or repairing places of worship , places of residence, schools or other buildings used or occupied by a religious society or by the ministers thereof...or to any other religious or charitable purpose." (p. 3876)

Mr Groom addressed New Zealand legislation that exempted land owned by charitable and religious societies, "if the land....or rents and profits of such land, are used exclusively for religious, charitable. or educational purposes. That is as wide a provision as that which I intend to ask the Committee to accept in this case." (p. 3876)

Land Tax Assessment Bill 1910 (Commonwealth) Hansard of 7 October 1910, House of Representatives

The Attorney-General Mr Hughes proposed an amendment that would remove the word "public" before the words "charitable" and "educational".

Estate Duty Assessment Bill 1914 (Commonwealth) Hansard of 15-16 December 1914, House of Representatives

Comment:

> *The debate regarding this Bill centred around ensuring that the language used did not overly limit the range of institutions that would have tax exempt status. Nowhere did Parliament seek to limit exemptions to "public benevolent institutions", a form of words that was not discussed. Rather, the debate examined the word "public" in an effort to determine whether it imposed an unwanted limitation on the words "charitable purpose".*

Mr Hughes, the Attorney-General, proposed to move an amendment to exempt all bequests for charitable and religious purposes.

Mr Groom moved an amendment: "Estate duty shall not be assessed or payable upon so much of the estate as is devised or bequeathed for religious, charitable, scientific, or educational purposes." Mr Hughes accepted the amendment. (p. 2026)

Comment:

> *Mr Hughes moved the following amendment: "Estate duty shall not be assessed or payable upon so much of the estate as is devised or bequeathed or passes by gift inter vivos or settlement for religious, scientific, public charitable, or public educational purposes." (p. 2031, italics added). This amendment brought forth debate on the nature of the word "public" in relation to charitable purposes. Again, concern was voiced as to whether the word "public" might limit the width of exemptions, contrary to the intention of the legislature.*

Sir William Irvine*: "What is the meaning of the word 'public' in relation to the 'charitable'? The term 'charitable purposes' has a perfectly defined meaning in law, and the word 'public' before it may give some undefined limitation.* (p 2032, italics added)

Mr Hughes*:* These words are taken from the Victorian Statute. (p. 2032)

Mr Glynn: *"The Attorney-General will remember that when the Land Tax Assessment Bill was debated before the House in 1910 we then debated for a couple of days the question of the distinction between "private" and 'public" in relation to the word 'charitable'. Eventually the House decided to use only the word "charitable", because the qualifying word might exclude a large number of persons form the purview of Parliament's intent. Paragraph e of Section 13 contains these words—All land owned by or in trust for a charitable or educational institution, if the institution, however formed or constituted, is carried on solely for charitable or educational purposes, and not for pecuniary profit."* (p. 2032, italics added)

Mr Hughes: *"The Victorian Amending Act of 1907, section 3, subsection 2, says----.....in this section the term 'public charitable bequest' or 'public charitable settlement' means devise, bequest.....to or for any free public library, or any free public museum, or any public institution for the promotion of science and art...or any public university or any public hospital, or any public benevolent asylum...."* (p. 2032, italics added*)*

Comment:

> *The width of exemption alluded to above by Mr Hughes was far wider than public benevolent institutions and even so, Mr Glynn stated that "A great many charities will not be covered by*

that". (p. 2032)

Mr Groom stated that "I hope the Attorney-General will omit the word "public" because it will restrict the interpretation of the measure..." (p. 2032) He stated, "the honorable member ought to define the words 'public charitable'. If the honorable member takes the words from the Victorian Act, he must insert the Victorian definition. *Take the case of the Salvation Army, to which a man may leave large sums of money for the establishment of some institution like the Boy's Home. Or there is the instance of Dr. Barnardo's Home. Institutions of that character are established by private bequest, and are governed by the deed or charter that creates them. But by inserting the word 'public' in this sub-clause, that institution would probably not come within the definition of a charitable institution. By the omission of the word 'public', the Attorney-General will get nearer to his intention..."* (p. 2032, italics added)

Mr Watt stated that *"the word 'charitable' is as clearly defined in case law as any word in the language, but the words "public charitable" were very confusing to the Court....I think it would be better in view of the experience we have had, if the established meaning of old words were adhered to and the word "public" struck out". (p. 2032,* italics added)

Mr Glynn*: I also hope the Attorney-General will strike out the word "public" because I can assure him that a great many charities which are exempt under the State law will be brought under this taxation if that word is allowed to remain. The English Courts have discussed particularly in the case of The Commissioner of Taxes v Pemsel what were the charities within the meaning of the Act....I am quite sure that the public sense of the community will recognise that the insertion of the word "public" will place upon what ought to be the intention of parliament a limitation which they never would sanction."* (p. 2033, italics added)

Mr Hughes*: ...The term "public charitable purposes" is very wide. As to what extent it is narrower than "charitable purposes" I cannot for the moment say. Questions continually arise in the Courts as to what is a "charitable" gift or settlement...."* (p. 2033, italics added)

Mr Glynn also thought that the word "public" should be removed from before" educational" so that there was no room for doubt that "*the object is not to tax people who are not making education a commercial enterprise".* (p. 2033, italics added)

Mr Glynn: "I would refer the honorable member to the District Councils Act of South Australia, and also to the Water Conservation Act of 1886, under which *a question as to what was the meaning of 'charity' arose in a case in which I happened to be engaged as counsel. In all these the intention, and, in most of them, the expression, is to give the benefit of exemption to private, as well as public, institutions of the kind...Why should we throw upon the High Court the almost impossible obligation of finding out what is in our minds in regard to this expression?"* (Pp. 2033-2034, italics added)

Mr Glynn: " *I know there has been a great deal if litigation in England owing to the use of the word 'public,' and even in the case of the smallest class of churches the question has arisen whether a contribution made by parishioners, in some cases to schools, took the institutions outside the category of charity in the meaning of the Act. That I wish to avoid..."*(p 2035, italics added)

Comment:

In the above debate, the issue did not involve limiting exemptions for charity or education provided solely to the poor and disadvantaged. Parliament understood the word "charity" in

the wider legal sense of its meaning in Pemsel's Case, which was apparently without question taken as the basic definition. The use of the word "public" was not used to modify "charitable" in a way that would apply the exemption only to organizations which alleviated poverty in the community, or schools for the disadvantaged; such restrictions did not enter into the debate.

Income tax Assessment Bill 1915 (Commonwealth) Hansard of 1 September 1915, Senate

An amendment to the Bill was introduced in the Senate which stated that "Gifts exceeding twenty pounds each to *public charitable institutions* in Australia" would be tax deductible. The original clause, 18 (h), was extremely narrow, reflecting war-time patriotism (p. 6744) The threshold amount for deductibility was debated. Parliament recognized that charitable institutions must be supported. Parliament did not seek to limit the exemption to alleviation of poverty and considered the inclusion of various organizations, such as temperance societies, although this was seen as a political, rather than charitable organization. Although the amendment originated in the Senate, the House of Representatives took up the Bill with this amendment included.

Exempt from income tax were religious, scientific, charitable, or public educational institutions as well as trade unions and friendly societies. Discussing these exemptions in the House of Representatives, Mr Hughes said, "The exemptions in some of the existing (State) Acts go a little further, but most of them not quite as far as is proposed in this Bill...We shall exempt friendly societies, trade unions, and religious, scientific, *charitable* or public educational institutions." (pp. 6546-6547,italics added)

Income Tax Assessment Bill 1927 Hansard of 29 November 1927, House of Representatives

Comment:

The debate reflected a change in attitude toward the concept of charity, a change engendered by decisions of the High Court and Privy Council which the Commonwealth Parliament now addressed legislatively, but without a great deal of discussion. The discussion did not allude to former debates regarding the meaning and treatment of charities in previous legislation.

Now, the legislation included a much narrower definition of "public charitable institution", following the decision in the Swinburne case and the High Court in Chesterman, before that view was overturned by the Privy Council. The Privy Council took the view that such phrases as "charitable purpose" should have their wider legal meaning, that is, the meaning found in Pemsel's Case .

"Public charitable institution" was now defined as: "a public hospital, a public benevolent institution and includes a public fund established and maintained for the purpose of providing money for such institutions or for the relief of persons in necessitous circumstances". Religious bodies or institutions, found in the exemption provision of previous legislation, were no longer included.

Dr Earle Page, in the Second Reading Speech, stated: *"*...A concession is granted in respect of gifts to charitable institutions, etc. Deductions are allowed for so much of the taxpayer's assessable income as is donated in cash or is used to purchase gifts in kind to public charitable institutions..." (p. 1392) He also stated: "...As regards gifts to public charitable institutions*, the term 'charitable institution' is*

being defined in order to remove any possible difficulty which might arise in litigation through what is apparently regarded by the court as a somewhat obscure provision." (p. 1395, italics added)

Comment:

> *On the contrary, the Privy Council, in both Chesterman's Case and in St. Mark's Case, had been very clear in setting out its test for delineating charities.*

During the debate, Dr Earle Page stated that "it is because of administrative difficulties that...a definition of "Public charitable institutions" is being inserted in the measure. We have been forced to define the terms. (p. 2165)

During the course of the debate, Dr Earle Page was concerned that amendments to the Bill which would further exempt education and research were too wide "from the point of view of, first, the administration, and, the probable effect on the revenue." (p. 2168)

Comment:

> *It seems that an underlying motive for the new definition was the increase to the revenue afforded by a narrower definition of "public charitable institution". The courts in Australia had begun to give this term a narrower definition, limiting its meaning to charities for the alleviation of poverty. This narrowing of interpretation became the new status quo in Australia until 1925, when the High Court's narrow interpretation in Chesterman was overturned by the Privy Council (thus reinstating the wider definition found in Pemsel and adhered to in previous Commonwealth legislation). The Commonwealth Government then responded by seeking to legislate so as to enshrine the narrower definition.*

Estates Duty Assessment Bill 1929 Hansard of 19 September 1929, House of Representatives

In this debate, Parliamentarians directly addressed the issue raised in *Chesterman's* case. The government sought to reverse the Privy Council via legislation.

Dr. Earle Page: "The main purpose of this measure is to remedy certain defects in the Estate Duty Assessment Act, *which are responsible for a considerable loss of revenue*...It has been necessary to restate the provisions of the law relating to settlements, bequests or devises of property for religious, scientific, charitable or public educational purposes, so as to limit the exception to bequests for such purposes in Australia...*This re-statement of the law in respect to charitable bequests has been necessitated by a decision of the Privy Council over-ruling the judgment of the High Court in (Chesterman's Case)...The High Court held that this bequest is not a charitable bequest within the meaning of the Act because its character is not eleemosynary and because the word 'charitable' was, in the opinion of the court (sic), used in the act (sic) in its popular meaning which involves the idea of assisting poverty or destitution. The Privy Council held that the four words 'religious', 'scientific', 'charitable', and 'public educational' as used in the section are not mutually exclusive and that the word 'charitable' as used in the act (sic) must be given its technical legal meaning as used in the Elizabethan sense* (relief of poverty, advancement of education, advancement of religion, or other purposes beneficial to the community)...*when the estate Duty Act was passed it was intended that the four terms referred to should be mutually exclusive...*" (pp. 6565-6568, italics added)

Comment:

> *With respect, the Parliamentary debates prior to the enactment of the Estate Duty Act, as discussed above, show no such intention whatsoever.*

In the Senate, Senator Sir George Pearce repeated the Second Reading Speech delivered by Dr. Earle Page in the House of Representatives. The Senate did not debate the proposed amendments limiting the ambit of exemptions for charities.

Interestingly, Mr Duncan-Hughes, Member for Boothby, complained during the Estate Duty Assessment Bill debate on 14 September 1928, that: "....I regret that a bill like this, which the Treasurer himself described as extremely techmical, should have been introduced under circumstances which afford honorable members very little opportunity to examine it thoroughly..." (p. 6739)