Royal Automobile Club of Victoria

Submission in response to the Discussion Paper entitled

'Fairer, simpler and more effective tax concessions for the not-for-profit sector'

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1 Proposed reform of the mutuality principle

The Royal Automobile Club of Victoria Limited ("**RACV**") provides this submission in response to the discussion paper released by the Not-For-Profit Sector Tax Concession Working Group in November 2012 entitled '*Fairer, simpler and more effective tax concessions for the not-for-profit sector*' (the "**Discussion Paper**").

This submission addresses the proposed reform of the mutuality principle outlined in Chapter 5 of the Discussion Paper only.

2 Summary

RACV was established in 1903 and is now one of Australia's largest mutual clubs with over 2 million members. RACV exists to deliver benefits to its members and their communities by informing and advising them, representing members' interests and providing them with assistance when in need by delivering products and services in its fields of motoring, mobility, leisure, assurance, financial services, salary packaging services, social well-being and the home. RACV is a diverse organisation with significant mutual and non-mutual activities.

RACV is committed to the broader community through its partnership programs, research funding, the provision of vital funds to not-for-profit grassroots community organisations through the RACV Foundation and Good Citizen Program. It has also demonstrated a continued commitment to communities in their times of need, including the support following the Victorian floods and Black Saturday bushfires.

RACV's purpose is to deliver maximum value and benefits to its members and the broader community rather than seeking to maximise profits. These valuable member and community benefits would not otherwise be provided by RACV if it operated for profit.

In RACV's view, the long standing mutuality principle should be retained in its present form.

The stability of the mutuality principle is critical to the strategic direction and allocation of resources of many bona fide clubs. Preservation of the mutuality principle in its current form will contribute to the continued investment by such clubs in member value projects, social capital and community wellbeing. Any erosion of the mutuality principle may lead to a reduction in the allocation of resources to community enriching projects, to the detriment of club members and the broader community.

We consider that the impact of the mutuality principle on the notion of competitive neutrality is not significant. The motivation of for-profit organisations is typically to achieve expected rates of return that allow them to make profits and return surplus funds to owners. On the contrary, not-for-profit clubs exist for the purpose of returning maximum member benefits and are prohibited from returning surplus funds to members. The latter enables not-for-profit clubs to provide member benefits in some circumstances at a competitive advantage over the provision of the same products and services where they are provided by for-profit entities to their

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customers. Importantly, this is regardless of and despite (in the case of products and services provided at a net cost) the tax consequences.

The mischief that the Discussion Paper is largely targeting – being large clubs, often with dubious membership requirements, which undertake gambling and certain hospitality type activities – does not require radical changes in the law. The Australian Commissioner of Taxation (the "**Commissioner**") already has significant powers to enforce the bona fide application of the mutuality principle by clubs.

While RACV does not advocate codifying or narrowing the application of the mutuality principle, should Treasury determine to codify the principle, RACV submits:

- It is crucial that the application of the mutuality principle to the mutual activities of bona fide clubs is not put at risk as a result of any legislation (particularly, any legislation that narrows the application of the principle);

- The core purpose of the principle must be maintained such that the important distinction of mutual and non-mutual is based on the nature of the activities undertaken, and not based on the use of any arbitrary thresholds;

- If the principle is subject to any legislative narrowing, the legislation must only restrict the operation of the mutuality principle in relation to the areas of concern identified in the Discussion Paper (namely gambling and certain hospitality activities);

- The calculation methodology to be used by clubs should be broadly defined as being on a reasonable basis to ensure each club is able to use a formula which best represents their individual circumstances; and

- Specific anti-avoidance provisions are not required. The Commissioner already has sufficient and extensive powers under the general anti avoidance rules to ensure compliance with the tax legislation. Additionally, any legislated principle should be drafted with sufficient clarity to ensure there is no need for specific anti-avoidance provisions.

3 Background

The foundation of the mutuality principle is that a taxpayer cannot derive income from itself. Under the mutuality principle, if members contribute to a common fund created and controlled by them for a common purpose and those contributing members are essentially the same as those members who participate in the fund, then member contributions and receipts from member dealings that are not of a commercial nature are not taxable income and expenditure incurred in deriving mutual receipts is non-deductible.

The Australian landscape of mutual organisations has evolved over the years. While there have been a number of demutualisations in recent history, there remains a significant number of bona fide clubs in Australia whose activities and operations rely, to an extent, on the principle of mutuality. These bona fide clubs, such as automobile clubs like RACV, various sporting clubs, and other community based clubs, play a significant role in the development of social capital

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and community wellbeing. These civic-minded clubs represent a large cross section of Australia's demography and provide an influential voice promoting their members' interests responsibly in the market segments in which they operate.

RACV's involvement in activities for the benefit of members and the community has developed over time with the assistance of the mutuality principle. However, any tax benefit that may arise through the application of the mutuality principle is not the driving factor for RACV's investment and resource allocation decisions. As with all mutual organisations, RACV has in its objects a non-distribution clause meaning funds cannot be returned to members and must instead be maintained as surpluses for the provision of member benefits.

The surplus maintained by RACV has developed over years and allows RACV to make decisions that are not motivated by tax. The surplus allows RACV to focus on longer term strategies to provide benefits which are valued by its members and often the wider community but that may not be feasible should a strategy be based purely on financial returns to a different group of stakeholders.

Despite an organisation being considered a 'mutual', the mutuality principle does not centre on the organisation itself; rather, it focuses on the nature of activities of the organisation and the interrelationship with members. Modifying the mutuality principle to incorporate a threshold requirement on the size of organisation would destabilise the foundations of the long standing principle and erode the confidence of such organisations in relying on the mutuality principle in their strategic planning.

In the case of RACV, a bona fide club, the mutuality principle is only applied to activities to the extent they have been determined as being mutual in nature, meeting the requirements of a common purpose provided to members and *not in the nature of trading with members for profit*.

Tax concepts have evolved to recognise the unique characteristics of a mutual entity and have developed into sound principles for determining the fair allocation between mutual and non-mutual receipts and outgoings based on the nature of the club's particular activities. The mutual status of bona fide clubs provides the opportunity for these clubs to invest in projects to develop social infrastructure, community programs and member wellbeing – projects that may not otherwise be pursued as they do not have the required return measured in purely financial terms. For example, RACV's objects in its Memorandum of Association include promoting the interests of motorists and other road users in good roads, safety and consumer protection. RACV's 'Royal Auto' magazine, which represents a significant member benefit and is produced at considerable cost to RACV, embodies this object through promoting road safety to its readership of approximately 1.5 million Victorians.

Indeed, the importance of clarity for the mutual status of RACV's activities is evident through its review in *Royal Automobile Club of Victoria (R.A.C.V.) v Federal Commissioner of Taxation 73 ATC 4153* (the "**RACV Decision**"). In that case, Justice Anderson ruled on the mutual status of many of RACV's activities, which provides RACV with the certainty it requires for its strategic planning. Most notably, Justice Anderson held that there was *no dispute* that road service is a mutual activity.

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As noted in the Discussion Paper, reform of the principle of mutuality has been mooted from time to time. Indeed the Review of Business Taxation Report 1999 (the "**Ralph Report**") proposed that two principal aspects of the common law surrounding the principle of mutuality be enacted. Firstly, the Ralph Report recommended that legislation explicitly sets out that mutual gains are excluded from assessable income. The Ralph Report also recommended enacting provisions to determine the apportionment of expenditure between mutual and assessable income. The Ralph Report recommendations are yet to be fully implemented. We suggest this may be because the established principles at common law are sufficient and already deal appropriately with the recommendations.

In addition, following the *Coleambally* case where the Federal Court ruled that the mutuality principle required profits to be directly redistributable to members, the Commonwealth Government introduced retrospective legislation to uphold these clubs' status as mutual organisations. The Explanatory Memorandum accompanying the retrospective legislation stated the amendments were designed to effectively restore the longstanding benefits of the mutuality principle to those not-for-profit entities affected by the decision in *Coleambally*. Clearly, the Commonwealth Government recognised the importance of preserving this socially beneficial area of law.

4 Submission on the proposed reform of the mutuality principle

4.1 Option 5.1: Gaming, catering, entertainment and hospitality trading activities

4.1.1 Consultation question 50: *Should the gaming, catering, entertainment and hospitality activities of NFP clubs and societies be subject to a concessional rate of tax, for income greater than a relatively high threshold, instead of being exempt?*

The use of a concessional rate of taxation for income greater than a defined threshold inherently sets arbitrary targets which encourage the adoption of tax planning techniques by organisations to fit within any defined threshold adopted. Difficulties encountered in the use of thresholds in tax legislation is evidenced by the legislative requirements set for an entity to qualify as a 'small business' for the purpose of gaining access to concessions under Australia's capital gains tax and capital allowance regimes. These requirements, including limits on an entity's turnover and net asset value, have encouraged organisations to manipulate their profile in order to 'tick-the-box' to gain access to the tax concessions. RACV submits the investment of time and resources required to determine, implement and administer a threshold may be better utilised on the many important tax reforms currently in progress.

The size of the club or society should not be at issue but rather the activities which it undertakes; as the mischief which exists is in relation to the types of activities certain clubs are undertaking, rather than the scope of their operations. A threshold indicates that the mutuality principle is appropriate to apply to all gaming, catering, entertainment and hospitality trading activities when they are undertaken by some clubs, but not others. This results in an inconsistent application of the established law – the stability of which is fundamental to the operations and strategic direction of many bona fide clubs.

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To illustrate this point: receipts from certain entertainment and hospitality activities may fluctuate as the clubs' activities and the market conditions change from year to year to the point that it is conceivable some mutual clubs may land either side of the threshold in different income years. To suggest a club does not satisfy the mutuality principle in one year due to breaching the threshold and then does in a future year due to a drop in entertainment or hospitality revenue is not a fair or equitable outcome.

The inconsistent application of the principle also fails to take into account that large and small clubs support different segments of the community and provide a different range and scale of member benefits and services. While smaller clubs may be more personalised with stronger connections to individual members, larger clubs are able to provide services of a greater range and larger scale which small clubs cannot provide, having broader social and economic impacts on the communities which they support. Both large and small mutual clubs play important roles in Australian society, to set limits that encourage clubs to be smaller in size may cause the loss of benefits to both members and the communities in which they operate.

While tax is one factor in a mutual organisation's resource allocation decisions, any change to the mutuality principle which may result in some clubs reducing the level of investment they undertake will have broader social and economic impacts. Australian communities may receive a lower level of service from clubs and may not receive the broader benefits to the community of investments that would otherwise have been made. This can be illustrated in the case of RACV which has created many job opportunities and provided economic boosts to local communities, including Torquay, Healesville, Cape Schanck, Cobram and Inverloch, as a result of substantial investment in member facilities.

We submit that it is quite clear that the concerns outlined in the Discussion Paper on this issue can be dealt with through the enforcement of the correct application of the mutuality principle as it currently stands. Activities including gambling that, in substance, are trading activities with members for profit are not mutual activities. Simply, profits derived from such activities are income under the current application of the common law mutuality principle. This is outlined by the Commissioner in *Taxation Determination 1999/38*, which stated that income derived from gambling activities is not mutual in nature.

4.1.2 Solution

The existing principle of mutuality should be maintained such that the important distinction with all activities is whether the particular activity is mutual in nature, determined on a case-by-case basis.

While we do not advocate legislatively modifying the mutuality principle, if any legislation is introduced it is critical that any modification is confined to restricting the operation of the mutuality principle only in relation to the areas of concern identified in the Discussion Paper.

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4.1.3 Consultation question 51: *What would be a suitable threshold and rate of tax if such activities were to be subject to tax?*

The use of a threshold will not increase the efficiency and administration of mutual entities. Rather, it will introduce further complexities in the tax law and may yield inconsistent outcomes for entities with similar objects differing only in size. In addition, a threshold will encourage the use of tax planning techniques to exploit the mutuality principle.

4.1.4 Solution

The current status of the principle of mutuality should be maintained without introducing a threshold for certain activities. Should Parliament wish to legislate to exclude certain activities from being mutual in nature it must be carefully drafted to ensure there is no unintended consequence which removes the application of the principle for activities beyond the areas of concern identified in the Discussion Paper.

4.2 Option 5.3: Repeal the common law principle and legislate a narrower principle

4.2.1 Consultation question 53: *Should the mutuality principle be legislated to provide that all income from dealings between entities and their members is assessable?*

Removal of the mutuality principle

If the mutuality principle was removed and all income from dealings between mutual entities and their members were deemed assessable, the strategic direction and allocation of resources of bona fide mutual organisations may be reconsidered by some mutual organisations and may have a detrimental impact on their members and society as a whole.

Such a course of action would undermine the outcomes from previous reviews of the mutuality principle in the context of the Australian tax system, including the Discussion Paper and the Australia's Future Tax System – Report to the Treasurer (the "**AFTS Report**") which supported upholding the mutuality principle.

The AFTS Report outlined how not-for-profit organisations make highly valued contributions to community wellbeing and supply goods and services with broad public benefits that would not otherwise be provided by private businesses. Similarly, mutual clubs do not operate for a profit making purpose; their objects ensure surplus funds are put towards the benefit of members and society as a whole. It is clear that bona fide mutual clubs are not motivated in the same way as profit-oriented organisations, and they should not be taxed as profit-oriented organisations.

The divergent tax treatment of for-profit and not-for-profit organisations does not provide any competitive advantage to not-for-profit organisations. Rather, it is the not-for-profit organisation's flexibility in relation to retention of surplus funds that provides them with a competitive advantage. This can be evidenced in the case of RACV where comprehensive roadside service across rural, regional and metropolitan Victoria, is a notable member benefit

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which does not necessarily make sense for a standalone for-profit organisation given the cost of service provision in remote areas.

Indeed, the Government specifically enacted reforms after the decision in the *Coleambally* case threatened the equitable application of the principle to ensure it continued to operate as intended.

The purpose of bona fide clubs can be illustrated in the case of RACV through a perusal of speeches made by the President and Managing Director at RACV's 2012 Annual General Meeting. These speeches support the objects of the club and described the fact RACV exists not for the intention to make a profit but to deliver value and benefits to its more than 2 million members and the broader community. These benefits are provided through member representation on motoring and mobility interests, information and advisory services provided through the 'member only' RoyalAuto magazine (determined in the RACV Decision to be a mutual activity, aside from advertising aspect) and the improvement of member resorts and facilities.

RACV has continued to show it is committed to the broader community through provision of financial assistance and advocacy to community groups for road safety, better roads and public transport policies and a continued commitment to communities in their times of need including the support following the Victorian floods, Black Saturday bushfires and the Good Citizen program.

If the mutuality principle was removed such that revenue from members which was previously mutual became subject to taxation, some clubs may reduce the extent of activities that they currently undertake. The AFTS Report set out that it is unlikely the private sector would be willing to fill the void created as it may not make commercial sense for any for-profit organisation to undertake these activities; such benefits provided by mutual organisations to members and society may be forfeited or may otherwise need to be provided by Government.

Any reduction in investment by large mutual organisations caused by the removal of the mutuality principle will have broader social and economic impacts. Australian communities may not receive the benefits of investments that would otherwise have been made. Benefits provided to smaller regional and rural communities can be illustrated in the case of RACV which has created many job opportunities and provided economic boosts to local communities, including Torquay, Healesville, Cape Schanck, Cobram and Inverloch, as a result of substantial investment in member resort facilities, and throughout Victoria by its roadside service activities.

While this should not drive policy intent, we do note that it is not uncommon for mutual organisations to provide hospitality activities to members at a net cost. Abolition of mutuality principle may lead to an unintended consequence of certain organisations generating tax losses that may otherwise not be generated if the mutuality principle is retained.

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Narrowing the mutuality principle

RACV does not support the narrowing of the mutuality principle from its present form. This is consistent with the outcomes of the previous reviews of Australia's taxation system, including the Ralph Report.

The continued relevance of the mutuality principle in providing benefits to society can be seen in other jurisdictions including the United States, Canada and New Zealand who decided to enact the mutuality principle to ensure that bona fide mutual organisations which provide benefits to members and society are statutorily protected within their respective taxation systems.

If Treasury determines that, as in the case of some overseas jurisdictions, the mutuality principle should be legislated, RACV submits that it should be drafted in such a way that ensures legitimate mutual activities which benefit members and society, such as RACV roadside service, remain subject to the principle of mutuality. This will ensure that, consistent with comparable foreign jurisdictions, Australia protects the benefits mutual organisations provide to society.

If the mutuality principle is subject to any legislative narrowing, it must only restrict the operation of the mutuality principle in relation to the areas of concern identified in the Discussion Paper.

RACV does not support any codification of the mutuality principle that follows the USA and Canada models. These involve the use of income thresholds, would be difficult to administer and apply, and create an inequitable application of the law for different mutual organisations. Moreover, application of a threshold could be impacted where clubs have asset sales or wish to invest amounts in taxable investments to generate income to support their mutual activities.

4.2.2 Solution

The mutuality principle should be kept in its present form as a product of the common law.

While we do not advocate codifying the mutuality principle, if legislation is introduced codifying the principle such legislation should not narrow the principle. If narrowing legislation is to be introduced, at an absolute minimum, it must only restrict the operation of the mutuality principle in relation to the areas of concern identified in the Discussion Paper (specifically, gambling and certain hospitality activities).

4.2.3 Consultation question 54: *Should a balancing adjustment be allowed for mutual clubs and societies to allow for mutual gains or mutual losses?*

A prescribed balancing adjustment formula may not operate equitably for all bona fide mutual organisations, could cause inconsistency and may encourage the use of tax planning techniques to circumvent the legislation.

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On a related note, the Discussion Paper indicates uncertainty and complexity may exist in tracking mutual and non-mutual receipts. This is an issue for the mutual organisation itself, and not an issue that demands another legislative requirement which adds to the complexity and/or administration costs of tax legislation. The onus is on the mutual organisation to satisfy record keeping requirements and to have the processes and systems in place to demonstrate to the Australian Taxation Office an appropriate application of the mutuality principle to all of its receipts and outgoings.

4.2.4 Solution

The mutuality principle should be kept in its present form as a product of the common law.

Any codification of the mutuality principle already applied by many mutual organisations may result in unintended consequences and complexity. It is important to weigh up the risk of creating unintended consequences against the upside of merely codifying a well established, flexible and working principle.

Should Government require the mutuality principle be legislated to provide for a mutual balancing adjustment for receipts and outgoings, it should express a 'reasonable basis' principle. There should not be any prescribed formula. A 'reasonable basis' principle is consistent with other areas of Australia's tax law including the similar concept for apportionment of deductible and non-deductible expenditure in relation to superannuation funds which derive exempt income. Any unintended consequences which may be produced through using a 'reasonable basis' approach should be dealt with by the Commissioner's powers under Australia's general anti-avoidance rules.

A single inflexible calculation method would be unworkable as there is no 'one-sized fits all' solution. This is supported by an existing mutuality calculation methodology, developed in the *Waratah* case and later supported by the Commissioner in *Taxation Determination TD 93/194* and *OG 72,* as a rule of thumb only. As indicated in *OG72* mutual clubs need to ensure that the variables used in the formula are representative of their own individual club circumstances, as what works for one mutual club may not work for another.

4.3 Option 5.4: Enact anti-avoidance rules, or enforce the mutuality principle more strictly

4.3.1 Consultation question 55: *Is existing law adequate to address concerns about exploitation of the mutuality principle for tax evasion? Should a specific anti-avoidance rule be introduced to allow more effective action to be taken to address such concerns?*

We agree that there is scope to abuse the mutuality principle, for example, the 'temporary' or 'instant' memberships scenario where the club's operations are largely restaurant, bar and gaming type activities. However, this type of mischief does not require specific anti-avoidance legislation.

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Under the current law the Commissioner has broad powers to review and audit a taxpayer's affairs to ensure compliance with Australia's tax law. Any scheme in place to exploit the mutuality principle should fall under the general anti avoidance rules contained in Part IVA, which are currently being rewritten to ensure their continuing and improved effectiveness.

The introduction of any specific mutuality anti-avoidance provisions would not add power which is not already available to the Commissioner in relation to any abuse of the system and may not add any additional deterrence to taxpayers; rather it would needlessly increase the complexity of the operation of the tax law at the expense of bona fide mutual organisations.

4.3.2 Solution

The Commissioner may consider running a test case on a club that it suspects is exploiting the mutuality principle. If the judiciary permits the exploitation of the mutuality principle – which we strongly doubt – then the legislature should look to tightening the tax avoidance measures in place to cater for such abuse.

If the mutuality principle is legislated, the legislation should be drafted to focus on and provide clarity as to which activities are not mutual in nature. This would make the need for any specific anti-avoidance rules redundant.

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