MOORES*LEGAL*

Submission on the *Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No. 1) 2011: tax exempt body "in Australia" requirements*

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1. INTRODUCTION

1.1.1 Moores Legal is an Australian law firm with a team that practices exclusively in the area of Not for Profit (“NFP”) law and governance and advises a wide range of organisations in the NFP sector.

1.1.2 This submission is based on our understanding of the history, policy, case law and client needs of the NFP sector and the application of NFP law.

1.1.3 In our submission, the proposed legislation is ill-conceived, unnecessary and unworkable.

1.1.4 The exposure draft is contrary to the principles set out in the *National Compact* and will conversely result in burdening the NFP sector with unnecessary complexity and compliance requirements.

1.1.5 It ought to be withdrawn pending an informed consideration.

2. POLICY OBJECTIVES

2.1 Reasons for proposed legislation

2.1.1 The current “in Australia” special conditions in s 50-50 of the *Income Tax Assessment Act 1997* (“ITAA 1997”) had their origin in the *Taxation Laws Amendment Act (No 4) 1997* (Cth). Their purpose is explained in paragraphs 86-87 of the Explanatory Memorandum to that Act. They are:

- To prevent tax avoidance arrangements; and
- To prevent Australian-sourced income, which is exempt in Australia, from being taxed in a foreign jurisdiction.

2.1.2 These were and are valid policy considerations designed to protect the integrity of charitable activity. Current legislation meets these objectives. Please refer to our comments below under the heading “Current protections”.

2.1.3 The Explanatory Material now says that a new “in Australia” test is required to ensure concessions are used for the “broad benefit of Australians” and interprets this to limit the generosity of Australians beyond Australian borders.

2.1.4 This represents a *new* objective that calls for critical examination. That is, is it Australian Government policy that the generosity of Australia should not extend beyond Australian borders other than through international affairs deductible gift recipient (“DGR”) funds?

2.1.5 The Explanatory Material implies that there is a heightened mischief of money-laundering and terrorism funding through Australian NFPs. Paragraph 1.43 identifies this as a “possible” abuse. This appears to be a vague and unsubstantiated observation. If such abuse exists, it is more appropriately addressed through targeted intervention rather than assuming it is rife within the NFP sector. If it is considered that the current legislation is inadequate to meet this potential mischief, the appropriate response is to use the existing criminal laws or make changes to the criminal laws to stamp out criminal behaviour.

2.2 Current protections

2.2.1 There is adequate provision in the current taxation legislation to deal with perceived abuses. Examples include:

- The Commissioner has power under s 50-140 to require an exempt entity to give the Commissioner information relevant to their endorsement;

- The Commissioner has power under s 50-155(1) to revoke the endorsement of an exempt entity if the entity is not entitled to be endorsed (i.e. it is not a legitimate exempt entity), or if it fails to provide the Commissioner with any information requested by the Commissioner.

The combination of these powers enables the Commissioner to investigate an entity that the Commissioner suspects is engaged in an anti-avoidance scheme, and if that is in fact the case, revoke its endorsement and issue an assessment notice.

2.2.2 It was the view of the High Court in *Federal Commissioner of Taxation v Word Investments Ltd* (2008) 236 CLR 204 ("*Word*"), that the combination of the above powers was sufficient to achieve the anti-avoidance purposes of s 50-50.

2.2.3 If they are not sufficient, the Explanatory Material ought to state why they are not sufficient. The Explanatory Material does not offer any explanation in this regard.

2.2.4 The Commissioner's powers are not defeated by an organisation making a distribution to another entity in Australia because both entities must satisfy the requirements of s 50-50 (or other special conditions under other sections) in order to be exempt.

2.3 Critical examination of new objectives

2.3.1 The new objective appears to be that these provisions are required for the "broad benefit of Australians". This rhetoric needs critical examination.

2.3.2 Do Australians only benefit from the activities of international affairs DGR funds? The activities of those entities do not cover the charitable fields of advancement of religion, the advancement of education, provision of welfare or other beneficial purposes such as environmental conservation. Australian organisations have made a substantial contribution in these fields. This is both in the interests of individual Australians who desire to act altruistically and in the interests of Australia as a contributor to global wellbeing.

2.3.3 Is tax exemption for NFPs a tax forgone? There is an assumption that NFP tax concessions are a drain on the Commonwealth's revenue.

2.4 Are tax exemptions tax forgone?

2.4.1 There is a presumption in the Explanatory Material that tax exemptions constitute tax forgone or tax expenditure. In our view this is a false assumption.

2.4.2 We submit that income tax exemption, at least for charities, if not every form of exempt entity in Division 50, should not be considered tax expenditure. Rather, it is *outside* the tax base.

2.4.3 If the forgone revenue is *outside* the tax base, then there appears no justification for requiring it to be used *for the broad benefit of Australians*.

2.4.4 The distinction between tax expenditure, and revenue that falls outside the tax basis was explained by in *Australia's future tax system: Report to the Treasurer* (2009) (“the Henry Review”) (at 731):

“Not all concessional elements of the tax system are classified as tax expenditures. This is because some concessions are considered to be structural elements of the tax system … For example, the personal income tax system includes a progressive marginal tax rate scale, which results in individuals on lower incomes paying a lower marginal rate of income tax than those on higher incomes. This arrangement is a structural design feature of the Australian tax system and is therefore not identified as a tax expenditure.”

2.4.5 It is our view that there are several reasons why income tax exemption (at least for charities) should be classified as falling outside the tax base rather than as tax expenditure. This view is explained in the following paragraphs 2.4.6 - 2.4.10 of this submission.

2.4.6 Sometimes an argument is made to the effect that charities receive taxation concessions (characterised as tax expenditure) because they carry out the work of government by providing welfare services which the government would otherwise have to provide. This is inconsistent with the role of charities in history. Charities have provided welfare services since before the emergence of the welfare state and their concessions cannot be justified on that basis. We suggest that the historical independence of charities would support the characterisation of the taxation concessions as outside the tax base and not tax expenditure.

2.4.7 The Henry Review accurately notes that “in order to identify a tax expenditure, the tax treatment that would normally apply (the benchmark) needs to be identified” (page 731). If it is to be said that income tax concession for charities are tax expenditure, then an explanation of what the benchmark is needs to be provided. No such explanation has been provided and we suggest that there would be significant difficulties in doing so given that Charities have been exempt from the payment of income tax since the enactment of the first income tax act by William Pitt in England in the 18th century. How can it be said that income, never received because it was never owing, is expenditure?

2.4.8 A number of organisations are exempt from income taxation on the principle of mutuality. These exemptions are not considered to be tax expenditure. Under the principle of mutuality, an organisation cannot earn income from itself. That is, where members of an organisation such as a club, pool funds, the collective pool is not taxed. Why are tax concessions for NFPs (in general, or at least for charities in particular) not treated as an extension of the principle of mutuality? Given that charities are by definition entities established to carry into effect a charitable (that is public benefitting) purpose. It may be said that when people associate voluntarily or contribute voluntarily for a charitable purpose, it is an example of the community giving to itself. So why are NFP tax concessions treated as tax expenditure when mutual income is revenue outside the tax base?

2.4.9 Our taxation system is designed to tax individual, private benefit. NFPs are, by definition, entities established for a purpose *other* than the private benefit of their owners or members. Charities, as a subset of the NFP sector, are by definition entities established to carry into effect a charitable (that is, a public benefitting) purpose. What is the rationale for suggesting that these entities fall within a tax base designed to tax individual private benefit?

2.4.10 It is notable that in comparable OECD economies there is a mechanism for either the individual or the charitable organisation to recover tax that would have been payable if income were for personal gain and not put back into the community. For example, tax deductibility in the United States and GiftAID in the United Kingdom.

2.4.11 In many instances, taxpayers will support income tax exempt entities with after-tax income. If the entity were not income-tax exempt, the funds would be taxed twice. This is inconsistent with the approach taken in Australia to the taxation of companies where shareholders are able to claim franking credits for tax already paid by the Company.

2.5 Ensuring proper application of funds

2.5.1 The Explanatory Material suggests that the new "in Australia" special conditions are necessary to ensure the proper application of funds by NFPs. We disagree.

2.5.2 The Commissioner has powers to investigate and withdraw income tax exempt status if funds not being appropriately applied. (We refer to our comments in section 2.2 "Current protections" above).

2.5.3 An entity will not be entitled to exemption if its constituent documents allow it to apply its assets other than for the purpose for which it was established.

2.5.4 The State Attorneys-General has power to bring an action requiring the proper application of funds in the context of charitable trusts, and we expect that this function will be given to the Australian Charities and Not for Profits Commission ("ACNC") in respect of NFPs generally.

3. TREATMENT OF DEDUCTIBLE GIFT RECIPIENTS: DIVISION 30 OF THE ITAA 1997

3.1 The requirement to donate only to DGRs

3.1.1 We refer to s 30-18(3) of the exposure draft:

"The fund, authority or institution must not donate money or property to an entity that is not a *deductible gift recipient."

3.1.2 This provision shows a misunderstanding of how DGR funds operate. A DGR must apply its funds for its purpose. It may be that a donation to a non-DGR is a legitimate application of the funds for the purpose of the DGR. Such donations should not be excluded.

3.1.3 Examples of the potential practical difficulties with s 30-18(3) include:

- A gift from a necessitous circumstances fund within the meaning of item 4.1.3 of s 30-45 of ITAA 1997 to an individual in necessitous circumstances;

- A gift by a public hospital within the meaning of item 1.1.1 of the table in s 30-20 of the ITAA to a scientific institution within the meaning of item 1.3 of the table in s 50-5 of the ITAA 1997;

- Sponsorship by a health promotion charity within the meaning of item 1.1.6 of s 30-20 of the ITAA 1997 of a public fun-run.

- A donation by a scholarship fund within the meaning of item 2.1.13 of s 30-25 of the ITAA 1997 to a recipient student;

- A donation by a welfare organisation (e.g. a public benevolent institution) to an individual in need of relief.

(We note that the definition of "entity" in s 960-100 includes an individual).

3.1.4 Paragraph 1.65 of the Explanatory Material provides some context for understanding the meaning of "donation". It provides:

"A donation does not include a payment for goods or services to another entity made in pursuing its own purposes. This is considered as part of the core operating 'in Australia' test. A donation relates to money gifted to another entity unconditionally, and not the day-to-day running of the entity directly pursuing its objectives."

3.1.5 This definition of "donation" is not included anywhere in the legislation. It is provided in the context of commentary regarding Division 50. However, in case it was intended to bring comfort regarding the application of the proposed s30-18(3) (or the application of the proposed s 50-50(2)(c)), our comment on its suitability is as follows:

3.1.6 Drawing a distinction between money gifted "unconditionally" to an entity (including an individual) and "the day-to-day running of the entity directly pursuing its objectives" is impossible. Consider its application to the necessitous circumstances fund described in 3.1.3.

3.1.7 It is our submission that s 30-18(3) ought be omitted. We think that the existing law is suitable.

3.2 Section 30-18(1)(b)-(d): the new "in Australia" test for DGRs

3.2.1 We refer to our comments above in section 2 "policy objectives" regarding the adequacy of the current law and the inappropriateness of the new objectives.

3.3 International Affairs Deductible Gift Recipients

3.3.1 We refer to s30-18(4) of the exposure draft:

"An entity covered by section 30-80 (international affairs deductible gift recipients) satisfies the conditions in this section if it satisfies the conditions in subsection (1)(a)."

3.3.2 It is our submission that the wording of this provision is problematic.

3.3.3 Section 30-80(1) of the ITAA 1997 lists a table that sets out general categories of international affairs recipients. There are two items listed in that table. Each item is a public fund. Clearly, these funds are exempt.

3.3.4 However, what is not clear, is whether the organisations that operate those funds are also exempt. If they are not exempt, the application of s 30-18(4) of the exposure draft would lead to anomalous results.

3.3.5 For example:

- Item 9.1.2. of s 30-80(1) of the ITAA 1997 exempts a public fund that is established and maintained by a public benevolent institution.
- While "public benevolent institution" is a common law term, a public benevolent institution cannot obtain tax concessions unless it is endorsed by the Australian Taxation Office.
- Therefore, to obtain any tax concessions, a public benevolent institution would have to satisfy the "in Australia" conditions as set out in s 50-50 and s 30-18 of the exposure draft.
- However, if the public benevolent institution is not covered by s 30-18(4) it would not satisfy the "in Australia" conditions.
- If the public benevolent institution operating the public fund listed in item 9.1.2 was not eligible for tax concessions, then there appears to be no reason to require a public fund listed in item 9.1.2 to be operated by a public benevolent institution. It could be operated by any other form of entity with the same result.

3.3.6 Problems also arise in the context of item 9.1.1 of the table in s 30-80(1):

- Item 9.1.1 of the table includes "a public fund declared by the Treasurer to be a developing country relief fund" that meets the special conditions set out in s 30-85.
- Section 30-85 provides that a fund must be established by an organisation that is declared by the Foreign Affairs minister to be an "approved organisation".

- It is not clear from the terms of s 30-18(4) whether it exempts only the public fund, or whether the approved organisation which operates the fund is also exempted.

- If the exemption does not cover the approved organisation, then approved organisation is at risk of losing its income tax exemption and fringe benefits concessions. This is likely to create difficulties because in practice, although it is the public fund that is endorsed as a DGR, the entity that operates it also applies for income tax exemption and fringe benefits tax concessions in its own right. If that entity is not a DGR, it is unlikely to satisfy the new “in Australia” special conditions in s 50-50(2). Although s 50-50(3) effectively exempts DGRs from the requirements of s 50-50(2), in the event that s 30-18(4) of the exposure draft exempted only the fund, the approved organisation would be unlikely to satisfy the new “in Australia” conditions.

3.3.7 When interpreting s 30-18(4) in light of the meaning of DGR (s 30-227) and the definition of “entity” (s 960-100), it might be argued that the organisation operating the public fund described in item 9.1.1 is a DGR in its capacity as trustee and therefore satisfies the requirements of s 50-50 in that capacity. However, the entity would *only* be a DGR in that capacity. In practice this would be problematic. For one, it is administratively burdensome. Two, the reasoning does not apply to funds described in item 9.1.2.

4. CHARITIES AND NOT-FOR-PROFITS: DIVISION 50 OF THE ITAA 1997

4.1 The “at all times” requirement

4.1.1 We refer to the s 50-50(1) of the exposure draft which requires a not-for-profit entity to comply with the special conditions “at all times”.

4.1.2 It is our submission that this requirement is too harsh and unnecessary. It is also inconsistent with the spirit of the *National Compact*.

4.1.3 We are particularly concerned by the operation of the “at all times” requirement with s 50-50(3)(a). The effect is to disentitle any organisation which breaches its governing rules to income tax exemption. It has this effect irrespective of how minor or irrelevant the rule was to the organisation’s tax exempt status. Not every provision of an organisation’s governing rules are relevant to its tax concession status. There are usually only three provisions (colloquially known as the objects clause, the not-for-profit clause and the dissolution clause) relevant to tax status. The law already provides for tax exempt status to be revoked for material breaches of these provisions. We also note that the consequence of the operation of such a harsh and unnecessary provision provides an incentive for organisations to adopt minimalist rules.

4.1.4 We are also concerned by the operation of the “at all times” requirement when read together with s 50-50(2)(c). Section 50-50(2)(c) prevents an entity from donating money to another entity, unless the other entity is an exempt entity. For example, it would disentitle a church that made a donation to a missionary, or to a sister-church overseas, or to any needy person whether in Australia or not. This would impact virtually every church in Australia. There would be a similar impact for other religious traditions.

4.1.5 It is our submission that the words “at all times” should be deleted from s50-50(1) of the exposure draft.

4.2 The new “in Australia” requirements (s50-50(2))

4.2.1 We refer to s 50-50(2) of the exposure draft. It is our submission that these provisions should not be enacted. We refer to our comments in section 2 “Policy Objectives”.

4.3 The “comply with all the requirements in its governing rules” requirement

4.3.1 We refer to s 50-50(3)(b) of the exposure draft. We also refer to our comments in paragraph 4.1.3. It is our submission that this provision should be deleted on the basis that it is harsh and unnecessary.

4.3.2 We note the decision of the Full Federal Court in *Bargwanna (Trustee) v Commissioner of Taxation* [2010] FCAFC 126 (8 October 2010). The Court considered whether a fund had been “applied” for the purposes for which it was established as required by s 50-60. The Court held that the relevant question was “whether, having regard to the **whole** administration of the relevant fund, it is to be concluded that the fund “is applied” to the relevant charitable purpose.” It found that not every breach of trust will lead to the conclusion that the fund as a whole has been misapplied. We endorse this approach.

4.4 The “use its income and assets solely to pursue the purposes for which it was established” requirement

4.4.1 No reason has been provided for adopting a “solely” test in place of the current dominant / principal purpose established by common law.

4.5 Prescribed organisations

4.5.1 We are concerned by the omission of an equivalent s 50-50(d). This would affect in particular virtually every Australian missionary organisation and any church that donates to them.

4.5.2 There is a prohibition in the exposure draft in s 50-50(2)(c) on donating to any entity that is not an exempt entity. Almost every church in Australia would provide some form of money or property contribution to missionary organisations, overseas churches or educational institutions and accordingly lose tax concession charity (“TCC”) status. There would be a similar impact for other religious traditions.

4.5.3 These problems were foreshadowed when the “in Australia” test was first introduced into the ITAA 1997. At that time the Commonwealth Treasurer made it clear that bona fide organisations would not be disaffected.

4.5.4 One mechanism to achieve this was to allow bona fide organisations or their members to be “prescribed” and accordingly, exempted from the “in Australia” test.

4.5.5 Regrettably the draft legislation now confines such prescription to foreign entities - a test that Australian NFPs would fail. Accordingly the gateway to prescription has been closed in the face of Australian NFPs but opened to foreign charities. Is there any justification for closing the gate on existing organisations? Is there any evidence that they have been abusing their taxation concessions?

4.6 Removal of exception for certain gifts and grants (s 50-75)

4.6.1 We note that there is no equivalent s 50-75 of the ITAA 1997 included in the exposure draft. This means that gifts and grants will be included in the definition of income for calculation of whether an entity is operating principally “in Australia” and pursuing its purposes principally “in Australia”.

4.6.2 There was good reason for these exceptions. In many instances, gifts are made to income tax exempt entities from after-tax income. The omission of s 50-75 of the ITAA 1997 will prevent an income tax exempt entity from expending funds for the benefit of non-Australians even where those funds have already been taxed. The omission of s 50-75 also creates the potential for the taxation of government grants.

5. DEFINITION OF NOT FOR PROFIT ENTITY

5.1.1 We refer to the proposed definition of “not-for-profit entity” in s 995-1(1) of the ITAA:

“not-for-profit entity means an entity that:

(a) does not carry on its activities for the purposes of profit or gain for particular entities, including its owners or members, either while it is operating or upon winding up; and

(b) does not distribute its profits or assets to particular entities, including its owners or members, either while it is operating or upon winding up.”

5.1.2 We accept that paragraph (a) is a fair statement of the law: a NFP must carry on its activities other than for the purposes of profit or gain to other entities. Profit or gain in this context has always been understood to mean private benefit and any distribution to achieve a charitable purpose was acceptable.

5.1.3 However, the second limb of the definition, set out in paragraph (b), provides that any distribution of profit or assets to another entity (including to an owner or member) forfeits NFP status.

5.1.4 This would occur regardless of whether such distribution is in furtherance of a bona fide charitable purpose or not. The current law would allow such a distribution and this is recognised in draft taxation ruling TR 2011/D2 (see paragraphs 45 and 46).

5.1.5 It is invariably the requirement of winding up clauses in NFP constituent documents to require the transfer of surplus assets to another NFP entity with similar purposes. Part of the difficulty is the fact that this new concept of “particular entity” is undefined either in the Statute or at common law. The exposure draft could therefore make all such NFPs subject to taxation.

5.1.6 It is common for an NFP to structure itself as a number of separate legal entities that operate in concert. For example, a public benevolent institution may establish one subsidiary for its community housing program, another subsidiary for its aged care services, and another subsidiary for its fundraising. Another example is a national organisation which separately incorporates each state branch as a subsidiary. The definition of “not-for-profit entity” creates problems for such organisations.

5.1.7 This definition represents a radical change from the existing law and would have the effect of excluding a large number of legitimate not-for-profit organisations.

5.1.8 The unrelated commercial activities tax (“UCAT”) contemplates that NFPs will create a separate legal entity to undertake commercial operations. The assurance is that if business surplus is immediately applied to a charitable purpose (through a related charitable entity) the surplus will be untaxed. However the proposed definition will disentitle the income generating entity from income tax exemption.

6. CONCLUSION

6.1.1 There are numerous concerns with the exposure draft which will have far reaching implications for NFP and charitable activity in Australia and beyond. It will severely inhibit aspirations for Australia to strengthen its civil society through altruistic activity. The exposure draft should be withdrawn. The existing law is adequate.

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