The Institute of Chartered Accountants in Australia

15 August 2011

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Dear Chris

Exposure Draft: Restating the "in Australia" special conditions for tax concession entities

The Institute of Chartered Accountants in Australia ("the Institute") welcomes the opportunity to put forward our views on the exposure draft legislation (the "Exposure Draft") and the accompanying explanatory memorandum (the "EM") released on 4 July 2011 by the Assistant Treasurer, the Hon Bill Shorten MP.

The Exposure Draft and EM together legislatively re-state the "in Australia" special conditions that apply to both tax exempt entities and deductible gift recipients ("DGR").

The Institute supports the Government's policy aims but is concerned that the proposed changes to the "in Australia" requirement, as currently drafted, go beyond the stated policy objectives and will have unintended and adverse consequences for not-for-profit entities (NFPs) with DGR and/ or tax exempt status.

While the uniform application of a single test to the different categories of tax exempt entities has the benefit of consistency and simplification, it may not necessarily consider the inherent differences within the various NFP sectors. Therefore, the Institute considers that it is not appropriate to treat NFP entities in a homogenous way for the purposes of preventing tax avoidance and the misuse of tax exemption.

We also consider that it is important to ensure that the single test amendment does not inadvertently remove existing concessions and exclusions from the "in Australia" requirement (eg current concession for making distributions overseas).

Some of the Institute's key concerns include that:

- The Government should consider a legislative definition of the term "principally" for the purposes of the "in Australia" requirement and/or clear guidelines on how the requirement would be applied in practice so that NFPs can get some level of certainty.

- The drafting of the proposed requirement that tax-exempt entities can only donate to other tax-exempt entities needs to be reconsidered as it has potentially a much wider application than may have been intended (ie limited to conduit NFP entities).

- The proposed test for DGRs in being subject to the new "in Australia" conditions, but with a stricter threshold test with only very limited exclusions may severely impede the scope of DGRs not engaged in "international affairs" to carry out or support overseas activities.

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These and other concerns are set out in detail in the attached submission.

Finally, the Institute notes that the proposed "in Australia" amendments are to apply for income years following Royal Assent. However, the Institute's preferred position is that this measure ought to be considered in the context of, and in conjunction with, the other tax and non-tax reforms to the NFP sector (such as the establishment of a national regulator, changes to the tax concession for unrelated commercial activities and a statutory definition for charities). At the very least given the potential impact on NFP entities and the possible need to restructure their activities, the Institute is of the view that a minimum 12 month transitional period should be provided.

Please do not hesitate to contact me on (02) 9290 5623 or Karen Smith on 0425 326 564 if you need clarification in respect of any of our comments.

Yours sincerely

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Introduction

This submission is in response to the measures announced on 4 July 2011 by the Assistant Treasurer, the Hon Bill Shorten MP, comprising of exposure draft legislation (the "Exposure Draft") and the accompanying explanatory memorandum (the "EM"). The Exposure Draft and EM together legislatively re-state the "in Australia" special conditions that apply to both tax exempt entities and deductible gift recipients ("DGR").

The Institute would like to address specific concerns with the Exposure Draft and in particular, draw attention to its implications for not-for-profit ("NFP") entities.

The effect of these reforms is to apply more stringent conditions for tax exempt and DGR status.

The NFP sector plays a fundamental role in society both globally and within the Australian community. For these entities, tax concessions also provide necessary administrative benefits that arise from tax exemption and the ability to raise money from the public through deductible gifts.

The purpose of these reforms reflect the Government's continued policy aims which have historically focused on illegal and tax avoidance arrangements involving tax exempt NFP entities. The aims stated in the EM include the following:

- to address tax avoidance arrangements which could use charitable trusts and certain NFP organisations to shift untaxed funds overseas;
- to minimise the risk of income tax exempt entities being used for terrorist financing and money laundering; and
- to ensure the proper operation of NFP entities and their use of public donations and funds.

The Institute supports the Government's policy aims as stated above but is concerned that the proposed changes to the "in Australia" requirement, as currently drafted, go beyond the stated policy objectives and will have unintended and adverse consequences for NFPs with DGR and/or tax exempt status.

The proposed new "in Australia" conditions are the Government's response to the decision in *Federal Commissioner of Taxation of the Commonwealth of Australia v Word Investments Limited*[1]. The Institute is of the view that the decision acted to clarify existing legislation and did not change the law.

Furthermore, in relation to the policy aim to minimise risks of tax exempt entities being used for terrorism financing and money laundering, the Institute submits that there is existing and more appropriate legislation to address these risks, for example, the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006.*

The proposed "in Australia" amendments are to apply for income years following Royal Assent. However, the Institute's preferred position is that this measure ought to be considered in the context of, and in conjunction with, the other tax and non-tax reforms to the NFP sector (such as the establishment of a national regulator, changes to the tax concession for unrelated commercial activities and a statutory definition for charities). At the very least given the potential impact on NFP entities and the possible need to restructure their activities, the Institute is of the view that a minimum 12 month transitional period should be provided.

The proposed reforms – tax exempt entities

In broad terms, the Exposure Draft provides that in order to qualify as exempt from income tax, NFP entities must at all times (emphasis added):

- be an **NFP entity**;
- operate **principally** in Australia;
- pursue its purposes **principally** in Australia;
- not donate money to **any entity which is not an exempt entity**;
- comply with **all** the requirements in its governing rules; and
- use its income and assets **solely** to pursue the purposes for which it was established.

[1] (2008) 236 CLR 204

The new "in Australia" requirements are proposed to be standardised across the various categories of tax exempt entities. In addition, there is an intentional move away from the current "expenditure" based test, to one which focuses on where an entity "operates" and "pursues its purposes".

The Institute acknowledges that the uniform application of a single test to the different categories of tax exempt entities has the benefit of consistency and simplification. However, the move to a single test may not necessarily consider the inherent differences within the various NFP sectors. It is important to recognise that NFP sectors such as education, health, community services, environment, sport and religion all operate and carry out their altruistic purposes in different environments. It is not appropriate to treat NFP entities in a homogenous way for the purposes of preventing tax avoidance and the misuse of tax exemption.

Furthermore, it is important to ensure that the single test amendment does not inadvertently remove existing concessions and exclusions from the "in Australia" requirement. For example, section 50-50(d) of the *Income Tax Assessment Act 1997* (ITAA 1997) which exempted specifically prescribed institutions that have a physical presence in Australia but which incur expenditure and pursue their objectives outside Australia from the "in Australia" requirement appears to have been omitted in the proposed legislation through the repeal of the current section 50-50 and the exemptions not completely replicated in the new proposed section 50-51.

"Principally in Australia" requirement

The EM notes at paragraph 1.49 that the term "principally" means "mainly or chiefly" and that "less than 50% is not considered principally". The EM also states that various factors such as residency, expenditure, management and the location of employees and beneficiaries would be relevant factors in satisfying this requirement. Some of the examples in the EM discussing this requirement indicate that a potentially more lenient interpretation may be adopted.

The Institute is of the view that the Government should consider a legislative definition of the term "principally" for the purposes of the "in Australia" requirement and/or clear guidelines on how the requirement would be applied in practice so that NFPs can get some level of certainty. Otherwise the subjective interpretation and judgment of the Australian Taxation Office personnel may result in inconsistent application of the law.

"Donate money only to other income tax exempt entities" requirement

This additional requirement in the "in Australia" special conditions means that tax-exempt entities can only donate to other tax-exempt entities, which must therefore also have satisfied the "in Australia" requirements. The EM appears to suggest that this particular requirement is focused towards "conduit" NFP entities, and is aimed ultimately at ensuring that tax-exempt money raised stays within the "exempt entity framework" and is applied primarily for the benefit of Australians.

The Institute submits that the drafting of this proposed requirement has potentially a much wider application than may have been intended. The Institute is of the view that as currently drafted the requirement effectively applies to all tax exempt entities, and not just confined to conduit NFP entities.

For example on occasions it may be necessary for an exempt entity to donate funds to organisations that are not tax exempt in themselves. It may be those organisations do not have the structure or capacity to apply for tax deductibility in their own right. The Institute considers that the question should turn on whether the NFP is distributing its funds in accordance with donor's wishes and within its constitution. As all NFPs must have restrictive clauses in their constitutions that make them eligible for NFP status, satisfying this should ensure entitlement to tax deductibility.

As a further example, a charity that is currently income tax exempt may make small donations to an overseas entity which is pursuing the same charitable purposes. This new proposed requirement could operate to deny the donor entity tax-exempt status. The Institute submits that such a result would be contrary to the Government's stated policy aims as it effectively imposes an "only" or "sole" test, as opposed to the "principal" test in the context of donations.

The Institute submits that this requirement also has negative ramifications for the Australian NFP sector, and may lead to Australia being considered comparatively unfavourable from an international aid, charitable or fundraising perspective due to Australian tax exempt entities being required to donate solely to other Australian exempt entities.

As NFPs increasingly operate in a global environment through global networks in the case of large international NFPs, various international affiliations or cooperation among international organisations pursuing the same altruistic purposes, the restriction on donations to overseas NFPs pursuing the same altruistic purposes which are not tax exempt under Australian law, is not in line with international practice. Australia will therefore be compared unfavourably to other developed countries such as the US which do not have such strict restrictions on overseas donations. It will also adversely impact on the effectiveness of some larger Australian NFPs.

Section 50-75 of the ITAA 1997 is not addressed in the policy justification for the exposure draft, and it is arguable that a wholesale repeal of the section goes beyond the stated policy intent. In the interests of recognising global affiliations, it would be ideal to have the statutory disregard that currently exists in section 50-75 retained under the new legislation as it provides a significant safe harbour for intra-group transfers within international networks of affiliated charities.

Definition of "donation"

The Institute notes the term "donation" is defined in the EM at paragraph 1.63 to mean a gift of money "unconditionally to another entity to fulfil its own purposes". The Institute submits that in many instances, it can be difficult to determine with certainty whether a payment or grant of monies will be regarded as a donation.

This is evidenced by the need for additional guidelines such as Taxation Ruling 2005/13 *Income tax: tax deductible gifts – what is a gift* ("TR 2005/13") on the meaning of the term 'gift' for the purposes of Division 30 of the *Income Tax Assessment Act 1997*. At paragraphs 12-13 of TR 2005/13, the term 'gift' is taken to have its ordinary meaning and have the following broad features:

- a voluntary transfer of a beneficial interest in property;
- arising by way of benefaction; and
- no material benefit or advantage is received by the giver by way of return.
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TR 2005/13 notes at paragraphs 14 and 15 that such a criteria "may not be absolute and may involve a matter of degree" and involves an analysis of the substance and reality of the transfer.

As an example, if a tax exempt entity makes a grant to an NFP research organisation to undertake research in a particular area relevant to the tax exempt entity, with minimal conditions such as the research being made available to the public, would the grant be regarded as a donation? If it is regarded as a donation, then as mentioned above, the tax exempt entity would fail the new proposed "in Australia" conditions. Another example is the grant of money by one country member of a global NFP organisation to another country member of the same global NPF organisation to undertake work to advance the global organisation's charitable purposes, eg the achievement of a global environmental objective which will directly or indirectly benefit Australia. There would then be a need for the tax exempt entity to structure the grant so that it is not considered a donation.

This has the potential of complicating simple arrangements and increasing costs to tax exempt entities without necessarily achieving the Government's policy objectives.

"Comply with all the requirements in its governing rules" requirement

The EM suggests that this requirement is intended to ensure that the actual activities of a tax exempt entity are consistent with the entity's stated purposes and objectives. The Institute supports this policy aim. However, the requirement, as currently drafted, is very wide and could potentially catch minor non-compliance with process or procedures stated in the entity's governing rules (for example, process around timing and notice of members' meetings). Minor and inadvertent non-compliance with process should not jeopardise an entity's tax exempt status. Accordingly, the Institute submits that the requirement be drafted to address specifically material non-compliance with stated purposes and objectives of the entity.

The proposed reforms – Deductible Gift Recipients ("DGRs")

Under the proposed legislation, DGRs will also be subject to the new "in Australia" conditions, but with a stricter threshold test. In order to be a DGR, an entity (other than international affairs DGRs) must:
operate solely in Australia at all times;

- pursue its purposes solely in Australia at all times; and
- must not donate money or property to non-DGRs.

The EM notes that "solely in Australia" has been interpreted to require DGRs "to be established and operated only in Australia (including control, activities and assets) and must have their purpose and beneficiaries only in Australia". The EM does not state the source of the interpretation. It appears that the interpretation is similar to that stated in Taxation Ruling 2003/5 *Income tax and fringe benefits tax: public benevolent institutions* ("TR 2003/5"). Paragraph 129 of TR 2003/ 5 states that "to be in Australia a public benevolent institution must be established, controlled, maintained and operated in Australia and its benevolent purposes must be in Australia. Because the purpose of public benevolent institutions is to provide direct relief to persons in need, this will mean that relief will be provided to people located in Australia".

While we acknowledge that the strict "in Australia" test may be appropriate for public benevolent institutions ("PBI"), it is not necessarily appropriate for other categories of DGRs. For example, a charitable institution promoting the prevention or the control of diseases in human beings ("health promotion charity") may provide grants for research into cures for the disease, and it may be that the most promising or innovative research may be undertaken by an overseas NFP research organisation. Applying the strict "in Australia" requirement may result in the health promotion charity losing its DGR status on the basis that:

- it is not operating and pursuing its purposes solely in Australia; and/or
- if the research grant is considered a donation, the health promotion charity will also breach the requirement to donate only to DGRs.

The EM noted that a DGR will not fail the "in Australia" requirement if the overseas activities are merely incidental or minor in extent and importance. This is consistent with the current practice adopted by the Commissioner of Taxation (TR 2003/5, paragraph 130). We submit that this concession should be legislated and further clarification on what would be considered "incidental or minor" is required to enable DGRs to ascertain compliance with the "in Australia" requirement.

As the proposed rules will apply to all DGRs (except for international affairs DGRs), those DGRs specifically listed by name in the tax legislation will also be impacted notwithstanding that some of them may have been granted DGR status with full knowledge of overseas activities that were considered acceptable under the current "in Australia" requirement but would no longer be under the new proposed test. These affected DGRs may have been specifically established to pursue charitable purposes which included overseas objectives, with Government or Ministerial approval. We submit that these DGR should not be impacted by the proposed changes.

The Institute submits that it is concerned that the strict test of this new requirement together with the very limited exclusions may severely limit the scope of DGRs not engaged in "international affairs" to carry out or support overseas activities. The application of the new requirement has the potential to impact a substantial number of DGRs by impacting their ability to raise funds to support their purposes. Therefore, the Institute is of the view that the Government should consider widening the types of entities that would be excluded from the proposed new rules, for example by widening the types of entities that are included in the "international affairs" category. In light of growing international co-operation between NFP entities and the fact that many issues being addressed by the NFP sector are global and internationally interconnected, eg health and environmental issues, the proposed requirements would severely restrict Australian NFP interactions with their global associated organisations. Again, for a number of the larger NFP entities, the loss of DGR status would threaten their ability to raise funds and therefore their very existence. The proposed changes would necessitate significant restructuring in order to maintain their DGR status and limit their effectiveness in that their international cooperation would be restricted.

"Disregarded amounts" ATO concession should be preserved

The ATO's *Income Tax Guide for Non-Profit Organisations* (NAT 7967-03.2007) provides an important concession for "disregarded amounts" in applying the existing physical presence in Australia test (refer to page 29 of the guide).

Distributions of "disregarded amounts" are disregarded when working out where the entity pursues its objectives and incurs its expenditure.

Disregarded amounts are amounts that the organisation receives as:

- gifts, including testamentary gifts (that is, gifts made under a will)
- proceeds from raffles, dinners, auctions, jumble sales and similar fundraising activities, or
- government grants.

The disregarded amount concession is important especially for NFP entities that receive government grants. There are sufficient existing integrity mechanisms associated with government grants to ensure that such funds are appropriately applied by recipients, so there is no need for any further integrity measures in relation to disregarded amounts.

We submit that "disregarded amounts" should be expressly excluded from the proposed "operating and pursuing purposes in Australia test".

Administrative obligations

Many DGRs and tax-exempt entities would have to restructure their operations if the proposed changes are enacted so that local and international operations are clearly operated and accounted for separately. Without restructuring, their tax exempt and DGR status would be jeopardised. However, restructuring itself can also lead to the loss of tax exempt and/ or DGR status for parts of their activities.

For example, an entity which carries on certain overseas activities but still within the proposed new "in Australia" requirements for income tax exemption may well fail the stricter "in Australia" requirements for DGR status. One option to maintain the DGR status would be to separate the overseas activities into a separate entity or fund. However, by doing so, that new entity will not be eligible for either income tax exempt or DGR status and will also lose fringe benefits tax and GST concessions . There will be increased accounting and tax obligations and compliance costs. In addition, without DGR status, the separated entity or fund would struggle to raise moneys to fund the complementary overseas interactions and activities. Another option would be for such NFPs to cease having complementary international affiliations and activities which would erode their effectiveness. As both income tax exempt (and associated tax concessions) and DGR status are equally vital to NFPs, they would have to weigh up the relatively cost and benefit in deciding which option to pursue.

In addition to the potential loss of tax concessions and DGR status, restructuring may involve significant administrative, financial and legal burdens. Most tax exempt entities do not have the resources to deal with potentially complex restructuring issues such as the transfer of property and other legal arrangements. The additional time and costs required to deal with such issues would detract the NFP entity from its core altruistic purposes.