10 August 2011

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Dear Sir/Madam

**NFP Reform: Exposure Draft – 'In Australia' Special Conditions for Tax Concession Entities**

This submission of the Taxation Committee of the Business Law Section of the Law Council of Australia ('the Committee') is in response to the Exposure Draft (**ED)** for proposed reforms to 'In Australia' Special Conditions for Tax Concession Entities and the accompanying draft Explanatory Memorandum (**EM**).

## 1. Overall Policy and Legislative Approach to Not-for-Profits

The overarching purpose of regulation and taxation of charitable, benevolent and community organisations should be to facilitate an outcome of public benefit, while preventing potential regulatory or tax abuse of concessions.

It is submitted that overall, the government's policy about these organisations remains confused and its legislative reforms are being introduced in an unnecessarily piecemeal manner. The government is in the process, the Committee understands, of establishing a Not For Profit regulator which, at least as originally proposed, is to be independent of the Commissioner of Taxation. However, rather than provide a single regulatory approach that ties back into the tax system on a holistic basis, the government remains wedded to a strict approach that largely seeks to regulate the sector through the tax law (particularly the *Income Tax Assessment Act* 1997, *A New Tax System (Goods and Services Tax) Act* 1999, *Fringe Benefits Tax Assessment Act* 1986 and *Taxation Administration Act* 1953). Breach of these strict requirements has potentially draconian consequences for NFP organisations. The government's approach reflects an apparent misunderstanding of the sector.

The ED refers to the views of the Commissioner of Taxation (the ***Commissioner***) in justifying the changes.[1] The Committee notes that the Commissioner is an administrator and should not be determining the governmental policy that guides Australian philanthropy and charitable activity. There is an inherent contradiction between raising revenue as the Commissioner must and acting as the gatekeeper for philanthropy.

## 2. The 'in Australia' requirement

### a. Underlying policy intent

In respect of the 'in Australia' condition, it appears that the government has a fundamental policy of minimising the role of the broad community in the delivery of aid to those in need who are outside Australia, and in restricting the benefit of subsidised charitable activities and gifts to, in the main, Australians. It does this by creating statutory controls that ensure that any such aid must be delivered through entities prescribed by the government, or through its own, governmental aid program.

It is suggested that, if this is the underlying policy, it is misplaced in today's globalised world. It reflects an historicl mentality that suggests that the community should have little role in the delivery of overseas aid and that, to the extent that the community is involved in the delivery of that aid, it is for the Government to tell the community what causes are worthy. Bearing in mind the world-leading efforts of Australia's charities and other not-for-profit entities, in delivering skills to and relieving the causes of poverty in, developing countries, and the government's commitment to globalization in business, education and other aspects of social and economic life, it is odd that it should evidence a heightened parochialism in its decision to further constrain the work of these entities through a narrowing of the "in Australia" principle.

The negative impact of the 'in Australia' restriction is illustrated by Example 1.8 in the EM, which concerns a conduit organisation which runs a commercial bread business for profit, with the objective of helping the poor by donating all funds to a not-for-profit entity that runs homeless shelters in Australia and Asia. In the example, as 75 percent of funding goes to homeless shelters in Asia, the organisation fails the 'in Australia' special conditions and so is disqualified as tax-exempt. But it could be reasonably argued that it is for the public benefit in general, and even in Australia's particular benefit, that Australians contribute to the relief of homelessness in the Asian region.

While it appears that the government policy underlying the 'in Australia' condition is that it should only be Australians, predominantly, who benefit from Australian charitable activity or gifts, this policy is not clearly stated in either the ED or the EM. A hint of this policy is indicated in the EM, which states that the conditions

[1] See, eg, paras [1.9], [1.27], [1.31] of the EM.

ensure that tax-exempt entities “generally must be operated principally in Australia and for the broad benefit of the Australian community”.[2]

The Committee understands that the government is particularly concerned about the impact on interpretation of the ‘in Australia’ requirement of the decision in FCT v Word Investments (2008), as indicated in the EM [1.8]-[1.9] and announcement by Assistant Treasurer Chris Bowen in 2009:[3]

> “the Government's interim response to the High Court of Australia's decision in *Federal Commissioner of Taxation v Word Investments*. The High Court handed down its decision on 3 December 2008. Two issues were resolved in favour of the taxpayer and contrary to longstanding ATO tax rulings … charities are considered to be pursuing their objectives principally 'in Australia' if they merely pass funds within Australia to another charity that conducts its activities overseas.
>
> *Passing funds to overseas charities*
>
> The Government will amend the 'in Australia' requirements in Division 50 of the *Income Tax Assessment Act 1997* to ensure that Parliament retains the ability to fully scrutinise those organisations seeking to pass money to overseas charities and other entities. This measure will have effect from the date of Royal Assent of the amending legislation.
>
> The measure will reverse the decision that charities and other income tax exempt entities can direct funds to overseas projects outside the current restrictions. The measure will reinstate the principles underlying the current integrity rules.”

The Committee notes that the above statement refers only to amendments to Div 50, however the government has also chosen in the ED to tighten up the “in Australia” requirements for Div 30 gifts to Deductible Gift Recipient funds or organisations (**DGRs**).

In conclusion, the Committee would question the fundamental policy underlying the ‘in Australia’ condition. However, it is of course open for the Government to adopt this policy and establish it in legislation. In this regard, it is submitted that the ED would be improved by a clear statement of the policy for the ‘in Australia’ condition for both tax-exempt entities and DGRs.

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2 EM, para [1.44] and see para [1.39].

3 Media Release No. 043 of 2009

## b. Stated rationales in the EM for the ‘in Australia’ restriction are inadequate

The EM provides two other rationales for the ‘in Australia’ condition, which mirror the reasons stated for the original introduction of the restriction in 1997, explained in the accompanying Explanatory Memorandum as follows:[4]

> "The measures will address avoidance arrangements which take advantage of the tax exempt status of charitable trusts and close off the possibility of certain organisations which also currently enjoy an income tax exemption from being used for tax avoidance purposes. Additionally, they will prevent, in particular circumstances, the transfer of revenue from Australia to a foreign country where Australia foregoes its taxing right by providing an income tax exemption for the Australian source income of an offshore organisation but the organisation is not exempt from tax on this income in its home country."

The restriction in s 23(e)(i) of ITAA 1936 was re-enacted in s 50-50(a), in exactly the same terms. It is submitted that neither of these stated rationales provide adequate support for the strict “in Australia” special conditions.

*(1) Tax avoidance/evasion rationale*

It is accepted that there may be some circumstances in which the government is concerned to prevent tax avoidance by illegal shifting of untaxed funds overseas, through the vehicle of a charitable or tax-exempt entity. The Committee notes that the High Court stated of this concern of the government (para [72] *Word Investments*):

> “The Commissioner's contention that the revenue authorities would have great difficulty in monitoring the use of funds generated by a body in Australia and given to another body active overseas is exaggerated. “

The EM does not explain why this is considered to be such a serious risk. Similarly, the EM refers to the use of tax-exempt monies to fund ‘terrorist’ organisations or ‘money-laundering’ (eg, para [1.43]), however, it does not provide any indication as to the risk or likelihood of this occurring in tax-exempt, rather than business or investment, entities.

In any event, the Committeel would question whether the legislative response to this potential problem is either proportionate to the risk or appropriate. Why restrict *all* tax-exempt entities or DGRs from carrying out or funding activities offshore, by the draconian mechanism of removing their tax-exempt or DGR status in its entirety, on this basis?

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4 Explanatory Memorandum, Taxation Laws Amendment Bill (No 4) 1997 (Cth) at [5.2]; and see [5.24]-[5.25].

The Committee finds it extraordinary that the government considers it appropriate to use general tax philanthropic rules to deal with such criminal activities. The Committee notes that if any tax-exempt entity or DGR in fact did any of the above, it would be open to, indeed incumbent on, the government, to remove that organisation's endorsement or status because the funds would not be put to the relevant purpose, and/or would be used illegally. This is regardless of whether it has breached any 'in Australia' condition. Uncovering such illegal activity would likely require a similar level of audit or disclosure to the uncovering of foreign activities, donations or transactions.

*(2) Possible 'transfer' of funds to foreign Treasuries*

In respect of the second rationale, it is accepted that the government may wish to prevent a "treasury to treasury" transfer of revenue, by granting a tax exemption or gift deduction in respect of an Australian charity, or fund, where the revenue would be taxable in the foreign jurisdiction. However, again, the Committee would question whether this concern really justifies the proposed legislative solution.

First, the Committee would submit that in the vast majority of cases, the relevant entity or fund would be tax-exempt in the foreign jurisdiction, and so the concern does not arise. It was accepted, for example, in *Word Investments*, that this issue was not of relevance to the case.

Second, it may be possible to deal with this issue by requiring a charity or fund to produce proof, for example a letter from a foreign revenue agency, that it is tax-exempt in the foreign jurisdiction, before it would be able to operate or receive monies in respect of that jurisdiction. The government would be justified in denying the deduction, or tax-exemption, until such proof was provided. This could be checked with increasingly strong country-to-country exchange of information requirements.

### c. Detailed comments

On the assumption that the government proposes that it will proceed with the current policy, the Committee provides the following specific comments.

*(1) New sec 50-50: tax-exempt entities*

*'Principally in Australia'*

The approach of removing the "incurs expenditure" element of the "in Australia" condition is supported. This element does not provide any real indication of the purposes or activities of the entity. In addition, the retention of the phrase "principally in Australia" is supported, as this is already established in the law, and provides a reasonable threshold of activity, being not less than 50% in all the

circumstances of the case. This is briefly explained in the EM para [1.49], following the approach in the earlier Explanatory Memorandum which explained that:[5]

> "An institution … generally only has to pursue its objects '***principally***' in Australia. This term is also not defined in the legislation. The dictionary meaning of the word 'principally' is mainly or chiefly. Accordingly, it is not possible to specify a particular percentage but less than 50% would not be considered to meet the 'principally' requirement. Where there is some doubt whether this requirement is satisfied it will be necessary to examine each institution's individual circumstances."

The reformed provision changes the language and focus of the provision, without there necessarily being any real warrant to do this. The Committee notes, for example, that it is usual to refer to the purposes of a not-for-profit organisation as its "objects", however, the adoption of the word "purposes" and the phrase "pursuing its purposes" seems reasonably clear. The Committee notes a typographical error in the EM, para [1.48] in this regard.

*"Operating in Australia"*

A more novel aspect of the proposed new s 50-50(2) is the reference to "operating in Australia", replacing the "physical presence" and "to the extent" elements of the current test.

First, the Committee notes that it is more usual in the existing law to refer to "carrying on" activities and the Comittee notes that this phrase is widely used in current tax-exempt provisions, as well as in other contexts (such as "carrying on business"). The new term "operating" will inevitably lead to some uncertainties in interpretation.

Second, the EM suggests that "to be operating in Australia, an entity will be expected to be an Australian resident or have a sufficient connection and presence in Australia" (EM, para [1.52]). It refers to the concept of residence in Australia, as requiring (as noted at para [1.53], "central management and control". It then compares the rule with the establishment of a "permanent establishment".
The Committee submits that these various attempts to explain the concept of "operating in Australia" are confusing. The various factors and circumstances set out in para [1.48] of the EM are useful. However, the Committee notes that in para [1.52], reference is specifically made to an expectation that an organisation will be a "resident". The Committee queries whether an organisation being an Australian resident may be, in fact, enough to establish that it is "operating in Australia", given the interpretation of "central management and control". The discussion in para [1.48] suggests that this is not the case.

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[5] Explanatory Memorandum, Taxation Laws Amendment Bill (No 7) 1997 (Cth) at [3.14].

Third, as a general matter, the Committee suggests that most NFPs (and many of their advisors) may not be familiar with the concept of "permanent establishment" which is, of course, an international tax law concept that is relevant primarily to businesses operating across borders. The Committee notes that it is inherent in the notion of "permanent establishment" that the entity is, in fact, *not* an Australian resident – but nonetheless carries on business in an Australia above a certain threshold. The Committee suggests that moving in the same paragraph from "residence" to "permanent establishment", is confusing. The concept of a "sufficient connection and presence", the Committee suggests, begs the question as to what the government considers "sufficient".

Third, is it intended that NFPs could operate through an "agent" and be "operating" in Australia? It would be the case, in some circumstances, for a business that operates through an agent to have a permanent establishment, but the approach will differ depending on whether the agent is dependent or independent, and the matters can become quite complex and disputed. The Committee would query whether the Treasury wishes to bring these aspects of international tax law interpretation into the sphere of ascertaining whether a NFP is "operating in Australia". If this analogy is to be used, it should be explained further and relevant additional references provided.

The Examples in the EM go some way to clarifying the intended meaning of "operating in Australia". In this regard, we find the title of Example 1.4 unclear and query whether it should read "Global organisation funding Australian branches".

*(2) DGRs: Division 30*

The primary change is in relation to Item 1 of the table in subsection 30-15(2). The current "in Australia" requirement is in paragraph (a) of the special conditions.

Broadly, Item 1 speaks of a "fund, authority or institution" and paragraph (a) imposes on the "fund, authority or institution" an obligation to "be in Australia".

This is to be replaced by 4 requirements (proposed section 30-18) all of which must be satisfied:

a. <u>The fund, authority or institution</u> is established in Australia (subject to no exception).

b. <u>The fund, authority or institution</u> operates solely in Australia (subject to an incidental exception).

c. <u>The fund, authority or institution</u> pursues its purposes solely in Australia (subject to an incidental exception).

d. <u>The fund, authority or institution</u> does not "donate" (an undefined term) money or property to an entity that is not a deductible gift recipient (subject to no exception).

*“An entity covered by s 30-80”, in proposed new s 30-18*

The ED seeks to exclude from requirements 2, 3 and 4 those “entities” that are covered by section 30-80 – see proposed subsection 30-18(4).

Paragraph 1.98 of the EM says that this exclusion applies to entities *that are themselves deductible gift recipients and those that are deductible gift recipients because they operate a public fund*.

In the Committee’s view, the use of the expression “entity covered by section 30-80” in the ED would appear to narrow the exclusion. A fund may not be an “entity”, even as that term is defined in s 960-100 of ITAA 1997, as this term is commonly used by DGRs to refer to a separate account of monies or sub-fund, under the authority of an overarching fund or institution. In many cases, the entity is not covered by s 30-80, but one of its funds would be so covered. On a simple reading of the proposed change, the entity will not satisfy the new requirements notwithstanding what is said in the ED.

If the amendments were to be consistent with the language of section 30-15 and 30-80, then proposed subsection 30-18(4) should read as follows:

> *An entity covered by section 30-80 <u>or an entity with a fund covered by that section</u> satisfies the conditions in this section if it satisfies the conditions in paragraph (a) of subsection (1).*

The Commitee submits that this minor change will achieve the certainty that is necessary.

As a general matter, is it intended that the term “entity” used throughout the ED (in respect of both Div 30 and Div 50 changes), is the defined term in s 960-100? We consider that this is not clear at present.

*(3) “Donate”*

In respect of tax-exempts, there is a condition that the entity must “not donate” money to any other entity, unless that other entity is an exempt entity as defined, that is, satisfies the same conditions. In respect of DGRs, requirement (d) of proposed s 30-18 set out above imposes an obligation on the “fund, authority or institution” not to “donate any money or property” to any entity that is not a DGR. This donation restriction is described in the EM as applying to “conduit not-for-profit entities” (para [1.60]).

First, the Committee asks why would it not be acceptable to have a tax-exempt donate money to a DGR, as the conditions for the latter are in fact stricter than the conditions for exempt entities? Is the assumption made, here, that not all DGRs are tax-exempt under Div 30? (The Committee suggests that this may be the case in some circumstances).

Second, it is not entirely clear what is meant by "donate", which is an undefined term. The ordinary meaning should apply; the Committee notes that the dictionary meaning of "donate" includes "give", "provide" etc. On this basis, it is submitted that the "donate" condition is too broad, when understood in the context of the purposes and activities of both tax-exempts and DGRs. The discussion in the EM[6] speaks to a situation that is just an example of what would be covered by proposed subsection 30-18(3).

A simple example of the difficulty with this condition for a DGR is The Smith Family. It gives books to children in need. It certainly appears to "donate" its property to people who are not DGRs. A similar analysis could be made in respect of many tax-exempts which, as part of their operations, provide in kind assistance to poor or disadvantaged people across a whole range of contexts and activities.

In this regard, it is noted that the "donate" condition refers to "money" for tax-exempt entities (proposed new s 50-50(2)(c), but to both "money and property" for DGRs (proposed new s 30-18(3)). No explanation is provided for this difference in the EM, but it may perhaps be explained by the expectation that tax-exempts may provide property or "in kind" donations or support to their beneficiaries in the ordinary course of their activities. However, this is not addressed at all in the EM.

Further, the condition not to "donate money" for both tax-exempts and DGRs, may prevent organisations from providing small amounts of cash to people in need (would the payment, for example, of utility bills of those people be a "donation"?). If this is the policy, again, there is no explanation of it in the ED or EM. The Committee suggests that there would be circumstances when a tax-exempt entity under Div 50, or a DGR under Div 30, would be giving money to those in necessitous circumstances from time to time.

It is proposed that if the Government wishes to ensure that the property of either a tax-exempt entity or a DGR is used in an appropriate way, in accordance with the purposes of the organisation, the relevant provisions should be subject to an exclusion in terms such as the following:

> *[s 50-50(2)] (d) The entity does not breach the condition in (c) if it provides money or property to individuals consistent with its purposes.*
>
> *[s 30-18] The fund, authority or institution does not breach subsection (3) if it provides money or property to individuals consistent with its purposes.*

### 3. "Not for profit" definition

The Committee notes that although the focus of the ED is the "in Australia" special condition, the proposed reform is not limited to amending this requirement. In addition, it makes a significant amendment to income tax law by inserting a proposed new definition of "not for profit entity".

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The ED states that this definition is based on the one that appeared in the Charities Bill 2003 (paragraph 1.76), which the Committee notes was a failed reform by the previous government. This is no justification for a poorly drafted and ill considered definition that is central to the entities to be covered by Division 30 and the exemption in Division 50.

### (a) Proposed standardised definition of ‘not-for-profit’

The ED proposes the following standardised definition of ‘not-for-profit entity’ in s 955-1 of the ITAA 1997:

> 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.[7]

The EM explains that this proposed definition is based on that in the exposure draft of the Charities Bill 2003 (Cth),[8] with the only change that reference is made to ‘entities’ rather than ‘persons’.

However, it is submitted that this definition makes very significant changes that would render it unworkable and run counter to other aspects of government policy. It is not clear what is intended to be achieved by these significant changes in wording. The proposed new definition:

- Extends the scope of both the purpose and non-distribution requirements beyond members to include other (undefined) ‘particular entities’, including owners;
- Removes the critical word ‘individual’ before that of ‘members’ in the requirement of purpose;
- Alters the purpose requirement by introducing a focus on carrying on ‘activities’; and
- Removes the requirement that the organisation must have a non-distribution requirement in its constituent documents.

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[7] *Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No. 1) Exposure Draft 2011* Sch 1 it 7.

[8] See [1.76] of the Explanatory Memorandum to the Exposure Draft. Some submissions to the Board of Taxation Inquiry on that exposure draft did point out that the proposed definition extended beyond the common law, but these were overshadowed by other concerns: The Board of Taxation, *Consultation on the Definition of a Charity* (December 2003) <http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/definition_of_a_charity/default.htm &pageid=007>, [4.7]-[4.8].

*(1) Codifying the common law for charities*

The current statute does not contain a requirement, at all, for a charitable institution or fund established for public charitable purposes, or other trust or fund for "charity, education, science and religion", under s 50-5, to be "not for profit". Rather, this requirement arises in the common law, as an element of the requirement for "public benefit" – that is, not for *private or individual benefit or gain*.

The insertion of the proposed definition into s 50-50 adds an extra requirement for an entity to qualify as a tax-exempt charity. The point of the statutory addition, presumably, is to codify the existing common law requirement. It is useful to consider the exact intention of that requirement at common law, as it goes to the fundamental purpose of the tax exemption, which relates to organisations of public benefit.

A discussion of the common law requirement of 'not-for-profit' is in *Incorporated Council of Law Reporting of State of Queensland v. FCT* 71 ATC 4206; (1971) 125 CLR 659. The High Court there found that law reporting, not for private benefit, satisfied the definition of charity. Barwick CJ said at p. 4211-2, after concluding that the publication of law reports was a charitable purpose:

> "All that remains is to add the ***lack of private gain by the members of the Council***. That the Council itself should profit by the production of the law reports cannot prevent the Council being a charitable institution. Indeed, the very fact that the Act exempts the income of a charitable institution concedes that such an institution may derive profits from its activities.
>
> Here there are two significant matters. First, the Memorandum of Association forbids any distribution of the profits of the Council to or amongst its members. No doubt the presence of such a provision was material to the incorporation of the Council as a company limited by guarantee. Second, the actual distributions of the Council's profits have been confined to grants to the libraries of the Supreme Court of Queensland. Those libraries are themselves important adjuncts to the administration of the law. They facilitate the very purpose the production of the law reports is designed to achieve. They do so nonetheless because their holdings are not available to every member of the public but only to those with or seeking training in the law. Indeed they are available to all those groups of the community who in general can profit by their use. The application of the profits of the Council to the support of the Supreme Court Libraries is itself, in my opinion, an application to charity.

McTiernan J and Windeyer J agreed, the latter stating:

> The main object which the Council exists to carry into effect is the publication of law reports. Any profits it makes by so doing must be devoted

> to aiding the law libraries of the Supreme Court of Queensland. *They cannot be diverted into the pockets of individuals.*

It is also instructive to examine the memorandum and articles of the Council, which stated:

> 4. The income and property of the Association, whencesoever derived, shall be applied solely towards the promotion of the objects of the Association as set forth in this Memorandum of Association, and ***no portion thereof shall be paid or transferred directly or indirectly by way of dividend, bonus or otherwise howsoever by way of profit to the persons who at any time are or have been Members of the Association or to any of them or to any person claiming through them: Provided that nothing herein shall prevent the payment in good faith of remuneration to any Editors, Reporters, Secretaries, officers or servants of the Association, or to any member of the Association or other person, in return for any services actually rendered to the Association.***
>
> 8. If after the dissolution of the Association there remains after the satisfaction of all its debts and liabilities ***any property whatever the same shall not be paid to or distributed among the members of the Association, but shall be given or transferred to the Committee of the Library of the Supreme Court of the State of Queensland*** at Brisbane to be distributed amongst the Committees of the Libraries of the Supreme Courts of the said State in such proportions as the Committee of the said firstmentioned Library shall determine or if at that time such lastmentioned Committee shall not be in existence to such Public Legal Library or Libraries in the State of Queensland and in such proportions as a Justice of the Supreme Court of the said State having jurisdiction in the matter may determine for the purpose of purchasing legal or other works for the said Library or Libraries."

In conclusion, the case law indicates that the legal meaning, and indeed fundamental purpose, of the 'non-profit' restriction has always been to ensure that a company (or other entity) is not allowed, by its own constitution, to conduct activities or distribute any amounts for private profit or gain of its "individual members", in contrast to conducting activities that may profit the organisation, or be of public benefit, as a whole through fulfilment of purposes of the organisation.

*(2) Existing 'non-profit' statutory definitions*

In other contexts, the proposed change, for hospitals that are deductible gift recipients, replaces the requirement in s 30-20(1), item 1.1.2, that if carried on by a society or association, a hospital must be carried on "***otherwise than for the purposes of profit or gain to the individual members*** of the society or association". Similar requirements apply for other Funds, authorities or institutions

listed in Div 30, and for entities that are made tax-exempt in Div 50 (eg, s 50-30 (hospitals), s 50-40 (resources and tourism).

More generally, the proposed definition replaces a range of other, more focused, definitions, such as that of a "non-profit company" in the current definition in the Income Tax Rates Act 1986 (Cth), s 3:

> non-profit company means:
> (a) a company that is not carried on ***for the purposes of profit or gain to its individual members*** and is, ***by the terms of the company's constituent document, prohibited from making any distribution, whether in money, property or otherwise, to its members***; …

*(3) 'Particular entities'; contrast 'Individual profit or gain'*

The proposed reform uses the phrase 'particular entities', however, it is submitted that this phrase does not convey the essential meaning of private or individual profit or gain that is illustrated in the *Law Reports* case, discussed above.

The proposed definition omits the key word 'individual', apparently replacing it with 'particular'. However, reading this as the phrase 'particular entities', this has the potential to have a much broader meaning. It is not clear why the concept of "individual members" has been dropped from the definition itself, but remains in the Explanatory Memorandum (para [1.74]). The use of this phrase in the EM, as illustrated in the *Council of Law Reporting* case above, indicates that it is useful because it makes clear that it is the separate and distinct, private benefit of members of the entity that is of concern, rather than carrying on operations for profit or gain in a general sense (which is allowed at law, and would also be allowed under the Government's proposed policy for business activity of not-for-profits).

The expression "particular entities" has no clear or established legal meaning. How does anyone determine who or what is a "particular entity" as distinct from "any entity"? For example, is a recipient of philanthropy, such as a child receiving a book from The Smith Family, a "particular entity" to whom an asset has been distributed?

The concept of gain for 'individual members' was also recently considered by the Full Federal Court in the case of *Commissioner of Taxation v Co-operative Bulk Handling Limited* [2010] FCAFC 155, which helpfully collected the relevant case law on this phrase. The Court concluded that an entity could be 'not carried on for the purpose of profit or gain to individual members' even where the members derived a benefit or gain, as long as that gain was not produced *by reason of individual membership*. Although the members in that case received benefits from

the existence of that organisation, those benefits were similarly open to others in the community.[9]

It is not clear whether it is the intention of the government to overrule the result in *Cooperative Bulk Holding*, or to avoid its application by avoiding the term “individual”; if this is the case, it is submitted that this should be fully explained in the EM, to prevent uncertainty.

*Distributions to exempt entities that are owners or members*

As currently drafted, the “not-for-profit” requirement prevents any tax-exempt or organization or DGR from distributing profits, which it may legitimately make, to an owner which is itself tax-exempt (or a DGR). This is contrary to the law as established by *Word Investments* and other cases. It also appears to overlap with the special condition regarding “donations” by tax-exempts or DGRs, which appears to be intended to overcome the outcome of *Word Investments*.

*Employee remuneration*

The proposed legislation does not include any provisions for reasonable remuneration of employees. It may be contrasted with the specific statement in the memo and articles of the *Council of Law Reporting*, quoted above, that the requirement does not prevent payment in good faith of remuneration for services to carry out the purposes of the organisation.

*Proposed revision*

It is submitted that, for clarity, the definition of “not-for-profit entity” should refer specifically to “individual” or “private” gain:

> ***not-for-profit entity*** *means an entity that:*
>
> *(a) does not carry on its activities for the purposes of [individual/private] profit or gain for its owners or members, either while it is operating or upon winding up; and*
>
> *(b) does not distribute its profits or assets to its owners or members for their [individual/private] benefit or gain, either while it is operating or upon winding up.*

It is noted that, as a general principle, if a tax-exempt entity or DGR were operated for the private benefit of related parties of the owners or members or third (commercial) parties, then it would not be an entity that is ever likely to meet those objects and purposes that are the other precondition for exemption or DGR status.

[9] *Commissioner of Taxation v Co-operative Bulk Handling Limited* [2010] FCAFC 155, [94].

Furthermore, in view of the intention to replace all references to non-profit bodies or entities in a range of tax legislation, including the GST and FBT, it is submitted that more consultation and explanation is required of these significant changes.

Please contact the Committee Chairman, Teresa Dyson on Teresa.dyson@blakedawson.com or 07 3259 7369 if you would like any further information, or to provide further assistance in this review.

Yours sincerely,

Bill Grant
**Secretary-General**