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Dear Sir/Madam

Submission on the exposure draft legislation:

Tax Laws Amendment (2012 Measures No.4) Bill 2012: tax exempt body "in Australia" requirements

"Restating and standardising the special conditions for tax concession entities" 17 April 2012

Thank you for the opportunity to provide the Not for Profit (NFP) industry's views on the reforms proposed in the exposure draft legislation Tax Laws Amendment (2012 Measures No.4) Bill 2012: tax exempt body "in Australia" requirements ("the ED legislation") and the accompanying explanatory memorandum ("the EDEM") released on 17 April 2012.

1 About Moore Stephens

We are writing on behalf of the Moore Stephens Australia network of eight independent firms of accountants and advisors. Moore Stephens have a real understanding of the environment in which our clients operate. We currently service a diverse range of entities within the NFP sector and specialise in providing assurance, accounting, tax and advisory services to our NFP clients. We provide a national service offering to a number of key clients operating in the NFP sector, including the following:

- Religious organisations
- Large charities
- Football clubs and sporting associations; and
- Universities and many TAFE colleges in Australia.

We have had a long standing commitment and involvement for the past 50 years in this sector. We have been active in recent years in providing submissions to the Government's various committees and consultations to support the sector through this reform phase.

2 General comments

We have had the opportunity to review the submission made by Moores Legal in relation to this issue and agree that the ED legislation should be withdrawn for the reasons outlined in their submission.

We also highlight that getting this wrong can lead to significant competitive disadvantages for Australian not for profits. Therefore, it is important that this legislation is drafted correctly the first time and that there are no mistakes or unintended consequences.

However, in the event that the ED legislation is not withdrawn we make the following comments to ensure that the adverse impact to the NFP sector is minimised.

We refer to our previous submission dated 12 August 2011 responding to the Consultation Paper – "'In Australia' special conditions for tax concession entities" and are pleased that the Government has taken into consideration some of our comments and have largely addressed 2 of the 3 main concerns that we raised in this submission. However, we believe that some fine tuning is still required to be made to the ED legislation to ensure that onerous administration is removed from the process.

3 Main concerns

Our main concerns are:

3.1. Restriction on distributions to NFP entities that do not have similar purposes.

The ED legislation now allows NFPs to transfer profits or assets to another NFP entity with a "similar purpose" even if the other NFP entity is an owner or member. We commend the Government for clarifying this issue.

However, we do not see why there is any need to restrict the transfer of profits to assets to another NFP entity with a "similar purpose". A NFP should be able to transfer profits or assets to any NFP. This "similar purpose" restriction will create added complexity when trying to determine whether NFPs have a "similar purpose".

In particular subsidiaries of NFPs are generally set up for specific purposes and therefore never have identical purposes to their parents. The current legislation is not clear on what is considered to be a "similar purpose". As a minimum, we request an example in the EM to show that a subsidiary of a NFP would by definition be considered to have similar objectives.

We have included an example at Appendix A that highlights typical objectives of a University and a University subsidiary. Whilst we would hope that these objectives would be considered to be similar purpose this is not clear. We request greater guidance either in the legislation or the explanatory memorandum.

3.2. Clarification of phrases 'genuine compensation' and 'reasonable expenses' and burden of proof

We note that paragraph (b), of the proposed definition of a 'not-for-profit entity', refers to 'genuine compensation for services provided to, or reasonable expenses incurred on behalf of, the entity' (sub-paragraph (ii)) as a type of distribution that would be excluded from the general prohibition on distributions of profits or assets to owners and members. We request clarification firstly for the phrases 'genuine compensation' and 'reasonable expenses' and secondly the extent to which a 'not-for-profit entity' would be required to substantiate such a requirement.

3.3. Sole purpose test for use of assets by tax exempt entities – needs to be more flexible

The proposed section 50-1 still imposes a strict requirement for the tax exempt entity to:

"use its income and assets solely to pursue the purposes for which it was established"

We believe that the ED legislation should provide some leeway for:

a) minor or insignificant breaches; and

b) entities that have shifted their purposes over time. For example we have concern about the terminology "for which it was established", as tax exempt entities may have been established for a specific tax exempt purpose but over time their purposes have changed / expanded to include other tax exempt purposes. This is common in religious organisations

some of which are hundreds of years old and going back and determine the purposes for which it was established would be quite difficult. The types of changes that could occur arise are where an entity was originally established for education purposes and it then expands into providing aged care or health services.

3.4. Clarification of increased tracing burden requirements

The proposed Section 50-(4) imposes a significant tracing burden on tax exempt entities, it states:

> *"If an entity gives money or property to another entity that is not an *exempt entity, the use of the money by the recipient (or any other entity) must be taken into account when determining whether the first mentioned entity satisfies the requirements in paragraph (2)(a) and (b)."*

This will require the exempt entity to take into account the use of the money by the recipient when the tax exempt entity determines whether they operate principally in Australia. This will place a greater burden on tax exempt entities to trace the use of funds that they provide to non-tax exempt entities, than is currently the case.

We require further guidance on the extent of investigation/tracing required. For example:

- What is meant by "the use of the money"?
- Where payments are made to unrelated parties it is extremely difficult to obtain relevant current financial data. Is a review of the prior year's financials sufficient? What happens if the unrelated entity that you make a payment to embarks on a major overseas expansion after you have made the payment?

We have provided two examples that highlight the type of tracing difficulties that NFPs will have to consider at Appendix B.

3.5. Allow an option for 5 year averaging for tracing test

A NFP entity is required to determine if the 'principally in Australia' rule is satisfied on an annual basis. While we agree with this annual requirement, we believe it does not take into consideration one-off events beyond the control of an NFP entity, such as natural disasters. There may also be circumstances where expenditure is made in a particular year but relates to a longer time frame. To take such one-off events into consideration without threatening the continued entitlement to tax exempt status for an NFP entity, we recommend the insertion of an option to allow for averaging over five (5) years to determine the 'principally in Australia' requirement.

3.6. Strict 'In Australia' test for DGRs

Subsections 30-18(1)(b) & (c) will require most DGRs to operate and pursue their purposes "solely" in Australia (subject to a few exceptions including the carve out contained in section 30-18(2) for activities that are "merely incidental" or "minor in extent and importance").

In addition section 30-18(3) states *"if a DGR gives money or property to another entity that is not a DGR, take into account the use of the money or property by that other entity (or any other entity) into account when determining whether the deductible gift recipient satisfies the requirements in paragraphs (1)(b) and (c)."*

In other words it will have to look through any entity that it provides money to determine the final use of the money under the sole purpose test. This will place a greater burden on tax exempt entities to trace the use of funds that they provide to non-tax exempt entities, than is currently the case.

Our main concerns are the extra burden required to determine what is considered to be:

- merely incidental to its activities in Australia; or
- minor in extent and importance when considered with reference to its activities in Australia.

We have provided examples at Appendix C that highlight some of the difficulties that can arise when determining what is considered to be merely incidental or minor.

Certainty is an important factor for NFPs. We would recommend greater clarity in these definitions to address the questions raised in our Appendix C.

3.7. Strict 'In Australia' test for DGRs – EDEM clarification of Example 1.18

We would like Example 1.18 in the Explanatory Memorandum clarified.

Example 1.18 states:

> *"Deductible gift recipient funds could be used to purchase the instrument, as the instrument will be used mainly in Australia, and its use overseas is incidental to this.*
>
> *However, deductible gift recipient funds will not be able to be used to cover the flights of the orchestra members, and other tour costs incurred while the orchestra is touring overseas.*

This could be read such that:

- a DGR can quarantine donated funds to Australian activities (i.e. the purchase of the instrument) and not lose its DGR status even if it funds overseas activities that are not considered incidental (i.e. overseas tour costs) out of general operating revenue (i.e. funds that are not donated).
- Alternatively, is this example trying to indicate that the DGR status would be lost if the DGR undertakes and any overseas tours.

3.8. Strict 'In Australia' test for DGRs – EDEM clarification of interaction between income tax exempt and DGR tests.

We would like paragraph 1.118 and Example 1.119 in the Explanatory Memorandum clarified.

Paragraph 1.118 states:

> *"**these conditions** only apply to the **portion of the entity or public fund** that is endorsed as a deductible gift recipient."*

What do "these conditions" refer to? Do they refer to the requirements in paragraph 1.115 or the solely 'in Australia' conditions included in section 30-18(1)?

Example 1.19 states:

> *"Only the funds relating to the public fund are required to meet the deductible gift recipient 'in Australia special conditions, not the entire entity. The charitable entity is required to operate principally 'in Australia' in order to be income tax exempt. This **consideration** does not include funds related to the deductible recipient portion of the organisation"*

Based on paragraph 1.118 and Example 1.19, where the whole of the entity is endorsed as a DGR, is the DGR able to account for the donations in a separate account and apply the DGR 'In Australia' special conditions in section 30-18(1) to this account only?

3.9. Overseas Aid funds

Currently a number of overseas aid funds are endorsed as whole of entity DGRs and also operate a Gift Fund that has DGR status. However, going forward they would lose their DGR status due to the "In Australia" changes under the current drafting. We agree with Moores Legal's view that the proposed Section 30-18(4) should be amended to state:

> *"A fund, authority or institution that operates a fund referred to in the table of s30-80 satisfies the conditions in this section if it satisfies the conditions in paragraph (1)(a)."*

4 Possible remedies for strict "in Australia" conditions for DGRS

We have highlighted some of the problems with the strict in Australia special conditions for DGRs.

Possible remedies are:

i. Insert a new provision that excludes from the operation of the special conditions all international activities that have a purpose of bringing funds into Australia (either directly or indirectly) or otherwise generating a benefit for Australia (directly or indirectly).
ii. Alternatively, adjust the current ED provisions to ensure that an entity may retain DGR status where it is able to establish that no DGR funds are expended in undertaking activities outside of Australia (excluding minor or incidental expenditure).

5 Conclusion

In formulating our response to the ED legislation we have actively sought feedback from a range of organisations within the sector. Our submission incorporates a number of the issues and concerns which have been identified in these discussions.

We request that the Government does not rush through this legislation without ensuring that the unintended consequences are thoroughly considered and mitigated.

If you have any queries please contact me or any of the contributors to this submission:

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Yours faithfully

Joe Shannon
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MOORE STEPHENS AUSTRALIA

Encl

Appendix A

Restriction on distributions to NFP entities that do not have similar purposes

Example A - DGR "operates solely in Australia" test

Facts A:

A University's objectives are:

(a) to provide education at university standard; and
(b) to provide facilities for study and research generally; and
(c) to encourage study and research generally; and
(d) to provide courses of study or instruction (at the levels of achievement the council considers appropriate) to meet the needs of the community; and
(e) to confer higher education awards; and
(f) to disseminate knowledge and promote scholarship; and
(g) to provide facilities and resources for the wellbeing of the university's staff, students and other persons undertaking courses at the university; and
(h) to exploit commercially, for the university's benefit, a facility or resource of the university, including, for example, study, research or knowledge, or the practical application of study, research or knowledge, belonging to the university, whether alone or with someone else; and
(i) to perform other functions given to the university under this or another Act.

A University subsidiary's objectives are:

(a) to act as the commercial investment arm for the University; and
(b) to exploit the intellectual property of the University; and
(c) to support the University in the execution of its functions, including through the provision of financial support and accommodation; and
(d) any other object or purpose not inconsistent with the objects specified in this Constitution, which is consistent with the provisions of the University Act and which the Directors in consultation with the Council consider appropriate.

Question A:

Would the University's objectives and University subsidiary's objectives be considered to be similar purpose?

Appendix B

Example B.1 - Use of money

Facts B.1:

Tax Exempt Entity A ("Entity A") has a $20m operation in Australia. It provides $1m seed capital for a 50% interest in a start up IT business in India ("India Co.") that supports public health initiatives which align with the objectives of Entity A.

India Co. is extremely successful and 5 years later it is a $50m self funding operation. Entity A's Australian operations have not expanded.

Question B.1:

What amount would you need to take into account when determining whether Entity A satisfies the operating and pursuing purposes in Australia requirement in:

- Year 1- the $1m?
- Year 5 – nil (as no expenditure incurred by A), $1m (the initial investment), $25m (50% of the turnover in India Co.) or 50% of the market value of India Co.?

Example B.2 Increased tracing burden for tax exempts

Facts B.2:

In 2011 Entity X paid $1m to Entity Y.
Entity Y carried on its operations entirely in Australia in 2011.
In 2012 Entity X again paid $1m to Entity Y.
In 2012 as Y had shown specialist skills they also received a $5m donation from overseas to expand their charitable activities into Indonesia. As a result of the $5m donation Entity Y no longer would be considered to be NFP in Australia for the 2012 year. This change occurred after Entity X made their payment and was outside the control of Entity X.

Question B.2:

Does this mean that Entity X no longer satisfies the "In Australia" requirements for a NFP for the 2012 year?

Appendix C

Example C - DGR “operates solely in Australia” test

Facts C.1:

- City University is an income tax exempt entity and has deductible gift recipient status.
- Apart from its Australian activities, City University has entered into numerous joint ventures in overseas countries to provide degree courses in these overseas countries.
- City University is required to provide course materials and course assessors.
- City University’s course assessors are required to fly overseas to attend examinations and to review the exam papers.
- Their joint venture partners are responsible for providing academic teaching staff, facilities and administration support.
- The revenue returned to the University from the overseas joint ventures is less than 5% of the University’s total revenue.

Question C.1:

- Would providing degree courses , course materials and assessors be considered to be:
    - Merely incidental to its activities in Australia? or
    - Minor in extent and importance when considered with reference to its activities in Australia?
- Would they still be considered to be minor if the revenue was less than 10% or 15% of the University’s total revenue?
- As the activities are Education course related would they be considered incidental no matter what quantum of revenue is derived by the University?
- What about if the revenue is not repatriated to Australia but retained in a non-resident company?

Example C - DGR "operates solely in Australia" test

Facts C.2:

- Country University is an income tax exempt entity and has deductible gift recipient status.
- Country University has a wholly owned Australian subsidiary (Company A) which holds a 49% interest in Company B.
- Country University paid $200m as initial capital to Company A. Company A in turn invested $200m as initial capital for its 49% interest in Company B.
- Company As directors are all Australian residents and Company B has 4 directors one being an Australian resident and one a non-Australian resident who was nominated by the University.
- Company B operates a University overseas. It has operated for 3 years but has never made a profit and has never returned any dividends to Country University.
- City University is required to provide course materials and course assessors to company B.
- City University's course assessors are required to fly overseas to attend examinations and to review the exam papers.
- The $200m investment is 20% of the Universities annual revenue.
- The Company B also has $200m revenue which is 20% of the revenue of Country University.

Question C.2:

- Will Company A be able to obtain tax exempt status under the ED legislation?
  As Company A has no income only investment overseas. Can it be argued that it "pursues its purposes principally in Australia"?
- Will company A be able to obtain DGR status as it does not have any Australian activities?
- Will Country University be able to retain its DGR status in the year of the investment? Do you have to look at the size of the initial investment or any expenditure?
- In future years Company B does not require any additional cash injections. Are we correct to assume that Country University would retain its DGR status in future years?