National Roundtable of
Nonprofit
Organisations

RESTATING AND STANDARDISING THE SPECIAL CONDITIONS FOR TAX CONCESSION ENTITIES (INCLUDING THE 'IN AUSTRALIA' CONDITIONS)

SUBMISSION IN RESPONSE TO THE REVISED EXPOSURE DRAFT OF LEGISLATION

1. INTRODUCTION

The National Roundtable of Nonprofit Organisations Ltd ("NRNO") is an independent, non-partisan organisation with a diverse membership of peak bodies and national not-for-profit ("NFP") organisations. Based on the active engagement of member agencies representing more than 20,000 NFP organisations across Australia, the NRNO facilitates consideration of regulatory, taxation and sustainable financing issues and coordinates member engagement with the Australian community and public policy processes.

Together with many other NFP organisations, the NRNO has contributed actively to government Inquiries and Reviews. This submission reflects consultation with organisations represented by NRNO members.

This submission has been drafted on the basis of the concerns and experience of the member organisations of the NRNO.

The NRNO welcomes opportunity to comment on the exposure draft legislation.

2. MATTERS ADDRESSED

Firstly, we welcome a number of revisions that have been made to the first exposure draft legislation which was released for consultation in July of last year.

For example:

- the requirement for income tax exempt entities to "comply with all the requirements in its governing rules", being replaced with an obligation to "comply with all the *substantive* requirements in its governing rules.

- The inclusion of a provision similar to that of current section 50-75 of the *Income Tax Assessment Act 1997* (Cth) ("ITAA 97") allowing for government grants and gifts to be disregarded in the application of the "in Australia" test. Although we do make some comments regarding the wording below.

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- Replacement of the absolute prohibition against a DGR donating to a non-DGR (and the same for income tax exempt entities), with a tracing test. Although again, we make some comments regarding the extent of the tracing obligation.

Nevertheless, there are a number of issues on which we wish to comment and request that further consideration be given.

3. POLICY

The Explanatory Material ("EM") and Media Release regarding the revised exposure draft legislation state that the legislation is needed for a number of reasons:

1. to discourage tax avoidance arrangements which use charitable trusts and certain other not-for-profit organisations to shift untaxed funds overseas.

2. to support anti-avoidance measures in the tax law which limit income tax exempt entities expending money offshore.

3. to satisfy Australia's international obligations as a member of the intergovernmental Financial Action Task Force, where Australia was found to be only partially compliant with the recommendation to members that they "combat the misuse of NPOs (nonprofit organisations) for the purpose of terrorism financing."

4. to minimise the risk of income tax exempt entities being used for terrorist financing and money laundering.

5. to ensure the proper operation of not-for-profit entities and their use of public donations and funds.

6. to combat the decision in *Federal Commissioner of Taxation of the Commonwealth of Australia v Word Investments Limited* (2008) 236 CLR 204 ("*Word Investments"*) which was inconsistent with the Commissioner of Taxation's interpretation and the clear policy intent.

7. to ensure that tax concessional money stays within the exempt entity framework and gets used principally in Australia for the broad benefit of Australia, and not being passed on through entities and then spent overseas outside of the authorised categories.

We do not believe that these policy statements are justified.

3.1 Broad Benefit of Australia

We are disappointed by the rhetoric that Australian tax concessions should be for the broad benefit of Australians. We are not convinced that this sentiment would be shared by the majority of Australians.

In our view it represents a narrow view of Australia's international engagement and is not appropriate in an increasingly interconnected global world. NFPs commonly establish partnerships with NFPs located overseas and the mutual encouragement, sharing of knowledge, expertise and innovation is for the benefit of the Sector and the broader community.

In a globalised world, it is inappropriate and impractical to draw sharp jurisdictional boundaries.

3.2 Word Investments

The decision in *Word Investments* involved an income tax exempt charity, Word Investments Limited ("WIL"), running a funeral business. WIL then distributed surplus funds to Wycliffe Bible Translators. Wycliffe is an institution prescribed in the income tax regulations.

If this exposure draft legislation had been the law at the time, this arrangement would not have affected the income tax exempt status of either WIL or Wycliffe. WIL would not have been subject to the tracing obligations of proposed section 50-50(4) because both organisations were income tax exempt.

3.3 Recommendations of the Financial Action Task Force

The intergovernmental Financial Action Task Force of which Australia is a member, requires members to take steps to prevent the incidence of non-profit organisations being used as vehicles for terrorist financing or money laundering.

We understand that the report which recommended that "Australia should give further consideration to implementing specific measures from the Best Practices Paper to SR VIII…" was published in November 2006. It made reference to some of the government enquiries that had taken place to date regarding the NFP sector and various proposals that had been made but had not yet been implemented.

Two such proposals were the introduction of a new statutory definition of "charity" and a national charities commission. Since this paper was produced, the Australian Government has committed to proceed with both.

The paper concludes by recommending that Australia give further consideration to the specific measures from the Best Practices Paper (BPP). The BPP dated 11 October 2002 recommends that nations implement a number of preventative measures – for example:

- to encourage financial transparency by requiring NFPs to present a full program budget,
- to require independent auditing,
- to undertake programmatic verification particularly where there is a home office and field offices,
- to ensure that the Board of Directors of NFPs recognise their critical governance role,
- to ensure there is appropriate oversight – for example through introducing a charity commission and to ensure inter-agency cooperation.

Many of these measures will be implemented as part of the Government's NFP reform package. For example, charities will be required to submit an annual information statement and financial information to the Australian Charities and Not-for-profits Commission. The Government has recently consulted on the implementation of governance standards for NFPs. If a review was conducted now or in the near future, we suspect that Australia's report card would be significantly improved.

In the BPP, we could find no indication that the FATR was encouraging member countries to limit the operations of NFPs to its jurisdiction. In fact, a number of the measures specifically contemplate that NFPs will operate overseas.

Finally, the Mutual Evaluation Report on Australia's performance states that:

> *"To date there have been no substantiated links between terrorist groups and non-profit organisations in Australia."*

In light of this we submit that constraining the extent to which Australian NFP's operate overseas is a disproportionate response and is not justified on the basis of Australia's international commitments.

In conclusion, we submit that the policy justifications underpinning the amendment to the special conditions for tax concession entities are not substantiated. Most NFPs appropriately steward their resources. To the extent that they do not, Australia has existing counter-terrorism and money laundering legislation to address criminal activity. We respectively

submit that the reform initiatives being implemented by the Government including oversight by the ACNC, together with the ATO and agencies such as AUSTRAC will address any perceived abuse.

4. SUBSTANTIVE PROVISIONS

With regard to the substantive provisions in the exposure draft legislation, we will comment on:

1. Application to:
    a. Overseas Aid Funds;
    b. Prescribed Institutions; and
    c. Australian Scholarship Funds
2. The application of proposed section 30-18.
3. The "tracing" obligation.
4. The provision regarding "disregarded amounts";
5. The replacement of the "expenditure test" with the "operation test";
6. The "not-for-profit entity" definition.

4.1 Application to Australian Aid Funds

Numerous organisations are currently entitled to whole of entity endorsement as a DGR (such as public benevolent institutions or health promotion charities), and also are also entitled to endorsement for the operation of a fund (such as an approved fund administered pursuant to the Overseas Aid Gift Deduction Scheme.

Section 30-18 as currently expressed would result in those organisations losing their entitlement to whole of entity endorsement because most of their work is conducted overseas.

Furthermore, they would also lose their endorsement as a charitable institution.

This appears to be an unintended consequence of the exposure draft. Accordingly we submit that proposed section 30-18(4) should be reworded, and we suggest the following wording:

"A fund, authority or institution that operates a fund, institution or authority covered by section 30-80 satisfies the conditions in this section if it satisfies the conditions in paragraph (1)(a)."

4.2 Application to Prescribed Institutions

The exposure draft legislation provides an avenue for Australian and overseas organisations to be prescribed as income tax exempt entities in the regulations.

We are alarmed that the explanatory material states that a "decision to prescribe an entity in the regulations is a policy decision that would be made only in exceptional circumstances." [1.82].

One of the conditions to becoming a prescribed entity is that they satisfy the conditions (if any) prescribed in the regulations – proposed section 50-51(c)(iii). The availability of prescription could turn on the nature of these conditions and therefore they ought to be in the legislation not the regulations. This is particularly so if a decision on prescription is to be a policy decision.

Furthermore, the explanatory material at 1.44 states that existing prescribed entities are to be "grandfathered". This term usually suggests a change in law where those affected will be subject to transitional arrangements. It is not clear whether transitional arrangements will apply to the many existing prescribed entities, and if so, what they are.

Clarity on this point would be of assurance to these prescribed organisations.

4.3 Application to Australian Scholarship Funds

Item 2.1.13 of section 30-15 of the ITAA 97 establishes a DGR category for scholarship funds. Section 30-75 of the ITAA 97 is a special condition applicable to this category and is not to be repealed by the exposure draft legislation.

It states that the scholarship, bursary or prize offered is to promote the recipients' education in either or both of:

(a) "pre-school courses, primary courses, secondary courses or tertiary courses;

(b) educational institutions overseas, by way of study of a component of a course covered by subparagraph (i); and"

A scholarship fund established for courses covered by paragraph (b) may find itself in danger of breaching the "in Australia" conditions. This may have been an unintended consequence.

4.4 The application of proposed section 30-18

The first exposure draft legislation released in July 2011 provided that special condition (a) of item 1 of the table in section 30-15(2) was to be substituted with the following wording:

"(a) the fund, authority or institution must satisfy the conditions in section 30-18."

The revised exposure draft does not contain this statement. Mechanically this provision provides a connection to the requirements set out in section 30-18. We suggest that this be given consideration.

4.5 The "tracing" obligation

We submit that the requirements in proposed sections 50-50(4) and 30-18(3) that require an entity to trace funds are unworkable.

We cite the following statement by Lord Justice Oliver in *Inland Revenue Commissioners v Helen Slater Charitable Trust* [1981] 3 W.L.R. 377, 382 (Court of Appeal), which reflects the position at common law (emphasis added):

> *"The Crown's proposition is a startling one; it involves this, that the trustees of a grant-making charity, although they may discharge themselves as a matter of law by making a grant to another properly constituted charity, are obliged, if they wish to claim exemption under the subsections, to inquire into the application of the funds given and to demonstrate to the Revenue* ***how those funds have been dealt with by other trustees over whom they have no control and for whose actions they are not answerable. Anything more inconvenient would be difficult to imagine****…."*

This tracing obligation will only add to the compliance costs of tax concession entities. It is impractical to require them to trace through the ultimate use of funds, even if they pass through more than one entity.

4.6 The provision regarding "disregarded amounts"

We submit that the wording of proposed subsection 50-50(5) is overly complex. Furthermore it applies to disregard government grants and deductible gifts only if the entity complies with the conditions (if any) prescribed in the regulations. The application of this section will be significantly impacted if conditions are prescribed,

and if so, their content. This would effectively allow legislative power on policy issues to be set out in delegated legislation.

In our view the wording of the present section 50-75 is preferable.

4.7 **The replacement of the "expenditure test" with the "operation test"**

Proposed section 50(2)(a) replaces one of the current conditions for income tax exempt entities - that they must incur their expenditure principally in Australia. The new condition is that they must "operate principally in Australia".

We understand that the rationale behind this is to enable a more holistic analysis of the entity's operations. However the benefit of the current test is that it is more objective. The proposed subjective test is more open to uncertainty.

Given that the income tax legislation imports a duty on endorsed entities to tell the Commissioner of Taxation if they cease to be entitled to endorsement (s.426-45 of the *Taxation Administration Act 1953* (Cth)), it is imperative that organisations have clarity about how this test will be administered.

4.8 **The "not-for-profit entity" definition.**

With regard to the new "not-for-profit entity" definition, proposed subsection 995-1(b)(i) provides an exception for distributions to members that are not-for-profit entities "with a similar purpose". Our submission is that the requirement for the not-for-profit to have a similar purpose is too restrictive.

The wording fails to address transfers between exempt entities which are not charities, or where only one of the entities is a charity. Why should a charitable institution be prevented from making a distribution to its income tax exempt parent body (or vice versa)? As long as the distribution is made by the first entity in furtherance of its purpose, it should not be restricted in the manner proposed.

If the distribution exhibits a failure by the first entity to pursue its purpose then we suggest that the fault is with the governance of the organisation, and that the remedy does not lie in amending the income tax legislation but strengthening governance frameworks (which we understand is the subject of a separate consultation process).

Furthermore, the explanatory material at 1.77 asserts that a distribution from one charity to another would constitute a distribution for a similar purpose. However this assertion is inadequate for such a fundamental question and is not consistent with general interpretation principles. A principle of interpretation of this significance ought to be stated in the legislation.

5. CONCLUSION

We welcome the opportunity to comment on these matters and look forward to further dialogue with the Government on these important matters.