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NFP Sector Tax Concession Working Group Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600
By email: NFPReform@treasury.gov.au

To the Secretariat

Submission to the Not-for-profit Sector Tax Concessions Discussion Paper

King & Wood Mallesons ("**KWM**") welcomes the opportunity to provide a submission to the Not-for-profit ("**NFP**") Sector Tax Concession Working Group.

KWM has a long-standing involvement with the NFP sector. Through our pro bono program and general advisory work, we have established and assisted a diverse range of Australian and global charities and NFP entities.

In our experience, charities face particular challenges in negotiating the myriad of different legal and regulatory regimes which apply in Australia.

The lengthy and ongoing reform initiatives have added further complexity to the operation of the sector.

KWM encourages the Working Group to focus on measures which promote the ultimate aims of certainty, consistency and harmonisation in Australia across the NFP sector, and reduction in compliance and administrative costs.

We have included in this submission responses to a number of the questions raised in the Discussion Paper. We have discussed these matters with a range of our clients in the NFP sector.

Yours sincerely

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KING&WOOD MALLESONS

Submission to Treasury - NFP Sector Tax Concessions

1 General Comments

There are three key matters we consider the Working Group should focus on. These are:

(a) **alignment of concession categories** - it is important to align and simplify the eligibility categories across various frameworks for tax concessions including income tax exemption, deductible gift recipient ("**DGR**") endorsement, franking refunds and GST concessions. This issue was identified by the Productivity Commission in their Report on Contributions of the Not-for-profit Sector released in February 2010 ("**PC Report**");

(b) **issues for large NFPs** – large NFPs and NFP groups face particular issues under the existing tax regime. These issues have not been addressed to date. We support the Working Group focusing on initiatives to address the complexity and compliance costs of managing large NFP operations; and

(c) **FBT concessions** – the Working Group should carefully assess the benefits derived by the NFP sector under the existing FBT framework. Any measures proposed in relation to the FBT concessions should take into account that many NFP entities rely heavily on these FBT arrangements to support their existing operations. Any changes to the FBT regime may have significant adverse consequences to the NFP sector.

Our responses to the particular questions raised in relation to each exemption or concession type are set out below.

We have not sought to address every issue raised. There are a number of items which we would not have expected to have been included as part of the Working Group's review. This includes, the operation of the mutuality principle. We would regard this principle as unrelated to the existing tax concession regimes for NFPs.

2 Income Tax Exemption and Refundable Franking Credits

Q1 What criteria should be used to determine whether an entity is entitled to an income tax exemption?

We broadly support the use of the existing criteria to determine tax exempt status. We consider it appropriate to have regard to the objects of an entity as stated in its constituent documents and the range of activities being undertaken (or proposed to be undertaken) by the entity.

There are two specific issues which should be reviewed:

(a) firstly, an entity may be endorsed prior to commencing any activity as a charity purely on the basis of its constitution if there are reasonable grounds for believing that the entity will meet the special conditions applying to it: subsection 50-110(5)(b). The asymmetric treatment of new and existing charities is not well understood within the existing framework and clearer guidance or better defined criteria should be provided in relation to this. In particular, we are aware of circumstances where historic activities have prejudiced an entity's access to tax exempt status in relation to its future plans (which would otherwise have met the requirements). Further guidance should be provided for entities which are in transition in this way;

(b) secondly, the relevance of a "government instrumentality criterion" should be revisited. Currently, an entity is not regarded as a charitable institution or fund if it is controlled by government even though its sole object or purpose may be charitable within the spirit and intendment of the Statue of Elizabeth.[1]

The exclusion of government instrumentality is at odd with a number of existing provisions allowing government bodies at different levels to be exempted from income tax: section 50-25 of the ITAA 1997 and Division 1AB of Part III of the ITAA 1936. It is also inconsistent with the charitable trust legislation (see for example section 7K of the Charities Act 1978 (Vic)).

Q2 Are the current categories of income tax exempt entity appropriate? If not, what entities should cease to be exempt or what additional entities should be exempt?

The current category in section 50-45 for "sports, culture and recreation" entities are not sufficiently broad. The particular exempt entities are limited to societies, associations and clubs established for the encouragement of animal racing, art, a game or sport, literature, or music or for musical purposes.

In comparison, the types of entities that can be listed on the Register of Cultural Organisation under Subdivision 30-F for **DGR** endorsement purposes are much broader. They include crafts, design, television, video, radio, film, or movable cultural heritage. This has meant that a number of NFP entities in these groups have had to obtain the income tax exemption under the charity head and to satisfy the public benefit test.

[1] Taxation Ruling 2011/4 "Income tax and fringe benefits tax: charities", paragraph 287.

This can be a challenging process for them especially where the benefits that they are offering are intangible and may be specific or focus on a particular segment of the public.[2]

Q4	**Does the tax system create particular impediments for large or complex NFPs?**

Large and complex NFPs face numerous challenges in connection with the current tax law. A range of the tax impediments are canvassed below.

Ability to distribute dividends to tax exempt members and owners

- The position clarified in TR 2011/4, that the distribution of dividends to members and owners who are themselves charitable entities is permitted, is important and appropriate. This treatment should be confirmed as part of any further NFP reforms.

Difficulty to prove main or sole purpose where activities may fit within more than one category

- It is difficult for a large NFP entity with multiple purposes, where each of those purposes may fit in a category of income tax exempt entity, to satisfy that the entity has a main purpose consistent with a particular category. A large NFP may be required to separate its activities to different entities to confirm a concessionary tax status.

Inability to transfer funds across entities within a NFP group

- A large and complex NFP entity may have multiple entities within its group under a common board of directors. This structure may arise (and may need to be maintained) for a range of reasons. These groups face practical difficulties in trying to manage their financial arrangements as funds cannot be easily transferred within the group. This is because the transfer of funds may not be regarded as in furtherance of the constitutional object or purpose of the individual entity. It would be helpful to permit a collection of entities to be endorsed as a tax concession group and for transactions between intra-group entities to be ignored for tax purposes.

Lack of guidance in joint venture activities

- It is common for NFP entities to enter into a joint venture with other taxable or NFP entities to advance their charitable objects. There is little comfort in the rules to help ascertain how joint activities are treated. It is unclear if the NFP entity may be regarded as being responsible for the joint activities as a whole or their specific contribution only. This is important in monitoring ongoing compliance.

Engagement in overseas activities

- It is common for large and complex NFP entities to engage at least in part in overseas activities. The revised "in Australia" rules as currently expressed in the Tax Laws Amendment (Special Conditions For Not-For-Profit Concessions) Bill 2012 require a balancing test based on the predominant activities to show that the operation and the purpose of the

[2] The difficulty for entities in this category to obtain DGR endorsement is also acknowledged in the Victorian Government's Submission to the Productivity Commission titled "Comment on the Draft Research Report Contribution of the Not-for-Profit Sector" (December 2009), paragraph 2.10, page 23.

entity are "in Australia". This may be difficult for a complex NFP to assess in any particular period.

Specific listing process

- The process for specific listing for income tax exempt status is largely unspecified. This causes particular problems for large and complex NFP entities that may not fit well within a particular category under Division 50 but may regard themselves as appropriate to be provided with an income tax exemption.

Q5	**Should other types of NFPs also be able to claim a refund of franking credits?**

Yes. The distinction between NFP entities which are and which are not eligible for a refund of franking credits currently distorts the investment decisions of NFPs.

There should be no disincentives for any NFP to invest in shares. The rules in section 207-115 of the ITAA 1997 should be expanded.

Q6	**Should the ability of tax exempt charities and DGRs to receive refunds for franking credits be limited?**

We do not support any measure to limit the ability of tax exempt charities and DGRs to receive refunds for franking credits.

This will distort the investment decisions of NFPs.

Q7	**Should the ATO endorsement framework be extended to include NFP entities other than charities seeking tax exemption?**

No. Eligible entities should continue to be able to self-assess their income tax exemption status. Various small NFP organisations should not have to go through the administrative burden of the endorsement process.

Self-assessed NFP entities that are of a significant size or scale may already obtain sufficient certainty from the ATO with respect to their tax treatment through the current private binding ruling request process, assuming an endorsement is not required.[3]

We also suggest the requirement in section 50-52 be removed. The legislation should provide with clarity whether or not an entity is required to seek endorsement. This is because these are a range of entities identified in Division 50 which may have purposes which fit within the broad fourth head of charity. These entities should not be compelled to seek endorsement as a charity to confirm their position.

Q8	**Should the income tax exemptions for State, Territory and local government bodies be simplified and consolidated into the ITAA 1997? Which entities should be included?**

We support the consolidation of existing income tax exemptions for State, Territory and local government bodies into the ITAA 1997. We recommend a comprehensive aggregation of existing provisions in the ITAA 1936 that directly affect the taxation treatment of NFP entities including the income tax exemption in Division1AB of Part III, the integrity rules in section 78A of Part III and the transition to "for-profit" rules in Division 57 of Schedule 2D to the ITAA 1997. To

[3] See the private ruling for scientific institutions as listed out above in footnote [5].

the extent possible, the provisions for taxation of the NFP sector should be in one place for simplicity.

Q10	**Please outline any other suggestions you have to improve the fairness, simplicity and effectiveness of the income tax exemption regime, having regard to the terms of reference.**

The rules related to the transition from income tax exempt entities to taxable entities should be reviewed. These entities are generally in a difficult position under the current regime. The allocation of income and deductions under Division 57 of Schedule 2D of the ITAA 1936 is complex.

The transitioning process generally requires substantial changes to the entity's constitution to provide for distribution of profits to its members.

3 Deductible Gift Recipients

Q11	**Should all charities be DGRs? Should some entities that are charities (for example, those for the advancement of religion, charitable child care services, and primary and secondary education) be excluded?**

The discussion in the Consultation Paper indicates that a significant concern regarding the proposed extension of the DGR rules, is that the extension may facilitate the provision of private benefits.

In this respect, we submit that there are existing measures in section 78A of Part III of the ITAA 1936 that disallow the deduction of gifts that would otherwise be deductible under Division 30 where the donor or its associate may obtain any private benefits. These rules are also reflected in Taxation Ruling 2005/13 "What is a Gift" for the purposes of Division 30 of the ITAA 1997.

These measures may be strengthened as required and act as a sufficient anti-avoidance mechanism to ensure the integrity of the deductible gifts and contributions concessions.

In our experience, charities which are not endorsed as DGRs but want to access DGR funds might ordinarily seek to partner with another charity that has been endorsed as a DGR and has a common charitable purpose to carry out an activity. This may undermine the existing distinctions in any case.

There are also other bases on which a contribution to an entity, which is not a DGR, may be deductible to the donor (eg: section 8-1).

We expect that the reinforcement of existing integrity measures, coupled with the proposed increase in reporting requirements for registered charities under the Australian Charities and Not-for-profits Commission should be adequate to prevent any abuse of the tax concessions.

Q14	**If DGR status is extended to all endorsed charities, should this reform be implemented in stages (for example, over a period of years) in line with the PC's recommendations, or should it be implemented in some other way?**

We concur with the Productivity Commission's recommendation to implement the reform progressively.

Q15	**Would a fixed tax offset deliver fairer outcomes? Would a fixed tax offset be more complex than the current system? Would a fixed tax offset be as effective as the current system in terms of recognising giving?**

We do not support the application of a fixed tax offset to recognise giving.

A fixed tax offset may fulfil the criterion of "fairness" by providing the same level of benefits across donors regardless of their income levels.

Our concern is that a fixed tax offset will not have the same effect as a tax deduction in motivating high income earners to donate.

This may result in a significant reduction in benefaction in Australia.

In addition, the regime suggested in the Consultation Paper would result in increased complexity and uncertainty and would require substantial new legislation, guidance and considerable community engagement and education.

Q19	**Would a clearing house linked to the ACN Register be beneficial for the sector and public?**

A clearing house linked to the ACN Register would be beneficial to promote giving and provide taxpayers with a range of choices.

It is important to ensure that the establishment of a central clearing house does not take in any way limit the existing mechanisms that are currently adopted to access and promote giving.

That is, the clearing house should be in addition to and not supplant the existing systems.

Q20	**Are there any barriers which could prohibit the wider adoption of workplace giving programs in Australia? Is there anything the Working Group could recommend to help increase workplace giving in Australia?**

It has been observed that small and medium businesses are less likely to engage in workplace giving.[4]

Small and medium businesses sector provides approximately 70.5% of Australian total industry employment.[5]

Any incentives to encourage the adoption of workplace giving and employers' matching among these businesses could significantly increase the participation in workplace giving in Australia.

SME employees may be encouraged to implement workplace giving programs by:

(a) increasing the deduction rate for "matched" contribution by employers; or

(b) reducing administrative complexities for SME which adopt giving programs.

Q21	**Do valuation requirements and costs restrict the donation of property? What could be done to improve the requirements?**

Valuation requirements and costs have a considerable role in restricting the donation of property.

It should not be necessary to appoint a valuer each time a potential donor wishes to donate property.

The rules should provide for self-assessment by the donors which must be properly documented and subject to ordinary compliance and review.

Q24	**Are the public fund requirements, currently administered by the ATO, either inadequate or unnecessarily onerous?**

Generally yes. Our clients are often surprised by the "qualified persons" requirement that seeks to draw a line between certain people who are regarded as having a degree of responsibility to the community and others who are not

[4] Department of Planning and Community Development, State Government of Victoria (May 2011) "Establishing a workplace giving relation with businesses"

[5] Department of Innovation, Industry, Science and Research (2011) "Key statistics: Australian small businesses", retrieved at http://www.innovation.gov.au/SmallBusiness/Pages/default.aspx

(because they do not perform a public function or belong to a professional body).[6] The relevance and need for this requirement should be revisited.

Q26	**Should the threshold for deductible gifts be increased from $2 to $25 (or to some other amount)?**

We do not support increasing the threshold for deductible gifts from the current level of $2. Increasing this threshold will inhibit the ability of charities to access individual donations.

More importantly an increase in the deduction threshold devalues the participation in the NFP sector by individuals who cannot afford larger donations. The proposed is not equitable and does not support the sector.

There does not appear to be a sound policy base for lifting the threshold.

Large numbers of individual donors will make donations which are less than $25. The monetary contribution of these individuals may not be significant in the context of the total financial contributions provided to the NFP sector.

The personal engagement of these individuals remains very important. The act of giving by these individuals builds a connection between the NFP and the community, which supports the activities of the NFP as a whole.

The opportunity to connect with the community will be adversely affected in the minimum deduction threshold is increased.

[6] Taxation Ruling TR 95/27 "Income tax: public funds", paragraph 21

4 Fringe Benefits Tax Concessions

Q28 Assuming that the current two tiered concessions structure remains (see Part B), what criteria should determine an entity's eligibility to provide exempt benefits to its employees?

We understand that Questions 28 and 29 aim at refining the existing criteria for determining an entity's eligibility for FBT concessions assuming the current two-tiered structure (the FBT exemption and FBT rebate) is retained in the long term.

It is not appropriate to impose any further limitations on the eligibility criteria for FBT exemptions. Exempt benefits (subject to different caps) have been provided to PBIs, public and NFP hospitals, health promotion charities and religious institutions (in relation to certain pastoral and propagandised activities) over a long period of time and are deeply entrenched in the financial models of these entities.

We consider that the current difference between entities who can provide exempt benefits and those who provide rebateable benefits may be considered arbitrary.

It is important that access to exempt benefits is not limited. Any changes should be limited to expanding the categories of FBT exempt entities and making narrow limitations to the types of benefits available, as discussed in Question 32 below.

Q29 Also assuming that the current two tiered concessions structure remains (see Part B), what criteria should determine an entity's eligibility to provide rebateable benefits to its employees? Should this be restricted to charities? Should it be extended to all NFP entities? Are there any entities currently entitled to the concessions that should not be eligible?

Currently the list of NFP entities that are eligible to provide rebateable benefits is set out in subsection 65J(1) of Part IIA of *the Fringe Benefits Tax Assessment Act 1986.*

This list closely resembles the categories for income tax exemption status under Division 50 of the ITAA 1997, except for income tax exempt entities that are governmental.

As mentioned in our response to Question 2 above, we are strongly of the opinion that any effort to simplify the current tax concessions system for NFP sector should require an alignment of the eligibility categories across the different concessional regimes, including in this particular case, between the income tax exemption status and the rebateable employer status. This would mean that any reform measures that are going to affect the income tax exemption groups as discussed above in Question 3 should also be taken into account in considering the relevant criteria under this question.

In general, we would support expanding the list of rebateable employers to all NFP entities that are exempt from income tax rather than restricting it to charities on the ground of fairness.

Q31 Should salary sacrificed meal entertainment and entertainment facility leasing benefits be brought within the existing caps on FBT concessions?

The provision of these benefits has attracted considerable attention following the findings by the Productivity Commission that highlighted a number of examples where the utilisation of these benefits was not made in appropriate circumstances.[7]

[7] PC Report, pages 214-215.

We understand the exclusion of these benefits was due to historical reason without any real underlying policy.[8]

The anecdotal evidence regarding their inappropriate usage, also suggests these entertainment benefits should be brought within the existing caps on FBT concessions.

The NFP sector relies heavily on the available FBT concessions to attract and retain employees. Any limitations to these concessions should take this carefully into account.

Q35	**Should the rate for FBT rebates be realigned with the FBT tax rate? Is there any reason for not aligning the rates?**

There does not appear to be a sound policy reason or benefit in keeping the FBT rebates rate above the FBT tax rate.

[8] As identified in the PC Report, page 214.

5 Goods and Services Tax Concessions

Q47	**Would an opt in arrangement result in a reduced compliance burden for charities that would otherwise need to apply apportionment rules to supplies made for nominal consideration?**
Q48	**If an opt in arrangement is favoured, would the preference be to treat the supplies as taxable or input taxed? Why?**

A large charity is unlikely to elect to treat its supply as taxable or input taxed even if it is qualified for the opt in arrangement.

This is because while this may be the simpler solution, it will increase the cost pressure on the customers or clients of the charity who will in effect bear the liability for GST that is not claimable for input taxed supplies or for any GST imposed on the entity's goods and services when the supplies are brought to the system.

In our experience, the difficulty with the apportionment rule under section 38-250, is the valuation requirement. A charity wishing to claim under subsection (1) of that section will have to undertake a hypothetical exercise to work out the GST inclusive market value of their supply in order to know whether the consideration is nominal. This process is complex and costly.

A better option to reduce the compliance burden is to require the charity to demonstrate the linkage between the relevant supply and their charitable purposes in order to claim GST-free tax concession.