UNIVERSITIES AUSTRALIA

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Submission to the Not-For-Profit Sector Tax Concession Working Group

December 2012

Contents

Summary

This submission makes the following points:

- Public universities are not-for-profit organisations formed to provide public goods. Most universities are established by law and required to "serve the public interest". Therefore universities should remain exempt from paying personal income tax.
- Universities Australia supports existing arrangements for income tax exempt deductible gift recipients (DGRs) being able to claim a refund of franking credits on distributions from Australian companies.
- We would not support any change that limits universities' abilities to receive refunds on franking credits. Such a change would create large economic distortions and inefficiencies that are inconsistent with the goals and guiding principles of the current review.
- Universities have significant investments in Australian shares which generate income to provide important public goods such as scholarships, education, and research. Any change to the current system that prevented universities accessing franking credits may require the Government to contribute an additional $760m to the sector, or there would be a reduction in the education, research and other public good activities performed by universities.
- Donations by individuals, at a minimum, should be tax deductible at the individual's personal marginal tax rate, otherwise the incentive to give is inefficiently reduced and horizontal equity distortions are introduced.
- Universities Australia estimates welfare losses to society that may exceed $400m per annum if the tax deductible rate for donations from high income earners was reduced from 46.5 per cent to 38 per cent.
- The Not-For-Profit (NFP) Working Group should promote enhanced incentives to give through the tax system. Increased giving produces large benefits to society.
- Universities Australia supports the current concessional GST treatment for charitable institutions. Such concessions are a vital component of the provision of important university services such as affordable student accommodation — which promote important equity objectives such as access to tertiary education for regional and low income students.
- In terms of the further consultation process, we encourage the NFP Working Group to produce a draft report, and allow a reasonable time for further submissions and consultation, before any final report is produced.
- Universities Australia may make further submissions to the current review.

Introduction

This submission by University Australia responds to the discussion paper: *Fairer, Simpler, and more effective tax concessions for the not-for profit sector.* The paper was issued by the Not-For-Profit Sector (NFP) Tax Concession Working Group in November 2012 (NFP Working Group).

This submission covers the criteria used to determine income tax exemption status, the tax treatment of share investments and franking credits for public universities, the tax deduction rate for individual donations, and current concessional GST treatment. The framework we use adopts the guiding principles of the review,[1] that any changes to the current system should:

1. maximise the social good;
2. recognise giving in Australia, providing a supportive environment in which the community can support the NFP sector;
3. be fair, treating like with like;
4. be effective, enabling policy outcomes that maximise the social good; and
5. be efficient, causing the least possible cost to economic efficiency.

Universities do not and should not pay income tax

This section addresses the public policy rationale for universities being exempt from paying income tax and why such an exemption should continue.

Income tax is only borne by individuals in a society and is only imposed on entities as a proxy for the payment of personal income tax. Public universities are not-for-profit organisations formed for the purpose of providing public goods: education and research. Most universities are established under State or Territory Acts of Parliament and required by those laws to pursue public good objectives: *"to serve the [State], Australian and international communities and the public interest."*

The current tax law provides an income tax exemption to entities that are not-for-profit and primarily undertake purposes that are broadly beneficial to the community. Therefore universities are exempt from paying income tax on revenues earned. Any income earned by public universities is ultimately put to the provision of public services such as subsidised education[2], not to the distribution of profit to individuals, which is why universities are not and should not be subject to any proxy income taxes.

The NFP discussion paper (at p. 14 and Question 1) asks who should be eligible for exemption from income tax and what criteria should be used to determine eligibility? Universities Australia supports the existing criteria to determine eligibility for the income tax exemption: not-for profit and pursuing public benefit objectives. We emphasise it is essential that public universities maintain their income tax exempt status under this current review.

[1] See pages 6 and 7 of the discussion paper: "*Fairer, Simpler, and more effective tax concessions for the not-for profit sector*; November 2012, hereafter the NFP discussion paper.

[2] For example, most public universities supply undergraduate courses to domestic students free of upfront charges or with very low charges, where the per annum costs of supply typically range between $15,000 and $30,000 per course. To support the provision of these below cost education services the Government paid universities about $10bn in CGS payments in 2011, comprising 43% of total university revenues, and a further $3.26 bn in FEE-HELP and HECS HELP payments (14% of university revenues). These latter payments are income contingent, low interest loans to students provided by Government, most of which are ultimately borne by the students and paid back to Government.

Franking credit refunds for universities should continue

Entities that are income tax exempt charities or income tax exempt Deductible Gift Recipients (DGRs) are in general able to claim a refund of franking credits on distributions by Australian companies. Universities fall under the category of income tax exempt DGRs and therefore are entitled to claim the refund.

The NFP discussion paper (at Question 6) asks "Should the ability of tax exempt charities and DGRs to receive refunds for franking credits be limited?" Universities Australia supports the current position where public universities can claim a full refund for franking credits from share investments. Our rationale is explained below.

Public universities are not subject to general income tax and therefore should not be taxed on income derived from share investments

Under the classical tax system with full dividend imputation, companies are a veil,[3] and company tax is theoretically designed to be a pre-collection of personal income tax. People who invest in Australian shares ultimately pay net tax on share income at their personal marginal tax rate.[4] Therefore, as universities are not-for-profit entities, they should not be liable for personal income tax on share investments.

Universities should therefore be able to claim a full refund for franking credits paid by companies — because the franking credit is a pre-payment of personal income tax.

Any change to the current system which limited universities' abilities to obtain refunds for franking credits would:

- introduce large economic distortions and inefficiencies into the system;
- significantly reduce university income; and
- require the government to provide significant extra funding to universities or services would be cut.

We explain these points below.

Limiting franking credit refunds would cause significant income losses for universities and cause large economic inefficiencies

Australian universities have significant investments in Australian shares. As at the end of 2011, universities had $54.5bn of total assets on their balance sheet, of which $7bn was investments. Investment revenue was $866m for 2011 or about 4 per cent of total university revenue of $23bn.[5] This demonstrates the importance of investment revenue as a source of funding for universities.

A sample of universities' investment portfolios indicates that:

- a large proportion of universities' total investments are held in Australian shares, typically ranging between 25 per cent and 45 per cent, with a simple average of 34 per cent;
- the projected annual income yield on the share investments, inclusive of franking credits, ranges between 6 per cent and 8 per cent (average 7.2 per cent), with franking credits on average comprising about 1.75 per cent of the total yield; and

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[3] The term company veil describes the legal, but not economic, separation of a company from its owners (shareholders). So shareholders fully own the economic surplus or profits generated by a company, which are subject to tax, but are shielded from personal legal liability for the company's actions.

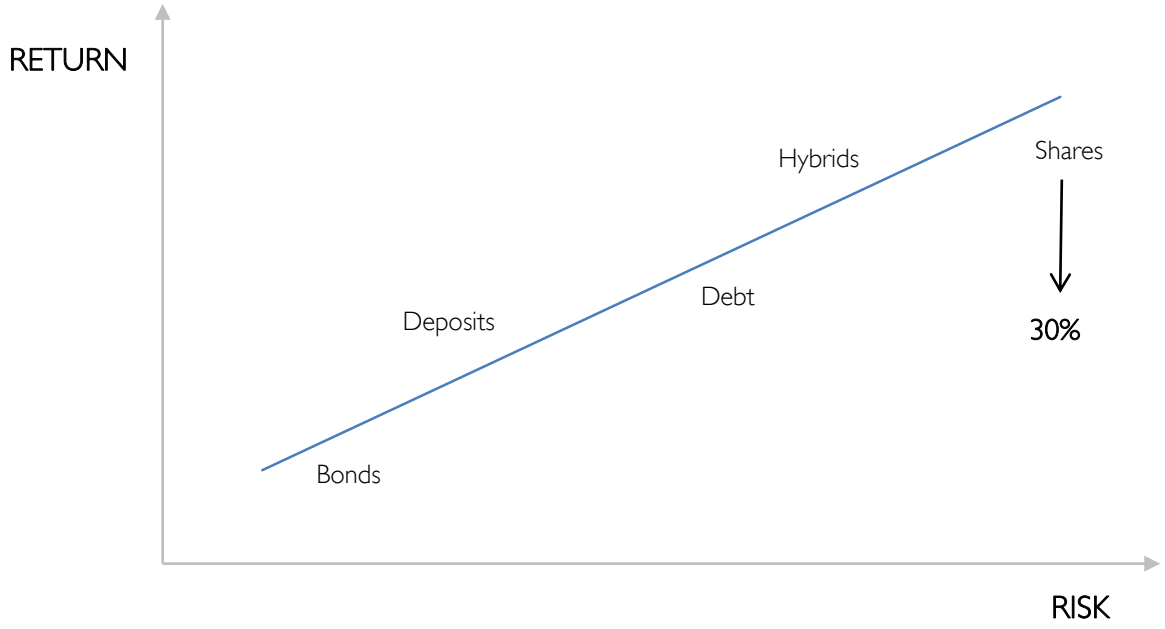
[4] For example, people with no income tax liability who earn dividend income from share investments can fully claim a tax refund for franking credits paid in distributions, ultimately paying no tax on the income distributed by the company.

[5] See Finance 2011, Financial Reports of Higher Education Providers, October 2012 at pages 3 and 5.

- other non-share investments in the university portfolio are typically lower risk/lower return such as deposits and bonds, which return on average 4 per cent to 5 per cent per annum, and are not subject to similar income growth characteristics as shares.

The risk/reward matrix for university investments is illustrated in Figure 1.

Figure 1: Risk/Return Matrix for university investments



If franking credits were no longer refundable for universities, a series of economic inefficiencies would be needlessly introduced that are inconsistent with the guiding principles of the review:

- One class of investments (shares) made by universities would be subject to a 30 per cent income tax rate, whereas other investments such as bonds, debt, hybrids, and trusts including REITS[6] would be subject to no tax. The portfolio investment decisions of universities would therefore be distorted in an economically inefficient manner away from shares towards other types of investments. In this case, the new tax would not be competitively neutral. *(Inconsistent with Guiding Principle 3 Fairness and treating like with like, and Guiding Principle 5 Economic Efficiency)*
- Donors will be deterred giving to universities, knowing the returns from such donations will be materially lower, or the price of giving has significantly risen.[7] Donors would also be deterred from gifting shares to universities, knowing the investment would be less tax effective than cash. Such a change could harm universities' abilities to attract large share endowments or other grants from well-off individuals. *(Inconsistent with Guiding Principle 2 on recognising giving and providing an environment supportive of giving).*

[6] Real Estate Investment Trusts

[7] As we explain below, the expected income return on share investments may be reduced from 7.2 per cent to 5.45 per cent. So a donor considering giving $100,000 to establish a permanent scholarship would be significantly deterred knowing the income value of such a donation may be reduced from $7200 pa to $5450 pa, or the price of giving has risen by over 30 per cent.

- The tax on shares would be highly inefficient comprising a narrow base of 34 per cent of total university investments *(Inconsistent with Guiding Principles 1,4 and 5)*.[8]
- Universities would have a less diverse investment portfolio with one important investment class being arbitrarily made less attractive *(Inconsistent with Guiding Principles 1,3 and 5)*.
- The total investment revenue derived by universities would significantly decrease from three sources:
    - universities no longer receiving franking credit income from share investments;
    - universities substituting other generally lower risk/lower return investments for shares; and
    - a lower level of donations to universities.

(*Inconsistent with Guiding Principles 1, 2 and 5)*

Universities may require $764 million of additional investment funds to continue current service provision if franking credits were no longer refunded

Universities Australia has made the following calculation of the shortfall in funds for universities if franking credit refunds were no longer available. Pressure would fall on Government to make up the shortfall and restore university investment income to the same level as before the new tax was introduced.

Table 1: Additional investment funds required if franking credit refunds no longer available

Additional funds calculation	
Total investments by Universities	$7bn
Estimated proportion of investments held in Australian shares	34%
Expected total income return from shares per annum	7.2%
Franking credit component of total return	1.75%
Expected income return without franking credit refund	5.45%
Extra assets required to generate same return post tax change	$7bn x 34% x 1.75%/5.45%= **$764m**

Longer term, universities would be likely to move their investment portfolios away from higher return/higher growth shares to bonds and deposits, and donations would be reduced, because of the distorting new tax on franking credits.

Therefore, the total amount paid by Government to universities would need to significantly increase above $764m over time to enable the universities to generate the same income and growth in investment assets that would have occurred but for the new tax. The ultimate effect on the Government's balance sheet may be quite negative.

[8] We advocate no new tax being introduced here. As a general principle, if new taxes are introduced, it can be shown that it is better to levy the tax on as broad a base as possible, allowing a lower rate to collect the same amount of tax, and causing less distortion to decisions. For example, a 30 per cent tax covering 34 per cent of a total base causes investment distortions and welfare losses that are 800 per cent greater than a tax set at 10 per cent covering the whole base which would collect the same amount of revenue.

The tax deduction rate for individual donations

Donations to charities and DGRs are tax deductible at the individual's personal marginal tax rate. The NFP discussion paper (at pages 26-28) asks whether moving to a fixed tax offset rate of 38 per cent for all donations, or a two-tiered 34 per cent , 38 per cent rate, would be fairer and encourage giving by higher income earners (Questions 15, 16, 17)?

Universities Australia makes the following points:

- Donations to charities and individuals should, at a minimum, be deductible at the individual's personal marginal tax rate. Therefore, persons on a 46.5 per cent effective tax rate, should be able to tax deduct donations at 46.5 per cent, not 38 per cent.
- Any change to the system which did not allow high income earners to deduct donations at a 46.5 per cent rate would:
    - significantly reduce incentives to give and not support the NFP sector;
    - be horizontally inequitable; and
    - significantly reduce the incentives to work for charitable purposes — because the effective marginal tax rate on working and giving is 108.5 per cent.
- Giving produces high net benefits to society. Therefore, the NFP Working Group should recommend reforms that enhance, not diminish, the incentives to give.

Incentives to give are significantly reduced if the 46.5 per cent offset rate is reduced

Universities Australia has sampled university donations and found the following:

- Gift and bequests exceeding $100,000 in value represent a large proportion of all donations that come from individuals, including alumni and staff members. Our consultations suggest gifts of $100,000 or more typically exceed 40 per cent of a University's total donations by value.[9]
- Whilst universities do not generally maintain demographic information on donor income, a reasonable conclusion can be made that high value gifts (defined as exceeding $100,000 for this purpose) would come from high wealth individuals (typically on the highest marginal tax bracket).
- Based on these assumptions, it is reasonable to assume that the capping of the tax refund on donations below the 46.5 per cent marginal tax rate would provide a severe disincentive to give, therefore undermining the universities' capacities to generate large gifts from such high wealth individuals. Universities, in general, think the deterrence on giving would be high.
- Total bequests and donations to universities typically range between $8m to $15m per annum. Some universities as part of new strategic plans have identified as a key goal increased giving by staff, alumni and the general public. This goal is consistent with the Government's encouragement of the sector to diversify its revenue base. With increased pressure on discretionary revenue sources, donations are a key area of new revenue growth.
- Universities primarily invest donations, and utilise the earnings from those gifts, to support vital research, student scholarships and high profile appointments. So universities would strongly argue against any reduction of incentives to give, such as lowering the offset rate from 46.5 per cent to 38 per cent for high income individuals.

[9] If we assume nearly all gifts of $100,000 or greater are made by those on the highest marginal tax rate, it is likely total donations by people on a 46.5 per cent tax rate may be significantly greater than 40 per cent, given gifts of smaller amounts such as $50,000 will also be made by these people.

Horizontal inequity if the 46.5 per cent deduction rate is reduced

A basic principle of good tax design is horizontal equity: two people who earn the same income should pay the same amount of tax.

If high income earners can no longer deduct donations at 46.5 per cent the system becomes horizontally inequitable, penalising charitable giving. Consider two people, one who earns $200,000, and the other earns $300,000 and is benevolent, giving away $100,000 to a charitable organisation. Therefore, the two people have the same pre-tax disposable income of $200,000.

Under a good tax system both people should pay the same amount of personal income tax. However, under a fixed tax offset system set at 38 per cent, the $200,000 earner has a post-tax income of $133,543 whilst the generous person who gave $100,000 to charity has a post-tax income of $124,953. The generous person is $8500 worse off even though both people have the same pre-tax net income of $200,000. This produces horizontal inequities in the system.

Incentives to work and give for charitable purposes are inefficiently reduced

Under a 38 per cent fixed tax offset system, high income individuals face negative incentives to increase work effort and give the extra money to charitable purposes. As previously discussed, the person who earns $200,000 pa is $8500 worse off if she decides to work harder, earns an extra $100,000 and gives that extra money to a DGR entity. At the margin, every extra $1 earned and given away leaves her 8.5 cents worse off, or the effective marginal tax rate is 108.5 per cent. Such incentives are, in economic terms, highly inefficient.

A fixed offset system for high income earners may cost Government and society over $400m pa

We note Treasury analysis suggesting a fixed tax offset at 38 per cent may produce revenue savings to Government of around $135m pa because donations to DGRs would decline by around 5 per cent due to behavioural responses of high income earners.[10]

Such analysis is static, partial equilibrium modelling,[11] when what is required is a dynamic general equilibrium model of the situation to assess the full welfare effects of any such policy change. In particular, the Treasury modelling suggests $290m pa less will be donated to the NFP sector, resulting initially in a $290m reduction in supply of NFP services. A better model would identify the reduction in NFP supply, and assess whether the Government would step in to fill the gap in the provision of the NFP services.

If the Government did step in on a one for one basis:

The net cost to Government would be a loss of $165m, **not** a tax saving of $135m. The net cost to society would be about $400m from the tax increase required, given the increased excess burden or welfare loss from the Government having to raise $290m of additional tax revenue to fund its own substitute provision of NFP services.[12]

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[10] See NFP discussion paper at pages 26 and 27.

[11] The analysis, contrary to reality, changes one variable whilst holding all other parameters constant. It assumes if $290m less is given to essential and important charitable services such as providing food and shelter to needy people, that the Government will not step in and spend money filling the gap provided by the reduction in provision of essential services.

[12] The excess burden of income tax has typically been estimated at between 30 per cent and 50 per cent: every $1 of tax revenue raised causes a $1.30 to $1.50 economic cost to society from the distortion to consumer and producer preferences: the tax wedge preventing mutually beneficial trade occurring. See, for example, "The effect of taxes on efficiency and growth", NBER Working paper no 12201, by Martin Feldstein, 2006.

Here the government must raise an additional $290m of tax to fill the $290m reduction in NFP supply. Assuming tax excess burden running at 40 per cent, the total cost to society from the policy change that deters giving is $406m.

Alternatively, if the Government decided to spend on other things:

From society's perspective, the alternative spending by Government would need to generate 2.5 times the benefit per dollar than the 'lost' NFP spending, for the outcome to be net beneficial to society.[13] Such an outcome is unlikely. NFP spending in general will be better targeted because it reflects individual preferences and private sector supply.

In simple terms, private voluntary giving produces doubly charged benefits to society. Each $1 of giving costs the government only 46.5 cents of foregone tax revenue at most, and is likely to produce over $1 of benefit to society from the spending on worthy causes, and over 50 cents of benefit to the giver. It is unlikely the Government could do better by introducing tax measures to stop such giving, and instead spending the extra 46.5 cents tax take on other matters.

In summary, the 38 per cent tax offset for high income earners is inconsistent with the review's guiding principles:

- It decreases the social good by reducing donations from those on high incomes, where total welfare losses may be $400m or higher *(Inconsistent with Guiding Principle 1)*;
- It penalizes giving in Australia, decreasing the support provided to the NFP sector *(Inconsistent with Guiding Principle 2)*;
- It is unfair, departing from basic tax principles of horizontal equity *(Inconsistent with Guiding Principle 3)*;
- It is inefficient, providing negative incentives for people to work and give, and replacing private sector NFP services with lower value Government spending *(Inconsistent with Guiding Principle 5)*.

Reforms should focus on tax incentives to increase giving

The NFP Working Group should focus on providing enhanced tax incentives that encourage **increased** giving — because of the high society benefits from such giving. For example, a minimum deduction rate of 38 per cent, or more, for low and middle income earners, accompanied by a deduction rate of 50 per cent or more for high income earners is a worthy reform the Working Group should consider recommending.

As previously discussed, given a tax deduction rate set at 50 per cent, society's welfare is likely to increase by at least 50 cents per extra $1 given.[14] So enhanced tax incentives that encourage increased giving promotes the core guiding principles of the review by:

- maximising the social good *(Principle 1)*;
- recognising giving in Australia, providing a supportive environment that highlights the benefits of giving *(Principle 2)*; and
- enhancing economic efficiency, by directing resources to where they have a higher economic value-add *(Principle 5)*.

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[13] Government spending of $135m would need to generate benefits in aggregate greater than $290m of DGR spending and $54m of tax excess burden, or aggregate benefits exceeding $344m. The generalised formula is Government spending must generate benefits to society at least (1+ (excess tax burden x marginal tax rate))/(marginal tax rate) > the NFP sector spending it is replacing or society will be worse off.

[14] Each $1 extra of giving should generate at least $1 of public benefit from the increased NFP spending plus over 50 cents of benefit to the giver, or over 50 cents of economic value-add. For every extra $1 donated, the foregone Government tax revenue and spending would have needed to generate benefits at least 2.4 times the increased NFP sector spending, or society's welfare will increase from higher donations. There is good reason to presume the NFP spending will, in fact, generate superior benefits per dollar than government spending because of better targeting and private sector delivery efficiencies.

Goods and services tax concessions should continue

The NFP discussion paper discusses current goods and services tax concessions and asks (at Question 45) should current concessions continue to apply?

As charitable institutions, universities are endorsed to access concessional GST treatment on supplies made for nominal consideration. This concession allows universities to treat the supply of student accommodation as GST- free rather than input taxed.

Over the past decade universities have invested in excess of $1 billion in new building projects relating to the supply of student accommodation. The removal of concessional GST treatment:

- may trigger a claw back GST adjustment (which would presumably be in the tens of millions of dollars across the sector); and
- would also increase the cost base by 10 per cent on future residential supplies made by universities.

In addition, the rent paid under accommodation at Halls of Residence is generally GST free and an important concession for students and universities. Universities Australia, therefore, supports current concessional GST treatment, especially with student accommodation. Any reduction of such concessions would have a significant negative impact on university cash flows and inhibit their ability to provide affordable housing to students in the future.

Students from low income households[15] and regional areas tend to be important beneficiaries from the provision of low-cost accommodation. Hence, important equity objectives, including those of the current Government, are furthered by the current GST concessions.

Process to produce a final report

The NFP discussion paper is unclear on the further consultation process the NFP Working Group will undertake prior to the making of a final report to Government. We note the NFP Working Group is required by the terms of reference to "consult widely with the NFP sector".

We would encourage the NFP Working Group to produce a draft report, and allow sufficient time for consultations with the NFP sector and for stakeholders to develop further submissions, prior to any final report being produced.

Other issues

This paper raises a non-exhaustive list of some of the more important issues of interest to universities raised by the NFP discussion paper. The NFP discussion paper raises a large number of issues, and has provided limited time for initial responses to its extensive list of 57 questions. Universities Australia continues to consult with its members and may make further submissions to the current review depending on the outcome of such consultations.

We will be in contact shortly to arrange a convenient time to present the main points of our submission to the Working Group, and look forward to engaging in constructive discussions to promote effective tax reform that encourages giving and economic efficiency more broadly in the NFP sector.

[15] Low socio-economic status students are generally defined as falling in the bottom 25 per cent of income by households as currently measured by post code area.