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

in response to the Discussion Paper dated November 2012

17 December 2012

Table of Contents

Executive Summary

Mattila Lawyers is a boutique Australian law firm that specialises in the water, renewable energy and clean technology, agribusiness and carbon sectors. Mattila Lawyers has extensive experience acting for Government and private water service providers, advising on industry restructuring, converting large infrastructure schemes to local ownership, and structuring and setting up community owned projects. The firm's expertise spans legal, policy and regulatory advisory.

Many of Mattila Lawyers' clients own and operate significant infrastructure in the rural sector, particularly the water, agribusiness and renewable energy sectors. A number of our rural clients operate significant community owned and operated infrastructure that was privatised from Government. The infrastructure was past the end of its useful life when privatised but was nevertheless critical to the ongoing financial viability of those local communities.

Those communities have structured their community infrastructure operations around a dual co-operative and mutual structure with a view to financial sustainability, long-term infrastructure maintenance and renewal, and inter-generational equity. The dual mutual/ co-operative structure has allowed those communities operating irrigation infrastructure to establish cost effective sinking or common funds for whole of life asset maintenance and renewal. Harvey Water in Western Australia and Coleambally Irrigation are recognised as world leaders in their field for their long term financially sustainable approach to water infrastructure. Their long term viability is inherently linked to their dual mutual/co-operative structure.

The concept of mutual funds being the member's own money is recognised around the world. Mutuals and NFPs are often dealt with as if they are legally interchangeable, this is not correct – the two concepts are legally different.

We have limited our response to Chapter 5 of the Discussion Paper on Mutuality, Clubs and Societies.

KEY POINTS

1. Mutuals are not necessarily NFPs and NFPs are not necessarily legally mutuals. The two legal concepts should not be confused.

2. This section of the Discussion Paper seems to focus on making changes to the taxation legislation to address Government issues with a small number of clubs. The consequences of change would be out of proportion to the collateral damage caused to communities from the loss of access to important mutual structures used to address the loss of Government provided community services.

3. Mutuals are used around the World where Government is unable to provide critical infrastructure. The cost of number of the proposed changes would be a major disincentive to communities from providing and operating their own infrastructure.

Concerns about the principle of mutuality

While there are no questions in this section, we would like to make the following points.

The mutual sector is an important component of Australia's social and community capital. These organisations provide for self-funding of community support activities and infrastructure that in many cases can no longer be provided by government. Governments have encouraged communities to provide self funded key infrastructure and require them to restrict their reliance on government support. Community infrastructure in most cases cannot be operated by companies as there is insufficient or no profit margin. In most cases infrastructure services can only be successfully retained in rural and regional areas after Government withdraws by utilising the members own money in a mutual structure.

Irrigation infrastructure ownership in Australia and the issue of run down infrastructure and no sinking or common funds

Many of Mattila Lawyers' clients own and operate significant infrastructure in the rural sector, particularly the water, agribusiness and renewable energy sectors. Most have structured their operations as co-operatives or mutuals. Community infrastructure operators and owners utilise a low cost dual co-operative and mutual structure. The mutual structures assist rural communities with financially sustainable, long-term infrastructure maintenance and renewal and inter-generational equity.

The dual co-operative/mutual framework was chosen by a number of rural irrigation communities because it provides a range of benefits:

- The aim of locally owned irrigation infrastructure owner-operators is to achieve the best annual total cost of irrigation water consistent with the provision of efficient irrigation infrastructure and services over the long term. They need to balance the short-term business priorities with long-term financial sustainability and asset maintenance and renewal.

- It is unlikely that locally owned irrigation infrastructure owner-operators would be able to build new irrigation assets as significant borrowings are almost impossible. This system allows the members to raise their own funds and own the unencumbered assets that are acquired with accumulated funds.

- Borrowing, if available, would place the burden of funding the debt on one generation, whereas a mutual sinking or common fund is more consistent with the fact that the use of the assets will cross several generations (inter-generational equity).

- The structure provides a more stable financial structure for the irrigation scheme. The assets are not in the hands of an operating entity and subject to operating risks.

- The structure introduces a series of checks and balances in relation to asset maintenance and renewal expenditure. The mutual board has a long term focus

and is obligated to maintain the infrastructure for the long haul, as against short-term operating considerations.

- The structure addresses the issue of asset maintenance and renewal expenditure spikes without risking the viability of the common fund. Recent history is littered with problems of run down Government and former Government infrastructure with no sinking funds, e.g. NSW railways, California electricity, UK water companies. Government owned irrigation infrastructure assets have not historically been adequately maintained and any sinking funds are at risk of being raided for dividends to Treasury. In 1997, while in NSW Government ownership, Coleambally Irrigation had to pay its entire sinking fund of $17.6 million to the NSW Government as a dividend.

- The dual structure addresses the traditional problems associated with infrastructure assets. These problems are mainly caused by the failure to provide for the long term viability of the assets due to the pressures of short term issues of the day-to-day operations.

The need to provide a cost effective form of operating and financing rural and regional community infrastructure is recognised around the World. An example is the recognition of mutuality for irrigation infrastructure by specific legislation in the USA (Internal Revenue Code 501(c)(12)). Legislative recognition is necessary as the USA operates on a civil law system.

The continued operation of irrigation schemes and other key rural infrastructure is essential to ensuring the livelihood of the members of the community.

Our irrigation clients have established 50 – 100 year asset maintenance and renewal schedules for their irrigation schemes in Australia. Each scheme, to a greater or lesser degree, has an expenditure spike of between 10-20 times normal expenditure approximately every 20 years. These expenditure spikes make it difficult if not impossible to fund irrigation schemes through standard company arrangements, as it is unlikely that there would ever be a return on capital within the foreseeable future. In the majority of cases it is not possible to fund these expenditure spikes through major debt funding within Australia.

It should be noted that irrigation schemes that were converted into a standard company structure have been unable to borrow to fund their infrastructure requirements and have significant financial problems and aged infrastructure. All dual structure co-operative/mutuals are debt free and have modernised their infrastructure.

Sinking or common fund contributions result in a system whereby members pay an amount closer to the true cost of water rather than forcing the next generation to borrow to cover the costs of the current generation. Over time, the mutuals must raise the full amount of funds necessary to cover the expenditure spike. Debt funding is impossible to raise to any significant extent as irrigation schemes do not have assets that are suitable as security for borrowing.

The clear mandate of the mutual is to fund these expenditure spikes with the lowest possible cost of funds and provide for the maintenance and capital works program.

Benefits for community:

- Often irrigation infrastructure owners have inherited the assets from government and are responsible for redressing decades of government neglect.

- The irrigation replacement and renewal program is fundamental in reducing transpiration and transmission losses in the Murray-Darling Basin. Channel improvements reduce seepage and help to reduce losses in over-allocated waterways. Channel upgrading is critical to reducing rising groundwater and salinity problems and other environmental damage caused by poorly maintained irrigation infrastructure.

Key points

- Mutuals are important legal structures that have a long history under the common law. Not all mutuals are NFPs. Mutuals unlike NFPs allow for the return of members own money on winding up. Alternatively like NFPs they may allow members on winding up to direct their funds to a third party NFP.
- As Governments withdraw from the provision of key community services, mutuals provide an increasingly important legal structure for rural and regional communities to establish, own and continue to operate crucial community infrastructure.
- The benefits to the community of maintaining access to genuine mutual structures for infrastructure and community services, will far outweigh any short term gain to revenue caused by changes to taxation legislation.

2. Reform Option 5.2: Extend the Mutuality Principle

Q52. Should the mutuality principle be extended to all NFP member-based organisations?

In our view mutuals and NFPs are legally and structurally different entities.

Many of the problems that both types of organizations face are caused by the assumption that mutuals are NFPs and NFPs are mutuals.

Justice Hill in *Coleambally Irrigation Mutual Co-operative Limited v FCT* [2004] FCA 2 took the view that where the members of an organisation are prevented from obtaining the value of the assets of the organisation on winding up, then the organisation cannot be for their mutual benefit, and the principle of mutuality cannot apply. In Justice Hill's view a mutual could never be a NFP.

Justice Hill noted during the hearing that strata title common funds fitted the concept of mutuality as they consisted only of their members own money.

On 7 September 2004 the Full Federal Court dismissed an appeal by Coleambally Irrigation Mutual Co-operative Limited. The Income Tax Assessment Act was amended by Tax Laws Amendment (2005 Measures No. 6) Bill 2005 that re-instated the generally accepted view in Australia and around the world that a mutual may have a NFP winding up rule while still complying with the common law principles of mutuality.

Mutuals are part of the common law built up over two hundred years, with a heritage that goes back to the earliest forms of life assurance developed by the Roman legions and mutual irrigation schemes established in Ancient Sumer. Mutual or common funds are members own money and those funds obviously do not fall within the definition of income.

NFP's tax status is a construct of legislation.

Key points

- Mutuals should maintain their existing common law status - a mutual or common fund is the member's own money.
- NFP's do not usually manage and operate a transparent common fund consisting only of member's money - a prerequisite to mutuality.
- NFPs should continue to be subject to their own separate status.
- NFPs tax status is currently "cherry picked" based on whether their area of operation is considered to be "worthy".
- NFP's are not necessarily mutuals and vice versa and the two should not be legally confused for tax purposes.

3. Reform Option 5.3: Repeal the Common Law Principles and Legislate a Narrower Principle

Q53. Should the mutuality principle be legislated to provide that all income from dealings between entities and their members is assessable?

Mutual funds are the members own money, those funds are retained in a common fund. Mutuals are now stepping into the void left by the exit of government services from rural and regional communities.

The importance of mutuals is only just being accepted at a political level in Australia as a method of providing services in rural and regional Australia.

It is important to note that the rural USA only developed when co-operatives and mutuals were supported as part of the New Deal. During the Depression rural towns in the USA had few if any Government provided services; approximately 90% of rural towns in the 1930s had no electricity, running water or telephone utilities. The USA is a civil law country, Franklin D Roosevelt introduced laws support for electric, telephone and water services operated by community owned mutuals and co-operatives. To this day many of those mutuals and co-operatives established as part of the New Deal still exist and provide millions of Americans with key low cost infrastructure services. In the USA there are:

- 3,300 water co-operatives/mutuals;
- 260 telecommunications cooperatives/mutuals;
- 864 electricity distribution cooperatives/mutuals and 66 generation and transmission co-operative/mutuals.

  Source: University of Wisconsin Center for Co-operatives website "Research on the Economic Impact of Co-operatives"

Legislating narrower mutuality principles than the existing common law will reduce the ability of communities to proactively address the loss of Government services. The cost to Government of restricting the ability of mutuals to self fund community assets will far outweigh any marginal increase in taxation revenue.

Key point

- Common law mutuals should not be disadvantaged due to Governments perceived political problems with some clubs.
- Common law mutuals fill a critical gap left by the ongoing exit of Government from providing community infrastructure

Q54. Should a balancing act adjustment be allowed for mutual clubs and societies to allow for mutual gains or mutual losses?

The proposals if implemented are entirely focused on the issues surrounding a relatively small number of clubs which in many circumstances may be not-for-profit but do not necessarily comply with common law principles of mutuality.

The proposals if adopted present the risk of genuine mutuals and NFP organizations being collateral damage to the Governments attempt to rein in a small number of clubs.

We do not support the proposal for a balancing adjustment for mutual gains and losses as mutuals are only taxed on their very limited non-member income and as a result any accumulated losses present little loss to revenue to the Commonwealth.

Key point

- We do not support a balancing adjustment form mutual gains and losses.

4. Reform Option 5.4: Enact Anti-Avoidance Rules, or Enforce the Principle More Strictly

Q55. Is existing law adequate to address concerns about exploitation of the mutuality principle for tax evasion? Should a specific anti-avoidance rule be introduced to allow more effective action to be taken to address such concerns?

Instant memberships can easily be dealt with by requiring all members to sign an application for membership that must be approved by the board or by the general manger by delegation of the board before a person can be admitted to membership.

These problems often arise because a number of clubs were forced out of the Co-operatives Act which always required this process and into the (now) Corporations Act. The Commonwealth and NSW Government policy in the 1990s of attempting to force all incorporated entities into the Corporations Act has created this problem.

Key points

- All proposed members of clubs should be approved by the Board or by the general manager by delegation of the Board.