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Submission in response to the Australian Charities and Not-for-profits Commission Bill 2012 Exposure Draft

Open Universities Australia Pty Ltd ("OUA")

Proposed Amendments to Exposure Draft

To ensure that the proposed changes to the law are aligned with the principle that entities can distribute to members only for the purposes of the subsidiary's public interest objectives we propose the insertion of an extended definition of NFP entity into the revised version of the ACNC Exposure Draft and the in Australia Exposure Draft. For example:

A Not For Profit entity is as an entity that:

(i) does not carry on its activities for the purposes of profit or gain for particular entities, including its owners or members ("other entities"), either while it is operating or upon winding up;

and

(ii) does not distribute its profits or assets to other entities, either while it is operating or upon winding up;

unless,

the other entities are registered entities or are entitled to be registered [and have same objects].

1. Introduction

This submission is made by Open Universities Australia with the assistance of Ernst & Young.

OUA is a charitable institution that may be adversely affected by the *Australian Charities and Not-for-profits Commission Bill 2012* Exposure Draft ("ACNC Exposure Draft") and the Exposure Draft of the Tax Laws Amendment (2011) Miscellaneous Measures) Bill (No. 1) 2011 ("in Australia Exposure Draft"),[1] (collectively "the Exposure Drafts").

Broadly, the Exposure Drafts prohibit an entity which can distribute its profits or assets to its owners or members from being registered as a not-for-profit ("NFP") entity, even if it has public benefit purposes, the owners or members have the same public benefit purpose, and the distributions are solely for the shared public benefit purposes.

We submit that this approach is unnecessarily narrow and, if enacted, will impose a significant commercial impediment for the development of the operations of OUA and similarly structured NFP

[1] Although the submissions for the in Australia Exposure Draft closed on 12 August 2011, the then Assistant Treasurer Bill Shorten flagged in a speech to the Australian Charity Law Association Annual Conference on 23 September 2011 that a new exposure draft of this legislation would be released subsequently. Accordingly, this submission discusses both the Exposure Draft and the in Australia Exposure Draft.

entities. Further, there is no sound basis for seeking to encourage NFP entities to conduct operations and donate funds to other endorsed NFP entities but penalise NFP entities that effectively do the same by paying dividends to the same endorsed NFP entities.

Rather, the current law should be retained so that a charitable entity can be endorsed/registered notwithstanding that it can make distributions to owners or members provided those owners or members:

- have the same objects as the payer entity; and
- are registered or entitled to be registered as NFP entities.

We note that the in Australia Exposure Draft provides that an entity is not a NFP if it carries on its activities "for the purposes of profit or gain for particular entities". We read this provision as applying where the profit or gain is intended for particular entities, rather than where the activities are carried on for the purposes of profit or gain for the public benefit purpose of the entity. This interpretation is consistent with the statement in paragraph 1.78 of the Explanatory Materials to the in Australia Exposure Draft, which states that:

> the fact that a not-for-profit entity may make a profit does not negate its not-for-profit status so long as the profit is applied to the not-for-profit purposes of the entity and the profit does not accrue to the benefit of identifiable members either directly or indirectly.

Please let us know if our interpretation is incorrect, so that we can make further submissions on this provision.

2. Proposed Changes

Under the ACNC Exposure Draft registration by the Commissioner of the ACNC ("ACNC Commissioner") is a necessary prerequisite to obtaining income tax exempt ("ITE") or deductible gift recipient ("DGR") status.

A requirement of ACNC registration is that the entity must be a NFP entity.[2] The ACNC Exposure Draft does not define NFP entity.[3] However, paragraph 1.13 of Chapter 2 of the Explanatory Materials to the ACNC Exposure Draft ("Explanatory Materials") states that:

> An entity will only meet the definition of a NFP if it:
>
> - does not carry on its activities for the purposes of profit or gain for particular entities, including the owners or members, either while it is operating or upon winding up; and
> - does not distribute its profits or assets to particular entities, including its owners or members, either while it is operating or on winding up.

Similarly, the in Australia Exposure Draft proposes a new definition of "not-for-profit entity" that will be relevant to the endorsement of ITE entities or DGRs under the Income Tax Assessment Act 1997 ("ITAA97") as follows:

> ***not-for-profit entity*** means an entity that:

[2] Exposure Draft, Section 5-10(1A)(a).
[3] s 5-10.

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(a) does not carry on its activities for the purpose of profit or gain for particular entities, including its owners or members, either while it is operating or upon winding up; and

(b) does not distribute its profits or assets to particular entities, including its owners or members, either while it is operating or upon winding up.

If these proposals are implemented, an entity that pays dividends or distributes assets on a winding up to its members will not be entitled to endorsement as ITE entities or DGRs. This will be the case even if the member receiving the moneys/assets is endorsed as an ITE charitable institution.

Thus, there is the potential for an illogical outcome where an entity paying funds on a winding up to an ITE charitable institution that is not a member of the entity will not be precluded from endorsement, whereas endorsement will be precluded for an entity making a payment of the same nature to an ITE charitable institution that is a member of the entity.

3. OUA's position

OUA is an Australian limited liability proprietary company established for, and carried on for, the purpose of advancing education. It is currently endorsed as an ITE charitable institution.

It has seven members (shareholders), all of which are endorsed tax-exempt charitable institutions established for, and carried on for, the purpose of advancing education.

Under OUA's Memorandum of Association, the income and property of OUA must be applied solely towards OUA's objects. Subject to this requirement:

- dividend distributions can be made to members of OUA that are endorsed as ITE charitable institutions; and
- distributions of any property or assets remaining on a winding up can be paid to or distributed equally among those members which are ITE entities at the time of allocation.

Consistent with current law, the ATO has accepted by way of private binding ruling dated 6 May 2011 that OUA meets the requirements of a charitable institution for the purpose of section 50-5 (Item 1.1) of the ITAA97. It is stated in the ruling by way of support for this position:

> Distributions of profits, or the potential for an entity to distribute profits, from a commercial activity to the entity's owners or members will not always result in a private benefit to the owner or member....
>
> OUA has a sole charitable purpose; it may distribute its profits or surplus to members, but only to effect a charitable purpose of advancing tertiary education. Whilst its ownership is not limited to educational charities, clauses 3(ii) and 3(iv) of its MoA require that payments be made to endorsed charities (that is, payment by way of dividends and as surplus on winding up), and clause 3 (i) requires that the whole of the income and property of the Company must be applied to its objects. It is not considered that the ability to make payments to members indicates that OUA has a purpose of providing private benefits to its shareholders.

However, the position of OUA and like NFP entities has been put in doubt by the release of the Exposure Drafts. There is a significant risk that OUA would lose its entitlement to ITE endorsement if

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the Exposure Drafts were enacted in their current form. This would be an anomalous outcome given that:

- the sole purpose of OUA is charitable;
- its constituent documents allow it to distribute its surplus or profit to another entity only in order to effect that sole charitable purpose; and
- its constituent documents restrict potential recipients of the surplus or profit to charitable entities that have the same charitable purpose as OUA.

4. Submission

It is submitted that ITE and DGR endorsement/registration should not be precluded merely because an entity can make distributions to members provided that the recipient members are endorsed/registered NFP entities and have the same objects as the payer entity as:

- this position reflects the current law;
- the review of the NFP regime was not intended to impose further limitations on entitlement to endorsement for ITE or DGR purposes;
- it is inconsistent to encourage NFP entities to make donations but preclude dividend payments to entities that could receive donations;
- NFP entities such as OUA that are currently endorsed will lose endorsement and therefore be disadvantaged;
- the proposed amendment will have the effect of forcing entities to pay out taxed income by way of dividend and therefore limit the ability of the payer entity to reinvest in its public benefit activities; and
- the proposed amendment will cause NFPs to reconsider investing with a conglomerate of NFPs into a joint venture entity formed to carrying on the investor entities objects.

5. Proposed law inconsistent with current law

It is submitted that, in terms of the issue to which this submission relates, the Exposure Drafts are inconsistent with the current legal understanding as to what is a charitable institution.

The Commissioner of Taxation has acknowledged in Taxation Ruling TR 2011/4 that an entity making distributions can be charitable (at paragraph [243]):

> On the basis of the decision in *Word Investments*, critical questions in circumstances similar to those considered in that case are whether the institution has charitable as opposed to purely commercial objects, and whether the application or distribution of profits is in furtherance of those charitable objects. The fact that the recipient could be an owner or member of the institution does not alter the characterisation of the institution as long as:
>
> - the sole purpose of the institution making the distribution is charitable;

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- its constituent documents allow it to distribute its surplus or profit to another entity or entities in order to effect that sole charitable purpose; and
- its constituent documents restrict potential recipients of the surplus or profit to charitable entities that have a similar charitable purpose as the institution itself.

> In these circumstances, the Commissioner will accept that the distribution of profit is not for the private benefit of the members or owners but for the benefit of the public generally.

The current reform process has been put in to place to, among other things, ensure that the current legal interpretation of what is meant by the term "charitable" reflects contemporary society and its charitable needs. This was in the expectation that the term could have a broader application than previously contemplated. The purpose of the process was not to impose a limitation on that meaning that does not currently exist.

Further, there is no policy reason to limit the meaning of charity in the manner contemplated. If an entity has charitable objects and pays moneys by way of donation or dividend to another NFP entity with the same objects there is no disadvantage to the revenue and, more importantly, there is a continuing investment in the charitable purpose that underpinned the activities.

6. Inconsistent to purport to encourage donations but preclude dividends

The ACNC Exposure Draft explains that the reforms by the Government are intended to:

> encourage charities to direct profits generated by unrelated commercial activities back to their charity's altruistic purpose. NFP entities will pay income tax on profits from their unrelated commercial activities that are not directed back to their altruistic purpose, that is, the earnings they retain in their commercial undertaking.[4]

Further, the Explanatory Materials for the in Australia Exposure Draft contemplate that an entity can be a NFP entity if it "advances its charitable purposes by undertaking commercial activities with the purpose of generating surpluses that are donated to another entity with similar charitable purposes" so long as the donee is endorsed as income tax exempt.[5]

Given the proposed dividend prohibition, it appears that NFPs are being encouraged to donate funds for their altruistic purposes. From a policy perspective it should make no difference whether an amount is paid to another NFP entity by way of dividend or donation. However, from a commercial perspective it is a significant issue as NFP entities that invest in NFP entities would prefer to be able to be confident that any excess funds will be returned to them to invest in their charitable purposes rather than be able to be paid by way of donation to another charitable entity.

To the extent that the NFP reforms are intended to wind back the operation of the High Court's decision in *Commissioner of Taxation of the Commonwealth of Australia v Word Investments Limited*[6] ("Word Investments"), we note that in *Word Investments,* the entity did not carry out any of its own public benefit purposes, but rather merely carried out unrelated commercial activities. This is distinct from the situation of OUA, which carries out its educational purposes through its own activities,

[4] Explanatory Materials, Chapter 1, paragraph 1.42.
[5] Explanatory Materials to in Australia Exposure Draft, paragraphs 1.60 to 1.67.
[6] [2008] HCA 55; (2008) 236 CLR 204; 70 ATR 225; 83 ALJR 105; 251 ALR 206; 2008 ATC 20-072; [2009] ALMD 1206; [2009] ALMD 1207.

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which are of public benefit and recognised to be charitable in nature. That is, OUA on a standalone basis, having regard to its own activities and ignoring any distributions or donations made to other entities, is a charitable institution with independent charitable activities (unlike *Word Investments*). The option to make payments to members who also have educational purposes is only another way for OUA to carry out its own educational objects.

7. Public benefit test satisfied

It is submitted that the fact that an entity with charitable or other public benefit objectives can pay dividends to members which are also NFP entities (but only for the objects of the entity making the distribution) does not meant that the entity paying the dividend ("paying entity") no longer provides a public benefit, so long as the making of a profit and the potential to pay such dividends is ancillary to the primary purposes of the paying entity (being its charitable or other public benefit purposes).

It is apparent that in circumstances where any dividends can only flow to charitable entities with the same purposes, and the dividend is paid for the public benefit purposes of the paying entity, the entity paying the dividend is still operating for the benefit of the public.

8. Currently endorsed entities disadvantaged

Having regard to the inconsistency of the proposed provisions with the existing law, it is likely that NFP entities such as OUA that are currently endorsed would lose endorsement if the Exposure Drafts are enacted, and therefore would be disadvantaged by the new laws.

These entities have been operated on the basis that any profits can be returned to the shareholder NFP entities by way of dividend. The proposed amendments would mean that the commercial understanding between the shareholders and subsidiaries would have to change as the dividend paying entity would become taxable and therefore would have to:

- plan their tax affairs to have no profit (eg by way of donation);
- pay up dividends to shareholders at a time when they might not have otherwise done so (eg because funds required to continue commercial operations) to ensure that franking credits are not trapped in the paying entity;
- not pay up a dividend and therefore have the tax expense trapped in the entity and therefore not being available for the charitable purposes; and/or
- some other action.

We submit that this is not an intended consequence of the in Australia Exposure Draft, the Explanatory Materials to which refer to the new law standardising the definition of NFP.[7]

[7] Explanatory Materials to in Australia Exposure Draft, paragraph 1.82.

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9. Forced dividend payments not in interest of payer entity

The removal of the dividend restriction merely gives NFP entities more flexibility to meet their objectives. The ability to pay a distribution to a member who has the same public benefit purposes allows the paying entity to contribute to current or proposed programs which have been or will be established by its members, where these programs are consistent with the paying entity's objectives. This prevents duplication of effort by the subsidiary and is a more efficient and economical way to meet the entity's advancement of its public benefit objectives. The condition that dividends can only be paid to further the entity's purposes demonstrates that commercial gain is, at most, an ancillary purpose for the entity to enable it to meet its public benefit objectives.

It is recognised that if the entity making the distribution was not an ITE entity but the member entities were, the member entities would be able to indirectly recover the tax paid by the paying entity. This is because even if the paying entity is not an ITE entity, it could pay income tax and then frank its dividends, and the member entities (as ITE entities) would be able to obtain tax refunds for the franking credits.

Prima facie, it could be argued that the ultimate outcome for the (member) NFP entity is identical (assuming that a paying entity only has ITE members which are able to recover the full franking credit). However, this assumes the paying entity will distribute all of its profits each year, and creates disincentives for the paying entity to retain profits for its own (public benefit) purposes. This is not preferable as it means that the paying entity would be heavily limited in the public benefit which it is able to undertake without retained profits. Alternatively, if the paying entity decided not to distribute all its profits, it would have tax expenses trapped, which would then be unavailable for use by the paying entity or its ITE members for public benefit purposes.

Further, assuming that the paying entity could in any case distribute all profits in a franked dividend, there is no gain to the government in prohibiting distributions, as the net effect would be the same. Conversely, there would be administrative disadvantages for the paying entity, which would be required to keep a franking account and otherwise comply with the franking rules. The members would also have a timing disadvantage in that they would have to seek refunds of the franking credits, and therefore would receive the refund amount in a subsequent income year rather at the time that the dividend is paid.

Accordingly, we submit that the proposed provisions will have adverse consequences for certain ITE entities such as OUA who have members which are also ITE entities, without any substantive consequential benefit for the Government. Conversely, the amendments that we propose (set out below) are unlikely to lead to substantial loss of revenue for the Government, having regard to the fact that there are relatively few NFP entities which have members with the same NFP objects, but will give NFP entities more flexibility in the way that they meet their public benefit objectives.

10. Block investment opportunities into NFP joint venture entities

Entities such as OUA are formed when a number of charitable entities with the same objects see the benefits of investing together to achieve more. That is to extend the benefits of their charitable operations.

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The advantage of a structure like that of OUA is that it enables a group of ITE entities to work together in what is, effectively, an incorporated joint venture carried on for a public benefit purpose. The ITE members can contribute capital to the venture and recover funds from the venture for its own (public benefit) purposes.

The proposed law would result in impediments to joint venture activities in the charitable sector. Entities looking a JV opportunities would have to make a decision on whether the entity should be ITE (in which case they would have to give up the right to receive distributions of profits) or taxable (in which case there would be the timing disadvantage of having tax paid before franking credit refunds can be claimed and the disadvantage of the payer entity not being able to retain funds for ongoing operations without tax payments being trapped in the entity).

Thus, if the law is changed so that entities such as OUA are unable to distribute profits to members which share its public benefit purpose, this will deter NFP entities from acting jointly in carrying on the NFP entities' purposes, and, would present a commercial impediment to NFP entities who want to combine forces to achieve their public benefit purposes.

11. Proposed amendments

To ensure that the proposed changes to the law are aligned with the principle that entities can distribute to members only for the purposes of the subsidiary's public interest objectives we propose the insertion of an extended definition of NFP entity into the revised version of the ACNC Exposure Draft and the in Australia Exposure Draft. For example:

A Not For Profit entity is as an entity that:

(i) does not carry on its activities for the purposes of profit or gain for particular entities, including its owners or members ("other entities"), either while it is operating or upon winding up;

and

(ii) does not distribute its profits or assets to other entities, either while it is operating or upon winding up;

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27 January 2011