

Charities Alert May 2011

Taxing charities for conducting commercial activities

In the 2011-12 Federal Budget, the Government announced that it will change the tax concessions provided to not-for-profit (NFP) entities. The changes will affect certain charities and other NFP entities that conduct commercial activities.

The Government has proposed that the new arrangements will commence on 1 July 2011. Broadly, they will initially affect new 'unrelated' commercial activities that commence after 7.30pm (AEST) on 10 May 2011.

The purposes of this alert are to:

- outline the key features of the Government's proposal that will affect charities that conduct commercial activities; and
- analyse the key issues raised in the Government's proposal.

Background

In *Commissioner of Taxation v Word Investments Limited* [2008] HCA 55, the High Court of Australia, by a majority of 4:1, held that a company undertaking commercial activities can be a charitable institution and exempt from tax. This is as long as all of the following conditions are met:

- the company's main purposes and objectives are charitable;
- the company's profits are raised for charitable purposes and directed to charitable institutions;
- the charitable institutions (that the funds are directed to) are obligated to use the funds for charitable purposes; and

- the company itself has a physical presence in Australia and it incurs its expenditure and pursues its objectives principally in Australia.

The decision left open the possibility that a support entity of a charitable group conducting commercial activities, if it provides financial support to that charitable entity, could be tax exempt.

In *Australia's Future Tax System – Report to the Treasurer (Henry Tax Review)*, it was recognised that the *Word Investments* decision means that charities have a significantly larger scope to undertake commercial activities on a concessionally taxed basis than before that case was decided¹.

The Henry Tax Review recommended that² NFP entities that currently receive income tax or GST concessions should retain these concessions. In addition, NFP entities should be permitted to apply their income tax concessions to their commercial activities. This would reflect the principles of the *Word Investments* decision.

Despite the Henry Tax Review recommendation, the Government proposed in the 2011-12 Federal Budget to restrict the use of tax concessions by businesses run by charities, such as the type of commercial activities in *Word Investments*. The Government's proposal would also affect charities which only have relatively minor commercial activities.

The Government proposed to change this area of law because³:

- the Government believes it is important that charities use their tax concessions only to assist disadvantaged people and not for 'unrelated' commercial activities; and

¹ Treasury (2010), *Australia's Future Tax System – Report to the Treasurer*, at 208

² Treasury (2010), *Australia's Future Tax System – Report to the Treasurer*, at 211 (Recommendation 42)

³ Assistant Treasurer's Press Release No.077 (10 May 2011) – Making it easier for charities to help those who need it

- the Government considers that the change will encourage charities to direct profits generated by 'unrelated' commercial activities back to the charities' altruistic purposes.

Key features of the Government's proposal

The key features of the Government's proposal are outlined below.⁴

Which entities will be affected

The proposed changes will affect the tax concessions provided to NFP entities (including charities).

What tax concessions will be affected

The tax concessions affected under the proposal are:

- income tax and capital gains tax (**CGT**) exemptions;
- fringe benefit tax (**FBT**) exemptions and rebate;
- goods and services tax (**GST**) concessions; and
- deductible gift recipient (**DGR**) support.

Activities that will attract tax concessions

Income tax and CGT exemptions for charities will continue to apply to profits or gains generated by any of the following activities:

- non-commercial activities;
- related commercial activities (ie commercial activities that further the charities' altruistic purpose. These include not-for-profit hospitals, op-shops that sell second-hand household items and clothing at discounted prices to those in need, NFP child care centres, and businesses whose purpose is to provide meaningful employment to disabled persons);
- unrelated commercial activities in which profits or gains are directed back to the charity to carry out its altruistic work;
- small scale and low-risk unrelated commercial activities (eg lamington drive fundraisers, school fetes and leasing out of church halls);
- unrelated commercial activities that exist as at 7.30pm (AEST) on 10 May 2011; or

- activities under a government service delivery contract entered into by charities as at 7.30pm on 10 May 2011.

As with income tax and CGT exemptions, charities will continue to have access to the FBT exemptions or rebate, GST concessions, or DGR support in relation to the above activities.

In respect of the unrelated commercial activities that exist as at 7.30pm on 10 May 2011, charities will initially be able to continue to use their tax concessions to support these activities. However, the Government will consult on the transitional arrangements for these activities. The Government intends to phase out the tax concessions in relation to these activities over time.

Activities that will not attract tax concessions

From 1 July 2011, even though a charity has its tax concession charity endorsement, the charity will still be required to pay income tax on profits and CGT on capital gains from the charity's activities that meet all of the following conditions:

- the activities are new unrelated commercial activities that commence after 7.30pm (AEST) on 10 May 2011;
- the profits or gains from the activities are not directed back to the charity's altruistic purpose (eg earnings that the charities retain in their commercial undertaking); and
- they are not small scale and low-risk unrelated commercial activities.

In respect of the activities that meet the above conditions, in addition to not having access to income tax and CGT exemptions, the charities will also not have access to the FBT exemptions or rebate, GST concessions, or DGR support.

The charities' tax concession charity endorsement and DGR endorsement (if they are also DGRs) will not be affected even if the charities carry out activities that meet the above conditions. Although these charities can still keep their tax concession charity endorsement, they will still have to pay tax in respect of the activities that meet the above conditions.

⁴ Assistant Treasurer's Press Release No.077 (10 May 2011) – Making it easier for charities to help those who need it; Federal Budget 2011-12 Paper No.2

Key issues raised in the Government's proposal

Some of the key issues raised in the Government's proposal are discussed below.

Commercial vs non-commercial activities

Charities will need to determine which of their activities are commercial.

This raises the following issues:

- are activities such as property development, investing in passive investments, and renting out properties, 'commercial activities'? How will investment activities be distinguished from commercial activities? In the income tax area, if a taxpayer develops and sells property, there is an issue of whether the taxpayer is carrying on a business. This area of law is often difficult to apply;
- does the determination depend on the size and scale of the activities, and if so, how?
- if the activities amount to a 'business' for income tax purposes or an 'enterprise' for GST purposes, would these activities be commercial?
- if a charity is set up as a group of companies limited by guarantee, will services provided by a company in the group to other group companies be commercial activities? Should all revenue from related party activities be excluded from commercial activities revenue?

Related vs unrelated commercial activities

In respect of the charities' commercial activities, charities will need to determine which of these are related, and which of these are unrelated to their altruistic activities.

Related commercial activities are the ones that further the charities' altruistic purpose. The Government gave examples of related commercial activities, which include:

- not-for-profit hospitals;
- op-shops that sell second-hand household items and clothing at discounted prices to those in charitable need;
- NFP child care centres, and

- businesses whose purpose is to provide meaningful employment to disabled persons.

Presumably, in determining whether the charities' commercial activities further their altruistic purposes, they can seek guidance from the existing case law on what purposes are charitable purposes.

For example, in the High Court of Australia decision in *Aid/Watch Incorporated v Commissioner of Taxation* [2010] HCA 42, it was held by majority that an organisation involved in promoting and campaigning for effective foreign aid policies through the generation of public debate was a charitable institution for tax exemption purposes.

The Court stated that the lawful generation of public debate concerning the efficiency of foreign aid directed to the relief of poverty is a purpose beneficial to the community.

The majority also stated that there is no broad general rule excluding 'political objects' from charitable purposes. As *Aid/Watch's* activities contributed to the public welfare, it was entitled to be regarded as a charitable institution.

An implication of the *Aid/Watch* decision is that there would be instances where political lobbying would not be considered to be a charitable purpose. In the Australian Taxation Office (ATO)'s Decision Impact Statement on the *Aid/Watch* decision, the ATO stated that the generation of public debate about subject matters not falling within the four charitable heads does not fall within the majority's decision and reasoning.

So, for example, the taxability of revenue from commercial activities used to fund what may be considered to be 'political objects' would depend upon the precise characterisation of those activities relating to 'political objects'.

Also, difficulties may arise in determining whether commercial activities are in furtherance of charitable purposes. In the ATO's draft Taxation Ruling TR 2011/D2, the ATO provided some limited guidance through examples.

In paragraphs 80 to 81 of the ruling, the ATO gave an example of commercial activities that further a charitable purpose. In this example, a company has the purpose of encouraging the Christian faith by conducting evangelistic services and other religious gatherings, bible study, and the production and distribution of evangelistic literature. However, the company does not undertake any of these activities, but carries on a commercial activity of selling

musical instruments and recordings to generate funds for an unincorporated association that is an endorsed charity established for the advancement of religion. The unincorporated association conducts the religious services and other religious events.

The ATO considered that the company's commercial activities are merely a means to give effect to its charitable purpose.

In the Henry Tax Review, it was recognised that the distinction between a related and an unrelated commercial activity could be contentious. The Henry Tax Review gave an example that the Seventh Day Adventist Church has publicly argued that the sale of vegetarian products by their Sanitarium business advances the tenet of vegetarianism advocated by their religion⁵.

New vs existing unrelated commercial activities

The change will affect new unrelated commercial activities that commence after 7.30pm (AEST) on 10 May 2011.

There is an issue of whether a change to any existing unrelated commercial activity or government contract in existence before 7.30pm (AEST) on 10 May 2011 could cause the activity or contract to become a new activity, and so the new rules would apply to the activity.

Small-scale and low-risk unrelated commercial activities

In respect of the charities' 'small-scale and low-risk unrelated commercial activities', tax concessions will still be available. The issues include:

- must an activity be both small-scale and low-risk for tax concessions to be available?
- why would 'low-risk' be a factor in deciding whether tax concessions would be available?
- what are 'small-scale and low-risk' unrelated commercial activities? The Government did not give much guidance, other than giving examples of 'small-scale and low-risk activities' which include lamington drive fundraisers, school fetes and leasing out of church halls. Does this mean that leasing out a portfolio of properties could be unrelated commercial activities that are subject to the taxing regime?

Directing profits back to charities for their altruistic work

In respect of unrelated commercial activities in which profits are directed back to the charities to carry out their altruistic work, the charities will continue to have tax concessions.

Charities may want to invest the profits from the unrelated commercial activities before they direct them back to carry out their altruistic work. Relevant issues include:

- how quickly do the charities need to direct these profits back to their altruistic work, so that the charities will have tax concessions in respect of the unrelated commercial activities (eg would two years be soon enough)?
- how to trace the charities' funds relating to profits derived from a particular activity;
- if a charity is set up as a group of companies limited by guarantee and one company provides administrative services to others in the group, will those administrative services be commercial activities and, if so, what will be necessary to show that the profits are directed back to the charity's altruistic work?
- what is the tax result if a charity is set up as a group of companies and one company owns land and leases it out to operating charitable entities, and the rent is used to pay off bank debt?

Deriving further profits from the initial tax exempt profits

After charities derive tax exempt profits, they may invest the profits, which in turn generate more profits. In this situation, the tax exempt character may not be maintained, so that the subsequent profits may be taxable.

For example, a charity generates \$1,000 of profit from its uncommercial activities (eg charitable activities). The charity then invests the \$1,000, which in turn generates a profit of \$100. The subsequent \$100 profit will be taxable unless it itself satisfies a particular exception.

Applicable income tax rate

In respect of activities that will attract income tax, what would be the relevant income tax rate for the charities?

⁵ Treasury (2010), *Australia's Future Tax System – Report to the Treasurer*, at 212

Currently, without any tax concession, if a non-charitable trust accumulates income, the trustee would be taxed at the top marginal tax rate. On the other hand, without any tax concession, a company is taxed at the lower corporate tax rate.

Under the new arrangements, there is an issue of whether charities should be taxed at different rates according to their structures. Will the top marginal tax rate or the corporate tax rate apply to the trustee of a charitable trust under the new arrangements? We consider that it is reasonably likely that the Government would apply the corporate tax rate, rather than the top marginal tax rate.

Apportionment issues

If charities carry out a number of activities, some generating profits that are taxable, and others generating profits that are exempt from tax, this would raise the following issues:

- how should the charities determine the amount of their income that will be taxable?
- how should the charities determine the amount of expenses relating to their assessable income? This could be difficult for indirect expenses, eg CEO's salary.

Apportionment could be a complex exercise. For example, there are 34 pages in the ATO's GST Ruling 2001/8 Goods and Services Tax: apportioning the consideration for a supply that includes taxable and non-taxable parts.

Investment vs operating entities

The proposed reform could give rise to different tax outcomes for charities that invest compared to charities that conduct unrelated commercial activities:

- on the one hand, if the charities invest in a portfolio of shares in companies, the charities would be entitled to a tax refund that is equal to the franking credits on the distributions made by the companies to the charities;
- on the other hand, charities that undertake taxable commercial unrelated activities through their operating entities would be fully taxable, and would not be entitled to any tax refund.

Public ancillary funds

There is an issue of whether there is a potential advantage in having funds invested in a public ancillary fund, rather than by having an operating entity carrying out taxable

unrelated commercial activities. This has implications on how charities should raise their funds to finance their charitable projects.

One way that charities can raise funds to finance their charitable projects is through public ancillary funds.

Public ancillary funds are public funds that have DGR status that distribute money to 'doing' DGRs (eg DGRs that themselves conduct charitable activities).

Typically, the trustee of a public ancillary fund is a public company limited by guarantee. The ATO's current requirement is that the majority of the directors of the board of the trustee must be persons who have a degree of responsibility to the community as a whole.

The fund must also satisfy the ATO's requirements in relation to what must be included in the trust deed. For example, the fund must invite the public to contribute to it, and it must operate on a non-profit basis. Should the fund be wound up or its DGR status be revoked, any surplus money or other assets of the fund must be transferred to another DGR.

Following the Government's announcement in last year's 2010-11 Federal Budget that it would introduce a new regulatory framework for public ancillary funds, the Assistant Treasurer released a discussion paper on the proposed regulatory changes to public ancillary funds.⁶ It is anticipated that the Government will introduce and finalise the legislation by 1 July 2011. The proposed changes are intended to be effective from 1 July 2011.

The Government intends to introduce guidelines that require public ancillary funds to value assets annually, and this 'closing value' will be used to calculate a minimum amount that must be distributed over the following 12 months (to the end of the following financial year).

It is anticipated that the minimum distribution rate will be greater than 5% of the market value of the fund's net assets in each financial year. Private ancillary funds are required to distribute at least 5%.

The current law does not expressly require public ancillary funds to value their assets and distribute on an annual basis.

How would these new rules for public ancillary funds operate in parallel with the proposed new rules on taxing charities on their unrelated commercial activities? This would have implications for charities on where they should hold their funds for financing their projects (ie whether they should raise funds through a public ancillary

⁶ Treasury, "Improving the integrity of public ancillary funds", Discussion Paper November 2010

fund, or through an operating entity that carries on unrelated commercial activities):

- on the one hand, if the charities use public ancillary funds to raise money to finance their projects, the minimum distribution requirement in the proposed new public ancillary fund regime means that the funds must distribute each year. This could mean that public ancillary funds cannot build up capital to be later used on particular projects;
- on the other hand, if charities have operating entities that make investments, under the proposed new taxing rule, the investments made by the operating entities may be unrelated commercial activities. If the profits from the investments are not used for the charities' altruistic purposes, the profits would be taxable. This could mean that charities can't accumulate funds in their operating entities to finance particular projects.

Costs

The proposed changes will likely give more compliance and administration work to charities, so this would increase charities' costs.

In terms of compliance and preparing tax returns, there could be more work for charities than fully taxable taxpayers. This is because charities will first need to decide whether they will be taxable or not by examining their activities. If they decide that they will be taxable, they will need to apply the tax law to their unrelated commercial activities. So they will need to deal with apportionment of expenses and other issues that a fully taxable taxpayer does not generally have to deal with.

Charities will also need to set up a system, and determine what costs will be attributed to their unrelated commercial activities. If their employees are involved in both unrelated commercial activities and other activities, will they need to record their time appropriately so that the charities can apportion the labour costs between unrelated commercial activities and other activities?

GST issues

There are issues arising from the restriction of GST concessions in relation to charities' unrelated commercial activities (subject to certain exceptions discussed above):

- currently, if an entity is carrying on an enterprise, and the entity's GST turnover meets the registration turnover threshold, the entity is required to be registered for GST.⁷ The registration turnover threshold is \$75,000

unless the entity is a non-profit entity. The registration turnover threshold for a non-profit entity is \$150,000.⁸ Would the charity tax changes mean that if charities carry on unrelated commercial activities, they would not be non-profit entities for GST purposes and the lower registration turnover threshold of \$75,000 would apply?

- how can charities pass on their GST risk to the recipients of the taxable supplies made by these charities?

FBT issues

There is an issue of how to apply the restriction of FBT concessions in relation to charities' unrelated commercial activities (subject to certain exceptions discussed above).

Would the restriction depend on whether the employees are principally or predominantly involved in unrelated commercial activities? Or would the restriction be worked out by some sort of pro-rata method?

The restriction could mean that a public benevolent institution will no longer be able to provide exempt fringe benefits (up to the relevant threshold) to its employees who carry out unrelated commercial activities.

If a charity's employees spend 40% of their time on its unrelated commercial activities, how much of their fringe benefits will be exempt from FBT (0%, 40% or 100%)? How would the threshold apply?

DGR issues

Under the new arrangements, charities will not have access to DGR support in relation to unrelated commercial activities. It is unclear how this will work.

For example, if a donor donates \$100 to the DGR, and the DGR undertakes both unrelated commercial activities and charitable activities, the following issues are raised:

- how much of the donation will the donor be entitled to deduct?
- does the deduction depend on whether the donation is used in the DGR's charitable activities or unrelated commercial activities?
- is the deduction determined on a pro-rata basis?
- how would the donor know whether the donation will be used in unrelated commercial activities or charitable activities?

⁷ Section 23-5 of A New Tax System (Goods and Services Tax) Act 1999 (GST Act)

⁸ Regulation 23-15.01 and regulation 23-15.02 of A New Tax System (Goods and Services Tax) Act 1999 (GST Regulation)

Structuring charities

How should charities structure/restructure their entities to achieve their commercial outcomes and objectives?

If charities restructure to obtain tax outcomes, would the general anti-avoidance provisions under Part IVA of the *Income Tax Assessment Act 1936* and/or under Division 165 of *A New Tax System (Goods and Services Tax) Act 1999* apply?

Model for implementation

The Government will consult to determine the most appropriate model for implementing the tax changes. Examples of models that may be considered by the Government include those adopted by Canada, the United States, the United Kingdom, Ireland and South Africa.

Although we do not have further details at this stage, we consider that it is worthwhile to observe the comments in the Productivity Commission Research Report on Contribution of the Not-for-Profit Sector (January 2010), page 205.

The Productivity Commission commented that NFPs' income tax exemptions are unlikely to significantly distort resource allocation, but they can obscure the quantum of subsidies provided to NFPs.

The Productivity Commission further commented that the Australian tax treatment of NFPs is comparatively generous relative to other countries. In various overseas countries, activities above a certain scale are separately incorporated into for-profit businesses. They are taxed as normal, and distributions are then made to the owner of the business (an NFP or charity).

In the report, the Productivity Commission examined treatment of business income of charities in the United States, Canada, England, Wales and Ireland.

The report referred to various submissions that contained details on the treatment of business income in these countries. In these countries, to get tax concessions, charities are required to conduct activities that are substantially related to the organisation's charitable purpose. They must offer their goods and services to a broad section of the public without financial, social or economic restrictions. If their activities are outside of their charitable purposes, these activities must only be a small or incidental part of their operations.

The report gave further details on the treatment of business income in each of these countries. The details are summarised in the table below.

Country	Key features
United States	<ul style="list-style-type: none"> • Net income from 'unrelated business activities' is subject to Unrelated Business Income Tax (UBIT). • UBIT is taxed at ordinary corporate (or trust) tax rates. • UBIT excludes dividends, interest, rents and royalties. • UBIT applies to commercial activities 'unrelated' to the organisation's charitable purpose.
Canada	<ul style="list-style-type: none"> • A business operation of a charity must be subsidiary to the charitable purpose of the organisation. • Unrelated businesses of a charity must be in a separate and taxable corporation.
England & Wales	<ul style="list-style-type: none"> • Unrelated businesses of a charity must be in a separate and taxable corporation. • A charity cannot be registered when its purpose is, or includes, the carrying out of trade.
Ireland	<ul style="list-style-type: none"> • Tax concession is available in respect of profits arising from small-scale fundraising activities that have been run for charitable purposes only.

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