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**THE INDUSTRY COMMISSION'S
FINAL REPORT ON THE
TAXATION OF CHARITIES**

**WORKING PAPER NO. PONC62
Dr Myles McGregor-Lowndes and Sandra Rodman**

Q.U.T.

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INTRODUCTION

The Industry Commission (the Commission) has recently completed its wide-ranging final report on charitable organisations.¹ We have previously commented on the draft report of the Commission.² This article discusses the Commission's final recommendations. Part of the Industry Commission's brief was to examine the appropriateness of the taxation treatment of charities (known in the report as "community social welfare organisations"(CSWOs)).

The Commission was instructed by the Assistant Treasurer in December 1993 to examine the state of community human service provision by non-profit organisations in Australia. The brief included the accountability, regulation and taxation status of such organisations. The Commission received nearly 800 written submissions and over 250 oral submissions most of which touched on taxation. The final 500 page report contains 31 recommendations relating to issues such as quality assurance, government funding, tendering and corporate structure as well as taxation.

The federal government will formally respond to the recommendations in coming months, but has issued a statement briefly responding to the major recommendations of the report.³ It has tagged most of the recommendations for further consideration. With a federal election pressing it is unlikely the government will seek to provoke charities with hasty alterations to the charity tax environment.

The taxation areas the Commission examined were:

- the exemption from income tax;
- the exemptions from indirect and input taxes;
- the deductibility of donations (including the capital gains tax (CGT) consequences of bequests);
- wastage of dividend imputation credits; and
- administration of the Australian Taxation Office (the Tax Office).

EXEMPTION FROM INCOME TAX

The Commission examined both the exemption from income tax for charities and the Tax Office practice in relation to the accumulation of income in charitable trusts.

Exemption From Income Tax

The Commission has recommended the retention of the section 23⁴ income tax exemption for charities. Charities exempt under section 23⁵ are exempt from tax on income from their core activities and on income from unrelated business activities that cross subsidise the core purpose. Arguments were raised before the Commission that the exemption gave charities an unfair competitive advantage. The advantage arises because charities are able to under-cut competitors through income tax savings and also by having better cash flows to expand their business. This argument was not accepted by the Commission. Also, technical difficulties of defining the unrelated business income of charities and the administrative cost of collecting such revenue, swayed the Commission to leave the exemption alone. As a result, Australia retains one of the most liberal treatments of charity unrelated business income in the western world.

Accumulation of Income by Charitable Trusts

Section 23(j)⁶ exempts from income tax public funds established by will or trust deed for public charitable purposes. The Tax Office has sought by administrative fiat to force at least 85% of the annual income to be applied for the purposes of the trust. The Tax Office has, however, been willing in appropriate circumstances to permit charitable trusts to accumulate income over a number of years. The Commission received submissions which indicated that this guideline was hampering charitable trusts from accumulating funds necessary to permit long term planning and financial flexibility. The Commission recommended that the Tax Office remove such restrictions on the accumulation of income in the future.

INDIRECT OR INPUT TAXES

The Commission took a keen interest in state and federal indirect taxes which they termed "input taxes". In the draft report the Commission recommended that consideration be given by all governments for such tax exemptions to be replaced by a revenue neutral package of assistance for CSWOs. In response to this draft recommendation charities expressed their scepticism about the nature and continuing tenure of any replacement assistance. Large charitable organisations offering salary packaging for their senior employees were also concerned at the Commission's strong recommendation for the removal of fringe benefits tax (FBT) exemptions.

FBT Exemptions

Some charities with public benevolent institution (PBI) status are able to offer senior employees tax exempt fringe benefits. Charities claim that such arrangements permit them to attract quality senior staff despite their financial constraints. The Commission was concerned an opportunity for abuse existed which could discredit charitable organisations. It felt such abuses could result in declining donations and volunteers. Notably, the Commission did not specifically identify any such abuses. It was also concerned that non-PBI organisations were at disadvantage in employing staff because they could not offer the same employment terms.

The Commission recommended that CSWOs which were also PBIs should have their fringe benefits exemption removed in two years time. This period would give charities time to adjust to a loss of the exemption. The Commission specifically noted that the terms of their brief would not permit them to make recommendations about other exempt organisations such as public hospitals. It is probably not politically feasible to remove one section of organisations from exemption and not the others. In any case, the Federal government has issued a press release stating that it does not accept that the FBT exemption should be removed.⁷ It should be noted however, that government members have some serious concerns over the potential abuse of the fringe benefits exemption. Senator Chris Evans who moved the reception of the report in the Senate said,

I do not want to pre-empt any decisions that need to be taken when dealing with the totality of the report, but it is of concern that the Industry Commission has identified abuse and unscrupulous practices developing in the charitable organisations and other organisations that benefit from this fringe benefits tax exemption. It fits with my concern about the abuse by the Western Australian state Liberal government of the remuneration packages that they are offering to employees of public benevolent institutions and their abuse of those fringe benefits tax exemptions.⁸

Other Input Taxes

The Commission also examined other input taxes such as wholesale sales tax, payroll tax, land tax and stamp duties. The Commission estimated that the cost of charity input tax exemptions was about \$400 million per year. It was concerned that this indirect government funding of charitable organisations had adverse side-effects. Firstly, the exemption allowed unfair competition with for-profit service providers who are starting to compete in areas such as healthcare, education and sports. Secondly, the Commission found that there was a lack of transparency in the use of such exemptions and the possibility of inappropriate resource practices

such as turning over fleets of cars every two years or buying rather than renting property. Thirdly, there were inequities in eligibility for exemption between organisations delivering the same service. Finally, there were increasing compliance costs for governments, wholesalers and retailers associated with these exemptions.

The Commission in its draft report wished to abolish all input exemptions and replace them with a more neutral form of assistance such as a grant. The Commission in its final report has softened its initial stance and recommended that the Council of Australian Governments (COAG) consider simplifying and standardising the criteria for input tax exemptions across all jurisdictions. Charities are concerned that the COAG process to date has not been characterised by genuine community consultation and will no doubt keep a close watch on any government move to place such matters on the COAG agenda.

TAX DEDUCTIBILITY OF DONATIONS

The Federal Treasury estimates that about 160 million is forgone annually as a result of the tax deductibility of donations to PBI and other authorised institutions. The Commission believed that tax deductibility for donations should continue, but recommended some alterations to the existing law.

The Commission recommended that the \$2 lower limit for donations be abolished and individual organisations be given the ability to decide which donations are to be treated as tax deductible. Some charities had argued that the administrative and report keeping requirements of a \$2 donation outweighed the actual donation and a higher level would encourage a more meaningful contribution. Other charities argued that an increased level would adversely affect their donation income from lower income earners. The Commission decided that flexibility of levels would be the best solution, despite possible confusion amongst donors about what the level of deductible donation is for individual charities.

The Commission has also recommended the extension of tax deductibility to more organisations than catered for in the present definition of PBI. This is to be achieved, not by altering the definition of PBI, but by adding a new category of tax deductible organisations. The Commission has recommended the extension of deductibility status to:

- charities (as legally defined), which either:
- relieve poverty (the legal charitable definition); or
- benefit the community (the legal charitable definition) through the advancement of

social welfare; and

- are incorporated with the Australian Securities Commission under a yet to be devised corporate structure.

Elsewhere in the report the Commission has recommended that a new form of incorporation based on the Corporations Law section 383 company limited by guarantee be provided for community organisations. All organisations that wish to qualify for deductibility status (present and future) will have to obtain this incorporation. The Commission specifically states that organisations with their own Act of Parliament (eg, church owned social welfare agencies) which want tax deductibility status will be required to move to the Australian Securities Commission register. If this recommendation is accepted by government, it will be an exceedingly complex and expensive procedure for many charities.

Another issue for concern is the definition of "the advancement of social welfare" proposed by the Commission to qualify benefit to the community. This rider was inserted to confine the broader legal charity definition of "community benefit" which includes public works, recreation and leisure facilities. It was not the Commission's intention to permit tax deductibility for these purposes. The term "the advancement of social welfare" has been discussed in a series of English decisions about council rate exemptions, but is not a settled common law definition.⁹ In the case used as authority by the Commission the judge remarked about the term,

No precise definition has ever been attempted of the words "otherwise concerned with the advancement of social welfare," nor, perhaps, is any such definition possible. I shall certainly attempt none.¹⁰

The English statutory context was to define bodies which were outside the definition of charity. The Commission plans to use the term in another way, that is, to define a sub-set of **within** the definition of charities which may lead to confusion. This produces some legal problems which require clarification before implementation.

More work is also necessary on this definitional issue before advocacy, preventative and self-help organisations can be assured of tax deductibility qualification, without tax avoidance gaps being opened up. It is not clear whether this rider will also apply to the relief of poverty class which in charity law needs no element of public benefit, so that trusts for "your poor relations" are charitable.

CAPITAL GAINS TAX

Currently if a capital asset is bequeathed to a tax exempt body a CGT liability may arise to the estate as a result of the bequest.¹¹ The tax burden either falls upon the charitable body receiving the bequest or upon the remaining beneficiaries of the estate. The Commission felt that this taxation treatment was unnecessarily limiting the bequests received by charities.

The Commission has recommended that assets bequeathed to charitable organisations which enjoy tax deductibility status should be free of any capital gains tax liability. Not all tax exempt organisations are also eligible for deductibility of donations. As a result of this recommendation there will still be some bequests to tax exempt bodies which will give rise to a CGT liability to the estate of the deceased. The Commission believed that the removal of this disincentive to bequeath assets to charities would outweigh any revenue costs.

DIVIDEND IMPUTATION REBATES

Some charities argued before the Commission that the dividend imputation system was biased against them as the imputation rebates could not be used to offset other taxation liabilities. The Commission recommended that such distortions be reviewed with a view to their removal. The government has already indicated that it does not believe such a review is warranted.¹²

TAX OFFICE ADMINISTRATION

The Commission made recommendations about the Tax Office administration of charity tax benefits and exemptions. It received evidence from charities of inconsistent rulings between different offices of the Tax Office and difficulties in applying the exemption definitions. The Commission recommended that:

- criteria for tax exemptions should be simplified and standardised; and
- the Tax Office should introduce a process of regular review of charitable organisations receiving tax deductibility and other taxation benefits.

Given the self assessment system, any simplification of Tax Office guidelines for exemption will be welcomed by charitable organisations. The various tax exemption categories are also used widely in other Commonwealth and State statutes and are also fair game for rationalisation.

The Tax Office argued in its submission to the Commission that committing the Tax Office to a charity enforcement program would divert resources away from areas that may be of greater risk to the revenue base.¹³ In any case, the Tax Office has started to revise its tax rulings relating to non-profit organisations such as sporting bodies and public funds.¹⁴ For a practical guide to putting a charities affairs in order for a possible audit see our previous article.¹⁵

CONCLUSION

The Industry Commission's report has raised many taxation issues concerning charities which have previously been neglected. Advisers ought to keep a close watch in coming months on the fate of these recommendations. The requirement of incorporation with the Australian Securities Commission before tax deductibility status will be conferred or continued will probably engender the most debate. It will also be difficult to quarantine many of the tax recommendations to only charities. Other community organisations such as sporting bodies, health organisations, education, arts and conservation may also be affected. Although the Government has ruled out alterations to FBT exemptions in the short term, there is a certain unease in political circles about the exemption and the long term future of the exemption may not be so bright.

ENDNOTES

1. Industry Commission, *Charitable Organisations in Australia*, Report no. 45, AGPS, Melbourne, 1995.
2. M.McGregor-Lowndes & S. Rodman, "Charitable Organisations, the Industry Commission and Tax Office Audits: How a Stitch in Time Might Save Nine", *The CCH Journal of Australian Taxation*, Vol. 7, Issue 2, 1995, pp 16-24.
3. Joint Media Release, Minister for Human Services and Health, Minister for Development Cooperation and Pacific Island Affairs, Treasurer and Assistant Treasurer, "Government Welcomes Report on Charitable Organisations", 27 September. 1995.
4. *Income Tax Assessment Act 1936*.
5. *Income Tax Assessment Act 1936*.
6. *Income Tax Assessment Act 1936*.
7. Joint Media Release, Minister for Human Services and Health, Minister for Development Cooperation and Pacific Island Affairs, Treasurer and Assistant Treasurer, "Government Welcomes Report on Charitable Organisations", 27 September. 1995.

8. Hansard, 27 September, 1995, p 1604.
9. For a discussion of the UK cases see DWM Waters, "*Social Welfare*", *The Conveyancer*, Vol. 23, pp 365-391.
10. *Waterson v Hendon Borough Council* [1959] 1 WLR 985 at p 991.
11. Sec 160Y.
12. Joint Media Release, Minister for Human Services and Health, Minister for Development Cooperation and Pacific Island Affairs, Treasurer and Assistant Treasurer, "*Government Welcomes Report on Charitable Organisations*", 27 September. 1995.
13. *Tax Office, Industry Commission Submission no.DR693*, dated 7 February, 1995.
14. Taxation Ruling TR 95/27: Gift provisions - public funds, Draft Taxation Ruling TR 95/D18: Income Tax: tax exemption available to non-profit bodies established for the encouragement or promotion of a game or sport, see also CCH Tax Week, Issue 38; 1 September, 1995.
15. M. McGregor-Lowndes & S. Rodman, '*Charitable Organisations, the Industry Commission and Tax Office Audits: How a Stitch in Time Might Save Nine*', *The CCH Journal of Australian Taxation*, Vol.7, Issue 2, 1995, p.16-24