pilchconnect

a specialist legal service
for community organisations

17 May 2012

Submission to the Treasury:

Restating and standardising the special conditions for tax concession entities (including the 'in Australia' conditions)

PilchConnect welcomes the opportunity to respond to the revised Exposure Draft of the Tax Laws Amendment (2012 Measures No. 4) Bill 2012 (***Revised Exposure Draft***), as explained by the accompanying Explanatory Material and Fact Sheet.

PilchConnect is a specialist legal service for not-for-profit community organisations (***NFPs***). A summary of our service is included at Appendix A.

We wish to commend the Government at the outset for reconsidering the Exposure Draft of the Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No.1) (2011) (***Original Exposure Draft***) in light of concerns raised in the previous consultation process. We acknowledge that a number of our concerns on the Original Exposure Draft, as set out in our previous submission dated 17 August 2011, have been addressed in the Revised Exposure Draft, including the:

- unintended consequences of the definition of 'not-for-profit' in the Original Exposure Draft;
- prohibitions on donations to entities that do not have deductible gift recipient (***DGR***) or income tax exempt (***ITE***) status; and
- modification of the requirement to comply with all governing rules.

Unfortunately, however, we continue to have concerns about aspects of the Revised Exposure Draft. We set out our key concerns below and also refer the Treasury to the submission prepared by the University of Melbourne Law School's Not-for-Profit Project (***Melbourne University***) for a detailed analysis of these and other issues raised by the Exposure Draft.

PilchConnect's approach to this submission

PilchConnect does not intend to comprehensively address to all aspects of the Revised Exposure Draft in this submission.

In the course of considering our response, we have had the opportunity provide feedback to Melbourne University and have discussed with them what we see as key issues arising from the draft legislation. As a result, there is a strong alignment between our views, and those outlined by Melbourne University in their submission.

We therefore endorse the recommendations made by Melbourne University, and urge the Treasury to have due regard to those matters raised in their submission.

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Our key issues

In the context of our broad support for the legal analysis and recommendations in the Melbourne University submission, we wish to highlight the following issues which form the basis of our main ongoing concerns with the Revised Exposure Draft. The focus of our comment is particularly in relation to the impact of the proposed measures on our core client base: small/medium NFPs with 'public interest' objectives.

Policy basis for the proposed measures

As we noted in our previous submission, there are important issues of public policy involved in the concept of the 'in Australia' requirement which we do not consider have been fully ventilated in the consultations and materials for proposed measures to date. We continue to be concerned that the measures proposed in the Revised Exposure Draft, if implemented, would impose some of the highest barriers to international participation and engagement by NFPs in the world and represent an unduly restrictive approach to achieving the policy objectives articulated in the Explanatory Material.[1]

Increasingly international engagement and collaboration are vital to NFPs' ability to further their purposes – indeed, for many organisations, participation in activities and networks outside Australia is an essential part of what they do in (and critical to the benefits they provide to) Australia. For example, medical research institutes may conduct clinical trials overseas and cultural organisations regularly tour to international festivals – the work of such organisations is beneficial to Australia precisely because it involves a presence and activities overseas. Like Melbourne University, we question whether an 'in Australia' requirement continues to be justifiable in our contemporary globalising world and in light of our moral obligations as global citizens and the benefits of international engagement. In our view, limiting eligibility for tax concessions to entities that are established in and operate and pursue their purposes 'principally' or 'solely' in Australia has parochial overtones and is not necessary to achieve the stated policy objectives.

We also consider the proposed measures would produce results which are contrary to the Government's commitments to reducing regulatory complexity and encouraging innovation in the NFP sector, and would create undue confusion and anxiety within the sector if implemented at the current time (our views on timing are discussed further below).

We refer to Melbourne University's discussion of policy issues in relation to the 'in Australia' requirement. Consistent with their recommendations, we suggest that if a policy of restricting benefits geographically is to be adopted, consideration should be given to potential alternative mechanisms, in particular:

[1] The Explanatory Material identifies three policy justifications for the proposed conditions: (a) the notion that tax concessions should only be available to an entity that operates for the broad benefit of the Australian community, (b) to address tax avoidance issues associated with funds being moved overseas by tax concession entities, and (c) to mitigate risks of terrorism and money laundering (see Explanatory Materials [1.2], [1.7], [1.47], [1.8], [1.48]-[1.49]).

- reframing geographical restrictions on tax concession entities to focus on entities whose purposes and activities are 'in the interests of Australia' broadly defined; and/or
- replacing the 'in Australia' conditions with requirements on charities to report on their overseas funding and activities to the ACNC, which would be scrutinised as part of the ACNC's regulatory functions, and (in the interim) imposing a requirement on other NFPs to report to the ATO in accordance with the same policy devised by the ACNC for charities.

Interaction with the role and functions of the ACNC

We note there is no reference in the Revised Exposure Draft or Explanatory Material to the Australian Charities and Not-for-Profits Commission (***ACNC***). We assume therefore that the proposed measures in the Revised Exposure Draft are intended to sit entirely outside the regulatory framework of the ACNC. This is, in our view, a missed opportunity to streamline requirements for tax concessions and integrate them with the new regulatory and reporting functions of the ACNC. We note that many of the measures sought to be imposed by the Revised Exposure Draft are regulatory matters which could be more appropriately monitored and enforced by the ACNC – including for example, an entity's compliance with rules, reporting on activities and finances, accountability for use of donated funds, governance issues, and investigations aimed at preventing terrorist financing and money laundering.

There is clearly a need to avoid undue complexity and regulatory duplication between the new ACNC and the ATO. In our experience many NFPs are unsure, and sometimes misinformed, about what the relationship between these two regulators will be once the ACNC commences. We observe that many NFPs we work with are under the erroneous assumption that because the ACNC will soon regulate charities, any charitable/NFP tax concessions they are eligible for *will also be decided by the ACNC.* This confusion is understandable, given that currently the main reason that many organisations seek endorsement as a charity is to access tax concessions charity (**TCC**) status. Most groups do not appreciate that while they will soon be able to register with the ACNC as a *charity*, they will nevertheless be ineligible for charitable *tax concessions* if they may not meet additional special conditions, which are decided by the ATO.

We urge the Government to avoid a situation where the ACNC and ATO are imposing separate, but related and overlapping, regulatory requirements (which are introduced at the same time). This is undesirable, and contrary to the Government's aims in establishing the ACNC. It also has potential consequences for the ACNC's credibility with the sector in its early stages. For example, will the ACNC provide guidance and education to charities on governance-related aspects of the 'in Australia' and 'not-for-profit' conditions of the Revised Exposure Draft? If the answer is no (because the proposed measures fall outside the jurisdiction of the ACNC), then the concept of the ACNC as a 'one stop shop' national regulator is called into question.

We appreciate that initially the ACNC will only regulate charities, not other (non-charitable) NFPs. We understand however the intention is that other NFPs that access Commonwealth tax concessions will

be transitioned into the regulatory framework of the ACNC in future. In the interim, consistent with the Melbourne University submission we suggest that where NFP entities are not initially regulated by the ACNC, they should be required to report to the ATO in a manner consistent with what is required of charities regulated by the ACNC.

It is also worth noting that in initial public announcements about the establishment of the ACNC, it was anticipated that the new regulator would determine charitable, PBI and *other NFP status for all Commonwealth purposes*'.[2] While we understand the ACNC's regulatory role will necessarily be an evolving process, we urge the Government to keep its commitments to streamline reporting, improve regulatory oversight, and simplify tax concessions in mind when assessing the benefits of implementing the Revised Exposure Draft. [3]

Proposed test for operating or pursuing purposes 'in Australia'

In our previous submission, we expressed concern about the vagueness of the proposed test for operating in Australia and pursuing purposes in Australia, which takes into account 'all surrounding circumstances' including a non-exclusive list of 'factors'. While we appreciate that the Explanatory Material for the Revised Exposure Draft aims to clarify the proposed test by reference to a range of examples, we continue to hold the view that the qualitative nature of the test will add to uncertainty and inhibit reasonable and legitimate engagement by NFPs with overseas organisations and institutions. It is illustrative that a number of the examples in the Explanatory Material are not definitively answered as either clearly satisfying (or not satisfying) the 'in Australia' requirement.

For instance, Example 1.5 concludes:

> *'**It is likely on balance** that [the organisation] will meet the 'in Australia' special conditions … the amount of expenditure, operations and beneficiaries located in Australia **could satisfy** the special conditions'.*

And in Example 1.7:

> *'… **on balance,** the fact that the organisation owns assets, conducts fundraising, employs Australian individuals and spends money in Australia **would likely lead to it** meeting the 'in Australia' special conditions.'*

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[2] Bill Shorten, 'Next stage for Not-for-profit reforms announced', Media release, May 2011, at http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/083.htm&pageID=003&min=brs&Year=&DocType

[3] Indeed more fundamentally we question whether the ATO should have a continued role in deciding on eligibility for NFP tax concessions (including whether an entity is 'in Australia') once the ACNC is established and has the capacity to regulate the NFP sector more broadly. We note that the Productivity Commission's (2010) recommendation that 'at a minimum, endorsement of Commonwealth tax concessions for NFPs that are currently undertaken by the ATO should be undertaken by the [new national regulator]': at p 145. As we submitted to the scoping study for the national regulator, in our view ultimately the ATO's function should be limited to applying tax concessions to those organisations that are independently determined as falling within the relevant taxation categories, and taking action where there is a suspected contravention of taxation laws.

The uncertainties raised by the examples (and the analysis in the Melbourne University submission) suggests that the approach lacks the necessary clarity to enable NFPs (particularly smaller and start-up groups) to confidently determine whether their activities will fall within the requirements. Where a test is based on all surrounding circumstances, with no guidance as to the relative weighting of various factors, it can be difficult for NFPs (and their lawyers) to assess where they can legitimately draw the line. We are particularly concerned that the 'all things considered' approach will cause NFPs to adopt an unduly cautious approach, or even abandon any overseas activities altogether, for fear of falling foul of the requirement.

We also note that small NFPs with no employees or real property may find the list of factors lacking in relevance to their operations (for example, there no reference to volunteers).

A failure to comply with the special conditions under the Revised Exposure Draft would result in the loss of entitlement by an entity to tax concession status. This is a very serious (potentially draconian) consequence of non-compliance – we suggest that a fairer and more proportionate approach would be to reduce an entity's income tax exemption to the extent that the purposes or activities are not in Australia, as recommended by Melbourne University's submission.

Stricter test for DGRs

The Revised Exposure Draft proposes a new stricter test for DGRs – that is, they must operate and pursue their purposes 'solely' in Australia. We do not support the introduction of this stricter test, for the reasons explored in Melbourne University's submission and in our previous submission. Critically, the new conditions impose significantly more restrictive conditions for DGRs that limit the extent of their operations, purposes and beneficiaries.

At PilchConnect, many of our clients are DGRs (or those seeking DGR status) and many are working with international partners, would like to leverage opportunities that arise overseas, or are seeking international cooperation on global issues that impact on Australians. Overseas engagement is legitimate and often essential for various types of DGRs and we see no valid reason why, as a matter of policy, they should be required to operate and pursue purposes 'solely' in Australia, while income tax exempt entities are required to do so 'principally' in Australia.

We agree with Melbourne University's submission that the differing thresholds for DGRs and income tax exempt entities create needless complexity and confusion. We note for example the potential for confusion, and inadvertent breach, where a TCC entity also administers a DGR fund – in such a case, the entity would have to ensure compliance with two different standards: one for the DGR fund, and another for the entity as a whole. Obviously, it would be much easier if such entities only had to deal with one 'in Australia' standard. We refer to Melbourne University's discussion of this issue and endorse the recommendation made in their submission.

Prescribed entities

We support the Revised Exposure Draft's enabling of prescribed entities not to be required to meet the 'in Australia' conditions in proposed s 50-51(2)(c), (d) and in relation to environmental organisations, however, we have concerns about the mechanism proposed to achieve this.

The process of prescribing entities in the Revised Exposure Draft is similar to 'specific listing' under the current tax laws. At PilchConnect, we often give advice to small organisations that are exploring specific listing as a DGR because, despite their charitable objectives, they not fit into any of the DGR categories available. Our experience is that once they understand the process, most organisations do not even attempt it as it is time-consuming, uncertain, and sadly often beyond small, grassroots organisations that do not have the advocacy skills and political influence needed to achieve a result.

A fairer and more appropriate mechanism would be one that empowers the prescription of entities based on clear criteria set out in the legislation/regulations (we submit that such criteria should be the subject of further consultation, as we share Melbourne University's concerns about the appropriateness and enforceability of factors set out in the Explanatory Material). We suggest that prescription should involve a single clear process that is available to all entities that are subject to the 'in Australia' conditions (not singling out environmental organisations), that prescription should not be limited to 'exceptional circumstances', and there should be right of review. We refer to and endorse the recommendations of Melbourne University on this issue.

Government grants and gifts

We appreciate that the Revised Exposure Draft includes a provision which enables certain government grants and gifts to be disregarded for the purposes of assessing the in Australia requirement. However we remain concerned about the restrictiveness of the re-drafted provision, for the reasons outlined by Melbourne University in their submission. In particular we are concerned that:

- the regulatory conditions required to trigger the provision are onerous, unworkable in their current form, and some are too subjective and/or otherwise inappropriate; and
- the requirement that gifts must *not* be not tax deductible in order to be disregarded, will result in a restrictive and unnecessarily complex situation.

We support Melbourne University's recommendations that proposed s 50-50(56) should be redrafted, and that further consideration should be given to the regulatory conditions for excluding the application of the 'in Australia' conditions (including in particular the proposed conditions in relation to compliance with Australian and foreign laws and treaty obligations).

Timing and sector awareness issues

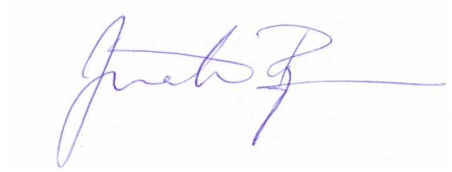
This is a time of great change for the sector – a time when charities are dealing with the transition to a new regulator, proposed new reporting obligations and other requirements, and a range of other significant regulatory reforms at state and federal level (including for example the introduction of harmonised OHS laws in most states, and proposed changes to federal privacy and anti-discrimination laws). At PilchConnect, many of the organisations we work with are small community groups that rely on volunteers, have limited resources, and little or no access to paid professional/legal services to help them understand new laws and transition to new regulatory arrangements. There is therefore a real danger that implementation of the Revised Exposure Draft without affording sufficient time for NFPs to understand the implications and make appropriate adjustments, and at the same time as establishment of the ACNC, could undermine the goodwill that currently exists in the sector for the new regulator and the federal NFP reform agenda more broadly.

For these reasons we submit that further consultation is needed to inform the sector about the impact of the Revised Exposure Draft and we endorse Melbourne University's recommendation that the measure (or at least its implementation) should be delayed by at least a year to enable NFPs to assess the impact of the measure on their operations, to be properly consulted, and to enable them to comply.

Conclusion

We would be happy to elaborate on any of the issues raised in this letter and hope to engage further with the Treasury in relation to these and related NFP regulatory reforms.

Yours sincerely,



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Endorsements

This submission is endorsed by the Public Interest Law Clearing House NSW.

APPENDIX A

About PilchConnect

PilchConnect is an independent, specialist community legal service that provides not-for-profit (**NFP**) organisations with access to free or low cost legal help (information, advice and training). We support small-medium NFP community organisations to be better run. We do this because when organisations are well run, they are more likely to achieve their mission, and trust and confidence in the NFP sector is likely to be improved.

By supporting NFPs in this way, we aim to contribute to a better civil society with more connected communities.

We fill a niche role; sitting between regulators and the private legal profession. As an independent, sector-based intermediary we understand the practical constraints that small community organisations operate under, and are trusted by them to provide practical, NFP-relevant legal help or direct them to other assistance. We often help organisations work out if they really do have a legal problem, how serious it is and what possible next steps are. We prioritise NFPs that assist marginalised and disadvantaged people and in rural and regional areas.

Our submission work is based on empirical evidence and practical examples drawn from our legal inquiry, advice and case work.