

# Tax Insight



## Extensive tax reforms for not-for-profit entities and charities

### At a glance

- ▶ Government's intention to tax certain new commercial activities from 1 July 2011
- ▶ Changes proposed to GST, FBT and Deductible Gift Recipient concessions
- ▶ Potential impacts for NFPs and charities
- ▶ How Ernst & Young can help

One of the most significant and concerning aspects of the 2011 Federal Budget was the Government's announcement regarding a number of proposals which will significantly alter the taxation and financial reporting landscape for the not-for-profit (NFP) and charity sectors. The impacts for charities, universities, religious and scientific institutions and sporting clubs will vary based on the activities they undertake; with action required ranging from process reviews to a complete analysis of the entity's structure and operations.

The Government has released a Treasury Consultation Paper: *Better Targeting of Not-For-Profit Tax Concessions* (the paper), which confirms the Budget announcements and poses a number of questions regarding the development of these reforms. Input is sought by 8 July 2011; we outline below some of the key considerations and issues.

The paper confirms the Government's intention to tax certain new commercial activities (commenced after 10 May 2011) from 1 July 2011 unless profits are directed back to the NFP's 'altruistic objects'. Certain existing commercial activities will also be taxed, from a date to be determined, following the consultation process. Changes are also proposed to Goods and Services Tax (GST), Fringe Benefits Tax (FBT) and Deductible Gift Recipient (DGR) concessions.

The paper indicates that the regimes adopted in the United Kingdom, the United States, Canada, South Africa and Ireland will be considered in developing the Australian framework. Our experience regarding the transition to and operation of these regimes suggests that the reforms may result in complicated rules which are highly dependent on the circumstances of particular NFPs and the activities they undertake. Although the Government has attempted to ease concerns with the prediction of revenue neutrality, experience in other countries has shown that unintended revenue impacts can result.

Accordingly, NFPs and charities need to engage in the consultation process to understand the potential impacts of the reforms on their activities. The first step is to respond to the questions in the Government's paper and prepare for more detailed consultations to come on transitional and implementation issues.

A more welcome development for the NFP and charity sector is the 11 May 2011 draft Australian Taxation Office (ATO) ruling clarifying the Commissioner's views on the meaning of 'charitable' and 'funds established for public charitable purposes'. This positive development might result in refunds for some business activities under the current law (pending the reform process), and we address this issue in more detail below.

## Key components of the proposed reforms

The proposed reforms seek to:

- ▶ Tax 'unrelated commercial activities' not 'directed' to the altruistic purpose of the NFP, that is, to tax those profits which are not used in the organisation's altruistic activities
- ▶ Remove certain GST, FBT and DGR concessions available to NFPs
- ▶ Target low tax or tax exempt entities receiving profits through commercial trust structures
- ▶ Establish a new independent Australian Charities and Not-for-profits Commission (ACNC) from 1 July 2012 to deliver smarter regulation, reduced red tape and improve transparency and accountability of the sector
- ▶ Introduce a statutory definition of 'charity'

The proposals seek to address the Government's concerns regarding the lack of uniformity of taxation across the sector and the consequential impacts on competition within the national economy. They also seek to ensure commercial profits are directed to altruistic purposes.

## Critical issues in the *Better Targeting of Not-For-Profit Tax Concessions* Consultation Paper

The paper is highly significant for NFPs' existing and future commercial activities and the structures used for these activities. Employee compensation, GST cost and future funding are all likely to be impacted. Financial reporting systems may need to change to capture the information required as a result of these reforms.

The critical issues from the paper include:

### 1. Unrelated commercial activities and profits directed to altruistic activities

NFP income tax concessions will only apply to profits generated from unrelated commercial activities that are directed back to a NFP carrying on its altruistic objects.

NFPs will need to understand where and how to draw the line between the altruistic core activities and their commercial trade or business activities. Unfortunately the paper provides little guidance on this point. While the Government has made it clear that fetes and lamington drives will not be affected, it is unclear whether, for example, the following commercial activities might be considered 'related' or 'unrelated':

- ▶ Sale of TV and media rights by sporting organisations and bodies
- ▶ Diversified investment revenues of sporting clubs
- ▶ Various mental health, social welfare, training or certification services provided by religious institutions
- ▶ Monetisation of research and revenues from research centres operated by Universities
- ▶ Furniture or apparel retail revenues derived by charities

NFPs and charities will need to undertake analysis specific to both the individual organisation and the industry in which it operates. An examination of the organisation's objects will be required to determine whether the main or dominant objects, as compared to any incidental or ancillary objects, are sufficiently altruistic to retain

the tax concessions.

## **2. Transitional issues including impact on existing businesses**

New activities commencing after 10 May 2011 will be subject to taxation from 1 July 2011.

The paper also refers to situations where existing businesses, or new activities of existing businesses, can be treated as new businesses and potentially caught by the reform from 1 July 2011. The paper suggests that the criteria used in the tax loss 'same business test' be used to determine whether this applies. This is a considerable undertaking for entities that are not used to the complexities of tax law.

For existing businesses there may be other significant transitional issues in dealing with tax consequences that arise where a previously exempt entity or business becomes taxable. NFPs will need to consider the starting base (and relevant valuations) for the recognition of existing assets, for example, land, buildings and intellectual property.

## **3. The legal structures through which unrelated activities are carried on**

If the Australian framework is modelled on the UK system, which seems to be preferred in the paper, 'non-core commercial activity' may need to be conducted in a separate entity. Whether to restructure, and the taxation impacts (e.g., income tax, GST and stamp duty) which may follow, will be important decisions for NFPs and charities to make.

NFPs will need to study the implications for their commercial activities conducted through companies, trusts, partnerships or other entities.

## **4. Funding and development issues**

NFPs may need to reconsider their organisation's objects and the manner in which those objects are obtained to ensure that funds raised are appropriately directed.

The reforms will significantly impact many NFPs' business-related funding, reinvestment and expansion plans. For example, the paper appears to favour a cash flow model as a basis for determining whether the profits of unrelated commercial activity are directed back to the NFP's altruistic purpose. If an annual cash flow requirement is introduced, it may inhibit the ability of the NFP to reinvest and fund expansion capital for the business. This might impede NFPs' entrepreneurial development of funding sources.

Consequential changes required to financial and reporting systems, human resources and information technology systems will also need to be considered.

## **Action required**

The proposed changes are likely to give rise to complex rules. To understand the scope of the reform and how prescriptive the reforms might ultimately be, NFPs will need to understand the underlying policy and engage in the consultation process.

Transitional rules will apply, and the consultation process will need to address the starting basis for entities which will be subject to tax under the new regime. Similarly, guidance around defining an 'unrelated commercial activity' and the potential impacts of likely forced restructures will also be paramount to the consultation process.

To this end, it is important to act now and provide strong input to the questions raised in the paper. In our view the impact of these changes to the NFP sector will critically depend on the consultation period ahead.

## Good news on ATO view of charity in new Draft Taxation Ruling

In addition to the Government's announced reforms, the ATO has released Draft Taxation Ruling TR 2011/D2. The draft ruling, issued on 11 May 2011, sets out the ATO's updated views on the meaning of 'charitable' and 'fund established for public charitable purposes' for income tax and FBT purposes.

The draft ruling rewrites the previously issued Taxation Ruling TR 2005/21 in light of court decisions including *Word Investments Limited* (2008) and *Aid/Watch Incorporated* (2010). The draft ruling contains positive comments which may provide opportunities for a broader range of entities to qualify for NFP and charity tax concessions under existing law. This might generate tax refund opportunities. However, these entities' tax position will eventually be affected by the proposed reforms discussed above.

Organisations that did not previously qualify as a 'charitable institution' should review their position in light of the draft tax ruling to determine whether they may now be eligible. If the ruling is unlikely to change the organisation's classification, consideration should be given to responding to the draft ruling for clarification or recommendations.

## Action required on other relevant reforms

A new body is being set up to regulate the NFP sector from 1 July 2012. NFPs may be required to report to this body. At the very least, there will be additional scrutiny of the NFP sector with the likelihood of increased ATO reviews. NFPs should consider both current and prior year positions taken and ensure that these positions are documented appropriately.

The Government has also announced measures directed at 'improving the trust income tax laws'. Some NFPs conduct commercial activities through a trust with the NFP being a beneficiary of the trust's commercial activities. It is likely that these measures will target the use of low tax or tax exempt entities as beneficiaries of such trusts.

## How can we help?

Ernst and Young can work with you to establish a project team, and facilitate engagement with key stakeholders, including your executive team and Board of Directors, to consider the implications of the various reform initiatives outlined above. We also encourage you to engage with Treasury and Government on the development of the proposals, and we can advise you on how best to participate in the consultation process.

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