

THE HENRY REVIEW AND CHARITABLE PURPOSE. WORKABLE SOLUTIONS OR ANOTHER BAND-AID?

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I. INTRODUCTION

Charity, so they say, starts at home. But how about tax deductible charity? There has been over the last decade, several reviews of charitable purpose and of Not-For-Profit Organisations ('NFPs') generally. The most recent review is Australia's Future Tax System Report (hereinafter known as the 'Henry Review'). The Final Report was delivered to the Federal Government in December 2009 but made publically available on 2 May 2010.

The Henry Review identified key issues with respect to the Not-for-Profit ('NFP') sector, which includes charities and their activities within the framework of the tax and transfer system. One of the biggest issues facing NFPs is obviously that the current concession based system is complex, both legally and administratively. This is not a new finding — see also the Australian Government's Productivity Commission's Report on the same.¹ This article will focus on the idea underpinning much of the NFP sector's treatment in the Henry Review that the current tax concession based system for NFPs 'does not fully reflect current community values about the merit and social worth of the activities it subsidises.'² The particular focus will be on charities and entities conducting activities for a charitable purpose.

A. *Henry Review*

The Henry Review took a 'root and branch' approach to tax reform and examined Australian and State government taxes, and interactions with the transfer system in order to make recommendations to the Federal government which would position Australia to deal with the demographic, social, economic and environmental challenges that lie ahead. As part of this Review the role of the NFP sector was examined as a standalone issue but framed within the context of the need to simplify the taxation system as a whole and improve overall efficacy and fairness.

Focusing in on the NFP section, the Henry Review raised the issue of the complexity of tax including Fringe Benefits Tax ('FBT') and Goods and Services Tax ('GST') concessions currently available for the NFP sector and sought options to improve equity and simplicity in this area. The Henry Review, at the consultation stage posed two specific questions in relation to NFP organisations:

- What is the appropriate tax treatment for NFP organisations, including compliance obligations?
- Given the impact of the tax concessions on NFP organisations regarding competition, compliance costs and equity, would alternative arrangements such as the provision of direct funding be a more efficient way of assisting these organisation to further their philanthropic and community based activities?³

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1 Productivity Commission, *Contribution of the Not-for-Profit Sector Research Report* (2010).

2 Commonwealth of Australia, *Australia's Future Tax System, Final Report, Detailed Analysis* (2009) pt 2 vol 1, 205 ('Henry Review Final Report').

3 Commonwealth of Australia, *Australia's Future Tax System, Consultation Paper* (2008) 161.

Thus, the framework that the Henry Review of NFP's operated within was consideration of the main tax concessions available to NFP organisations. It did not canvass issues that are the subject of separate inquiries, such as accountability and disclosure issues, the contribution of the NFP sector overall to the economy, and proposals to improve the integrity of prescribed private funds.⁴

II. WHAT IS A NOT-FOR-PROFIT ORGANISATION?

For the purposes of this article, the ordinary meaning of NFP should be used to understand references made to NFP. That is, a NFP organisation is one that is not operating for the profit or gain of its individual members. The definition applies whether these gains are received directly or indirectly. Any profit made by the organisation goes back into the operation of the organisation to carry out its purposes and is not distributed to any of its members. Within this general category of NFPs there is a sub-category of organisations that engage in activities that are charitable in nature. If the organisation is an institution established and maintained for purposes that are charitable in the technical legal sense then it will be an entity whose income is exempt under Division 50 of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997').⁵ The exemption is not self-executing but is subject to the Commissioner endorsing the entity as having met the exemption requirements.⁶

The High Court decision in *Commissioner of Taxation of the Commonwealth of Australia v Word Investments Limited*⁷ ('*Word Investments*') considered 'charitable purpose' in a technical legal sense. The Court held that the documentation (such as memorandum of association) of a charitable organisation should contain acceptable clauses showing the organisation's NFP character.⁸ The activities of that organisation are required to have sufficient nexus to its proclaimed purposes. Documentation containing clauses that describe business activities run the risk of the purpose of the entity being characterised as commercial and therefore not charitable.⁹ Business activity clauses that are directly connected with a charitable purpose such as selling law journals for a fee to support the publication of law journals are clearly permissible. The significance of *Word Investments* was to make explicit that clauses supporting the business activities of the entity will not necessarily change the underlying charitable purpose character of the entity if those profits are used for charitable purposes.¹⁰ If the organisation's purposes are solely charitable then it can carry on commercial businesses in order to effectuate those purposes.¹¹ However this raises the question, as Ian Murray asked of how 'close must the nexus be between the commercial activities and the charitable object?'¹² *Word Investments* did not provide a specific guidance and if we look to older cases, the question becomes whether the object in the clause is 'conducive to promoting'¹³ the charitable purpose. The High Court in *Word Investments* cautions us that to isolate the goal of profit as the relevant purpose in the objects of the entity's documentation is to 'create a false dichotomy between characterisation of an institution as commercial and characterisation of it as charitable'.¹⁴

Charitable purpose is an area acknowledged to be fraught with difficulties, artificiality and otherwise inconsistency.¹⁵ However the central tenets are generally agreed to have been sourced 'in spirit and intendment'¹⁶ from the Statute of Elizabeth, *Charitable Uses Act 1601*

4 Ibid.

5 ITAA 1997 s 50.5 item 1.1.

6 ITAA 1997 s 50.52(1).

7 (2008) 236 CLR 204 ('*Word Investments*').

8 *Word Investments* (2008) 236 CLR 204, [172] (Kirby J).

9 Australian Tax Office, *Income Tax and Fringe Benefits Tax: Charities*, TR 2005/21 (21 December 2005) [20].

10 *Word Investments Pty Ltd* was conducting such activities.

11 *Word Investments* (2008) 236 CLR 204, [24], [27] (Gummow, Heydon, Hayne and Crennan JJ).

12 Ian Murray, 'Charity Means Business' (2009) 31 *Sydney Law Review* 309, 316.

13 *Stratton v Simpson* (1970) 125 CLR 138, 148 (Windeyer J); see also 159–60 (Barwick CJ, Gibbs and Menzies JJ agreeing).

14 *Word Investments* (2008) 236 CLR 204, [24] (Gummow, Hayne, Heydon, Crennan JJ).

15 *Word Investments* (2008) 236 CLR 204, [76] (Kirby J).

16 Australian Tax Office, *Income Tax: Tax Deductible Gifts — What is a Gift*, TR 2005/13 (20 July 2005) [12].

(UK)¹⁷ which granted exempt income status to charities and the decision of the Privy Council in *Commissioners for Special Purposes of the Income Tax v Pemsel*¹⁸. It is these judicial decisions and legislative frameworks in the United Kingdom, Australia and other countries that have followed these basic premises. The Statute of Elizabeth set out the following categories:

- relief of the aged, impotent and poor;
- maintenance of sick and maimed soldiers and mariners;
- schools and scholars in universities;
- repair of bridges, ports, havens, causeways, churches, sea-banks and highways;
- education and preferment of orphans;
- maintenance of prisons;
- marriages of poor maids;
- aid and help of young tradesmen and handicraftsmen;
- aid and help of persons decayed;
- the relief or redemption of prisoners or captives;
- the aid or ease of any poor inhabitants concerning payment of fifteens; and
- setting out of soldiers and other taxes.

The judgment of Lord Macnaghten in *Pemsel*¹⁹ is often considered the starting point for identifying the four ‘heads’ of charity from which much of our modern legal definitions of charity are derived. The four heads were:

- the relief of poverty;
- the advancement of education;
- the advancement of religion; and
- other purposes beneficial to the community.

However *Pemsel*²⁰ was decided in 1891 and as times have changed and community expectations have shifted so too have courts wrangled with the application of these four heads to a variety of circumstances. Although there have been repeated calls from the judiciary,²¹ academics²² and review bodies²³ to legislate a definition or definitions, we are still without a clear legislative definition of what could fall within these four heads. We have come close with a draft bill, the Charities Bill 2003 (Cth). However, it was abandoned — primarily due to the negative response by the NFP community²⁴ and the Board of Taxation was similarly negative that the proposed public benefit definition had achieved requisite certainty.²⁵ Instead an Act was passed in 2004 to extend definitions (contained in the ITAA 1997) in the Extension of Charitable Purpose Act 2004 (Cth). This Act included the provision of childcare,²⁶ and the provision of a rental dwelling under the National Rental Affordability Scheme both as a charitable purpose.²⁷ Further it allows for an open and non-discriminatory self-help group,²⁸ and a closed or contemplative religious order that regularly undertakes prayerful intervention²⁹ at the request of members of the public, to be recognised as institutions that may be for a public benefit.³⁰

17 43 Eliz 1 c 4.

18 [1891] AC 531 (*‘Pemsel’*).

19 Ibid.

20 Ibid.

21 See *Central Bayside General Practice Association Ltd v Commissioner of State Revenue* (2006) 228 CLR 168, [116]–[117] (Kirby J).

22 See Paul Harpur, ‘Charity Law’s Public Benefit Test: Is Legislative Reform in the Public Interest?’ (2003) 3(2) *Queensland University of Technology Law and Justice Journal* 422–37.

23 Charities Definition Inquiry, Parliament of Australia, *Report of the Inquiry into the Definition of Charities and Related Organisations* (2001) (‘CDI’). See especially chs 4, 13.

24 See, eg, ‘Church Calls Charities Bill “Unworkable”’, *Catholic News* (online), 9 October 2003 <<http://cathnews.acu.edu.au/310/42.php>> at 25 November 2010.

25 Peter Costello, ‘Final Response to the Charities Definition Inquiry’ (Press Release, 11 May 2004).

26 *Extension to Charitable Purposes Act 2004* (Cth) s 4(1) (*‘Charitable Purposes Act’*).

27 *Charitable Purposes Act* s 5(1).

28 *Charitable Purposes Act* s 6(1)(a).

29 There is authority for the counterargument that intercessory prayer is not for the public benefit, starting from *Gilmour v Coates* [1949] AC 426, thus the need for legislative inclusion.

30 *Charitable Purposes Act* s 6(1)(b).

Therefore it is not enough to be simply charitable in purpose, but that purpose must also meet a public benefit test, unless the organisation is engaged in the relief of poverty. As acknowledged by Paul Harpur, the public benefit aspect has not been extensively explored in case law, and indeed has puzzled many a great mind.³¹ It is generally understood that purpose is beneficial to the public if the purpose is aimed at achieving a universal or common good, it must have practical utility and it must be for the benefit of the general community or a sufficient section of it.³²

Review of the Taxation Ruling TR 2005/21 illustrates that the Australian Tax Office's view of the definition of charitable purpose for the purposes of applying the income tax and fringe benefits concessions. The Ruling holds that for a purpose to fall within the technical legal meaning of 'charitable' it must be:

beneficial to the community, or deemed to be for the public benefit by legislation applying for that purpose; and

within the spirit and intendment of the Statute of Elizabeth, or deemed to be charitable by legislation applying for that purpose.

The benefit of a charitable purpose need not be for the whole community; it is sufficient that it is for an appreciable section of the public.

However, this public benefit requirement does not apply where the charitable purpose is the relief of poverty. Those who benefit from such a charity need not be a section of the public.³³

III. WHAT DOES THE TAX LAW DO?

There are a number of tax concessions available to NFPs. The main concessions are income tax exempt status GST concessions, FBT exemptions, FBT rebate, and registration on the Deductible Gift Registry ('DGR') status. NFP entities may have more than one status so that a charity may have income tax exemption status and it may be on the DGR.

A. Income Tax Exemption

To access any of these concessions a charitable organisation must first be endorsed; merely stating you are charitable does not grant automatic exemption status. The process to become a tax exempt charitable institution is set out in the ITAA 1997. A charitable entity must therefore be an 'entity'³⁴ covered by the table set out in section 50-5 of that Act. Section 50-52 of the ITAA 1997 provides that an entity is not exempt from income tax unless the entity is endorsed as exempt from income tax under subdivision 50-B. The requirements under section 50-50 are a series of alternatives and exempt status will not be granted unless the entity either meets a physical presence in Australia test, or it is listed on the deductible gifts register in section 30-15 of the ITAA 1997 or it is prescribed by law — that is, prescribed by name in the income tax regulations. The process is undertaken under Division 426 of the Tax Administration Act 1953 (Cth). Once an organisation is endorsed as a charity the income from the entity's activities are income exempt from tax.

³¹ Harpur, above n 22, 423.

³² CDI, above n 23, 8.

³³ Australian Taxation Office, *Income Tax and Fringe Benefits Tax: Charities*, above n 9, [8]–[10].

³⁴ Note that parts of entities cannot be a charitable entity for the purposes of tax-exempt status. The legislation is concerned with 'an entity' and an entity is defined in ITAA 1997 s 960.100 as individuals, a body corporate, a body politic, a partnership; any other unincorporated association or body of persons; a trust; a superannuation fund; and an approved deposit fund — clearly not all of these structures will themselves meet the test for being a charity.

B. Fringe Benefits Tax

FBT concessions amounted to around \$1 billion in tax expenditures for 2008-09.³⁵ State payroll concessions for NFPs are greater than \$800 million per annum.³⁶ In the FBT provisions concerned with providing tax concessions for NFPs there is a capped exemption for benefits provided to an employee of a public benevolent institution,³⁷ or a health promotion charity, or public hospital and public ambulance services,³⁸ or a religious institution.³⁹ Additionally a rebate is provided to certain non-profit employees⁴⁰ that reduces the FBT burden to the employer. Both concessions act to tax labour at a reduced effective rate. The concern is that this allows NFPs a competitive advantage in attracting staff in labour markets by enabling them to pay the market wage at a lower cost.⁴¹ Several of the submissions to the Henry Review were concerned with this aspect of tax concessions.⁴² The Henry Review included concerns that it creates direct iniquity between employees performing similar work — but receiving different after-tax remuneration.⁴³ The example given is that of nurses employed in a public hospital compared to those employed in a commercial hospital. The concern is that the FBT concessions are not helping to increase the overall pool of nursing staff and instead contribute to wage inflation across the nursing sector.⁴⁴

1. DGR Status

As at the end of October 2009, there were 52,775 tax concession charities and 26,549 active deductible gift recipients ('DGRs').⁴⁵ DGRs are entities to which donors can make income tax deductible gifts. They are either prescribed private funds listed by name in the Income Tax Assessment Regulations 1997 (Cth), or other DGRs listed by name in the ITAA 1997. Broadly, DGR status is extended to those organisations whose activities provide a benefit to the public or a significant group within the public. The general DGR categories include public benevolent institutions, public universities, public hospitals, approved research institutes, arts and cultural organisations, environmental organisations, school building funds and overseas aid funds.⁴⁶ The government also has the power to enact legislation to create types or categories of deductible gift recipient. For example in 2003 a new type called Harm Prevention Charitable Institution⁴⁷ was created in response to the Charities Definition Inquiry ('CDI').⁴⁸ DGRs can be searched for on the Australian Business Register.⁴⁹ A donor will be granted a tax deduction to reduce their assessable income, this is a highly attractive incentive to choose a DGR over another potential

35 Access Economics Report, *Strengthening Australia's Community Organisations, Reforming Taxation Concessions Arrangements* (2010) vi ('Access Economics Report').

36 *Ibid.*

37 If it has been endorsed under *Fringe Benefits Tax Assessment Act 1986* (Cth) s 123C ('FBTAA').

38 FBTAA s57A.

39 FBTAA s57.

40 FBTAA s 65J(1) lists 14 categories including trade unions, schools, and other non-profit but not charitable institutions.

41 Australia's Future Tax System Report to the Treasurer, above n 2, 210.

42 See Australian Charity for the Children of Vietnam to Parliament of Australia, Treasury, *Australia's Future Tax System* 17 October 2008 for an example of a submission seeking to protect this advantage. For an example of a submission concerned with unfairness see Secular Party of Australia to Parliament of Australia, Treasury, *Australia's Future Tax System* 13 October 2008 <<http://taxreview.treasury.gov.au/content/submission.aspx?round=1>> at 25 November 2010.

43 The difference identified in the Henry Review Final Report was that nurses in public and NFP hospitals had around \$2800 per annum in additional after-tax remuneration: Henry Review Final Report, above n 2, 211.

44 Henry Review Final Report, above n 2, 210–11.

45 Australian Taxation Office, *Taxation Statistics 2007–08 Charities and Deductible Gifts* (2010) <<http://www.ato.gov.au/corporate/content.asp?doc=/content/00225078.htm&page=45&H45=&pc=001/001/009/005&mmu=43433&mfp=001&st=&cy=1>> at 25 November 2010.

46 ITAA 1997 subdv 30-B.

47 ITAA 1997 s 30.288.

48 CDI, above n 23.

49 Commonwealth of Australia, *Welcome to ABN Lookup*, ABN Lookup <<http://www.abn.business.gov.au>> at 25 November 2010.

recipient. For the 2007–08 income year, individuals claimed \$2,346 million in deductible gifts, an increase of 24.5% on the previous year.⁵⁰

2. *Prescribed Private Funds and Private Ancillary Funds*

Since 2001, individuals, families and businesses have been able to establish their own DGRs, and these were initially known as prescribed private funds ('PPFs'). PPFs were abolished in 2008 and private ancillary funds were created.⁵¹ Private ancillary funds are trusts with DGR status that can receive donations for distribution to other DGRs — but are prohibited from distributing their donations or other profits to other private ancillary funds. As of 31 October 2009 there were 769 private funds receiving \$728 million in donations and making \$129 million in distributions.⁵²

3. *GST Concessions*

The GST turnover registration threshold (where registration for GST becomes mandatory) is twice that of other enterprises, and is currently \$150,000.⁵³ There is a range of other GST concessions available to NFPs mostly providing exemptions. For example sale of donated second hand goods is GST free, and fundraising events may be input taxed supplies. However the Henry Review reported that, overall the effect of GST concessions for NFPs is significantly moderated by the fact that where NFPs operate in commercial markets their activities are taxable under GST legislation. The Henry Review postulated that this did not adversely affect the principle of competitive neutrality.⁵⁴ However, it must be noted that the NFP specific exemptions add to the overall complexity of compliance with GST requirements. This is particularly so when one considers the inconsistency whereby some trade receipts of charities are exempt from GST and others are not (in addition to the ordinary exempt categories).⁵⁵

IV. ISSUES

The Henry Review put forward the idea that the status quo 'does not fully reflect current community values about the merit and social worth of the activities it subsidises.'⁵⁶ Although it is not explicit in defining what 'community values' are, the subtext implies that the tax regulatory regime neither meets the needs of the NFP community nor that of the wider community to whom the charities are meant to serve. Evaluation of the proposals for reform put forward in the Henry Review must be considered from this community perspective.

Why then is there this disjuncture between the tax concessions available to NFPs and community expectation? The reasoning of the Henry Review suggests that it is a two-fold issue. The first is the degree of complexity of the system, which acts to inhibit the activities of organisations both through confusion over scope, excessive administrative burden and diversion of monies (donated or derived profits) to compliance. The second is the constraints inherent in the system itself — the difficulty of responding in a timely manner to changing or emerging community expectations and needs. If complexity is removed then the system will become more efficient and there will be a better outcome for the community as a whole. If the system is modernised and becomes flexible then the sector will become more responsive to community needs and changing expectations.

⁵⁰ Australian Taxation Office, *ATO Taxation Statistics 2007–08* (2008) ch 10 (Charities and Deductible Gifts) 104. These ATO statistics include data processed up to 31 October 2009.

⁵¹ *Tax Administration Act 1953* (Cth) subdiv 426-D.

⁵² Australian Taxation Office, *ATO Taxation Statistics 2007–08*, above n 50, 109.

⁵³ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 23.15(2) ('GST Act').

⁵⁴ Henry Review Final Report, above n 2, 210.

⁵⁵ See Explanatory Memorandum, *A New Tax System (Goods and Services Tax) Bill 1998*, 5.97- 5.105

⁵⁶ Henry Review Final Report, above n 2, 210.

A. Complexity

The complexity according to the Henry Review is derived from the fact that there are multiple tax concessions available to NFPs.⁵⁷ This reiterates and draws on the findings of earlier inquiries such as the CDI which noted ‘much of the confusion in the sector is related to what tax or other concessions attach to what type of entities and what the boundaries are between different types of entities’.⁵⁸ It should be noted that each tax concession must be applied for; none of them are automatically granted upon the successful gaining of another concession. For example income tax-exempt status for the purposes of Division 50 of the ITAA 1997 does not grant FBT concessions status. Moreover if the concessions considered are combined with all federal and state concessions (which have not been considered in this article) then at least 40 separate pieces of legislation are involved and they are administered by 19 different agencies.⁵⁹ Each agency and most legislation enacting its own purposes will have slightly different interpretations of what is an eligible entity and eligible charitable purpose. Although the Australian Taxation Office (‘ATO’) appears to have emerged as the de facto regulator for charitable purpose, its decision does not bind any other authority.⁶⁰ Furthermore, apart from New Zealand, no other jurisdiction imposes a separate tax on the provision of benefits to employees; therefore on an international comparative basis Australian charities are overburdened.⁶¹ This multiplicity of agencies and legislation is particularly burdensome for any entity operating across multiple state jurisdictions. This, complexity rises further if it is operating or engaging in several different types of activity, eg fundraising, donation solicitation, sales of goods or services and peak body representation or lobbying. The sector itself is sometimes uncertain as to whether its activities come within the meanings covered by the legislation (even after endorsement) and frequently resort to (costly) legal advice.⁶²

Another identified cause of complexity is the uneven application of tax concessions. For example a charity may be exempt from income tax and have DGR status but be ineligible for FBT concessions. These concerns were articulated in RSPCA Australia’s submission to the Senate Economics Committee 2008 inquiry into the disclosure regimes for charities and NFP organisations.⁶³ The submission indicated that the current arrangements ‘infer that some charitable purposes are more worthy than others’.⁶⁴ The requisite definition threshold for endorsement from exemption from FBT is specified in s 123E(1) of the FBTAA which, in turn, refers to the same endorsement process prescribed by the *Taxation Administration Act 1953* (Cth) which is used for endorsement for the income tax exemption. Nonetheless an organisation may not qualify under FBT for the concessions notwithstanding their qualification under income tax. One implication of this unevenness is that organisations may be receiving different status due to their political and or lobbying power rather than on independent merit.⁶⁵

B. A System Constrained

The system is based on over 400 years of evolving case law and piecemeal legislation. The rationale for tax concessions to charitable NFPs in Australia is not articulated in legislation, nor in the supporting documents. Yet there is an underlying assumption that tax concessions are granted to support charitable NFPs because they serve the community through their activities either directly (for example running a soup kitchen) or indirectly (for example advancement of religion), and their activities provide positive public benefits. That is, the services deliver

⁵⁷ Ibid 206

⁵⁸ CDI, above n 23, 34.

⁵⁹ Henry Review Final Report, above n 2, 207.

⁶⁰ Productivity Commission, above n 1, 164.

⁶¹ Anne O’Connell, ‘The Tax Positions of Charities in Australia – Why Does It Have to Be So Complicated?’ (2008) 37 *Australian Tax Review* 17, 36.

⁶² Productivity Commission, above n 1, 163.

⁶³ Senate Standing Committee, Commonwealth of Australia, *Disclosure Regimes for Charities and Not-for-Profit Organisations* (2008).

⁶⁴ See also Access Economics Report, above n 35, 24.

⁶⁵ Fiona Martin, ‘Is It Time for an Independent Regulator of the Non Profit Sector in Australia?’ (2009) 12(3) *The Tax Specialist* 149–59, 157.

benefits that are not restricted to the immediate recipient of the benefit (the soup kitchen visitor), but also generate important social, economic and cultural benefits to the wider community.⁶⁶ Furthermore, there is support for the idea that the NFP sector is better positioned than governments and the business community to deliver these public benefits through their smaller scale, their connections to various members and classes of society, and their flexibility and capacity to engage private individuals in support of public purposes.⁶⁷ Generally there is also public support for this use of public funds. Therefore tax exemptions are designed to allow charitable organisations to devote more of their income to their charitable mission.⁶⁸ However it is the view of the Henry Review that the complexity of the system and the administration of the system are hindering both the delivery by the sector of those perceived benefits and the benefit in the sector being the one to make those deliveries.

The Henry Review thus appears to adopt the twin focuses of assessing the charitable sector's efficiency and acceptance of the pluralism-enhancing advantages of having charities provide public goods instead of, or in addition to the government.⁶⁹ If it is accepted, as it is in the Henry Review, that the role of charitable organisations in society is to deliver important social, economic and cultural benefits then, given the identified issues of complexity and overregulation, what does the Henry Review offer by way of remedy? The solution must be predicated on the ability of those organisations to deliver the benefits in a flexible manner that adapts to the changing needs of the wider community.⁷⁰ The challenge for permitting flexibility is to encourage more of the beneficial activity, and not merely to deliver a financial gain to those who would have undertaken the activity anyway.

V. HENRY REVIEW SOLUTIONS

The Henry Review Final Report recommendations are as follows:⁷¹

A. Recommendation 41

Consistent with the recommendations of previous inquiries, a national charities commission should be established to monitor, regulate and provide advice to all not-for-profit (NFP) organisations (including private ancillary funds). The charities commission should be tasked with streamlining the NFP tax concessions (including the application process for gift deductibility), and modernising and codifying the definition of a charity.

The introduction of a single regulatory body reflects emerging practices in overseas jurisdictions such as the United Kingdom.⁷² The Henry Report reiterates the call for a national charities commission citing the consistency of the recommendation for its introduction from 1995 onwards.⁷³ The experience in these jurisdictions suggests that the net benefit is positive and well received within the NFP sector and the general public. The strength of the recommendation for a national commission is that it has strong support from the sector itself and from numerous government⁷⁴ and non-government⁷⁵ inquiries.

⁶⁶ Access Economics Report, above n 35, 24.

⁶⁷ Martin, 'Is It Time for an Independent Regulator of the Non Profit Sector in Australia?', above n 65, 157.

⁶⁸ Mark Lyons, *Third Sector: The Contribution of Non-Profit and Cooperative Enterprises in Australia* (2001) 20, 182.

⁶⁹ See, eg, Miranda Fleischer, 'Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice', Research Paper No. LE09-006, *Illinois Law and Economics Research Papers Series 4*.

⁷⁰ Fiona Martin, 'Charities for the Benefit of Employees: Why Trusts for the Benefit of Employees Fail the Public Benefit Test' (2007) 15(1) *e-Journal of Tax Research* 59-70, for example, suggests a purpose test that the entity's activities will add to or advantage the community rather than individuals.

⁷¹ It should be noted that recommendations 41-3 are taken verbatim from the Henry Review Final Report, above n 2, 211-12.

⁷² See generally Martin, 'Is It Time for an Independent Regulator of the Non Profit Sector in Australia?', above n 65.

⁷³ Henry Final Report, above n 2, 212.

⁷⁴ See, eg, Productivity Commission, above n 1.

⁷⁵ See, eg, National Roundtable of Nonprofit Organisations, *Our Mission National Roundtable of Non-Profit Organisations* <<http://www.nonprofitroundtable.org.au>> at 25 November 2010.

The risks lie not with the creation of a charities commission but whether it is suitably equipped for the task it will be asked and expected to perform. The regulatory body should be given a framework for creating a cohesive and rational policy basis against which developments in taxation law must be formulated. Creating an administrative regulator without this articulated policy basis risks replication of the position the ATO currently occupies. Without the impetus to address the inconsistencies or complexity within the system, this will undermine the usefulness of the role and risk creation of another layer of complexity or imposition of just another regulating body.⁷⁶ Additionally it must also be asked as to how another regulatory body will add flexibility to the system beyond lightening the administrative burdens of the sector.

However a centralised body offers the advantage of participants gaining efficiencies in sourcing information and of provision of information in a standardised manner. This would increase our overall body of knowledge in relation to the sector and make implementation of new policies or directions simpler and more cost effective. In addition it creates an opportunity to cut through a particular source of complexity of multiple agencies with multiple definitions. This could be a system analogous to the one created in England and Wales where registration with the Charities Commission creates a legal presumption that the organisation is a charity and must be accepted as a charity by other government bodies including the Inland Revenue.⁷⁷

The current de facto regulator of the ATO is far from ideal as it sees its role as protector of the revenue — maximising tax compliance among NFPs in the key areas of registration, keeping proper records, lodging forms on time, reporting correct information and paying tax on time.⁷⁸ In addition, unlike a suitably empowered Commission, the ATO is unable to address the lack of co-ordination between Commonwealth and State exemptions and administration.

However as an alternative to an independent commission, the ATO could be enlarged and a dedicated NFP sector within its structure created and similarly tasked to modernise and codify the definition of a charity. Recognition of the ATO's exemption status determination could be underpinned by appropriate legislation. The ATO has previously undertaken similar parallel functions such as Child Support collections and if adequately funded could assume many of the commission's functions. The advantage of this approach is that it will prevent the creation of another bureaucracy with attendant (significant) revenue demands upon the Australian Government. For example, the Charity Commission for England and Wales administers nearly 163,000 charities with annual income of nearly £52 billion⁷⁹ and spends around £30 million a year pursuing its objectives.⁸⁰

B. Recommendation 42

Categories of NFP organisations that currently receive income tax or GST concessions should retain these concessions. NFP organisations should be permitted to apply their income tax concessions to their commercial activities.

This recommendation attempts to provide a framework for any changes to the regulatory framework. That is, the Henry Review Final Report should not be read as a recommendation to remove the income tax and GST concessions but to change the implementation and regulation of the concessions. The rationale given is that NFPs deliver benefits to the wider community that either complement or support the government's activities (such as in health care) or deliver benefits that neither the government nor the private sector are willing or able to.⁸¹ Tax concessions enable NFPs to continue this beneficial activity in a relatively targeted way as they have been an important and longstanding source of financial support.⁸²

⁷⁶ Martin, 'Is It Time for an Independent Regulator of the Non Profit Sector in Australia?', above n 65, 157.

⁷⁷ Charity Commission, *CC2 — Charities and the Charity Commission* (2002) 5; *ibid* 151–2.

⁷⁸ Australian Taxation Office, *2006–07 Compliance Program* (2006) [43].

⁷⁹ Charity Commission of England and Wales, *Facts and Figures* <http://www.charity-commission.gov.uk/About_us/About_charities/factfigures.aspx> at 25 November 2010.

⁸⁰ (Charity Commission of England and Wales, *Annual Report of the Charity Commission of England and Wales* (2009/10) 14.

⁸¹ Henry Review Final Report, above n 2, 206.

⁸² O'Connell, above n 61, 36.

Giving NFPs the scope to conduct commercial activities freely, it is argued, would potentially reduce costs associated with education, assistance, advice, disputes and litigation on the ATO's interpretation of a 'charitable purpose', and would reflect the principles of the High Court of Australia's *Word Investments* decision.⁸³ The underlying idea is to allow charities to become self-sufficient as they would generate income tax exempt income through the provision of goods and services. This would remove some of the demands for increased government funding and therefore also remove concerns that direct government funding would negatively impact on operational flexibility, create greater certainty (rather than a system dependent on budget cycles), and promote social innovation.⁸⁴

The criticism of this commercial openness approach is that NFPs are servicing commercial markets unrelated to their philanthropic activities, including: turf supplies; insurance; music sales; pizza shops; and breakfast and health foods.⁸⁵ The fear is that these activities undermine competing taxable entities and therefore, ultimately, undermine the revenue base as consumers purchase from tax exempt entities in preference to taxable entities. Kirby J in dissent in *Word Investments* noted that exempted trading activities afford 'an unfair economic advantage'.⁸⁶ Murray highlighted in anticipation of the Henry Review Final Report the potential risks of this approach and raised the following as being of concern (in addition to the competitive neutrality concern): the increase in the risk of loss of an entity's charitable assets if commercial liabilities are not quarantined; the 'diversion' of the efforts of the controllers of an entity away from its charitable purpose and towards its commercial activities; and that individuals may view charities as less altruistic if they expand their commercial activities.⁸⁷

The Henry Review did not address many of these and relied upon the preemption of concerns about tax arbitrage by acknowledging that although there may be a degree of erosion of the revenue base the benefits to society as a whole outweigh the disadvantages.⁸⁸ This was the view adopted in New Zealand.⁸⁹ The Henry Review also adopted the view that an after-profits based income tax exemption does not affect the behavior of the entity setting its prices on a cost recovery basis, and thus competitive neutrality is not undermined by this concession.⁹⁰ Nonetheless this must be ultimately seen as a failure of the Henry Review to adequately address the legitimate concerns of these concessions from a public confidence perspective⁹¹ or how increased trading activities might place charity assets at risk.

C. Recommendation 43

1. NFP FBT concessions should be reconfigured.

- a) *The capped concessions should be phased out over ten years. In the transition period, the value of the caps would gradually be reduced. Reportable fringe benefits for affected employees (that is, those benefits that are readily valued and attributed) would be exempt from tax up to the relevant cap, and taxed at the employee's marginal tax rate above the cap. The market value of these benefits would be taken into account for transfer payment purposes. Non-reportable fringe benefits would be taxable for NFP employers.*
- b) *The FBT concessions should be replaced with direct government funding, to be administered by relevant Commonwealth portfolio agencies or the charities commission. All NFP organisations eligible for tax concessions should be able to apply to the relevant body for funding for specific projects or for assistance with the costs of recruiting specialist staff.*

⁸³ Henry Review Final Report, above n 2, 212; *Word Investments* (2008) 236 CLR 204.

⁸⁴ Access Economics Report, above n 35, 24–5.

⁸⁵ Henry Review Final Report, above n 2, 162–3.

⁸⁶ *Word Investments* (2008) 236 CLR 204, [170] (Kirby J).

⁸⁷ Murray, above n 12, 326.

⁸⁸ Henry Review Final Report, above n 2, 208–9.

⁸⁹ Working Party on Charities and Sporting Bodies, *Report to the Minister of Finance and the Minister of Social Welfare* (1989) 34–5 (the 'Russell Report').

⁹⁰ Henry Review Final Report, above n 2, 208–9.

⁹¹ See concerns of Law Reform Commission (Ireland), *Charitable Trusts and Legal Structures for Charities* LRC 80–2006 (2006) [3.04].

The Henry Review outlines that the benefit of this system is that it does much to restore the remuneration system that is both complex and increasingly inequitable. However the Henry Review Final Report noted that the impact of the removal of FBT concessions is less clear in situations where there is no direct for-profit competition (for example, in the provision of health services in remote areas). The removal of FBT concessions in these cases may make it difficult for NFPs to attract appropriately qualified staff, which may result in the downsizing or closure of programs.⁹² The FBT concessions have been identified as causing public confidence issues and raises concerns that taxpayer dollars are subsidising non-charitable items.⁹³ Any behaviour perceived as unfair risks an overall reduction in participation by the public including reduction of donations and/or resistance to continued tax advantaging of such entities.⁹⁴ The proposal includes a significant phasing in period of 10 years together with interim measures such as taxing at taxpayer's marginal rates the market value⁹⁵ of the benefit above those rates. A concomitant requirement of the disclosure of the transitional benefits is included to increase the transparency of the process and to limit access to other transfer payments by the employees.⁹⁶

It is of note to compare this to the results of the New Zealand government review of FBT in 2003 which also considered whether the exemption for charities should be retained and heard similar arguments in relation to lack of fairness.⁹⁷ The decision was made in New Zealand to retain the concessions in part due to the fact that many charities are not large enough to have significant numbers of employees obtaining significant benefits under the system.⁹⁸ It is perhaps inconsistent of the Henry Review that the issue of fairness and public perception is addressed in relation to the provision of benefits to employees of charities but is inadequately dealt with in relation to exempting trading activities.

It can be seen that the measures regarding FBT are aimed at the fairness issue — fairness to existing beneficiaries of the system (by having a 10 year transition period) and fairness to the general public and taxpayers dollars. The measures can be seen as attempting to balance the needs of the sector with the public need for greater transparency in the system regarding taxpayer funds. The proposed measures will undoubtedly create short term additional complexity within the remuneration system through the introduction of transitional arrangements together with the possibility of 'grandfathering' of current arrangements for beneficiaries under the current system. The risk to the sector is that the changes to the FBT system will be implemented without the recommendation 43(b) proposed replacement with direct government funding, to be administered by relevant Commonwealth portfolio agencies or the Charities Commission. Even if recommendation 43(b) is implemented, the value of the direct funding may erode over time.

VI. GOVERNMENT RESPONSE

The May 2010 Budget has included only the following:

- extending deductible gift recipient status to all volunteer fire brigades and other emergency service entities
- improving the regulatory framework for public ancillary funds
- updating the list of specifically listed deductible gift recipients.

That is, the proposals are merely peripheral and ignore the heart of the Henry Review NFP recommendations.

⁹² Henry Review Final Report, above n 2, 210.

⁹³ Access Economics Report, above n 35, 24.

⁹⁴ There are many studies on the relationship between fairness and public goods from experimental economics. See Andrew Reeson and Simon Dunstall, *Behavioral Economics and Complex Decision-Making, Implications for the Australian Tax and Transfer System* (CMIS Report 09/110, CSIRO, 2009) 8.

⁹⁵ FBT liability in Australia is triggered by the 'taxable value' of a benefit which is not necessarily the market value of the benefit; a good example of this is a motor vehicle which is concessionally treated based on high kilometre usage: FBTA ss 9, 10.

⁹⁶ Henry Review Final Report, above n 2, 211.

⁹⁷ New Zealand Government, *Tax and Charities, Discussion Document* (2001) <<http://taxpolicy.ird.govt.nz/sites/default/files/2001-dd-charities.pdf>> at 25 November 2010.

⁹⁸ O'Connell, above n 61, 36

The official government response to the Henry Review Final Report can be found in the Tax Policy Statement ‘Stronger, Fairer, Simpler’.⁹⁹ The incumbent government overall has ‘cherry picked’ a few ideas from the Henry Review Final Report and is at the time of writing focused on gaining public support for the ‘resources super profits’ tax on mining companies. Ancillary focus is on cutting the tax rate to companies, simplifying taxes on businesses generally and reconfiguring superannuation and other retirement based savings.¹⁰⁰

In addition, the Henry Review Final Report was released in an ‘election year’ and as such any major reforms are likely to await re-election. The Federal Opposition’s policies at the time of writing do not include any formal response to the recommendations in the Henry Review Final Report. Thus although there are merits in the proposals at the end of the day there is unlikely to be any significant change to the tax concessions of NFPs.

A. Recent Developments

In addition to the projected Federal election being called there has also been a change in Prime Minister (from Kevin Rudd to Julia Gillard). The tax platform of the Labor party includes changes to superannuation, a renamed ‘superprofits tax’ — now the Mineral Resource Rent Tax and minor changes to the tax acts in respect of deductions.¹⁰¹ That is, there is nothing in the election platform to date to suggest that this is a focus area for either party. On 13 May 2010 the Senate referred the Tax Laws Amendment (Public Benefit Test) Bill 2010 for inquiry and report by the Senate Economics Legislation Committee. The Report was handed down on 7 September 2010; calling once again, for a national commission to be established; thus maintaining the momentum for reform.¹⁰² The Tax Laws Amendment (Public Benefit Test) Bill 2010 sought to amend the tax laws to require that religious and charitable institutions meet a public benefit test to justify their exemption from taxation. The Committee however determined that reform of the public interest test should form part of a major reform rather than another piecemeal amendment to a complicated area of law.

VII. CONCLUSION

The Henry Review focuses on a few key reforms — the introduction of a regulatory body, the expansion of commercial activity tax exemption and reconfiguration of FBT exemptions. The risk it runs however is that it is simply another report commissioned by a yet another government, requesting something that has already been identified in numerous reports already commissioned by previous or other governments. In summary, the Henry Review has not provided much in the way of originality to the arguments surrounding the need to reform the charitable sector. In addition it is inclined to the view that simplification of regulation and tax concessions is the cornerstone of delivering community expectation without necessarily substantiating that belief. However the proposed solutions, in their very lack of originality, lend weight to the idea that reform need not be radical and that Australia is lagging behind other Commonwealth countries. There is still much energy and interest in reform from the sector itself thus the issue will not simply ‘go away’ despite current government preoccupation with other activities.

In the end, charity begins not at home, but in the House of Parliament.

⁹⁹ Australian Taxation Office, *Tax Policy Statement, ‘Stronger, Fairer Simpler, A Tax Plan for the Future’* <www.futuretax.gov.au> at 25 November 2010.

¹⁰⁰ See, eg, Henry Review Final Report, above n 2, 3, 5.

¹⁰¹ Australian Labor Party, *Agenda, A Tax Plan for Our Future* <<http://www.alp.org.au/agenda/more---policies/tax-reform-a-tax-plan-for-our-future/>> at 25 November 2010.

¹⁰² Senate Economics Legislation Committee, Parliament of Australia, *Tax Laws Amendment (Public Benefit Test) Bill 2010, (2010.)1-2*