Submission to the Australian Government Productivity Commission

In response to the Productivity Commission Draft Research Report of October 2009, *Contribution of the Not-for-Profit Sector*.

Submitted by:

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Basis of Submission

This Submission addresses an issue that the submitter notes has been omitted from the Productivity Commission Draft Research Report ("the Report") in general, and Chapter 8 in particular, with respect to the discussion on the income tax exemption.

The income tax exemption

The focus of the discussion in the Report concerning the income tax exemption is commercial activity. The Report states that:

> [o]n balance, income tax exemptions are not significantly distortionary as not-for-profits (NFPs) have an incentive to maximise the returns on their commercial activities that they then put towards achieving their community purpose.[1]

[1] Productivity Commission, *Contribution of the Not-for-Profit Sector* Draft Research Report (October 2009) 8.1.

While citing the Unrelated Business Income Tax (UBIT) regime in North America, this statement ignores the rationale underlying UBIT and associated case law, as well as the (minority) dissenting but significant judgment of Kirby J in *Word Investments Ltd*.[2] However, I do not intend to focus on this issue but I recommend that the Productivity Commission undertake further research, from an international perspective, regarding the thesis stated above.

An omission from the Report

There is no discussion in the Report concerning the income tax exemption and NFPs behaviour with respect to investment policies. The income tax exemption does not only apply to income generated from commercial activity, but also to income from funds invested by NFPs. Empirical evidence suggests that charities in New Zealand may be acting in a manner to create and maintain wealth instead of applying surplus funds to their charitable purposes. The most recent example of this behaviour was reported in the media with respect to Primary Health Organisations (PHOs), which were created to deliver health care throughout New Zealand "to provide essential primary health care to enrolled patients."[3] The Minister of Health has stated that the PHOs, which are incorporated as charitable trusts, have accumulated in excess of NZD$115 million in investments. These are income tax exempt funds which have not been applied to the purposes that the government, through the District Health Boards, intended the funds to be used.

An example of an NFP apparently accumulating wealth can be seen in a prominent Australian organisation, Mission Australia. An analysis of the financial statements of Mission Australia indicates that its investments are a

[2] *Commissioner of Taxation v Word Investments Ltd* [2008] HCA 55.
[3] Tracy Watkins and Ruth Hill, *Govt probes $115m in PHOs' coffers* The Press 16 November 2009 A3.

significant proportion of its net assets, or equity, as detailed in the following Table.[4]

Table 1 Balance Sheets of Mission Australia – Investments 2006-2008

	2006 **$**	**2007** **$**	**2008** **$**
Other Investments	17,018,749	20,105,941	18,502,919
Investments	5,012,115	5,458,523	4,930,916
Total Investments	**22,030,864**	**25,564,464**	**23,433,835**
Total Equity	**50,802,849**	**50,283,072**	**59,780,877**
Total Investments as a percentage of Total Equity	43.36%	50.84%	39.20%

There is no evidence in the Annual Reviews for 2007 and 2008 of a rationale for the level of investments held by Mission Australia. The only comment on Mission Australia's investing strategy is to be found in the Corporate Governance Statement that "[t]he CFO is responsible for ... ensuring that the investment strategy is implemented and maintained."[5] However, the level of funds invested as a percentage of equity, particularly given the magnitude of those funds, must raise questions as to why those funds are not being applied to charitable purposes. The creation of wealth is not a charitable purpose. As the income from invested funds are exempt from income tax, there is an attraction in growing funds because of that fiscal privilege. However, I believe that Mission Australia should be required to disclose its rationale for holding invested funds at such a significant percentage of total equity.

<u>The Charity Commission for England and Wales – CC19 Charities' Reserves (CC19)</u>

The New Zealand Charities Commission has yet to develop guidelines regarding the levels of funds held by charities in their reserve accounts. However, the

[4] Mission Australia, Annual Reviews 2007 and 2008, at www.missionaustralia.com.au (as at 17 November 2009).
[5] See, for example, Mission Australia, above n 4, Annual Review 2008, 34.

Charity Commission for England and Wales requires charities to justify to the public the levels of reserves that they hold: "The giving public ...are entitled to be reassured that a charity with reserves has good reasons for keeping funds in reserve, *and to know what those reasons are* (emphasis added)."[6] CC19 explains that "[j]ustifying reserves ... means being able to demonstrate, by reference to a charity's current position and future prospects, why holding a particular level of reserves is right for the charity at that time."[7] CC19 requires, in accordance with Paragraph 55(a) of SORP 2005, that trustees should:

- Describe their charity's reserve policy;
- Explain why they hold or do not hold reserves;
- Quantify and explain the purpose of any material designated funds, and where set aside for future expenditure, the likely timing of that expenditure; and
- Give the level of reserves at the last day of the financial year to which the report relates.[8]

Concluding comments

As NFPs are not required to file tax returns, there is no monitoring of the *actual* revenue forgone by the government because of the fiscal policy of exempting NFP funds from income tax. It would be fair to say that both Federal and State governments have an expectation that tax-exempt funds are being applied by NFPs to charitable purposes in a responsible manner. The cost to the Queensland Government alone of the estimated tax expenditure from the exemption for 2007-08 was AUD$55 million and, for 2008-09, AUD$66 million.[9] The public has a right to know that these tax-exempt funds are being held by NFPs with the best of intentions and that a rationale exists, at Board level, which explains to the public how and when those funds are to be applied to public benevolent and charitable purposes.

[6] The Charity Commission for England and Wales, *CC19 – Charities' Reserves* Clause 2 at www.charity-commission.gov.uk/publications/cc19.asp (as at 17 November 2009).
[7] The Charity Commission for England and Wales, ibid clause 3.
[8] The Charity Commission for England and Wales, ibid clause 56.
[9] Budget Paper 2, Budget Strategy and Outlook 2009-10,Table A.1 *Tax expenditure summary,* 203 at www.budget.qld.gov.au/budget-papers/bps.shtml (as at 16 November 2009)