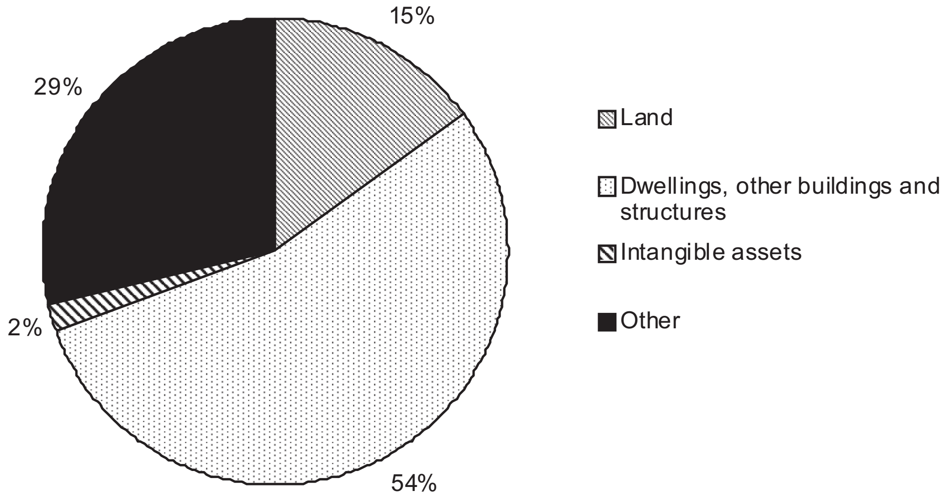
Figure 7.2 **Capital expenditure by NFPs, 2006-07**



Data source: ABS (2009f).

In 2006-07, capital expenditure for the economically significant part of the NFP sector was in excess of $8.4 billion (ABS 2009f). Although there has been a move away from governments funding capital directly, government funding for specific capital items still amounted to $666 million. Other funding for capital development was sourced from general revenue sources, such as profits from the sale of goods and services, philanthropic gifts, investment income and other sources.

7.2 Taxation arrangements affecting not-for-profits

Australian governments support certain NFPs indirectly through a variety of tax concessions. It is widely acknowledged by governments and the sector that the current eligibility requirements and endorsement processes for organisations to access tax concessions are complex, inefficient and inequitable (chapter 6).

This section initially outlines the rationale for giving tax concessions to certain NFPs before exploring what types of tax concessions are available, who receives tax concessions and the value of these concessions. It then considers who should be eligible for tax concessions and assesses some options to streamline the system.

Why does the government provide indirect funding?

Rationale for providing indirect support

The rationale for governments giving tax concessions to NFPs in Australia is not clear in legislation and only a few supporting documents that offer any insight.

The most common reason advanced for providing tax concessions to NFPs is that these organisations should be supported in their endeavours because they serve the community and their activities provide positive public benefits. Public benefits include engagement through volunteering, greater community self-reliance and hence resilience, and community endowments. In addition, society benefits from a multitude of visions and goals which individuals pursue through NFPs, rather than a single vision set by government (IC 1995).

In *Third Sector: The contribution of nonprofit and cooperative enterprises in Australia*, Lyons contends that:

> In broad, tax exemptions are designed to assist certain third sector organisations by allowing them to devote more of their income to their mission ... [and] are provided to nonprofit organisations because they are judged to provide a public benefit. The greater the benefit, the larger the range of exemptions. (Lyons 2001, pp. 20 and 182)

In *Tax and Charities*, Cullen, Swain and Wright consider:

> Subsidizing charities enables governments to further their social objectives, including by means of increasing support to the disadvantaged members of society … governments provide subsidies to the private sector rather than simply increasing state provision is that it can result in better targeting of resources … Subsidizing charities also ensures that those members of society who do not donate to charities but who nevertheless benefit indirectly from charities are contributing through their general tax payments. (2001, p. 2)

In addition to the public benefits outlined above, tax concessions may:

- provide greater funding certainty for organisations as they are less volatile than direct funding mechanisms which may be affected by deteriorations in the government's fiscal position or changes in government preferences. This view was outlined by ACROD (now National Disability Services) in their submission to the Industry Commission's 1995 inquiry into charitable organisations.
- be administratively more efficient than direct funding mechanisms. The costs to both government and organisations in taxing NFPs and the reallocating these taxes back to the same organisations through direct funding mechanisms could be substantial.

However, there may be some disadvantages to indirect funding of NFPs.

- Tax concessions can be less efficient in targeting their intended beneficiaries.
- Tax concessions raise the complexity of the tax system overall and may be subject to abuse. Increased complexity can also reduce the efficiency of concession administration.
- Total tax expenditure (cost of foregone revenue) can also be difficult to control, especially with regard to income tax and philanthropic deductibility.
- The assistance granted to NFPs through the tax system is not transparent. As a result, it disguises the total level of government expenditure to different parts of the sector and in aggregate.

Why give tax concessions for philanthropy?

In addition to the general discussion of indirect support outlined above, there are number of issues specifically relating to giving tax incentives for philanthropy.

Deductibility of philanthropic gifts is potentially the only way that individual taxpayers (including businesses) can direct government revenue to causes that they themselves would like to see funded. Deductibility is only provided for certain gifts to organisations that have been endorsed under division 30 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Krever (1991, p. 12) outlines four arguments in support of deductibility as a tax payer directed mechanism in the allocation of government resources to NFPs. First, individuals may be better able to identify the most appropriate causes in their local area than bureaucrats in a central location. Second, individuals may be better able to identify those organisations which are most capable of addressing the needs of the local community. Third, this form of assistance relies on the initiative of individuals and may reinforce socially desirable conduct associated with supporting the community. Finally, pluralism (individual choice) allows individuals to support cause that may be socially beneficial but may be politically unattractive.

Who receives tax concessions?

Few tax concessions apply to all organisations in the sector — they generally apply to particular types of NFPs. However, almost all NFPs are eligible to receive some concessions.

In general, NFPs which provide the most benefit to the community in terms of alleviation of disadvantage (such as public benevolent institutions (PBIs)) are eligible to receive the most generous tax concessions, including income tax exemption (box 7.1), the capacity to receive deductible gifts and fringe benefit tax (FBT) exemption for staff (capped up to $30 000). The level of tax concessions are progressively scaled back as the level of community benefit decreases. For example, charitable and religious institutions are able to receive income tax exemption and a $30 000 rebate on FBT expenses for staff. Other non-charitable organisations, especially those who predominantly serve members, are only entitled to an income tax threshold of $416 (before they are subject to tax) and no FBT concession.

Broader taxation reform

The taxation arrangements relating to NFPs form part of the broader taxation policy of Australia. As such, any proposed reforms to NFP tax policy need to consider the impact of potential changes in the broader policy framework.

In this context, the Review of Australia's Future Tax System (AFTS) has outlined some design principles which are expected to guide tax policy development in the medium term. The five main design principles are equity, efficiency, simplicity, sustainability and policy consistency (Treasury 2008a).

There are two main issues relating to NFP tax concessions arising from the AFTS review. The first is how equity, efficiency and simplicity should be applied to the tax concessions given to organisations. The second is how changes to the personal income tax system may impact on philanthropy, given the current deductibility system. Issues relating to the effect of tax concessions on competitive neutrality are discussed in chapter 8.

Box 7.1 **Main types of NFPs for income tax exemption purposes**

Public benevolent institution

An NFP institution organised for the direct relief of poverty, sickness, suffering, distress, misfortune, disability or helplessness. PBIs require endorsement from the ATO to access tax concessions.

Charitable institution or fund

A charitable institution is run solely to advance or promote a charitable purpose. A charitable fund is an instrument of trust or a will run for a charitable purpose. Charitable purposes include:

- the relief of poverty or sickness or the needs of the aged
- the advancement of education
- the advancement of religion
- other purposes beneficial of community — including: promoting health; providing community facilities; promoting art and culture; helping to maintain defence and public order and providing emergency services; relieving distress due to natural disasters; providing social welfare; helping people with unemployment; promoting scientific research; advancing commerce and industry; protecting animals; and preserving historic buildings.

Charitable institutions and funds require endorsement from the ATO to access tax concessions.

Income tax exempt fund

An income tax exempt fund (ITEF) is a non-charitable fund that is endorsed by the tax office to access income tax exemption. ITEFs are established under a will or instrument of trust solely for the purpose of providing money, property or benefits to income tax exempt deductable gift receipitants (DGRs), or the establishment of DGRs.

Community service organisation

A society, association or club established for community service purposes (except political or lobbying purposes) that is not carried on for the purpose of profit or gain of its individual members. Community purposes include the promotion, provision or carrying out of activities, facilities and projects for the benefit of the community or any members who have a particular need by reason of youth, age, infirmity or disablement, poverty or social or economic circumstances. Community service organisations can self assess their eligibility for income tax exemption.

Other exempt organisations

Other income tax exempt organisations include NFP societies, associations or clubs where the main purpose is the encouragement of culture, resource development, science or sport. Organisations can self assess their exemption from income tax.

Sources: ATO (2007b); Sheppard, Fitzgerald and Gonski (2001).

How do governments provide indirect funding to the NFP sector?

Types of tax concessions

Australian governments provide indirect funding to NFPs through tax concessions in four main ways — input tax concessions (including FBT), goods and services tax (GST), payroll tax, stamp duty and gambling tax concessions); income tax concessions; wealth tax concessions (such as land tax) and the capacity for organisations to receive deductible gifts (box 7.2).

The value of NFP tax concessions

The value of tax concessions provided to the NFP sector can be calculated using a tax expenditure framework, although there is some debate as to if NFP concessions should be considered tax expenditures (box 7.3). In Australia, tax expenditures measure the difference in tax paid by taxpayers who receive a particular concession, relative to similar taxpayers who do not receive the concession. However, each jurisdiction uses a slightly different methodology for estimating tax expenditures which complicates comparisons between jurisdictions and makes aggregation imprecise.

In addition, tax expenditure estimates for many NFP concessions and exemptions are not able to be calculated accurately because much of the necessary data is not required to be submitted to the ATO or relevant jurisdictional entities. For example, most NFPs are not required to lodge income tax returns so it difficult to estimate the revenue foregone. In addition, many state and territory governments do not provide tax expenditures estimates, and for many of those that do, they often do not distinguish between NFPs and other concessional organisations, such as government entities.

On the best available data, the value of tax concessions is estimated to be at least $4 billion in 2008-09. Fringe benefits and payroll tax concessions are estimated to be worth at least $1 billion and $610 million respectively with income tax deductions for approved donations equivalent to over $1 billion in foregone tax revenue. Concessional rates of tax for income from gaming machines in registered clubs is valued at $724 million.

Box 7.2 Tax concessions provided to NFPs

Income tax

Income tax exemptions are provided to NFPs whose purposes are broadly beneficial to the wider Australian community, such as charitable, religious and scientific institutions.

PBIs, charities and income tax exempt funds within the NFP sector must be endorsed by the ATO to be exempt from income tax or specifically named in the income tax act. Other categories — such as cultural, community service and sporting organisations — can self-assess their exemption.

Non-exempt NFPs do not pay income tax on the first $416 each year but they are liable for tax on income greater than this amount. This concession is intended to ensure small organisations do not incur the administration costs associated with managing their tax affairs, such as lodging annual income tax returns.

Income from mutual receipts

Receipts from members of clubs (including member subscriptions and trading income relating to members) are not included in the assessable income of NFP clubs, societies or associations. All other income is taxable — for example, interest and profits from trading with non-members.

Fringe benefits tax

PBIs and health promotion charities are provided with a $30 000 capped exemption from FBT per employee, and public and NFP hospitals and public ambulance services are provided with a capped exemption of $17 000 per employee. These caps are not indexed.

Other endorsed charities and religious institutions are entitled to have their FBT liability reduced by a rebate equal to 48 per cent of the gross FBT payable (capped at $30 000 per employee).

The exemptions and rebates do not limit the amount of other FBT-exempt benefits (for example, superannuation contributions, work-related mobile phones, entertainment expenses and other miscellaneous benefits).

Goods and services tax

Not-for-profit organisations

NFPs, including charities, have a GST registration threshold of $150 000 a year compared with the general registration threshold of $75 000 a year for other companies.

Where an organisation is not registered for GST, it does not pay GST on its supplies and is not entitled to input tax credits for the GST paid on its inputs. NFP entities with a turnover below the threshold can choose to be registered. Registered entities pay GST on the taxable supplies they make and are entitled to input tax credits for the GST paid for their creditable acquisitions.

Donations to a NFP (including charities) that are made voluntarily and for no material benefit are not subject to GST.

(continued next page)

Box 7.2 **(continued)**

Concessions for charities, DGRs and government schools

Charities, DGRs and government schools receive a range of GST concessions including the ability to make supplies GST-free in certain circumstances, the ability to make supplies of second hand goods GST-free, and the ability to treat certain fundraising events as input-taxed.

Gift deductibility

Certain organisations are entitled to receive income tax deductible gifts and contributions. These organisations are called deductible gift recipients (DGRs) and are either:

- endorsed by the ATO, or
- be listed by name.

For an organisation to be endorsed by the ATO, it must satisfy the requirements of a general DGR category set out in division 30 of the ITAA 1997. Endorsement may be for the organisation as a whole or for the organisation to operate a DGR endorsed fund, such as a building fund. In the later case, only gifts to the endorsed part of the organisation are deductible.

The government may also list DGRs by name. For prescribed private funds, the government gazettes them into the ITAA. For others, Parliament amends the income tax law to list the organisation by name in the ITAA.

Payroll tax

Wages paid or payable by NFPs are exempt from payroll tax if paid or payable by a:

- religious organisation
- PBI
- NFP who objectives are solely or dominantly for charitable, benevolent, philanthropic or patriotic purposes
- NFP private school or educational institution that provide education at the secondary level and below
- NFP hospital that is carried on by a society or association.

Other tax concessions

At the state level, many charitable institutions are exempt from municipal rates, stamp duty, motor vehicle registration and land tax. At the federal level, exemptions from customs duty apply, as well as certain fuel tax concessions. In addition, registered clubs also have concessional gaming tax rates on income from poker machines.

Sources: Treasury (2008b); OSR 2008.

Box 7.3 Should NFP concessions be considered tax expenditures?

There is some debate about whether NFP tax concessions should be considered tax expenditures.

On one hand, the Australian Treasury believes that concessions given to NFPs form part of the government's support for the sector and should be considered tax expenditures. This view was shared by the Industry Commission (1995) who concluded that the tax expenditure framework is the most appropriate way to view government support for community service organisations.

On the other hand, some of the sector argue that deductions and exemptions given to these organisations represent an appropriate adjustment of the tax base and should not, as a result, be considered expenditures as they fall outside the realm of taxable income. For example, Ted Flack argued:

> The relatively recent Treasury practice of constructing tax-deductibility of gifts to DGRs as a "tax expenditure", as if tax deductions are a subsidy, is conceptually flawed. The notion that because a group of transactions is not taxed, it is being subsidised to the value of the tax foregone is not a sustainable argument. There are many transfers that take place inside families for example, that are not subject to income tax or GST — they are simply outside the taxable economy. (sub. 29, p. 13)

On balance, considering NFP concessions as tax expenditures is useful from a policy perspective as it allows policy options, such as direct funding, loan guarantees and interest rate subsidies, to be analysed to ascertain the most economically efficient way to allocate resources to supporting the sector.

Almost all tax concessions extended to NFPs are considered to be tax expenditures by those Australian treasury departments who estimate tax concessions. Income derived from mutual organisations is the only major concessional type not considered to be a tax expenditure because this type of income is not explicitly within the scope of the ITAA).

It is feasible that the total value of tax concessions could be in excess of double this amount if expenditures could be calculated for all concessions in all jurisdictions (appendix F). The estimate of $4 billion does not include a number of tax concessions and exemptions including: income tax exemption for religious, scientific, charitable or public education institutions; interest withholding tax and dividend withholding tax exemptions for overseas charitable institutions; income tax exemption for distributions to charitable fund and refund of franking credits for eligible funds; GST on supplies by charitable institutions and NFP bodies.

The system is complex, inequitable and costly to administer

The system of providing tax concessions to NFPs is complex, inequitable and inconsistent. This is predominantly the result of each jurisdiction having different types of exemptions and different exemption legislation for organisations and different means by which organisations need to apply to access these concessions.

The Smith Family clearly articulated the views of many submissions regarding NFP tax concessions:

> The overall taxation system for non-profit organisations is a confusing one with many tax concessions being differentially applied according to the nature of each type of not-for-profit organisation (for example charities, public benevolent institutions and health promotion charities, deductible gift recipients, not-for-profit and public hospitals), while state-based taxes and duties are inconsistently applied. (sub. 59, p. 39)

In addition, Australia is unique in that it provides tax concessions to almost all NFPs in one form or another which contributes to the complexity of the tax system. By contrast, most other developed nations, such as the United Kingdom (UK) and New Zealand, only provide tax concessions to a specific part of the sector, generally just organisations with a charitable purpose.

Across all Australian governments, there are 40 statutes which provide tax concessions to charitable organisations and 19 separate agencies that regularly make determinations of charitable status (NRNO 2007). The resulting administrative and compliance burden associated with applying for concessional status or fundraising endorsement for organisations operating across jurisdictions is onerous.

There is also complexity involved with administering individual concessions. For example, with regard to FBT arrangements, PeakCare Queensland notes:

> Complex analysis and complicated administrative and accounting processes surrounding salary packaging often take the benefit from it. The need for organizations to buy in advice and consultants to ensure they are meeting complex and ever changing regulations is also a consideration worthy of note. (sub. 81, p. 6)

Some organisations are required to be endorsed for taxation purposes while others can self-assess. At the Commonwealth level, charities and PBIs must be endorsed to access tax concessions by the ATO, with separate applications in each case. Other organisations are entitled to self-assess their concession status (particularly for income tax and GST), with no checks on their activities unless the ATO investigates.

It appears that some organisations operating in the same sector can be categorised differently for tax purposes and, as a result, have access to different tax concessions. This issue was raised by Family Relationship Services Australia:

> The fact that some organisations are defined as Public Benevolent Institutions for taxation purposes while others are not creates inequities in the cost of service delivery and the conditions that can be offered to staff. (sub. 132, p.17)

Inconsistency emerges between jurisdictions which have different legislative exemptions for the same type of concession. For example, all charities are entitled to land tax exemption in New South Wales, South Australia and Western Australia, but Queensland, Tasmania and Victoria give exemptions to only certain organisations or activities.[3] In addition, eligible organisations need to apply in each jurisdiction in which they operate to access concessions.

Options to streamline access to tax concessions

As organisations and governments incur substantial costs in endorsing NFPs for each different tax concession, there would appear to be opportunities to streamline process of accessing tax concessions and reduce the costs to all parties involved.

Transaction costs for both organisations and government could be reduced by introducing a single application process to determine eligibility for all relevant tax concessions. However, work would need to be undertaken to harmonise legislation granting NFP tax concessions as the eligibility criteria is not the same in each jurisdiction. This approach may be feasible as COAG has harmonised payroll tax legislation and made exemption categories consistent across jurisdictions. It is not essential that the concessional rates be the same in each jurisdiction — that is a policy decision for the individual jurisdictions.

In addition to streamlining the endorsement process, options for streamlining the categories for tax concessions could be considered to reduce complexity and increase administrative efficiency. The current issues are clearly expressed by Family Relationship Services Australia:

> At the Commonwealth level, the legal and administrative framework needs to be amended to reduce the number of categories of not–for–profits for tax purposes, and to establish how each category of not–for–profit should be treated in relation to the various types of concessions; this must be done within a consistent and clearly articulated framework. (sub. 132, p. 17)

[3] NT does not levy land tax.

Moving to a more streamlined system would require legislative change to harmonise division 30 and 50 of the ITAA and other relevant tax legislation. Research would need to be undertaken to determine if the costs of implementing a streamlined system would be outweighed by the long term benefits.

Further, some have suggested that consideration should be given to extending endorsement for organisations that receive significant benefits through Commonwealth tax concessions beyond the current requirements in order to create equity and to ensure that tax concessions are being given to appropriate organisations.

DRAFT RECOMMENDATION 7.1

Australian governments should recognise the tax concession status endorsement of not-for-profits at the Commonwealth level, and explore the scope for a single national application process for organisations for tax status endorsement, or mutual recognition of endorsement, across all jurisdictions.

The Commission seeks comments on whether the range of not-for-profits requiring formal endorsement for Commonwealth tax concessions (as distinct from self assessment) should be expanded.

7.3 Philanthropic support by individuals and business

Overview of philanthropy in Australia

The philanthropic sector in Australia consists of donors, intermediaries and recipient organisations (figure 7.3). While the majority of movement of funds through the sector occurs directly between donors and recipients, philanthropic intermediaries play an important role in engaging wealthy individuals and the business community, and distributing their donations, or the earnings from endowments.

Giving Australia (FACS 2005) estimated the total giving of money by individuals and businesses to be almost $11 billion (including charity gambling) in the year to January 2005. Individual donations made up $5.7 billion with another $2 billion raised through charity gambling or support for events. Of the remainder, $2.3 billion was money given by business while a further $1 billion worth of goods and services was donated.