

Taxing the Not-for-profit sector – Starting Now!

The 2011 Federal Budget foreshadowed changes to the tax treatment of not-for-profits (NFPs).

The changes included some worthwhile initiatives such as:

- Establishing from 1 July 2012 the Australian Charities and Not-for-profits Commission as a 'one stop shop' for the support and regulation of the NFP sector; and
- Developing a standard definition of a charity to be used for Federal law purposes to take effect from 1 July 2013.

More significantly, the Budget included a key proposal described as "**Better Targeting of not-for-profit tax concessions**". The Treasury have released a consultation paper (**Consultation Paper**) outlining the proposal and seeking input. The Consultation Paper can be accessed at [<click here>](#).

The proposal targets "Unrelated Commercial Activities" of an NFP, the profits of which are not directed to the NFPs altruistic purposes. Those profits will become subject to income tax and various other existing tax concessions available to an NFP in relation to the "Unrelated Commercial Activities" will also be restricted.

We explore below what the proposal means for NFPs and what NFP Boards should be turning their minds to now.

We encourage readers of this edition of The Assessment to forward it to other contacts who may act as a Board member of an NFP.

(a) Background and what does it mean for NFPs

As first glance, the 'targeting' proposal seems directed at certain sectors of the NFP landscape that have grown significant commercial activities within an NFP structure. These commercial activities may compete with the 'for profit' sector, but enjoy the benefit of various tax concessions that flow from the current singular approach of the income tax system which treats an entity as exempt or taxable. Various other tax concessions at a Federal and State level also flow to an NFP that may benefit the NFP as regards its commercial activities *vis-a-vis* 'for profit' sector competitors.

The proposed changes require the Boards of NFPs to do some serious 'tax' navel gazing (and soon) in terms of what the NFP currently does and plans to do.

The starting point for any Board is, however, not the proposed changes but instead nailing down the NFP's current tax position.

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Whilst larger NFPs generally have the resources needed to be on top of their tax position, many smaller NFPs do not - with many smaller NFPs operating on a presumption that they are entitled to tax exemption /concessions merely because they are an NFP.

(b) What is tax position of the entity?

This question is answered by considering the NFP's objects and activities against the criteria required for eligibility to the various tax concessions that may apply. The key Federal and State tax concessions that may apply include:

- Income tax exemption
- Deductible Gift Recipient Status
- FBT exemptions or FBT rebates
- GST concessions
- Refund of Imputation Credits
- Stamp Duty
- Pay-roll Tax
- Land Tax

(c) Is the tax position being applied by the entity correct?

The NFPs entitlement to tax exemption and concessions needs then to be contrasted to the actual tax position adopted by it.

What this analysis will throw up is a separate and distinct exercise to analysing the impact of the 'targeting' proposals. However, it is an obvious and necessary first step before considering the changes.

(d) Assessing the impact of the proposal – identifying impacted Unrelated Commercial Activities

The proposal targets Unrelated Commercial Activities of an NFP, the profits of which are not directed to the NFPs altruistic purposes.

Using the information provided in the Consultation Paper, NFP Boards initially need to identify what 'Unrelated Commercial Activities' (UCA's) are currently undertaken and what UCA's may be proposed.

The Consultation Paper sheds some light on what is a UCA, but pending final law no comfort should be taken that activities will or will not be a UCA.

Some of the key principles emanating from the Consultation Paper are:

- Commercial activities that are related to a NFP's altruistic activities will not be impacted UCA – for example a NFP that exists to support people with disabilities to gain employment and which operates a commercial business such as a nursery with a view to giving disabled
- people work experience would be taken not to run a UCA where the purpose of the activity is consistent with the NFP .
- Passive investment income such as interest and dividend income will not be treated as a UCA.
- Small scale and low risk UCAs will be excluded from the rules - presumably based on some type of de-minimis test as used in other jurisdictions. (We note the Consultation Paper interchanges between use of the phrase 'small scale and low risk' and 'small scale or low risk'. The Budget papers used the phrase 'small scale and low risk'.)

Precisely what is a UCA and when it commences (at feasibility stage, Board approval, etc) is unclear. The Consultation Paper seeks public input into what should constitute a UCA. We will monitor this (and other aspects of the consultation process) with a view to issuing a subsequent edition of *The Assessment*, once more detail is known.

Having identified a UCA, it is then necessary to ascertain whether the "profits" of the UCA are directed to the NFP's altruistic purpose. Only where the profits of a UCA are not directed to the altruistic purpose (e.g. retained for the purposes of the UCA) will a tax liability arise.

How this will play out in practice is a difficult to gauge at the moment and potentially a raft of structuring initiatives will be used to limit the extent to which the profit from a UCA can be said to be retained for non-altruistic purposes. This will particularly be the case where a refund of imputation credits is not available should a UCA be housed in a separate entity (see further below). Obvious other issues are: how profit is determined (using tax or accounting principles); how debt servicing is taken into account; and how capital expenditure requirements are met.

It is critical that Boards are aware that new UCAs commenced after Budget night (7.30pm, 10th May) will be subject to tax as from 1 July 2011. As a result, notwithstanding the uncertainty as to what is a UCA, Boards should make sufficient enquiries now, in order to determine whether any new activities may constitute UCAs and fall within the proposal.

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Existing UCA's (at Budget night) impacted by the proposal will have tax exemption and concessions phased out under yet to be announced transitional arrangements.

Where a new UCA exists, this will mean a raft of immediate commercial implications in terms of cash flow and impact of returns, including the obvious tax and compliance issues that will also arise.

Boards also need to consider carefully the demarcation between a 'new activity' and the variation of an existing activity and, in particular, whether there any potential transitional implications.

It should not be assumed that any change to an existing activity will not produce a 'new activity'. While the Consultation Paper gives some guidance, it invites input into the test of a 'new activity'.

A Board of an NFP which has a government service contract will need to be especially vigilant and may need to seek advice in relation to contractual dealings affecting existing government contracts.

(e) Fringe Benefits Tax changes – impact for salaries

Inherent in the 'targeting' proposal is an intention to deny FBT capped rebates and exemptions where employees work in the UCA. The Budget papers and the Consultation Paper suggest this will be the case regardless of whether profits from the UCA are applied to altruistic purposes.

This aspect of the proposal raises several issues:

- when do the FBT changes start; and
- how to treat employees where their employment involves both UCAs and work related to altruistic purposes.

NFP Boards will need to ascertain the cost structure and HR impact where employees lose the benefit of the FBT concessions and seek higher salaries to compensate.

(f) GST changes

In this edition of *The Assessment* we won't deal with the impact of the proposals on GST concessions. At this stage, we merely flag these as further issues Boards/Finance of NFP will need to be across. In practice, we do not see this aspect of the proposal creating too many issues.

(g) Structuring UCAs in separate taxable entities - Refunds of Imputation credits

For NFPs not entitled to tax exemption on the profits of a UCA, one simple structuring option may be to move the UCA into a separate entity, pay tax on profits and then pay franked dividends to the head entity if the head entity is entitled to refunds of imputation credits. The tax paid would then

become a cash flow and timing issue as opposed to a permanent cost given the amount of tax paid should ultimately be recovered as a credit by the head entity.

However, only a limited group of NFP's enjoy access to refunds on imputation credits.

Significantly, this group generally includes Charities but does not include sports bodies and other non-charity tax exempt bodies. The Treasury Consultation paper at paragraph 57.1 states that *'Further consideration should be given to widening refundable franking credit rules to achieve the policy intent'*. Albeit unlikely, the inclusion of sports bodies and other NFPs that do not currently enjoy access to refund of imputation credits would do much to remove the disincentive to simply moving or establishing UCAs in separate taxable entities.

A whole raft of tax and legal issues considerations arise however where existing or new UCA's are to be established in taxable entities.

Issues include:

- possible stamp duty consequences on asset transfers
- how to value assets /goodwill etc that may be moved
- apportionment of costs between a taxable and exempt entity
- the treatment of loans to a UCA
- the treatment of 'transfers' between a NFP and a taxable entity

(h) So what should the Board of a NFP be doing now?

NFP Boards are encouraged to:

- ascertain with certainty their NFP's current tax position in terms of Federal and State entitlements and the compliance therewith;
- understand the implications of the proposed changes on current and proposed business activities and profit retention strategies, including noting that new UCAs commenced after 10 May 2011 are to be subject to tax from 1 July 2011 - put another way, identify current and proposed UCAs and assess tax and legal structuring issues including commercial impacts on cash flows, salary costs and returns;
- as a separate point related to the preceding subparagraph:
 - o be aware of the potential scope of what constitutes a new UCA;
 - o understand the implications of potential transitional arrangements; and
 - o consider and attend now to any HR ramifications of the changes;

- for NPF's with government service contracts, consider the potential loss of transitional benefits from any present dealings in relation to these contracts;
- consider accounting and tax compliance issues and implement a strategy for discharging compliance obligations; and
- continue to gather information about the proposals and stay on top of developments as the proposals are fleshed out in law and ATO rulings – this should include:
 - o ensuring senior administrative personnel of NFP are aware of the proposals, the consultation process and its potential implications, and
 - o a standing Board agenda item for a report on the current position at each Board meeting.

This edition of 'The Assessment' was prepared by Michael Doran & Andrew Orange. If you would like assistance in relation to the content of this newsletter please feel free contact Michael or Andrew by phone on **03 8662 3200** or by email at michaeld@webbmartinconsulting.com.au or andrewo@webbmartinconsulting.com.au

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