

Taxing the Commercial Activities of Not-for-Profit Organisations

Not for Profit Update

In the 2011/12 Federal Budget, the Federal Government announced a number of reforms in relation to the not-for-profit ("NFP") sector. These reforms include changes to the taxation of NFP's commercial activities.

On 27 May 2011 the Assistant Treasurer released a consultation paper, 'Better targeting of not-for-profit tax concessions' which outlines the Federal Government's preliminary views as to the proposed reforms. A summary of the proposed NFP tax concession reforms is set out below.

Proposed Reforms

Under the Federal Government's proposed NFP reforms, income tax concessions will only apply to profits generated by unrelated commercial activities if they are directed back to a NFP entity to carry out its altruistic work. This means that NFPs will have to pay income tax on those profits that are not directed back to its altruistic purpose.

In order to achieve this result, the Federal Government distinguishes between 'related' (or primary purpose) and 'unrelated' commercial activities and proposes that all unrelated commercial activities must be either carried out by a separate entity or accounted for separately (see below).

Commercial Activities that are not affected by the Proposed Reforms

1. The Government intends that the following commercial activities will not be affected by the reforms:
 - (ii) related (or primary purpose) commercial activities;
 - (ii) passive investment activities; and

Who does this affect?

Not-for-profit organisations.

Article Highlights

- From 1 July 2014, NFPs will have to pay income tax on new unrelated commercial activities that commenced after 7:30pm (AEST) on 10 May 2011.
- As part of the transitional arrangements, unrelated commercial activities that commence prior to 7:30pm (AEST) on 10 May 2011, will not be subject to the new taxing arrangements until 1 July 2015.



- (ii) small-scale or low-risk commercial activities, such as lamington drive fundraisers and school fetes. The Federal Government is consulting on the introduction of a small-scale threshold, which would allow NFP entities to continue to undertake unrelated commercial activities which fall below the threshold.

Related (or primary purpose) versus unrelated commercial activities

2. Related commercial activities are those that directly further a NFP's altruistic purposes, being the purposes for which the Federal Government provides the tax concessions (generally provided on the basis of the organisation's objects as outlined in its constitution).
3. The Federal Government considers tests used in various common law jurisdictions, which apply either a 'primary purpose', 'related activity' or 'unrelated trade or business' test, to distinguish between related and unrelated commercial activities. Each test results in commercial activities that directly further a NFP's altruistic purposes being an activity that the NFP entity may continue to undertake.
4. Although the exact mechanism by which the Federal Government intends to distinguish related and unrelated commercial activities is yet to be decided, activities which are intrinsically charitable or merely ancillary or incidental to a NFP entity's charitable purposes are considered primary purpose activities.
5. An intrinsically charitable commercial activity is one which is in itself charitable, however is being carried out in a way that is commercial. For example, NFP hospitals, op-shops that sell second hand household items and clothing at discounted prices to those in charitable need, NFP child care centres and businesses whose purpose is to provide meaningful employment to disabled persons.
6. An activity is incidental or ancillary if it assists or goes naturally with the achievement of the charitable purpose. Note that it is specifically stated in the Consultation Paper that a commercial activity will not be regarded as ancillary to the carrying out of a primary purpose simply because its purpose is to raise funds or income for the charity.
7. The Australian Taxation Office ("ATO") has outlined categories of related activities (provided as a guide only) to include integrated business-like activities, by-products, fees charged for charitable services and commercial methods for charitable operations (see appendix 3 of the Consultation Paper for specific examples which fall under each of these categories). These are activities that the ATO considers are only carried out for the sake of, or in aid of, or in furtherance of the NFP entity's altruistic purposes.

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8. Commercial methods for charitable operations include, for example, a library which uses a commercial supplier to provide books and puts the contract to public tender every four years, or a counselling organisation that provides its counselling services solely through its employees who are professionally accredited and remunerated at professional rates.

Entity Structure

9. The exact structure that will be used to tax income resulting from unrelated commercial activities where the profits are not directed back to the NFP entity's altruistic purposes is yet to be decided, however the Federal Government is considering the following three options:

- (ii) Option 1 – Unrelated commercial activities could be undertaken through a separate entity which would be taxed equivalently to other commercial activities, however, where profits are provided to the charity for altruistic purposes they would effectively be income tax exempt.

This option would allow a commercial entity to utilise existing tax law mechanisms to provide funds to the charity or NFP entity in the following ways:

- (a) if the commercial entity is operated through a subsidiary, the commercial subsidiary may pay a franked dividend to the parent charity which, subject to entitlement as a charity or deductible gift recipient ("DGR"), applies for a refund of franking credits;
 - (b) if the commercial entity is operated through a subsidiary and the parent is a DGR, the subsidiary may make a tax deductible donation (subject to certain requirements) to the parent DGR; or
 - (c) if the commercial entity is operated through a trust, the income of the trust may be distributed to the charity and, subject to the income being applied for altruistic purposes, neither the charity nor the trustee is likely to be subject to income tax.

- (ii) Option 2 – Unrelated commercial activities could be undertaken through a separate entity and only those profits retained in the entity at the end of the year (i.e. not distributed to the NFP entity) would be taxed.

This option has a cash-flow advantage over Option 1, as ordinary commercial activities are subject to pay as you go instalments and therefore the separate commercial entity would be paying income tax throughout the year. However, unlike Option 1, this option would require the development of new taxation rules.

- (ii) Option 3 – Unrelated commercial activities could be undertaken by the NFP entity however must be accounted for separately and any profits not directed to its altruistic purposes would be taxed.



Although this option has the benefits of minimising the costs of restructuring and allowing NFPs to commence new commercial activities without setting up a new entity, it is unlikely to be the option chosen by the Federal Government as, among other things, it would place high compliance costs on the NFP and would be complex to administer. Given these complexities, we would also not recommend this structure even if it were the option chosen by the Government.

Transition

11. The new arrangements were initially intended to retrospectively commence on 1 July 2011. After a number of deferrals, it is now proposed that the new arrangements will commence on 1 July 2014. The extension is intended to enable further consultation and engagement with the NFP sector on the reforms and will allow an opportunity for detailed stakeholder input to be provided.
12. The extended start date of 1 July 2014 will only apply to new unrelated commercial activities that commenced after 7:30pm (AEST) on 10 May 2011 (in order to determine whether an unrelated commercial activity is a new or existing activity, the Consultation Paper proposes the 'same business test'). These activities will be taxable and therefore (depending on the option chosen) must either be accounted for separately or undertaken in a separate entity. The new arrangements will not impact on tax concessions that were used for these activities prior to 1 July 2014.
13. As part of the transitional arrangements, relevant activities that commenced prior to 7:30 pm (AEST) on 10 May 2011 will not become subject to the new arrangements until 1 July 2015. The new arrangements will not impact on tax concessions that were used for these activities prior to 1 July 2015.

Tax Office administrative treatment

14. The ATO has released retrospective arrangements that it will apply in respect of tax returns, business activity statements ("**BAS**") and fringe benefits tax ("**FBT**") returns that are lodged during the period up until the new arrangements are introduced.
15. These retrospective arrangements are as follows:
 - (a) NFP organisations that chose to anticipate the changes and do so correctly, do not need to do anything more.
 - (b) NFP organisations that do not anticipate the changes correctly, may need to seek an amendment to their earlier BAS, FBT or income tax return.



- (c) NFP organisations that act reasonably in anticipating the change will not be subject to a tax shortfall penalty and, if they actively seek to amend within a reasonable time, the ATO will remit the general interest charge ("GIC") attributable to the amendment to nil. Otherwise the full GIC will run from the date the change becomes law. If the amendments reduce the NFP organisation's liability, interest will be payable.
- (d) If the NFP organisation lodged their BAS, FBT or income tax return in accordance with the law as it was before the new arrangements were passed, it should seek an amendment. No tax shortfall penalties will apply, and any interest attributable to the shortfall will be remitted to nil, up to the date of enactment of the new arrangements. In addition, the interest will be remitted for NFP organisations who actively seek to appropriately amend their returns or revise their activity statements within a reasonable time after the enactment of the new arrangements.

Consequences

- 16. It is important that NFPs keep in mind the financial viability of proposed projects if their activities are to become taxable. Further, if an NFP intends to transfer any real property from one entity to another, it will be liable to pay duty when this occurs.

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