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RESPONSE TO CONSULTATION PAPER: BETTER TARGETING OF NOT-FOR-PROFIT TAX CONCESSIONS

RESPONSE DATE: 8 JULY 2011

CONSULTATION PAPER: BETTER TARGETING OF NOT-FOR-PROFIT TAX CONCESSIONS

1. BACKGROUND

PowerHousing Australia is a national peer network and business alliance of the nation's top-performing Not-For-Profit (**NFP**) housing organisations and was formed with the aim of providing its members with knowledge of the best practices, contract management and quality assurance in the social and affordable housing sector.

The members of PowerHousing Australia are NFP entities which are tax-exempt as charitable institutions under the head of "the relief of poverty"; their purpose being to provide more affordable housing to those in need (Section 50-5 item 1.1 of the Income Tax Assessment Act 1997). The members of PowerHousing Australia are also eligible for other taxation exemptions and concessions such as Goods and Services Tax (**GST**), Fringe Benefits Tax (**FBT**) and various State taxes.

A list of PowerHousing Australia's members is set out at **Appendix A** of this document.

2. EXECUTIVE SUMMARY

PowerHousing Australia fully supports the Government's goal to better target tax concessions to the NFP sector so that only those entities that are truly altruistic in nature are afforded the tax concession. However, PowerHousing Australia does not support a separate taxing regime for the NFP sector in order to achieve this goal.

PowerHousing Australia strongly believes that the Government's goal may be achieved by a better targeted compliance and review program of those entities which currently claim tax concession relief as an NFP but are at risk of conducting commercial activities that are clearly not for altruistic purposes. This goal could also be achieved by assessing the appropriateness of the tests in place for the current tax exempt status.

PowerHousing Australia submits that the introduction of a separate tax regime for the taxation of the NFP sector as set out in the Consultation Paper is inappropriately broad and complex and will inadvertently subject to taxation NFPs which are conducting activities wholly for an altruistic purpose.

In support of this contention we set out below our key concerns with the proposed tax reforms:

1. The proposed primary purpose test needs to be broad enough to properly capture NFP activities

An NFP may conduct commercial activities in the same industry using the same skill set used to provide its charitable services to the community. These activities would be permitted by the NFP's current Constitution where the profits of these activities are directed towards altruistic purposes.

We submit that an indicator of whether an activity remains a part of the primary purpose activity of an NFP should include consideration of whether existing skill sets are utilised, whether the activity remains within the NFP's industry and within the confines of the NFP's Constitution.

The proposed definition of primary purpose should therefore be broad enough to encompass activities which satisfy the abovementioned indicators.

The primary purpose test should be broad enough to encompass activities undertaken using the same skill set, in the same industry and within the confines of the Constitution.

2. Commercial activities where profits are directed towards altruistic purpose will be taxed

The proposed taxation regime could result in profits retained at the end of the year (by a separate entity) being taxed, with a refund provided when the profits are repatriated to the NFP in the following year. This will result in significant timing and cash flow issues for the NFP. Profits in a separate entity may not be repatriated in the current year due to commercial reasons such as a requirement to satisfy debt covenants and ongoing funding needs of the activity. This should not immediately result in a conclusion that the profit from the activity is retained for a non-altruistic purpose.

In addition, other tax concessions such as those afforded in the context of FBT, GST and state taxes may be lost where these activities are quarantined in a separate entity (as no tax refunds are currently available on payment of these taxes when profits are repatriated to the NFP, unlike income tax). This would be an unfair result given the ultimate altruistic purpose of the activities.

It is recommended that the primary purpose activity of an NFP continue to be described as activities exercised in the course of the actual carrying out of a primary purpose of an entity and taxation not be dependent upon repatriation of profits to an NFP in the current year.

3. Repatriation time frame is unrealistic and unreasonable

It is not reasonable for repatriation to be required in the current year given that the financial accounts will not be prepared until sometime after the end of the financial year. It would be unfair and unrealistic to expect an NFP to calculate the profit and repatriate this profit in the same financial year.

If repatriation is required, commercial activities should remain tax free if the profits are repatriated to the NFP in the current year or a subsequent year.

4. Re-contribution into a separate entity to continue funding of the activity is currently complex

If repatriation of profits is required for a tax exempt status, a simple re-contribution mechanism will be required to enable continued funding of the activity. Currently re-contribution into a separate entity is subject to complex tax legislation and corporations law compliance requirements.

If profit repatriation is required, a simple re-contribution mechanism is needed to avoid complex tax and corporations law compliance requirements.

5. Lack of clarity in relation to what it means to direct funds to an altruistic purpose within an NFP

For commercial activities carried on within an NFP (outlined in Option 3), it is unclear as to what it means to direct funds with an altruistic purpose within the year such that the NFP remains tax exempt. For example, it would be unreasonable to consider the funds as not being used for an altruistic purpose where the funds are accumulated in order to carry out the altruistic purpose of the entity, such as acquisition of a capital asset.

The legislation needs to define what “directed” means and that definition should be sufficiently broad to take into account that funds may be accumulated in order to carry out the altruistic purpose of the NFP entity.

6. Entities wholly affiliated with tax-exempt parents or who are limited by their Constitution to use profits only for altruistic purposes should be tax-exempt

Given the issues set out in relation to the repatriation of profits and complexity of re-contribution, we recommend that where a separate entity is required to repatriate its profits to an NFP (by its Constitution or membership) the entity be treated as wholly tax exempt.

To avoid complexity of re-contribution and repatriation requirements, entities which have no choice but to use their profits for altruistic purposes should be treated as wholly tax exempt.

7. Additional administration costs for segregation of activities

Where activities are required to be segregated into a separate entity or a separate cost centre within the existing NFP entity, there will be significant costs to document and calculate the profits from these activities. In particular where these activities are quarantined in a separate entity, there will be additional compliance required such as the preparation of financial statements, tax returns and other corporations law reporting and compliance requirements.

This is of particular concern to a sector that can least afford these additional costs.

Any tax reform introduced to the NFP sector needs to be simple to administer in order to reduce compliance costs.

8. Inadequate time to transition

The Consultation Paper proposes to apply the new tax regime to all new activities that commenced from 7:30pm 10 May 2011. Given the lack of detail regarding the proposed regime at the time of lodging this submission, it is the view of PowerHousing Australia that it is not appropriate for the legislation to apply from that date.

It is our view that it would be fair and reasonable for the legislation to take effect at the beginning of a tax year of income (after Royal Assent) for ease of administration and compliance with presumably new tax reporting and payment obligations (if applicable). At the earliest, this date should be 1 July 2012 to allow the new provisions to be properly drafted taking all relevant factors into account and also for those entities affected to have the time to properly understand the implications of the new regime and manage those implications.

Tax reform if introduced, should apply from the first tax year after the date of Royal Assent of the legislation.

3. DETAILED COMMENTS

We provide our detailed comments below in accordance with selected questions set out in the Consultation Paper, for ease of reference.

The proposed primary purpose test

Question 1: What should be the scope of a related business, unrelated business, primary purpose or a non-primary purpose test?

A broad summary of the current and future activities of members of PowerHousing Australia are as follows:

- Leasing of affordable housing to eligible tenants;
- Receipt of Government grants to provide affordable housing to eligible tenants;
- Management of affordable tenancies on behalf of other organisations;
- Development of properties for the provision of affordable housing or alternatively for sale in order to repay debt and create funds for further re-investment in affordable housing;
- Strata scheme administration for affordable tenancies;
- Management of commercial tenancies on behalf of other organisations (profits to be directed to altruistic outcomes);
- Project sponsor for social housing initiatives such as Public Private Partnerships;
- Joint venture property development with private company / government where properties developed are provided for affordable housing;
- Joint venture property development with private company / government where properties developed are provided for commercial sale (profits to be directed to altruistic outcomes); and
- Equity home loans to tenants eligible for affordable housing (rent to buy).

PowerHousing Australia does not consider that any of the abovementioned activities constitute unrelated commercial activities as defined in the Consultation Paper. However, the members of PowerHousing Australia are concerned that the effect of the proposed provisions may be that some of these activities will be caught within the proposed taxing regime.

The Consultation Paper appears to assume that where profits are retained in a commercial undertaking this means the profits will not be directed towards an altruistic purpose (page 1, point 3). This is not strictly correct as in a commercial enterprise a certain amount of profit may be required to be retained for a number of commercial reasons without regard to the altruistic outcomes.

For example there may be solvency requirements where borrowings are undertaken and debt covenants need to be satisfied. Retention of profits may also mitigate commercial risks of potential losses to ensure the commercial enterprise remains self-funding. This is particularly relevant in a property development context where members may have to retain profits from a previous property developed in order to fund a new property development project (due to high start up costs of property development projects).

As can be inferred from the above list of activities, all current and proposed activities by members relate to property management or development. In addition, these activities utilise the existing skills developed by the Member in provision of affordable housing.

It is submitted that any primary purpose test must be able to include activities which require the continued use of established skill sets within the same industry. In other words, where activities require the use of existing skill sets and remain within the same industry of the NFP, the primary purpose test should be satisfied.

In that regard, PowerHousing Australia's view would be that any primary purpose test should apply such that any activities which fit within the Constitution of the NFP will always satisfy that test. Any definition of primary purpose will need to be broad enough to encompass activities permitted by the NFP's Constitution.

For reasons set out above it is submitted that 'primary purpose activities' be described as activities exercised in the course of the actual carrying out of a primary purpose of an entity. These activities will be exercised in such a manner that they draw upon existing skill sets used by an NFP, remain within the same industry and are within their existing Constitutional structures.

Recommendation 1

'Primary purpose activities' be described as activities exercised in the course of the actual carrying out of a primary purpose of an entity.

'Primary purpose activities' should be broad enough to encompass activities permitted by an NFP's Constitution that are within the existing skills set and industry of the NFP.

Repatriation of profits - timing issues, appropriate mechanisms and unintended consequences

Question 4: Would there be any unintended consequences resulting from any of these options?

For all options we note that the intention of any legislation must be that the commercial activity remain tax free if all profits are directed back to altruistic purposes at the end of the year. As a result, the timing of profit repatriation will be an issue. Generally the financial accounts (and therefore profit) of an entity will not be available until some time after the financial year. As such, profit will therefore not be able to be repatriated until such time as the year's profits are actually determined (ie. in the following year).

There needs to be a sufficient time frame to allow NFP's to meet the requirements for tax free status where the profits will ultimately be directed towards an altruistic purpose.

Recommendation 2

Commercial activities are tax free if profits are repatriated to the NFP in the current or subsequent year.

Profit retention beyond the current year may be required for a number of commercial reasons without regard to the altruistic outcomes, such as solvency and funding requirements for start up costs. As a result once profit is repatriated there needs to be a mechanism for re-contribution of funds into the entity without tax consequences and complexity. If the commercial activity is undertaken in a separate entity (Option 1 and 2) re-contribution is likely to be a complex process within the tax law and there are numerous compliance requirements under the Corporations Act 2001.

Recommendation 3

Legislation be developed to allow re-contribution without complexity in tax law and corporations law.

In terms of Option 1, PowerHousing Australia also notes the following unintended consequences of the proposed tax regime:

- There will be significant administrative and other costs if current activities are required to be restructured and transferred into a separate entity. Such costs include legal costs in drafting new contracts, stamp duties, and accounting costs to administer an overhead charge to the separate taxable entity.

- This approach may also impact the current tax status of the activity in other areas such as fringe benefits tax (FBT), GST, payroll tax and stamp duties. In such cases there is no existing mechanism to obtain a refund of tax paid (if profit is repatriated to an NFP).
- Additional administrative costs to a member to prepare an additional set of financial statements for the separate entity, income tax return, compliance with ASIC and other compliance requirements.
- The Consultation Paper notes that this option provides risk mitigation for a non-profit entity. We consider that there are no such risk mitigation benefits if the non-profit parent is required to provide guarantees for the separate entity which is common in a property development context when funding is required.

Option 2 proposes that unrelated commercial activities be undertaken in a separate entity under a new tax regime where profits retained at the end of the year would be taxed. We note the issues with this approach are the same as Option 1.

Option 3 proposes NFP entities could undertake unrelated commercial activities within the NFP entity and profits not directed to altruistic purposes within the year would be subject to taxation.

We agree with the comments set out in the Consultation Paper that this option will increase complexity in administering the financial and taxation affairs of the NFP in that all activities will need to be assessed for its tax status and profit determined at the end of the year. It is expected the calculation of appropriate allocation of direct and overhead costs to each activity will be complex and costly.

We understand that where profits from the activity are directed to an altruistic purpose in the current year the NFP will remain tax free. It is unclear what the Consultation Paper means when it refers to the "direction of funds to an altruistic purpose".

Where the funds are not immediately spent within the current year in carrying out the NFP's altruistic activities and are instead being accumulated in order to carry out the altruistic purpose of the entity at a later point in time, such as the acquisition of a capital asset, it is not clear whether these funds will be considered as "directed" towards an altruistic activity. If this option is to be adopted, further guidance will be required regarding what it means for an NFP to "direct" their profits towards an altruistic purpose from a commercial activity.

Recommendation 4

The legislation needs to define what "directed" means and that definition should be sufficiently broad to take into account that funds may be accumulated in order to carry out the altruistic purpose of the NFP entity.

Carve out provisions for entities who are required under their Constitution to repatriate all profits to an NFP

Question 5: Which option do you prefer and why?

Any Option adopted will need to address the issue of the requirement to pay tax where profits are not immediately repatriated for commercial reasons (ie debt covenants) and provide for an ability to re-contribute into the commercial activity without significant complexity.

Generally Option 1 and 2 are the least preferred options due to the reasons already discussed. However, if they were to be implemented, we would strongly recommend that carve out provisions be included which exempt those entities that must pay their profits back to an NFP affiliate. . These entities should be treated as wholly tax exempt and be provided with the same tax concessions as their NFP affiliate.

Recommendation 5

Where a separate entity has to repatriate its profits to an NFP (by its Constitution or membership) the entity should be treated as tax exempt.

Option 3 is the most preferred option as this will not result in significant restructuring. We note however the same issue as with Option 1 and 2 - it is not reasonable to impose tax where profits not repatriated in the same year due to commercial reasons (unrelated to altruistic purposes) and there needs to be a simple mechanism for re-contribution of funds back into the activity.

Identification of existing activities

Question 10: Would identification of the existing activity be by reference to the overall business or to particular activities? Provide examples including an explanation of the nature of the activity/activities.

Identification of existing activities by reference to the overall business will be more appropriate as it is easily identified and consequently easier to administer.

As an example, one of the existing activities of a member of PowerHousing Australia would be the leasing of properties to tenants. Where this property is leased to a non-profit childcare organisation (inside the affordable housing complex), we consider that such an activity would be an existing activity within the overall property related business (one of the activities being the leasing of properties).

However where an affordable childcare services centre is run by the member (within the affordable housing complex), we would consider that such an activity would constitute a new activity as this would no longer be a property related business and the activity would require the use of new skill sets.

Recommendation 6

Existing and new activities should be identified by reference to the overall business.

Inadequate time to transition

Question 11: Should activities intended to be carried on or contracted to enter into before 7:30pm (AEST) on 10 May 2011 be included? How would this be evidenced?

It is the view of PowerHousing Australia that it would not be appropriate to apply the new tax regime to activities commenced prior to the date of Royal Assent of the new legislation. The Consultation Paper seeks feedback from the NFP sector as to the appropriate definition of what is considered a primary purpose activity and what should be defined as "unrelated commercial activities" but does not provide any definitive answers from which NFPs could quantify any potential tax liabilities in order to appropriately deal with them.

In general it would be preferable to have the legislation take effect at the beginning of a taxpayer's year of income (after Royal Assent) for ease of administration and compliance with presumably new tax reporting and payment obligations (if applicable). At the earliest this date should be 1 July 2012.

For completeness, in PowerHousing Australia's view a new activity would be evidenced by any document indicating the Board's intention to proceed with a new activity. We suggest this could be used as an indicator of a new activity for the purpose of the application of the new legislation.

APPENDIX A:

List of PowerHousing Australia Members

NEW SOUTH WALES

Compass Housing
Hume Community Housing
Argyle Community Housing
Southern Cross Community Housing
Pacific Link Community Housing
St George Community Housing
Wentworth Community Housing
BlueCHP Limited
North Coast Community Housing Company Limited
Affordable Community Housing
UnitingCare Ageing NSW.ACT
Bridge Housing Limited

VICTORIA

Haven; Home, Safe
Housing Choices Australia
Rural Housing Network
Port Phillip Housing Association
Women's Housing Ltd.
Common Equity Housing Limited
YMCA Victoria

WESTERN AUSTRALIA

Foundation Housing Limited
Access Housing Limited
Southern Cross Housing Ltd.
Bethanie Housing Group

SOUTH AUSTRALIA

Unity Housing Company Ltd
Junction Housing
Anglicare SA

TASMANIA

STEPS Housing Limited

QUEENSLAND

Regional Housing Limited

Horizon Housing Company Ltd

NORTHERN TERRITORY

Central Australian Affordable Housing Company

