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HIGHLIGHTS FROM THE FEDERAL BUDGET 2014-15 ON NOT-FOR-PROFIT TAX CONCESSIONS

In the Federal Budget 2014-15, the Government announced a number of measures that affect not-for-profit (**NFP**) tax concessions.

Click here for the Federal Budget 2014-15 Paper No.2.

Taxing NFPs for conducting certain unrelated commercial activities

On 14 December 2013 the Government announced that it would not proceed with the previous proposal to tax NFPs on their unrelated commercial activities. However, it stated that it would consider alternatives.

In the Federal Budget 2014-15 and the Acting Assistant Treasurer's media release 'More Progress in Restoring Integrity in the Tax System' dated 13 May 2014, the Government further announced that it considered alternatives to the proposed taxation of unrelated commercial activities are not required at this time.

This decision will be welcomed by most NFPs because had the Government proceeded with the original proposal or alternative measures, it would have created considerable difficulties for those NFPs that conduct commercial activities to generate funds to advance their charitable objectives.

Click here for the media release.

Fringe benefits tax exemption and rebate

In the Federal Budget 2014-15, the Government announced that it will increase the annual fringe benefits tax (**FBT**) caps for employees of public benevolent institutions (**PBIs**) and health promotion charities, public and not-for-profit hospitals, public ambulance services and certain other tax-exempt entities. The announcement was accompanied by the introduction of the *Tax Laws Amendment (Temporary Budget Repair Levy) Bill 2014*. The Bill has been referred to the Senate Economics Legislation Committee on 15 May 2014 and a report from the Committee is due 16 June 2014.

Click here for the Explanatory Memorandum for the Bill.

The effect of the change is that for PBIs and health promotion charities, the FBT exemption for benefits will increase to a grossed-up annual cap of $31,177 per employee (currently $30,000). For public and not-for-profit hospitals and public ambulance services, the FBT exemption for benefits will increase to a grossed-up annual cap of $17,667 per employee (currently $17,000).

The increase of the FBT caps applies from 1 April 2015 until 31 March 2017, and is to protect the cash value of the benefits received by employees of these entities, as the government announced that it will increase the FBT rate from 47% to 49% from 1 April 2015 until 31 March 2017.

Also, the FBT rebate rate will be aligned with the FBT rate from 1 April 2015. This means that for certain other tax-exempt entities, such as charitable institutions, that are currently entitled to a 48% rebate of the FBT otherwise payable up to a grossed up cap of $30,000, the rebate rate will increase to 49% from 1 April 2015 until 31 March 2017, and then fall to 47% (not 48%) from 1 April 2017. The cap will be increased from $30,000 to $31,177 from 1 April 2015 until 31 March 2017.

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ARE THE ASX CORPORATE GOVERNANCE PRINCIPLES RELEVANT TO CHARITIES?

The ASX Corporate Governance Council of the Australian Stock Exchange recently released the Third Edition of the ASX Corporate Governance Principles and Recommendations (**ASX Principles**) that entities listed on the stock exchange must comply with or explain why they don't. We have highlighted the key changes below and also outlined why the ASX Principles have relevance to charities.

The updates

The updates to the ASX Principles have been drafted to help listed companies adapt to the new financial landscape in the wake of the 2008 Global Financial Crisis.

The changes include:

- recommendations that organisations review the independence of their directors annually to reflect changes in share holdings and relationships with executive management;
- allowing multi-national organisations' CEOs/COOs to make completeness and accuracy declarations regarding the organisation's records in any jurisdiction, meaning that overseas managers can lodge foreign declarations with the ASX;
- removing the recommendation to include clawbacks in executive employment contracts for performance-based remuneration;
- strong encouragement for organisations to complete a 'Director Skills Matrix' outlining the diversity of skills amongst its current board members and to identify areas in which the board is lacking expertise; and
- removal of the recommendation for an organisation's board to assess specified business risks. The onus is now on the board itself to determine the greatest risks to the organisation and implement risk management strategies accordingly.

The revised Principles and their relevance to NFPs

Directors, members and other governing bodies of charities may well ask what relevance recommendations of the Stock Exchange have to their operations? The answer is that almost all of the ASX Principles provide useful guidance for the governance of any large charity.

In the listed environment, the 'security holders' are the shareholders who seek to benefit from participation in the company by receiving dividends and seeing the value of their shares increase. This is not the case with charities. However, most charities of any size will operate through a corporate structure with members controlling the composition of the board and with members and directors exercising similar respective powers that the shareholders and directors have in a for-profit company. Members of a charitable entity are not participating for their own benefit but to ensure that the charity succeeds, true to its charitable purpose. If the ASX Principles are read in this context, their applicability to most charities can readily be seen.

The ASX Principles seek to promote 8 central elements of good governance. There are 29 specific recommendations giving effect to those central elements. The 8 central principles and their relevance to charities are briefly considered in the following table:

ASX PRINCIPLE	RELEVANCE TO NFPs
Lay solid foundations for management and oversight: A listed entity should establish and disclose the respective roles and responsibilities of its board and management and how their performance is monitored and evaluated.	Equally relevant - this is an essential element in the good governance of any charity.
Structure the board to add value: A listed entity should have a board of appropriate size, composition, skills and commitment to enable it to discharge its duties effectively.	Equally relevant – the Board must have the skills appropriate to the circumstances and needs of the charity.
Act ethically and responsibly: A listed entity should act ethically and responsibly.	Perhaps even more relevant to charities.
Safeguard integrity in corporate reporting: A listed entity should have formal and rigorous processes that independently verify and safeguard the integrity of its corporate reporting.	Equally relevant – most charities have an obligation for at least some reporting to members or a sponsoring organisation. Many also have obligations to provide a measure of reporting to the wider public. Integrity in all types of reporting is important in maintaining support and confidence of members and the wider community.
Make timely and balanced disclosure: A listed entity should make timely and balanced disclosure of all matters that a reasonable person would expect to have a material effect on the price or value of its securities.	While this principle is directed at effect on value of securities, Boards of charities do need to keep their members up to date on major developments affecting charities.
Respect the rights of security holders: A listed entity should respect the rights of its security holders by providing them with appropriate information and facilities to allow them to exercise those rights effectively.	Equally relevant – members of charitable entities must be well informed in making decisions within their powers.
Recognise and manage risk: A listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework.	Equally relevant – poor risk management has the potential to damage a charity to a similar extent as it does with a for-profit entity.

ASX PRINCIPLE	RELEVANCE TO NFPs
Remunerate fairly and responsibly: A listed entity should pay director remuneration sufficient to attract and retain high quality directors and design its executive remuneration to attract, retain and motivate high quality senior executives and to align their interests with the creation of value for security holders	Equally relevant in the case of senior employees. In the case of directors, many charities find that attraction and retention of appropriately skilled directors does not require payment of any remuneration. However, some large and complex charities may find it appropriate to pay directors. The 'alignment of interest' issue with charities is not to generate value for members but to ensure commitment and motivation of the board to the charitable purpose whether or not they are paid.

More detail on the ASX Principles may be accessed here.

Boards of NFP entities have access to other resources to assist them in establishing and maintaining good governance of charities. In particular, *Good Governance Principles and Guidance for NFP Organisations* published by the Australian Institute of Company Directors on its website is very useful and may be accessed - click here.

Other material that smaller charities in particular may find useful is on the ACNC website.

For further information on good governance of NFPs please contact Lucinda Smith or Jim Baillie.

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CHANGES TO THE ESSENTIAL CONDITIONS FOR TAX CONCESSION ENTITIES

On 12 March 2014, the Treasury issued an exposure draft of the *Tax and Superannuation Laws Amendment (2014 Measure No.3) Bill 2014: in Australia special conditions* (**TSLA Bill 2014**) and associated explanatory materials. It proposes to amend the tax law to restate and centralise the special conditions for tax concession entities.

Click here to view.

Background and changes to law that currently apply generally from 1 July 2013

In 2012, the former Government released the revised exposure draft of *Tax Laws Amendment (Special Conditions for Not-for-profit Concessions) Bill 2012* (**TLAB 2012**) which proposed to amend the tax law to restate and centralise the Special Conditions for tax concession entities. This did not become law.

Subsequent to the revised exposure draft of the TLAB 2012, some amendments were made to the law under the *Tax Laws Amendment (2013 Measures No.2) Act 2013* (**TLAA 2013**).

The tax law was then amended under TLAA 2013 to standardise some requirements for various types of tax concession entities, including entities registered with the Australian Charities and Not-for-profits Commission

(**ACNC**) as charities (**registered charities**).

The amended law requires that for a registered charity to be exempt from income tax, it must:

- comply with **all** the substantive requirements in the entity's governing rules, and
- apply its income and assets **solely** for the purpose for which the entity is established (s50-50(2) of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 97**)).

Broadly, the above amendments to the law are very similar to what was proposed previously by the former Government.

These amendments apply to income years starting on or after TLAA 2013 received Royal Assent (ie 30 June 2013). That is, the amendments that are already law will generally apply from 1 July 2013 to many registered charities that are exempt from income tax. Accordingly, registered charities that are currently income tax exempt should review their objectives, constituent documents, governance arrangements, activities and application of their income and assets for compliance with the amended law.

Suggested action to deal with changes already in the law

In particular, we consider the following should be done:

- The entity should review its governing rules (eg constitutions and trust deeds). Are all the substantive requirements of its governing rules being complied with? Do the rules need to be varied?
- The entity should review its application of income and assets. Is the entity applying its income and assets **solely** for the purpose for which the entity is established? Do the activities of the entity need to change so that it is applying its income and assets solely for the purpose for which it is established?

Failure to comply with these requirements would risk the charity's income tax exemption endorsements being revoked by the Commissioner. The Commissioner has the power to revoke these endorsements under s426-55 of Schedule 1 of the *Taxation Administration Act 1953* (**TAA 1953**).

The Commissioner may require an endorsed entity to give the Commissioner information or documents that are relevant to the entity's entitlement to endorsement. The entity must comply with this requirement. Failure to provide such information to the Commissioner within the time period required would also risk the charity's income tax exemption endorsements being revoked by the Commissioner.

In addition, the revocation of endorsements by the Commissioner may be retrospective. Under s426-55 of Schedule 1 of TAA 1953, the Commissioner may specify the effective date for the revocation. This date may be before the date of decision of the Commissioner, but must not be before the date that the entity first ceased to be entitled to the endorsement.

Definition of 'not-for-profit' not proceeded with

On 14 December 2013, the Government announced that it would not proceed with defining and standardising the use of the term 'not-for-profit' throughout the tax laws.

A definition of 'not-for-profit' was proposed by the previous Government in TLAB 2012. It allowed a NFP to gift surpluses and assets to other NFPs, even if those entities were owners or members, if the purpose of those entities was similar. Accordingly, the significant concession under the previously proposed change for groups of income tax exempt entities will no longer be available. Any charities that contemplated using this concession would need to review their group structure to ensure that they are complying with the current law.

Proposed changes under the exposure draft TSLA Bill 2014

In this exposure draft, the Government proposes changes to address some of the concerns raised by the public on the former Government's TLAB 2012.

Below are some important points from the exposure draft TSLA Bill 2014.

Income tax exempt entities – 'in Australia' special condition and Word Investments decision

The exposure draft TSLA Bill 2014 restates the 'in Australia' special condition that applies to income tax exempt entities, ie the condition that these entities generally must operate and pursue their objectives **principally** in Australia, and for the broad benefit of the Australian community.

The reason for restating this special condition is that the High Court of Australia in *Federal Commissioner of Taxation v Word Investments Limited* (2008) 236 CLR 204 (**Word**) decided that a charity is considered to pursue its objectives principally 'in Australia', if it merely operates to pass funds within Australia to another charity that conducts activities overseas.

This finding was inconsistent with the Government's policy underlying this special condition.

Proposed change to 'in Australia' special condition

The current law essentially contains an 'expenditure' based test to determine whether an entity meets the 'in Australia' special condition. This will be replaced with an 'operates' and 'pursues its purposes' based test, so a wider range of circumstances will be relevant.

Under the new test, relevant factors will include where the entity incurs its expenditure, where it undertakes its activities, where its property is located, where it is managed from and who directly and indirectly benefit from its activities.

If an entity gives money or property to another entity that is not exempt, the use of the money and property by that other entity is taken into account in determining whether the first entity is operating principally in Australia and pursuing its purposes principally in Australia. This in particular is aimed at overcoming the effect of the Word decision.

The entity only needs to take reasonable steps to confirm or trace the use of the money, property or benefits outside Australia.

Making distributions overseas and ignoring distributions to the income tax exempt entity

The exposure draft TSLA Bill 2014 tightens the exception for distributions that an income tax exempt entity may make overseas which are disregarded when considering whether the entity meets the 'in Australia' special condition. These distributions must be distributions received by the entity by way of government grant or gift or contributions (money or other property) in circumstances where the provider is **not an income tax exempt entity**, and is **not entitled to an income tax deduction** in respect of the gift or contribution. The entity must **also** ensure that requirements in the regulations are met.

According to the explanatory materials, it is expected that the regulations will include the following requirements:

- The entity must take reasonable steps to obtain evidence that shows that any activities undertaken outside Australia are a genuine attempt to give effect to its purposes, and the use of any money or property outside Australia is effective in achieving the entity's purpose.
- If the entity works with another person on activities outside Australia, the entity must take reasonable steps to obtain evidence showing that it effectively interacts and coordinates activities with the other person.
- The entity must not commit a serious infringement of Australian laws.
- If the entity is registered with the ACNC, it must be in compliance with the ACNC governance standards.
- If the entity is not registered with the ACNC, it must have reasonable processes in place to ensure it is giving effect to its purposes, to manage the risk of a breach of its governing rules, and manage the risk of fraud or misconduct by those managing or administering it.

A slightly narrower test will apply to deductible gift recipients (**DGRs**).

Under the current law, distributions received by the entity by way of government grant or gift (money or property), **whether tax deductible or not**, and w**hether the provider is an income tax exempt entity or not,** may be distributed overseas, **without** additional requirements in the regulations. Accordingly, the proposed change will be significant for those income tax exempt entities that currently make distributions overseas.

Deductible gift recipients – 'in Australia' special condition

The exposure draft TSLA Bill 2014 codifies the 'in Australia' special condition that applies to deductible gift recipients (**DGRs**), including the requirement that these entities must generally be established in Australia, operate **solely** in Australia, and pursue their purposes **solely** in Australia and for the broad benefit of the Australian community. This is stricter than for income tax exempt entities generally where pursuing objectives **principally** in Australia is required.

If an entity provides money or property to other members of a group of entities that this entity is a member of, it may have to take account of the eventual use of the money or property. Therefore, if a DGR conducts substantial activities outside Australia, it may consider establishing a separate subsidiary to undertake these activities.

Also, if an overseas entity owns the majority of an Australian subsidiary, this would not of itself contravene the 'in Australia' requirement.

For international affairs DGRs (eg overseas aid funds), they are not required to meet the condition of operating solely in Australia and pursuing purposes solely in Australia.

A DGR will not breach the 'solely in Australia' test if its activities outside Australia are merely incidental to its operations and pursuit of purposes in Australia or its activities outside Australia are minor in extent and importance when considered with reference to its operations and pursuit of purposes in Australia.

If an entity provides money, property or other benefits to another entity that is not a DGR, the entity need only take reasonable steps to have knowledge of the use of the money, property or benefits by the other entity outside Australia.

The proposed law also creates a new DGR category for medical research institutions that operate outside Australia. Medical research institutions listed in this new DGR category will still be required to be established in Australia, but will be exempt from the requirements of operating solely in Australia and pursuing purposes solely in Australia.

There is also an exemption for certain touring arts organisations and entities on the Register of Environmental Organisations, if the conditions in the proposed law and regulations are satisfied.

Timing

The proposed new law will apply to determine whether an entity is entitled to be or remain income tax exempt/ DGR for income tax years starting the day after Royal Assent. For those entities that are endorsed as DGRs before introduction of the proposed Bill, and are not meeting the 'in Australia' special conditions, they have a transitional period of 12 months in which to comply with the new rules.

Suggested action to deal with proposed changes

While this is an exposure draft, and there is still the consultation process, because this is an exposure draft prepared after the previous consultation process, it is reasonably likely that the final legislation will be substantially the same as this exposure draft.

If it becomes law and receives Royal Assent by 30 June 2014, then it will generally apply from 1 July 2014.

Entities that are currently income tax exempt entities and DGRs should review their operations, objectives, constituent documents, activities and governance arrangements for compliance with the proposed new law.

In particular, we consider the following should be done:

- If the entity is a DGR, is it operated **solely** in Australia and pursuing its purposes **solely** in Australia? Consider all relevant activities. For example, a hospital may consider it obviously satisfies this test. But what does it do outside Australia? Does it have medical staff on secondment to overseas hospitals? Does it conduct overseas conferences? Does it support overseas healthcare activities? Does it bring in patients from overseas? Are the overseas activities merely incidental to its Australian activities or minor in extent and importance when considering its Australian activities?

- For medical research institutions that operate outside Australia, they should consider whether they will be able to be endorsed as a DGR under the new DGR category.

- If the entity is relying on the current concession that effectively excludes overseas distributions received as gifts in applying the 'in Australia' test, what will be the effect of the new, much tougher, law?

- Charities that are set up by overseas charities should consider how the new 'in Australia' condition will apply to them, and what changes should be made. If the Australian activities are not separately incorporated, would this be necessary in their particular circumstances?

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