

# Border Patrol: Charitable Status Despite Inurement or Private Benefit?

## An Australian Perspective\*

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### OVERVIEW

This paper compares how issues of inappropriate private benefit involving nonprofit organisations are dealt with by the law in Australia as compared to the United States. The heart of this discussion is not the lack of “public benefit” in a charity’s stated and demonstrated objects, but private benefit that results from breaches of the non-distribution constraint. This goes to the core of the legal conception of a nonprofit organisation. Prof Henry Hansmann describes the non-distribution constraint:

A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.<sup>1</sup>

Because the profit motive is eliminated, the non-distribution constraint reduces the incentive for nonprofit firms to take advantage of consumers – as for-profit firms may do – in cases of asymmetrical information (“contract failure”).<sup>2</sup> The constraint has still to be enforced as “nonprofits may succeed in distributing some of their net earnings through inflated salaries, various perquisites granted to employees, and other forms of excess payments”.<sup>3</sup>

This border protecting the non-distribution constraint is patrolled in the US by several boundary riders: the organisation itself, through its own internal rules and constitution; state authorities; the IRS. In the American context it is the IRS that commands the most attention in its border patrol laws and scrutiny and this paper follows that focus. Simon, Dale and Chisolm identify three tax inspired doctrines that bear on public charities: “(1) the proscription against inurement, (2) the proscription against more-than-incidental private

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<sup>1</sup> HB Hansman, ‘The Role of Nonprofit Enterprise’ (1980) 89(5) *Yale Law Journal* 835, 838.

<sup>2</sup> Ibid 844.

<sup>3</sup> Ibid.

benefit, and (3) the rules imposing excise taxes on excess-benefit transactions”.<sup>4</sup> There are even more stringent IRS border patrol policies for private foundations in relation to self-dealing, payout of annual distributions, jeopardizing investment and excess business holding.<sup>5</sup>

By contrast, in Australia border patrol activities have not been pursued either by state or federal regulators in past decades. While some breaches of the non-distribution constraint have received publicity, they have not been enough to drive substantial regulatory enforcement activity or reform to counter the alleged abuses. The lack of action by regulators may be accounted for by a combination of strong grassroots cultural and social beliefs about private benefit from nonprofit activity and absolute prohibition on certain activities. In 1980, Hansmann observed in the USA that,

these abuses appear to be the exception rather than the rule: in spite of minimal policing of the non-distribution constraint, nonprofit institutions in most industries evidently are operated on a fairly circumspect basis. Such broad compliance with a poorly policed constraint is presumably due to adherence to social norms that reinforce the legal restraints on profiteering by conditioning individual behaviour even when legal constraints are unlikely to be enforced. Indeed, such ethical constraints may be far more important than legal sanctions in causing the managers of nonprofits to adhere to their fiduciary responsibilities.<sup>6</sup>

The Australian Taxation Office (ATO), the federal government’s tax agency, is beginning to increase border patrol activity and plans more. The apparent drivers are the growth of the sector, its increasing importance for government in providing community services, the shift from general grant financing to competitive tendering and new tax incentives to encourage greater philanthropic investment which may increase the incidence of tax abuses.

The paper first describes briefly the current trends and context of the Australian nonprofit sector to help locate the ensuing discussion. The place of the non-distribution constraint is then mapped through the major legal forms available for nonprofit enterprise in

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<sup>4</sup> John Simon, Harvey Dale, Laura Chisolm, ‘The Federal Tax Treatment of Charitable Organizations’, in Walter W Powell and Richard Steinberg (eds) *The Nonprofit Sector: a Research Handbook* (2<sup>nd</sup> ed, Yale University Press, 2006) 282.

<sup>5</sup> Ibid 283.

<sup>6</sup> Hansman, above n 1 at 875.

Australia. The paper then moves to examine the state of border patrol in relation to inurement and self-dealing, before examining the emerging regulation in relation to private foundations being permitted tax deductible gift status – a recent innovation in Australia.

## THE AUSTRALIAN CONTEXT

It is important that the legal and social context be kept in mind in any jurisdictional comparison and particularly one which involves charitable organisations which are significantly influenced by history, cultural attitudes and behaviours. Apart from Australia's strong English heritage in relation to the legal system, common law and in particular charity law, there are two contextual matters that should be noted. The first is that the Australian nonprofit sector is growing rapidly. Sector growth has outpaced the rest of the Australian economy over the last decade bringing the usual pressures associated with a growth 'bubble'. Second there are extensive nonprofit sector reform agendas in progress involving all levels of government. Overdue regulatory reforms are being implemented on top of a confused and scant regulatory framework.

Over the last decade Australia's economic climate has generally been robust compared to the rest of the world. This, together with increasing government purchase of community services, volunteering and philanthropy, has assisted the sector as a whole to grow. In January 2010, the Productivity Commission<sup>7</sup> published a comprehensive research report on the sector. It found that from 2000 to 2007 the sector's contribution to GDP grew at an average rate of 7.7 per cent per annum in real terms with sector employment growing from 6.8 per cent of total employment in 2000 to 8.5 per cent in 2007.<sup>8</sup> Volunteer time in the same period grew by 2.2 per cent annually in total hours, rising in value from \$8.9b to \$14.6b. While it is estimated that there are some 600,000 nonprofit organisations in Australia, there are only about 53,600 strictly "charitable" entities, in terms of English or American (section 501(c)(3)) definitions.<sup>9</sup> These organisations employed 667,934 individuals in the 2008-09 tax year.

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<sup>7</sup> An independent, but government funded and established 'think tank'.

<sup>8</sup> Productivity Commission (Australia), *Contribution of the Not-for-Profit Sector: Research Report* (2010) 53.

<sup>9</sup> Australian Taxation Office, *Taxation Statistics 2008-09* (2011) 108.

Approximately 540 000, are small, non-employing organisations that rely on voluntary contributions (not necessarily charitable).<sup>10</sup>

This growth has not been uniform over all segments of the nonprofit sector with health, education and community services having a significant growth profile in employment, volunteering, and funding.<sup>11</sup> As a percentage of total funding, it is government purchasing of health and community services provision which has seen significant growth since 2000. Individual giving has also kept pace over this period with an 11 per cent annual increase.<sup>12</sup> In 2010, the Productivity Commission reported that in 2006–07, for economically significant nonprofit organisations, philanthropy revenue was \$7.2 billion, represented by:

- Donations from philanthropic trusts/foundations - \$0.3 billion;
- Donations from business/organisations - \$0.6 billion;
- Sponsorships - \$1.1 billion;
- Donations from individuals - \$1.0 billion;
- Other fundraising - \$1.0 billion.<sup>13</sup>

The total amount donated and claimed as tax-deductible donations in 2008–09 was \$2.093 billion.<sup>14</sup> This constitutes an increase of \$1.349b from the 2000 income year. This remarkable increase is due in part to incentives to encourage philanthropy, such as Private Ancillary Funds (PAFs) which were introduced in 2000-01,<sup>15</sup> and the relatively strong economic conditions in Australia. PAFs are usually private charitable trusts to which taxpayers can make tax deductible donations, and can be closely controlled by private interests such as families. The sole purpose of a PAF must be to provide money, property or benefits to funds, authorities or

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<sup>10</sup> The majority of nonprofit organisations which are entitled to tax exemption are able to self-assess and do not need to register in any way with the ATO: Productivity Commission, above n 7 at 158.

<sup>11</sup> Productivity Commission, above n 7 at 68–73.

<sup>12</sup> Productivity Commission, above n 7 at 77.

<sup>13</sup> Productivity Commission, above n 7 at 72.

<sup>14</sup> Myles McGregor-Lowndes and Emma Pelling, *An Examination of Tax Deductible Donations Made By Individual Australian Taxpayers in 2008–09* (Australian Centre for Philanthropy and Nonprofit Studies, Working Paper No CPNS 54, 2011).

<sup>15</sup> PAFs are similar to a private foundation that has gift deductibility status.

institutions which are deductible gift recipients. As at 31 October 2009 there were 858 PAFs with corpus of \$2.016b and distributions in that year of \$153m.<sup>16</sup>

The second matter is the significant reform agenda starting to unfold which may affect the regulatory environment of the whole nonprofit sector. There have been several government sponsored reports since 1995 which have recommended legal and regulatory reform, but only minor matters have been acted upon. While there have not been any national charity scandals to create a pressing climate for reform, there has been growing consensus among various government agencies and the sector that there is a need for streamlined regulation and greater disclosure of sector performance. The Productivity Commission's report on the sector included a detailed reform agenda, which has largely been adopted in principle by the current federal government. The recommendations included establishing a central regulator and a disclosure register, reform of government contracts for service provision and monitoring, stimuli for philanthropy, social and sector innovation, as well as improved national data recording and sector capacity.<sup>17</sup> The initial work to develop and realize such extensive reforms is underway with the appointment of a number of implementation bodies<sup>18</sup> and consultation on specific reforms.<sup>19</sup> One of these consultation documents touches squarely upon the fidelity of the non-distribution constraint in the context of taxation exemption.<sup>20</sup>

It may be expected that greater levels of disclosure, with information publicly accessible will encourage more informed scrutiny of individual organizations and new regulators will be more proactive in scrutinizing and acting upon breaches of the law. The borders are about to be re-surveyed and survey pegs staked in contested territory, and patrolling is set to start in earnest.

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<sup>16</sup> Australian Taxation Office, above n 8 at 111.

<sup>17</sup> Productivity Commission, above n 7 at XLI–LII.

<sup>18</sup> Treasury, *Budget Measures 2011–12* (Budget Paper No 2, 10 May 2011) 37, 322–3

<sup>19</sup> Treasury, *Final Report: Scoping Study for a National Not-For-Profit Regulator* (2011); Treasury, *Better Targeting of Not-For-Profit Tax Concessions: Consultation Paper* (2011), [www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2056](http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2056); Treasury, *Exposure Draft: Public Ancillary Funds Bill* (14 July 2011) [www.treasury.gov.au/documents/2048/PDF/exposure\\_draft\\_public\\_ancillary\\_funds.pdf](http://www.treasury.gov.au/documents/2048/PDF/exposure_draft_public_ancillary_funds.pdf).

<sup>20</sup> Treasury, *Exposure Draft: Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No. 1) 2011*: inserting a new definition into sub-s 995–1(1) of the *Income Tax Assessment Act 1997*, defining “not-for-profit entity” for the purpose of tax exempt body “in Australia” requirements.

## The place of the non-distribution constraint border in Australian law

The non-distribution constraint finds its way into Australia law by a number of pathways. For incorporated associations, the most popular legal form, the constraint is part of the enabling legislation. For charitable trusts, it is a matter for common law. Nonprofit companies limited by guarantee incorporate the non-distribution constraint in their constitutions. While there are a number of other legal forms that nonprofit enterprises can adopt, these account for the greatest proportion of the sector. There is also the influence of income tax exemption for nonprofit organizations in the taxation legislation. The paper examines each in turn.

### Incorporated Associations

Incorporated associations are a legal form provided by each Australian State and Territory. It is a general incorporated body adopted by a large variety of nonprofit enterprises, including religious, sporting and community membership bodies. The association has members which must directly elect a board which is referred to as a committee or management committee. There are approximately 136,000 incorporated associations<sup>21</sup> and all are subject to a statutory requirement of non-distribution as an underlying principle.<sup>22</sup> In Queensland, this is expressed as:

An association is not eligible for incorporation under this Act if the association...is formed or carried on for the purpose of providing financial gain for its members.<sup>23</sup>

There is guidance in some of the provisions about the boundaries of “providing financial gain for its members”. For example in Queensland the statute deals with the boundaries in this way:

- (1) An association is not formed or carried on for the purpose of financial gain for its members merely because 1 or more of the following circumstances apply to it—

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<sup>21</sup> Productivity Commission, above n 7 at 58.

<sup>22</sup> *Associations Incorporation Act 1991* (ACT), ss 14(1), 14(2); *Associations Incorporation Act 2009* (NSW), s 40; *Associations Incorporation Act 1981* (Qld), s 5(1)(c); *Associations Incorporation Act 1985* (SA), ss 18(5), 55(1); *Associations Incorporation Act 1964* (Tas), s 2(1); *Associations Incorporation Act 1981* (Vic), s 51(1)(b); *Associations Incorporation Act 1987* (WA), s 4(2); *Associations Act* (NT) s 13A – note that in the Northern Territory “incorporated trading associations” are permitted to distribute profits to members.

<sup>23</sup> *Associations Incorporation Act 1981* (Qld), s 5(1)(c).

- (a) the association makes a financial gain, but no part of the gain is divided among, or received by, any of the association's members;
  - (b) the association is established to protect or regulate a trade, business, industry or calling (the pursuit) engaged in by its members, or in which they are interested, but the association does not itself engage or take part in the pursuit;
  - (c) the association provides its members with facilities or services;
  - (d) the association trades with its members, but the trade is ancillary to its principal purpose;
  - (e) the association trades with the public, but the trade is ancillary to the association's principal purpose and is not substantial when compared with its other activities;
  - (f) the association makes a financial gain from—
    - (i) trading to which paragraph (d) or (e) applies; or
    - (ii) charging admission fees to displays, exhibitions, contests, sporting fixtures or other occasions conducted to promote its objects; or
    - (iii) charging subscriptions to further its objects; or
    - (iv) receiving donations to further its objects;
  - (g) the members of the association are entitled to divide the property of the association between them on its dissolution;
  - (h) a member of the association—
    - (i) receives a salary as an employee or officer of the association; or
    - (ii) makes a financial gain from the association to which a non-member, acting instead of the member, would equally be entitled; or
    - (iii) receives a trophy or prize (other than money) from the association because of a competition; or
    - (iv) receives temporary assistance because of illness, injury or bereavement or other financial hardship suffered by the member.
- (2) If a person receives a financial gain from an association because of the membership of the association of someone else (the member), the financial gain is taken to have been received by the member.<sup>24</sup>

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<sup>24</sup> *Associations Incorporation Act 1981 (Qld)*, s 4

Such provisions appear to be commonly observed by associations and their members, however the statutory deterrent or the ability of regulators to enforce them is not always readily apparent. Only in four jurisdictions, the Australian Capital Territory, New South Wales, South Australia and Victoria, does a breach of the non-distribution principle give rise to a specific statutory offence that is enforceable against the incorporated association and/or a committee member.<sup>25</sup> Even in these jurisdictions, the deterrence factor may be limited by the penalties in the legislation. For example, in New South Wales the maximum penalty that may be imposed on an association or committee member in breach of the non-distribution principle is a relatively light \$660.<sup>26</sup>

In Western Australia, the regulator may be able indirectly to enforce compliance with the non-distribution principle, by action against a committee member on the basis that the committee member has failed to take all reasonable steps to ensure that the association complied with the Act.<sup>27</sup> The maximum fine is \$500.<sup>28</sup> There does not appear to be an equivalent action that the regulator can pursue against the association itself. The Northern Territory has the same provision for an action against a committee member, but not an association,<sup>29</sup> with a relatively high maximum penalty of \$13,700.<sup>30</sup>

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<sup>25</sup> *Associations Incorporation Act 1991* (ACT), ss 106(1), 109(1) (against the association); ss 106(1), 108(1), 109(1) (against the committee member); *Associations Incorporation Act 2009* (NSW), s 40 (against the association); s 91 (against the committee member); *Associations Incorporation Act 1985* (SA), s 55(1) (against the association); ss 55(1) and 55(4) (against the committee member); *Associations Incorporation Act 1981* (Vic), s 51(1) (against the association); ss 51(1), 51(3) (against the committee member).

<sup>26</sup> *Associations Incorporation Act 2009* (NSW) s 40; *Interpretation Act 1987* (NSW), s 21 and the *Crimes (Sentencing Procedure) Act 1999* (NSW), s 17. In the Australian Capital Territory, the maximum penalties that can be enforced against the association and committee are \$27,500 and \$5,500 respectively: *Legislation Act 2001* (ACT), s 133. In South Australia, the maximum penalty that can be enforced against the association and committee member is \$5,000: *Associations Incorporation Act 1985* (SA), s 55. In Victoria, the maximum penalty that can be enforced against the association and committee member is \$7,328.40: *Associations Incorporation Act 1981* (Vic) s 51(1)–(3); *Interpretation of Legislation Act 1984* (Vic), s 38; *Monetary Units Act 2004* (Vic); *Gazette* (No 158, 26 May 2011).

<sup>27</sup> *Associations Incorporation Act 1987* (WA), s 42. An equivalent right exists in South Australia: *Associations Incorporation Act 1985* (SA), s 57(1) with a maximum penalty \$1,250.

<sup>28</sup> *Associations Incorporation Act 1987* (WA), s 42.

<sup>29</sup> *Associations Act* (NT), s 106(1).

<sup>30</sup> *Associations Act* (NT), s 106(1); *Interpretation Act* (NT), s 17; *Penalty Units Act* (NT), s 3, as at August 2011. Alternatively, a Commissioner may apply to the Supreme Court for an order of damages if a committee member is guilty of fraud, negligence, default, breach of trust or duty in relation to the association: *Associations Act* (NT), s 100(2).

In Queensland and Tasmania, there are no penalty provisions for non-compliance with the non-distribution constraint. In all jurisdictions, regulators can withdraw an association's corporate status by cancelling its registration,<sup>31</sup> however this is a drastic penalty which may incline regulators not to act in many cases.

### Companies Limited by Guarantee

The federal government's *Corporations Act 2001* permits the incorporation of companies limited by guarantee, most of which are nonprofit. The Australian company limited by guarantee is modelled closely on the English company limited by guarantee. It has no shareholders, only members who guarantee to pay a certain sum to creditors if, upon dissolution, the company is unable to pay its debts. The guarantee sum is found in the constitution of the company and is usually quite nominal. There are currently about 11,700 of these companies in Australia. They can be formed for any lawful purpose,<sup>32</sup> but in practice, their formal objects, stated in their constitutions, usually restrict their purposes.

While most companies limited by guarantee are nonprofit, there is no statutory requirement that they must be nonprofit and abide by a non-distribution constraint. The source of the non-distribution constraint for nonprofit companies limited by guarantee is in their constitutions. It can be enforced or altered by the members of the company in accordance with the procedures set out in its constitution and applicable statute.<sup>33</sup>

Section 150 of the *Corporations Act 2001* enables the regulator to allow a company to omit the word 'Limited' or 'Ltd' from its title (a name licence) in certain circumstances, the main one being that it has charitable purposes.<sup>34</sup> All other limited companies are required to

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<sup>31</sup> *Associations Incorporation Act 1981* (Qld), s 93(1)(a), (c); *Associations Incorporation Act 1964* (Tas), s 34 (although the Commission would need to argue that the transactions of the associations are such that the association is no longer an association within the meaning of the Act); *Associations Incorporation Act 1991* (ACT) s 83; *Associations Incorporation Act 2009* (NSW), ss 63, 73; *Associations Act* (NT), s 65(1); *Associations Incorporation Act 1985* (SA), ss 41(1)(c), 41(3) (Minister's approval required); *Associations Incorporation Act 1981* (Vic), ss 35(1), 35(2)(c), 36E; *Associations Incorporation Act 1987* (WA), ss 34, 35.

<sup>32</sup> Productivity Commission, above n 7 at 58.

<sup>33</sup> *Corporations Act 2001* (Cth) s 136.

<sup>34</sup> *Corporations Act 2001* (Cth), ss 150, 151.

have ‘Limited’ or ‘Ltd’ at the end of their names.<sup>35</sup> The benefit of having a name licence is that it enables a charity to distinguish itself more obviously from a for-profit business.<sup>36</sup> In exchange for a name licence, the entity is required to apply its income exclusively in pursuance of its charitable purposes and prohibit board or member inurement.<sup>37</sup>

## Charitable Trusts

The common law of each state and territory allows for the creation of charitable trusts with some modification provided by their trusts legislation.<sup>38</sup> It is not known how many charitable trusts there are in Australia. Trusts as a legal form are not required to register or notify any authority of their existence. Although many charitable trusts may be recorded as income tax exempt, the records are not readily available by legal form. The non-distribution constraint is inherent in the common law concept of a charitable trust. A charitable trust, by definition, is not charitable unless its assets and property are used solely for the advancement of religion, relief of poverty, advancement of education or other purposes beneficial to the community (and always in the public benefit). Charitable trustees are subject to the highest order fiduciary duties;<sup>39</sup> they must avoid acting in their own interest in conflict with their duties as a trustee and must not derive an unauthorised profit or benefit from their position as trustee.<sup>40</sup> Charitable trustees may be remunerated where expressly authorised by the trust deed or authorised by a court.<sup>41</sup>

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<sup>35</sup> *Corporations Act 2001* (Cth), s 148(2).

<sup>36</sup> M McGregor-Lowndes and K Levy, ‘Name Licences: the Company Name You Have When You are Not Having a Commercial Company Name’ (1996) 4 *Current Commercial Law* 12 (although the benefit has been watered down by the requirement that all companies include their ACN/ABN on all public documents: *Corporations Act 2001* (Cth), s 153).

<sup>37</sup> *Corporations Act 2001* (Cth), ss 150(1)(a), (b).

<sup>38</sup> *Charitable Trusts Act 1993* (NSW); *Charities Act 1978* (Vic); *Trusts Act 1973* (Qld) Part 8; *Trustee Act 1936* (SA) Part 4; *Trustee Act 1898* (Tas); *Charitable Trusts Act 1962* (WA); *Trustee Act 1925* (ACT); *Trustee Act* (NT).

<sup>39</sup> *Re Permanent Trustee Australia Ltd* (1997) 137 FLR 190.

<sup>40</sup> *Robinson v Pett* (1734) 3 P Wms 249 24 ER 1049; *Re Queensland Coal and Oil Shale Mining Industry (Superannuation) Ltd* [1999] 2 Qd R 524.

<sup>41</sup> In some jurisdictions, the requirement of court authorisation overrides any provision in the trust deed.

## The Income tax border

Federal income tax legislation exempts certain nonprofit organisations from paying income tax.<sup>42</sup> Many of the specific exemption definitions are based on the entity being a “nonprofit company” together with other criteria such as encouragement of art, music or encouragement of sport. The *Income Tax Assessment Act 1997* (Cth) currently defines a nonprofit company as “a company that is not carried on for the purposes of profit or gain to its individual members and is, by the terms of the company's constituent document, prohibited from making any distribution, whether in money, property or otherwise, to its members”. The nonprofit company’s constitution must require adherence to the non-distribution constraint both while it is a going concern and in the event of its dissolution or winding up.<sup>43</sup>

As part of the present reform agenda, it has been proposed that this definition be amended. A consultation draft proposes the following definition:<sup>44</sup>

*not-for-profit entity* means an entity that:

- (a) does not carry on its activities for the purposes of profit or gain for particular entities, including its owners or members, either while it is operating or upon winding up; and
- (b) does not distribute its profits or assets to particular entities, including its owners or members, either while it is operating or upon winding up.

It is likely that this will be altered before being put to Parliament as a number of possible unintended consequences may flow from the proposal. Some of these arise because the qualification will:

- now apply to charitable institutions and funds, not just nonprofit companies in specific categories;

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<sup>42</sup> *Income Tax Assessment Act 1997* (Cth), s 50.

<sup>43</sup> Australian Taxation Office, *Income tax guide for non-profit organisations* (Nat 7967-3.2007), <http://www.ato.gov.au/content/29074.htm>.

<sup>44</sup> Exposure Draft: Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No. 1) 2011 (Cth), cl 27: inserting definition of not-for-profit entity into Income Tax Act, for purposes of tax exempt body “in Australia” requirements; see [http://www.treasury.gov.au/documents/2053/PDF/exposure\\_draft\\_In\\_Australia.pdf](http://www.treasury.gov.au/documents/2053/PDF/exposure_draft_In_Australia.pdf).

- apply to “particular entities including its owners or members” not just “individual members”;
- move the focus from stated “purposes” of an entity to “activities”; and
- remove the reference to constitutions to establish the non-distribution constraint.

### The Inurement border in Australia

The first US corporate excise tax included a provision which prohibited a public charity accruing private benefits to “insiders” such as director, officers, or employees where the benefit conferred was not commensurate with the services provided. The penalty imposed on the organisation was termination of its concessional tax status.<sup>45</sup>

In Australia directors of clubs, associations, charities and foundations have traditionally been unremunerated for their services. This behaviour is largely derived from entrenched social norms, rather than any specific statutory or common law principle. Expectations of stakeholders such as financial donors and volunteers are that the governing body of a nonprofit organisation will be unremunerated. The most extensive research to date in Australia about attitudes to giving, led researchers to report that:

There were harsh criticisms by everyday individuals of those nonprofit CEOs who appeared to “profit” from the nonprofit organisations they headed: many reported examples they had seen in the media of nonprofit CEOs with “excessive” salaries and other benefits such as expensive “status” cars and travel that were inappropriately “over the top”. While CEOs in the private sector were given such generous packages, many believed that nonprofit managers should be motivated by different values and ideals. Thus, there was a moral dimension to CEO packages that extended into other aspects of nonprofit operations. For example, everyday people commonly criticised the notion of paid staff at nonprofits, preferring volunteers to staff the organisations, and in particular, they were antagonistic towards paying fundraisers.<sup>46</sup>

The State of New South Wales is the only Australian jurisdiction to legislate specifically about nonprofit board remuneration. Section 48 of the *Charitable Fundraising Act 1991* (NSW) provides that any member of a governing board of a nonprofit organisation

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<sup>45</sup> Simon, Dale and Chisolm, above n 4 at 283.

<sup>46</sup> Australia, Department of Families, Community Services and Indigenous Affairs, Centre for Philanthropy and Nonprofit Studies (QUT), *Giving Australia: Research on Philanthropy in Australia: Report on Qualitative Research* (2006), 38, [http://www.fahcsia.gov.au/sa/communities/progserv/Documents/ga\\_qualitative\\_report.pdf](http://www.fahcsia.gov.au/sa/communities/progserv/Documents/ga_qualitative_report.pdf).

operating in New South Wales, having charitable objects as one of its purposes, can only be remunerated with approval of the relevant Minister. Remuneration includes receiving any “benefit from the organisation”, which would probably cover the circumstance of any clients or employees of the organisation being on the governing body. Although the provision is found in the fundraising statute, it applies to nonprofit organisations across the jurisdiction, even those exempted from the fundraising sections of the Act. Further, the term charitable purposes is defined widely, beyond the technical common law definition of charity, to include “any benevolent, philanthropic or patriotic purpose”.<sup>47</sup> The regulator has issued guidelines for the section and indicated that applications involving employees and clients of the organisation will be usual, but the appointment of more than one remunerated board member would be unusual.<sup>48</sup> If Ministerial approval is given, the matter must also be approved by a general meeting of the organisation’s members with certain disclosures made:

The following information shall be provided in a note accompanying the statement of income and expenditure and the balance sheet:

(a) Details of any remuneration or benefit received by a member of the governing body of the authority holder (other than reimbursement of reasonable out-of-pocket expenses), the name and position held by each recipient and details of the type and the amount of the remuneration or benefit.

(b) For the purposes of this condition, details of the amount of remuneration or benefit is only required to be disclosed where it is received as a direct result of holding office as a member of the governing body. For example, the remuneration or benefit received is by payment of a director’s fee, salary or allowance, or by the provision of free accommodation or a car.<sup>49</sup>

The number of applications, approvals or rejections is not publicly available, but in the two years from May 2008 there were 39 applications, which were all approved.<sup>50</sup> The provision does not appear to be widely known in the sector or publicised by the supervising agency outside a question on the fundraising licence application. There are currently about

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<sup>47</sup> *Charitable Fundraising Act 1991* (NSW), s 4

<sup>48</sup> New South Wales Office of Liquor, Gaming and Racing, *Best Practice Guidelines: For Charitable Organisations* (4<sup>th</sup> ed, 2002), 23, [http://www.olgr.nsw.gov.au/pdfs/char\\_fund\\_bpg.pdf](http://www.olgr.nsw.gov.au/pdfs/char_fund_bpg.pdf).

<sup>49</sup> *Ibid* 24.

<sup>50</sup> Personal correspondence with the Assistant Director, Charities, NSW Office of Liquor, Gaming and Racing, dated 11 August 2011.

5,000 fundraising licences in New South Wales from over 30,000 incorporated associations, 4,000 companies limited by guarantee and an unknown number of charitable trusts and unincorporated associations.<sup>51</sup>

As noted, section 150 of the *Corporations Act* prohibits remuneration to directors of companies limited by guarantee who enjoy the benefits of name licence provisions.<sup>52</sup> The corporate regulator, the Australian Securities and Investments Commission (ASIC), explains the rationale as:<sup>53</sup>

The payment of directors' fees (no matter how commercial the rate) is not consistent with the intention of [s150] and the ASC will require the company's memorandum or articles to include a prohibition on any payments to directors for serving in that capacity. Despite this prohibition it is prepared to issue a licence even if the company's articles permit payments to be made to directors in the following circumstances:

- (a) for the payment of out-of-pocket expenses incurred in carrying out the duties of a director where the payments do not exceed an amount previously approved by the board;
- (b) for any service rendered to the company in a professional or technical capacity, where the provision of that service has the prior approval of the board and the amount payable is approved by a resolution of the board and is on reasonable commercial terms; or
- (c) as an employee of the company, where the terms of employment have been approved by a resolution of the board.

Approval and supervision of board and employee remuneration largely fall to the constitution and governance of the nonprofit organisation itself. The internal governance

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<sup>51</sup> Andrew Passey, *Linking Society & Economy through Membership: Associations in New South Wales* (Australian Centre for Co-operative Research and Development, 2004) 14, [http://www.accord.org.au/publications/ACCORD\\_report\\_linking\\_society.pdf](http://www.accord.org.au/publications/ACCORD_report_linking_society.pdf).

<sup>52</sup> *Corporations Act 2001* (Cth), ss 150(1)(a), (b).

<sup>53</sup> Australian Securities and Investments Commission, *Omission of "Limited" from Company Names*, (Regulatory Guide 50, 29 March 1993), para RG 50.14 (at the time of this RG, s 150 was s 383).

rules of a company<sup>54</sup> and an incorporated association<sup>55</sup> usually dictate that the business of an organisation is to be managed by, or under the supervision of its directors or committee members respectively. Member approval of management decisions is normally only required in relation to a limited number of matters, which would not usually include decisions concerning the remuneration of the board or employees.<sup>56</sup> However, a company limited by guarantee whose constitution provides for remuneration of board members may adopt the Replaceable Rule in section 202A of the *Corporations Act*, in which case a resolution requires member approval. The mandatory provisions requiring directors to disclose a material personal interest and against voting on any matter involving a material personal interest that is not disclosed do not apply to matters of directors' remuneration.<sup>57</sup> Listed public companies must allow a vote on the directors' remuneration report at their AGM, but the resolution is advisory only and the provision does not apply to companies limited by guarantee.<sup>58</sup>

To protect the rights and interests of the members of a company (including a company limited by guarantee), the law requires company directors to comply with certain duties when making decisions. Although these duties are legislated under the *Corporations Act*, their origins lie in the law as developed by the courts over time. Today the statutory and common law duties operate together, the major difference being the common law duties are enforceable by the company, whilst the statutory duties are enforceable by the corporate regulator, the ASIC.

The relevant duties applying to decision-making on remuneration matters would be:

- a duty to act with reasonable care and diligence;<sup>59</sup>

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<sup>54</sup> See *Corporations Act 2001* (Cth) s 198A(1) (Replaceable Rule). See also *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34 (CA); *John Shaw and Sons (Salford) Ltd v Shaw* [1935] All ER Rep 456 (CA); *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666.

<sup>55</sup> This is expressly provided for in *Associations Incorporation Act 1991* (ACT), s 60(2); *Associations Incorporation Act 2009* (NSW) s 28; *Associations Act* (NT) s 4; *Associations Incorporation Act 1981* (Qld), s 60(1); *Associations Incorporation Act 1985* (SA), s 29; *Associations Incorporation Act 1964* (TAS) s 2(1); *Associations Incorporation Act 1981* (VIC) ss 3(1), 23; *Associations Incorporation Act 1987* (WA), s 20.

<sup>56</sup> See *Corporations Act 2001* (Cth), s 211(1): member approval is not needed if the remuneration is reasonable given the circumstances of the public company or entity giving the remuneration (other conditions apply).

<sup>57</sup> *Corporations Act 2001*(Cth), s 191(2)(a)(ii).

<sup>58</sup> *Corporations Act 2001* (Cth), s 250R(2), (3).

<sup>59</sup> *Corporations Act 2001* (Cth), s 180.

- a duty not to make improper use of a director's position;<sup>60</sup> and
- a duty to act in good faith in the best interests of the company and for a proper purpose.<sup>61</sup>

In regard to incorporated associations, the situation is slightly different. In New South Wales, the Northern Territory, South Australia and Victoria, members of the management committee have a statutory duty not to make improper use of their position or information gained through their position.<sup>62</sup> In the Northern Territory and South Australia, an additional statutory duty exists not to deceive or defraud the association or the association's members.<sup>63</sup> In South Australia a further duty to act with reasonable care and diligence also applies.<sup>64</sup> In their different ways, these duties are applicable to members of a management committee when making decisions on remuneration.

The common law duties that are imposed on directors of companies as mentioned above are likely, by analogy, to supplement this statutory regime.<sup>65</sup> As is the case with a director, a member of a management committee is in a position of trust, confidence, influence and responsibility with respect to the association. Arguably these attributes give rise to a fiduciary relationship, as they do for directors of companies, which in turn should trigger the common law duties.<sup>66</sup>

Decisions on matters of remuneration go largely unscrutinised in the nonprofit sector. Although section 300A(1) of the *Corporations Act* may require<sup>67</sup> public companies to disclose

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<sup>60</sup> *Corporations Act 2001* (Cth), s 182 (at common law, a duty to avoid conflicts of interest).

<sup>61</sup> *Corporations Act 2001* (Cth), s 181.

<sup>62</sup> *Associations Act* (NT), s 33(2), (3); *Associations Incorporation Act 2009* (NSW) ss 32, 33; *Associations Incorporation Act 1985* (SA), s 39A(2), (3); *Associations Incorporation Act 1981* (Vic), s 29A(1), (2).

<sup>63</sup> *Associations Act* (NT), s 33(1); *Associations Incorporation Act 1985* (SA), s 39A(1).

<sup>64</sup> *Associations Incorporation Act 1985* (SA), s 39A(4).

<sup>65</sup> RA Fisher, 'Duties of Company Directors and Committee Members of Incorporated associations: Have the Paths Divided?' (2001) 13 *AJCL* 143, 147; *Haselhurst v Wright* (1991) 4 *ACSR* 527 at 531 per Owen J and *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] *BCLC* 239 at 241 per Vinelott J.

<sup>66</sup> *Hospital Products Ltd v United States Surgical Corp* (1984) 156 *CLR* 41 per Gibbs CJ at 67, Mason J at 96-7.

<sup>67</sup> Companies need only make the disclosures if requested by members with at least 5% of the votes, or 100 members who are entitled to vote: s 202B(1). If a company is a club operating in New South Wales, the *Registered Clubs Act 1976*, ss 37A, 41H, 41E & 41F require disclosure of director remuneration in certain circumstances.

board policies on remuneration of “key management personnel” (which includes executive and non-executive directors), as part of their annual reporting requirements, this section applies to listed public companies, not companies limited by guarantee. In New South Wales, specific legislation<sup>68</sup> relating to member clubs operating gaming machines<sup>69</sup> requires an employment contract with a senior employee to be approved by the governing body.

Disclosure under the various State and Territory incorporated associations Acts is even less onerous and reflects the minimalist approach to intervention that was adopted by government when legislation was first enacted.<sup>70</sup> Accordingly, there are no requirements for associations to disclose non-executive remuneration. The exception is in South Australia where annual disclosure to members is required.<sup>71</sup>

There are no reported cases involving exercise of the governing body’s powers in relation to remunerating board members or employees. Nor has there been any significant media reporting recently of instances of excessive remuneration in the nonprofit sector.

There are indications that more nonprofit organisations are moving towards remunerating board members. A survey conducted by Woodward and Marshall of companies limited by guarantee (which are overwhelmingly nonprofit organisations) indicates a shift by nonprofit boards away from the practice of volunteerism.<sup>72</sup> Approximately 8 per cent of responding companies limited by guarantee indicated that they remunerate their board

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<sup>68</sup> *Registered Clubs Act 1976* (NSW), s 41M.

<sup>69</sup> Also known as poker, slot or fruit machines.

<sup>70</sup> S Sievers, ‘Incorporation of Non-Profit Associations: The Way Ahead?’ (2000) 18 *Company and Securities Law Journal* 311, 316; and Fletcher KL, *The Law Relating to Non-Profit Associations in Australia and New Zealand* (The Law Book Company Ltd, 1986) at 310.

<sup>71</sup> *Associations Incorporation Act 1985* (SA), ss 35(5), (6). While s 36 allows for the regulations to specify filing of such material with the regulator, the regulations are silent on this matter. In Queensland, *Associations Incorporation Act 1981* s 59C provides for inspection of financial documents upon member request but there is no specific reference to remuneration.

<sup>72</sup> S Woodward and S Marshall S, *A Better Framework: reforming not-for-profit regulation* (Centre for Corporate Law and Securities Regulation, The University of Melbourne, 2004), <http://cclsr.law.unimelb.edu.au/activities/not-for-profit/>. Although only 1665 of the 9,800 companies registered with Australian Securities and Investment Commission responded (approximately 17% response rate), this is to date the most significant survey on companies limited by guarantee: see S Woodward, “‘Not-for-profit’ motivation in a “for-profit” company law regime – national baseline data’ (2003) 21 *Company and Securities Law Journal* 102, 109.

members.<sup>73</sup> About 18 per cent of surveyed boards had a mix of executive and non-executive directors, whilst 5 per cent comprised only executive members.<sup>74</sup>

One issue that might drive the shift towards remuneration of board members is the problem of recruitment. The survey found that:<sup>75</sup>

- 29% of the respondents reported difficulties recruiting non-executive directors;
- 16% of the respondents reported difficulty in retaining non-executive directors;
- 64% of the respondents said that Board elections were ‘rarely’ contested, whilst another 20% said that elections were only ‘sometimes’ contested; and
- 38% of the respondents said that they had unfilled positions on the Board; and 60% of these respondents indicated that nearly a third of positions were unfilled.

The findings indicate that the move to remuneration is occurring in larger companies and those involved in business, professional and health activities.<sup>76</sup> Health nonprofit organisations such as hospitals, disability and aged care organisations are increasingly funded and regulated by government to deliver services that were once the province of the state and are inherently complex. Such larger nonprofits may have a greater preparedness to implement business models including ‘pay for performance’, in pursuit of their objects.<sup>77</sup>

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<sup>73</sup> Woodward and Marshall, above n 72 at 110. Levels of remuneration ranged from \$100 to \$480,000 (presumably a total for all non-executive directors on a board).

<sup>74</sup> Woodward, above n 72 at 116. An earlier study over the period of 1997–1998 on 118 Australian boards conducted by Peter Steane and Michael Christie found that on average 80% of all directors (total 1405) were non-executive: PD Steane and M Christie, ‘Nonprofit Boards in Australia: A Distinctive Governance Approach’ (2001) 9 *Corporate Governance* 48, 54.

<sup>75</sup> Woodward and Marshall, above n 72 at 97, 121–25.

<sup>76</sup> See e.g., A Preston A, ‘Compensation in Nonprofit Organizations’ in DR Young (ed), *Effective Economic Decision-Making by Nonprofit Organizations* (The Foundation Center, 2004) 61 (studies have almost universally shown that compensation levels are a function of size); K Hallock, ‘Managerial Pay and Governance in American Nonprofits’ (2002) 41 *Industrial Relations* 377, 379 (studies show a robust link when performance is measured as some function of organisational size).

<sup>77</sup> Woodward, above n 72 at 121; Sievers, above n 70 at 316; NJ Crimm, ‘Shortcomings in America’s Federal Tax Regulatory Regime of Private Foundations: Insights for Australia’ (2002) 31 *Australian Tax Review* 90, 99; M Lyons, ‘Defining the Nonprofit Sector: Australia’ (Working Papers No CNP–WP–40, Johns Hopkins Comparative Nonprofit Sector Project, 1998) 8, [http://www.ccss.jhu.edu/pdfs/CNP\\_Working\\_Papers/CNP\\_WP30\\_Australia\\_1998.pdf](http://www.ccss.jhu.edu/pdfs/CNP_Working_Papers/CNP_WP30_Australia_1998.pdf).

The survey revealed that 83 per cent of the respondents who paid a director fee (whether executive or non-executive) voluntarily disclosed the amount in the company's annual accounts even though disclosure was not mandated by the law.<sup>78</sup>

Nearly 14 per cent of respondents had no problems with board members being remunerated.<sup>79</sup> That is, nearly 1 in every 5 companies either already remunerate their non-executive directors, or do not object to it in principle.<sup>80</sup> However, of those boards not paying directors, only 15 per cent said they would consider remuneration as an option.<sup>81</sup>

### **Private Benefit and Excess Benefit Transaction Borders**

The IRS provisions addressing private benefit which applies to 'outsiders' have no direct equivalent in Australia. Under the Australian federal taxation statutes the conduct would have to amount to such a diversion of funds that the entity would fail to meet its fundamental tax exemption criteria of being a nonprofit company, a charitable fund or institution. There is no specific provision, such as in the US, for 'intermediate sanction' type rules which would allow graduated regulatory responses appropriate for the mischief.

Under general nonprofit entity laws the conflicts of interest provisions will apply to decisions of the board, committee or trustees when a conflict arises. Directors of a nonprofit company, committee members of an incorporated association and trustees of a charitable trust are all under fiduciary duties to avoid conflict of interest situations and to act in the interests of their organisation or objects (beneficiaries). There are varying standards, but such duties all address unapproved inurement by those in governance positions.

Chapter 2E of the *Corporations Act* governs 'related party transactions' of public companies including companies limited by guarantee. It prohibits a public company from

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<sup>78</sup> Woodward and Marshall, above n 72 at 114–5.

<sup>79</sup> Woodward and Marshall, above n 72 at 112.

<sup>80</sup> This is consistent with an English survey, conducted in 1993 on 625 voluntary groups, which revealed that paying volunteers is a widespread phenomenon with almost 30% of respondents paying volunteers: see S Blacksell and DR Phillips, 'Paid to Volunteer: The extent of paying volunteers in the 1990s' (Voluntary Action Research, Third Series, Paper 2, Volunteering England, 1994) 5.

<sup>81</sup> Woodward and Marshall above n 72 at 97.

giving a financial benefit to a director (as a related party)<sup>82</sup> without obtaining member approval.<sup>83</sup> Related parties include persons connected to directors for example relatives and controlled or associated entities.<sup>84</sup>

The incorporated associations acts in Queensland and Tasmania completely fail to deal with the issue of conflicts at all. In most remaining jurisdictions, mention is made, but the provisions generally do not go beyond the protection offered under the *Corporations Act*.<sup>85</sup> However in New South Wales, recent amendments have inserted conflict of duty provisions which include indirect as well as direct conflicts for committee members and unless the committee otherwise decides, the conflicted member cannot take part in the decision.<sup>86</sup>

Perhaps the slow development of the law and policy in this area is due to the fortuitous lack of public scandals, lack of regulatory interest and fractured federal nature of the legal system in Australia. The paper now turns to an area which has recently been reformed to allow patrolling of the borders of private benefit with a number of similarities to US policy and regulatory devices.

### **New Borders for Private Foundations**

In the US, private foundations are regulated more strictly than public charities, with self-dealing rules, annual payout requirements, restricted investment practices and rules against excess business holdings.<sup>87</sup> Largely as a result of the Tax Reform Act of 1969, private foundations are singled out for special regulatory attention because of the perceptions of fiscal abuses, political meddling through lobbying and warehousing of resources.<sup>88</sup> Until recently in Australia, tax deductibility for private foundations was not possible, but the introduction of the

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<sup>82</sup> *Corporations Act 2001* (Cth), s 228(2).

<sup>83</sup> *Corporations Act 2001* (Cth), s 208(1), although member approval is not required if the provision of remuneration is 'reasonable' taking into consideration the circumstances of both the public company and the director: *Corporations Act 2001* (Cth), s 211(1).

<sup>84</sup> *Corporations Act 2001* (Cth), s 228.

<sup>85</sup> *Associations Incorporation Act 1991* (ACT), ss 65(1), (2); *Associations Act* (NT), ss 31(1), 32(2); *Associations Incorporation Act 1985* (SA), ss 31(1), 32(2); *Associations Incorporation Act 1981* (Vic), ss 29B(1), 29C(1); *Associations Incorporation Act 1987* (WA), ss 21(1), 22(1).

<sup>86</sup> *Associations Incorporation Act 2009* (NSW), s 31.

<sup>87</sup> Simon, Dale and Chisolm, above n 4 at 283–4.

<sup>88</sup> *Ibid* 269.

gift deductible private foundation has brought new regulation to address issues similar to those driving US laws, but with variations.

Private groups such as businesses, families and individuals who established foundations in Australia could access income tax exemptions, but were practically excluded from receiving tax deductions for their gifts to these foundations. This was because of two fundamental characteristics required of tax deductible foundations (generally known as ‘ancillary funds’). First, for the purposes of tax deductions for gifts, the control of the foundation had to be overtly public, rather than closely controlled;<sup>89</sup> and second, donations to the foundation had to be sourced from the general public, not from a single or associated donors. This structural inflexibility provided protection from private benefit abuses by mandating public governance arrangements and the scrutiny by numerous independent public donors. However, it was also thought to be a barrier to increased philanthropy by high net worth taxpayers. The government decided to initiate a range of reforms to encourage philanthropy in 1999 and one reform was to allow gift deductibility status for an ancillary fund which permitted donations only from private groups with closely held control of the fund.<sup>90</sup> The first new funds, known as Prescribed Private Funds (PPF), were approved by the government in June 2001. As noted earlier the measure proved successful in encouraging high net wealth taxpayers to create such foundations with some 900 being established in the first ten years.

There was minimal amendment to the *Income Tax Assessment Act 1997* (ITAA 97) to achieve the policy change<sup>91</sup> with regulations made under the ITAA 97 to provide the framework for registration and scrutiny. Private benefit abuses would be controlled by the provisions of a model trust deed and a requirement for an annual return to the ATO. Approval of PPF status was at the discretion of the responsible Minister. There was no public disclosure of the annual returns or any other information apart from the listing of the name of the PPF and date of creation in the tax regulations.

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<sup>89</sup> *Bray v FCT* (1978) 52 ALJR 484

<sup>90</sup> PPFs were part of the Howard Government’s response to the report on philanthropy in Australia by the Business and Community Partnerships Working Group on Taxation Reform, on 26 March 1999. Amendments were introduced in Schedule 5 to the Taxation Laws Amendment Bill (No 8) 1999 (Cth), but were not enacted until 2000

<sup>91</sup> Achieved through minor amendment to ITAA 97, ss 30-15 and 995-1.

While it appears that the great majority of PPF founders had genuine philanthropic motivations the government became concerned that there was some private benefit occurring and other inappropriate activity.<sup>92</sup> In the 2008 Budget, the Treasurer announced tightening of the regulation of PPFs with the new provisions coming into operation in 2009.<sup>93</sup>

The new provisions removed the Minister from the approval process and gave the ATO full administration through expanded guidelines which take the form of a regulatory legislative instrument.<sup>94</sup> Private foundations were also renamed private ancillary funds (PAFs). There was no greater disclosure of records for public scrutiny, but rather increased powers of investigation and sanction given to the ATO. For example:

- The ATO has the power to remove or suspend a trustee of a PAF who breaches the guidelines or any other Australian law.<sup>95</sup>
- Administrative penalties are now imposed on trustees and the directors of trustees who hold a PAF out as being endorsed, entitled to be endorsed, or entitled to remain endorsed as a DGR.<sup>96</sup>

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<sup>92</sup> Patrick Durkin, 'Trusts help make charity pay', *Australian Financial Review* (30 May 2007) 20; John Kehoe, 'Slow economy and red tape hit philanthropic funds', *Australian Financial Review* (30 July 2009) 11

<sup>93</sup> C Bowen MP [then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs], 'Improving the integrity of prescribed private funds – consultation paper released' (Media Release, no 101, 26 November 2008)

<http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/101.htm&pageID=003&min=ceb&Year=&DocType=>; Australia, Treasury, *Improving the Integrity of Prescribed Private Funds: Discussion Paper* (2008) [http://www.treasury.gov.au/documents/1444/PDF/Prescribed\\_Private\\_Funds.pdf](http://www.treasury.gov.au/documents/1444/PDF/Prescribed_Private_Funds.pdf)

Australia, Treasury, *Exposure Draft: Tax Laws Amendment (2009 Measures No 4) Bill 2009: Prescribed Private Funds*, (2009) [http://www.treasury.gov.au/documents/1541/PDF/Exposure\\_Draft\\_PPF.pdf](http://www.treasury.gov.au/documents/1541/PDF/Exposure_Draft_PPF.pdf); Australia, Treasury, *Exposure Draft: Tax Laws Amendment (Prescribed Private Funds) Bill 2009: Explanatory Material* (2009) 13, <http://www.treasury.gov.au/documents/1541/PDF/090514%20-%20EM%20-%20master%20update%203%20%28consultation%20version%29.pdf>. *Tax Laws Amendment (2009 Measures No. 4) Act 2009* which commenced on 1 October 2009 permitted the regulations in relation to PAFs to be made.

<sup>94</sup> The Governor-General and Treasurer no longer have a role in determining whether a particular trust fund is entitled to be a PPF: ITAA 97, Schedule 2, items 4 and 22; sub-s 30-15(2) table, item 2; Taxation Administration Act 1953 (TAA), Schedule 1, Subdiv 426-D.

<sup>95</sup> TAA Schedule 2, item 22; Schedule 1, s 426-125. The Commissioner's decisions are reviewable by the Administrative Appeals Tribunal and the Federal Court of Australia.

<sup>96</sup> TAA Schedule 2, item 22; Schedule 1 sub-ss 426-120(1) and (2).

The *Private Ancillary Fund Guidelines 2009*<sup>97</sup> introduce a raft of provisions aimed at private benefit infractions as well as general governance and disclosure reforms. The specific provisions include:

- Prohibition on borrowing money except in very limited circumstances;<sup>98</sup>
- Prohibition on giving security over an asset of the fund;<sup>99</sup>
- Prohibition of having collectables (eg. art, stamps) as part of the fund;<sup>100</sup>
- Prohibition on acquiring assets (except by way of gift, arm's length transaction or a transaction favourable to the fund) from a founder, donor, trustee, person associated with the trustee or their associates;<sup>101</sup>
- Prohibition against carrying on a business;<sup>102</sup>
- Prohibition against entering into any uncommercial transaction apart from proper distributions;<sup>103</sup> and
- Distribution of at least 5 per cent of the net value of the fund at 30 June during the following financial year (with a minimum annual distribution of \$11,000 unless expenses of the fund are being met from outside the fund).<sup>104</sup>

While the trustee can be reimbursed from the fund for expenses incurred on behalf of the fund and can receive 'fair and reasonable remuneration' for administering the fund,<sup>105</sup> no other direct or indirect benefit can be provided to the trustee.<sup>106</sup> This provision is extended to a member, director, employee, agent or officer of the trustee, donor to the fund, founder of the

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<sup>97</sup> A legislative instrument under the *Taxation Administration Act 1953* (Cth), <http://www.comlaw.gov.au/Details/F2009L03700>.

<sup>98</sup> *Private Fund Ancillary Guidelines 2009*, rule 33

<sup>99</sup> *Ibid* rule 35.

<sup>100</sup> *Ibid* rule 38

<sup>101</sup> *Ibid* rule 36

<sup>102</sup> *Ibid* rule 40

<sup>103</sup> *Ibid* rule 41

<sup>104</sup> *Ibid* rule 19

<sup>105</sup> *Ibid* rule 43

<sup>106</sup> *Ibid* rule 42.

fund or an associate of any of these.<sup>107</sup> Associate is interpreted widely to include relatives and other corporate and unincorporated structures which may be sufficiently influenced.<sup>108</sup>

PAFs must file an annual income tax return. This is significant because, unlike many other jurisdictions, income tax returns are not generally required of tax exempt or deductible entities in Australia.<sup>109</sup> However, unlike the situation in the US, the returns are not made public.

Much of the private benefit abuse is the primary responsibility of trust and charities law which is constitutionally the province of the Australian States and Territories. State and Territory Attorneys-General are the ‘protectors’ of charities. Traditionally, they have had the sole responsibility for ensuring that trustees of charitable trusts act in accordance with a trust’s governing rules and relevant state law. The Attorneys-General are also the only authority with standing to take legal action in protection of a charitable trust. For various reasons they have not been active in this supervisory role; however, the ATO can now disclose information to State and Territory Attorneys-General that relates to non-compliance with an Australian law by a charity or a PAF.

The new measures have added more regulatory options for the ATO to police private benefit in these foundations with the ability to use intermediate type sanctions such as trustee replacement and reporting to the prime regulators for charitable trusts, the State Attorneys-General. The rules for operation of PAFs have been tightened to control avenues of private benefit such as loans, illiquid assets, valuations, remuneration, and mixing business transactions. While adherence to the law will rely on self-compliance by the trustees governing the PAFs, the ATO will scrutinise PAFs’ annual tax returns and conduct its own compliance activities. It is pointless to rely on public disclosure and scrutiny by third parties to encourage compliance or bring attention to non-compliance, because public disclosure in these foundations is not mandated. While the numbers and complexity of PAFs’ operations remain modest, individual scrutiny of their operations may be within the resources of the

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<sup>107</sup> Ibid rule 42

<sup>108</sup> *Income Tax Assessment Act 1936*, (Cth) s 318.

<sup>109</sup> Explanatory Memorandum, Tax Laws Amendment (Measures No 4) Bill 2009 paras 2.40 to 2.42

ATO, but this may falter if ATO resources do not keep pace with the continued growth and complexity of these legal forms.

## CONCLUSION

It is clear that the US tax law and its IRS regulator are more actively proscribing and prescribing behaviours that involve public charities, inurement and private benefit, than is currently the situation in Australia. This ranges across the borders of private inurement to insiders, private benefit to outsiders, and the more recent flexible sanctions to deal with those who approve or receive excess benefits from nonprofit organisations. Private foundations have been more closely regulated than public charities in the US for some time, with greater detail in substantive laws and a more rigorous enforcement regime.

The situation in Australia is far less prescriptive in terms of tax driven regulation with a greater role by default of nonprofit legal form legislation and regulators. Accepted societal behaviours in relation to board member remuneration and other benefits, and general attitude to private benefit from nonprofit organisations have probably been effective in curbing the incidence of abusive behaviours in this arena in Australia. However, given the lack of public disclosure, and in some cases only limited disclosure even within organisations or to regulators, there are lingering doubts about the integrity of the border. One wonders whether private benefit abuses are actually substantial, but hidden from view of the general public and regulators?

The context of Australian nonprofit enterprise is changing rapidly, with substantial growth in some sectors, particularly with government competitive tendering of community services such as health, aged and disability care, unemployment services and education, and with flexible tax incentives. In some of these sectors, isomorphic tendencies are causing for-profit and nonprofit business models to converge,<sup>110</sup> which may weaken the cultural and social proscriptions on private benefit in these transforming organisations. Although there has been no notable public scandal involving a breach of the non-distribution constraint,

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<sup>110</sup> Jeffrey Leiter, 'Structural Isomorphism in Australian Nonprofit Organizations' (2005) 16 *Voluntas: International Journal of Voluntary and Nonprofit Organizations*, 1.

governments are moving towards broad regulatory reforms which include greater patrolling of the private benefit border.

The recent introduction of tax deductible gift concessions for private foundations was accompanied by greater attention to possible weak points in the border, with a range of measures such as the requirement to file audited financial returns to the ATO, and restrictions on inurement, investment and related party transactions. One interesting difference from the US model is that there is still relatively little public disclosure of this information on private foundations.

While the reformed framework for regulation of the nonprofit sector is still being developed in Australia, it appears that the ATO may not play as great a role as that of the IRS. The federal government has proposed establishing an Australian Charities and Not for Profits Commission (ACNC). This will be an independent statutory agency charged with sole responsibility for determining tax status for certain nonprofit organisations, a general public reporting framework for charities, and an education and support role for the sector.<sup>111</sup> It is not clear what investigatory and enforcement powers the ACNC will have, to deal with issues that arise from reports made to it by nonprofit organisations which are then made available for public scrutiny. Much may depend upon the outcome of discussions with state and territory jurisdictions about the possibilities of co-operation to create a national regulatory framework rather than the patchwork which currently exists. The ACNC is expected to begin operations on 1 July 2012, with an information portal for charity reporting open by 2013.

Australia is coming to substantial reform of its nonprofit sector later than other OECD nations and without the driver of a public scandal overshadowing rational consideration of the policy alternatives. It appears that accepted societal behaviours may have kept private benefit borders largely intact unless there is substantial hidden abusive behaviour occurring. It is assumed that in some nonprofit industry sectors these norms may be waning and more specific regulation is required. A bigger patrol force, equipped with new detection tools and weapons is promised for the new borders. Societal norms have so far been working to

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<sup>111</sup> Treasury, above n 20 at 322.

regulate abusive private benefit activities involving nonprofit organisations, with little direct cost to society. It is unfortunate they cannot simply be left unaided to ensure appropriate conduct.