

**Structures at the Seam: The Architecture of Charities' Commercial Activities  
– An Australian Perspective\***

**National Center on Philanthropy and the Law  
20th Annual Conference  
24 October, 2008**

**Panel Session: *Comparative Analysis: The Global Perspective***



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## OVERVIEW

This paper examines the legal structures of Australian charities as influenced by consideration of their commercial revenue generation activities. First, the Australian context is described in comparison to the United States of America (USA) and the United Kingdom (UK). It indicates that the Australian nonprofit sector has a significant proportion of commercial income compared to both these jurisdictions. There have been growing claims by business interests that this represents ‘unfair competition’ and a ‘leakage’ of taxation revenue. Some acknowledgement of these views are found in recent government inquiries.

Second, the corporate and then taxation provisions which affect the entity structures of charities are examined in turn. Tax is clearly the driver in such structuring and the lines between exempt income and assessable income are blurring. The revenue authority has recently taken a test case to the highest Australian court seeking to establish a bright line between income which is ancillary or incidental to the purpose of a charity and that which should be taxed as a business. Whatever the decision of the High Court, it is probable in an environment of a new federal government which is seeking to reform both nonprofit regulation and the entire income tax system that the issue of unrelated commercial income will receive legislative attention.

## THE AUSTRALIAN CONTEXT

While it is estimated that there are some 700,000 nonprofit organisations in Australia,<sup>1</sup> there are only about 50,600 strictly “charitable” entities in line with English or section 501(c)(3) definitions.<sup>2</sup> As at June 2007 the nonprofit sector employs 8.4% of

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1 Lyons, Mark (2001) *Third Sector. The Contribution of Nonprofit and Cooperative Enterprises in Australia*. Crows Nest: Allen and Unwin.

2 ATO, Taxation Statistics 2005-06 Chapter 10 Charities and Deductible Gifts available at <http://www.ato.gov.au/corporate/content.asp?doc=/content/00117625.htm&mnu=41468&mfp=001>



employed Australians<sup>3</sup> (similar to the USA, but larger than the UK) and in 2004, 6.3m adult Australians (41%) volunteered a total of 750m hours.<sup>4</sup>

In 2007 sector revenue was A\$74.5b being 7.5% of GDP growing from 6.3% in 1995-96.<sup>5</sup> A third (34.1%) of this revenue came from increasing government funding with over two thirds being tied to fee for service or quasi-voucher arrangements. About 9.4% of revenue was sourced from donations, sponsorship and fundraising. This has increased from a low base since 2000 together with 3.4% from investment income. In 2007, about 40% of revenue was generated from sale of goods and services. When this trading revenue is combined with government fee for service revenues (not grants) the amount reaches 63% of revenue.

Australia has been popularly characterised as being closer in revenue structure to the UK sector with greater funding by government within a welfare state of socialised service provision. Emerging research over the last decade indicates that it is much closer to the situation in the USA. The Johns Hopkins Global Civil Society Project findings indicated that the Australian sector is more reliant on fees and charges (62.5%) than the United States (57%) and the UK (44%).<sup>6</sup>

Figure 1 below shows the amount of commercial revenue received by different types of nonprofit organisations by type. Government fee for service income is separated from sales of goods and services, being led by education, social services and hospitals.

Figure 2 below represents the percentage of commercial income for each type of nonprofit organisation, again combining both government fee for service as well as

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3 ABS Not-for-profit Organisations, Australia, 2006-07 Cat. No. 8106.0 available at <http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/8106.0Main+Features12006-07?OpenDocument>

4 ACOSS, *Giving Australia: Research on Philanthropy in Australia*, October 2005, available at [http://www.acoss.org.au/upload/publications/papers/301\\_Giving%20Australia%20Summary.pdf](http://www.acoss.org.au/upload/publications/papers/301_Giving%20Australia%20Summary.pdf)

5 ABS *Not-for-profit Organisations, Australia*, 2006-07 Cat. No. 8106.0 available at <http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/8106.0Main+Features12006-07?OpenDocument>

6 LM Salamon, SW Sokolowski & R List, *Global Civil Society: An Overview*, The Johns Hopkins Comparative Nonprofit Sector Research Project, Baltimore, 2003. Differences in measurement account for some of the difference between this study and the latest Australian Bureau of Statistics quoted above, while an increase in government funding between the two studies may account for the rest.



sales from goods and services. The percentage of commercial income is greatest in hospitals followed by education and health.

From time to time the media carries claims by small business owners or columnists who complain about the ‘unfair advantage’ that competing nonprofit organisations have through taxation concessions. Often the target is wealthy religious organisations criticised for not serving the public interest, and lacking transparency and accountability. It appears that such comments are growing with the blurring of the boundaries between sectors, due to governments encouraging for profit providers or subsidising services through nonprofit organisations. Examples are child care, education, training and job placement as well as hospitals and health. In many cases business organisations appear to have taken significant market share from nonprofit and community organisations.

In the past, this issue has been considered by taxation policy review bodies in cases dealing with income tax exemption for sporting bodies. The Taxation Review Committee in 1975 endorsed the exemptions<sup>7</sup> as appropriate but noted:

“the committee considers that these institutions and funds should continue to be exempt from income tax, though it acknowledges that the exemption may have to be qualified if business activities are carried on which compete with the activities of commercial organisations.”<sup>8</sup>

The committee focused on income tax exempt membership organisations competing with commercial operations such as sporting clubs. It was not clear how competition was to be defined, but it appeared not to include:

“business activities directly related to the carrying out of the purpose of which the organisation was established and which gives it entitlement to exemption but not to other business income.”<sup>9</sup>

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7 *Income Tax Assessment Act 1936* (Cth) s 23 (predecessor to s 50-5 ITAA 1997)

8 Commonwealth of Australia, Taxation Review Committee, *Full Report*, 31 January 1975, The Government Printer of Australia, Canberra, 1976 at p.342.

9 *Ibid.* at p.344.



The 1995 Industry Commission Report on Charitable Organisations examined the effect of unrelated business activity by income tax exempt charitable organisations and found that many charitable organisations engaged in a number of fundraising activities that were not related to their core activities.<sup>10</sup> They gave the examples of “general insurance, financial services, worm farms, recycled clothing, packaging, sheet metal products and sales of Christmas puddings.”<sup>11</sup> The Commission came to the conclusion that “unrelated business income is a concept that is too difficult to define and too costly to enforce, and consequently the costs are likely to outweigh the benefits”.<sup>12</sup> It indicated that concessional treatment in respect of input taxes was less clear cut as it created a distortion for charities to favour the use of inputs that attracted such concessions.

The 2001 Charity Definition Inquiry devoted a chapter to commercial purposes and commercial activity as it had received a small number of submissions from the health care sector, tomato growers, breakfast cereal manufacturers and those against religious organisations being given tax exemptions for unrelated business income.<sup>13</sup> It endorsed the findings of the Industry Commission about competitive neutrality and further decided that entities should not be denied charitable status because other sectors of society engage in activities previously only undertaken by charities. Since the Industry Commission report the replacement of sales tax concessions with a broad based transaction tax and capping of Fringe Benefits Tax for nonprofit organisations had also ‘considerably reduced’ input tax concessions where legitimate concern could be sustained<sup>14</sup>

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10 Industry Commission, (1995) *Charitable Organisations in Australia*, Report No. 45, Canberra, AGPS p.309.

11 Ibid.

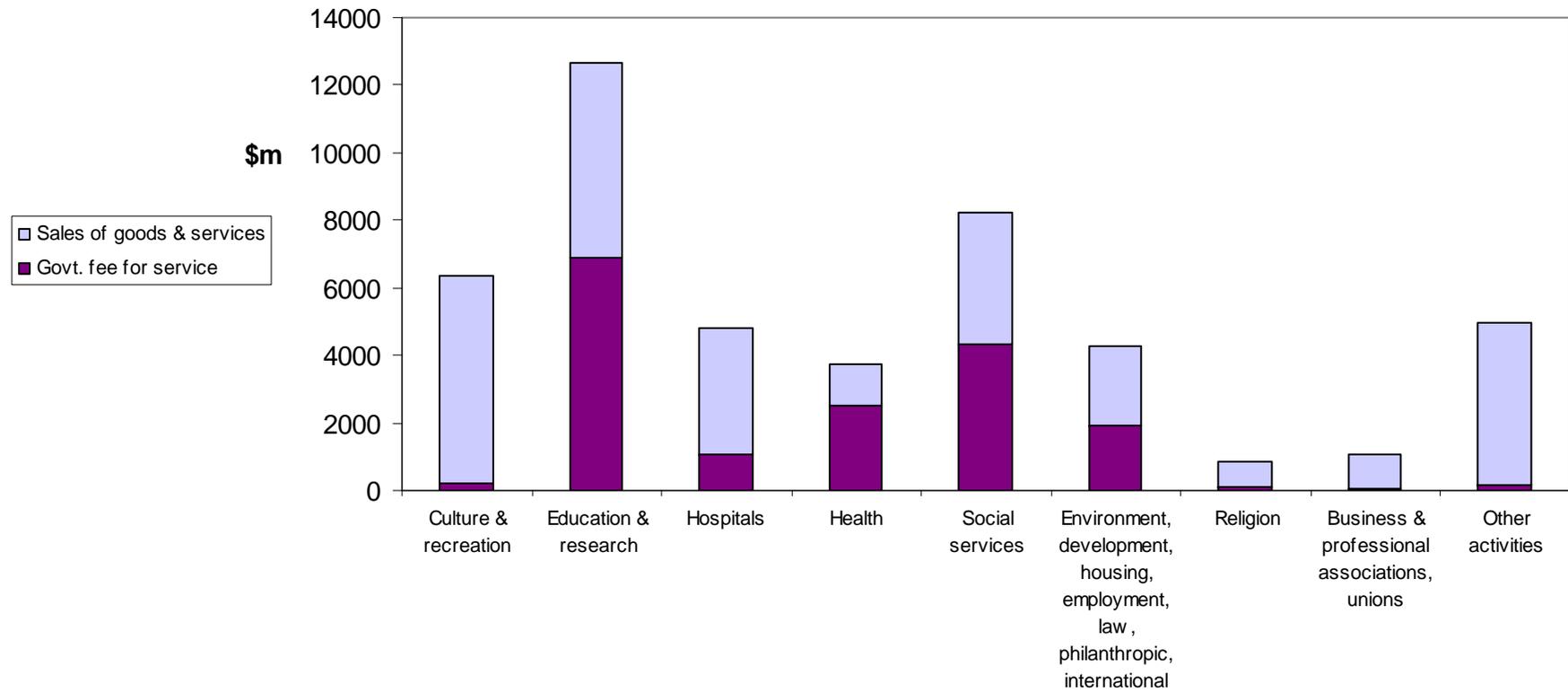
12 Industry Commission, op. cit., p.316.

13 Sheppard, I., Fitzgerald, M., Gonski, D. (2001) *Report of the Inquiry into the Definition of Charities and Related Organisations*, Canprint, Chapter 27 p 219-231.

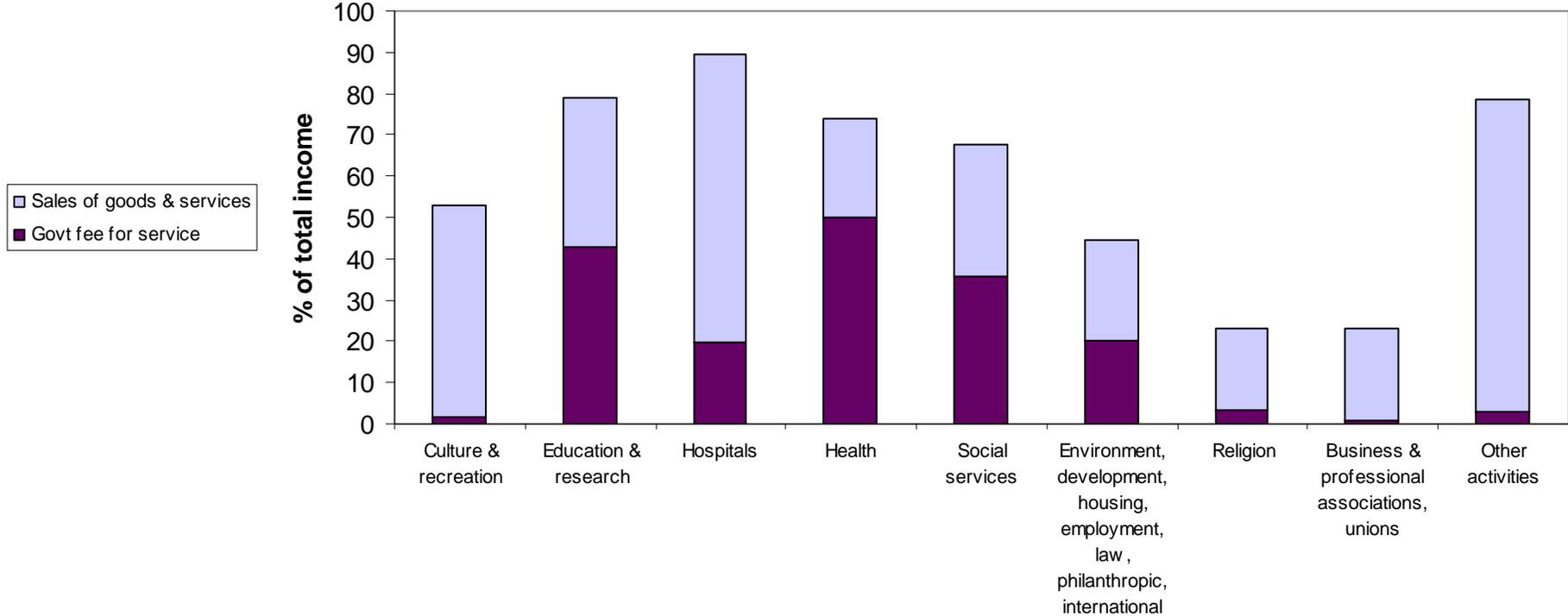
14 Ibid, p 230.



**Figure 1: Sources of Commercial Income by Type of Organisation**



**Figure 2: Sources of Commercial Income as a Percentage of Total Income by Type of Organisation**



## CORPORATE ENTITY ISSUES AND COMMERCIAL ACTIVITIES

The Australian nonprofit sector has a number of corporate structures which are available for arranging their affairs. It takes on some characteristics of the UK system of corporate law, charitable trusts and unincorporated associations and a form of incorporated association which probably had its origins in early New York legislation.<sup>15</sup>

There are some 134,858 incorporated associations, 1,837 cooperatives, 11,000 companies limited by guarantee and an unknown number of charitable trusts, unincorporated associations and special incorporated bodies with grants from the crown and the like.

There are no significant corporate law barriers which prevent companies limited by guarantee or cooperatives from engaging in commercial activities.<sup>16</sup> The *ultra vires* rule which would once limit a corporation's contractual capacity to activities directly within its stated objectives has been reformed.<sup>17</sup> The terms of the constitution (either objects or prohibited activities) do not limit the capacity of the corporation to engage in those activities vis-a-vis outsiders to the company, such as third party creditors. A breach of the constitution may be relied upon by members of the corporation to control directors (ie the constitution may be enforceable internally – by the members against the directors), but this does not appear to have been a barrier to companies and cooperatives engaging in commercial activities which may once have been outside their formal objects.

The commercial activities of incorporated associations and charitable trusts have been more problematic because of some entity constraints on commercial activities. Given that charity trusts are not strictly corporate entities and their definition is adopted in

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15 G Taylor (2003) 'The origins of Association Incorporation Legislation – The Association Incorporation Act 1858 of South Australia', *University of Queensland Law Journal*, 22:2, 224-238.

16 Section 150 *Corporations Act 2001* (Cth) and ASIC Regulatory Guide 50 prevents those companies seeking a licence to dispense with the term 'limited' from their name from trading unless they are charities or have liabilities of less than A\$500,000.

17 Section 125 of the *Corporations Act 2001* (Cth)

the taxation concessions, the situation for this class of entity is dealt with in the discussion of taxation, below. Each state and territory jurisdiction's incorporated association statute has slightly different provisions, but associations cannot be formed for a "purpose of trading or securing pecuniary profit to its members."<sup>18</sup>

In most jurisdictions a grey issue arises concerning where to draw the line between activities that are permissible being ancillary or incidental to its principal objects and when such commercial activities are no longer ancillary and become a principal purpose or object in themselves. In Queensland, the legislation uses the phrase "the trade is ancillary to the association's principal purpose and is not substantial when compared to its other activities."<sup>19</sup> However, it is used within a definition section which seeks to explain whether an "association is formed or carried on for the purposes of financial gain for its members".<sup>20</sup> There do not appear to have been any reported cases directly concerning this issue for about 30 years. In *Ex parte Western Australian National Football League*,<sup>21</sup> Chief Justice Barwick stated:

"What the proviso intends to exclude from the operation of the Associations Act are associations which are formed to trade for the profit of its members. The language of the proviso should be read as a whole and not in self-contained segments. It is not the purpose of entering into trading transactions which it is intended to disqualify: the disqualification is in the purpose of gaining by trading or otherwise pecuniary profit for the members."<sup>22</sup>

In Victoria the provisions are drafted in an unfortunate style sprinkled with double negatives with a carve out for ancillary trading by associations with charitable objects, and the regulator attempts to enforce the provision with some zeal.<sup>23</sup> In other

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18 Fletcher, K.L. (1986) *The Law Relating to Non-Profit Associations in Australia and New Zealand*, The Law Book Co, p. 231.

19 Section 4(1)(e) *Associations Incorporation Act 1981* (Qld).

<sup>20</sup> *Id.*

21 *Ex p Western Australian National Football league Inc* (1979) 143 CLR 190 at 198-9.

22 (1979) 143 CLR 190 at 199. Note that this issue was only raised by one judge and was not the reason for deciding the case.

23 Sections 3(2) and 51 *Associations Incorporation Act 1981* (Vic).

jurisdictions slightly different variations are in existence, often with exemption provisions exercised by the Minister responsible.<sup>24</sup>

The structuring which occurs in the sector is to either avoid an incorporated association form and instead choose a company limited by guarantee or incorporate a separate corporate body to carry out commercial trading. This separate body may be either a company limited by guarantee or a proprietary limited company closely controlled by the parent body. Revenues can be drawn across from the trading body by either tax deductible gifts or fully franked dividends and hence incur little or no income tax. Australian income tax law does not have any capping of tax deductible gifts or associate provisions to limit or hamper the transfer of the trading surpluses.

## TAXATION CONCESSIONS FOR NONPROFIT ORGANISATIONS

Most nonprofit organisations are entitled to varying degrees of exemption or concessions from taxes, charges and fees. Nonprofit organisations may have exemption from paying any income tax, capital gains tax, or fringe benefits tax, in addition to their donors claiming an income tax deduction for gifts. They may also be exempt from state taxes such as land tax, payroll tax, stamp duty and various transaction tax imposts. Local councils give various concessions in respect of rates and charges. At all levels of government and quasi-government bodies and utilities, fees and charges are often waived or discounted for nonprofit organisations.

The most important categories of income taxation exemption are the exemption from paying income tax, capital gains or fringe benefit tax exemptions. It is the availability of these concessions that most influence nonprofit entity structures.

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<sup>24</sup> For example South Australia, s18(5) *Associations Incorporation Act 1985* (SA)

## Exemptions from Income Tax

Australian nonprofit organisations are lightly regulated in terms of taxation in that no exempt entities (apart from Prescribed Private Funds<sup>25</sup>) is required to file annual returns. Not being required to pay income tax or even have the compliance costs of preparing an income tax return is a significant concession for these nonprofit organisations. Further commercial activities are tolerated to a surprising level in the taxation regime.

Exemption from taxation by nonprofit bodies can occur through:

- the common law doctrine of mutuality, or
- statutory intervention (Division 50 of the *Income Tax Assessment Act 1997*).

Both categories are now reviewed in relation to their toleration of commercial activities.

## Mutuality

The mutuality principle is a common law concept based on the proposition that a person's income consists only of funds derived from external sources and that funds derived from internal sources are therefore not assessable for income tax purposes. The mutuality principle is enjoyed by numerous entities within the Australian nonprofit sector to access tax exemptions.

The concept of mutuality was established in *The Glasgow Corporation Waterworks Acts v IRC*.<sup>26</sup> The court held that the concept of mutuality was based on an association of persons, who had joined together, not to derive profits or gains, but to achieve through their mutual contributions, a purpose or benefit in which all the members could, or

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<sup>25</sup> This category is akin to a private foundation in the USA.

<sup>26</sup> (1875) 1 TC 28. It is widely reported that the first authoritative recognition of the principle is to be found in *Styles (Surveyor of Taxes) v New York Life Insurance Company* (1889) 2 TC 460. This was the first reported case dealing with the concept of mutuality in relation to self insurance; other subsequent major UK cases include *The Equitable Life Assurance Society of the US v Bishop* [1900] 1 QB 177 and *Jones v The South-West Lancashire Coal Owners' Association Ltd* [1927] AC 827.

were entitled to participate. These organisations were established on the basis of a legal relationship between the members that gave rise to mutual rights and obligations by the entity towards its members. It is the nature of the legal relationship and the resulting rights which define the mutual character of the entity. This English concept has been confirmed as the situation in Australian law.<sup>27</sup>

Over the years, some commercial mutuals have been excluded from the application of the mutuality principle by specific income tax provisions including life assurance companies,<sup>28</sup> life insurance companies,<sup>29</sup> specific friendly societies,<sup>30</sup> certain cooperatives,<sup>31</sup> mutual insurance companies<sup>32</sup> and credit unions.<sup>33</sup> It appears that as markets and for profit competitors have arisen in their sphere of activities, the legislature has brought them into the tax base.

However, Australian gaming machine (fruit/slot/poker machines) clubs have not been brought into the taxation base despite their proliferation in all states and territories. Many are operated on a mutual basis, although as detailed in the next section, there is a specific legislative exemption for sporting clubs. These clubs are significant operations largely because of their gambling revenue and they exercise significant political leverage from time to time. Based on the clubs' operating profits of \$561 million for the 1997-98 financial year,<sup>34</sup> the Productivity Commission estimated that the Government would have collected an additional \$202 million in taxation revenue if the clubs had been taxed at the company rate on their total profits. However, this figure may be underestimated as the operating profits derived from bar and catering trade are usually artificially low due to subsidies provided from the profits generated from the gaming activities. The results of a survey of 150 clubs in Queensland, New South Wales and

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27 *The Bohemians Club v FCT* [1918] 24 CLR 334.

28 Division 320 *Income Tax Assessment Act 1997* (Cth) (ITAA 1997).

29 Division 320 ITAA 1997 (Cth).

30 Section 119 ITAA 1936 (Cth).

31 Section 118 ITAA 1936 (Cth).

32 Section 117(2) ITAA 1936 (Cth).

33 Section 117 ITAA 1936 (Cth).

34 Productivity Commission (1999) *Australia's Gambling Industries* Report No 10, Volume 2, Canberra, AGPS.

Victoria showed that 23% of the clubs had not paid any income tax in recent years on revenues totalling \$80million.<sup>35</sup>

The last review of business taxation, known as the Ralph Report contained a recommendation to reform the common law principle of ‘mutuality’.<sup>36</sup>

Recommendation 5.6 of the report stated that the mutuality principle should be included as an integral part of the taxation system and be given explicit effect in taxation law, rather than be left to the common law. The inclusion of legislative provisions for the apportionment of expenditure between taxable and non-taxable income was also suggested. However, this recommendation was never acted upon by the government and attracted no further comment.

A full Federal Court decision involving the Coleambally Irrigation Mutual Co-operative<sup>37</sup> is the only major case in the last decade involving mutuality. The Court held that the mutuality principle did not apply when the members of the mutual entity were not entitled to receive a distribution of profits on the winding up of the entity. Both major political parties bowed to intense pressure by gaming machine clubs before an election to reverse the decision by statute.<sup>38</sup> *Tax Laws Amendment (2005 Measures No.6) Act 2005* made retrospective to 1 July 2000 ensured the taxation status of nonprofit entities relying on mutuality was not adversely affected by the Federal Court’s decision in the *Coleambally case*.

## Statutory Exemption

A list of nonprofit entities exempt from income tax is set out in Division 50 of the *Income tax Assessment Act 1997*. The specific exemptions in the Act are not mutually exclusive and often an entity may fall within more than one category. An example is

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35 Arthur Andersen (1996) Unpublished survey commissioned by the Australian Hotels Association.

36 Australia Review of Business Taxation (1999), *The Review of Business Taxation Report “A Tax System Redesigned”*.

37 *Coleambally Irrigation Mutual Co-operative Limited v FCT* [2004] FCAFC 250.

38 Assistant Treasurer’s Press Release No 46, 30/5/2005, Canberra.

that a school may be both a “public education institution” as well as a “charitable institution”, as may a religious institution or a scientific institution.

The categories of income tax exemption from Division 50 *Income Tax Assessment Act 1997* are reproduced below:

*50-5 Charity, education, science and religion*

Item	Exempt entity
1.1	*Charitable institution
1.2	Religious institution
1.3	Scientific institution
1.4	Public educational institution
1.5	*Fund established for public charitable purposes by will before 1 July 1997
1.5A	*Trust covered by paragraph 50-80(1)(c)
1.5B	*Fund established in Australia for public charitable purposes by will or instrument of trust (and not covered by item 1.5 or 1.5A)
1.6	Fund established to enable scientific research to be conducted by or in conjunction with a public university or public hospital
1.7	Society, association or club established for the encouragement of science

\*Any entity covered by item 1.1, 1.5, 1.5A and 1.5B is not exempt from income tax unless the entity is endorsed as exempt from income tax by the Australia Taxation Office.

*50-10 Community service*

Item	Exempt entity
2.1	Society, association or club established for community service purposes (except political or lobbying purposes)

*50-15 Employees and employers*

Item	Exempt entity	Special conditions
3.1	(a) employee association; or  (b) employer association	the association: (a) is registered under an Australian Law relating to the settlement of industrial disputes; and (b) is located in Australia, and incurs its expenditure and pursues its objectives principally in Australia
3.2	Trade union	located in Australia and incurring its expenditure and pursuing its objectives principally in Australia

Note: Despite items 3.1 and 3.2, certain ordinary and statutory income of some associations of employees and some registered trade unions may be subject to income

tax under Division 8A of Part III of the *Income Tax Assessment Act 1936*.

#### 50-20 Finance

Item	Exempt entity
4.1	a friendly society (except a friendly society dispensary)

#### 50-25 Government

Item	Exempt entity
5.1	(a) a municipal corporation; or (b) a local governing body
5.2	a public authority constituted under an Australian Law

*Note:* The ordinary and statutory income of a State or Territory body is exempt: see Division 1AB of Part III of the *Income Tax Assessment Act 1936*.

#### 50-30 Health

Item	Exempt entity
6.1	Public hospital
6.2	Hospital carried on by a society or association (not carried on for the profit or gain of its individual members)
6.3	the following organisations registered for the purposes of the <i>National Health Act 1953</i> : (a) a medical benefits organisation; (b) a health benefits organisation; a hospital benefits organisation (not carried on for the profit or gain of its individual members)

#### 50-35 Mining

Item	Exempt entity
7.1	the Phosphate Mining Company of Christmas Island Limited (incorporated in the Australian Capital Territory)
7.2	The British Phosphate Commissioners Banaba Contingency Fund (established on 1 June 1981)

#### 50-40 Primary and secondary resources, and tourism

Item	Exempt entity
8.1	A society or association established for the purpose of promoting the development of: (a) aviation; or (b) tourism (not carried on for the profit or gain of its individual members)

Item	Exempt entity
8.2	A society or association established for the purpose of promoting the development of any of the following Australian resources: (a) agricultural resources; (b) horticultural resources; (c) industrial resources; (d) manufacturing resources; (e) pastoral resources; (f) viticultural resources; (g) aquacultural resources; (h) fishing resources (not carried on for the profit or gain of its individual members)

50-45 Sports, culture, film and recreation

Item	Exempt entity
9.1	a society, association or club established for the encouragement of: (a) animal racing; or (b) art; or (c) a game or sport; or (d) literature; or (e) music
9.2	a society, association or club established for musical purposes
9.3	the Australian Film Finance Corporation Pty Limited (incorporated under the <i>Companies Act 1981</i> on 12 July 1988)

The law generally exempts from tax all income generated by these organisations provided that:

1. the organisation's main purpose or object is exempt and its actual activity is directed to these purposes;
2. the organisation is nonprofit (ie. it does not distribute, and is constitutionally prohibited from distributing, its surplus to anyone or any purpose, other than its stated exempt objectives); and
3. the organisation has an appropriate dissolution clause which transfers any surplus to a similar tax exempt organisation, not its members or controllers.

Charitable bodies must also have certain attributes:

- the organisation has a physical presence in Australia and to the extent of that presence incurs its expenditure and pursues its objectives principally in Australia

OR



- the organisation is one referred to in Subdivision 30-15 ITAA 1997 (ie, a Deductible Gift Recipient)

OR

- the organisation is a prescribed institution which is located outside Australia and is exempt from income tax in its country of residence

OR

- the organisation is a prescribed charitable or religious institution that has a physical presence in Australia, but incurs its expenditure and pursues its objects principally outside Australia.

Gifts and government grants can be applied overseas without affecting the income status of the exempt organisation and are to be disregarded for the purpose of determining whether the entity incurs its expenditure and pursues its objects in Australia.

Nowhere are ‘unrelated income’ or commercial activities mentioned specifically in the statute as a disqualifying factor to exempt status. However, the issue of commercial activities is being increasingly considered by taxation regulators and the courts. The basic contention is that at some point the weight of commercial activity makes an entity a business with some exempt purposes, rather than a tax exempt entity with some commercial activities. The inquiry depends on the way in which the exemption is expressed in the statute and the underlying case law. The two main categories under such scrutiny are the “charitable fund/institution” exemption and “a society, association or club established for the encouragement of: a game or sport.” These two categories attract public and revenue authority attention because of the growing commercialisation of both sectors’ activities. Social welfare organisations are generating substantial revenues from government contracts as well as cross subsidising their mission from commercial revenues. Gaming machine clubs are also significant players in the hospitality market with such activities overshadowing the sporting activities that give them exempt status. The paper turns to examine both in turn.

## Charitable trusts and institutions

A trust expressed to be for both charitable and non-charitable purposes is invalid.<sup>39</sup> However, the fact that a charitable institution has non-charitable purposes incidental or ancillary to its charitable purposes does not invalidate gifts to the institution.<sup>40</sup> This principle of trust law is also applied to determining the charity status of incorporated bodies and for taxation purposes. An institution is accepted as charitable if its dominant purpose is charitable.<sup>41</sup> Any non-charitable purposes of the institution must be no more than incidental or ancillary to this dominant purpose. Finding an institution's sole or dominant purpose involves an objective weighing of all its features. They include its constitutive or governing documents, its activities, policies and plans, administration, finances, history and control, and any legislation governing its operation.<sup>42</sup>

The introduction of a GST into Australia brought special treatment for certain tax classifications of some nonprofit entities. To protect the GST revenue base, these entities which had not previously been registered by the ATO, were required to be vetted and placed on a publicly accessible register. To guide this vetting process the ATO published a series of draft rulings and one set out the Tax Commissioner's view of what was a 'charitable institution or fund' for the purposes of income tax exemption.<sup>43</sup> Finalisation of the ruling was delayed while the government considered its legislative response to the Charity Definition Inquiry recommendations during 2001-2002. An additional ruling on income tax exemption of companies controlled by

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39 Meagher, R. P. and W. M. C. Gummow. *Jacob's Law of Trusts in Australia*, 6th edition, Butterworths, Sydney, 1997, p. 237. Some State legislation operates to save, as charitable, trusts which would otherwise be invalid because of mixed charitable and non-charitable purposes: *Charitable Trusts Act 1993* (NSW) s 23(1); *Property Law Act 1958* (Vic) s 131(2); *Trusts Act 1973* (Qld) s 104; *Trustee Act 1936* (SA) s 69A(1); *Trustees Act 1962* (WA) s 102(1); and *Variation of Trusts Act 1994* (Tas) s 4(3). There is a question whether such legislation, dealing as it does with trusts, would apply to entities constituted as companies limited by guarantee or as associations. While the matter is not clear, the better view would seem to be that the legislation would apply.

40 *Congregational Union of New South Wales v Thistlethwayte* (1952) 87 CLR 375; *Stratton v Simpson* (1970) 125 CLR 138.

41 *Congregational Union of NSW v Thistlethwayte* (1952) 87 CLR 375 at 442 per Dixon CJ, McTiernan, Williams and Fullagar JJ.

42 Australian Taxation Office (ATO) 1999, *Draft Taxation Ruling — Income tax and fringe benefits tax: charities*, TR 1999/D21, paras 103 and 111-112.

43 ATO, TR 2005/21 *Income tax and fringe benefits tax: charities*.

exempt entities such as charitable institutions appeared when the second draft of the charity ruling was issued by the ATO.<sup>44</sup> There was spirited debate over the rulings, particularly about how one decided whether an organisation was ‘charitable’ and what part ‘commercial services’ played in this decision.

The ruling stated that:

“A purpose of carrying on a business or commercial enterprise as such is not charitable. This is the case even if the entity carrying on the enterprise is controlled by a charitable institution or its profits are ultimately applied for charitable purposes. However, a business or commercial enterprise that is merely incidental to the carrying out of a purpose that is otherwise charitable does not by itself prevent that purpose being charitable.”<sup>45</sup>

The finding of the bright line between a charity and a commercial enterprise is later explained as a holistic weighing of many factors ranging from the constitutional documents to the actual context and activities undertaken by the entity. The ruling continues:

“on their own, the facts that an organisation carries out operations to generate surpluses, in a commercial or business-like manner, in ways that have commercial or business-like features, do not show that the organisation lacks a charitable purpose. As noted, many organisations with such activities and incidental purposes are charities.

However, where an organisation’s purpose is in fact carrying on a commercial enterprise to generate surpluses, the purpose will not be charitable. The issue turns on *purpose*. Characterising a purpose or purposes can involve a weighing of different features. They can include (as well as the organisation’s objects and constituent documents) its plans and policies, its control, the uses of its surpluses, its activities, the involvement of volunteers, reliance on donors, its markets, the setting of prices and fees, comparisons with the operations of relevant for-profit businesses, how its business-like operations are related to or integrated with its other operations, and so on.”<sup>46</sup>

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44 ATO, TR 2005/22 Income tax: companies controlled by exempt entities.

45 TR 2005/21 at p 5.

46 TR 2005/21 at p 36.

The ATO decided to fund a test case to clarify the law. The *Word Investments case*<sup>47</sup> has proceeded from a tribunal through a single judge of the Federal Court, the full Federal Court and has recently been heard in the High Court of Australia. As the ultimate appeal court in Australia, the High Court decision may well bring an authoritative determination of the law in this area as the case chosen provides all the necessary features of the issue. However, it may well initiate legislative intervention by the government.

The *Word Investments case* been well argued, with senior counsel and detailed decisions in the lower courts. Word Investments Ltd (Word) was established in 1975 by Wycliffe Bible Translators (Wycliffe) to provide financial and fund-raising support to Wycliffe. Wycliffe is an evangelical missionary organisation that seeks to spread the Christian religion through literacy and translation work, predominantly in the developing world. Wycliffe was an income tax exempt charity and claimed that Word Investments was exempt as a charity as well.

Word Investments initially raised funds through housing development and then passed any surplus on to Wycliffe. These activities ceased in the early 1980s, but in the late 1980s Word took over the fundraising activities then carried on by Wycliffe which consisted of investing money borrowed at non-commercial rates from supporters. Word also offered financial planning at this time for a fee. Word continued to pass funds to Wycliffe until in 1996 it resolved to establish Bethel Funerals, a funeral business. Bethel Funerals traded with the public and surplus funds were given to Wycliffe.

In 2002, Word decided to create a separate trust – the Word Investments Foundation Trust – to operate the funeral business. In March 2005, Word was refused endorsement as a tax exempt charitable fund by the ATO and hence the proceedings arose. The factor that makes this case so instructive is the different arrangements put into place over the period of time which the court was required to decide.

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47 Re VT 2003/66 *v The Commissioner of Taxation* AAT, 2005 No VT 2003/66; *Commissioner of Taxation v Word Investments Ltd* [2006] FCA 1414 (2006 *Word case*); *Commissioner of Taxation v Word Investments Ltd* [2007] FCAFC 171 (2007 *Word case*).

First, there was the period before 1996 when Word carried on fundraising activities for Wycliffe. Was Word charitable? Both the tribunal, the Federal Court single judge and the Full Court of the Federal Court found by an examination of its constitution that it was charitable. It is notable that the Federal Court adopted the orthodox view that where it is not possible to determine an organisation's objects from its constitution, it is merely necessary to resort to an examination of activities, noting:

“Where it is unclear from the listed objects of an organisation what its main purpose is, or where the evidence shows that the listed objects do not reflect the actual purpose of the organisation, it is appropriate to look to the activities of the organisation together with expressed objects.”<sup>48</sup>

Second, there is the period from 1986/7 to 1996 with the establishment of Bethel Funerals. Here, the sole activity was generation of income from interest earned on deposits of money lent by supporters and surplus passed to Wycliffe.

After noting the cases where charities such as hospitals, schools and crematoriums can charge fees for services without endangering their charity status, Justice Sundberg wrote

“..I think it is clear from the above passage that the making of a profit through trade or business is not necessarily inconsistent with a charitable purpose and that the true question to be asked is the purpose of the making of the profit. If the purpose is commercial then the exclusive purpose of the organisation is not charitable; if the purpose is selfless then it may be.”<sup>49</sup>

Here it is the “purpose” and not the manner or activity that is crucial. Word was charitable during this period.

Third, did the effect of conducting a funeral business alter Word's charitable status? Again, it did not. Word's activities must be considered as a whole in determining whether its purposes were charitable. The reasoning of the Tribunal drawing a

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48 2006 *Word case* at paragraph 28.

49 2006 *Word case* at paragraph 37.

distinction between active (non charitable) and passive investment (charitable) which is also used in TR2005/22 was rejected. Justice Sundberg wrote

“The Tribunal’s distinction is at odds with the practice of contemporary organisations. With the decline of the welfare state, charitable organisations are expected to do more with the same resources. Reliance on donations alone will, in many cases, be insufficient. Hence many charitable organisations have established business ventures to generate the income necessary to support their activities. There may be a vast difference between selling lamingtons at a church fete and selling funeral services, but where the object of raising the funds is the same, I can see no reason to draw a legal distinction between the two.”<sup>50</sup>

Finally, from 2002 Bethel Funerals was run as a separate entity in a trust, rather than merely a part of Word. Both the Tribunal and the Federal Court found the activities were the same and hence were still charitable. The matter was argued before the High Court in late August 2008 and a decision is yet to be handed down at the time of writing.

### **Sporting clubs**

Most of the judicial comment on what is a dominant purpose of an exempt organisation and what is the role of unrelated business income in such a determination has arisen from sporting club cases. On the introduction of the expanded sporting income tax exemption provisions it appears that an assumption was made that a sporting club’s entertainment, social activities and poker machine income would be taxed. The Treasurer stated,

“Clubs, societies and associations will continue to be taxable where their activities go beyond the promotion or encouragement of sports or games, for example, where the provision of social facilities, entertainment and the like is more than incidental to sport promotion.”<sup>51</sup>

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<sup>50</sup> 2006 *Word case* at paragraph 60.

<sup>51</sup> Commonwealth of Australia, Budget Statements 1989-90 No. 1, Canberra, Commonwealth Government Printer, at p.4.21 and might be attributed to an incorrect application of the case of *"The Waratahs" Rugby Union Football Club v FCT* 79 ATC 4337.

The provisions were estimated to cost less than one million dollars annually.<sup>52</sup> Cases after the statement have shown exempt sporting clubs that hold \$10 million in cash assets generate over \$4.5 million in profits a year from gaming machines,<sup>53</sup> or spend only six percent of their annual expenditure directly on their sporting activities,<sup>54</sup> are not liable to be taxed on their income. The Commissioner was unsuccessful in a series of cases against sporting clubs with significant unrelated business income in claiming that a large percentage of unrelated business income meant that the exempt bodies' dominant purpose was no longer sport.<sup>55</sup>

In 1997, the Federal Court ruled in *St Marys Rugby League Club Limited v Federal Commissioner of Taxation* (1997) 97 ATC 4528 that a club whose profits from social activities increased from around \$815,000 in 1992 to \$1.9 million in 1995, qualified for exemption on the basis that it promoted Rugby League football. In this case, Hill J found that the club was exempt as there was 'an intensity of activity directed towards football which tips the balance in favour of the applicant'. He found it significant that control of the club vested in persons who had been footballers and that persons were drawn to membership because of their interest in Rugby League.

However, in 1999, the case of *North Suburban Club Inc v Federal Commissioner of Taxation* 99 ATR 2254 the AAT ruled that a club with substantial social facilities no longer had a predominant purpose of sport. This case involved a club that was founded in 1895 as the North Suburban Cycling club. At its height, it was said to have been the second highest cycling club in the world. However during the 1900s, cycling became less of an activity and by 1985, the club ceased any current association with the activity. Instead, its focus turned to various activities such as squash, billiards and

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52 Senator Robert Rae, Second Reading Speech of the Income Tax Laws Amendment Bill, 21 May 1990, Senate Hansard, at p.580.

53 Refer *Tweed Heads Bowls Club v FCT* 92 ATC 2087 and *Terranora Lakes Country Club Limited v FCT* 93 ATC 4078.

54 *Case W114 (Grand United Port Macquarie West Bowling Club v FCT)* 89 ATC 891.

55 Some of the cases are *Terranora Lakes Country Club Ltd v FCT* 93 ATC 4078; *St Marys Rugby League Club Limited v FCT* 97 ATC 4528, *Case X25* 90 ATC 251.

(social) golf. Shortly after, its social activities in the form of poker machines, bingo and bistro began to grow.

In 1995, a year in question, returns from poker machines exceeded \$2,000,000 and only \$8,376 of expenditure appeared to related directly to any form of sporting activity. The General Manager's Report in the 1995 Annual Report included the statement 'whilst the Club's core business in Poker Machines, some of you will be aware that our functions and bistro business continues to grow'. On consideration of the evidence, the court ruled that: 'while the history of the club had a substantial sporting emphasis, the more recent constitution and activities... clearly show the Club as having its primary purpose of providing gambling and social activities'. Hence, the club was not exempt from income tax on the basis that its predominant purpose was sport.

Therefore, the Australian cases have shown that an exempt NPO is permitted to participate in (often substantial) commercial activity. However, where commercial activity overtakes the exempt function to become the organisation's predominant focus, the organisation loses entitlement to income tax exemption.

## **Capital Gains Tax**

In Australia, there is no separate capital gains tax regime as it is treated as part of income tax. Thus capital gains tax does not apply to income tax exempt organisations as, despite any capital gains, they are exempted from income tax. The development of real estate by exempt organisations or trading in securities could benefit from such an exemption.

## **Goods and Services Tax (GST)**

Australia has had a broad based value added tax known as the Goods and Services Tax (GST) since 1 July 2000. The GST applies at the rate of 10% on the supply of most goods, services and anything else, including importations, consumed in Australia after 1

July 2000.

The previous sales tax regime gave significant exemptions for certain nonprofit organisations in the purchase of goods such as cars, consumer goods and equipment. The intent of the GST legislation was that commercial activities of these charitable entities would be taxable, but non-commercial supplies are supplies made by the charitable entity for nominal consideration and supplies of donated second-hand goods would be GST-free. Nominal consideration means the consideration for a supply is less than 50% of the GST inclusive market value of the supply or the consideration is less than 75% of the consideration provided to acquire the thing supplied. The exception to this is the supply of accommodation. In the case of supply of accommodation, nominal consideration means the consideration for a supply is less than 75% of the GST inclusive market value of the supply. So undervalue transactions by the charitable entity to clients (eg supported accommodation, discount clothing and furniture) are GST-free.

The sale of donated goods (e.g. clothing and cars) by registered charitable institutions, trustees of charitable funds and gift deductible entities will be GST-free. Sale of donated second hand goods between such bodies will also be GST-free. If the goods are dealt with in such a way that they lose their original character (eg repair or re-processing), the supply will not be GST-free.

Supplies of raffles and bingo by registered charitable institutions, trustees of charitable funds or gift deductible entities (excluding lotteries), that do not contravene a State or Territory law will be GST-free.

Charitable institutions and government schools can elect to have fundraising events treated as input taxed. This means that those activities will not be subject to GST and that a charity will not be able to claim input tax credits for related costs. Eligible events include fetes, balls, gala shows, dinners; and events involving the sale of fundraising items for \$20.00 or less such as flowers and sweets as long as it is not part of the normal business of the charity. The sale of alcoholic or tobacco products is not

permitted. Events can also be approved by the ATO as being under the section. An event must not be part of a regular series and this means that there can be no more than 15 events in any income year.

As noted earlier the GST which replaced a Wholesale Sales Tax contains far less tax distortions as only non-commercial activities of nonprofit organisations are permitted.

## **Fringe Benefits Tax**

Fringe benefits tax (FBT) is a tax payable by employers on the value of certain benefits, known as fringe benefits that have been provided to their employees or to associates of those employees in respect of their employment. Fringe benefits are governed by the *Fringe Benefits Tax Assessment Act 1986* (Cth).

There are specific exemptions for the following employers:

- Where the employer is a religious institution and the employee is a religious practitioner (which may include employees training to be a member of a religious order), then any benefits provided to the employee, their spouse or child that relate mainly to:
  1. Pastoral duties; or
  2. Other duties or activities that are directly related to the practice, study, teaching or propagation of religious beliefs, will be exempt from fringe benefits tax.
- Benefits provided in respect of the employment of employees of public benevolent institutions (including public hospitals).

Public benevolent institutions are exempt from FBT on benefits they provided to their employees to a grossed up value of \$30,000 per employee. This grossed up amount translates to fringe benefits totalling \$15,450 per employee. The cap applying to public and not-for-profit hospitals is \$17,000 of the grossed-up taxable value per employee. This grossed up amount translates to fringe benefits totalling \$8,755 per employee.

However, if an association was granted exemption from income tax, it will not receive an income tax deduction for the fringe benefit and FBT actually paid. To ensure that non-profit employers who are unable to claim a deduction for FBT are not disadvantaged, section 65J of the Act provides that a rebate of FBT at the rate of 48.5% will be available to wide range of nonprofit employers.

In some sectors, FBT exempt organisations have significant savings or ability to attract staff with salary packages. However, the recent imposition of a capped fringe benefit has lessened the significance of these savings. Over time the advantage will diminish further unless the provisions are indexed to inflation and wages growth. The structural effect on nonprofit organisations is that they seek to employ as many of their staff within FBT exempt organisations as possible. Where an organisation conducts FBT exempt and non-exempt activities, it will often have separate structures to take advantage of the FBT concessions for at least some of its staff.

## CONCLUSION

Australia has not sought to specifically separate commercial activities from traditional core nonprofit endeavours such as education, health, religion, culture and sport. There has been no serious attempt either in corporate entity or tax regulation to provide a bright line between a nonprofit entity with incidental and ancillary commercial activities and a commercial organisation within a traditional nonprofit entity structure. In any case, apart from some increased administration costs, most nonprofit entities can restructure their commercial affairs through a separate for profit entity and effectively pay no or little income tax.

In the area of mutuals such as insurance companies, building and friendly societies, credit unions and cooperatives the taxation policy was changed to bring these entities into the business tax fold. Such mutuals have declined rapidly over recent decades, but probably due more to the intense competition and regulatory burden imposed generally on the financial sector.

The evidence is that the Australian nonprofit sector has significant sources of income from fees, charges and unrelated business income compared to other OECD jurisdictions. There are pressures building from for profit businesses who perceive that the tax concessions of nonprofit organisations are unfair in the contestable market place and from governments who seek to maximise taxation revenues. The impending High Court decision in the Word Investments case combined with a ‘root and branch’ review of the Australian taxation system currently under way may well bring the federal government to consider reform in this area.

The reform task will not be simple because of the characteristics of the sector and also the structure of the Australian taxation system. First, the reliance of the sector on cross subsidised revenue is significant in relation to community welfare services and particularly in relation to the delivery of contracted out government services which are rarely fully funded. A bright line drawn to catch unrelated business income may result in more taxation revenue, but the government will have to pay more for contracted services or suffer a decrease in service provision. This may be a politically unattractive option in dealing with many parts of the nonprofit sector. Second, the reform of the taxation system to effectively tax unrelated business income will require extensive reform to the income tax laws, unless the government is willing to settle for some transparency of actual funds raised from unrelated business income. This presents a considerable task for any drafter in light of Australia’s uncapped donations regime; lack of associate prohibitions; and unsophisticated regulation of potential siphoning off of revenue through administration and management fees, unjust inurement, loan, lease and rental arrangements.