



# **ONE REGULATOR ONE SYSTEM ONE LAW**

## **The Case For Introducing a New Regulatory System for the Not for Profit Sector**

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# THE CASE FOR INTRODUCING A NEW REGULATORY SYSTEM FOR THE NOT FOR PROFIT SECTOR

A Discussion Paper by Senator Andrew Murray March 2006

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THIS DISCUSSION PAPER UPDATES THE FIRST DISCUSSION PAPER  
CIRCULATED TO MEMBERS AND SENATORS MARCH 2006.  
Updated July 2006.

## **THE CASE FOR INTRODUCING A NEW REGULATORY SYSTEM FOR THE NOT-FOR-PROFIT SECTOR**

**Note:** The March 2006 Discussion Paper “One Regulator One System One Law” was prepared for senators and members of the Federal Parliament by me to inform their deliberations in the House of Representatives and the Senate in relation to possible legislative regulation of the not-for-profit sector.

As a result of both feedback and further exploration I have updated this discussion paper to provide a more comprehensive assessment than the March discussion paper.

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### **1 MAKING THE CASE**

#### **1.1 REGULATING THE NOT FOR PROFIT SECTOR**

The Not-for-Profit (NFP) sector is very diverse and complex. It comprises churches, charities, sporting organisations, advocacy groups, community organisations and service providers. These NFP subsets are not discrete and are often interconnected.

In 1999 the Government agreed to the Democrats’ request that the confusing approach to the regulation of charities be examined and in 2000 the Government set up the *Inquiry into the Definition of Charities and Related Organisations 2001* (the Charities Definition Inquiry – CDI). It reported in August 2001.

For the purposes of this Discussion Paper, recommendations one and two from the CDI Report are used to refer to this diverse sector. In keeping with recommendation one, the term ‘not-for-profit’ (NFP) is used in place of the term ‘non-profit’ for the purposes of defining the relevant entities. In accordance with recommendation two, the term ‘entity’ is used to describe NFPs which include a body corporate;

a corporation sole; any association or body of persons whether incorporated or not; and a trust.<sup>1</sup>

There are at least three justifications for introducing a coherent national independent regulatory system for NFPs. These are that:

- Heavy public investment in NFPs through direct government expenditures and through tax expenditures<sup>2</sup> requires compliance with advanced integrity, reporting, and accountability standards;
- NFPs play a large part in the provision of government services, the private provision of public services, and the representation of public and community interest groups, so requiring regulation to ensure the safeguarding of the public interest; and,
- Modern governance recognises that economic or social sectors of a size such as the NFPs need to fall into an overall coherent framework of regulation that meets public expectations and standards, and matches the standard of regulation applying in other sizeable sectors.

NFPs have always been a substantial sector. Mediaeval guilds were as strong as trade unions ever were, and churches have been powerful institutions at various times in history. Indeed the rise of the rational secular welfare state might have been expected to see a reduction in the NFP sector, but it has not. The NFP sector has a strong role in a liberal secular western democracy. As US Professor Herrington Bryce points out:

*From its earliest days, a primary mission of the non profit sector has been the preservation and strengthening of American democracy. This role has taken many forms: protecting civil liberties and individual rights; levelling the playing field for all citizens; building strong democratic institutions;*

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<sup>1</sup>Inquiry into the Definition of Charities and Related Organisations, 30 June 2001, p13

<sup>2</sup> A tax expenditure is a tax concession that is designed to provide a benefit to a specified activity or class of taxpayer. A tax concession can include a tax exemption, tax deduction, tax rebate and reduced tax rate.

*providing a social safety net for the neediest members of society; and assuring a competitive free-enterprise system.*<sup>3</sup>

This paper is not intended to cover this topic in its entirety and several recipients of the first version pointed out that it did not. However, that this paper is not comprehensive should not stifle discussion but invigorate it. As Professor Mark Lyons points out:

*The third sector is as important a part of a well-functioning society as is government and business. Societies that have a small or barely existent third sector are societies with dictatorial or failing governments.*<sup>4</sup>

It is difficult to gain a full or complete statistical or analytical picture of NFPs in Australia, a situation highlighted recently in an extensive article in *BRW* by Adele Ferguson.<sup>5</sup> However, a study in 1999 of 22 countries showed that between “one-half and thirteen percent of the workforce”<sup>6</sup> was employed in the sector. This lack of statistics indicates that effective rationalised regulation of NFPs would be enhanced if the Australian Bureau of Statistics (ABS) and instrumentalities like the Australian Taxation Office (ATO) were able to upgrade their raw data and categorisation of NFPs. However, I have not explored this issue.

Governance in the public and private sector is an issue which has warranted and received a great deal of attention over the last decade. During that time there has been substantial change in corporate governance, public sector governance and accountability requirements generally.

It is time to ask why, despite several enquiries<sup>7</sup> into the NFP sector, no fundamental change has taken place. Several academics,<sup>8</sup> journalists<sup>9</sup> and peak bodies<sup>10</sup>

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<sup>3</sup> Bryce, H, *Introducing a Common, Global Framework of Nonprofits as Players in Civil Society*, *International Journal of Not-for-Profit Law*, vol 8, no.1 November 2005, p77 at p87

<sup>4</sup> Lyons, M, *The Legal and Regulatory Environment of the Third Sector*, *The Asian Journal of Public Administration*, 25(1), 2003: 87-106

<sup>5</sup> Ferguson, A, *The Business of Giving*, *BRW*, 29 June – 5 July 2006 pp27

<sup>6</sup> *ibid*, p2 referring to Salamon, LM, et al 1999 *Global Civil Society. Dimensions of the Nonprofit Sector*, Baltimore, The Johns Hopkins Center for Civil Society Studies.

<sup>7</sup> Inquiry into the Definition of Charities and Related organisations, 30 June 2001 and the Productivity Commission report into Charitable Organisations in Australia 1995

representing NFPs have asked during the last five years why this particular sector, which provides a myriad of goods and services to the Australian people, employs substantial numbers of Australians, and receives substantial benefits from federal, state and territory governments is, for all intents and purposes, unregulated as a sector.

Only some parts of the NFP sector are covered by comprehensive national legislation, for instance registered organisations (unions and employer organisations) through the *Workplace Relations Act*. However, even they do not have a well-resourced national independent workplace relations regulator to properly regulate and oversee a national unitary system. Other sectors of the economy have regulators like the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulatory Authority (APRA), and the Australian Competition and Consumer Commission (ACCC).

Over the last two decades there has been increasing regulation of the for-profit sector with the integration of the Corporations Law into a Federal system. The Corporations Law now has increased reporting requirements for corporate entities and has strengthened the powers of regulators like ASIC and the Australian Stock Exchange (ASX), so increasing their regulatory oversight. It has increased the disciplining and/or prosecution of directors and corporations and increased criminal sanctions and fines for corporate misconduct.

Australians, generally speaking, may like to figuratively thumb their noses at authority but at the same time they expect that everyone should get a fair go. They expect that shareholders should not be ripped off, that customers should get a good deal, and that they should be treated fairly in the workplace, no matter where they work, or what kind of entity they work for.

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<sup>8</sup> Johns, G *Informed Giving: Ensuring Charities Inform Donors* IPA Backgrounder October 2004, Volume 16/3; Woodward, S & Marshall, S *A Better Framework: reforming not-for-profit regulation*, Centre for Corporate Law & Securities Regulation, The University of Melbourne 2004, Lyons, M, *The Legal and Regulatory Environment of the Third Sector*, *The Asian Journal of Public Administration*, 25(1), 2003: 87-106

<sup>9</sup> In particular Adele Ferguson in BRW and Stephen Mayne from crikey.com.au

<sup>10</sup>National Roundtable of Nonprofit Organisations

However, in the time that the private sector has become increasingly accountable and transparent and the public sector has been required to lift its game to meet increased public expectations, the NFP sector has been flying under the radar of substantial regulation, transparency and accountability.

As the Nonprofit Roundtable points out:

*The Corporate Law Economic Reform Program (CLERP) developed by the present Treasurer has delivered significant regulatory improvements for business and the community. There is a strong case for a similar program for the reform of non profit law and regulation.*<sup>11</sup>

As pointed out in a submission to the CDI, four things are required to maintain public confidence in any system, regardless of context: clarity; consistency; accountability and ability to adapt to social change.<sup>12</sup>

## **1.2 A PROBLEM WITH DEFINITIONS**

NFPs, particularly churches and charities, have always been the recipients of government funds and concessions in Australia. However the sector has largely stood outside the tax system until the era of Pay as You Earn (PAYE), superannuation charges, fringe benefits tax (FBT), and the Goods and Services Tax (GST) forced them into the realm of formal systemised tax reporting.

It was the introduction of the GST that saw for the first time, the ATO, at the urging of the Australian Democrats, take a formal and professional NFP sectorial approach to smooth the GST implementation and reporting regime.

Earlier this paper stated that heavy public investment in NFPs through direct government expenditures and through tax expenditures requires attention to integrity, reporting, and accountability issues. Being publicly funded by governments or

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<sup>11</sup> Nonprofit Regulation Reform Program, An initial statement by the National Roundtable of Nonprofit Organisations, March 2004, p2

<sup>12</sup> Malleeson Stephen Jaques submission to the Inquiry into the Definition of Charities and Related Organisations January 2001, p1

receiving a tax concession that provides a benefit to a specified activity or class of taxpayer *because* your organisation has been classed as a public benevolent institution or a deductible gift recipient (DGR) means that getting that status has value. That status needs to be justifiable on objective rational public interest grounds.

According to the CDI it was held to be problematic whether an acceptable definition of a charity could be agreed upon by those in the sector or by legislators.<sup>13</sup> The CDI started by looking at the guidelines provided by the Preamble to the *Charitable Uses Act 1601*<sup>14</sup> and it accepted that the definition was not exhaustive even when it was initially drafted.<sup>15</sup>

Case law and interpretation have enhanced the initial legal definition of a charity and a charitable purpose but it remains an area of definitional inexactitude. The community fundamentally understands that a charity is an entity which relieves poverty or distress,<sup>16</sup> rather than an entity which runs banks, advocates for political change or provides insurance. As pointed out by Malleon Stephen Jaques in their submission to the 2001 CDI:

*Another issue relevant to charitable and not-for-profit bodies is their involvement in 'commercial activities'. This is a reality for many organisations, being a product of funding issues and the requirement for them to compete for government tenders on a commercial basis. Legal tests have, to date, focussed on the objects or purpose of an entity, rather than the activities undertaken to achieve those objects.*<sup>17</sup>

In relation to the for-profit sector, the High Court over a number of cases, but consolidated in *State Superannuation Board v Trade Practices Commission* (1982) 150 CLR 182 rejected the 'purpose test' for constitutional corporations. It held that a corporation will be a constitutional corporation under s51(xx) if it engages in substantial trading or financial activities. This interpretation makes sense when

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<sup>13</sup> Inquiry into the Definition of Charities and Related Organisations, 30 June 2001, p29ff

<sup>14</sup> 43 Eliz I c 4

<sup>15</sup> Inquiry into the Definition of Charities and Related Organisations, 30 June 2001, p25

<sup>16</sup> Ibid

<sup>17</sup> Malleon Stephen Jaques submission to the Definitions Inquiry January 2001, p3

looking at the purpose of a corporation. However, a risk exists that the purpose, 'on the paper', is very different from the actual activities of the entity. Accordingly, it could be suggested that a more objective activities-based test should be developed for the NFP sector.

This would have two advantages: it weeds out those NFPs which are facades for trading or financial commercial operations and it would harmonise the legal tests applicable to entities generally.

The NFP sector is able to take advantage of taxation concessions. The definition currently applied as to whether an NFP entity is a charity is set out in Taxation Ruling TR 2005/21.<sup>18</sup> This test is quite involved and requires an officer in the ATO to weigh up a number of considerations when determining whether an entity is a 'charity' for the purposes of the *Taxation Act*.

The NFP sector is dominated by large, multi-faceted organisations some of which have existed for hundreds of years.<sup>19</sup> Over time, the purposes for which many of the institutions were established have changed and the activities of the organisation expanded well beyond their initial primary focus and charitable purpose, yet their ongoing status as a charity for the purpose of various pieces of legislation has not been re-visited.

For example in the 19<sup>th</sup> and 20<sup>th</sup> century many hospitals were run by orders of religious nuns ministering to the sick. Their work was voluntary and seen as part of their vocation and the hospitals relied on donations for survival - not government subsidies.

Today the same hospitals receive funding from governments. There are virtually no members of religious orders running the institution and those that are, often receive a wage. Ministering to the sick and destitute is a substantially different thing from

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<sup>18</sup> Australian Taxation Office Taxation Ruling 2005/21 released 21 December 2005

<sup>19</sup> Charitable Organisations in Australia, Industry Commission Report No. 45, Melbourne, 16 June 1995, xvii

providing high quality private health care for those able to afford it. As pointed out by former Australian Democrats Senator John Cherry, a driving force behind the CDI:

*Look at churches running private hospitals. It is hard to find a charitable component, particularly when you look at the prices they charge,..... it would be a brave government that questions all of this and I'm sure this one won't be the one to do it.*<sup>20</sup>

The NFP sector also includes small voluntary organisations which do not receive government subsidies and which are run exclusively on donations from a small group of people and service the needs of other small groups. These small organisations made many submissions to the 2001 CDI and they are adamantly opposed to increased regulation. Their concerns are understandable but the larger issue cannot go unaddressed simply because it is a complex problem. Again, the Nonprofit Roundtable realises this as an important reform area to be addressed and propose reform to corporate structures that:

*.....will address the suitability of present corporate structures for nonprofit enterprises and propose effective additional structures to cater for emerging innovations and neglected small grassroots groups.*<sup>21</sup>

It is the complex nature of the NFP sector which has given governments pause in dealing with the regulation of the sector. Now is however the time for public policy makers to properly address the question. Taxation is a complex matter, as is the regulation of the corporate and for-profit sector, but successive governments have not shied away from preparing and passing legislation to address the private sector's problems.

The size, nature and growth of the NFP sector requires action. Today the NFP sector contributes massively to the social and economic strength of Australia. According to a recent study, NFPs contribute 4.7% of GDP and account for 6.8% of total

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<sup>20</sup> Ferguson, Adele *Tax Perks Under Pressure*, BRW, 5-11 May 2005, p23

<sup>21</sup> *Nonprofit Regulation Reform Program*, An initial statement by the National Roundtable of Nonprofit Organisations, March 2004, pp7

employment. In comparative terms, the NFP sector adds more to GDP than the mining industry.<sup>22</sup> They provide employment for a large number of people and they provide services to even more. They are major recipients of government grants and of tax concessions.

According to the *Giving Australia Report 2005*, the increasing generosity of Australians means that 87% of Australians donated an average of \$424 as part of a total \$7.7 billion in donations from individuals.<sup>23</sup> In light of the tax concessions and government grants that you can add to this sum, there is no doubt that the sector needs to set in place effective governance structures.

It is essential that there be best practice in the NFP sector. Best practice means transparency, accountability (to donors and to society), and regular rigorous reporting utilising key indicators, so that those giving to or using NFPs can do so in a fully informed way. That includes governments being able to assess whether the charities to which it outsources so many of its social obligations are giving value for taxpayer money.

The NFP sector is currently regulated in an ad hoc manner by a variety of regulators, and some are hardly regulated at all. Some NFPs, because of their corporate structure, come under the purview of ASIC with its stringent reporting and auditing requirements, which are exactly the same as their for-profit counterparts. Others may (or should) be regulated by bodies as diverse as APRA or the various State-based Fair Trading or Consumer Protection Authorities.

Often, an NFP's obligations under a statutory regulatory scheme only become clear to an NFP when they are sailing close to what may be a breach of a statutory obligation that they were not aware applied to the activity they were engaged in.<sup>24</sup>

The current regulatory system is inappropriate for such a large and diverse sector. It is time Australia introduced something similar to the Charities Commission in the UK

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<sup>22</sup> Woodward, S & Marshall, *A Better Framework: Reforming Not For Profit Regulation*, Centre for Corporate Law and Securities Regulation, University of Melbourne, 2004, p1 (quoting ABS statistics)

<sup>23</sup> Senator the Hon Kay Patterson, Media Release, 10 October 2005

<sup>24</sup> Gluyas, R *God's Banks to face crackdown*, *The Australian*, 28 October 2005, p4

or the newly established Charities Commission in New Zealand<sup>25</sup> to properly regulate the sector; or, alternatively, introduced a rationalised national regulatory regime.

Not all commentary on the sector agrees that a free standing entity is required to implement a regulatory regime of the sector. In a recent paper by the Institute of Public Affairs, author Ross Fox says that:

*In order to make the process of assessment of charitable status independent and transparent, it should be undertaken by an independent, a-political body.*<sup>26</sup>

Ross Fox sees the ATO as well placed to administer this function. The merit in this suggestion arises from a cost and continuity perspective and there is no doubting the expertise in the ATO.

It is also noted that in response to the first version of this discussion paper, the Treasurer<sup>27</sup> cited lack of ‘cost-effectiveness’ as one of the reasons the Government did not see a Charities Commission as the most appropriate way to achieve improved accountability and uniformity in the sector.

It is time that the definition of a charity was statutorily updated for the benefit of donors, for the benefit of recipients of services from the NFP, for transparency in political advocacy and for accountability to all the sector’s stakeholders. As pointed out by Professor Mark Lyons, what is needed is:

*one strong new law: a single, national non-profit incorporation and fundraising act having similar scope to the corporations law and administered by an independent commission.*<sup>28</sup>

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<sup>25</sup> Established by *The Charities Act 2005* (New Zealand)

<sup>26</sup> Fox, R *Promoting Freedom and Community Civil Society Organisations in Australia*, IPA Backgrounder, Volume 18/2, May 2006

<sup>27</sup> Letter from the Treasurer to Senator Andrew Murray dated 1 June 2006

<sup>28</sup> Lyons, M, *Charity Law Reform Needed*, BRW, Letters, 1-7 September 2005.

As Sue Woodward also points out in her study:

*the existing myriad of legal structures hampers nationally consistent accountability.*<sup>29</sup>

### **1.3 NOT ACCOUNTABLE ENOUGH**

In the 1990's the Australian Government commissioned a report on charitable organisations by the Industry Commission. It reported in June 1995. One of its key recommendations was:

*Accountability is an important operational issue for all Community Social Welfare Organisations (CSWOs). Their supporters and the general public expect, and are entitled to, information about the finances and operations of CSWOs in return for their donations, voluntary activities and taxation exemptions and concessions. Improved confidence that funds are being used appropriately by CSWOs can potentially increase the overall fundraising resources available to the sector.*<sup>30</sup>

The Report went on to state that:

*Accountability relies upon the provision of up to date accurate and relevant information relating to the operations and finances of organisations. Even when potential donors do not themselves seek information on individual organisations, the media may well do so. Better informed media coverage of the sector has the potential to improve community awareness and decisions.*<sup>31</sup>

This view was supported by the submission made by law firm Mallesons to the 2001 CDI:

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<sup>29</sup> Woodward, S p53

<sup>30</sup> Charitable Organisations in Australia, Industry Commission, Report No. 45, Melbourne, 16 June 1995, p201

<sup>31</sup> *ibid*

*Accountability is the key. The public needs to know there is accountability and it needs to be maintained.*<sup>32</sup>

The preliminary findings in February 2005 of *Giving Australia* also found that:

*businesses wanted non-profits to be more accountable and transparent for funds received: there had been an erosion of trust... that money given would be used for its stated purpose.*<sup>33</sup>

It is recognised that reform discussions relating to governance in the NFP sector are complicated by the fact that the legal organisational structures adopted by NFPs vary considerably.

In the sector there is everything from defined corporate structures to small incorporated associations, trusts and loose alliances of persons pursuing a particular cause. There are organisations whose work impacts on hundreds of thousands of people and there are those whose work impacts on less than 50 people.

There is also the complex and often vexed question of sporting clubs and whether they should be exempt from the payment of income tax.<sup>34</sup>

It is also noted that in 2005 the Government announced<sup>35</sup> that five new general deductible gift recipients (DGR) categories would come into effect from 1 July 2006. These new categories were contained in *Taxation Legislation Amendment Bill (No.3) 2006* passed on 22 June 2006. These new categories have merit; however this would appear to be an example of what Professor Lyons identifies as one of the problems for the sector, that is where:

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<sup>32</sup> Malleon Stephen Jaques submission to the Definitions Inquiry, January 2001, p19

<sup>33</sup> *Giving Australia: Research on Philanthropy in Australia*, Summary of Preliminary Qualitative Findings, February 2005, p7

<sup>34</sup> Ferguson, A, *Clubs under the gun*, BRW, 6-12 April 2006, p12 and *Sport v Profit*, BRW, 29 June-5 July 2006, p11, See also Senator Murray Ajourment Speech, Taxation: Clubs, Senate Hansard 10 December 2002, p7635

<sup>35</sup> Treasurer of the Commonwealth of Australia, Press Release No. 049, *Five New General Deductible Gift Recipient Categories*, 10 May 2005

*Laws are allowed to grow in a piecemeal fashion, inevitably leading to anachronisms and contradictions*<sup>36</sup>

However before discussing the issue of legal structure and its impact on accountability and transparency in the NFP sector, the identification of to whom NFPs should be accountable and transparent must be addressed.

#### **1.4 CHARITIES AND ADVOCACY – OR IS IT JUST POLITICS BY ANOTHER NAME?**

Political parties are NFPs. Self-evidently they are not charities, but they may at times engage in charitable works as genuine ancillary activities, relevant to their political objectives. Political parties are advocacy organisations dedicated to political outcomes, influence or power.

Charities are not political parties, but they may at times engage in political advocacy as genuine ancillary activities, relevant to their charitable objectives. So in principle, any NFP that has political advocacy or public policy advocacy as part of its motive – from churches to political groups – should not be subject to censure.

It is heartening to see that commentator Ross Fox agrees with this approach:

*The effect of restricting the participation of charities in political campaigning should not prevent charities from expressing views and continuing to contribute to the normal mechanisms and channels for public debate.*<sup>37</sup>

Nevertheless, the issue is rightly sensitive where advocacy within so-called non-political NFPs constitutes misleading and deceptive conduct because it is surrogate activity for a political party.

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<sup>36</sup> Lyons, M p7

<sup>37</sup> Fox, R *Promoting Freedom and Community, Civil Society Organisations in Australia*, Institute of Public Affairs, Volume 18/2, May 2006, p14.

*The concerns of the NGO sector were heightened by the proposal by Treasurer Peter Costello to disqualify a charity that engages in advocacy that is other than ancillary or incidental.*<sup>38</sup>

These concerns were reinforced when Government Senator Eric Abetz said in an address to the Sydney Institute<sup>39</sup> that the Federal Government would:

*strip charities of their tax deductible status if they run anti-government campaigns during elections.*

From a public interest perspective, it is important to distinguish between advocacy by an NFP that is simply a front for a political party, and advocacy by an NFP because it opposes or supports those policies of a political party that affect their legitimate interest.

In seeking regulation of the NFP sector it is not the intention of this discussion paper, to silence advocacy about public policy from the sector. Views expressed in some quarters that regulation of the sector will inevitably have this effect are indeed concerning.<sup>40</sup>

During the Estimates Committee hearings of the Senate Economics Legislation Committee in June 2005, Senator Mason asked Mr Konza from the ATO whether any charitable organisations had been investigated on the grounds that their activities were political.

Mr Konza confirmed that the ATO had initiated 43 investigations in the period since 2000 and that no organisation had lost its endorsement as a charity due to its political activities. However he did go on to point out:

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<sup>38</sup> Maddison, S; Dennis R; & Hamilton, C, 2004 *Silencing Dissent: Non-government Organisations and Australian Democracy; The Australia Institute Discussion Paper No. 65*,p7

<sup>39</sup> *Northern Territory News*, 5 October 2005,p14

<sup>40</sup> Staples, J *NGOs out in the cold: The Howard Government policy towards NGOs*, Democratic Audit of Australia, Discussion Paper 19/06 (June 2006) p19

*In the experience of the tax office most organisations, when confronted with a review and the prospect of losing their charitable status, will seek to change their activities and objects with a view to complying with the law.*<sup>41</sup>

The important question that this particular answer, and other answers to the Committee raise, is what exactly is meant by ‘ancillary to’ or ‘incidental to’ the primary purpose of the charity.

From the ATO’s perspective it applies Taxation Ruling TR 2005/21 which involves an objective weighing of all (the charity’s) features. How adequate or competent such a determination can be is unclear since it is unlikely that the ATO goes through a charity’s premises, papers and staff in any detail, or as a properly constituted regulator might do.<sup>42</sup>

NFPs cannot be certain of falling within the definition of a charity. There is no legislation which categorically defines a charity or a legislative definition of the actual percentage which would constitute an ‘ancillary’ or incidental purpose.<sup>43</sup> This leads to lack of certainty in the sector and creates extra work for the ATO in ‘investigations’ of NFPs which appear to be involving themselves in more lobbying or political activism than one might expect in their dominant charitable purpose. And of course ‘political’ advocacy is not constant – it will wax and wane in intensity according to the issue and the political cycle.

According to answers to questions on notice at the Senate Economics Legislation Committee on 17 February 2005 Mr Konza from the ATO advised that:

*.... The tax office does not seek to apply prescriptive rules for deciding whether particular purposes are incidental or ancillary to a main or dominant charitable purpose(s). It is a matter of weighing up all relevant features to assess whether certain purposes are ancillary or incidental.*

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<sup>41</sup> *Budget Estimates* 2 June 2005

<sup>42</sup> See Answers to Senate Economics Legislation Committee Estimates 17 February 2005

<sup>43</sup> The role of the ATO determinations and aspects of common law in determining definitions of ‘ancillary’ are acknowledged.

*While an organisation might engage in advocacy, that activity may be the means by which the main or fundamental charitable purposes of the organisation is or are achieved. For example an overseas aid organisation may seek to conduct a fundraising drive for starving children overseas and as part of that activity, raise public awareness by distributing leaflets or writing letters to the newspaper.*

***An institution or fund is not charitable if its purpose or one of its purposes is advocating for a political party or cause, attempting to change the law or government policy, or propagating or promoting a particular point of view. However if the purpose of an institution or fund is charitable the presence of political or lobbying programs and activities will not detract from this status, provided that they are incidental to the charitable purpose.***<sup>44</sup> [Bolding added]

There is, however, evidence that there are church organisations which directly contradict the bolded section of the above statement, and retain their charitable status, which is quite proper on a sensible reading of reality.

Environmental groups have come in for criticism from some sectors because of their political lobbying on issues such as forestry. For instance the National Association of Forest Industries (NAFI) criticised registered charities such as Greenpeace and the Wilderness Society as being political lobby groups rather than charities. NAFI said that the advocacy these entities undertook was not incidental to their purpose. The executive director of NAFI, Mrs Carnell asserted that their behaviour endangered the tax deductible status of genuine charities.<sup>45</sup>

Similar allegations were recently made about the group Australians for Constitutional Monarchy, with the Labor Party arguing that it was a lobby group which should not have been able to claim tax deductible gift recipient status.<sup>46</sup>

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<sup>44</sup> Answers to Questions on Notice, Senate Economics Legislation Committee, Australian Taxation Office, Additional Estimates 17 February 2005, Topic: Meaning of 'primary purpose' for DGR, p 4

<sup>45</sup> Media Release from National Association of Forest Industries, *Green Group Fundraising flouts the aims of charity tax laws*, 5 June 2004.

<sup>46</sup> *Monarchists in tax scam: Labor*, 14 February 2006, *Australian Financial Review*, p9

The views expressed by NAFI are similar to the discussion surrounding provisions of the *Charities Bill 2003* which aimed at curtailing the amount of lobbying a charity could undertake without losing its charitable status. The Bill did not proceed because according to the Board of Taxation:

*the draft legislation did not achieve the level of clarity and certainty that was intended to be brought to the charitable sector.*<sup>47</sup>

Whether the arguments put forward above have merit is open to discussion. Nevertheless, they do highlight the problem which still remains, NFPs themselves have to assess what level of political lobbying will be considered ancillary or incidental. This makes them vulnerable to inconsistency and to complaint or challenge, whether justified or partisan and vexatious. The ‘dominant purpose’ is determined by the entity itself and is confirmed by the ATO.

It is also unclear whether, upon complaint, a charity could lose its status and all that entails if it is found that its dominant purpose has changed from its original intention.

*Charity work is no longer unambiguously good, or for the public benefit. It may be altruistic, but increasingly it is embedded in a political framework that seeks to use public power for system change. These methods are unambiguously political in nature. Arguably it is at odds with the donating public’s expectations of the charities. These debates would not matter so much if charity status did not carry tax-assisted privileges and if donors were well aware of the work of charities.*<sup>48</sup>

It is therefore imperative that the recommendations of the CDI be revisited. These are issues that need to be resolved.

NFPs and charities should not be able to be held to ransom by partisan governments who can threaten selected targets with stripping them of their DGR status. The

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<sup>47</sup> Treasurer of Australia, *Final Response to the Charities Definition Inquiry*, Press Release No. 031, 11 May 2004,

<sup>48</sup> Johns, G p2

organisations should be able to plan ahead and they should know for sure whether they can advocate on behalf of the recipients of their goods or services, on behalf of their donors, and contribute to the policy debate on issues which impact on them and their constituency.

Clarity before the law is as important to the NFP sector as it is to the for-profit sector.

## 2 ISSUES OF ACCOUNTABILITY

### 2.1 NFP STAKEHOLDERS

#### 2.1.1 DONORS

Stakeholders in the NFP sector are many and varied and their interests do not always coincide. Stakeholders include donors, recipients of services, the taxpayer and the government which outsources services to the NFP sector.

When people make donations to an organisation, they assume the money given will be used for the purpose it is donated. If it is donated to build wells in Africa, then most people would prefer to know that it is actually used for that purpose, rather than to rent offices in the CBD of a large city.

*Giving Australia's* research supports the contention that most people like to know where their money is going and preferably how it is going to be used.<sup>49</sup> Some people take it as a matter of faith that the money will be used to support a specific cause. They do not assume it will go to ancillary services provided by the NFP such as office space and furniture or expensive advertising. As Johns points out:

*The donor's trust in the charity is assumed.*<sup>50</sup>

Donors, especially in areas where there are a variety of organisations which provide the same or similar services such as emergency relief, would, one assumes, like to be able to compare the organisations and determine the best use of their dollars. Most people do this in other areas of their life from purchasing groceries to buying insurance, so there is little reason to assume that they would not be interested in how their donations are used.

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<sup>49</sup> *Giving Australia, Research on Philanthropy in Australia*, the Prime Minister's Community business Partnership Secretariat, Dept of Family and Community Services, 10 October 2005

<sup>50</sup> Johns, G *Informed Giving Ensuring Charities Inform Donors*, IPA Backgrounder, Vol. 16/3 October 2004, p3

For example, it could be argued that CARE Australia, Oxfam and World Vision provide similar emergency relief overseas (and this would appear to be borne out by the fact that after the devastating 2004 Asian tsunami these organisations issued a joint press release). However, how can a donor determine which is best value for money (leaving aside the mission statements and core values of these organisations)? How can a donor determine which is the most effective provider of emergency assistance, or which targets the specific causes that their money is donated for? These organisations, it must be noted, do provide condensed financial information in their Annual Reports which is audited, so donors can make a limited assessment of how their donations are used.

However NFPs in general are not legally required to provide such financial information. Therefore, for every organisation that provides it, there are many that do not, so Australia has a non-regulated system where some organisations take their financial responsibilities and reporting to donors and grantors seriously, and others who take for granted their donors' faith that their money is being used appropriately.

There are times when donors' faith has been shaken and where, because of the outcry in the media, it has become obvious that donors feel their trust has been betrayed. In the USA, scandals involving excessive compensation, corruption and ethical lapses in the NFP sector have concerned donors and the public.<sup>51</sup> As yet this has not happened in Australia where the only major concern has been whether money donated for a specific cause was then used for general or ancillary purposes not related to the specific appeal.

This happened to the Red Cross in relation to the Bali Bombing in 2002. The Red Cross received overwhelming financial support from Australians donating to support the victims of the Bali bombing. However, when it was revealed that some of the money was not being used for the relief of Bali bombing victims there was a public outcry and a backlash against the Red Cross.

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<sup>51</sup> Eisenberg, P *Looking Ahead: What is the Future for the Nonprofit World*, International Journal of Not-for-Profit Law, Vol 8 No: 1, November 2005, p81

*When the story broke in the media, some \$6.6 million or 46% of the funds raised were either being spent on projects not related to the victims or held back with the potential to be spent on other projects. At that time only 54% or \$7.7 million had gone directly to the victims of the Bali bombing.*<sup>52</sup>

The American Red Cross was also reported to have diverted money raised for the families of victims of the September 11 terrorist attacks to other purposes.<sup>53</sup> There was a loss of confidence in the charity, and it had to work hard to regain donor trust. The flow-on effect from this was that other charitable organisations in the aftermath of the Boxing Day tsunami 2004 had to work to reassure donors that the money would go to provide relief to tsunami victims. Several NFPs (including the Red Cross) put out a press release promising to be *'open, transparent and accountable to our stakeholders in all aspects of our work'*.<sup>54</sup> The same is true in America where President Bush and former President Clinton had *'to reassure the public that they would monitor how the money was used'* after Hurricane Katrina and the Asian tsunami.<sup>55</sup>

Australians donated so extensively to the Asian tsunami that many NFPs decided it was prudent to advise donors that the money might be used for ancillary purposes or that it might go to other projects conducted by them. Some organisations asked donors if they wanted their donations returned if it was not necessary for tsunami relief, and hundreds of donors took them up on the offer.<sup>56</sup> This created an administrative burden for many NFPs, but it was seen as essential. In the words of the President of *Medicins san Frontieres*, Rowan Gillies felt that:

*.....it was ethically compelled to contact every donor (..) and offer to redirect their money or return it.*<sup>57</sup>

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<sup>52</sup> D'Cruz, D, *Who are Charity Donations Really Helping?* Adelaide Advertiser, 18 July 2003

<sup>53</sup> *The Business of Giving, The Economist*, 25 February 2006, p4

<sup>54</sup> Media Release, *Our Thanks and Promise to Australian Donors from Four Leading Agencies*, CARE Australia, World Vision Australia, Oxfam Community Aid Abroad, Australian Red Cross, 17 January 2005

<sup>55</sup> *The Business of Giving, The Economist*, 25 February 2006, p4

<sup>56</sup> Williams, L, *Too much tsunami cash – return to sender*, Sydney Morning Herald, 11 May 2005, p1

<sup>57</sup> *ibid*

Donating is not like the lottery – it should not be a gamble. The NFP donor should know where their money is going. Whether it is going to produce CDs or build a church, provide water to the Sudanese or to lobby for change to free trade agreements to protect a section of rainforest or to elect a member of Parliament.

Currently there are few ways for a donor to find out how their money is used and no way to assess whether the organisation to which they donate uses it more or less effectively than another organisation doing the same type of work. This needs to change. As Johns points out:

*The donor has the power to withdraw support if dissatisfied with the charity's performance..... Such a power is best used when based on good information – for example evidence of the fulfilment of the charity's mission.*<sup>58</sup>

Donors may also be interested in whether or not their donation is used to help the poor or whether it is used to advocate politically for change to help the poor. As Johns also points out:

*... the community sector can compete with private-sector providers to deliver services and at the same time have a considerable influence over the nature of the services. The 'compact' allows the community sector to act as both advocate and provider, using public funds in both roles.*<sup>59</sup>

NFPs such as the Salvation Army and Catholic Welfare Australia act as both providers which deliver employment placement services and as advocates on workplace and employment matters.

A donor to such an organisation may be willing to donate towards what it perceives as the 'charitable' work of the organisation but not towards its advocacy on behalf of the

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<sup>58</sup>Johns, G p3

<sup>59</sup>Johns, G p8

disadvantaged. When the Salvation Army spoke out against the Government's changes to the *Workplace Relations Act* (WorkChoices),<sup>60</sup> its stand was supported by several other employment placement services which:

*attacked the proposed welfare changes, saying they are based on a system of fear and will result in people having to rely on charity.*<sup>61</sup>

Currently, the donor has no way of ensuring that their donation is used for the purpose for which it is donated and not for other purposes or for political advocacy, with which they may not agree.

*...the roles of advocate and provider are best separated to the benefit of the government, the sector and the recipients of the programmes.*<sup>62</sup>

Naturally, many of those concerned with public policy want special interest, community, and political advocacy to remain alive and well-funded. The value of civil society and its contribution to our society in this respect should never be understated. Yet private donors or taxpayers-at-large who 'donate' through direct government funding or tax concessions are entitled to know what is being done in their name (so there is a need for comprehensive and relevant public reporting). Donors are also entitled to be able to determine to what purpose their money is put, (so there is a need for regulation and accountability).

The regime in place in Canada (which has had a registration process for charities for 35 years and is administered by a body attached to the Canadian equivalent of the ATO), investigates applications for registration as a charity. The criteria for registration has changed over time, to reflect societal changes. This body sets an upper limit on the expenditure that designated charities may spend on advocacy.<sup>63</sup>

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<sup>60</sup> Media Release, *Government's Industrial relations proposals not the best of reaching full employment say Salvos*, 17 October 2005

<sup>61</sup> Peatling, S, *No Hope, No dignity: welfare overhaul slammed*, *Sydney Morning Herald*, 21 November 2005, p1

<sup>62</sup> Johns, G, p8

<sup>63</sup> *Ibid*, p6

This is a system which works, is accepted by the public in Canada, and could be adopted in Australia.

Another example where donors may be unaware of the uses to which their donations may be put is in regard to environmental causes. Many people donate significant amounts to support environmental purposes such as to stop old growth forest logging, to clean up the Murray River, or to save a species.

The same people, however, may not be happy for their funds to be used to support a political candidate who is lobbying on these particular issues. Such donors might assume that if they wanted their money to go to supporting a political party, then they would give it directly to that political party.

It may be that people who are supporters of rainforests would and do willingly donate money to a political party which supports environmental issues. However, without a requirement of transparency, donors cannot readily make the assessment about whether they want their money to be used for rainforests at a practical level or for environmental advocacy at a political level.

As pointed out by Fox,<sup>64</sup> in the UK, pursuant to the UK Charities Commission guidelines, charities are prohibited from directly assisting political parties or candidates. They are, however, entitled to advocate and evaluate policy initiatives based on their purposes, but they must not seek to compare their own views with those of candidates or parties.

The basic principle is this - there should be transparency on this issue so that donors can make informed giving-decisions. This issue was canvassed on a number of occasions in 2005.

The then Special Minister of State Senator Eric Abetz referred to the Australian Conservation Foundation and the Wilderness Society who campaigned against the

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<sup>64</sup> Fox, R p15

Coalition's forests policy during the 2004 federal election. AAP<sup>65</sup> reported that Senator Abetz put forward for discussion the proposal for a new regime of accountability for charities including forcing them to disclose how much they spend on political campaigns each year.

Most Australians are fully aware of the nexus between the unions and the Labor Party. However, with other political parties, any nexus between them and various organisations may not be so transparent, and it should be. Although Senator Abetz was proposing that NFPs may lose their tax deductibility status because of political advocacy, which depending on the process might be seen as an inappropriate use of political power, there is merit to the argument that information about the advocacy work of NFPs should be disclosed to donors:

*... a better informed market will provide a powerful tool for scrutiny, as well as a guide to acceptable purposes and acceptable activities.*<sup>66</sup>

And as pointed out by Don D'Cruz in *BRW*:

*A sector which leverages off the best instincts in people has a moral obligation to adhere to the highest moral and ethical standards.*<sup>67</sup>

## **2.1.2 VOLUNTEERS**

The question is what volunteers expect to know, and are entitled to know, about NFPs. Other stakeholders in an NFP are those who provide voluntary services. According to a recent Government report *41 percent of Australian adults provid[e] 863 million hours of help.*<sup>68</sup>

That means that volunteers are significant stakeholders in the NFP sector. What may be of interest to people who are volunteering their time to an organisation would be

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<sup>65</sup> Hawthorne, M, AAP, 4 October, 2005

<sup>66</sup> Johns, G *Informed Giving Ensuring Charities Inform Donors*, IPA Backgrounder, Vol. 16/3 October 2004, p1

<sup>67</sup> Ferguson, A, *costly compassion*, *BRW*, 29 June – 5 July 2006, p52

<sup>68</sup> *Giving Australia: Research on Philanthropy in Australia*, The Prime Minister's Community Business Partnership Secretariat Department of Family & Community Services, 10 October 2005

the salaries paid to the staff at NFP organisations or the various benefits that the managers and staff enjoy.

There is little hard data available, but it seems likely that most NFPs do not pay their staff or executives high salaries. However because of the charitable status and the tax benefits that flow to the staff of those entities, salary packaging and fringe benefits are available so that net income is enhanced. A salary of \$50,000 can be packaged in such a way as to substantially increase its value.

Many NFP executives are supplied with mobile telephones and their telephone accounts are paid for. As with for-profit and public sector organisations they are often provided with a car and a car-parking space, which in the CBD of large capital cities can be worth a substantial amount per year. All of these benefits increase their real take home pay.

There may be good and justified public policy reasons for staff and executives in some NFPs to enjoy benefits not available to those in the for-profit sector, but accountability and transparency should require proper disclosure and reporting of such benefits. Although there may be managers and staff in many NFPs who take home substantially less than their for-profit counterparts, accountability principles must still apply.

However, some NFPs pay some executives handsomely, in cash and in kind. In the USA, excessive compensation to the executive officers of non-profit entities and sweetheart deals providing financial benefits to them has created conflict of interest problems.<sup>69</sup>

In the for-profit sector, section 250R of the *Corporations Law 2001* requires a non-binding resolution on board remuneration be presented at the company AGM. Remuneration information to shareholders is seen by regulators and the parliament as important, to assist shareholders to determine if they are getting value for money, and whether they want to continue to invest their money with the company. Shareholders

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<sup>69</sup> Eisenberg, P *Looking Ahead: What is the Future for the Nonprofit World?* International Journal of Not for Profit Law, volume 8, no. 1, November 2005, p81

may consider that in light of the remuneration level to directors, that the returns are insufficient and withdraw their money from the company. Or find other ways to show their lack of confidence in the decisions of the board.

Another issue of interest in the for-profit and public sector is the appointment process. Donors and volunteers to NFPs may be interested in how NFP executives and directors are appointed – whether through formal or democratic processes, such as apply in public corporations, or through patronage, or by some controlling entity or persons.

In the NFP sector volunteers may or may not necessarily invest (donate) money to the organisation, but they do invest time. They volunteer their services to the organisation. They are as entitled to be advised of the nature of the NFP's administrations costs, or the remuneration of the staff of the NFP, as are for-profit investors.

As pointed out by Duncan Power, the chief executive of Charities Aid Foundation:

*Lack of transparency and shoddy administration practice is holding back the community sector from being the groundbreaking force it needs to be.<sup>70</sup>*

It follows, therefore, that if the CLERP 9 Corporations Law disclosure scheme is in place in the for-profit sector, it is just as appropriate that such a disclosure scheme should be in place for the NFP sector.

A recent study by accounting firm BDO found that about 19% of NFP organisations experienced fraud over the past two years. It was pointed out by Lisa Bundesen, a partner in BDO's forensic services division, that:

*Effective internal controls are the most successful method of discovering fraud; 34% of fraud is discovered this way...*

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<sup>70</sup> As quoted in Ferguson, A, *Costly Compassion*, BRW, 29 June – 5 July 2006, p52

It was also pointed out that the cost of fraud in the NFP sector is more severe, because they rely heavily on the good will of donors.<sup>71</sup>

### 2.1.3 CLIENTS

Donors and volunteers are not the only stakeholders in the NFP sector. There are a great number of client stakeholders with a relevant interest in the work of NFP organisations. They may have different objectives from those in the for-profit sector, but their governance expectations are no different.<sup>72</sup>

Just as customers of for-profits do, users of NFP services have a legitimate interest in the way in which NFPs work, especially because of the large numbers involved. For example, church-based members of the Job Network which includes Catholic Welfare Australia, UnitingCare and Anglicare Australia account for 20 percent of the employment agencies used by the Federal government.<sup>73</sup>

These agencies work in competition with private sector providers to place the unemployed people in work. Not only should they provide the same level of reporting and accountability for-profit competitors do but, it could be argued, they should do more. They should disclose the competitive advantage they get from special treatment in the tax system, compared with the for-profits.

An unemployed person might want to know what level of success the different organisations have, or the job satisfaction of the people that it places in jobs. These are important factors for these prospective employees, given that their benefits can be cut off if they refuse a job or if they leave a job for a reason Centrelink deems unsatisfactory. If the person looking for a job is able to examine the track record of these different organisations in relation to placing jobseekers in satisfactory long-term employment, that may have an impact on the agency the job seeker approaches.

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<sup>71</sup> Heathcote, A, *A gender thing*, BRW, 6-12 April 2006

<sup>72</sup> Woodward, S & Marshall, S, *A Better Framework: Reforming Not-for-Profit regulation*, Centre for Corporate Law & Securities Regulation, The University of Melbourne 2004, p8

<sup>73</sup> Peatling, S, *No hope, no dignity on welfare overhaul*, *Sydney Morning Herald*, 21 November 2005 ([www.smh.com.au/news](http://www.smh.com.au/news) accessed 21/11/05)

Because of the increasing involvement of business with the NFP sector, as well as the ties between government and NFPs, there needs to be disclosure to all stakeholders of the way in which money or tax breaks are being used by NFP entities in a way similar to that required in the for-profit sector.

## 2.2 POOR REPORTING

The current reporting requirements of the NFP sector are best described as haphazard. Enmeshed with the question of their reporting requirements is the chosen legal structure.<sup>74</sup>

The legal structures used by NFP entities are many and varied. Entities can be trusts, incorporated associations or companies limited by guarantee. Some NFPs like The Brotherhood of St Laurence, the Royal Blind Society of NSW and the Anti-Cancer Council of Victoria were established by statute (and there are, of course, many others). As pointed out by the Industry Commission report:

*some CSWOs [NFPs] that are incorporated under their own Act of Parliament may not be subject to information reporting requirements notwithstanding their size and importance.*<sup>75</sup>

Some NFPs are regulated by State legislation (incorporated associations) with few or no reporting obligations. Others are regulated by the federal regulator ASIC with extensive reporting obligations which are the same as the for-profit sector. Those NFPs created by statute have reporting requirements that range from absolutely none, to provisions similar to those of for-profit entities.

Currently many NFPs are not legally obliged to report to donors, service recipients or to an independent auditing body. There is no prospectus-type or financial report obligation to give a detailed breakdown to donors of how their money is or was going to be used – how much will be used for administration or marketing and how much will be given directly to the cause that the donor wants to be supported. Some NFPs

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<sup>74</sup> Woodward, S p5

<sup>75</sup> Charitable Organisations in Australia, Industry Commission, Report No. 45, Melbourne, 16 June 1995, p205

do provide this information to maintain good relations with donors. However there is no legal obligation to do so.<sup>76</sup>

It is essential that people donating money are aware where the money is going. This issue is a recurring theme with a number of commentators on the sector.<sup>77</sup> If donors are giving money to a church they may want to know whether the money is going to build a new church, to proselytise, to produce CDs or to support a political candidate. Some organisations give the donor the option of where their funds will go. Some churches identify 'a building fund' for some donations. Oxfam gives donors options so their donations can be allocated to go to Africa or to India for a specific project. As pointed out by Barbara Stocking, the head of Oxfam in Britain:

*The public want to be transactional, to have a more direct relationship with where their money is going.*<sup>78</sup>

It is recognised, and has been stated previously in this paper, that churches have as much right to be mixed up in politics as business does.<sup>79</sup> In fact, in Australia there is a tradition of churches having a role in politics, whether it was Archbishop Daniel Mannix campaigning against conscription in the early part of the 20<sup>th</sup> century or calls from churches regarding social justice on the part of the working poor or the rights of refugees. However, as journalist David Marr observed in a presentation to the Fabian Society in June 2005:

*The greatest privilege Australia extends to its churches is the right to keep all their money to themselves and to keep it hidden.*<sup>80</sup>

This remark was made about the Hillsong church, in the presence of leading Hillsong pastor Brian Houston, but as Hillsong has pointed out:

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<sup>76</sup> Media Release, *Our thanks and promise to Australian Donors from four leading agencies, CARE Australia, World Vision Australia, Oxfam Community Aid Abroad, Australian Red Cross*, 17 January 2005

<sup>77</sup> Such as Woodward, Johns, Lyons, Marr

<sup>78</sup> *A survey of wealth and philanthropy, The rise of the social entrepreneur, The Economist*, 25 February 2006, p19

<sup>79</sup> Marr, D, *Are Moral Values the New Politics?*, presented at NSW Fabian Society, 22 June 2005, p1

<sup>80</sup> *ibid* p2

*Hillsong and its related entities are audited annually by KPMG and our audited reports are publicly listed with ASIC. We also release an annual report which outlines the breadth of Hillsong's initiatives and our aggregated financial statements.*

.....

*We also have comprehensive governance and reporting structures in place to ensure the highest level of accountability are met.<sup>81</sup>*

Poor reporting requirements and practices for NFPs affect not just what NFPs themselves report, but what is reported about them. One key concern is what NFPs actually cost taxpayers.

For example a recent decision by the State Administrative Tribunal in Western Australia found that retirement villages are used exclusively for the charitable purpose of 'relief of the aged' even though many of those living in these complexes are in good health over 55 years of age. This decision has the effect that these institutions are now exempt from the payment of land tax which has raised concerns for the Local Government Association in Western Australia. It has been pointed out:

*The consequences of this decision on retirement village developments can be clearly seen – one metropolitan Council has lost nearly \$300,000 of income per year..... any loss of income will result in remaining ratepayers having to make up the shortfall or suffer a reduction in services.<sup>82</sup>*

Although in this example, the LGA of WA has been able to identify the direct financial impact that charitable status has on their budget, it is not always easy to do, especially at higher levels of government.

Federal, state and territory governments do report direct government budgetary expenditures on NFPs as they occur, but NFP categorisation and identification in these reports is often not easy to make and governments seldom, if ever, report direct

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<sup>81</sup> Correspondence to Senator Murray dated 15 May 2006 from George Aghajanian General Manager of Hillsong Church

<sup>82</sup> Mitchell, B, *Rate Equity in Danger*, *The West Australian*, 25 April, 2006, p10

government budgetary expenditures for NFPs as an aggregated whole. Nevertheless, it is possible to find out, through careful questioning, what money out of the global government budget is paid to specific NFPs such as schools, hospitals or employment centres.

It is hard to analyse NFP benefits in Tax Expenditure reports. The Commonwealth produces an annual Tax Expenditures Statement that provides details of concessions, benefits and incentives delivered to taxpayers and beneficiaries through the tax system. The estimate for Commonwealth tax expenditures was around \$37 billion in 2004-05.<sup>83</sup>

The Statement reports around 270 tax expenditures across nine broad fields, but NFPs are not identified as a category (individuals and business are) and it is not certain which (if any) tax expenditures for NFPs may not be reported at all.

Importantly, even if NFP tax expenditure reporting was improved federally we would still be in the dark for the states, territories and local government. Land grants, exemption from duties, rates or taxes may, and do, give NFPs considerable benefits at public cost.

The rationale for the full reporting of NFP tax expenditures could not be better put than this:

*Provision of detailed information on tax expenditures allows for a more thorough assessment of the tax system in respect to:*

- *Its effect on resource allocation, incentives for taxpayer behaviour and distortions created by tax expenditures;*
- *The most appropriate way to administer concessions, particularly as most tax expenditures could be delivered as direct expenditures;*
- *Whether the policy intent to provide concessions through the tax system is achieved; and*

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<sup>83</sup> Australian Government: The Treasury: 2005 Tax Expenditures Statement: December 2005

- *The impact on different entities within the economy, particularly as tax expenditures shift the tax burden to entities that are not treated concessionally.*<sup>84</sup>

## **2.3 ROLE OF THE AUSTRALIAN TAX OFFICE IN REGULATING THE NFP SECTOR**

One of the few ways that (some) information about the NFP sector has been collated in the past is from the ATO. However even the ATO concedes it does not have a good idea of what the sector is worth, how the NFPs spend their money, or how much money is **not** collected by the ATO because of their tax exempt status.<sup>85</sup>

The ATO already has a role in regulating certain aspects of NFPs and it has a role in determining whether an entity is a charity for the purposes of taxation concessions. However the ATO has shown a reluctance to be the body in charge of defining and regulating the NFP sector:

*It is our view that the current system of tax concessions provides an unnecessary layer of administrative cost and complexity and lacks transparency. We would, accordingly, favour a single, targeted, transparent and accountable programme of direct outlays. It is also our view that administration would be better served by a single independent common point of decision-making on definitions leading to conclusions about whether organisations are charitable or non-profit, such as occurs with the Charity Commission in Britain for example.*<sup>86</sup>

It is a good administrative principle that the tax collector should not be burdened with non-tax regulation. The ATO enforces the tax system with respect to for-profits, but the dominant regulator of the corporate for-profit sector is ASIC. Similarly, there is a great deal of merit in having a separate independent entity which regulates the NFP sector which is unrelated to the ATO or the sector itself.

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<sup>84</sup> Australian Government: The Treasury: 2005 Tax Expenditures Statement: December 2005 pp 4-5

<sup>85</sup> Ferguson, A, *Much Ado About Giving*, BRW, 27 Oct – 2 Nov 2005, p12

<sup>86</sup> Ibid, p12 quoting Michael D'Ascenzo (now the ATO Commissioner)

Given the number of inquiries in recent years into the NFP sector it is unclear why the government continues to shy away from necessary reform, and given the comprehensive recommendations of the two recent inquiries and the several policy papers which have been written on the subject, reform is a must.

## **2.4 ACCOUNTING STANDARDS FOR NFPs**

NFPs have some requirements to report to the ATO and ASIC, but these are not nearly as extensive as for their private sector for-profit counterparts. For-profit companies are required to apply accounting standards issued by the Australian Accounting Standards Board (AASB) and these same accounting standards apply to those NFPs which are companies incorporated under the Corporations Act and include companies limited by guarantee. The ATO and particularly ASIC rely on accounting standards, directors and auditors to ensure uniform, consistent and truthful financial reporting.

The amendments to the Australian Accounting Standards to incorporate the International Accounting Standards have affected both incorporated for-profit entities and NFP incorporated entities.

*The Australian Accounting Standards Board (AASB) is implementing the Financial Reporting Council's policy of adopting the Standards of the International Accounting Standards Board (IASB) for application to reporting periods beginning on or after 1 January 2005. The AASB has decided it will continue to issue sector-neutral Standards, that is, Standards applicable to both for-profit and not-for-profit entities, including public sector entities. Except for Standards that are specific to the not-for-profit or public sectors or that are of a purely domestic nature, the AASB is using the IASB Standards as the 'foundation' Standards to which it adds material detailing the scope and applicability of a Standard in the Australian environment. Additions are*

*made, where necessary, to broaden the content to cover sectors not addressed by an IASB Standard and domestic, regulatory or other issues.*<sup>87</sup>

This standard requires entities to create and issue financial reports that contain high quality information which is transparent for users as set out by the AASB which can be generated at a cost that does not exceed the benefits to users (Article 1 of Standard AASB 1 Objective).<sup>88</sup>

Many people would argue, (especially small organisations in the NFP sector), that because of their size and limited resources, this standard of accounting is inappropriate for them, and should not be applied to them. However, the standard requires that the '*cost does not exceed the benefits to the user*' and that is the aspect which should be focussed upon.

Since the first version of this paper was issued (March 2006) it is noted that further discussion of accounting standards has occurred, particularly in relation to the NFP sector. Kimberly Smith, a chartered accountant and member of the AASB's consultative committee is reported as saying that:

*Existing standards ha(ve) long made charities' financial reports misleading to donors.*

She also points out that

*If you are a non-profit and you're showing \$2 million in the bank, how do you tell your donors that's all committed for the next year? That's why people want to show it as a liability.*<sup>89</sup>

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<sup>87</sup> Accounting Standard, AASB 1, July 2004, First-time Adoption of Australian Equivalents to International Financial Reporting Standards, Australian Government Australian Accounting Standards Board, p5

<sup>88</sup> Ibid p9

<sup>89</sup> Buffini, F *New accounting rules to keep no-profits in black*, Australian Financial Review, 3 April 2006, p6

The report also states that ‘two major accounting bodies are believed to be moving to support sector-specific standards in line with the International Accounting Standards Board’.<sup>90</sup>

The size of the organisation and the resources that it has at its disposal would, if this standard were applied, determine the level of reporting required. Because the NFP sector is big and getting bigger, the level of accountability should be increased.

*At the very least the income and expenditure of all not-for-profit organisations should be on the public record because they are subsidised by taxpayers. Some file accounts, some file summaries of accounts, some do not file any accounts. Others file accounts but do not give any financial details.*<sup>91</sup>

*A good example of transparency comes from the US conference of Catholic Bishops which publishes consolidated financial statements, supplementary information and reports on its website ( .... ) in Australia there is nothing like this.*<sup>92</sup>

As has been stated previously, there are NFP entities which are required to report their finances for scrutiny and which are audited regularly because they are either incorporated under the Corporations Law, or the statute establishing them requires it.<sup>93</sup>

Therefore, incorporated associations from the NFP sector do come under the regulation of ASIC. However it has taken a very lenient and light-handed approach to them. This raises the danger that, if the directors or managers are so inclined, they may get away with unethical, inappropriate or illegal behaviour that would not be tolerated in the for-profit sector.

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<sup>90</sup> *ibid*

<sup>91</sup> *ibid*

<sup>92</sup> Ferguson, A, *The \$70 billion sacred cow*, BRW, 12 April 2005

<sup>93</sup> For example section 11A of the *Victorian Cancer Act 1958*

*The states take little or no action to police the associations incorporation [sic] legislation. ASIC generally adopts a passive role in policing the rules, leaving matters to the Commissioner of Taxation.*<sup>94</sup>

Frankly, that is not good enough and can only change if ASIC was to be given direction and the necessary resources.

Woodward recommends that an NFP-specific accounting standard should be introduced for the sector.<sup>95</sup> It could be argued that the new AASB accounting standard, which now applies to incorporated NFP entities, can be applied to the whole of the sector, making sure that the ‘*cost does not exceed the benefits to the user.*’ Such a statement has a built in flexibility for large and small organisations which could be utilised and further developed.

Since the new international accounting standards apply in the United Kingdom, it would be interesting to see how the rationalised and centralised UK Charity Commission system has integrated its determinations and reporting systems.

There have been concerns voiced by the NFP sector that legislative changes to their legal structure will be cumbersome and difficult to implement and regulate. This overlooks Recommendation 27 of the Productivity Commission, which states that:

*Commonwealth and State/Territory governments should establish a form of incorporation under the Corporations Law for Community Social Welfare Organisations.*<sup>96</sup>

The current Government has been enthusiastic about legislative reform where matters which were formerly State responsibilities have been taken over by the Federal Government. The recent changes to the industrial relations laws overrode the state industrial relations system and created federal jurisdiction over the area utilising the federal corporations power.

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<sup>94</sup> Farrer, J, *Corporate Governance*, Oxford University Press, Melbourne, 2005, p421

<sup>95</sup> Woodward, S p6

<sup>96</sup> Productivity Commission Report, pXLV

In 2005 the Government also persuaded the states and territories to pass a uniform set of defamation laws implementing a national scheme. These are examples of the current Government's willingness, in areas where it really wants to achieve something, to bring about national legislative change.

On 24 January 2006 Attorney General Ruddock showed enthusiasm for the federal government to look at:

*other areas where laws could be unified to achieve better microeconomic reform.*<sup>97</sup>

Recent media reports<sup>98</sup> seem to indicate that his particular enthusiasm appears to be supported by the Treasurer, although his response to the first Discussion Paper of March 2006 was not encouraging.

The Treasurer cited the constitutional limitations on the power of the Australian Government to regulate the sector. He said that the responsibility for the regulation of the sector '*rests with the relevant State and Territory authorities*'. He went on to say

*Any proposal by the Australian Government to regulate this sector completely at the Commonwealth level would need the unanimous agreement and referral of power from the Commonwealth and State and Territory Attorneys-General sitting as the Standing Committee of Attorneys-General.*<sup>99</sup>

That may be so, but given recent industrial relations changes, where the Commonwealth Government relied on the corporations power in the constitution to take over state systems, not to mention the agreement from the states regarding defamation law, this has hardly been an insurmountable hurdle for the Government.

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<sup>97</sup> Priest, M, *Ruddock threat to grab state powers*, *Australian Financial Review*, 24 January 2006, p1

<sup>98</sup> Humphries, D & Wade, M, *Costello: the new federalism*, 3 July 2006 [www.smh.com.au](http://www.smh.com.au) accessed 6 July 2006

<sup>99</sup> Letter from the Treasurer to Senator Andrew Murray dated 1 June 2006

In light of this enthusiasm, perhaps the Federal Government could turn its attention to the NFP sector and regulatory reform at a national level.

## 2.5 POLITICAL CONNECTIONS TO NFPS

Political interaction with NFPs is no different to political interaction with any other significant sector. If it is large enough there will always be politics at play. Since time immemorial, churches, charities and advocacy groups have interacted closely with the political world. What is important is that the principles of transparency, accountability and good governance apply. There are grounds for arguing that they currently do not in any sufficient way.

In particular, there is great danger to the integrity of our democracy if NFPs who are the recipients of taxpayer largesse are also active participants in, or large donors to, the political parties that distribute that largesse.

The connection between the NFP sector and politics, whether the Government, opposition parties or lobby groups, is recognised by several commentators on the sector. As journalist Adele Ferguson points out:

*.... Many of the country's most powerful people either donate money or serve on the boards of these charitable groups.*<sup>100</sup>

In pursuing the link between politics and the NFP sector, the Hon Carmen Lawrence in 2005 put a series of questions on notice to the Government regarding grants to the NFP sector, in particular Hillsong Church, for the provision of certain services across a range of departments, to obtain some idea of where the grants were going.<sup>101</sup>

As the Hon Carmen Lawrence points out:

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<sup>100</sup> Ferguson, A *Much Ado about Giving*, BRW, 27 Oct – 2 Nov 2005 p 13

<sup>101</sup> Questions in Writing No2 321, 323, 325 House Hansard 8 February 2005, p189, No.322, House Hansard, 14 March 2005, p163, No: 628 House Hansard, 10 May 2005, p303, No. 630-632 House Hansard, 10 May 2005, p304 No. 633 House Hansard 10 May 2005, p305, No 634 House Hansard, 23 May 2005, p168; No: 636 & 639 House Hansard 31 May 2005, p204, No. 638 House Hansard 18 August 2005, p182, No. 629 House Hansard 14 June 2005, p192 and Question in Writing to Family & Community Services Minister, House Hansard, 9 February 2005, p280

*...it is essential that if taxpayers' money is involved, the grants and the use they are put to should be made public.*<sup>102</sup>

Many NFPs with affiliations to religious organisations are the recipients of Government grants, including long established entities such as Anglicare and newer entrants such as Hillsong, and the Assemblies of God. The religious schools sector is also heavily subsidised by Government and has long been so.

The issue here, as has been pointed out several times in this discussion paper, is not whether church based groups are sympathetic or antagonistic to particular political parties, but the transparency and accountability of the entire sector.

What needs to be considered by the sector itself and by the Government is the proper independent regulation of a sector where a variety of organisations are the recipients of large amounts of tax funds and concessions. This is a matter which it is in the national interest to openly discuss and thoroughly explore.

Influential segments of the NFP sector are unlikely to want greater regulation, and many have lobbied heavily against it. Given the number of inquiries and policy papers written in this area over the last ten years, the lack of political action could be explained by a connection between influential members of the sector and politics. It may help to explain why the Government, although aware of the need for better governance, is loathe to address reform, other than in a piecemeal way. There is no way of really knowing.

It is acknowledged, however, that there are parts of the NFP sector, such as the Nonprofit Roundtable (and several others), which are willing to enter into a free and frank discussion about the complexity of regulation of the sector, to lobby the Government for change, and to do this in a non-self-interested manner.

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<sup>102</sup>Ferguson, A, *Charity Cases*, BRW, 24-30 March 2005 p48

There have been instances during the last year when the current government has taken exception to the role of certain sections of the NFP sector and has asserted they are advocating policies with which it does not agree, or are supporting one of the opposition parties.<sup>103</sup>

*The RSPCA is at the top of the Government's hit list after running a campaign against live animal exports during the last election.*<sup>104</sup>

However, this stance has not been taken to its logical conclusion by the government. That is, the reform of the sector, and the proper regulation of it, which will make all NFPs transparent and accountable on an equal basis.

In Australia it is considered that advocacy must only be ancillary to the work of the charity, not the sole purpose of its existence. This is reflected in other Western democracies. In Canada, where there is a Charities Commission for the registration and regulation of NFPs, the situation is similar. In a recent case, an organisation dedicated to the abolition of torture, Action by Christians for the Abolition of Torture, was denied registration because it was heavily involved in mail-outs and campaigning, which were judged not to fall within the Canadian definition of a charity. The Federal Court of Canada upheld the decision and stated that:

*A charity can become involved in political activities if these help achieve the charity's purpose. However, such activities cannot become more than an ancillary and incidental concern of the organisation.*<sup>105</sup>

It should not be open to the Australian Government to threaten NFPs with de-registration, or loss of their DGR and related tax exempt status simply because the organisation takes an opposing public policy position to the government.

Sometimes these criticisms may be justified and sometimes not, but when government ministers appear to threaten NFPs about their actions in relation to advocacy, the issue

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<sup>103</sup> Hawthorne, M *Government threatens crackdown on campaigning charities*, AAP, 4 October 2005

<sup>104</sup> *ibid*

<sup>105</sup> *Action by Christians for the Abolition of Torture v Canada* [2003] 3F.C D-2 (Registered Charities Newsletter No. 15, p4 [www.cra-arc.gc.ca](http://www.cra-arc.gc.ca))

becomes political. If action is taken to end favourable taxation status, the Minister can readily be painted as vindictive and intimidatory. Such situations or complaints would be better handled by an objective independent regulator rather than via a Minister's office.

This is another argument for an independent body for the registration and regulation of charities with an appropriate framework and widely accepted guidelines to assess an NFP's status. Such a body would make the decisions about whether a charity falls within the definition, whether it should be registered and whether it should be able to avail itself of tax exempt status. And the decisions of that body should be reviewable by the Federal Court.

## **2.6 VESTED INTERESTS**

Many people from business and the professions see it as part of their civic duty to be on the boards of NFPs and to contribute their expertise to the sector. This is laudable, but they should not use their connections or vested interest to keep the sector unregulated. The community would expect that such representatives would bring good corporate governance systems to an NFP, and if they found that the procedures or corporate governance structures were lacking then the board member would bring their business acumen to bear and improve them.

*Many philanthropic donors have representatives on the boards of the beneficiaries of their gifts, so they are less likely to enforce a set of disclosures that would allow other donors to make a judgement about the performance of their charities.<sup>106</sup>*

While that would be a disappointing position for some board members to take, there are indications that there are those in the NFP sector willing to embrace regulation and see the advantages of it.

*.....the Epilepsy Association of Australia has been a strong advocate for the accountability transparency and rationalisation of the charity sector, and*

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<sup>106</sup> Johns, G p3

*Australasian Reporting Awards consider our annual report a model for all charities. Regrettably few other charities provide annual reports that allow appropriate benchmarking.*<sup>107</sup>

In a report in [crikey.com.au](http://crikey.com.au) on 28 September 2004, it was suggested that the Australian Consumers' Association, which often points out the corporate governance shortcomings of big business had itself only limited transparency about the election or appointment of people to its own board.<sup>108</sup> According to [crikey.com.au](http://crikey.com.au):

*The Australian Consumers' Association is now led by former senior ASIC regulator Peter Kell but some critics are questioning of the governance of the ACA itself.*

*For instance, did you know that:*

- *the 500,000 or so subscribers to CHOICE are specifically excluded from voting at ACA elections;*
- *membership of ACA is limited to no more than 500 and you have to be "approved" to get in;*
- *it is not clear how many members there are but there is talk it is only 250;*
- *you can't stand for council (the 20 person board) unless you have been a member for 3 years;*
- *no figures are published on the annual election results or on the membership figures.*

*Don't you just love the way ACA lecture big business of good corporate governance when their own house is so behind the times?*

If those criticisms were accurate at the time, hopefully the ACA has addressed them subsequently.

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<sup>107</sup> *Reporting Helps Benchmarking*, Letters, BRW 21 – 27 April 2005, Keith Roberts, chief executive, Epilepsy Association of Australia, Epping NSW, p8

<sup>108</sup> *Corporate Governance At the Consumers' Association*, [Crikey.com.au](http://Crikey.com.au), 28 September 2004

ASIC has a paramount regulatory role in Australia, and part of that responsibility is in regulating entities in the NFP sector that are companies limited by guarantee or companies incorporated under the previous Companies Code or current Corporations Law.

The requirements of the Corporations Law are principally designed to regulate the for-profit sector. Many of their reporting mechanisms carry compliance costs for NFPs, as they do for-profits. Leaving aside the question of cost, the more pressing question is – if reporting of this kind is appropriate for-profits *in the public interest*, why is it not appropriate for NFPs?

The establishment of a specific NFP legal organisational structure, with a specific regulatory body established to monitor the sector would ensure that all NFPs were subject to the same overall regulatory regime, adjusted according to their specific character and needs. The Industry Commission said:

*The Industry Commission considered several strategies for improving the accountability of charities to donors and the availability of information to the public:*

- *The establishment of a body responsible for supervision and monitoring charities;*
- *Charities to be incorporated as public companies under the Corporations Law;*
- *The Australian Government should provide resources to fund the development of an accounting standard specific to the sector.*<sup>109</sup>

These recommendations were made over 10 years ago now, and it is time to draft legislation to address them.

It is accepted that drafting such legislation would be a challenge.<sup>110</sup>

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<sup>109</sup> Industry Commission 1995, *Charitable Organisations in Australia*, AGPS, Report no. 45 p207

<sup>110</sup> Lyons, M, p7

### 3 LEGAL STRUCTURES

There is no consistency in legal structure adopted by NFPs. The structure chosen is generally the one that the initial members believe will work best for the benefit of the organisation at that time, or one (as with some church organisations) that has an historical basis.

Some legal structures are required by statute. For example NFP community radio stations are required to be companies limited by guarantee by the Australian Media and Communication Authority (ACMA, formerly the ABA), while the local branch of the Animal Welfare Organisation is more likely to be an incorporated association under state law. This variety is reflected in the for-profit world, where a large number of legal constructions are available, from joint-venture companies to trusts and partnerships. Nevertheless rationalisation and more consistency are desirable from an accountability and governance perspective.

*The related goals of improved accountability and good corporate governance must be supported by the underlying legal structure(s) adopted by NFPs. If the legal structure meets the needs of the organisation, then it will be easier to build consistent and appropriate reporting obligations. In turn, these are the cornerstone of accountability.<sup>111</sup>*

The various legal structures in the NFP sector mean that there are different levels of reporting, regulation and compliance required of different entities in the sector.

The argument often presented by those in the sector against a coherent legal framework and over-arching regulatory structure is that the different entity structures cater to the different needs of organisations. It is said that small organisations would be hampered by the regulatory or administrative burdens that can be carried by the larger NFP organisations. If this argument is accepted for the whole NFP sector, then desirable accountability and governance regimes will never be implemented.

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<sup>111</sup> Woodward, S, p3

This argument is a fallacy given that in the for-profit sector small business must comply with the same level of basic and essential regulation as big business. A greater onus is placed on listed companies, all of which, regardless of size, must comply with the rules of the ASX. A small company incorporated under the Corporations Law is regulated by ASIC just as the largest corporate entity in Australia is regulated by it. The directors of a small company can be prosecuted for failing in their duties to a small company as can those involved with a large company.

In the NFP sector, large non-profit organisations are often incorporated companies and therefore regulated by ASIC, while the small entities are incorporated associations or trusts. Incorporated associations are governed by State based legislation and it varies from State to State both in nature and enforcement. Such associations are lightly regulated with few reporting obligations. If the directors of incorporated associations are not conducting themselves appropriately, it is often only after a complaint is brought by members of the association that action is taken. This is an infrequent occurrence because often members of incorporated associations or others in the NFP sector are unaware of their rights in relation to initiating action.

A further difficulty with the regulation of the NFP sector is the fact that the fundraising aspect of charities is regulated by State legislation.<sup>112</sup>

The Productivity Commission addressed these concerns in its report in 1995. Recommendation 27 stated:

*The Commonwealth and State/territory governments should establish a form of incorporation under the Corporations Law for Community Social Welfare Organisations. Such organisations would be required to report using the accounting standards proposed in Recommendation 24.*<sup>113</sup>

The Government chose to do nothing.

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<sup>112</sup> *Public Collections Act (WA); Collection for Charitable Purposes Act (SA); Charitable Collections Act 2003 (ACT); Charitable Fundraising Act 1991 (NSW); Collection for Charities Act 2001 (Tas); Fundraising Appeals Act 1998 (Vic); Collections Act 1966 (Qld);*

<sup>113</sup> Productivity Commission Report 1995, Overview, pXLV

The matter was again addressed during the 2001 CDI in Recommendations 24 and 25:

*24. That the Government seek the agreement of all the State and Territory Governments to the adoption nationally of the definitional framework for charities and related entities recommended in this Report.*

*25. That the Government seek the agreement of all State and Territory Governments to establish an independent administrative body for charities and related entities, and to the legislative changes necessary for its establishment.<sup>114</sup>*

Again the Government decided that this was all too hard, and apart from some minor statutory changes<sup>115</sup> did not address the bulk of the 2001 CDI recommendations.

In her report Sue Woodward recommends that ASIC have an interim role in registering and regulating the NFP sector. Presumably her logic is that because ASIC already has a role in regulating companies limited by guarantee, this role could be extended to include other entities in the NFP sector.

Woodward sees this as an interim measure because, as she points out in her second recommendation, ASIC is not particularly user friendly to the NFP sector. There may be measures which can be taken to address this problem, including as Woodward recommends, the creation of plain language guides for the sector, especially if ASIC were to have a specialist NFP division in its structure. However, in the long run Woodward supports the creation of an independent national regulator for the NFP sector.

The establishment of an independent body such as the Charities Commission in the UK and a similar body recently established in New Zealand would address the variety of challenges which face this diverse sector.

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<sup>114</sup> [www.cdi.gov.au/report/cdi\\_summaryofrecs.htm](http://www.cdi.gov.au/report/cdi_summaryofrecs.htm) (accessed 6/2/06)

<sup>115</sup> Consultation on the Definition of a Charity, A Report to the Treasurer, Board of Taxation, December 2003

If the matter is to be adequately addressed, and from all detailed studies in this area and two government inquiries, then tackling the legal framework and establishing a registration and regulatory body to oversee the NFP sector is essential. These two actions would be the most likely to result in a strong accountable transparent and properly regulated sector, than simply introducing uniform legislation.

Representatives from philanthropic and charitable organisations themselves see the need for comprehensive regulatory reform to ensure transparency and accountability:

*The executive director of Philanthropy Australia, Elizabeth Cham says the sector needs a champion to make some necessary changes. She says most in the sector want change and that without transparency and with inconsistent legal structures the sector operates like a cottage industry. In many cases the organisations are inefficient.*

*Cham says that since 2001, 148 new foundations have been set up with a new breed of philanthropist. The sector wants change; it is the governments that don't want to make the changes. She says what the sector needs is a national regulatory code, and a new accounting code that understands the sector.<sup>116</sup>*

In the same article Andrew McCallum, President of ACOSS says:

*if the sector was given a new regulatory framework and an independent commission to monitor it, not-for profit organisations would become more efficient.<sup>117</sup>*

Sue Woodward recommends an Advisory Body for NFPs to provide advice on financial and taxation matters, auditing, legal advice, training, and dispute resolution and mediation services. After reviewing the UK experience, however, they are not in favour of combining the regulatory and advisory aspects.<sup>118</sup>

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<sup>116</sup> Ferguson, *Charity Cases*, BRW 24-30 March 2005, p54

<sup>117</sup> *ibid*

<sup>118</sup> Woodward, S p3

## 4 COMPETITIVE NEUTRALITY

According to the current Government's policy statements, one of its major objectives in the business arena is competitive neutrality. According to the Department of Finance and Administration's website:

*The objectives of the Australian Government's policy of competitive neutrality (CN) are:*

- *that significant Australian Government business activities do not enjoy net competitive advantages over their private sector competitors (or potential competitors) simply by virtue of their public sector ownership;*
- *to eliminate potential resource allocation distortions arising from the public ownership of significant business activities operating in contestable environments; and*
- *to encourage fair and effective competition in the supply of goods and services.*<sup>119</sup>

This concept is relevant, and increasingly so, to the NFP sector because of the range and scope of the goods and services now provided by NFPs and because many government services are being outsourced and run by the NFP sector.

Currently the NFP sector provides services similar to the public sector or as an adjunct to the services provided by the public sector. It also now receives Government grants for the work that the public sector has been responsible for in the past. Often the services provided by the NFP sector are in direct competition with those offered by the private for-profit business sector.

In the private sector there are often more stringent reporting procedures and more broad ranging accountability obligations which raise their costs, compared with their NFP counterpart.

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<sup>119</sup> [www.finance.gov.au](http://www.finance.gov.au)

If a company is incorporated under the Corporations Law, then it will have accounting and reporting obligations. It will be monitored by ASIC and be required to be audited. The business generally does not have tax exempt status or access to a volunteer workforce.

The NFP sector, on the other hand, has tax exempt status. Its workers can salary package their earnings, and they have access to free expertise and volunteers willing to give their time and energy to the organisation. As pointed out by Adele Ferguson:

*The not-for-profit sector carries on its daily activities mostly immune from taxes. This is a list of taxes the sector does not have to pay.*

- *Income tax. The primary source of exemption from income tax comes from s23(e) of the Income Tax Assessment Act which exempts from income tax 'the income of a religious, scientific, charitable or public educational institution'*
- *GST exemptions*
- *Fringe Benefit Tax exemptions of more than \$15,000 per employee*
- *Stamp duty on property transfers and some but not all, other stamp duties*
- *Payroll tax in relation to non-commercial activities. Commercial activities are subject to payroll tax*
- *Land tax where the land is used by a charitable institution exclusively for charitable purposes*
- *Stamp duty on property insurance cover (varies from state to state)*
- *Rates. Local governments forego large sums of money because of the exemptions from rates of property held by the non-profit sector*<sup>120</sup>

It follows therefore that if an NFP tenders for work from the government such as employment placement services, their tenders may be lower because of these advantages in comparison with their for-profit competitors. Because of this price differential they may win the tender over their for-profit competitor. It is, of course, recognised that they may win the tender because of their greater expertise in the area in which they are tendering, for instance, in the placement of people with disabilities.

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<sup>120</sup> Ferguson, A, *Charity Cases*, BRW, 24-30 March 2005, p46

However, the tax advantages for NFPs create inequity in the marketplace, something that the government, in other spheres, has been adamantly opposed to.

*The real-world situation in Australia includes examples where large amounts of public sector assistance in the name of helping charitable, religious and community service, not-for-profit activities are being channelled in an open-ended and in some cases, non-transparent and non-accountable way, into commercial activities on such a scale as to violate the very competitive neutrality principles to which the Commonwealth and State governments have themselves agreed.*<sup>121</sup>

In numerous submissions made to the CDI and the Industry Commission Inquiry 1995 for-profit business pointed out that the provision of tax concessions to charities, especially where those NFPs conduct a business competing in the same market,<sup>122</sup> contribute to a distortion of competition in that marketplace. This distortion is a direct result of tax concessions which constitute a benefit for the charity's business which is not available to a normal business competing in the same market.

One example is Kellogg (Australia) Pty Ltd, a for-profit business in the same market as Sanitarium which is run by the Seventh Day Adventist Church and endorsed as a charity for taxation purpose. Sanitarium has about 20 – 30 % of the ready to eat (RTE) breakfast cereal market in Australia.

Sanitarium is in direct competition with other companies in that market and because of its tax exempt status, receives a significant competitive advantage. Kellogg argues in its submission that it is:

*hardly a model of transparent, accountable use of taxpayers' money.*<sup>123</sup>

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<sup>121</sup> The Strong Case for a Clearer Activities based definition of Charities and related organisations, Submission to the Inquiry into the definition of Charities and related organisations, commissioned by Kellogg (AUST) Pty Ltd, prepared by Access Economics, January 2001, p:iv

<sup>122</sup> Malleson, Stephen Jaques Submission to the definition of Charities and related organisations, January 2001; p16

<sup>123</sup> Kelloggs, p v

According to Kellogg's submission to the 2001 CDI:

*...such activities should be subject to the principle of competitive neutrality as applies to similar commercial activities undertaken by government business enterprises and to private sector businesses. For public sector support to charities and related organisations to be effective, efficient, fair and transparent and accountable, it should be focussed on activities that are charitable, religious and community service not-for-profit in nature, and not extended to activities that are commercial in nature.*<sup>124</sup>

The submission from Kellogg goes further:

*Any eligible organisation that receives, say, tax concessions, such as exemption from income tax and access to FBT concessions, and where a substantial part of its activities are themselves purely commercial in nature (albeit justified as a funding source for its other charitable, religious and community service not-for-profit activities) is a potential source of non-transparent, non-accountable, and unfocussed assistance.*<sup>125</sup>

Many NFPs argue that they could not conduct their core business of aiding the sick and destitute or preventing cruelty to animals or saving the whales, if they did not have access to the funds raised by their other activities.

These funds may be raised through a variety of mechanisms. Many people consider the benefit shops run by churches such as The Salvation Army are part of the fundraising activities of the church. However, there are other activities which members of the general community may have difficulty in identifying as part of the charitable fundraising activities of churches.

The Australian Prudential Regulation Authority (according to a report in *The Australian* on 28 October 2005)<sup>126</sup> sent a draft policy to several churches offering

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<sup>124</sup> Ibid, pii

<sup>125</sup> ibid, piii

<sup>126</sup> Gluyas, R, *God's banks to face crackdown*, *The Australian*, 28 October 2005, p4

quasi financial services, including the Catholic, Anglican and Uniting churches as well as the Assemblies of God. According to the newspaper report, APRA warned churches that they would face being considered as financial institutions if they failed to prove their services were used for charitable purposes and not for commercial gain.

APRA has favoured light-handed regulation, with a standard class exemption for religious charitable development funds.<sup>127</sup> Whatever one might think of the merit of APRA's light touch, that they did review the situation is a sign of greater regulatory concern and interest.

It is important, both from the perspective of the NFPs themselves, and from the regulators of the various sectors which the activities of NFPs affect, that certainty is provided through proper overall regulation of the sector.

According to Kellogg's submission mentioned previously, the very different tax treatment of NFPs that are in competition with commercial enterprises impacts on competitive neutrality.

*This lack of transparency in relation to tax-exempt entities engaged in commercial activities in direct competition with tax-liable businesses is inconsistent with a transparent, accountable approach to the use of taxpayers' money.*<sup>128</sup>

*Because Section 23(e) of the Income Tax Assessment Act provides that 'the income of a religious, scientific, charitable or public educational institution' shall be exempt from tax, the business income generated by Sanitarium Health Food Co. is also income tax-exempt. Moreover, employees of Sanitarium seem likely to have access to the same FBT concessions as are available to the Seventh Day Adventist Church.*<sup>129</sup>

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<sup>127</sup> APRA media release 5 July 2006

<sup>128</sup> Kelloggs, p20

<sup>129</sup> *ibid*, p:iv-v

Another advantage for NFPs which impacts on competitive neutrality is that those NFPs which have large land holdings may not pay land tax.<sup>130</sup> This advantage is sometimes compounded by the church or charity having been granted the land in the first place. They are also exempt from the payment of capital gains tax when the land is sold.

In 2005 it was reported by crikey.com.au that the Salvation Army sold 14 properties to Macquarie Bank for an estimated \$120 million. The proceeds from the sale were, according to the report, completely free from any capital gains tax because of the Salvation Army's taxation status.<sup>131</sup>

Sporting clubs have in the past been exempt from the payment of income tax, a matter I have brought up on a number of occasions. While I support small community based organisations and sporting clubs having appropriate taxation exemptions:

*The large super clubs, however, are clearly major multimillion dollar commercial enterprises that must be taxed appropriately.*<sup>132</sup>

These examples show that there needs to be a revisiting of the activities-based definition of charities and various tax concessions so that competitive neutrality can be restored and certainty, transparency and accountability in the sector established.

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<sup>130</sup> Mitchell, B, *Rate Equity in Danger*, *The West Australian*, 25 April 2006, p10

<sup>131</sup> Mayne, S, *The privileged position of The Salvation Army*, *Crikey.com.au*, 14 November 2005

<sup>132</sup> Senator Murray (WA) Adjournment, Taxation: Clubs, Senate Hansard 18 October 1999 p9898

## 5 CONCLUSION

In the term of this Coalition Government there has been a considerable overhaul of regulatory law and practice to modernise governance and enforce higher standards in the public interest, whether it is the ATO, the Reserve Bank, Customs, APRA, ASIC, the ACCC or the other regulatory bodies within the for-profit sector. Little, however, has been done for the NFP sector apart from some changes to law affecting what the ATO treats as DGRs.

Throughout this discussion paper reference has been made to commentators, academics, journalists and sections of the NFP sector itself, which see the need for comprehensive reform and regulation of the sector.

The National Roundtable of Nonprofit Organisations says:

*Australia must have a regulatory environment that promotes nonprofit enterprise, integrity and funder confidence*<sup>133</sup>

Philanthropy Australia also identifies what it believes the government's role needs to be in this review process:

*An effective role for the Government would be to critically review all existing laws involved in corporate community programs to ensure simplification of the processes and governance requirements – making it easier to make a difference.*<sup>134</sup>

However, the question arises as to how these changes should be brought about and how they should be regulated.

As Professor Lyons points out:

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<sup>133</sup> Nonprofit Regulation Reform Program, *An initial statement by the National Roundtable of Nonprofit Organisations*, March 2004, p4

<sup>134</sup> Philanthropy Australia, *Inquiry into Corporate Responsibility and Triple-Bottom-Line reporting for incorporated entities in Australia*, 23 February 2006, p2

*Even well intentioned legislation and its accompanying regulation can damage the third sector if it is developed in a piecemeal fashion, without regard to the dynamic of the sector, to its current orientation and to the wider social and economic environment.*<sup>135</sup>

Where the regulator for the NFP sector should be located within the government administration is another question that must be addressed.

There seem to be only two sensible options: an independent Charities Commission; or a formally constituted and separately resourced division of ASIC that would oversee NFPs. The ATO has shown no enthusiasm for the task of regulating the NFP sector, and as previously stated, the arguments are convincing that the ATO should not be the regulator of NFPs.

Apart from the economies of scale and the easy continuity of interest within ASIC for NFP regulation, a Charities Commission (as its name indicates) is focussed on just one sector of NFPs, albeit a large and controversial one.

Several commentators<sup>136</sup> note that Australia's federal system leads to a fragmentation of the NFP sector. Different State laws apply to the NFP sector in relation to fundraising obligations and for those entities registered as Incorporated Associations under the different State Acts, there are different reporting obligations in place.

This fragmentation of the sector needs to be addressed from a regulatory perspective, so that the multiple laws which currently apply are streamlined. This may involve something similar to the States' agreement to transfer power in the area to the Commonwealth in a similar way to that achieved in relation to the Corporations Law. Or it may be possible to achieve this by activating existing powers under the Constitution, such as the taxation power.

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<sup>135</sup> Lyons, M p11

<sup>136</sup> In particular Lyons and Woodward

Sue Woodward recommends that there should be a single specialist legal structure for NFP entities with different reporting obligations similar to their for-profit counterparts and this view is supported by Lyons.

This recommendation has great merit. There is sufficient guidance and information to be gleaned from the UK experience in reforming the NFP sector, to apply to Australia.<sup>137</sup> It is time for steps to be taken in this area to achieve the reform that is necessary to make the sector more transparent and accountable.

No national scheme of this sort can work effectively without the formal agreement and cooperation of the States and Territories, including relevant referral of powers. Ideally, a national NFP regime would see either the harmonisation into uniform law, or the incorporation into federal law of the different State based Fundraising and Public Collections Acts as well as the State based Incorporated Associations Acts.

A streamlined legal framework will then lead naturally to a federal regulatory body.

The NFP regulator would be in charge of registering charities for the purposes of the NFP sector, and for adjudicating the tax status of other NFPs. To achieve registration an NFP would be required to show that it fitted within the purpose and activities test applicable to charities or public benevolent institutions and the extended statutory definition. This would have the effect of streamlining the registration process, it would make it flexible to changing conditions, and it would be transparent.

As an independent body, it would be up to the Regulator to determine whether an NFP entity fulfilled the registration requirements, it would not be up to an officer in the ATO. Any threats by partisan government ministers to deregister NFPs would not carry any weight as the matter would be in the hands of an independent entity. There would be a transparent process in place for registration and ongoing auditing of the NFP entity to ensure it continued to pursue its constitutional objectives.

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<sup>137</sup> Woodward, p54

In establishing the NFP registration and compliance functions it would be essential to determine the definition of a charity, with reference to an activities-based definition. It could be incorporated into legislation for certainty, with the public benefit and public interest test intact. Such determinations would affect ATO processes benignly because they would incorporate aspects that the ATO has previously taken into account in determining whether an entity is entitled to tax concessions. It would address the complex question of ‘ancillary’ or ‘incidental’ purpose test when an NFP is seeking registration.

The result would undoubtedly be a rationalisation of the tax concession regime for NFPs. Some NFPs would probably lose their present tax exempt status, in part or in whole if the ‘work’ they do does not relate to their core NFP activities. In those cases they should indeed be subject to the same taxation obligations as other entities.

Currently NFPs do not have to pay state payroll taxes on their non-commercial activities, only on their commercial activities. If this division between commercial and non-commercial activities is to continue (and it should) it should be applied to all other tax concessions applied to NFPs of a sufficient size.

The Commission would have an educative, regulatory and enforcement role within the NFP sector and could be a division of ASIC for the purposes of speed of establishment and reduction of cost.

In its educative role, it should provide financial and taxation advice, limited legal advice, support, training to managers and directors of NFPs (which should, of course, only be provided to those entities which deserve NFP status). Additionally, dispute resolution and mediation services for NFP stakeholders, which would include donors, volunteers and recipients of NFP services should be provided.

An entity of any size or complexity which wanted to incorporate as an NFP would apply for registration. The Regulator would provide information about how to register and what was required for the NFP to comply with the statutorily set out conditions for NFP status.

Once an NFP is registered it would be required to submit to annual audits and provide specified financial and operating reports under appropriate accounting standards. There would need to be some mechanism, if it is found that the NFP no longer fulfilled the conditions, for the entity to rectify the position or lose status. The Regulator would be funded to provide information services to the NFP sector about these reporting obligations and to ensure that appropriate information is made public.

The Regulator would have the power to enforce the reporting obligations on all registered NFPs, to investigate whether they continued to comply with their original registration and to follow up on complaints made about NFPs and their status.

This is an extensive role for the Regulator but it is only by this fully rounded approach to the NFP sector that significant and effective reform will be achieved in the national interest. It is the only way that the sector as a whole will be transparent and accountable to all of its stakeholders.