

## Better Targeting of Not-For-Profit Tax Concessions Consultation Paper Submission

Social Traders welcomes the opportunity to make this brief submission to the consultation paper on tax concessions for the not-for-profit sector.

Social Traders is a non-profit organisation established in 2008 to support and encourage the establishment of commercially viable social enterprises throughout Australia. Social Traders makes this submission in its capacity as an independent and specialist social enterprise development organisation that works with government, community, business and research partners to:

1. Open up markets for social enterprise;
2. Increase the trading capacity of social enterprises; and
3. Increase finance available to develop social enterprise.

Social Traders' response to the questions presented in the consultation paper is derived from our experience of:

- Direct investment in social enterprises through Social Traders' Social Enterprise Development Fund and associated development and support initiative 'The Crunch, which invested around \$950,000 in ten start-up social enterprises in its 2010 pilot year.
- Assisting social enterprises to become financially sustainable and/or investment-ready.
- Research on the social enterprise sector (Finding Australia's Social Enterprise Sector project) and on the development needs of social enterprises.
- Research and policy development on social impact measurement.
- Social enterprise development and networking support provided to social enterprises from around Australia.

Social enterprises are organisations that<sup>1</sup>:

- i. Are led by an economic, social, environmental or cultural mission that results in public or community benefit;
- ii. Trade to fulfil their mission;
- iii. Derive a substantial portion of income from trade; and
- iv. Reinvest the majority of profits to fulfil their mission.

Consistent with the broad definition of social enterprise above, social enterprises in Australia generally fall into three groups, based on their reason for establishment:

- i. Social enterprises that provide employment, training and support for members of the community that are marginalised from employment and economic participation, such as people with a physical or intellectual disability, those with mental illness, disadvantaged young people and the long-term unemployed.
- ii. Social enterprises that create or retain services in direct response to social or economic needs in the community, such as community childcare, community banking and social enterprises developed to respond to issues such as rural and regional decline.
- iii. Social enterprises that generate profits to support other community or not-for-profit organisational activities; this group includes 'charitable business ventures'.

Charitable business ventures are run by not-for-profit organisations to raise income which is reinvested in their charitable purpose. Some operate as divisions within charities, while others are separately incorporated as companies. They include smaller ventures, such as opportunity shops and community

book stores, through to large trading companies. Some charitable business ventures align their product with their mission – for example, opportunity shops provide access to affordable clothing and household goods for people their supporting charity seeks to serve – while others raise income through business activities unrelated to their mission.

It is this group of social enterprises, ‘charitable business ventures’, that stand to be most affected by the proposed changes to the tax concessions provided to not-for-profit organisations in Australia.

Social enterprise and in particular, charitable business ventures, are an important source of revenue generation for some not-for-profit organisations. 38% of the not-for-profit sector’s income is derived from the sale of goods and services<sup>ii</sup>. In some cases, they also provide niche goods and services that respond to the needs of disadvantaged citizens and communities.

The principal purpose of charitable business ventures is to enable not-for-profit organisations to fulfil their mission by reinvesting profits into their core activities. Those ventures that align their product with their mission also innovate to produce goods and services that make a positive contribution to the communities they serve, such as making particular goods and services more affordable or developing new products that respond to unmet needs. In recent years, some charitable business ventures have also provided leadership in the promotion of ethical business practices.

### Consultation questions and issues

Social Traders acknowledges the policy intent of the changes in income tax concessions for not-for-profit organisations, as described in section 2.1 of the consultation paper to be:

- i. Ensuring that the focus of the [not-for-profit] entity remains on the altruistic purpose;
- ii. Promoting an efficient use of resources for altruistic purposes;
- iii. Creation of a ‘level playing field’ for Australian businesses; and
- iv. Lessening the business risk to altruistic assets from unprofitable commercial activities.

However, as examination of many social enterprises established by not-for-profit organisations to provide a valuable source of revenue that is then applied to achieving social impact shows:

- The scale of social/altruistic benefit can be greatly enhanced through the existence of a trading entity and the additional, unrestricted, non-programmatic revenue that is generated;
- Under a social enterprise model, commercial operations add significant value to addressing Australia’s social problems;
- The business rigour that is necessary to operate a commercial business arm can have trickle-down benefits to the organisational culture that results in enhanced resource efficiency across the broader not-for-profit organisation;
- The social return that can be generated by every dollar of profit generated by the commercial activity is a reason to promote trading activity by not-for-profit organisations rather than discourage it;
- The cost imperatives on most not-for-profit organisations are a far more effective control against unprofitable commercial activities than an income tax mechanism that is only enacted when a commercial activity is profitable.

Furthermore, the claim of inequity for Australian commercial businesses as a result of income tax concessions is not supported by the Australian Productivity Commission’s finding that:

*“On balance, income tax exemptions are not significantly distortionary as not-for-profits (NFPs) have an incentive to maximise the returns on their commercial activities that they then put towards achieving their community purpose.”<sup>iii</sup>*

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

Given the issues raised above and acknowledging the value to Australian society created by the not-for-profit sector, the issue is not one of questioning the degree of relatedness of a not-for-profit organisation's commercial activity to their social purpose, but identifying when an otherwise commercial intent drives the establishment of a not-for-profit entity as a means of gaining favourable tax treatment, i.e. when the social mission is not the reason for the establishment of the entity, irrespective of the nature of the commercial activity and its relatedness to the social mission.

The degree of relatedness of a commercial activity established by a not-for-profit should *not* be an issue. Some charitable organisations will have the benefit of being able to commercialise an aspect of their operations to diversify and enhance revenues, but others will not. The latter group, who will have to look more broadly to identify revenue generation opportunities should not encounter different tax treatments to those that are able to undertake more mission related commercial activity.

Similarly, some not-for-profit organisations can more effectively apply their resources to an 'unrelated' commercial activity that yields higher profit margins than to a more 'related' commercial activity. Irrespective, the purpose of both activities is to generate revenue to be applied to the core social purpose.

Given not for profit organisations cannot distribute profits for personal gain, all charitable business ventures' profits serve to meet the core social purpose irrespective of their being derived from 'related' or 'unrelated' activity. Differing income tax regimes for not-for-profit organisations based on the social enterprise activity they undertake is inequitable, inconsistent with the Australian Productivity Commission's finding on competitive neutrality and serves to discourage innovative models for addressing some of Australia's most intractable social issues.

There is also a practical issue with the assessment of the degree of relatedness between the commercial activity and the social purpose. Mission relatedness of commercial activity for a social enterprise is a continuum rather than a dichotomy. For example, Mod-Style is an optical frames importing and wholesale business that The Brotherhood of St Laurence operates as a charitable business venture, with profits used to fund the Brotherhood's work. An initial assessment of Mod-Style as per the consultation paper would suggest that this commercial activity undertaken by The Brotherhood of St Laurence is 'unrelated' to their core purpose. However, The Brotherhood's association with the optical industry through Mod-Style has enabled them to be involved in research relating to eye health of Australians on low incomes. The issue of 'relatedness' run contrary to the innovative social benefits that can be achieved by a not-for-profit organisation through this type of commercial activity.

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

The unintended consequences of the proposed structural options - discouraging sound business practice in the not-for-profit sector and unreasonable cost burdens prior to trading - are detailed below.

#### **Discouraging sound business practice in the not-for-profit sector**

The options for entity structure presented in the consultation paper risk penalising charitable business venture-type social enterprises that undertake activities less related to their charitable activities against those that are able to commercialise their operations in some way to generate additional revenue. Specifically, all options encourage un-sound business practices and discourage charitable business ventures to retain earnings to support the future sustainability and growth. In the instance of social enterprises that exist for the achievement of the social mission, irrespective of the type of commercial activity they undertake, sustainability of the charitable business venture is the underlying determinant of how the altruistic activity is achieved. If these enterprises were to retain earnings to support their future sustainability and growth, as all businesses should, they would be required to report it as profit not applied to the altruistic purpose of the not-for-profit and incur income tax.

Therefore, given that under a not-for-profit structure no personal profit distributions can be made, if the policy is to be equitable, not threaten the viability of charitable business ventures and promote sound business practice in the not-for-profit sector, the threshold for profits allocated to the altruistic purpose should be significantly less than 100%.

### **Unreasonable cost burdens prior to trading**

Some not-for-profit organisations elect to establish a separate entity when developing a social enterprise such as a charitable business venture, often to protect the assets of the not-for-profit parent. However, for some smaller and less affluent organisations, the requirement to establish a separate entity prior to the commencement of trade may impose an excessive financial impost. The requirement to establish a separate entity prior to any income being generated by the commercial activity, as proposed in options 1 and 2, would most likely result in them choosing to not develop a social enterprise to increase and diversify their revenue. This will have significant flow-on effects, including ongoing dependence of these smaller organisations on government funding.

## **Conclusion**

Social Traders welcomes the opportunity to comment on the Consultation Paper. However, our view is that the Government's objective of better targeting of tax concessions should be focussed specifically to those instances where an otherwise commercial activity is established under the guise of a not-for-profit structure. That is, it is inappropriate for the Government to be making the proposed broader regulatory changes to the current tax concession arrangements for not-for-profit organisations who legitimately establish social enterprises (charitable business ventures) to generate revenue to support their social mission. If this logic is followed, the issue of relatedness of the commercial activity to the organisation's social purpose is not relevant. What is relevant is recognition of the considerable social value that can be created and leveraged along with the significant contribution that trading activity can make to the sustainability of the not-for-profit sector. Social Traders believes that the options being considered by Government will have unintended consequences and will prevent, or at least substantially reduce, the extent to which not-for-profit organisations undertake commercial activities as a means to supplement their income.

### **Ends**

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<sup>i</sup> Social Traders and Queensland University of Technology, 2010, *FASES: Finding Australia's Social Enterprise Sector*, Social Traders Ltd. Melbourne. The economic, social, environmental or cultural mission described here is consistent with the use of the term "altruistic purpose" used in the consultation paper.

<sup>ii</sup> Australian Bureau of Statistics (2008) 8106.0 *Not-for-profit Organisations, Australia, 2006-07*, <http://www.abs.gov.au/AUSSTATS/abs@.nsf/Latestproducts/8106.0Main%20Features12006-07?opendocument&tabname=Summary&prodno=8106.0&issue=2006-07&num=&view=>

<sup>iii</sup> Productivity Commission 2010, *Contribution of the Not-for-Profit Sector*, Research Report, Canberra p.197