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## 8 Competitive neutrality issues

### Key Points

- Competitive neutrality is a principle that promotes the equal treatment by governments of competing organisations to achieve a 'level playing field'. By encouraging competition for inputs and market share it aids in the efficient allocation of resources.
- The violation of competitive neutrality is only distortionary where government policy provides a systematic advantage to some organisations over others competing in the same market.
  - While there are many potential areas where competitive neutrality principles are not met, only those imposing significant distortions need to be addressed.
- 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.
- Input taxes, in particular payroll tax and fringe benefits tax (FBT) concessions, can confer a significant advantage to eligible organisations by reducing their employment costs. They can also distort decisions on the allocation of funds between capital and labour.
  - In principle, concessions are distortionary whenever an eligible organisation is in competition with a for-profit provider, or an NFP not eligible for the concessions.
  - In practice, only a few areas pose a concern. These include NFP hospitals and public hospitals which have a significant competitive advantage over for-profit hospitals.
  - For organisations competing for government funded services, competitive neutrality can be restored if input tax concessions are taken into account in assessing value for money.
  - As a rule, it would be preferable for services to be funded in a transparent fashion and not rely on input tax concessions that can be relatively complex, costly and distortionary.
- Clubs benefitting from the mutuality principle, and the exemption under division 50 of the *Income Tax Assessment Act 1997* (ITAA), also receive a significant competitive advantage from input tax exemptions that appear to extend to services beyond their traditional social, cultural and sporting functions.
  - Gaming activities in clubs are being heavily subsidised by taxpayers when compared with similar activities outside the club environment.

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The terms of reference to the study include a request that the Commission:

... examine the extent to which tax exemptions accessed by the commercial operations of not-for-profit organisations may affect the competitive neutrality of the market.

This chapter examines competitive neutrality issues in the not-for-profit (NFP) sector. While the analysis includes an examination of various tax concessions (discussed in chapter 7), they are only considered through the prism of competitive neutrality.

## **8.1 Why is competitive neutrality important?**

It has been well established that exposing firms to greater competition and increased openness has sharpened incentives to reduce costs and innovate (OECD 2009a; PC 2005c). Competitive neutrality is a key aspect in promoting strong competition by removing distortions that inhibit the flow of resources to their most efficient use.

The competitive neutrality principle is that sellers of goods and services should compete on a level playing field; that is, one provider should not receive an advantage over another due to government regulation, subsidies or tax concessions.

Competitive neutrality removes artificial advantages and allows businesses to compete on a basis that offers the best cost and quality combinations to customers. This is likely to result in more effective competition and more efficient outcomes.

Concerns about competitive neutrality are most likely to arise in an environment where one or more competitors receive significant government benefits — direct or indirect — not available to other competitors.

Governments provide direct and indirect assistance to many businesses, for example tax concessions for research and development, industry adjustment grants, and restrictions on the number of taxi plate licenses. Some of these advantages are well justified in terms of public confidence, or enhanced activity that also benefits others (externalities). Indeed, when the Government purchases goods and services from the private sector, it could be seen to favour one provider over another — this is why the Commonwealth's core principle for Government procurement is value for money (chapter 12).

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Some submissions<sup>1</sup> expressed concern that the Commission has applied a new and broader definition of competitive neutrality than in the Government's competitive neutrality policy (PC 1998). For example, Catholic Health Australia stated:

The draft consultation report of the Productivity Commission applies a new and broader definition. The application of the concept of 'competitive neutrality' appears to extend beyond government owned businesses competing with the private sector, to apply to not for profit businesses – specifically hospitals competing with private hospitals. It could be argued that the broadening of these principles are not necessarily valid as this does not align with the original intent of the National Competition Policy, 1996. (sub. DR198, p. 10)

DF Mortimer & Associates (sub. DR258) considered that the public interest exemption to competitive neutrality policy could be equated to the public benefit test applied to NFPs seeking charitable status. But the benefit test is a test of charitable behaviour and is not designed to apply to the commercial operations of NFPs.

While National Competition Policy does not apply to NFPs, the competitive neutrality principles articulated in this policy have a broader application. It is this broader application that is applied in the chapter as requested by the terms of reference.

In addition to concerns about the effect on competition, non-neutral tax treatment can compromise three key principles of optimal tax systems: efficiency, equity and simplicity (Australian Government 2009e).

- Efficiency can be compromised whenever decisions about resource allocation are driven by tax considerations drive rather than market signals of opportunity cost.
- Equity can be compromised whenever providers of similar or identical goods and services are treated differently by the tax system.
- Simplicity can be compromised whenever the tax system mandates special treatment of selected taxpayers.

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<sup>1</sup> For example Catholic Health Australia (sub. DR198); the Australian Catholic Bishops Conference (sub. DR201); Selected operators of not-for-profit hospitals (sub. DR209); and DF Mortimer & Associates (sub. DR258).

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## 8.2 Which concessions to not-for-profit organisations raise competitive neutrality concerns?

Submissions received by the Commission are split between those (generally NFPs) arguing for the retention of the present tax concessions and those (generally for-profit organisations) that prefer the concessions to be removed (box 8.1).

### Box 8.1 Comments from submissions on competitive neutrality

#### Those concerned about competitive neutrality

Pharmaceutical Society of Australia:

The taxation arrangements that apply differentially across the not-for-profit sector are neither fair nor efficient and fail to deliver an environment of competitive neutrality between organisations providing like functions within the sector. (sub. 22, p. 5)

ACL Pty Ltd:

The issue for ACL is that the significant cost advantages incurred through public subsidisation of commercial operations through tax and other exemptions, place it at an equivalent disadvantage in submitting a price competitive bid. (sub. 16, p. 2)

Dwyer:

I believe this sort of advantage is harmful, anti-competitive and counter productive to the industry and environment as a whole. Private sector businesses, such as the one I work for, are finding it increasingly difficult, and in a lot of cases impossible, to compete with the low cost alternatives that NGCs [non-government companies] such as (Greening Australia Victoria) are able to provide. (sub. 48, p. 1)

Commercial Hospital Operators Australia:

Over the past ten years, a series of acquisitions and developments of close to \$1 billion have been made by the NFP sector in direct competition with commercial operators ... increasingly NFP private hospitals are behaving in a commercial fashion: providing the same services and competing for patients, doctors, staff and infrastructure. The primary users of their services are people who enjoy middle to upper socio-economic status and can afford private health insurance, not the disadvantaged ... in this way NFP private hospitals enjoy tax concessions for activities which do not closely resemble, or form more than an incidental part of, their original charitable purpose. (sub. DR298, p. 2)

#### Those who feel the advantages are justified

Royal Flying Doctor Service:

To conclude that all NFPs are obtaining an advantage (or even an unfair advantage) over their not-for-profit competitors is a significant over-simplification. (sub. 84, p. 12)

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## Box 8.1 (continued)

### Family Planning NSW:

NFP organisations that exist to benefit the community cannot offer the same level of remuneration to employees as governments or business. ... [NFP] employees are prepared to accept a lower wage because they are committed to the goals of the organisation and value the contribution they are making to the community. ... These tax concessions are essential as a means of helping bridge the salary gap. If the concessions were removed these organisations could not compete on the open-labour market and the delivery of these essential services would be threatened. (sub. 73, p. 7)

### Mission Australia:

Mission Australia would, however, be open to the introduction of a 'Social Purposes Test' to assess the nature of profit making activities for taxation purposes. As a significant provider of government funded social services, Mission Australia enters into government contracts, the successful implementation of which can lead to surpluses which are channelled back into funding organisational infrastructure or deficit generated community programs. (sub. 56, p. 7)

### Australian Children's Television Foundation:

The ACTF believes tax exemptions should be maintained for not-for-profit organisations that, like the ACTF, have as their primary objectives cultural and educational outcomes. (sub. 35, p. 3)

### Catholic Health Australia:

... whilst both providers have delivered a basic human good (life and health care) their motivations are starkly different. It is possible to say one was carrying on a charitable or public benevolent activity and the other was not. (sub. DR198, p. 8)

### Friendly Society Private Hospital:

There are a number of fundamental differences between these two types of business which provide the basis for the case as to why the concessions should remain in place. Specifically, NFP hospitals fill an important gap in the health industry in areas that may be deemed to be financially unviable for a for-profit entity to establish a hospital due to the lower financial targets that are set by an NFP entity. (sub. DR217, p. 1)

The importance of potential competitive neutrality concerns is likely to be greatest when all of the following three criteria are met:

- there is differential treatment by government between organisations competing in the same market (including potential competitors)
- the treatment is distortionary in terms of resource allocation
- the differential treatment is not justified on net public benefit grounds.

The great majority of NFPs operate outside the market. These NFPs provide services — some community-wide, some member-based — that are not normally provided by businesses. This includes the provision of charitable services which are not funded by government or the private sector except through donations. There are

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few competitive neutrality concerns for these parts of the NFP sector except in relation to differential access to concessions (as discussed in chapter 7).

Some NFPs conduct commercial activities in direct competition with for-profit providers of goods and services. The remainder operate in areas in between; that is, providing services in areas that are currently of little interest to for-profit business and/or services to members that differ from those that for-profit businesses might provide. Thus there is a range of potential competitive neutrality scenarios: from clear areas where tax concessions and other government subsidies do not have competitive neutrality implications to those where the subsidies have a potentially significant effect on competition. This latter category may include organisations competing for government services.

Stakeholders have posited two justifications for providing advantage to NFPs:

- NFPs may face disadvantages relative to for-profit businesses, and concessions assist to offset these disadvantages. The main disadvantages cited are difficulties accessing capital and lack of size and scale, where economies of scale and scope may not be fully exploited. While there is some merit in the first point (chapter 7), many NFPs do not take advantage of opportunities to grow, preferring small scale, local connections and control (chapter 2). In any case, many of these perceived disadvantages are not exclusive to NFPs and are shared by small businesses.
- The policy motivation for providing concessions is the additional public benefit (spillovers) provided by an NFP's activities — such concessions vary according to the status of the NFP (chapter 7). Where NFPs compete with for-profit businesses, such concessions are only justified if they deliver spillovers commensurate with the effective subsidy provided less any costs imposed by the loss of competition. In addition, the government should have decided that the spillovers constitute a valid area for a subsidy.

Once government has decided to provide subsidies to NFPs, the form of the subsidy — whether tax concession, direct grant or something else — will affect the cost to the taxpayer and the distortions it introduces. The provision of input tax concessions — discussed below — is likely to be an ad hoc, arbitrary, non-transparent, and imprecise method of providing subsidies.

## **Tax concessions provided to NFPs**

Tax concessions on income and those on inputs have different implications. A key question is the extent to which tax concessions distort resource allocation or reduce competition by altering selective prices for certain market participants.

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The factors that affect resource allocation the most are likely to be those which provide a significant incentive to favour one input to production over another and result in a material distortion in resource allocation. Where this occurs, less efficient organisations may attract resources from more efficient organisations leading to lower levels of output (or quality) for the resources used.

Deloitte Touche Tohmatsu stated:

Some of the major benefits available to charitable institutions include a range of tax concessions and exemptions. The benefits include, but are not limited to, exemption from income, land and payroll taxes, exemption from local rates and stamp duties, GST concessions and significant Fringe Benefit Tax (FBT) concessions. Public Benevolent Institutions, which are charitable institutions that have a dominant purpose of providing benevolent relief, are entirely exempt from FBT, up to a specified capping threshold ... This generates a potential benefit to the organisation through reduced salary costs (as charitable organisations pursuing commercial activity systematically provide fringe benefits as part of remuneration packages) of an estimated range of \$9000–\$15 000 per employee. (attachment to ACL sub. 16, p. 5)

### **Income tax exemptions are unlikely to violate competitive neutrality**

Most NFPs are exempt from income tax. The Industry Commission in the *Charitable Organisations in Australia* report (IC 1995; box 8.2) concluded that such exemptions were unlikely to provide an unfair advantage to NFPs. Whether or not there is an income tax exemption, the output and pricing decisions to maximise a surplus (or profit) are the same. Thus the income tax exemption does not distort decisions such as how many people to employ, what price to charge and so forth, as long as tax is a fixed share of profit.

Put another way, the objective of a for-profit business is to maximise profit by either (or both) increasing revenue or cutting expenditure. For a given profit, the tax on the profit — income tax — does not affect the decision to maximise profit (although a sufficiently high income tax could make the business unviable). This applies similarly to income tax exempt NFPs, which seek to maximise their output for a given cost.

There is one potential hitch to this analysis, however: there is a different treatment in tax law of accounting profit (and profit as assessed by the Tax Office) to economic surplus. To the extent that for-profit organisations seek to minimise their accounting profit — that is, pay less tax — for a given level of economic surplus, there could potentially be a different allocation of resources by an NFP compared with a for-profit for an identical activity. The 1995 report posited that such effects would be insignificant. In view of more recent changes to accounting standards (including the adoption of International Financial Reporting Standards), which have

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as their aim to more closely align accounting and economic measures of surplus, it is likely that the differences have narrowed further.

**Box 8.2 Competitive neutrality findings from the Industry Commission's 1995 *Charities* report**

**Income Tax**

Income tax exemption does not compromise competitive neutrality between organisations. All organisations which, regardless of their taxation status, aim to maximise their surplus (profit), are unaffected in their business decisions by their tax or tax-exempt status.

**Input Tax**

Input tax exemptions affect resource allocation in two ways. They create distortions in the use of different inputs and they provide a competitive advantage for the commercial activities of [Community Social Welfare Organisations] CSWOs compared with for-profits.

Input tax exemptions are distortionary because they change the relative price of inputs. The exemption lowers the price of some inputs and present an incentive to CSWOs to favour the use of those inputs over other, relatively higher priced, inputs. Given that CSWOs are labour intensive — that is, they rely more on people to achieve their outcomes — the exemptions from taxes on labour (FBT and pay-roll tax), may create significant distortions, particularly for the larger organisations. This could affect efficiency because it may mean that CSWOs, because of the tax exemptions they receive, favour the use of tax exempt inputs over other, more efficient, mixes of inputs.

The size of the distortions created by input tax exemptions are currently unknown. As CSWOs are labour intensive, and are likely to be so regardless of tax treatment, the costs of the distortion may not be significant.

Input tax exemptions are also inefficient because they allow certain tax-exempt organisations to attract resources away from organisations that are not tax exempt. By lowering the costs faced by exempt organisations, less efficient organisations are able to survive — and perhaps even expand — often at the expense of firms that may be relatively more efficient but do not have access to the same competitive advantages.

*Source:* IC (1995).

In its submission, AccessPay (sub. DR237) stated that this analysis was flawed because it assumed that NFPs seek to maximise economic surplus and that other factors such as investment allowances could distort business decisions. While investment allowances and other tax incentives do affect business decisions — which is their aim — the analysis is based on how paying income tax or being exempt from income tax affects overall decision making.

In the *Word* case, the High Court affirmed the role of NFPs in making profits to support a charitable purpose

It is therefore necessary to reject the Commissioner's arguments so far as they submitted that *Word* had a 'commercial object of profit from the conduct of its business' which was 'an end in itself' and was not merely incidental or ancillary to

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Word's religious purposes. Word endeavoured to make a profit, but only in aid of its charitable purposes. To point to the goal of profit and isolate it as the relevant purpose is to create a false dichotomy between characterisation of an institution as commercial and characterisation of it as charitable. (Commissioner of Taxation v Word Investments [2008] HCA 55, p. 11)

Overall, income tax exemptions for NFPs are unlikely to significantly distort resource allocation, although they can obscure the quantum of subsidies provided to NFPs.

It is worth noting that the Australian tax treatment of NFPs is comparatively generous relative to other countries where activities above a certain scale are separately incorporated into for-profit businesses which are then subject to normal taxation treatment and distributions are made to the owner of the business — an NFP or charity (box 8.3).

### **Box 8.3 Business income — treatment in selected overseas jurisdictions**

In the United States, net income from 'unrelated business activities' is subject to the Unrelated Business Income Tax (UBIT) which effectively taxes such income at ordinary corporate (or trust) tax rates (although dividends, interest, rents and royalties are excluded from UBIT). The UBIT applies to commercial activities 'unrelated' to the organization's charitable purpose (Brody 2009).

In Canada, a business operation of a charity cannot be a purpose in its own right — it is subsidiary to the charitable purpose of the organisation. Unrelated businesses of a charity are to be in a separate and taxable corporation (Hunter 2009).

In England and Wales, unrelated businesses of a charity are also to be in a separate and taxable corporation. In addition:

The Charities Commission for England and Wales will not register a charity when its purpose is, or includes, the carrying out of trade. (Breen 2009, p. 7)

In Ireland, the Revenue Commissions can grant a concession from tax liability for fund-raising activities:

In respect of profits arising from small-scale activities which have been run to raise funds for charitable purposes only. (Breen 2009, p.13)

The Commercial Hospital Operators Australia submission provides more details on the arrangements for the treatment of business income in these countries and notes:

Further investigation conducted by CHOA indicates that eligibility for tax concessions in these jurisdictions requires charities to conduct activities which are *substantially* related to the organisation's charitable purpose and offer goods and services to a broad section of the public without financial/socio-economic restrictions. Activities outside of an organisation's charitable purpose must form only a *small or incidental part* of its operations. (sub. DR298, p. 4, emphasis in original)

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## **Input tax exemptions pose concerns for competitive neutrality**

There are a number of potential input tax exemptions provided to NFPs, including FBT, GST, payroll tax, stamp duty, land tax, and gambling and betting concessions. Input tax exemptions have the greatest potential for distorting resource allocation (box 8.2). If significant, input tax exemptions can provide the wrong incentives to NFPs by creating a substantial difference between the price paid for inputs and their cost to others in the market. Subsidising a sector through input tax exemptions is less transparent than providing direct grants or fees for service.

For Commonwealth exemptions, the size of the FBT concession is relatively large at more than \$1 billion in 2008-09 (chapter 7).<sup>2</sup> FBT concessions are also likely to be particularly distortionary where NFPs operate in competition with for-profit companies. However, apart from hospitals and aged care, data on the proportion of public benevolent institutions (PBIs) in competition with the for-profit sector are sparse.

Hospitals are unusual in that state and territory public hospitals are also granted PBI status. The estimated tax expenditure for public and NFP private hospitals of the FBT concession in 2008-09 was \$260 million. For non-hospital PBIs, including NFP aged-care providers, the estimated tax expenditure in 2008-09 was \$670 million (Australian Government 2009e). These tax expenditures exclude uncapped allowances for meal entertainment which could add as much as 50 per cent to tax expenditures and are likely to grow as the tax advantages of these allowances are being marketed more aggressively by salary providers (see section 8.3 and box 8.7).

Given the size of the FBT tax concession, and the fact that it has been the subject of concern from some participants, it is discussed in more detail below.

Submissions suggest that concerns about competitive neutrality are most acute in hospitals, but the concerns expressed may to varying degrees apply to industries such as aged care and employment services where the NFP and for-profit sectors compete (for example, for government contracts) and where NFP employees can access FBT concessions. The hospital sector provides a particularly interesting case study as there are three categories: public, NFP private and for-profit private hospitals<sup>3</sup>.

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<sup>2</sup> FBT exemptions are provided to PBIs, a subset of charitable and religious organisations. A less attractive concession — the FBT rebate — is provided to charitable and religious organisations that are not PBIs.

<sup>3</sup> There are also 21 NFP public hospitals — all under Catholic Health Australia (sub. DR198).

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State and territory governments provide a range of input tax concessions to some NFPs. From available estimates, it is gambling and payroll tax concessions that dominate in terms of the size of concessions and the associated potential distortions.

The tax expenditure relating to the gambling tax concession for 2008-09 is estimated to be \$518 million in New South Wales or a total of \$724 million for the four jurisdictions where there are concessional rates for NFPs. Gambling tax concessions are particularly relevant for mutual organisations such as registered clubs and those that receive concessions under division 50 of the ITAA (see section 8.4).

The tax expenditure of the payroll tax concession for 2008-09 is estimated to be \$386 million in Victoria, \$194 million in New South Wales, \$155 million in Queensland and \$31 million for South Australia — a total of \$766 million for the four jurisdictions that provided estimates (appendix E).

State and territory governments have agreed to harmonise the tax base and administrative arrangements of their payroll tax regimes (State and Territory Treasurers 2007). Payroll tax harmonisation is being progressively rolled out, with NSW and Victoria harmonising their payroll tax legislative and administrative arrangements from 1 July 2007 (OSR 2007).

However, harmonisation while reducing compliance costs for some NFPs — does not address the competitive neutrality concerns of payroll tax exemptions. For example, Deloitte Touche Tohmatsu estimated that its client, ACL (which provides accredited language, literacy and numeracy programs for adults of non-English speaking background) faced a large competitive disadvantage due to payroll tax and FBT exemptions. It found that the FBT concession provided the NFP competitors with a pricing advantage of between \$2 and \$3.3 million while the payroll tax concessions gave an advantage of around \$750 000. Deloitte Touche Tohmatsu stated:

The ACL consortium currently services the western Sydney and south western Sydney regions, a contract value of \$34.94 million. In a hypothetical re-tendering of the contract where ACL was competing with a charitable provider, that provider would *enjoy a comparative pricing advantage over ACL of between \$3.6 — \$4.95 million. Extrapolated more widely, the advantage for the NSW AMEP [Adult Migrant English Program] program would be in the range of \$7.3 — \$9.9 million and for the entire national program \$18.5 million — \$25.2 million per annum.* (attachment to sub. 16, p. 6 emphasis in original)

The principal difference between the effect of the FBT and payroll tax exemptions — aside from the magnitude of the concessions — is the incidence. Unlike the payroll tax exemption, where the eligible NFP is the direct beneficiary, the FBT

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concessions are a benefit provided directly to employees who vary in their ability to fully use the benefit provided. In other words, the size of the tax expenditure provided by the FBT concession varies according to its usage by employees. This benefits the NFP indirectly, by allowing it to employ staff at below market salaries (although there are exceptions such as nurses in hospitals as discussed below). For many NFPs operating outside the market sector this concession helps them to attract and retain staff even when they have insufficient revenue to pay full market salaries.

There are undoubtedly better ways than the FBT exemption to deliver government support. But the current system is well entrenched so any change needs very careful consideration and an appropriate transition period. This is consistent with the recommendation of the Industry Commission's *Charities* report to remove the FBT exemption from PBIs after a two-year phase out period (IC 1995).

The Australian Government has previously recognised the competitive neutrality issue in the aged care sector by providing a payroll tax supplement to commercial aged care providers (box 8.4).

#### **Box 8.4 Aged — – payroll tax supplement**

Section 44-16 of the *Aged Care Act 1997* enables additional supplements to be provided. The Aged Care (Payroll Tax Supplement) Determination 2001 provides a payroll tax supplement to aged care providers who care for high dependency residents and who are liable for state-based payroll tax (that is, commercial aged care providers as NFP aged care providers are exempt from payroll tax when they have PBI status).

This was noted in a 2003 report by the Allen Consulting Group:

While for profit providers are not eligible for payroll tax exemption, they are generally eligible to receive a Payroll Tax Supplement from the Commonwealth to compensate for their payroll tax liability. (p. 3)

The cleanest option would be to remove the tax concessions from those who receive them, but this is unlikely to be practicable given the Commonwealth's recent reaffirmation of the tax status of NFP organisations. The alternative is to compensate for the different tax treatment of providers through the aged care funding arrangements. This is currently done for payroll tax and would be in line with the Productivity Commission's principle that private providers should be supplemented to offset differential taxes levied on their inputs, provided the amounts involved are significant enough. (p. 10)

The existing Payroll Tax Supplement arrangements for residential aged care have not, to our knowledge, been replicated in other sectors or other parts of the health sector. Special GST arrangements also exist for residential aged care. (p. 10)

The Supplement is designed to offset the varying payroll tax treatment of different types of providers and is available to for-profit providers who incur a direct payroll tax liability and NFP and for-profit providers who incur an 'indirect' payroll tax liability. (p. 43)

Source: AGC (2003).

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## **There are valid concerns in regard to the implications of removing tax concessions**

A number of submissions outlined the reliance of NFPs on tax concessions as a form of government assistance (box 8.5). While a move to more direct and transparent grants would be more efficient than the input tax concessions, and show the full extent of government and taxpayer support of NFPs, it would be unfortunate if such grants were used to impose bureaucratic controls over NFPs as noted by Epworth Health Care (sub. DR195).

### **Box 8.5 The importance of tax concessions to NFPs**

#### **BoysTown:**

The removal of input tax concessions such as Fringe Benefits exemptions to staff of PBIs and Deductible Gift Recipient (DGR) organisations and exemption from payroll tax would threaten the viability and sustainability of most not for profit agencies and would increase social disadvantage in the community. (sub. DR251, p. 8)

#### **Catholic Health Australia:**

The result [of removal of tax concessions] in time is that civil society organisations would be indistinguishable from for profit organisations. Such an outcome would be detrimental to the development of social capital. (sub. DR198, p. 9)

[The removal of tax concessions] would have a devastating effect on the aged care sector. (sub. DR198, p. 15)

#### **Selected operators of not for profit private hospitals:**

For some of us, hospital operations would move from being viable to unviable if payroll tax concessions were removed. Margins are mostly slim in private not for profit hospitals, and many not for profit hospital operators already struggle to maintain operational viability whilst at the same time pursuing the constant demand for capital reinvestment that consumers require. (sub. DR209, pp. 3-4)

#### **Family Panning NSW:**

Reviewing these arrangements without providing substantial increases in funding to allow for wage parity would have a significant negative impact on the ability of NFPs to attract and retain skilled and qualified staff. (sub. DR230, p. 1)

#### **Australian Council for International Development:**

Without the FBT exemption the international development sector alone would need to make up a shortfall of over \$14 million for wages ... the Commission neglects that the aid and development sector is not a service provider on behalf of governments. Full funding by government would not help this sector and yet removal of the FBT exemption would crush it. Government would allow the gutting of a sector that the Australian public directly supports to the tune of a billion dollars per year. (sub. DR299, p. 2)

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## Government purchasing can also affect competitive neutrality

Government purchasing<sup>4</sup> behaviour can also affect competitive neutrality between for-profit organisations and NFPs. The Commonwealth's Procurement Guidelines, issued by the Minister for Finance and Deregulation under the *Financial Management and Accountability Regulations 1997*, give detailed advice to Commonwealth agencies on how they should implement the value for money principle. In particular, the guidelines outline that:

Value for money is the core principle underpinning Australian Government procurement. In a procurement process this principle requires a comparative analysis of all relevant costs and benefits of each proposal throughout the whole procurement cycle (whole-of-life costing).

Value for money is enhanced in government procurement by:

- a. encouraging competition by ensuring non-discrimination in procurement and using competitive procurement processes
- b. promoting the use of resources in an efficient, effective and ethical manner
- c. making decisions in an accountable and transparent manner. (Australian Government 2008, p. 10)

Advice received from the Department of Finance and Deregulation indicates that the guidelines do not require (nor prohibit) decision makers to account for tax expenditures provided to NFPs in their assessment of value for money (DFD pers. comm., 18 December 2009).

Deloitte Touche Tohmatsu argues:

The award of commercial contracts to organisations which are in effect themselves partially government funded represents a clear abrogation of the broader equitable principles behind competitive neutrality, which disadvantages private sector providers and unfairly distorts otherwise efficient markets ... these exemptions and benefits *represent a hidden cost to government above that of the tender cost*, which should be accounted for in a fair and transparent value for money evaluation. (attachment to sub. 16, p. 4) [emphasis in original]

By contrast, the Royal Flying Doctor Service (RFDS) stated:

The RFDS submits that any adjustment for these taxes would unnecessarily complicate the assessment process and would also introduce a separate layer of distortions. (sub. DR244, part 2, p. 5)

There is merit in Deloitte's argument, as the real cost to government of contracting a service includes both direct outlays (payments and directly related subsidies) and

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<sup>4</sup> This section is only concerned with government procurement.

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foregone tax revenue. In chapter 12, the Commission recommends that all significant benefits and costs associated with service provision be considered in the application of current procurement guidelines. The inclusion of the directly related tax concessions would be consistent with this recommendation. However, including a tax expenditure assessment in the procurement guidelines could significantly complicate the assessment process. In addition, it would be redundant if tax concessions provided to NFPs competing with the private sector were scaled back or withdrawn, or if the commercial operations of NFPs were separately constituted into tax paying companies. Given these issues, a thorough analysis of the costs and benefits of including tax concessions, to both NFPs and for-profit organisations<sup>5</sup>, in value for money assessments should be undertaken. This would be informed by the outcomes of the Henry review into Australia's future taxation system.

RECOMMENDATION 8.1

*The Departments of the Treasury and Finance and Deregulation should jointly conduct a review into the feasibility, the costs and the benefits of requiring value for money assessments for government procurement to consider significant input tax concessions. Such a review should be wide-ranging, including the not-for-profit and for-profit sectors.*

### 8.3 Fringe benefit tax concessions — hospitals

Competitive neutrality concerns are most evident in the hospital sector and to a lesser extent in the aged care sector. As mentioned, the hospital sector is unusual as concessions are also granted to public hospitals. The principal concern relates to the FBT concession.

The 1998 Tax Reform package changed the fringe benefit tax concessions for PBIs:

... stopping overuse of the concessional FBT treatment of public benevolent institutions and certain other not-for-profit organisations. This will be done by limiting, for each employee, the value of fringe benefits eligible for concessional treatment to \$17 000 of grossed-up taxable value per employee of such organisations (equivalent, in broad terms, to the grossed-up value of an average 6 cylinder car and some additional minor benefits). Any amount above this limit will be subject to the normal FBT treatment. (Australian Government 1998, p. 50)

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<sup>5</sup> For-profit organisations receive a variety of tax concessions such as accelerated depreciation and a 175 per cent premium tax concession for additional research and development.

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However, the legislation was amended before its passage so that exemptions for meal entertainment did not fall under the relevant FBT cap:

Benefits which constitute the provision of meal entertainment, that would be a car parking fringe benefit, or are attributable to entertainment facility leasing expenses, will retain their exemption from FBT for PBIs. These types of benefits are not included in the calculation of the 'aggregate non-exempt amount' because the additional compliance costs outweigh the equity considerations in allocating the taxable value of these benefits to individual employees.<sup>6</sup>

Since April 2000, the *Fringe Benefits Tax Assessment Act 1986* has allowed public and NFP hospitals which are classed as PBIs to extend FBT exemptions to the grossed up value of \$17 000 per annum to each employee<sup>7</sup>. The Act was amended in 2003 to allow public hospitals to provide this benefit to each employee. The relevant cap for non-hospital PBIs is \$30 000.

This has resulted in significant disparities between what can be paid — in after tax (net) terms — to hospital and aged care employees depending on the employer.

Evidence provided to the Commission indicates that the uniform nature of registered nurses' salaries leads to hospitals providing the same *gross* salary, with nurses receiving different *net* salaries (CHOA pers. comm., 10 August 2009).<sup>8</sup> This could lead to several levels of net salaries for nurses, ranging from nurses working in for-profit hospitals and for-profit aged care (with no FBT exemption), to those working in NFP hospitals (with an FBT exemption up to \$17 000), to those working in some non-hospital PBIs (with an FBT exemption up to \$30 000).

For PBI hospitals, with labour being relatively less expensive, there is a greater incentive to purchase more labour at the expense of capital (PC 2009c).

The FBT exemption is also inequitable as those employees with eligible expenditures in the \$17 000 cap will benefit commensurately more than other employees. KPMG outlined some reasons for the different take up of the FBT concession:

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<sup>6</sup> Explanatory Memorandum to A New Tax System (Fringe Benefits) Bill 2000.

<sup>7</sup> Employees, such as doctors, who work at two or more hospitals enjoy a multiple of the base FBT exemption. Evidence presented to the Commission suggests that a significant proportion of doctors receives an effective \$34 000 cap for benefits other than the meal entertainment benefit.

<sup>8</sup> Assuming a gross salary of \$60 000 per annum and no additional allowable deduction, a nurse employed by a for-profit hospital would pay tax of \$12 900 and receive a net salary of \$47 100. The same nurse in an NFP hospital would pay tax of \$10 035 and receive a net salary of \$49 965 — a 6 per cent increase in disposable income. The equivalent gross salary of a for-profit nurse would be \$64 190.

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Salary packaging is not appropriate for all staff, e.g. staff that are not full-time employees or have variable hours

Some new employees take time to understand the benefit of salary packaging

Some staff are not motivated by the additional savings

Some staff are concerned that including fringe benefits in their Reportable Fringe Benefit Amount (“RFBA”) will increase their HECS debt repayments, childcare payments etc. because the RFBA will generally be higher than the salary sacrifice made for such fringe benefits. (KPMG attachment to sub. DR198, p. 8).

The meal entertainment benefit is particularly inequitable, with greater benefits flowing to employees with higher salaries, and those who have greater financial freedom to spend their salaries on eligible items. Similarly, those employees with large one-off entertainment expenses benefit relatively more in that year. The variation in the use of the FBT benefit was noted by the Health Services Union (NSW Branch):

Anecdotal evidence suggests that there is wide variation in the uptake of *benefits* between different facilities and between professions/award classifications. (sub. DR214, p. 4)

In other words, the use of the benefit is essentially arbitrary, applying differently to people with the same income and the same job, and benefiting those who know about the concession (or are better placed to use it) compared to those who do not.

Overall, it seems likely that for-profit hospitals face a significant competitive disadvantage compared with both NFP hospitals and public hospitals (box 8.6) because of the FBT concession provided to NFP and public hospitals.

Some submissions also noted that the \$17 000 cap (and \$30 000 for non-hospital PBIs) to the FBT concession had not been indexed since its introduction in 2000. Catholic Health Australia argued that the cap should be increased from \$17 000 to \$40 000 per annum (sub. DR198).<sup>9</sup>

As the FBT concessions produce a number of significant distortions, affecting resource allocation and changing employee behaviour, the Commission concludes that there is no compelling reason to increase the cap. Indeed, it would be preferable to phase out the concessions. As discussed, the Commission recognises that this could impose hardship and would need an appropriate phasing out period and a means of providing intended support to those NFPs not competing in the market.

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<sup>9</sup> This is substantially more than needed to offset the effects of inflation. From June 2000 to June 2009, the CPI has increased 32.3 per cent implying that an indexed cap would be \$22 500 not \$40 000.

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### **Box 8.6 Estimated competitive disadvantage**

In its submission, the Commercial Hospital Operators Australia (CHOA) stated:

Across the CHOA membership, FBT amounts to over \$4.7 million pa in total. To put this into perspective, if commercial hospital operators were to offer the same FBT concessions to their nursing staff only as do the not-for-profit providers this would add another \$75 million to the cost line (@ \$2900 per nurse) and \$45.4 million for CHOA members alone. Put another way, the not-for-profit sector have a combined cost advantage of \$43 million pa over the commercial sector just in nurses alone.

Outside of FBT, current payroll provisions and differential application across private and the not-for-profit and public hospitals see CHOA members pay on average \$55.4 million pa, exacerbating an already tight financial position and uneven playing field for commercial operators. The not-for-profit sector enjoys a total tax advantage of around \$231 million each year as a result of payroll and land tax.

Combined, the industry advantage on the basis of tax and inefficiency of the public and not-for-profit hospital providers equates to around \$563 million each year. (sub. 171, pp. 6-7)

### **Meal entertainment benefit**

The meal entertainment exemption for public and NFP hospitals was originally introduced because of the difficulty of accounting for the provision of meals to hospital employees when most hospitals had a subsidised staff canteen. However, in recent years it appears that the use of these concessions has grown much wider than the original intent. The salary packaging providers are actively promoting the use of meal entertainment cards for dining and holidays – domestic and overseas (box 8.7).

While the meal entertainment benefit is limited only by the salary of the employee, a number of organisations impose a de facto limit on their employees' use of the benefit. In its submission, AccessPay stated:

Our advice has constantly been that whilst the benefit items themselves are legislatively uncapped, that a responsible approach from the employer, employee and social perspective is to have a cap on the value of the benefits to be provided. (sub. DR237, p. 10)

Catholic Health Australia (sub. DR198) proposed a cap of \$5000 per annum on the use of the meal entertainment benefit. This is no doubt an issue the Review into Australia's Future Tax System (RAFTS) may have examined. There appears to be a strong case to limit or eliminate the meal entertainment benefit.

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### Box 8.7 Examples of meal entertainment packaging benefits

Peter, a doctor in an NFP hospital, organises dinner with 10 of his friends. The bill comes to \$200 each, or \$2200. Peter pays the bill with his PBI credit card and collects \$2000 from his friends. Peter has a salary of \$250 000. This transaction reduces his after-tax income by \$1023. Since he has received \$2000 from his friends, Peter has enjoyed a free dinner with his friends and increased his after-tax income by \$823.<sup>10</sup>

Jane, a PBI employee, decides to package her \$40 000 wedding. Jane has a \$90 000 salary. By packaging the wedding, Jane reduces her tax payable from \$23 000 to \$9050. Effectively the taxpayer has contributed \$13 950 to Jane's wedding.

#### Marketing information from Salary Options:

John and Mary book a holiday in Europe which includes two weeks in London and Paris and a cruise down the Seine for a week. Under the new arrangements, they can package as exempt items: (a) meals while on holiday in a sit down restaurant, café or bar, including the meals on the cruise if they can be separately identified; ... and (b) accommodation costs in London and Paris. (2009, p. 1)

#### Marketing information from the McMillan Shakespeare *Meal Entertainment Payment Card* Brochure:

Did you realise you can pay for your dining-out expenses (excluding take-away) through salary packaging? This means you can pay for meal expenses, including drinks and taxi fares to and from your dining venue, from your pre-tax salary and experience tax savings each pay! (subject to your employer's Meal Entertainment Policy)

Did you also realise that you can salary package the catering for your special occasions, such as weddings, engagements or birthday parties?

And these expenses can be salary packaged over and above your capping limit that applies to Fringe Benefit Tax (FBT) benefit items such as mortgage repayments. (2009, p. 2)

#### Marketing information from EPAC Salary Solutions:

The EPAC meal entertainment card provides instant access to your meal entertainment funds. This is the most efficient way for employees of a Public Benevolent Institution or Hospital to package tax free the purchase of food and drink. The meal entertainment benefit is not included in your Fringe Benefit Tax thresholds, that is, it is an additional benefit. (EPAC 2009)

## Implications for competitive neutrality in the hospital sector

NFP hospitals operate in the market sector, in full competition with for-profit hospitals. NFP hospitals can afford to offer, and do offer, market-based salaries.

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<sup>10</sup> While there is uncertainty with respect to the legality of Peter's arrangement, anecdotal evidence suggests that the practice is relatively common. It would be very difficult for the ATO to police this activity — as such the legality has never been tested in Court.

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Although some submissions (for example, Health Services Union (NSW Branch), sub. DR214) argued that the FBT concession assists in recruiting staff to regional and remote locations, its application is general, providing the same benefit to employees of NFP (or public) hospitals working in cities as those working in regional areas.

The implication of the FBT distortion, where the direct beneficiary is the employee, is that nurses will tend to migrate to NFP and public hospitals. This is particularly problematic for for-profit hospitals in the context of a relatively tight labour market for health workers. If the use and awareness of salary packaging benefits becomes more widespread, there is likely to be increasing pressure on for-profit hospitals to match the net salaries paid by their NFP competitors. While the declining real value of the \$17 000 FBT cap will reduce this pressure, it will be counteracted by any increased use of the meal entertainment benefit.

The NFP hospital submissions highlighted the *motivation* of the NFP hospital provider — public benevolence — as against a for-profit hospital's profit maximisation as a justification for differential treatment (see for example Selected operators of not-for-profit private hospitals (sub. DR209) and Catholic Health Australia (sub. DR198)). However, in practice there appears little to distinguish the operations of a for-profit private hospital from most NFP private hospitals. Private hospitals — for-profit and NFP — treat much the same patients, receive much the same fees and provide much the same services. Both also provide *pro-bono* services to those in need.

Given the distortions, the significant transactions costs associated with salary packaging, and the lack of a clear public benefit justification, the FBT concession does not appear to be very effective, efficient or equitable. In the case of public hospitals, it also provides a non-transparent Commonwealth subsidy to state and territory public hospitals. In one instance — NSW public hospitals — the benefit of the FBT concession is shared 50/50 between the employer and the employee (box 8.8), effectively increasing the size of the Commonwealth subsidy to New South Wales Government.

Should the Government decide to make changes to these concessional benefits, in light of the RAFTS there would need to be a significant transitional period and appropriate phasing arrangements to reduce any sudden shocks or impacts. Catholic Health Australia provided advice that some employment contracts may have

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guaranteed the FBT benefit and argues that the employer might be required to fund the difference should the benefit be withdrawn (sub. DR198, attach A).<sup>11</sup>

### **Box 8.8 New South Wales public hospital Award**

The New South Wales Government appears to be alone in requiring its public hospital employees to share the benefit of the FBT concession 50/50 with the government. The Health Services Union (NSW Branch) advised that its members were offered an agreement on a take it or leave it basis — that is, either no salary packaging or a 50 per cent share.

The sharing by the employer of a benefit under Commonwealth tax law appears unorthodox and outside the intention of the FBT tax concession.

Section 45(iv) of the Health Employees' Conditions of Employment (State) Award provides:

The employer's share of savings, the combined administration cost, and the value of the package benefits, are deducted from pre-tax dollars.

The NSW Health *Salary Packaging Policy and Procedure Manual* provides further details on the items that may be packaged.

This tax saving, together with the annual administration fee charged to individual participants for administering their salary packaging arrangements, is shared on a 50/50 basis between employees and NSW Health. (p. 3)

On 4 October 2007, the Department of Health approved of 'meal entertainment' being introduced as a new salary packaging benefit on the basis that this benefit and any future benefit made available for salary packaging, will be strictly on the basis of 50/50 sharing of the income tax saving between employee and employer. (p. 3).

Meal entertainment is defined as 'the provision of entertainment by way of food and drink'. It includes food and drink purchased at a restaurant or attendance at a social gathering or consumed with other forms of entertainment. The meals and drinks (including those of guests with the eligible employee) do not have to be related to employment with NSW Health. (p. 16)

Accommodation or travel 'in connection with, or for the purpose of facilitating' meal entertainment eg. taxi charges, overnight stay in the city to attend the function etc, are an allowable part of this benefit.

Invoices/receipts must identify the restaurant/café/function centre/caterer. Health Services need to be satisfied that the employee paid the account. A simple receipt without any details is not proof of meal entertainment.

*Source:* Industrial Relations Commission of New South Wales (2008).

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<sup>11</sup> This argument is questionable, as it is generally the practice that changes in tax arrangements decided by government do not automatically lead to a contractual requirement for compensation by the employer.

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In its submission, Commercial Hospital Operators Australia provided some options involving a sliding scale of tax concessions depending on the extent to which an NFP private hospital is in competition with commercial hospitals. It also advocated that a transitional period not be available to new acquisitions by NFP hospitals (sub. DR298, policy options paper).

## **8.4 Clubs and mutuality**

Clubs are NFPs that provide services to their members. The essence of a club is that it has a set of aims or objectives — social, sporting, religious or cultural — and that its principal aim is to enhance the wellbeing of its members. Many clubs also distribute some of their surplus to charitable purposes as a subsidiary objective.

To join a club, a prospective member must be nominated and seconded by current members. Some clubs have even more restrictive joining rules (such as being of a particular age, gender or ethnicity). Clubs Australia (2009) estimates that there are around 4500 clubs in Australia, of which around half are in NSW.

Clubs benefit from a number of tax concessions, principally income tax and gambling tax concessions. In New South Wales alone, the estimated tax expenditure for gambling was \$518 million in 2008-09 (appendix E). There appear to be two potential competitive neutrality issues relating to clubs:

- Clubs have a competitive advantage over hotels and other entertainment venues providing gaming facilities because of the different tax treatment.
- Clubs have a competitive advantage when they embark on other commercial activities (for example, shopping centres and childcare) because they can generate significant surpluses, aided by tax concessions, and have no need to distribute dividends to shareholders. This gives clubs a competitive advantage in raising the capital needed for commercial developments, including new and better premises.

### **Income tax concessions**

Income tax concessions are provided through either the principle of mutuality (box 8.9) or, for certain clubs, division 50 of the ITAA.<sup>12</sup>

All clubs are mutual organisations and receive the benefit of mutuality; that is, income received from transactions with their members is tax exempt. However,

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<sup>12</sup> Presently the income tax exemption provided to organisations under division 50 of the ITAA is self-assessed.

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income received from non-members and from non-mutual activities (such as interest on investments) is subject to income tax.

By contrast, some clubs which are eligible under division 50 of the ITAA, such as sporting clubs, receive a tax exemption for all income, irrespective of whether their activities are mutual or non-mutual.

### **Box 8.9 The principle of mutuality**

The mutuality principle derives from common law and is not a provision in tax law, although this was a recommendation of the 1999 Review of Business Taxation.

The effect of the principle is that gains of organisations from some of their dealings with their members are not income for the purposes of income tax law. Under the common law exception, where a group of people contribute to a common fund created and controlled by them for a common purpose, any surplus created in the fund is not considered income for tax purposes.

In 2004, the Full Federal Court (*Coleambally Irrigation Mutual Co-operative Ltd v Commissioner of Taxation* [2004] FCAC 250) held that the mutuality principle did not apply to a fund created to meet future expenses of the Coleambally Irrigation Mutual Co-operative Ltd. The Court ruled in this way because Coleambally rules prohibited the return of any surplus property to members in the event of a winding up of the cooperative. Coleambally rules were similar to those of other NFP mutuals, which provided that surplus funds on winding up would be provided to an organisation with similar aims and objectives — this has been traditionally an essential condition for an organisation to be classified as a not-for-profit.

The Parliament restored the mutuality principle to its intended effect before the Coleambally decision with the *Tax Laws Amendment (2005 Measures No. 6) Act 2006*.

The ATO provides a formula to assist in the calculation of the proportion of a club's trading surplus attributable to members and non-members. In principle, the proportion of a club's surplus from members is tax free while that due to non-members (guests) is subject to tax.

While members collectively 'own' the club, and the benefits derived by members from club services can be seen as a return on their share in the club, ownership of club assets carries a lower level of property rights compared with a shareholding in a for-profit company. Shares in a company can be sold, while a club member who resigns loses all property rights in the assets of the club, without being able to sell his or her share in the club's assets.

*Sources:* Australian Government (1999); PC (1999a).

The main exemptions for clubs under division 50 are those specified under section 50-45 of the ITAA specifically:

A society, association or club established for the encouragement of: (a) animal racing; or (b) art; or (c) a game or sport; or (d) literature; or (e) music.

Because clubs are unable to distribute their surplus to owners (members) through dividends, accumulated surpluses are used in a variety of ways. Clubs could use surpluses to reduce membership charges or lower the prices charged for services to their members, make donations to charities or for other community purposes, or to purchase new assets or enhance existing assets. Many clubs do a combination of all of these.

## State and territory gambling tax concessions

In addition to income tax concessions, clubs receive significant gambling tax concessions from state and territory governments. Taking NSW as an example, which accounts for around 50 per cent of gaming machine expenditure,<sup>13</sup> the NSW government tax rate on gaming machines in clubs (table 8.1) is much lower than the tax rate on gaming machines in hotels (table 8.2).

**Table 8.1 New South Wales — tax rates on gaming machines in clubs**

<i>Annual Revenue</i>	<i>≤\$200 000</i>	<i>\$200 000 to \$1 million</i>	<i>\$1 million to \$5 million<sup>a</sup></i>	<i>\$5 million to \$10 million</i>	<i>&gt;\$10 million</i>
Rates from 1 September					
2004	0.0	10.8	18.3	19.7	20.4
2005	0.0	10.7	19.4	22.3	23.7
2006	0.0	10.5	20.5	24.8	26.9
2007	0.0	10.4	21.6	27.4	30.2
2008	0.0	10.3	22.8	29.9	33.5
2009	0.0	10.1	23.9	32.5	36.7
2010	0.0	10.0	25.0	35.0	40.0

<sup>a</sup> For gaming revenue higher than \$1 million, rates shown are before the 1.5 percentage point Community Development and Support rate reductions. Under the CDSE, the top marginal duty rate for clubs is reduced by 1.5 percentage points if clubs contribute 1.5 per cent of gaming revenues in excess of \$1 million to eligible community projects.

Source: Australasian Gaming Council (2008-09).

<sup>13</sup> Gaming machine expenditure in 2006-07 was \$10.6 billion in Australia and \$5.2 billion in NSW (Queensland Government Treasury 2009).

**Table 8.2 New South Wales — tax rates on gaming machines in hotels**

<i>Annual Revenue</i>	<i>≤ \$25 000</i>	<i>\$25 001 to \$200 000</i>	<i>\$200 001 to \$400 000</i>	<i>\$400 001 to \$1 million</i>	<i>&gt; \$1 million to \$5 million</i>	<i>&gt; \$5 million</i>
Per cent of gaming income						
2005	5.7	15.7	18.5	27.1	32.1	36.4
2006	5.5	15.5	19.8	27.7	32.7	39.1
2007	5.4	15.4	21.1	28.2	33.2	41.8
2008	5.3	15.3	22.4	28.8	33.8	44.5
2009	5.1	15.1	23.7	29.4	34.4	47.3
2010	5.0	15.0	25.0	30.0	35.0	50.0

Source: Australasian Gaming Council (2008-09).

### Trends in the industry

Clubs Australia (2009) noted the consolidation of clubs since 1999, with the formation of club ‘groups’ by amalgamation brought about by the deterioration in the financial position of smaller clubs.

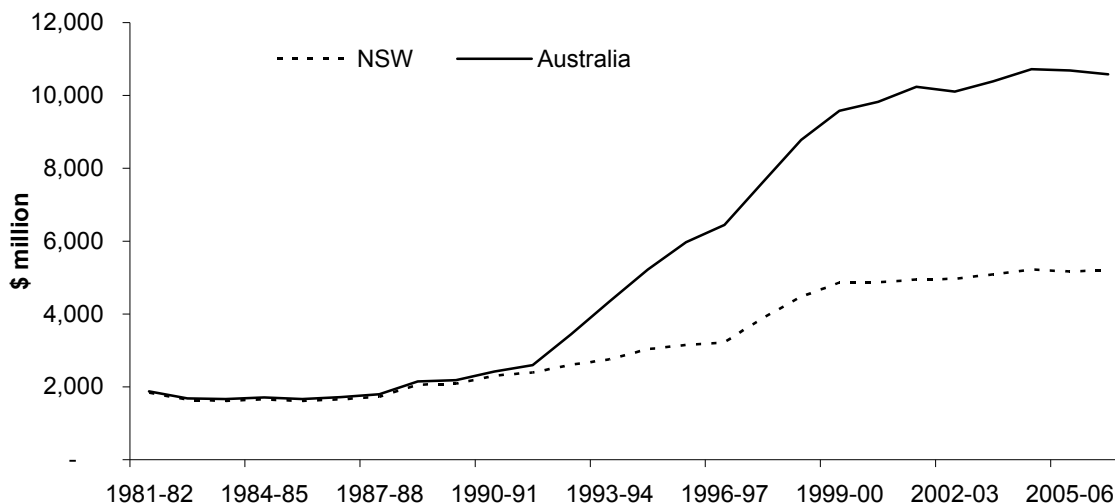
This evidence is supported by the ABS survey *Clubs, pubs, taverns and bars* (ABS 2006b). The survey<sup>14</sup> includes only hospitality clubs, excluding some very large sporting clubs. The survey found there were 2116 hospitality clubs operating in Australia at the end of June 2005. Of these, 1044 operated in NSW (50 per cent). Within this group of hospitality clubs, most have gaming facilities. Nationally, 85 per cent of hospitality clubs had gambling facilities; although in NSW only 56 per cent of such clubs had gambling facilities.

In 2004-05, the total income of hospitality clubs with gambling facilities was \$7103 million. Gambling income accounted for 60.9 per cent of the total income for these organisations. Nearly all the gambling income was generated by gaming machines, with the remainder of gambling income received as commissions for the provision of Keno and TAB facilities (figure 8.1).

<sup>14</sup> The most recent survey covers 2004-05.

**Figure 8.1 Gaming machines income — NSW and Australia (clubs and hotels)**

Real (CPI) — 2006-07 dollars



Data source: Queensland Government Treasury (2009).

By comparison, pubs, taverns and bars with gambling facilities recorded total revenue in 2004-05 of \$9565 million, with around 57 per cent of such premises having gaming machines. Gambling income accounted for 28 per cent of the total income for these organisations.

As the majority of their income derives from gaming machines, the rapid growth of some clubs appears to be driven by the growth of gaming revenue and the NFP nature of clubs. Their profits are much larger than clubs without gambling facilities. In 2004-05, for example, the operating profit of clubs was \$5.5 million for around 300 clubs — an average operating profit per club without gambling facilities of \$18 333. By contrast, the operating profit for clubs with gambling facilities was around 18 times higher, averaging \$334 361 per club (ABS 2006b).

Concern has been expressed to the Commission that some very large clubs are expanding — or planning to expand — into areas where they will provide goods and services to non-members, competing against the for-profit sector in these areas.

The growth of club business to provide commercial goods and services to non-members could raise competitive neutrality issues. There may be a reasonable rationale for continuing a tax exemption for income from member services. However, there is no particular reason to consider that this should be extended to non-mutual income where clubs are operating in full competition with for-profit

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companies providing similar goods and services and which are beyond traditional club activities.

Mutuality, by itself, is insufficient to provoke competitive neutrality concerns. But, in conjunction with the substantial tax concessions applied to a growing and dominant revenue source, mutuality gives clubs a significant competitive advantage. The competitive benefit of clubs is magnified when they are eligible for additional tax relief through division 50 of the ITAA.

### **The public benefit test**

Clubs Australia makes a strong case about the support that clubs provide to the community in general (box 8.10).

In particular, when comparing clubs to hotels, Clubs Australia stated:

Because of their for-profit nature, hotels do not return the same social dividends as clubs. While clubs' income is returned to their members and the community in the form of services, facilities and charitable support, hotels exist to create profits for their owners. In contrast, none of clubs' surplus or excess revenue is able to be accrued privately – dividends are not paid to individuals and the money stays with the club and is used for the benefit of its members and the community. (2009, p. 55)

There are numerous examples of community support by clubs. For example, in NSW, clubs with gaming machine revenue over \$1 million are required to allocate 1.5 per cent of that revenue to community groups and charities under the Community Development and Support Expenditure (CDSE) scheme.<sup>15</sup> Under this scheme, NSW clubs allocated \$62.6 million in 2008, which was \$26.6 million more than required under the CDSE (sub. DR272).

The Commission acknowledges that clubs have provided significant support to the community in general. The Independent Pricing and Regulatory Tribunal estimated that NSW clubs provided a direct cash contribution of \$91 million (IPART 2008). This is around 17.5 per cent of the estimated tax expenditure of the gaming concessions.

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<sup>15</sup> If NSW clubs do not allocate the 1.5 per cent according to CDSE guidelines, they must pay the balance in additional gambling tax.

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### Box 8.10 Submission by Clubs Australia

In its submission of November 2009, Clubs Australia (sub. DR272) made a number of arguments in support of the present tax arrangements.

Club funding to the community is unburdened by the complex reportage and accountability frameworks that Government employ in the granting of funds, leaving club funding more accessible and flexible in comparison. (p. 2)

Importantly, clubs' funding is also not exposed to the volatility of an electoral cycle and the shifting priorities of political parties in their pursuit of electoral approval. So unlike Government, clubs are more likely to allocate funds over a greater time frame to the causes and facilities they have been established to support. (p. 2)

If the current taxation regime for clubs were to be altered as suggested it would be highly detrimental to not only clubs and the way they serve the community, but also the wider NFP sector that would cease to benefit from the integral in-kind and financial support clubs provide. (p. 3)

If economic principles had to be strictly followed in all facets of modern business practice, registered clubs throughout Australia would be in breach of competitive neutrality principles ... the differing treatment of clubs is justified on cost-benefit analysis. (p. 3)

The industry employs approximately 43,000 NSW residents, generates \$1.3 billion per annum in direct wages which flow into the NSW economy and undertakes capital investment of approximately \$858 million per annum. (p. 11)

... clubs conservatively contribute to the community nearly double the value of the gaming tax concession that is received by clubs. (p. 12)

But the fact that clubs provide donations and other support to the community in general is not a *prima facie* argument for providing clubs with substantial tax concessions in relation to gaming income, especially given the cost of the concessions is considerably greater than the size of the donations.

For competitive neutrality purposes the issue is not whether public benefits may be generated but rather whether the way in which government support is delivered creates distortions. The Commission concludes that present tax concessions on gaming income provided to clubs by governments breach competitive neutrality principles. However any change in the taxation of club gaming revenue would need to be phased in over some years to allow time for adequate adjustments. In addition, adjustments should take into consideration the recommendations of the Commission's gambling inquiry — due to provide its final report to the Australian Government by 26 February 2010 — and the RAFTS.