# 7 Taxation, philanthropy and access to capital

**Key Points**

- Australian governments provide a range of tax concessions to eligible not-for-profit organisations (NFPs). Input tax concessions, income tax exemptions and wealth tax exemptions (principally land tax) are estimated to have provided at least $4 billion in 2008-09 in tax relief but could be up to twice this amount.
- The current system of NFP tax concessions is complex, inefficient and inequitable, imposing substantial administrative costs on both NFPs and governments. There is scope to streamline NFP tax concessions both within and between jurisdictions.
- Individuals and businesses are allowed to deduct from their income philanthropic gifts to organisations which are endorsed as deductible gift recipients. The value of deductible gifts claimed by Australian taxpayers on individual income tax returns was over $1.8 billion in 2006-07, with an estimated cost to tax revenue (tax expenditure) of $860 million.
- Giving in Australia appears to be higher than in New Zealand, Germany and France but clearly lower than in the United States, and slightly lower than in the United Kingdom and Canada (as a percentage of GDP). Compared to other countries, allowed deductions in Australia are generous, but the scope of organisations which can receive deducible gifts is relatively narrow. The Commission estimates that tax expenditures would have been around $577 million higher in 2006-07 if gift deductibility for donations had been available for all charities.
- Payroll giving, and planned giving more generally, is associated with higher levels of donations. However, compared to the UK and Canada, only a small number of employees participate in payroll giving. Moreover, evidence suggests that there is a limited amount of knowledge about payroll giving and the associated benefits. Planned giving through bequests is also relatively low in Australia.
- Access to capital resources is a concern for NFPs which require finance for investment, and for social enterprises that wish to establish or expand their activities. The nature of NFPs means that they are unable to access equity finance, and members are less willing to use personal assets as collateral. In addition, for some NFPs, lack of suitable assets for collateral and a stable revenue stream contribute to difficulties in accessing conventional loan finance.

This chapter explores issues related to tax concessions granted to not-for-profits (NFPs), the role of philanthropy as a source of funding to the sector, and ways to improve access to capital by NFPs to finance their development and growth.

## 7.1 Taxation arrangements affecting not-for-profits

Australian governments support eligible NFPs indirectly through a variety of tax concessions, mainly on inputs and income. They also grant deductible gift recipient (DGR) status to endorsed NFPs, allowing donors to these organisations to claim a deduction from their taxable income for eligible donations.

Taxation arrangements relating to NFPs form part of the broader taxation policy in Australia and are being examined by the Review of Australia's Future Tax System (RAFTS) in the context of equity, efficiency, simplicity, sustainability and policy consistency (Treasury 2008a). As such, this section should be considered in conjunction with the relevant sections of the RAFTS report.

The impact of tax concessions on competitive neutrality is a specific term of reference for this study — a detailed discussion is provided in chapter 8.

### Why does the government provide indirect funding?

The rationale for tax concessions to NFPs in Australia is not clearly set out in the legislation and only a few supporting documents offer any insight. Yet there is a general understanding that tax concessions are granted to support NFPs because they serve the community and their activities provide positive public benefits.

In *Third Sector: The Contribution of Nonprofit and Cooperative Enterprises in Australia*, Lyons contends that:

> In broad, tax exemptions are designed to assist certain third sector organisations by allowing them to devote more of their income to their mission ... [and] are provided to nonprofit organisations because they are judged to provide a public benefit. The greater the benefit, the larger the range of exemptions. (2001, pp. 20 and 182)

In *Tax and Charities*, Cullen, Swain and Wright consider that:

> Subsidizing charities enables governments to further their social objectives, including by means of increasing support to the disadvantaged members of society … [the reason] governments provide subsidies to the private sector rather than simply increasing state provision is that it can result in better targeting of resources … Subsidizing charities also ensures that those members of society who do not donate to

charities but who nevertheless benefit indirectly from charities are contributing through their general tax payments. (2001, p. 2)

In addition to the public benefits outlined above, tax concessions may:

- provide greater funding certainty for organisations as they may be less volatile than direct funding mechanisms as these may be affected by deteriorations in the government's fiscal position or changes in government preferences. This view was outlined by ACROD (now National Disability Services) in its submission to the Industry Commission's 1995 inquiry into charitable organisations
- be administratively more efficient than direct funding mechanisms. The costs to both government and organisations in taxing NFPs and then reallocating these taxes back to the same organisations through direct funding mechanisms could be substantial.

However, there may be some disadvantages to indirect funding of NFPs through input and income tax concessions.

- Tax concessions can be less efficient in targeting their intended beneficiaries.
- Tax concessions raise the complexity of the tax system overall and may be subject to abuse. Increased complexity can also reduce the efficiency of concession administration.
- Total tax expenditures (cost of foregone revenue) can also be difficult to control, especially with regard to income tax and philanthropic deductibility.
- The assistance granted to NFPs through the tax system is not transparent. As a result, it disguises the total level of government support to different parts of the sector and in aggregate.

Deductibility of philanthropic gifts is potentially the only direct way that individual taxpayers (including businesses) can allocate government revenue to causes that they themselves would like to see funded.

Krever (1991) outlines four arguments in support of deductibility as a tax payer directed mechanism for the allocation of government resources to NFPs. First, individuals may be better able to identify the most appropriate causes in their local area. Second, individuals may be better able to identify those organisations which are most capable of addressing the needs of the local community. Third, this form of assistance relies on the initiative of individuals and may reinforce socially desirable conduct associated with supporting the community. Finally, pluralism (individual choice) allows individuals to direct support to causes that may be socially beneficial but politically unattractive.

## How do governments provide indirect funding to the NFP sector?

There are four main types of tax concessions provided by Australian governments: input tax concessions (including fringe benefits tax (FBT), goods and services tax (GST), payroll tax, stamp duty and gambling tax concessions); income tax concessions; wealth tax concessions (such as land tax); and the capacity for organisations to receive deductible gifts (box 7.1). As a general rule, those NFPs which provide the most benefit to the community in terms of alleviation of disadvantage are eligible to receive the most generous tax concessions. However, Australia is unusual in providing some form of concession to most NFPs. Most other developed nations, such as the United Kingdom (UK) and New Zealand, provide tax concessions only to organisations with a charitable purpose.

### *Eligibility and endorsement for tax concessions*

Most NFPs are eligible for some sort of tax concessions from the Australian Government (box 7.2) and many access concessions from the states and territories. The concessions available, the eligibility criteria for concession status and the need for formal endorsement all differ across the nine jurisdictions.

At the Commonwealth level, endorsed public benevolent institutions (PBIs) receive the most generous concessions — income tax exemption, FBT exemption (capped at $30 000 per employee[1]), some GST concessions and DGR status. Endorsed charities receive income tax exemption, some GST concessions and an FBT rebate (capped at $30 000 per employee), but must seek separate endorsement for DGR status.

An income tax exemption is available for community service organisations and other non-charitable NFPs listed under division 50 of the *Income Tax Assessment Act 1997* (ITAA 1997). Other NFPs are not liable for tax on the first $416 of income per annum. However, any income above this amount is taxable at the company tax rate.

Endorsement requirements to access Commonwealth tax concessions vary. All DGRs must be endorsed, as do all income tax exempt funds. Tax concession charities must be endorsed, regardless of the type of concessions received. All other NFPs are entitled to self-assess (particularly for income tax and GST), with no checks on their activities unless the Australian Taxation Office (ATO) investigates.

[1] The FBT exemption and rebate cap excludes eligible meal and entertainment expenses (chapter 8). The value of the FBT exemption to the NFP is greater than that of the FBT rebate.

## Box 7.1 Tax concessions provided to NFPs

**Income tax**

Income tax exemptions are provided to NFPs whose purposes are broadly beneficial to the wider Australian community, such as charitable, religious and scientific institutions.

PBIs, charities and income tax exempt funds within the NFP sector must be endorsed by the ATO to be exempt from income tax or specifically named in the income tax act. Other categories — such as cultural, community service and sporting organisations — can self-assess their exemption.

Non-exempt NFPs do not pay income tax on the first $416 of taxable income each year but they are liable for tax on income in excess than this amount. This concession is intended to ensure small organisations do not incur the administration costs associated with managing their tax affairs, such as lodging annual income tax returns.

**Income from mutual receipts**

Receipts from members of clubs (including member subscriptions and trading income relating to members) are not included in the assessable income of NFP clubs, societies or associations. All other income is taxable — for example, interest and profits from trading with non-members.

**Fringe benefits tax**

PBIs and health promotion charities are provided with a $30 000 capped exemption from FBT per employee, and public and NFP hospitals and public ambulance services are provided with a capped exemption of $17 000 per employee. These caps are not indexed. FBT exemptions are also available for certain employees of religious institutions.

Other endorsed charities and religious institutions are entitled to have their FBT liability reduced by a rebate equal to 48 per cent of the gross FBT payable (capped at $30 000 per employee).

The exemptions and rebates do not limit the amount of other FBT-exempt benefits (for example, superannuation contributions, work-related mobile phones, entertainment expenses and other miscellaneous benefits).

**Goods and services tax**

*Not-for-profit organisations*

NFPs, including charities, have a GST registration threshold of $150 000 a year compared with the general registration threshold of $75 000 a year for other companies.

Where an organisation is not registered for GST, it does not pay GST on its supplies and is not entitled to input tax credits for the GST paid on its inputs. NFP entities with a turnover below the threshold can choose to be registered. Registered entities pay GST on the taxable supplies they make and are entitled to input tax credits for the GST paid for their creditable acquisitions.

Donations to a NFP (including charities) that are made voluntarily and for no material benefit are not subject to GST.

(continued next page)

Box 7.1 **(continued)**

*Concessions for charities, DGRs and government schools*

Charities, DGRs and government schools receive a range of GST concessions including the ability to make supplies GST-free in certain circumstances, the ability to make supplies of second hand goods GST-free, and the ability to treat certain fundraising events as input-taxed.

**Gift deductibility**

Certain organisations are entitled to receive income tax deductible gifts. These organisations are called deductible gift recipients (DGRs) and are:

- endorsed by the ATO, or
- listed by name.

For an organisation to be endorsed by the ATO, it must satisfy the requirements of a general DGR category set out in division 30 of the ITAA 1997. Endorsement may be for the organisation as a whole or for the organisation to operate a DGR endorsed fund, such as a building fund. In the later case, only gifts to the endorsed part of the organisation are deductible.

There are a number of ways an organisation can be listed by name. Either Parliament amends the income tax law to list an organisation by name in the ITAA 1997, or the Treasurer declares an organisation in the Gazette, or, for specific DGR registers, the Treasurer directs the relevant minister to enter an organisation on the specific register.

**Payroll tax**

Wages paid or payable by NFPs are exempt from payroll tax if paid or payable by a:

- a religious organisation
- a PBI
- an NFP whose objectives are solely or dominantly for charitable, benevolent, philanthropic or patriotic purposes
- an NFP private school or educational institution that provides education at the secondary level and below
- an NFP hospital that is carried on by a society or association.

**Other tax concessions**

At the state level, many charitable institutions are exempt from municipal rates, stamp duty, motor vehicle registration and land tax. At the federal level, exemptions from customs duty apply, as well as certain fuel tax concessions. In addition, registered clubs also have concessional gaming tax rates on income from poker machines in some jurisdictions.

*Sources*: ATO (2007b); OSR (2008).

## Box 7.2 **Main types of NFPs for income tax exemption purposes**

**Public benevolent institution (PBI)**

A PBI is an NFP institution organised for the direct relief of poverty, sickness, suffering, distress, misfortune, disability or helplessness. PBIs require endorsement from the ATO to access tax concessions.

**Charitable institution or fund**

A charitable institution is run solely to advance or promote a charitable purpose. A charitable fund is an instrument of trust or a will run for a charitable purpose. Charitable purposes include:

- the relief of poverty or sickness or the needs of the aged
- the advancement of education
- the advancement of religion
- other purposes beneficial of community — including: promoting health; providing community facilities; promoting art and culture; helping to maintain defence and public order and providing emergency services; relieving distress due to natural disasters; providing social welfare; helping unemployed people; promoting scientific research; advancing commerce and industry; protecting animals; and preserving historic buildings.

Charitable institutions and funds require endorsement from the ATO to access tax concessions.

**Income tax exempt fund (ITEF)**

An ITEF is a non-charitable fund that is endorsed by the ATO to access income tax exemption. ITEFs are established under a will or instrument of trust solely for the purpose of providing money, property or benefits to income tax exempt DGRs, or the establishment of DGRs.

**Community service organisation (CSO)**

A CSO is a society, association or club established for community service purposes (except for political or lobbying purposes) that is not carried on for the purpose of profit or gain of its individual members. Community purposes include the promotion, provision or carrying out of activities, facilities and projects for the benefit of the community or any members who have a particular need by reason of youth, age, infirmity or disablement, poverty or social or economic circumstances. Community service organisations can self assess their eligibility for income tax exemption.

**Other exempt organisations**

Other income tax exempt organisations include NFP societies, associations or clubs where the main purpose is the encouragement of culture, resource development, science or sport. Organisations can self assess their exemption from income tax.

*Sources*: ATO (2007b); Sheppard, Fitzgerald and Gonski (2001).

Charities (including PBIs), income tax exempt funds and DGRs are generally endorsed by the ATO. However, in certain circumstances the Treasurer may name an organisation for specific tax concessions or direct that an organisation be placed on a specific register or list (which may involve the passage of amending legislation through Parliament). For example, if an organisation seeks to be listed on a specific DGR register, such as the Register of Cultural Organisations, the Register for Environmental Organisations, or the Register for Harm Prevention Charities, it needs to apply through the relevant agency.[2] The Treasurer, after receiving advice from the relevant Minister, then decides whether an organisation is entered on the register.

Each state and territory not only has its own set of NFP tax concessions and eligibility criteria, but the categorisation of NFPs used by states and territories often differs from that used by the Australian Government. Eligibility for tax concessions in these jurisdictions generally requires endorsement from the relevant department/office within the jurisdiction. As such, there can be a large endorsement burden for NFPs seeking to access a broad range of tax concessions, especially in multiple jurisdictions.

### *The cost of NFP tax concessions*

Although there is some debate as to whether tax concessions to NFPs should be considered tax expenditures (appendix E), this approach provides a way to estimate their 'cost'. Tax expenditures measure the difference in tax paid by taxpayers who receive a particular concession, relative to taxpayers who do not receive the concession; however, each jurisdiction uses a slightly different estimation methodology. This complicates comparisons between jurisdictions and makes aggregation imprecise. In addition, much of the necessary data is not required to be submitted to the ATO or relevant jurisdictional entities. For example, most NFPs are not required to lodge income tax returns so it difficult to estimate the revenue foregone.

On the best available data, the value of tax concessions is estimated to be at least $4 billion in 2008-09 (appendix E). For that year, FBT concessions were estimated to be worth at least $1 billion while the tax expenditure for payroll tax was estimated to be $766 million (for the four states that provide estimates). Income tax deductions for approved donations were estimated to be worth over $1 billion in

[2] There is also departmental/ministerial involvement in determining organisations approved to be overseas aid funds, developed country disaster relief funds, Australian disaster relief funds, approved marriage guidance organisations, approved research institutes, TAFES and higher education institutions. However, each process is slightly different.

foregone tax revenue. Concessional rates of tax for income from gaming machines in registered clubs were estimated to be worth $724 million.

The total value of tax concessions could well be in excess of double this amount as tax expenditure estimates were only available for some concessions in some jurisdictions. The estimate of $4 billion does not include concessions and exemptions such as: the income tax exemption for religious, scientific, charitable or public education institutions; interest withholding tax and dividend withholding tax exemptions for overseas charitable institutions; income tax exemption for distributions to charitable funds and refund of franking credits for eligible funds; GST concessions on supplies by charitable institutions and NFP bodies; or the FBT exemption on meal and entertainment expenses.

### The system is complex, inequitable and costly to administer

Jurisdictional differences in the types of NFP tax concessions and their eligibility and endorsement requirements contribute to a complex, inequitable and inconsistent system. Even within systems, exemptions to protect existing entitlements, and tests that are no longer relevant, have resulted in unwarranted complexity.

These issues are not new. The 1995 Industry Commission report on community social welfare organisations concluded that COAG should simplify and standardise the criteria for granting tax concessions between jurisdictions (IC 1995). More recently, the RAFTS noted that 'The tax concessions for the NFP Sector are complex and applied unevenly' (Treasury 2008b, p. 161).

The Smith Family captured the views of many submissions regarding NFP tax concessions:

> The overall taxation system for non-profit organisations is a confusing one with many tax concessions being differentially applied according to the nature of each type of not-for-profit organisation (for example charities, public benevolent institutions and health promotion charities, deductible gift recipients, not-for-profit and public hospitals), while state-based taxes and duties are inconsistently applied. (sub. 59, p. 39)

Administering individual concessions can also be complex and costly. For example, with regard to FBT arrangements, PeakCare Queensland notes:

> Complex analysis and complicated administrative and accounting processes surrounding salary packaging often take the benefit from it. The need for organizations to buy in advice and consultants to ensure they are meeting complex and ever changing regulations is also a consideration worthy of note. (sub. 81, p. 6)

It appears that some organisations operating in the same sector can be categorised differently for tax purposes and, as a result, have access to different tax concessions. This issue was raised by Family Relationship Services Australia:

> The fact that some organisations are defined as Public Benevolent Institutions for taxation purposes while others are not creates inequities in the cost of service delivery and the conditions that can be offered to staff. (sub. 132, p. 17)

Even the same type of concession can have different legislative exemptions across jurisdictions. For example, all charities are entitled to land tax exemption in New South Wales, South Australia and Western Australia, but Queensland, Tasmania and Victoria only give exemptions to certain organisations or activities, while the Northern Territory does not levy land tax at all.

#### *Determining charitable status*

Submissions indicated that there was considerable confusion and inconsistency around the definition of charitable purposes (including PBI) for the determination of tax concessions. There was also dissatisfaction with the processes (and costs) associated with NFPs gaining tax concession status at different jurisdictional levels.

Across all Australian governments, there are 40 statutes which provide tax concessions to charitable organisations and 19 separate agencies that regularly make determinations of charitable status (NRNO 2007). The resulting administrative and compliance burden associated with applying for concessional status or fundraising endorsement for organisations operating across jurisdictions is onerous.

At the Commonwealth level, the ATO has, in effect, become the de facto ‘regulator’ in determining which NFPs qualify for charitable and/or DGR status. In other jurisdictions, the processes for determining charitable status vary significantly, with little coordination among agencies, and exhibit a high degree of inconsistency and duplication (NRNO 2007).

The Inquiry into the Definition of Charities and Related Organisations (box 7.3) was a response to legal disputes arising from the common law definition of charity and dissatisfaction with the process of determining charitable status (appendix F). While the inquiry’s recommendation for the introduction of a statutory definition of ‘charity’ was not adopted, its arguments and conclusions remain valid. Specifically, the adoption of a statutory definition of charity would ‘… provide better guidance about what is a charity than is presently available to the sector and the wider community’ (Sheppard, Fitzgerald and Gonski 2001, p. 39). The recommendation to introduce a statutory definition of ‘charity’ would reduce uncertainty for NFPs applying for charitable status.

## Box 7.3 **The Definition of Charities and Related Organisations**

On 18 September 2000, the then Prime Minister, Hon. John Howard MP announced the establishment of the Inquiry into the Definition of Charities and Related Organisations to explore definitional issues relating to charitable, religious and community service NFPs. He said:

> We need to ensure that the legislative and administrative framework in which they operate is appropriate to the modern social and economic environment. Yet the common law definition of a charity, which is based on a legal concept dating back to 1601, has resulted in a number of legal definitions and often gives rise to legal disputes. The Inquiry will provide the government with options for enhancing the clarity and consistency of the existing definitions with respect to Commonwealth law and administrative practice. These should lead to legislative and administrative frameworks appropriate for Australia's social and economic environment in the 21st Century.

In June 2001, the Inquiry made 27 recommendations, among which was the introduction of a statutory definition of 'charity' with an independent administrative body for federal law. After considering the Inquiry report, the Federal Treasurer released a draft Bill in July 2003 which took the traditional four heads of charity and divided them into seven heads, following the spirit of the Inquiry's recommendations. The draft Bill raised only minor public comment. Other provisions in the draft Bill did, however, cause significant public discussion and a number of organisations argued that the draft Bill was an attack on their ability to advocate for a political cause. The Board of Taxation handed its report on the workability of the proposed definition to the Treasurer in December 2003 and in May 2004 the Federal Treasurer announced that:

> … [t]he common law meaning of a charity will continue to apply, but the definition will be extended to include certain child care and self-help groups, and closed or contemplative religious orders. The Government has decided not to proceed with the draft Charities Bill.

The government enacted the *Extension of Charitable Purpose Act 2004 (Cth)* which confined itself to enlarging the charity law definition for federal purposes to include child care, self-help groups and closed religious orders. These three extensions were relatively uncontroversial and all federal statutes (not just taxing acts) are now modified by this legislation. However, these changes have not been taken up by any state jurisdiction to reform their definition of charity.

*Sources*: Howard (2000); Costello (2004).

## Options to streamline tax concessions arrangements

Streamlining and harmonising the tax concession systems would reduce compliance costs to all parties involved. Tax concession arrangements could be simplified by:

- reducing the number of NFP tax concession categories
- centralising registration and endorsement

- increasing the clarity in reporting for endorsement and maintenance of status
- ‘pre-qualification’ endorsement for use in other jurisdictions.

*Reducing the number of NFP tax concession categories*

Under the present arrangements, eligibility categories differ across legislation and sections of legislation. For example, there are different classification categories for gift deductibility and income tax exemption within the ITAA 1997, both of which are inconsistent with FBT concessions and GST concessions. The current issues are clearly expressed by Family Relationship Services Australia:

> At the Commonwealth level, the legal and administrative framework needs to be amended to reduce the number of categories of not–for–profits for tax purposes, and to establish how each category of not–for–profit should be treated in relation to the various types of concessions; this must be done within a consistent and clearly articulated framework. (sub. 132, p. 17)

While the Commission can see considerable merit in a simplified system, it is beyond the scope of this study to propose a new classification of NFPs for tax concession purposes.

There may be significant structural adjustment costs associated with any legislative change to harmonise tax concession categories across jurisdictions. However, it is envisaged that there would be substantial long-term benefits for NFPs and governments from such efforts. This is needed to underpin a truly one-stop endorsement for tax concessions, which would substantially reduce administration costs, confusion and frustration.

*Centralising registration and endorsement*

Given the variety of means by which NFPs can currently obtain tax concessions (particularly DGR), it would be more administratively efficient for all applications for Commonwealth tax concessions to go through a single portal. The proposed national Registrar of Community and Charitable Purpose Organisations should be responsible for coordinating and processing applications for Commonwealth endorsement, and the maintenance of all specific DGR registers.

In principle, the registrar should also have full powers of endorsement. However, it is recognised that the newly formed Registrar would need advice in assessing the appropriateness of an organisation to be listed on a specific DGR register, such as the Register of Cultural Organisations, and that the approval currently rests with the relevant Minister and the Treasurer. The Registrar should, at the very least, provide

the application portal and coordinate the process of entering an organisation on a specific register with the relevant department.

Further, once endorsed, the relevant organisation should be registered with the Registrar, with the current specific registers incorporated into the national register. Over time, the endorsement of all NFPs for tax concessions should be transferred to the Registrar.

Reviews of endorsement status could be requested by the Australian Commissioner of Taxation, the Treasurer or, in the case of specific DGR registers, the relevant department. Furthermore, the Australian Commissioner of Taxation should have the power to direct the registrar to remove an organisation's endorsement where there has been a breach of taxation compliance requirements.

### *Requirements for endorsement*

Submissions demonstrated mixed views as to whether the current Commonwealth endorsement requirements (for DGRs and charitable institutions and funds) were appropriate, or whether all NFPs accessing tax concessions (including those currently able to self assess) should undergo endorsement and regular reporting requirements.

At the Commonwealth level, the scope of those requiring endorsement seems appropriate, and the associated requirements are generally proportional to the benefit and the risk posed from rorting.

Currently, annual reports are not required to maintain endorsement. As outlined in chapter 6, while endorsement should remain a one-off requirement, annual community-purpose statements should be required to improve transparency and to identify any significant changes in purpose or activity. This will impose an additional reporting burden for NFPs that currently do not report this information. For very small NFPs this cost of regular reporting may outweigh the potential benefits provided by the tax concessions. However, there are likely to be more cost-effective and simpler options available for small eligible organisations to access tax benefits without being endorsed, such as through using Community Foundations (see below).

### *Making use of Commonwealth endorsement*

Endorsement registries maintained by the Registrar could be used by other jurisdictions in evaluating eligibility for tax concessions. However, for this to provide substantial benefit, the reporting requirements (such as an annual

community-purpose statement) and the eligibility categories (such as the relevant head of charity for endorsement) must align with the jurisdiction's eligibility requirements. Given the current disparities, it is envisaged that endorsement by the Registrar could only be used by other jurisdictions to simplify their own assessment processes.

Over time, harmonisation of tax concessions arrangements at the jurisdictional level would contribute to a more streamlined system with potential to further reduce administration costs. This does not imply that the concessional rates need be the same in each jurisdiction as that is a policy decision for the individual jurisdictions — for example, harmonised payroll tax only requires common application, not rates of tax. COAG could play a similar role in this process as it did for harmonisation of payroll tax.

RECOMMENDATION 7.1

***The Australian Government should adopt a statutory definition of charitable purposes in accordance with the recommendations of the 2001 Inquiry into the Definition of Charities and Related Organisations.***

RECOMMENDATION 7.2

***State and territory governments should recognise the tax concession status endorsement of not-for-profit organisations at the Commonwealth level. Given the disparities between eligibility for tax concessions across jurisdictions, state and territory governments should utilise such Commonwealth endorsements in determining eligibility for their jurisdictional concessions, and seek to harmonise tax concessional status definitions or classifications with the Commonwealth over time.***

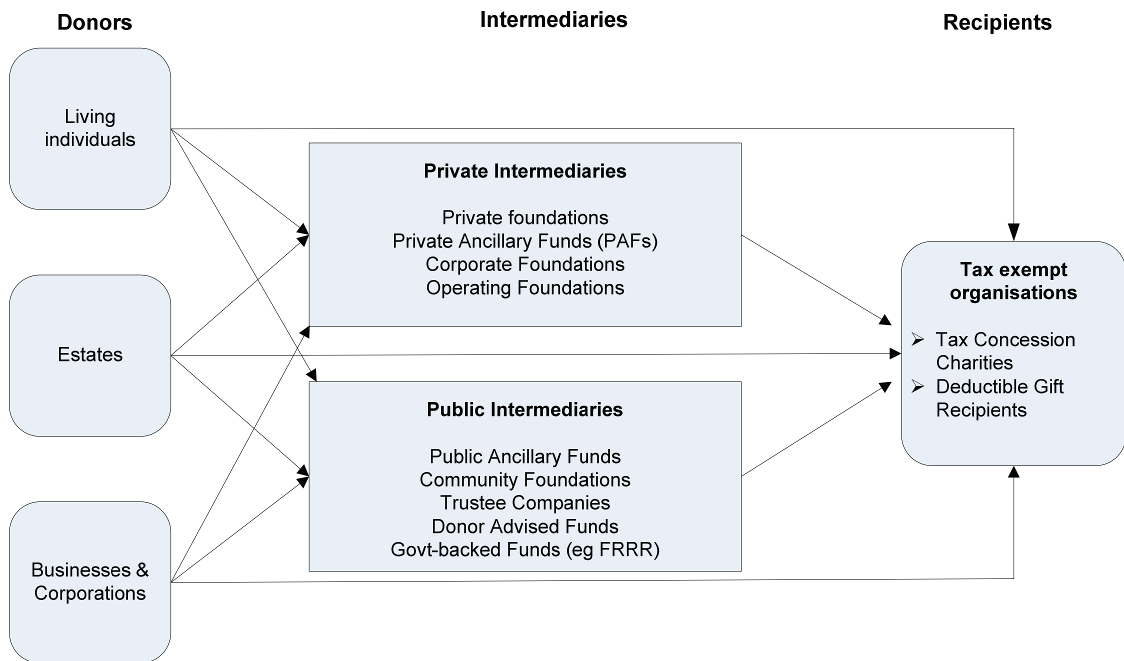
## 7.2 Philanthropic support by individuals and business

### Overview of philanthropy in Australia

*Giving Australia* (FACS 2005) estimated the total giving of money, goods and services by individuals and businesses to be almost $11 billion (including charity gambling) in the year to January 2005. Individual donations made up $5.7 billion with another $2 billion raised through charity gambling or support for events. $2.3 billion was money given by business while a further $1 billion worth of goods and services was donated.

While the majority of philanthropic transfers occurs directly between donors and recipients, philanthropic intermediaries play an important role in engaging wealthy individuals and the business community, and distributing their donations or the earnings from endowments (figure 7.1).

Figure 7.1 **The structure of philanthropy in Australia**




*Data source:* Adapted from Philanthropy Australia (sub. 62).

There are a various types of philanthropic intermediaries (box 7.4) but little is known about the total value of their assets and the distributions they make. Good data is available only for Private Ancillary Funds (PAFs), which were introduced in 2001. In April 2009, there were 775 PAFs with total assets of over $1.3 billion (*Income Tax Assessment Regulations 1997* (Cwlth); Treasury 2008b). PAFs distributed $117 million in 2007-08 while the 10 largest reporting foundations disbursed over $78 million in 2006-07 (ATO 2009c; Philanthropy Australia, sub. 62). It is also known that there are 9 trustee companies managing about 2000 charitable trusts and foundations with assets of about $3.9 billion which distributed $280 million in 2006-07 (Philanthropy Australia, sub. 62).

## Box 7.4 **Selected types of philanthropic intermediaries**

**Public Ancillary Funds**

A Public Ancillary Fund is a public fund established and maintained under a will or trust solely for the purpose of providing money, property or benefits to DGRs or the establishment of DGRs.

**Private Ancillary Funds (PAFs)**

A private ancillary fund is a trust to which businesses, families and individuals can make tax deductible donations. It is prescribed by law. PAFs may only make distributions to other DGRs. PAFs allow the donors control over which DGRs the fund contributes towards. These were formerly known as Prescribed Private Funds.

**Community Foundations**

Community Foundations are independent philanthropic organisations which work in a specified geographic area and build up endowed funds from many donors to provide services to the community and undertake community leadership and partnership activities to address a wide variety of needs in its service area. Community foundations are growing in popularity in Australia.

**Corporate Foundations**

A Corporate Foundation receives its income from the profit-making company whose name it bears, but is established as a separate legal entity, usually with a permanent endowment. They often receive staff contributions and/or contributions from company profits on a regular basis. Company-sponsored foundations are different from corporate giving programs which give grants directly to charities and are usually administered through the company's corporate affairs or public relations department. Most very large Australian companies have an associated corporate foundation.

**Government backed funds**

These philanthropic intermediaries have significant government funding in addition to being able to raise funding from the public. Examples include the Australian Council for the Arts and LotteryWest.

**'Auspicing' funds for specific purposes**

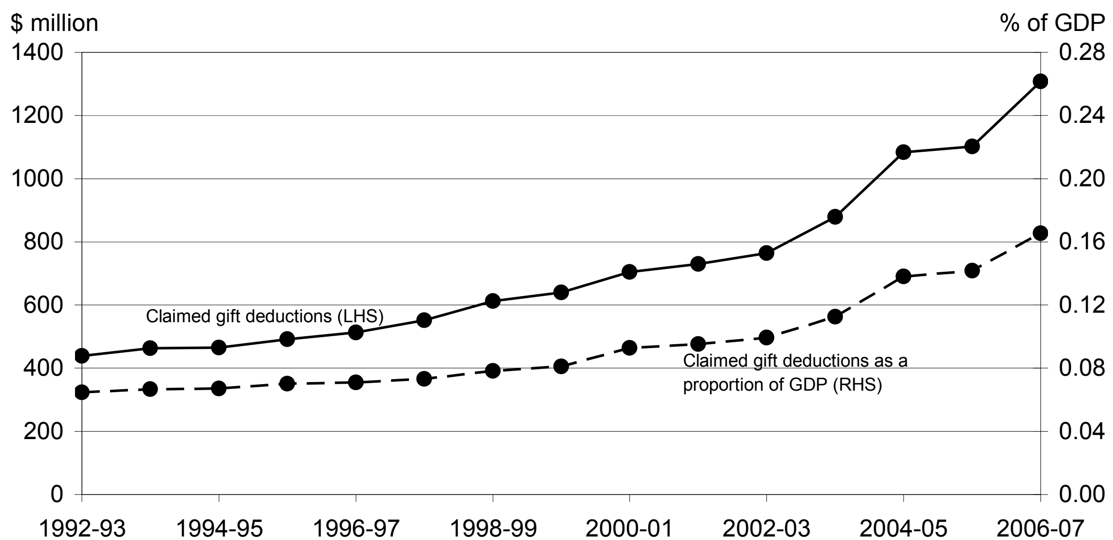
There are three philanthropic intermediaries which have DGR status but are able to provide grants to certain non-DGR entities. They are the Foundation for Rural and Regional Renewal, the Australian Sports Fund and the Australia Cultural Fund.

*Sources*: Philanthropy Australia (sub. 62); ATO (2007a); Leat (2004).

While there are no reliable estimates of trends, there are signs that philanthropy is increasing. Adjusted for inflation, philanthropic gifts claimed as tax deductions to the ATO have increased each year since 1992-93 (figure 7.2), rising also as a proportion of GDP. In 2006-07, over $1.8 billion in deductible gifts were claimed by over 4.2 million Australian taxpayers, which was estimated to have reduced tax revenue by $860 million (McGregor-Lowndes and Newton 2009; Australian Government 2009e).

Figure 7.2 **Gift deductions claimed by Australian taxpayers**

$ millions, inflation adjusted (base year = 1992-93)



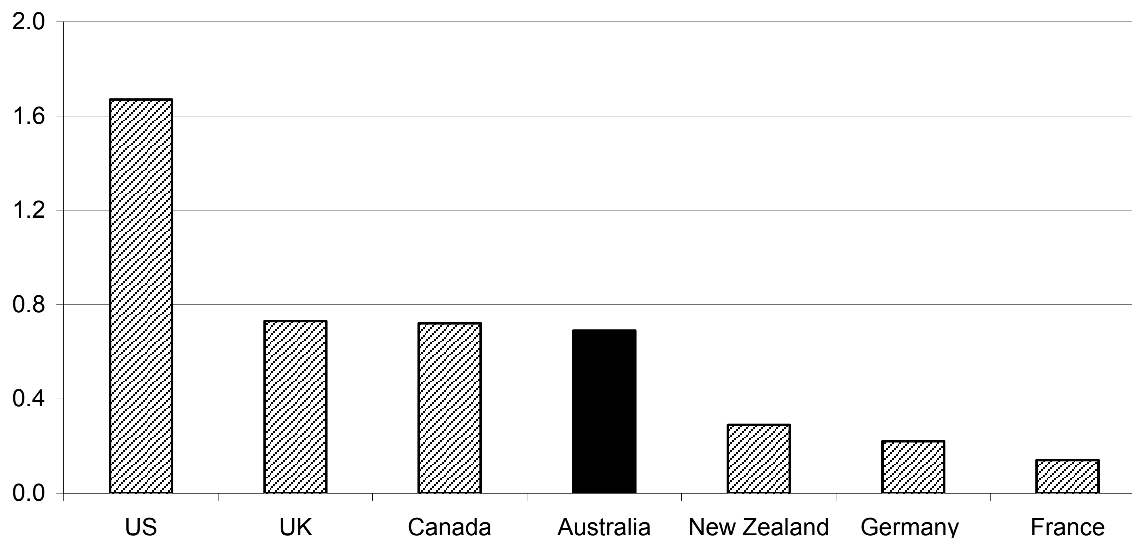

*Data sources:* ABS (2009b); McGregor-Lowndes and Newton (2009).

This amount is considerably less than that reported in *Giving Australia* (FACS 2005) as it excludes eligible gifts that are not claimed by taxpayers and philanthropic gifts to non-deductible entities.

By international standards, total giving in Australia (0.69 per cent of GDP in 2004) appears to be low relative to the US, slightly below the UK and Canada (1.67, 0.73 and 0.72 per cent respectively) but high compared to New Zealand (0.29 per cent in 2000) (figure 7.3). However, there are significant differences between countries in measuring philanthropic giving, as well as the cultural and institutional setting, which limits their usefulness as a benchmark for giving in Australia (appendix G).

Figure 7.3 **International comparison of philanthropic giving**[a]

Per cent of GDP, 2004[b]




[a] Legacies and religious taxes (including the German church taxes) as well as cash gifts given direct to the poor were excluded from the estimates. [b] Data for New Zealand is for households (rather than individuals) and is for 2000, while data for the UK is 2004-05.

*Data source*: CAF (2006).

## What stimulates giving?

An extensive survey of over 500 articles in the international literature on giving by Bekkers and Wiepking (2009) identified eight primary drivers of giving — awareness of need, solicitation, costs and benefits (including tax incentives), altruism, reputation, psychological benefits, values and efficacy (box G.3). Importantly for NFPs trying to attract funds, donors are particularly sensitive to organisations that demonstrate their impact in the community and create strong personal connections with donors.

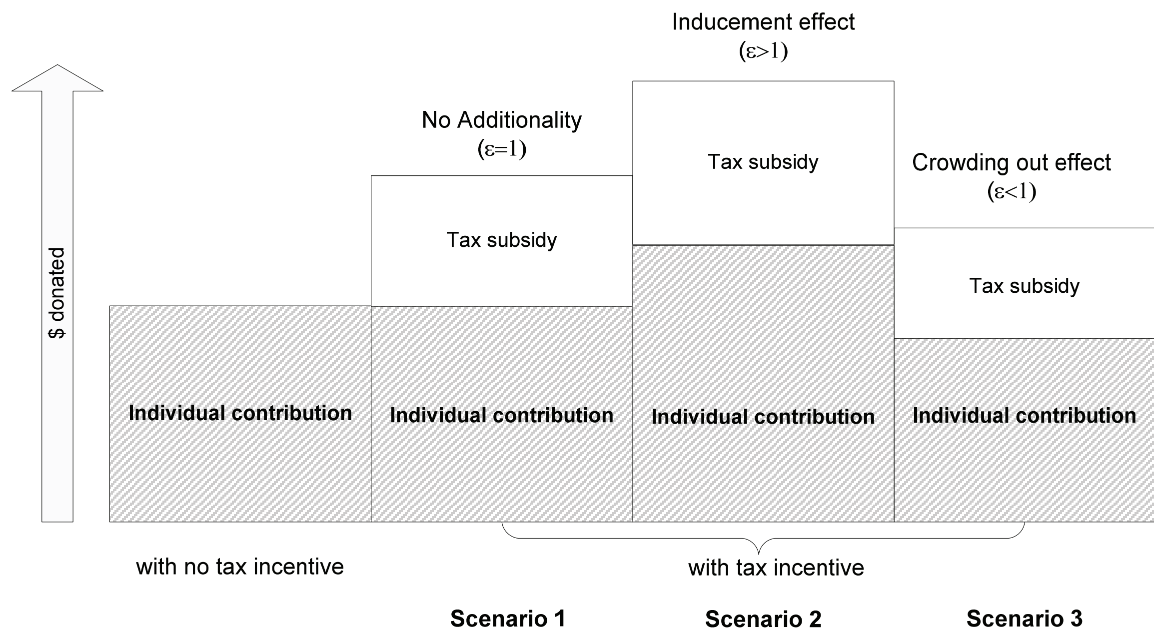
### *Do tax incentives increase giving?*

*Giving Australia* (FACS 2005) suggests that the main reasons for giving by Australians are very similar to those identified in the international literature — altruism, values and awareness of need. That said, by lowering the price of giving, tax incentives can potentially increase the amount donated and the number of individuals donating. Indeed, for wealthy individuals in particular, it appears that tax incentives are an important factor in influencing the amount given.

The critical question is whether this additional giving is greater or less than the value of the tax deduction provided. There are three possible scenarios (figure 7.4).

- In scenario 1, giving is higher by the exact value of the tax subsidy, effectively resulting in no change in the individual's contribution, with all of the tax subsidy going to the recipient DGR. In economic jargon, the price elasticity of giving is equal to one ($\varepsilon = 1$) and there is no additional inducement effect.[3]
- In scenario 2, giving rises by more than the value of the tax subsidy, effectively resulting in a higher level of giving by the individual. The DGR receives not only the tax subsidy but a higher level of donations from individuals. The price elasticity of giving is greater than one ($\varepsilon > 1$) and the inducement effect dominates (as such, tax deductibility is said to be 'treasury efficient').
- In scenario 3, individual giving rises by less than the value of the tax subsidy. This crowding out effect ($\varepsilon < 1$) means that private giving actually falls, although DGRs still receive an amount higher than with no tax incentive.

## Figure 7.4 **The impact of individual tax incentives on giving**[a]




[a] The price elasticity of giving (ε) is expressed in absolute terms.

The question for Australia is which scenario is likely to be the case. Since the late 1960s, a number of international studies (particular in the US) have attempted to estimate the relationship between charitable donations and the price of giving, as determined by tax incentives. Unfortunately, the literature has not come to a

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3 The price elasticity of giving (ε) is expressed in absolute terms throughout this chapter.

conclusion regarding the price elasticity of giving. Estimates of the persistent price elasticity from studies undertaken over the past decade and a half using panel data (which may provide less biased results), tend to fall between 0.51 and 1.26 — meaning that a one per cent decrease in the cost of giving results in a 0.51 to 1.26 permanent rise in the amount of giving. There is, however, evidence to suggest that the price elasticity of giving varies with income, with some studies finding that high income individuals are relative price elastic ($\varepsilon > 1$), and that the elasticity of giving varies between charitable causes (appendix G).

Although inconclusive, a number of overseas studies have estimated a price elasticity greater than one. Further, a higher top marginal tax rate in Australia compared to the US (46.5 per cent and 35 per cent respectively) implies that tax deductibility may have a larger impact on giving in Australia than in the US (IC 1995). With no evidence of a crowding out effect in Australia and anecdotal evidence on tax inducement, the presumption must be that tax deductibility encourages philanthropic giving, especially by high income taxpayers. However, this conclusion is tentative and more analysis of giving behaviour in Australia is needed.

Such analysis requires data on individual income and giving stretching over a period where tax rates or eligibility changes thereby altering the price of giving. In this regard, the ATO could construct a panel of individual income tax returns, covering a period of more than two years in which marginal tax rates change and, ideally, should be ongoing (see appendix G for a more detailed discussion).

#### *What are the options for providing tax incentives for philanthropy?*

Concerns have been raised about the inequity of income tax deductions that depend on the donor's marginal tax rate. Effectively those facing a higher marginal tax rate receive a greater tax 'benefit' than those on a lower marginal tax rate. This vertical inequity can be removed by a rebate system where each taxpayer faces the same price for giving (box 7.5). A number of other countries, including Canada and New Zealand, operate an individual rebate system. The UK has an individual tax deduction for payroll giving and an organisational rebate for other gifts.

While a move to either an individual or organisational rebate in Australia may improve vertical equity, the impact on overall giving and administrative costs need to be considered.

**Box 7.5 Tax incentives for giving**

There are three main mechanisms for providing a tax incentives for philanthropy.

- Individual tax deductibility — individuals deduct the full value of philanthropic gifts from their taxable income. This may be done through payroll giving, where donations are distributed from pre-tax income and the donor receives the tax benefit immediately, or when an individual submits their annual tax return.
- Individual tax rebate — individuals claim a (partial) rebate from the government for philanthropic gifts. An individual gives a donation and then applies for a tax rebate or reimbursement from the government at a later time. The most important difference between the deduction and rebate systems is that the rebate level is fixed at the same level for all taxpayers, regardless of their income.
- Organisational rebate — organisations claim a rebate from the government for philanthropic gifts received in lieu of the tax benefit being directed to the individual.

Moving from a tax deduction to a rebate is likely to lower the price of giving for low to middle income taxpayers but increase the price for high income taxpayers. The impact on overall giving will depend on the price elasticity of giving of these two broad groups of donors.

Using a range of price elasticity assumptions, the Commission estimates that the tax expenditure neutral rebate rate would have been around 38 per cent in 2006-07 (appendix G). Assuming tax incentives have an inducement effect on giving ($\varepsilon > 1$), the Commission estimates that introducing a neutral rebate would have resulted in a decline in donations to DGRs in 2006-07. Moreover, if tax deductions were replaced with an organisational, rather than an individual, rebate the cost to the government may be greater as DGRs are more likely to claim the rebate for all donations whereas individuals only claim a proportion of donations.

Tax deductions or individual rebates are the administratively easiest way to reimburse individuals if they are required to submit an income tax return. Yet, the RAFTS has canvassed the option of removing the requirement for some taxpayers to lodge tax returns (Treasury 2008b). If implemented, this may require affected individuals to submit a rebate claim independently of tax returns, potentially increasing administration costs (although many individuals may not bother to make a claim).

An organisational rebate may reduce compliance costs for donors but DGRs may incur substantial administration costs, particularly if donor information is required to match claims to individual tax liabilities to assess rebate eligibility.

The impact of any change in the current system for providing deducible gifts will be affected by the structure of the future individual income tax system. The most efficient and effective system can only be considered in the light of these decisions.

## Gift deductibility

For a donation to be tax deductible, it must satisfy three key requirements. First, the gift must be an eligible gift of cash or property (box 7.6).

Second, a deductible gift must have the following characteristics:

- there is a transfer of the beneficial interest in property
- the transfer is made voluntarily
- the transfer arises by way of benefaction
- no material benefit or advantage is received by the giver by way of return (ATO TR 2005/13; division 78A of ITAA 1936).

### Box 7.6 **Types of deductible gifts**

The main types of deductible gifts are:

- money — $2 or more
- property valued by the ATO at more than $5 000
- property purchased during the 12 months before the gift was made
- listed shares valued at $5 000 or less, and acquired at least 12 months before the gift was made
- trading stock disposed of outside the ordinary course of business
- property gifted under the Cultural Gifts Program
- heritage gifts — places included in the National Heritage List, the Commonwealth Heritage List or the Registrar of the National Estate.

*Source:* ATO (2007a).

If a donation does not have these characteristics then it is not a gift for tax deductibility purposes. For example, membership fees and payments where there is an understanding between the 'donor' and the recipient that the payment will be used to provide a benefit to the donor are not a gift (ATO 2007a).

Third, the gift recipient must be an endorsed DGR (box 7.1). Individuals who give to organisations without DGR status are unable to claim a deduction but businesses

may claim the outlay as a business expense under a sponsorship type arrangement. In addition, deductible gifts must be used by the DGR for charitable purposes or the purpose for which the entity was granted DGR status.

While DGR status covers a range of NFPs (broadly including PBIs, public universities, public hospitals, approved research institutes, arts and cultural organisations, environmental organisations, school building funds and overseas aid funds), the scope of eligible activities is narrow in Australia relative to that in comparable overseas countries. For example, donations to all charities and Community Amateur Sports Clubs are eligible for Gift Aid in the UK, while in Australia only 40 per cent of all tax concession charities are DGRs.

### *Who should be eligible to receive deductible gifts?*

DGR status is granted by the government to certain NFPs to promote philanthropic giving to these organisations. As of June 2009, there were 26 123 organisations with active DGR status of which 926 were specifically named in the relevant legislation by Parliament (ATO pers. comm., 24 June 2009). The main areas where organisations have been granted DGR status are welfare and human rights, education and culture (table G.1).

Access to DGR status is of major concern to NFPs where philanthropy is or could be an important source of funding. DGR status also allows NFPs to receive grants from the majority of philanthropic intermediaries, most of which can only distribute to DGRs.[4]

The current DGR system distorts philanthropic giving towards organisations with DGR status by reducing the cost of giving to DGR charities relative to non-DGR charities.[5] When all charities aim to provide a community benefit and potentially provide spillover benefits for the community, this raises questions as to the appropriateness of limiting DGR status to less than half of all registered charities.

If the definition of charitable purpose confirms a community benefit, widening the scope of DGR eligibility to include all charities would remove the current bias towards charities with DGR status and increase the choice of DGRs for donors. Further, if the definition of charities is widened in accordance with the principles

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4 There are three auspicing DGRs that can provide grants to certain non-DGR entities (box 7.4).

5 For example, the cost to a donor on a marginal tax rate of 30 per cent of donating $100 to a charity will depend on the charity's DGR status — for a DGR charity the donation will cost the donor $70 net of the tax deduction, whereas for a non-DGR charity the donation will cost the donor $100.

recommended by the 2001 Inquiry into the Definition of Charities and Related Organisations (as in recommendation 7.1), some charities with (non party-political) prevention purposes or activities may be eligible for DGR status.

Widening the scope of DGR eligibility increases the potential for rorting and would therefore increase the number of organisations that would need to be monitored. However, increased reporting requirements for endorsed organisations, especially community-purpose statements (which could include some financial information) as outlined in chapter 6, could facilitate the identification of fraudulent claims.

For some small charities, the reporting requirements proposed in chapter 6 may mean that it is not worth applying for DGR status. An alternative is to establish a new auspicing DGR that could provide grants to small (DGR eligible) charities. This may prove a cost-effective way to encourage philanthropic donations to such charities and, therefore, may be worth further investigation. To some extent Community Foundations play a similar role where instead of setting up a new charity, donations can be committed to the desired charitable cause.

*The impact of extending DGR status to all charities*

Widening DGR status to all charities will substantially lower the cost of giving to charities that previously could not receive tax deductible gifts. This may have a number of effects.

First, tax expenditures will increase because donations that were not claimable will be able to be claimed. If all such donations are claimed, the impact on tax expenditures 2006-07 would have been an additional $577 million (appendix H). Donations to religious organisations account for $359 million, or 62 per cent, of this increase, while donations to education institutions account for $16 million, or 3 per cent. Other charities, which could not be disaggregated by charity type, account for the remaining $202 million.

Second, overall donations to charities will be expected to be high but it is unknown by how much. This will depend on how individuals respond to the lower cost of donating to charities that previously could not receive tax deductible gifts. If the value of individual's donations was maintained ($\varepsilon = 1$), the tax expenditure estimate would have increased by another $271 million in 2006-07.

Finally, in addition to changing the overall level of donations, widening DGR status may alter the pattern of donations. This will occur if taxpayers reallocate their philanthropic giving from current to new DGRs and from non-DGRs to new DGRs. Any reallocation of gifts from existing to new DGRs will not impact on overall tax

expenditures. Moreover, such moves would suggest that current arrangements are unduly restricting donor choice. Tax expenditures will only be higher from a change in the pattern of donations where gifts are diverted from (non-DGR) NFPs to new DGR charities.

### *A way forward*

The Commission believes that gift deductibility should be widened to include all tax endorsed charities in the interests of equity and simplicity. The use of PBI status is no longer an appropriate basis for determining DGR eligibility for charitable endeavour. However, the Commission acknowledges that the revenue implications could be substantial, particularly if the definition of a gift is not strictly applied. Clearly the issue of greatest revenue concern is the inclusion of donations to religious organisations. As such, the Commission believes a progressive approach is warranted. One approach is for DGR eligibility to be widened by incrementally incorporating each 'head of charity' separately. This approach will also allow the Government to consider the impacts of any changes brought about by a new statutory definition of charities.

## Planned giving

In addition to tax incentives, planned giving (by employees and wealthy individuals) can encourage a greater level of overall philanthropic donations. Indeed, *Giving Australia* (FACS 2005) found that the average amount donated was four times greater when the gift was described as planned compared to gifts described as spontaneous. Further, a recent survey found that after commencing payroll giving three-fifths of employees increased their overall level of giving (ACF 2009).

Planned giving also has an number of other advantages including:

- reduced transaction and administration costs, greater levels of funding certainty and more reliable and consistent funding streams for NFPs
- donors can better plan their giving behaviour. For instance, payroll donations to DGRs can be deducted from pre-tax income providing the employee with an immediate tax benefit.

However, there may be substantial costs associated with setting up and administering some planned giving vehicles. In addition, there may be concerns that some specialised philanthropic vehicles can be subject to misuse without adequate

regulatory supervision. Such concerns were a motivating factor for some of the changes to PAFs in 2009 (Treasury 2008c).

There are various types of planned giving vehicles available in Australia, including payroll giving, bequests, direct debit payments and contributions to philanthropic intermediaries (such as PAFs). However, only 16 per cent of all giving activities are planned in Australia (FACS 2005).

#### *Promoting payroll giving*

The level of payroll giving in Australia is relatively low with only 0.6 per cent of adults participating in 2004 compared to the UK and Canada where participation levels are 1.3 per cent and 5.6 per cent respectively (PWC 2009a). Further, the number of participating Australian businesses does not appear to be large, with the *Giving Australia* survey of businesses indicating that only around 30 per cent of businesses offer payroll giving to their staff.

The *Workplace Giving Australia* program was set up under the Prime Minister’s Community Business Partnership to support businesses establishing a new or rejuvenating an existing payroll giving program (PMCBP 2006). Support material provided to businesses included, for example, information booklets and CDs, free workshops, and an email advisory service. The program also provided a case manager to Australian Government departments wanting to launch (or re-launch) a payroll giving scheme.

Despite these measures, current levels of participation in payroll giving in Australia remain low.

*Giving Australia* found that many businesses, including small to medium enterprises (SMEs) as well large businesses, felt that payroll giving would add layers of costly and time-consuming administration (FACS 2005). Indeed, the *SME Grants Programme* (which included government establishment grants) was set up in the UK to encourage the establishment of payroll giving in SMEs. However, while the program had some success in increasing the number of SMEs with a payroll giving program, it did not lead to a significant increase in employee participation (box 7.7).

Box 7.7 **Some United Kingdom payroll giving initiatives**

**The '10 per cent supplement'**

For the four years to March 2004, the United Kingdom (UK) government provided a 10 per cent supplement (or matching grant) on all payroll giving. The supplement appears to have encouraged employees, especially those subject to high tax rates, to donate through payroll giving. However, the impact on the number of employers offering payroll giving appears to be minimal.

**The UK 'SME Grants Programme'**

The UK small and medium enterprises (SME) Grants Programme was introduced in January 2005 to encourage SMEs (employing less than 500 employees) to set up payroll giving in their workplace.

The program consisted of three key mechanisms:

- SME employer grants — one-off grants of between 300 and 500 pounds (increasing with the number of employees) offered to SMEs setting up payroll giving between April 2004 and December 2006.
- Matched giving — for employees of SMEs who commenced payroll giving between April 2004 and March 2007, the UK government matched their donations (up to a value of 10 pounds per month) for the first 6 months.
- Quality Mark Awards for employers — established in 2006 to provide public recognition for employers achieving certain employee take-up rates.

The program also provided support material and resources for businesses to promote payroll giving in their workplace, and for charities to connect with local employers. In addition, there was a national payroll giving promotion campaign.

Over the life of the program, almost 3500 SMEs introduced payroll giving (5 per cent more than the target number of SMEs). However, the number of employees participating in payroll giving only increased by around 16 000, far below the target number of around 72 000 employees. Steele suggests that the low employee take-up may have been influenced by a delay between when SMEs established payroll giving and when they promoted it to their employees. For instance, around one third of participating SMEs established payroll giving in their workplace in the final 3 months of the program, leaving only a short period of time to promote payroll giving to their staff.

*Source*: Steele (2008).

This raises the question of the extent to which establishment costs are a barrier to payroll giving. In Australia, the cost of establishing a payroll giving program is not necessarily large — especially for small businesses running a payroll program in-house without the need for extensive staff consultation (box 7.8). This implies that it is lack of knowledge on how to establish and maintain a payroll giving scheme, and lack of pressure from staff for such a scheme, that pose the main barriers.

## Box 7.8 **Establishing a payroll giving program**

There are two main options for establishing a payroll giving program:

- an in-house program delivered through the business payroll system, where staff provide donations directly to DGRs
- a program established and managed with assistance from a payroll giving intermediary (such as the Australian Charities Fund, Charities Aid Foundation and United Way Community Fund of Australia). Such intermediaries may assist businesses with initial program design, staff surveys and promotion of the program. In addition, the intermediary may take on an ongoing management role, possibly including the distribution of donations to recipient DGRs. This second option is usually preferred by larger businesses.

Business may also choose to either: allow staff to nominate any DGR they wish to support (where the onus is on the employee to ensure that the recipient organisation has DGR status); or to provide staff with a selection of DGRs to support, where the selection of DGRs may be developed in consultation with staff; or a combination of both.

Generally, the cost of establishing a payroll giving program will not be high. However, the establishment (and ongoing) costs will depend on the particular features of the program and the size of the business. The main costs associated with payroll giving are the resources required to conduct staff consultation and program management. Payroll giving intermediaries also may charge a fee.

The Australian Charities Fund notes that from its experience as a payroll giving intermediary '…to effectively establish and promote a workplace giving program within an SME, an initial investment of $3,000-$5,000 is required' (sub. DR274, p. 5).

*Source*: PMCBP (2006).

The UK government provided an additional temporary tax incentive to stimulate payroll giving, with modest success (box 7.7). The most effective strategy identified in ACF's survey was where firms matched their employees' donations. Survey evidence suggests that for a large proportion of employees (60 per cent) employer matching was their primary motivation for payroll giving (ACF 2009). This may reflect the firm's culture and commitment to philanthropy as much as the financial inducement. Moreover, businesses can strengthen their relationship with employees by supporting payroll giving programs.

*Giving Australia* (FACS 2005) suggests that there is only a limited amount of knowledge about payroll giving and the associated tax benefits. This suggests that there is an ongoing role for the government in increasing public awareness of payroll giving.

The proposed national Registrar could assist with the establishment of payroll giving by providing a user-friendly list of active DGRs and their details (using relevant information lodged by DGRs to the registrar and the information available on the Australian Business Register). But it is not suited to driving business and employee interest in payroll giving.

The active promotion of payroll giving in Commonwealth and state government agencies could play a key role in a national promotional campaign. Indeed, the Centre for Social Impact (sub. DR285) suggested that governments, as employers, should model best practice in this area and that all government agencies should establish a payroll giving scheme. Public reviews of government payroll giving schemes may assist in the development of payroll giving within government, and provide an opportunity to advertise success to the wider community. In the case of Australian Government employees, the Australian Public Service Commission may be well placed to undertake any such review.

#### *Giving by wealthy individuals*

In Australia, there is a range of planned and structured giving vehicles individuals can use including: bequests; PAFs; private, family and independent foundations; community foundations; and government backed organisations such as the Foundation for Rural and Regional Renewal (Philanthropy Australia, sub. 62).

Planned giving has particular appeal to sophisticated wealthy givers (Brown 2004). In Australia, the demand for planned giving vehicles among wealthy individuals (and the importance of DGR status) is demonstrated by the high take-up of PAFs. The ability of the donor to direct their philanthropic gifts, as well as the ability to accumulate funds to build up an endowment, makes PAFs an attractive vehicle for donors.

While the rules governing PAFs are clear, this is not the case with a number of other philanthropic vehicles. Notably, a significant proportion of philanthropic gifts made through bequests in Australia are challenged through the court system resulting in charities losing some, if not all, of the bequest (McGregor-Lowndes and Hannah 2008). Indeed, planned giving through bequests is relatively low in Australia (Madden and Scaife 2008). The low level of bequests in Australia may be due to the absence of death taxes or estate duties (although there is some capital gains tax relief on bequests). International evidence indicates that these levies are an important factor in promoting planning giving strategies.

There appears to be scope to explore new philanthropic vehicles which can provide greater certainty for donors and recipient organisations alike. For example,

McGregor-Lowndes (2009) proposes a 'split interest contribution' whereby DGRs can receive an irrevocable, but deferred contribution of property. However, experience in the US indicates that these vehicles may be complex, administratively inefficient and open to abuse.

RECOMMENDATION 7.3

***The Australian Government should progressively widen the scope for gift deductibility to include all endorsed charitable institutions and charitable funds. Consistent with the Australian Taxation Office rulings on what constitutes a gift, payments for services should not qualify as a gift.***

RECOMMENDATION 7.4

***To encourage cost-effective giving, the Australian Government should explore options to promote and support planned giving, especially payroll giving. Specifically, the Australian Government should provide funding for a national campaign to promote payroll giving and the associated tax benefits. As part of the campaign, governments should encourage the establishment of payroll giving within all their agencies.***

## 7.3 Access to capital

A distinction needs to be made between funding and finance. Funding refers to income that has no obligation to be paid back and may come from an income stream from government contracts, other fee for service arrangements or direct grants from either government or philanthropy. By contrast, finance refers to either debt or equity capital which is injected into an NFP on the understanding that the investor will be compensated for the use of capital or, at a minimum, that the principal will be repaid in the future. This section explores issues relating to the difficulties that NFPs have in accessing finance — both through the capital market and by other means.

### What are the sources of capital for the sector?

NFPs access finance to invest in capital through a variety of sources, including conventional lenders, specialist lenders and financial intermediaries. They also fund capital expenditure through philanthropic donations or fundraising drives, non-operational government grants and surplus revenue from ordinary activities. Surplus revenue represents over 60 per cent of sector investment while debt capital accounts for only 15 per cent of gross capital formation (ABS 2009c).

Most larger NFPs involved in commercially viable business activities and with large asset bases have adequate access to capital from conventional lenders. However, other NFPs fail the lending criteria of conventional lenders and, as a result, often find accessing capital to develop or expand their activities difficult.

Some NFP groups, such as religious affiliates, have developed their own deposit taking funds which provide capital access to affiliates, for example to develop a school or build a place of worship. This model appears to work effectively for groups which have a suitable membership base and scope of activities. These schemes are exempt from the prudential requirements normally imposed on non-bank financial intermediaries.

Specialised financial intermediaries, such as community development finance institutions (CDFIs, box 7.9) have also emerged which tailor their activities to support the NFP sector by improving access to capital. These intermediaries do not just provide capital to NFPs, but actively work with them through each step of the financing process. There are only a few financial intermediaries in Australia which specialise in providing community development finance to NFPs.

### Box 7.9 **Role of community development financial institutions**

Community development financial institutions (CDFIs) increasingly play an essential role in providing credit, financial services and other services to under-served markets and populations, including NFPs. CDFIs are sustainable, mission-driven, independent financial institutions that supply capital and business support to individuals and organisations whose purpose is to create economic opportunity and social capital in disadvantaged communities or under-served markets. CDFIs provide social and financial returns to their investors by using flexible capital products to meet the needs of NFPs to effectively serve these markets while managing their inherent risks.

Types of CDFIs include:

- community development banks — for example, Community Sector Banking (incorporating Indigenous Business Australia)
- community development credit unions — for example, Maleny Credit Union and Fitzroy Carlton Credit Cooperative
- social/community investment funds — for example, Foresters Community Finance
- community development loan funds (including microenterprise loan funds)
- community development venture capital companies (for example, Social Ventures Australia's Social Enterprise Investment Fund).

Despite the ground breaking work of these organisations, the CDFI sector in Australia remains in the nascent stages of development.

*Sources:* Asia Pacific Centre for Social Investment and Philanthropy (APCSIP, sub. 41); Burkett and Drew (2008).

Governments may provide funding grants for capital projects and to assist organisations undertake structural change. Government funding for capital development has declined over the last few decades as priority has shifted towards the delivery of services. Although the cost of capital may be factored into payments for these services, this does not address the issue of accessing finance.

Philanthropic donations may also be used to fund investment, and some NFPs have had success in attracting philanthropic grants for development. For example, the Smith Family has successfully mobilised capital from philanthropic sources, such as the Westpac Foundation, to develop and expand the Learning for Life suite of programs (sub. 59). However, the use of philanthropic capital on a loan basis to NFPs is not widespread.

Beyond cash funding and borrowing, the options for financing investments are limited for most NFPs. By their nature they cannot issue equity, although some can issue their own debt instruments. For example, incorporated associations in Queensland are able to issue secured and unsecured notes, debentures and debenture stock (*Associations Incorporation Act 1981* (Qld)), but such instruments are not widely used. In addition, there are 100 NFP companies limited by guarantee and shares (ASIC pers. comm., 20 July 2009) which are able to issue equity capital, although this legal form is no longer available.

Many NFPs report difficulty accessing the capital they require (box 7.10). That said, the capital needs of organisations can be very different depending on the types of activities in which they engage. Burkett and Drew (2008) conclude that financial exclusion will be most acute for:

- small to medium sized NFPs
- independent localised community organisations — that is, entities such as neighbourhood centres
- start-up organisations in the first 5 years of operations, or those which do not have secure, recurrent or ongoing funding
- organisations which wish to grow or expand into innovative areas that are not currently the focus of funding or philanthropic bodies.

## Box 7.10 **Comments in submissions on access to capital**

Some submissions indicated that access to capital was a sector wide problem. For example, The Smith Family advanced:

> One of the most significant barriers to building stronger non-profits is the lack of access to growth capital — the funding that enables organisations to invest in themselves so they can grow, build, improve and strengthen their organisations and services for greater innovation, scale and impact. Without this growth capital, non-profits have had to limit their responses to opportunities within their grasp, rather than scale their organisations to realise their mission. (sub. 59, p. 31)

In addition:

> The difficulties faced by many NFP organisations in accessing capital slow the development of the sector as a whole. It distorts the ability of many NFP organisations to compete with for-profit organisations and inhibits the potential of the sector to be a major source of social innovation. (Australian Evangelical Alliance 8 Missions Interlink, sub. 55, p. 17)

Other submissions highlighted the difficulties of accessing capital in specific areas, such as organisations providing government funded services, social enterprises and smaller NFP organisations. For example:

> In areas of social assistance such as child welfare, women's or youth refuges and disability services, there is great frustration about the difficulties of obtaining capital. For some, particularly in the disability services field, there is a huge unmet need for capital to massively expand the provision of group homes. Because these require specialist fittings for many of their residents, they must be purpose built or obtained on a long term lease and renovated. Many others, providing vocational programs, day programs and the like are unable to access the small amounts of capital needed to operate efficiently and safely, such as renewing IT systems, or replacing an ageing bus. State government support is available, but it is grossly inadequate. The problem is particularly acute for disability services, especially for the provision of accommodation. (National Disability Services (ACT), sub. 85, pp. 7–8)

The main constraints on NFPs accessing capital are:

- the lack of collateral to guarantee loans
- the lack of a reliable revenue stream to service debt — possibly from inadequate and insecure funding from government or the inability of certain NFPs to access philanthropic donations (for example, by not having DGR status)
- large transaction costs relative to the amount of capital required
- the lack of experience in developing sustainable business plans — including a reluctance of boards and management to consider debt or equity options to finance expansion
- the lack of a suitable organisational structure which would allow organisations to raise equity capital.

## Initiatives to improve access to capital

A major constraint on capital access arises because the market which specialises in providing both finance and other support to NFPs is underdeveloped. As such, the development of a robust capital market for NFPs should be a priority.

The US and UK governments have promoted the development of a specialised market to allow NFPs to access capital at reasonable rates, predominantly through CDFIs. In addition, options to improve access to equity capital have emerged through the introduction of specialised legal forms.

### *Developing a robust market for NFP debt*

Like SMEs, NFPs that are financially sustainable and able to service their debt should be able to access capital. In Australia, however, there are relatively few financial intermediaries, either specialist or mainstream, that offer suitable loans or other investment products to NFPs. This could be due to failure by NFPs to demonstrate their ability to service debt, high costs for financial intermediaries in developing new business, and the still young market for capital that seeks return in more than financial benefits (for example, socially responsible investment). Change needs to be affected in all three areas to develop a sustainable primary market for NFP debt.

As the Australian Government has limited experience in this area, it should establish an advisory panel to provide options and assess progress in the development of a sustainable capital market for NFPs. Given the budget implications of any initiatives in this area, even the modest ones proposed below, the panel should be chaired by Treasury.

#### *Developing investment opportunities*

NFPs need to be able to offer investment opportunities that are attractive to lenders.

The most important feature is a reliable and sustainable funding stream from which to service any debt. Foresters Community Finance (sub. DR297) indicated that the NFPs it typically works with derive 85 to 95 per cent of their funding from government. However, contract periods are often shorter than the debt service period creating uncertainty over ability to repay. Chapter 12 recommends that funding certainty for NFPs should reflect the time period required to achieve agreed outcomes, rather than having arbitrary contract periods.

Collateral is another important feature for a good investment opportunity, as is ‘skin in the game’, to demonstrate incentives are aligned for making the investment pay. Many NFPs that rely heavily on government as a source of funds are unable to retain any surplus to use towards building a deposit (chapter 11). Donors also often want to see their donations put to immediate use. NFPs need to explore strategies to accumulate an asset base, including purpose based fundraising drives and trading activities, as long as these are not to the detriment of their other activities.

Investment opportunities also need to be sound and presented in a language that investors can understand. NFPs need to develop business plans and financial accounts that comply with mainstream financial market requirements. There is generally a lack of expertise in this area in NFP boards and management, especially in small to medium sized organisations. Government could assist NFP intermediaries to expand business support services in these areas (chapter 9). These services could be especially useful for emerging social enterprises.

*Overcoming the high transaction costs of establishing financial intermediation*

Even with sound investment opportunities, mainstream financial institutions may lack the skills and understanding to assess the quality of the investment. Strict credit criteria are an easy way for financial institutions to assess viability of a proposed loan. Given the nature of NFPs, many may fail these criteria because income (such as from donations) is inherently uncertain, and there is no ‘owner’ to put their personal assets at risk.

As a result, specialist financial intermediaries, such as CDFIs, play an important role in mobilising capital and linking it with NFPs. In doing so, CDFIs use different models from those employed by the mainstream market (Foresters Community Finance, sub. DR297).

CDFIs usually work with NFPs to develop an understanding of their organisational form, capacity and operation as part of the due diligence process prior to investing. As such, these intermediaries provide support services to assist NFPs access finance; however, the cost of finance is likely to relatively high compared to mainstream finance options.

To gain economies of scale in investing with NFPs, CDFIs may pool funds from a variety of sources — such as philanthropic foundations and trusts, superannuation funds, conventional lenders and government — to provide loans directly to NFPs. This also assists CDFIs manage investment risk through pooling a number of projects and investors together into a managed investment vehicle. Like other types

of investment classes, these vehicles need regulatory approval to assure investors of their stability and trustworthiness.

Internationally, governments have been proactive in the development of the CDFI sector. The US government established a CDFI Fund in 1994 to provide capital to individual CDFIs and their partners through a competitive application process. In addition, the Community Reinvestment Act (CRA) regulations were revised in 1995 to explicitly recognise loans and investments in CDFIs as qualified CRA activity. These two initiatives have resulted in the expansion of the CDFI sector with 842 certified CDFIs as of May 2009 (APCSIP, sub. 41).

In the UK, CDFIs developed during the late 1990s and early 2000s with official recognition, policy initiatives and financial support. The introduction of a Community Investment Tax Relief scheme was designed to encourage private investment in for-profit and NFP enterprises targeting community development in under-invested communities. In addition, over £42 million in direct government funding was also provided through the Phoenix Fund to support the development of 63 CDFIs. As at the end of March 2007, the Community Development Financial Association reported that 61 member organisations held an investment and loan portfolio totalling £287 million with total capital of £569 million (APCSIP, sub. 41).

In Australia, however, there has been limited government support to develop the CDFI sector. As a result, there are only a few CDFIs which provide specialised capital services to NFPs (box 7.9 lists the main CDFIs). These organisations have the potential to lead the development of a market for NFP debt. For example, Foresters Community Finance (sub. DR297) has secured an Australian Financial Services Licence to design and develop social investment products that are familiar to mainstream markets.

Given the importance of the CDFI sector in combating financial exclusion in comparable countries, the Australian Government should consider initiatives which will support the growth of existing CDFIs and explore opportunities for the development of new CDFIs to encourage greater competition and awareness. Given the relatively high transaction and administration costs involved in assisting NFPs develop, as well as assessing their investment opportunities, it may be necessary to provide both start-up funding and ongoing support for development activities. However, in the view of the Commission, such government support should not be extended to providing a capital fund from which CDFIs can borrow as it is more sustainable to mobilise capital from philanthropic and private sources.

*Increasing the supply of capital that accepts part of its return in social benefits*

Mainstream financial institutions and even special purpose community banks have difficulty lending to the NFP sector where, from a financial return perspective, the risk–return profile of NFP investments is less attractive than other investment types.

CDFIs source capital from institutional investors, individuals, philanthropic foundations, NFP cash reserves and governments. In some countries, government provides a risk capital tier, or provides other arrangements to subsidise the return to other investors (such as tax concessions on returns). This subsidy can be seen as a payment for the social benefit that is expected to be delivered from the investment. However, the accountability of these approaches is limited to the investment vehicle, rather than to the investment opportunity itself, which is where the social benefits need to arise. A better strategy to ensure social benefits are delivered is to link the subsidy to the investment opportunity. This subsidy could come from investors who are happy to receive a lower financial return on their investment as long as it generates a significant social benefit.

The growth in philanthropy indicates considerable public interest in these types of investments, but the market has yet to develop such investment vehicles (although ethical investments may go part of the way). One reason is that, in regards to investment, the rules governing fiduciary duty for financial institutions (including superannuation funds) and, more importantly charitable trusts and foundations, require trustees to preserve and grow the income producing capital base (Ward 2008).

In Australia, the fund corpus of philanthropic intermediaries appears to be an untapped source of capital for CDFIs and the NFP sector as a whole. Public and private ancillary funds can enter into uncommercial transactions (for example, subsidised loans) with DGRs that are in furtherance of the PAF's purpose. The difference between the interest on the actual loan and the interest that would have accrued if it were provided on a commercial basis is considered to be a charitable DGR distribution by the ATO. These funds may engage with non-DGRs but only for commercial transactions. It is unknown exactly how many loans are provided to the NFP sector by these funds but it is thought to be relatively low.

In the US, philanthropic intermediaries are encouraged to undertake 'program related investments' and 'mission related investments' to further the impact of their philanthropic activities. These investment types have been available for over 30 years and can take on a variety of investment forms, including common loans, cash equivalent deposits, equity stakes and loan guarantees (Carlson 2006).

Even if only a small proportion, say 5 per cent, of the billions of dollars held by philanthropic intermediaries in Australia were made available as a source of capital for NFP investment, it would greatly increase the supply of finance available to NFPs. This would require the development of appropriate investment vehicles and clarification of the fiduciary duty of trustees, allowing approved loans to be included in meeting (possibly expanded) disbursement requirements. This could see the development of a specialised capital market without the need for government subsidies. Initially, low interest loans made out of funds that have received a DGR concession may be limited to endorsed charities and DGRs, as they have been subject to an endorsement process to determine their charitable, or other approved, purpose (chapter 6).

In the context of other sources of investment capital, such as superannuation funds, the Australian Conservation Foundation indicated that:

> … key regulatory parameters applicable to for-profit vehicles lack the flexibility necessary to adapt to a context in which investment returns are viewed through a different and broader prism than traditional approaches. (sub. DR242, p. 19)

Some superannuation funds and investment managers have signed up to the UN Principles for Responsible Investment and take environmental, social and corporate governance (ESG) issues into account when assessing investment options (UNPRI Secretariat 2009). However, the investment options available that utilise these principles appear to use negative vetting techniques (that is, excluding investments which do not conform to ESG principles), rather than making an explicit trade-off between financial and social returns.

The government could play a role in promoting CDFIs and their investment products to the wider community to increase awareness of, and consequently capital investment in, their activities. The growth in funds allocated to ‘socially responsible’ investments is evidence that the Australian community will support investment products associated with a social or environmental cause, although the extent that they will forgo financial return to do so has yet to be tested. Liquidity and idiosyncratic risk may also be a concern. The development of a secondary market for NFP debt would facilitate the development of diversified products that, while offering a lower rate of return, would reduce the risk for the investor.

Governments could also increase capital to the sector by establishing a capital fund, as has been done in the US, from which organisations can borrow, or by providing tax incentives for private capital. However, the Commission is concerned about moral hazard issues associated with government providing finance directly through a capital fund, or through providing loan guarantees for private investors which may hinder the development of a long-term efficient market.

There may be specific circumstances where direct government intervention to provide capital is warranted. However, such intervention needs to be focussed on a particular social problem and designed to meet social policy objectives. For example, the National Rent Affordability Scheme (NRAS) is an Australian Government initiative designed to attract private capital into the housing market for people with low incomes. It is targeted to ensure that this capital is invested for the long term and that private investors are active in managing the associated risk (appendix I).

*Improving access to equity capital*

Currently, only NFPs that have a cooperative organisational structure, the small number of companies limited by shares, and incorporated associations in Queensland, are allowed to raise equity capital, either through issuing an equity stake or through subordinated debt instruments (such as bonds or notes). However, the cooperative organisational structure and these equity instruments are not widely used. As such, there may be scope for increasing the use of the cooperative structure provided NFPs are able to maintain their tax concession status (that is, they are not trading cooperatives).

Alternatively, governments could legislate to establish a new incorporated entity which would allow equity capital to be invested in organisations that provide substantial community benefits, such as social enterprises (chapter 9). Providing access to equity reduces the reliance on debt capital and may be appropriate for start-up social enterprises where there is limited collateral or the business model has not yet been shown to be viable.

Internationally, new legal forms, such as community interest companies (CICs) and low-profit, limited liability companies (L3Cs) (box 7.11), have emerged to meet the needs of NFPs that seek to source equity capital. Under these structures, financial returns are often capped to ensure that social returns are not compromised in the pursuit of profit maximisation.

However, these new legal forms have already posed concerns about the ability of investors to withdraw their capital. Without sufficient market liquidity, it may not be possible for investors to exit these types of investments in a timely manner. While the Australian Government could explore options to improve access to equity capital, its main efforts should be focussed on developing a sustainable market for NFP debt.

## Box 7.11 **New legal forms to support social enterprise**

In the states of Vermont and Michigan in the US, a new legal form of business entity — a low-profit, limited liability company (L3C) — has been created to bridge the gap between non-profit and for-profit investing by providing a structure that facilitates investments in socially beneficial, for-profit ventures. Unlike a standard limited liability company (LLC), the L3C has an explicit primary charitable mission and only a secondary profit concern. But unlike a charity, the L3C is free to distribute the profits, after taxes, to owners or investors. It has thus been designed to dovetail with the Internal Revenue Service regulations in respect of a program related investment (PRI) and facilitates tranched investing to increase the attractiveness to investors. For example, a L3C can accept a PRI from a foundation investor that takes the first risk position and introduce subsequent senior tiers of less risky capital with higher returns than the base capital of the PRI. These subsequent tiers may offer either market rate returns to appeal to investors or below market returns to appeal to other investors willing to accept a portion of return in the form of enhanced social welfare.

In the UK, a community interest company (CIC) has been designed specifically for social enterprises that want to use their profits and assets for the public good. CICs provide social enterprises with the flexibility of operating 'commercially' under the company form, but with special features — asset lock and capped dividend distribution — to ensure they are working for the benefit of the community without the need for charitable status. From a financing perspective, the CIC form expands access to finance for social enterprises as CICs are able to raise capital from issuing shares, albeit a capped share that restricts the level of dividends in order to protect community benefit.

*Source:* APCSIP (sub. 41).

RECOMMENDATION 7.5

***Australian governments should assist in the development of a sustainable market for not- for-profit organisations to access debt financing through:***

- ***building business planning skills for not-for-profit organisations, notably social enterprises (recommendations 9.2 and 9.6)***
- ***improving funding certainty for those not-for-profit organisations involved in the delivery of government services to improve loan viability by improving clarity about funding (recommendation 11.1) and the appropriate length of contract (recommendation 12.5)***
- ***exploring options to encourage (for a limited period) community development financial institutions to develop appropriate financial products and services for the sector***

- ***exploring options to make better use of the corpus of philanthropic foundations and trusts to make loans to deductible gift recipients and endorsed charitable institutions.***

***The Australian Government should establish an advisory panel, chaired by Treasury, to consider options and assess progress in developing a sustainable market for not-for-profit organisation debt products with the aim of establishing mainstream financial products for investors who are willing to accept a lower risk adjusted financial return for an accompanying social return.***