21 Mutuality

Box 21.1 **Key messages**

- Clubs play a major role in Australian society, providing significant benefits to both their members and to the local communities in which they operate.
- However, the growth of gambling has led to significant (and because of the mutuality principle, largely untaxed) income flows to *some* clubs in *some* jurisdictions, changing the character of a segment of the club sector.
- The Commission estimates that the tax forgone arising from the application of the mutuality principle to clubs was around $100 million in 1997-98.
- In some clubs the revenue from poker machines amounts to 80 per cent or more of total revenue, higher than is found in some casinos. Gambling revenues have grown rapidly in clubs — especially in New South Wales and the ACT. For example, real losses per adult from gaming machines in New South Wales clubs grew by a factor of about 17 from 1957 to 1998 — and are currently around $500.
- Overall, gambling income was just below 60 per cent of income earned by all clubs in New South Wales in 1997-98, and nearly 70 per cent in ACT clubs. In South Australia, by comparison, it was about 22 per cent, while for Tasmania, Western Australia and the Northern Territory combined it was around 10 per cent.
- There is evidence that clubs use gambling revenue to subsidise bar and other services to members. The odds for gaming machines are also slightly better in clubs than hotels. However, these better average odds appear to be more a product of some scale advantages enjoyed by super clubs (which are unencumbered by venue caps) than mutuality itself.
- The growth of gambling revenues in clubs, combined with mutuality, has the potential to result in excessive capital allocation in club facilities and other investments. It may also reduce equity by reducing tax revenues, which in turn crowds out government expenditure.
- The principle of mutuality is not, by itself, the source of the problems identified above. Mutuality has had unintended consequences for equity and efficiency when segments of the club industry gained access to substantial revenue from gaming machines.
- There are a number of options for addressing the problems raised by mutuality. Of these, the one which appears to offer the best prospects for remedying the worst problems, while allowing for the different contexts of clubs in different states, is the imposition of a higher level of state tax on gambling in clubs in some states.

21.1 Introduction

Clubs serve a very important role in Australian communities, providing:

- a mechanism by which people can pool resources for a common purpose;
- a focal point for local communities;
- a means of strengthening social cohesion; and
- a way of funding many charitable, sporting, recreational and community groups, which by themselves, lack the ability to raise funds efficiently.

But gambling has changed the circumstances of some parts of the club industry. While clubs play a pivotal role in Australian communities, the privileged access by clubs to highly profitable gambling opportunities, particularly gaming machines, *combined* with mutuality (which protects much of the revenue of clubs from income taxation) has been seen by some as unfair, inefficient and socially undesirable (Australian Hotels Association (NSW), sub. 68, p. 137). There has been a large expansion of part of the club sector in some states and an increased concentration on gambling as their main business. This has skewed the traditional nature of clubs — and has led to the development of 'super clubs' in some areas. This then raises the question of whether the club cocktail of mutuality, and a heavy and rapidly growing dependence on gambling revenues by a segment of the club industry, is one which policymakers should accept without restraint.

The chapter is organised as follows:

- section 21.2 is concerned with defining the mutuality principle;
- section 21.3 then examines how mutuality affects clubs, examining which sorts of income are taxed, and which are not;
- in considering any change to the current tax treatment of clubs, it is important to understand the context in which these clubs exist and the meteoric rise of super clubs in the 1990s in some states (section 21.4);
- the chapter then assesses the economic grounds for mutuality, and examines how, in special circumstances, equity or efficiency concerns could arise out of its application (section 21.5);
- section 21.6 then examines the combined efficiency, equity and social impacts of the combination of untaxed gaming machine revenues and the rapid growth of the club industry; and
- finally, the chapter assesses the scope for policy change, indicating the strengths and weaknesses of different approaches for dealing with the adverse outcomes of the existing arrangements (section 21.7).

21.2 What is the mutuality principle?

The mutuality 'principle' relates to the notion that a person cannot make a profit from selling to him or herself. An amount received from oneself is not regarded as income and is therefore not subject to tax. The concept has been extended to defined groups of people who contribute to a common fund, controlled by the group for a common benefit. Any amount surplus to that needed to pursue the common purpose is said to be simply an increase of the common fund and as such not considered income, and not subject to tax. Over time, groups which have been considered to have mutual income have included church groups, bodies corporate, clubs (including licensed clubs), friendly societies, credit unions, automobile associations, insurance companies and finance organisations.

Mutuality is not a form of organisation, even if the participants are often called members. Any organisation can have mutual activities. A common feature of mutual organisations in general, and of licensed clubs in particular, is that participants usually do not have property rights to their share in the common fund, nor can they sell their share. And when they cease to be members, they lose their right to participate without receiving a financial benefit from the surrender of their membership. A further feature of licensed clubs is that there are both membership fees and, where prices charged for club services are greater than their cost, additional contributions. It is these additional contributions which constitute mutual income.

Over the years there have been a number of challenges in the courts involving the mutuality principle (box 21.2). These challenges have generally not been concerned with the validity of not taxing mutual income. Rather, the challenges have been concerned with whether the surplus was mutual or not.

21.3 Clubs, mutuality and taxation

For many clubs the mutuality principle is irrelevant, because they are non-profit associations exempt from income tax by statute. These include, for instance, sporting clubs which satisfy the requirements of Taxation Ruling TR97/22. The main thrust of this ruling is that clubs will only be eligible for an exemption if they can demonstrate that their main or dominant activity is the encouragement or promotion of a sport (figure 21.1).

Box 21.2 **The mutuality principle at common law**

One of the earliest modern judicial statement of the mutuality principle is by Lord Watson in the House of Lords, in 1889, in *New York Life Insurance Co v Styles*:

> ... when a number of individuals agree to contribute funds for a common purpose ... and stipulate that their contributions, so far as not required for that purpose, shall be repaid to them. I cannot conceive whey they should be regarded as traders, or why contributions returned to them should be regarded as profits. (14 App Cas 318; 2 TC 460)

The High Court of Australia first considered the mutuality principle in *Bohemians Club v the Acting Federal Commissioner of Taxation* in 1918:

> A man is not the source of his own income ... A man's income consists of moneys derived from sources outside of himself. Contributions made by a person for expenditure in his business or otherwise for his own benefit cannot be regarded as his income ...
>
> The contributions are, in substance, advances of capital for a common purpose, which are expected to be exhausted during the year for which they are paid. They are not income of the collective body any more than the calls paid by members of a company upon their shares are income of the company. If anything is left unexpended it is not income or profits, but savings, which members may claim to have returned to them. (24 CLR 334-339)

In *Colonial Mutual Life Assurance Society v Federal Commissioner of Taxation* (1946) the High Court considered the issue of an association's surplus:

> Where a number of people, associated together for a common purpose, have contributed to a common fund in which all contributors are interested, the surplus of their contributions remaining after the fund has been applied to the common purpose, is in essence a return of their own moneys which they have overpaid and is not a profit. (73 CLR 604

In 1965, the High Court appeared to consider the issue as settled. In *Revesby Credit Union Co-operative Ltd v Federal Commission of Taxation*, McTiernan J stated:

> The principle of mutuality seems to me to be settled. Where a number of people contribute to a fund created and controlled by them for a common purpose any surplus paid to the contributors after the use of the fund for the common purpose is not income but is to be regarded as a mere repayment of the contributor's own money ... (112 CLR 574-575)

In Royal Automobile Club of Victoria v Federal Commissioner of Taxation (1973) it was held that where the activity is mutual, the fact that only some members chose to take advantage of the benefits did not affect the element of mutuality. Losses and outgoings between the organisation's mutual and non-mutual activities needed to be separately accounted; income from those which were non-mutual were taxable (4 ATR 471).

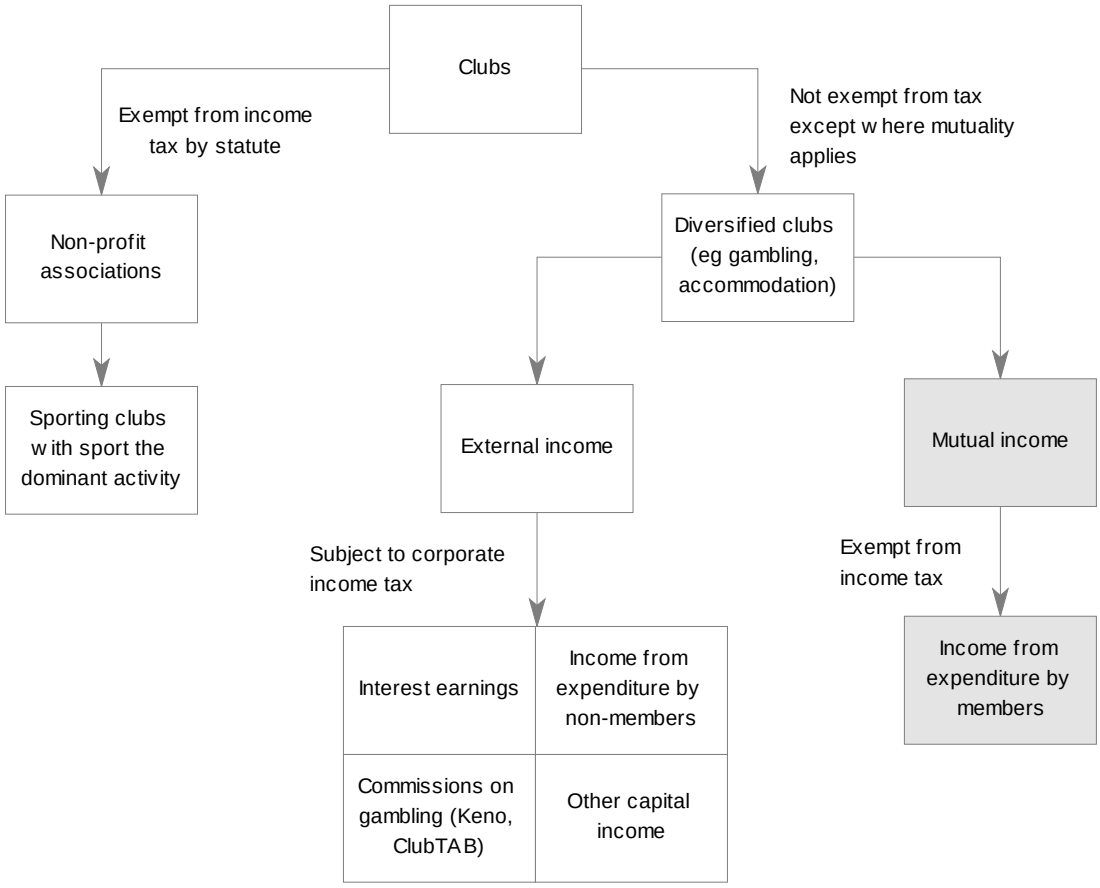
Source: sub. 137; sub. D265 to inquiry into private health insurance (PC 1997).

Many licensed clubs started off as sporting clubs. Indeed, many still provide sporting facilities. However, most are no longer eligible for an exemption by statute. That is because the provision of restaurant and bar services, as well as poker machines, and often additional services, such as entertainment and holiday accommodation, has become so large a proportion of their activities that the sports related activity is no longer dominant. Nevertheless, all or part of the surplus

generated by such clubs may not be considered income for the purposes of income tax because of the application of the mutuality principle.

Not all the surpluses of licensed clubs are subject to the mutuality principle, and consequently non-taxable. Whether they are, depends both on the rules governing the club and on how the income is generated.

Figure 21.1 **Where does the mutuality principle apply?**



Member receipts

Both membership fees and receipts from trading with members are covered by the mutuality principle. As stated in the Australian Master Tax Guide (CCH 1999), the member receipts of licensed clubs will be excluded from assessable income where the rules of the club:

(1) prohibit any distribution of surplus to the members; or

(2) provide that any surplus may be distributed only among members who have contributed to the common fund and in substantial proportion to the amount of their respective contributions (p. 126).

In practice, as regards clubs, the latter condition is irrelevant, as licensed clubs must be 'non-profit' organisations. That also means that in the case of a club being wound up, any proceeds must be distributed to a comparable non-profit organisation or charity. It does not mean clubs cannot generate surpluses through member trading, but they must use their surpluses for purposes other than distribution to members. Licensed clubs are also governed by individual state legislation. For instance, in New South Wales clubs are regulated by the *Registered Clubs Act 1976*. This Act prescribes in detail all the conditions licensed clubs must satisfy (box 21.3).

Non-member receipts and investment income

Not all income earned by clubs is free of income tax. Three categories of income are assessable.

First, if a person entering a club is not a full member (that is, they are either a guest or a temporary member) and purchases club goods and services, including playing gaming machines owned by the venue, then this is regarded as external income earned by club members, and is subject to tax.

Second, income from external investments, such as interest on accounts or dividends is fully taxable.

Finally, gambling income earned as commissions is fully taxable. For example, keno and TAB surpluses are taxable whether they are generated by members or by non-members. That is because these games are played under licence and the commission received is considered to be 'external' income. In Victoria, because poker machines in clubs are owned by an external operator (box 21.4) and the clubs receive a commission, the ATO has ruled (after initial disputation by the clubs) that all gaming machine income is taxable (TD1999/38).

To arrive at taxable income, the expenditure associated with earning assessable income may be deducted. Expenditure, therefore, also needs to be allocated between that attributable to members, that attributable to non-members and that attributable to other income (box 21.5).

Box 21.3 **New South Wales licensed clubs**

Licensed clubs were first established in New South Wales in the period following World War II, as licensed clubs for returned servicemen, to provide a congenial environment for socialising and pursuing common interests. In most places where they were established they existed side by side with hotels. Court decisions in 1947 first confirmed the clubs' entitlement to serve their members liquor outside the licensed premises trading hours which had to be observed by hotels. The concept of 'licensed club' spread to clubs promoting some game or sport, and those with cultural or other objectives.

In 1956, following considerable community debate, poker machine gaming in New South Wales clubs was legalised. A per machine licence fee applied, which was to be directed to the Hospitals' Fund. No cap was set on the number of poker machines allowed. In the following decades New South Wales clubs enjoyed rapid growth, some growing into large entities, providing a large variety of services. Apart from gaming, bar and restaurant services the larger clubs today often provide entertainment for both members and non-members, sometimes holiday and/or motel accommodation, and even invest in hairdressing establishments or butcher shops.

There are now more than 1500 licensed clubs in New South Wales, just under 60 per cent of which are located in rural areas. They employ around 65 000 people and hold a similar or slightly larger number of poker machines.

The *Registered Clubs Act 1976* (of New South Wales) requires that members of licensed clubs shall not be entitled to derive directly or indirectly, any profit, benefit or advantage from the club that is not offered equally to every full member of the club. It also requires that any profits or other income shall be applied only to the promotion of the purposes of the club and shall not be paid to or distributed among the members of the club. In the case of a club being wound up, any proceeds must be distributed to a comparable non-profit organisation, charity or an association exempt from income tax.

Licensed clubs are not prohibited from trading with non-members. So long as they are living at least 5 kilometres away from the club premises or are members of another similar registered club, non-members can be granted temporary membership status and still use club facilities. However, if a person does not meet these conditions, they are not eligible for temporary membership and can only be admitted as the guest of an accompanying member.

Box 21.4 **The structure of the Victorian poker machine industry – implications for mutuality**

In most states, clubs own the gaming machines and any surpluses generated by members is mutual income and not assessable for income tax purposes. Only that proportion of poker machine surpluses generated by non-members is assessable.

In Victoria this is not so. Poker machines were introduced in Victoria in 1992. However, Victorian clubs do not own the poker machines installed on their premises. Under Victoria's gaming regulation, the two gaming operators, Tabcorp and Tattersall's, who are each permitted to operate 50 per cent of the 27 500 gaming machines permitted to be available for gaming in all licensed venues, remain the owners of the poker machines. A club takes the money out of the poker machines and banks all of the proceeds in a trust account. The relevant operator later pays one third to the club, one third to the Victorian Government and retains one third for itself.

The Victorian clubs initially assumed that the member portion of the commission received on the poker machine proceeds was mutual income and not assessable. Self-assessment led to this situation continuing until the introduction of keno in New South Wales clubs in 1995, and the decision that keno surpluses were taxable because they were in the nature of commission earned, and therefore income from outside the club. The Victorian circumstances then also came to the notice of the ATO. The ATO subsequently informed the Victorian clubs that their poker machine income was derived by the gaming operator and not the club venue operator, and was therefore fully assessable.

Initially the Victorian clubs were informed that they would be taxed retrospectively to 1992. This was later relaxed to retrospection to the 1996-97 tax year. The Victorian clubs initially disputed this matter but ATO Taxation Determination TD1999/38 stated:

> If a club enters into an arrangement with an external gaming operator under which gaming machines are installed on the club's premises, the gaming income is derived by the gaming operator from the players … The amounts paid or allowed to a club by the gaming operator under such an arrangement is derived by the club from the external operator and not from the members/non members. Therefore, such income is fully assessable to the club because it is derived from an external source and is not subject to the principle of mutuality (TD1999/38).

Source: Australian Taxation Office.

Taxing non-mutual income

All clubs are regarded as companies for income tax purposes (except where exempted as non-profit associations) and, where there is taxable income, the normal company tax rate (currently 36 per cent) applies. For non-profit companies, including clubs, there is a phasing in of the full 36 per cent rate. No tax is payable if taxable income (for the 1998-99 tax year) is less than $417. Once taxable income reaches $1204, the full rate applies to the whole of the taxable income.

Box 21.5 **Assessable income and expenses of a licensed club**

The assessable income of a licensed club may comprise:

- any investment income (rents, interest, etc);
- the 'non-member percentage' of gross trading income (eg gross poker machine, bar and restaurant receipts).

Expenses relating specifically to members are not allowable deductions. The allowable deductions may comprise:

- expenses relating specifically to non-members (eg non-members only promotions, visitor sign-in books);
- expenses relating to wholly assessable income (eg investment expenses);
- non-apportionable deductions (eg contributions to staff superannuation, donations and costs of preparing tax returns) and
- the 'non-member percentage' of the apportionable expenditure (ie the remaining expenditure, other than expenditure relating solely to members and non-allowable items such as expenditure of a capital nature).

Source: CCH 1999.

As receipts from members are excluded from taxable income, clubs need to isolate those receipts from those of non-members and investment income when preparing tax returns. This is not likely to be a problem in the case of investment income, but presents difficulties in the case of receipts from non-members. To overcome this problem, the ATO has adopted a formula (box 21.6) to calculate the proportion of club receipts which are attributable to non-members. The formula has been accepted by tribunals as reasonable in the absence of evidence from clubs to show that it is unjustified. Clubs do not have to use the formula but can use any alternative method which they can demonstrate produces reasonable and accurate results.

Tax paid by clubs

Information extracted from the annual reports of 28 licensed clubs in New South Wales indicates that the total amount of income tax paid by those clubs in 1996-97 was just over $8 million (a selection is given in table 21.1). Since the rate of income tax was 36 per cent, total taxable income for income tax purposes could have been around $22 million. Total reported surpluses for the clubs involved were nearly $80 million. From this it can be deduced that the proportion of net income attributable to non-members and investment income was around 28 per cent.

Box 21.6 **The 'Waratahs' formula**

To isolate a club's receipts and expenses from trading with non-members from those from trading with members, the ATO assumed that expenditure by non-members is the same as that by members, and developed the formula below. It is known as the 'Waratahs' formula, so called after a decision in *Waratahs Rugby Union Football Club v Federal Commissioner of Taxation* (1979) 10 ATR 33; 79 ATC 4337). The proportion of income which is assessable (p) is:

$$p = \frac{B \times 0.75 + C}{(R \times S \times T) + A}$$

where:

A = total visitors for the year of income;

B = members' guests, ie visitors who are accompanied to the club by a member and signed in by that member. The formula assumes that 25 per cent of members' guests do not contribute to the club's assessable income, ie they are non-paying guests or non-working spouses of members;

C = A - B;

R = average number of subscribed members for the year of income;

S = the percentage of members that attend the club on a daily basis; and

T = the number of trading days for the year of income.

Factor A can be determined by summation of the visitors' books. Clubs are required by law to keep a register of members' guests and visitors. A club should conduct surveys to determine the percentage of members attending the club on a daily basis.

Source: CCH 1999.

For Australia as a whole, clubs earned operating profits before tax of $561 million (of which $530.9 million are accounted for by clubs with gambling). If this surplus was taxed at the company tax rate, this would generate revenue of $202 million. Assuming that 28 per cent of the income was already subject to tax suggests that the additional revenue forgone through the mutuality principle is around $145 million. However, this somewhat overstates the true tax forgone as a result of mutuality since Australia has a dividend imputation system in place. If club income was treated like other corporate income, it is ultimately taxed at the average marginal rates of personal taxpayers. Supposing this tax rate to be around 25 per cent for the average club 'shareholder', this would imply tax forgone of around $100 million in 1997-98 as a result of the mutuality principle, principally from New South Wales clubs. Over time, this loss could be expected to grow. Moreover, the real loss of tax may be higher than this, as operating profits may be artificially low due to subsidised services — in principle, governments should be taxing any implicit income earned by club members (section 21.5).

Table 21.1 **Income tax paid by selected clubs, 1996–97**

	Operating profits before income tax[a]	*Gaming net profit*[b]	*Income tax paid*	*Income tax as % of operating profit*	*Income tax as % of poker machine net profit*
	$000	$000	$000	%	%
Penrith Rugby League Club	573	28 926	73	13	3
Canterbury-Bankstown League Club	6 846	21 242	863	13	4
Rooty Hill RSL Club	6 682	18 970	795	12	4
Mt Pritchard & District Community Club	6 686	15 810	1 014	15	6
Bankstown District Sports Club	4 069	23 899	126	3	<1
North Sydney Leagues Club	4 017	..	94	2	..
Eastern Suburbs Leagues Club	2 472	12 158	380	15	3
Blacktown Workers' Club Limited	1 896	13 384	201	11	2
Cabra-Vale Ex-Active Servicemen's Club	5 341	12 016	747	14	6
Revesby Workers' Club	1 120	9 467	119	10	1
Western Suburbs Leagues Club	3 009	10 780	309	10	3
Canterbury-Hurlstone Park RSL Club	1 598	9 534	171	11	2
Manly-Warringa Rugby League Club	2 562	10 785	..	..	..
Liverpool Catholic Club	2 632	9 383	136	5	1
Campbell Town Catholic Club	4 009	9 767	148	4	2
North Ryde RSL Club	3 018	10 268	180	6	2
Marrickville RSL Club	661	7 235	235	36	3
Burwood RSL Club	2 223	7 861	184	8	2
Gosford RSL Club	648	3 264	5	<1	<1

a Operating profits represents total revenue less costs, before income tax.

b Poker machine net profit comprises net receipts (takings less payouts and prizes) less direct costs attributable to poker machines.

Source: Club annual reports.

21.4 The club industry

Currently there are some 5600 registered and licensed clubs in Australia. They cover a large variety of interests, including sports, workers, cultural, ethnic, religious, RSL, ex-services, community and social objectives. Sporting clubs make up about half of all registered and licensed clubs, but many clubs not initially established to promote a sport provide a range of subsidiary clubs and organisations devoted to some sport or game. Other clubs were established to bring together ethnic groups, those belonging to a specific religion, ex-service personnel or some other group within the community with similar interests. Total membership Australia-wide is estimated at around nine million (sub. 142, p. 1) although that is likely to be an overestimate as many people belong to more than one club. Many of the clubs offer gaming facilities other than poker machines, such as TAB and keno,

but, as shown in table 21.2, poker machines provide by far the largest proportion of gambling revenue.

Table 21.2 **Net profit/loss from selected club activities**
Selected clubs, $'000s, 1997

Club	*Poker machine net profit*	*Other gaming*	*Bar trading*	*Catering*
Penrith Rugby League Club	28 926	43	3 070	621
Canterbury-Bankstown League Club	21 242	n/a	(353)	(499)
Cabra-Vale Ex-Active Servicemen's Club	12 016	(31)	(137)	(649)
Western Suburbs Leagues Club	10 780	(84)	(187)	(4)
Canterbury-Hurlstone Park RSL Club	9 534	45	(50)	(383)
Burwood RSL Club	7 861	23	407	(310)
Eastern Suburbs Leagues Club	12 158	236	314	(328)
Liverpool Catholic Club	9 383	146	245	(51)
Revesby Workers' Club	9 466	(39)	579	(424)
Blacktown Workers' Club Limited	13 384	99	390	(289)
Rooty Hill RSL Club	18 970	163	141	(278)
Mt Pritchard & District Community Club	15 810	n/a	(457)	(242)

Source: Club annual reports.

The licensed club industry is extensively regulated, mainly through state legislation. Much of each state's regulation was put in place at the time poker machines were first introduced in that state. State regulation generally covers such matters as state taxes, numbers of poker machines permitted, compulsory contributions to the community, the physical location of poker machines in clubs, minimum age of persons permitted to play poker machines, ownership of poker machines, and minimum payout ratios. Table 21.3 provides some information about the number of clubs and poker machines in Australia and some of the regulatory provisions applied to them.

In particular table 21.3 reveals the high dependence on gambling (mainly gaming machines) by clubs in the ACT and New South Wales:

- About 60 per cent of income of clubs with gambling facilities is derived from gambling in New South Wales. This dependence reaches nearly 70 per cent in the ACT. In contrast, it is around 50 per cent in Victoria and Queensland, and about 35 per cent in South Australia;
- Other data from the ABS reveal that in 1997-98, those states in which club gambling was most intense had the smallest non-gambling club sector. For example, non-gambling clubs accounted for only 1.4 per cent of total club income in New South Wales and 1.8 per cent in the ACT. In contrast, non-

gambling clubs accounted for just over 35 per cent of total club income in Victoria and South Australia.

Table 21.3 **Clubs with gambling facilities, 1997–98**

State	*Number of clubs 1997-98*	*Gambling revenue to total sales*	*Numbers of poker machines 1997-98*[a]	*When machines introduced*	*Maximum permitted per club*	*Payout ratio*	*Owned by*	*Does mutuality apply?*
	No.	%	No.					
NSW	1 474	60.8	65 000	1956	No limit	85% min	Club	Yes
Vic	205	49.7	13 230	1991	105	87% min	Operator	No
Qld	615	46.7	16 624	1992	270[b]	85%-92%	Gov/club[c]	Yes
WA	9[d]	np	0	..	0	..	..	..
SA	93	35.7	..	1994	40	85% min	Club	Yes
Tas	42	np	..	1997	No limit	85% min	Operator	No
ACT	63	69.4	4 376	1976	No limit	85% min	Club	Yes
NT	25	np	404	1996	No limit	89%-92%	Gov[e]	Yes
Australia	2 525	57.5	..					

a 1997-98 figures shown for comparability. See table 13.1 in chapter 13 for most recent gaming machine numbers in each jurisdiction. **b** Phasing up to 300 from 1 July 2001. **c** In transition from government to club ownership. **d** Western Australia does not allow electronic gaming machines into clubs or hotels, but does allow video lottery terminals and other gambling forms. **e** No lease fee applies.

Source: Data for the number of clubs with gambling facilities and gambling dependence is from ABS (1996b). Other data are from subs. 103 and 128.

Overall, gambling income was just below 60 per cent of income earned by all clubs in New South Wales in 1997-98, and still nearly 70 per cent in ACT clubs. In South Australia, by comparison, it was about 22 per cent, while for Tasmania, Western Australia and the Northern Territory combined it was around 10 per cent. Clubs are located both in urban and metropolitan centres. For example, of the registered clubs in New South Wales, 57 per cent are located in rural areas, often being the largest business operating in the community. The total net worth of Australian clubs at 30 June 1995 was $4 billion. Capital expenditure during 1994-95 was $714 million (ABS 1996b).

Clubs are a considerable source of employment, full-time as well as part-time. Total employment by Australian clubs as at 30 June 1998 was 67 272. Around 59 543 or 88.5 per cent of these worked in clubs with gambling facilities. By far the largest proportion of those employed in clubs with gambling facilities worked in New South Wales (69 per cent).[1]

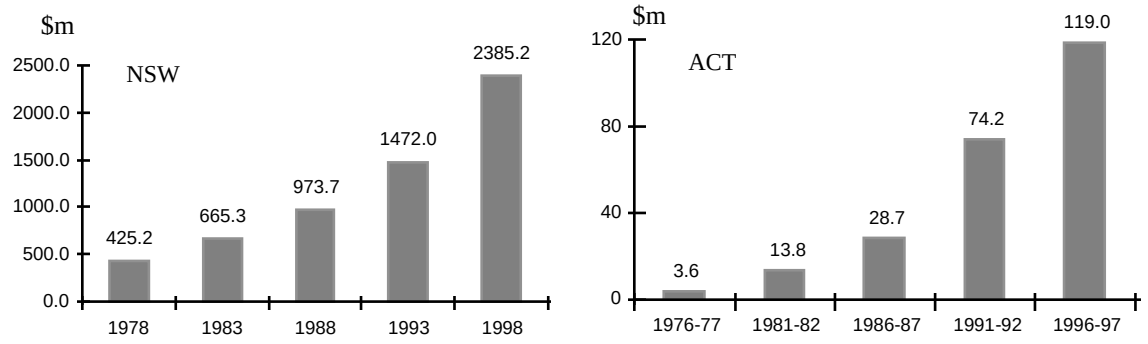
[1] Based on data from ABS (Cat. no. 8687.0, June 1999).

The growth of licensed clubs

Even before poker machines were introduced in Australian clubs, licensed clubs formed an important part of the social life of many Australians. However, they generally remained relatively small, having a minimal impact on the economic environment of the area in which they operated.

Currently, in New South Wales and the ACT there are a number of very large clubs — 'super clubs' — with significant 'members' equity' (in a number of cases exceeding $30 million) and turnovers of many millions of dollars, mainly from poker machines. Figure 21.2 shows the rapid growth in poker machine revenue in New South Wales clubs, where poker machines became legal over forty years ago, and ACT clubs, where poker machines were introduced in 1976. Real losses per adult from gaming machines in New South Wales clubs grew by a factor of about 17 from 1957 to 1998, and are currently around $500.

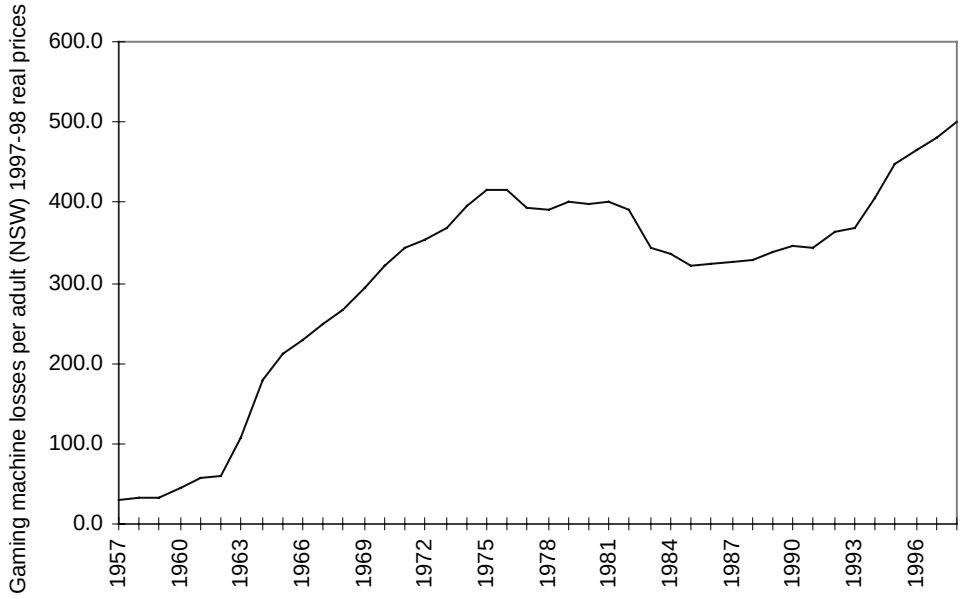
Figure 21.2 **New South Wales and ACT clubs – gaming machine revenue**
$ million



Data source: NSW Department of Gaming and Racing 1999, *Gaming Analysis 1997-98*; *Registered Clubs, Quarterly Gaming Analysis May 1998*; and Revenue Management Branch, Office of Financial Management, Chief Minister's Department, ACT.

However, while revenues in New South Wales have grown rapidly in the last decade, this has not been true for all periods since the removal of the prohibition on gaming machines in the early 1950s (figure 21.3). This suggests that the rapid growth seen recently may not persist. However, even if growth were to abate, it would be expected that the stock of club assets would continue to grow significantly over time.

Figure 21.3 **Gaming machine revenue per adult**
New South Wales real (1997-98) prices ($)



Data source: NSW Department of Gaming and Racing, *Gaming Analysis 1996-97* (1998) and *Registered Clubs, Quarterly Gaming Analysis May 1998* (1999); and data on the adult population and the Sydney CPI from ABS data in Econdata.

In some cases the revenue from poker machines amounts to as much as 80 per cent or more of total revenue (table 21.4), while the net surpluses from poker machines can be more than 60 per cent of machine revenue (table 21.5). In those states where poker machine numbers are capped, or not permitted at all, clubs have tended to remain smaller, with fewer and less luxurious facilities. Examination of the annual accounts of some of the large 'super clubs' also reveals that poker machine surpluses offset losses made from other club services, predominantly restaurant and bar services (table 21.2). The implication is that prices for non-gambling goods and services are subsidised by gambling.

In New South Wales, Queensland and the ACT, the commencement of rapid growth in club facilities and expansion in club services appears to have coincided with the introduction of gaming machines. The Council of Community Clubs of Australia & New Zealand said there can be no doubt:

> ... that the major social impact of clubs came about as a direct result of the licensing of poker machines in the mid-1950s [in New South Wales]. This ... saw an expansion of the Club Movement which was neither predicted nor planned, and has culminated in the huge leisure industry that clubs represent today (Directors Guide, 5th edition, Registered Clubs Association of New South Wales, quoted in sub. 142).

Table 21.4 **Club poker machine revenue as a proportion of total revenue**

Selected clubs, 1997

Club	*Total revenue*	*Poker machine revenue*	*Proportion of total revenue*
	$000	$000	%
Canterbury Bankstown League Club	42 577	37 340	88
Marrickville RSL Club	15 569	13 338	86
North Sydney Leagues' Club	25 173	20 956	83
Dee Why RSL Club	16 594	13 459	81
Cabra-Vale Ex-Active Servicemen's Club	25 087	20 167	80
Western Suburbs Leagues Club	22 078	17 331	79
Manly-Warringa Rugby League Club	20 696	16 005	77
Canterbury-Hurlstone Park RSL Club	22 319	16 620	75
Burwood RSL Club	16 104	11 951	74
Eastern Suburbs Leagues Club	25 385	18 397	73
Liverpool Catholic Club	22 540	15 197	67
Revesby Workers' Club	24 394	16 042	66
Blacktown Workers Club	31 705	20 410	65

Source: Club annual reports.

Table 21.5 **Poker machine net profit as a proportion of poker machine revenue**

Selected clubs, 1997

	Poker machine revenue	*Poker machine net profit*	*Net profit as a proportion of revenue*
	$000	$000	%
Canterbury Bankstown League Club	37 340	21 242	57
Marrickville RSL Club	13 338	7 236	54
Cabra-Vale Ex-Active Servicemen's Club	20 167	12 016	60
Western Suburbs Leagues Club	17 331	10 780	62
Manly-Warringa Rugby League Club	16 005	10 785	67
Canterbury-Hurlstone Park RSL Club	16 620	9 534	57
Burwood RSL Club	11 951	7 861	66
Eastern Suburbs Leagues Club	18 397	12 158	66
Liverpool Catholic Club	15 197	9 383	62
Revesby Workers' Club	16 042	9 467	59
Blacktown Workers Club	20 410	13 384	66

Source: Club annual reports.

With distribution of surpluses as cash dividends to members not an option, clubs have several alternatives. They can use surpluses to reduce membership charges, to lower the prices charged for services, they can use them to provide benefits for the community as a whole, to make donations to charities, or they can use them to expand services provided to members. Many clubs do all of these, and indeed, state

regulation, and sometimes local government by-laws, require contributions to be made to the community as a condition of licence. Sometimes these requirements are very specific and spell out precisely the contributions required. Annual membership charges are already low, and, in New South Wales, cannot legally be less than $2. However, club objectives generally provide that surpluses be used for the benefit of members, and members are likely to prefer the majority of surpluses to be so used. With poker machine surpluses constituting the bulk of club surpluses, it seems clear that it is those which are driving the expansion of clubs.

The question then is whether the changed nature of parts of the Australian club sector — associated with burgeoning profits from gambling — form a basis for re-evaluating the application of the mutuality principle. To consider this question, the next section looks at the economic principles that should underlie tax exemption. These principles are then used as a basis for assessing the economic and social impacts of club expansion in section 21.6.

21.5 What are the *economic* grounds for the mutuality principle?

There are a number of key issues when considering whether mutuality is an appropriate basis for exemption from income tax.

Is mutual income genuine income?

One threshold issue is whether any part of the surpluses generated by mutual organisations constitute genuine economic income (box 21.7). If that were so, this would provide an in-principle rationale for some taxation of mutual income, consistent with the treatment of other economic income.

Whether mutual surpluses can be considered as economic income to members depends on the way in which they have been derived. If, for example, the surpluses arise because members pay membership subscriptions or higher than market prices for goods or services in order to buy some common facility, then they are not income, but rather capital contributions. In this instance, there would be no economic grounds for taxation of these surpluses.

Box 21.7 **A story about beer and gambling**

John is a member of a club (which, through mutuality, is exempt from income tax) that sells its beer at $1.50 a glass, 50 cents below the asking price at nearby hotels. At face value, it appears that John is receiving untaxed 'in-kind' income of about 50 cents for every glass of beer drunk. But matters are more complex than this. How can the club sell the beer at a price lower than that in hotels? Say that the beer is subsidised by gambling in the club. But to subsidise beer means that gambling prices must be higher than they would otherwise be. That means that John and other club members might get benefits from cheap beer, but these benefits are exactly offset by more expensive gambling. It looks like the apparent 'in-kind' income represented by cheap beer has just disappeared!

The story is similar if the beer is priced at the same price as hotels, but gambling is still priced higher than its full economic cost to the club — in this case, the club makes a surplus, and it is precisely that surplus which the mutuality principle protects from income taxation.

But what happens if the costs of gambling in clubs are *lower* than in hotels — not because of any natural advantage of clubs — but because of the different ways in which governments treat clubs versus pubs? Gambling in pubs will be more expensive than in clubs for three reasons. Pubs have to:

- pay bigger state taxes on gambling losses made by their customers;
- pay hefty license fees for new gaming machines (when they want to have more than 15 machines);
- bear income tax on any profits from gambling.[2]

In that case, whatever the club charges for gambling compared to hotels, there is a *component*, equal to the subsidy afforded clubs through preferential regulatory and taxation treatment, which represents implicit income to club members.

It is this subsidy which allows the club to sell its overall package of goods and services at cheaper prices than their members could get from commercial operators.

The story has some important implications. In particular, the surplus of any club will only imperfectly match the implicit income received by members. For example, imagine two clubs. One makes its beer very cheap and exhausts all of the surpluses it receives from gambling, so that its overall surplus is zero. Another, maintains beer at market prices and accumulates a large surplus. In both cases, members have received exactly the same implicit income — one in current consumption, the other in future consumption.

However, in other circumstances, members do receive benefits, which could be seen as intangible income. These benefits may be derived from receiving the services

[2] If the income tax system imposed neutral pure profit taxes on capital it would not affect the price of gambling in hotels — but Australia's tax system is not like this (and nor is anybody else's).

provided by the mutual organisation at prices lower than those charged by commercial enterprises. Or, if prices *paid* are not actually lower, the environment in which the services are enjoyed may be more luxurious than those of commercial establishments providing the same service at the same price. These benefits are hard to measure, but in theory they are income which, like other income, should be ideally subject to tax. In fact, for pragmatic reasons, generally only financial flows are taxed under the Australian income tax system. For instance, home owners are not taxed on the imputed rent earned from living in their own home.

There is another complication. While members collectively 'own' the club, and the benefits derived by members from club services can be seen as a return on their share in the club, ownership of club assets carries a reduced level of property rights compared with a shareholding in a publicly listed company. Shares in a publicly listed company can be sold. A club member, on ceasing to be a member, loses all property rights in the assets of the club, without being able to sell his or her share in the club's assets. Strictly speaking, that could be seen to constitute a capital loss. In contrast, a new member, through gaining a share in the assets of the club simply by paying a (generally very low) membership fee, could be said to be making a capital gain.

Thus, notwithstanding the different nature of property rights that exist for members of mutual organisations, that does not alter the fact that members sometimes enjoy services and facilities at lower prices than would be charged by other commercial enterprises — in effect, they earn untaxed income.

The mutuality principle is a common law principle which establishes a useful rule-of-thumb for the tax treatment of surpluses generated by mutual groups. It recognises that in many cases any surpluses generated by a mutual organisation are really savings, rather than genuine profits. In other instances, the application of the principle may be rationalised by the pragmatic difficulties of assessing and taxing any implicit income to members. But where it is justified, is practicable and meets standard taxation principles — a fairly stringent test — then it may be appropriate to tax some of the income of mutual organisations.

One illustration of some of the problems in the application of the mutuality principle is the different tax treatment of gambling commission income from Club Keno and Club TAB, and of commission income from gaming machines in Victorian clubs. In New South Wales, clubs pay no corporate tax on the income earned from gaming machines, because the machines are owned by the club and the expenditure is made by members. However, New South Wales clubs do pay corporate tax on commission income from Club Keno and Club TAB, even where the expenditure is made by members. Similarly, in Victoria, although the

expenditure is made by members, the fact that payments are mediated through a third party (the owner of the machines) and then repatriated to the club as commission income, means that the income is regarded as external — and therefore subject to taxation.

Does mutuality create the right incentives for efficiency?

As noted above, a key feature of mutuality is limited property rights for members. Amongst other things, this means that mutual organisations cannot distribute surpluses to members, but must either invest them or provide additional services at prices that do not reflect their costs.

Normally, this does not have significant economic implications. Many mutual organisations charge prices which are close to the full economic costs of the services that they provide, and any residual profits are very small. For example, in 1997-98 the operating profit per club without gambling facilities was about $13 000.[3] With close to zero surpluses it is likely that any changes to the tax treatment of these clubs would fail to collect any significant revenue, would not correct any inefficiencies and would adversely affect their ability to maintain valuable community facilities.

But when mutuality is combined with a highly profitable and growing activity — such as gambling — this implies substantial surpluses are available for investment or subsidisation of other goods. The existing odds for gaming machines appear to provide significant profits to clubs in excess of what would be required to cover costs associated with the machines (including provision for a normal rate of return on the assets used) — so-called economic 'rents'. The evidence for this is that:

- hotels in New South Wales have to bid for licences for gaming machines in excess of 15 up to the cap limit of 30, with the bid prices per machine licence being in excess of $50 000. Clubs, in contrast, are able to buy additional machines without paying such costs. Moreover, hotels face a top tax rate of 40 per cent on machine revenues, whereas clubs face a maximum tax rate of 24.75 per cent. The implication is that clubs not only are exempt from federal income tax on the profits they make, but that the profits include a substantial rent that has not been appropriated for the wider community by the New South Wales government; and

[3] In contrast, the operating profit per club with gambling was around $201 000 per year (about 16 time bigger). Based on data from ABS (Cat. no. 8687.0, June 1999).

- gaming machine prices in Victoria are lower than in New South Wales, despite a higher tax rate on machine revenue and the existence of large license fees paid by the duopoly machine owners to the Victorian Government.

Thus it is the particular combination of rents from gambling *and* mutuality, which provide the greatest potential for inefficiency.

The policy implications

Once it is recognised that it might sometimes be appropriate to tax (at least part of) mutual income, then this suggests the application of broadly accepted taxation principles — a good tax system aims to collect revenue in a way that is equitable and efficient, taking into account the transactions costs of collection (such as administrative and compliance burdens) and other feasibility issues.

Tax relief arising from mutuality has the *potential* to distort prices or investment in the economy, with possible adverse efficiency, equity or social impacts. **The Commission is of the view, that *where* this is the case, and it is feasible and cost-effective to tax any relevant income — or to find other ways of effectively countering the inefficiencies that mutuality generates — the application of the mutuality 'principle' should be open to examination.**

21.6 The consequences of growth

Clubs potentially serve a useful social purpose when they are formed by groups of people who pool their resources to pursue a common purpose (for instance craft clubs, church groups, bodies corporate). Often they fill a void, where the service provided by the club is not available commercially. CCCANZ said:

> It is important to note that clubs locate their facilities according to community need and not potential commercial return … Private entrepreneurs are different because they seek to maximise shareholder value. This is not, and can not be, an objective of a not-for-profit club … (sub. D226, p. 13).

While clubs retain their club nature, and provide services generally not available in the market place, their character can be said to be truly mutual. However, it has been asserted that the super clubs that have developed cannot be characterised this way.

The nature of the large clubs

The large licensed clubs, providing bar, restaurant, poker machine, entertainment and often other services to members and non-members alike, often with turnovers exceeding $20 million annually, are in character very different from the common purpose clubs described above. While many may have started off as sporting clubs exclusively, often the sporting objective has been eclipsed by gambling, bar, restaurant and entertainment services. In addition, there are few restrictions on who can use club facilities. Membership appears to be open to all (at a token 'membership' fee), and in any case, non-members are generally welcome, with few if any restrictions, to use club facilities. They have the appearance of being more like commercial enterprises, with expert commercial management and ambitious expansion plans.

Looked at from the members' perspective, in the case of the large clubs, do members still feel a sense of ownership, a sense of common purpose? Or has the club taken on a 'life of its own', separate and removed from the members? It is true that clubs publish annual reports and members are invited to elect the board, but how aware are members of how decisions are taken? How accountable really is the board and club management? Importantly also, when people use club services, is it just the same for them as going to some commercial establishment?

The fact that some clubs now have the character of large commercial enterprises raises the question of whether the surpluses earned by the clubs can still be regarded as mutual. The Australian Hotels Association (NSW), while not questioning the application of the mutuality principle to certain types of organisations, said the large clubs, having become huge commercial enterprises, lack a mutual character (sub. 137). The Industry Commission also, in its report on tourist accommodation, found that:

> ... given the changing nature and scope of some large clubs, the Tax Commissioner may need to review their eligibility for access to concessions under the mutuality principle (IC 1996, p. 176).

In a countervailing viewpoint, the Council of Community Clubs of Australia & New Zealand said:

> The size of the club is immaterial to mutuality, as the larger the club the greater the membership, and the more extensive the facilities available to these members and to that section of the community that extends beyond the club's membership (sub. 142, p. 19).

It also said that 'members do join particular clubs because they have an affinity with that club' (sub. D226 p. 25).

The Commission accepts that the fact that some clubs are large, is not, by itself, an argument for revoking mutuality for those clubs. Size has potential advantages to members and the communities in which they are located. For example, large clubs may reap economies of scale, which allow them to offer club facilities at lower prices than otherwise. However, the fact that they generate such large surpluses relative to their income — the source of funding for their rapid expansion — is a potential concern, as examined below. As one participant observed, bigness is the result of a problem, not the problem itself.

What are the effects on efficiency and equity?

Private taxable commercial enterprises must finance their reinvestment and expansion out of post-tax profits, as well as providing dividends to owners. Clubs, in addition to not paying tax, do not have to provide a direct financial return to their owners in the same way as commercial enterprises. Club rules, as well as the legislation governing licensed clubs, prohibit the distribution of surpluses to members. The only way in which clubs can provide a return to their members is by:

- subsidising goods and services provided to members;
- upgrading club facilities, or
- expansion into new club activities.

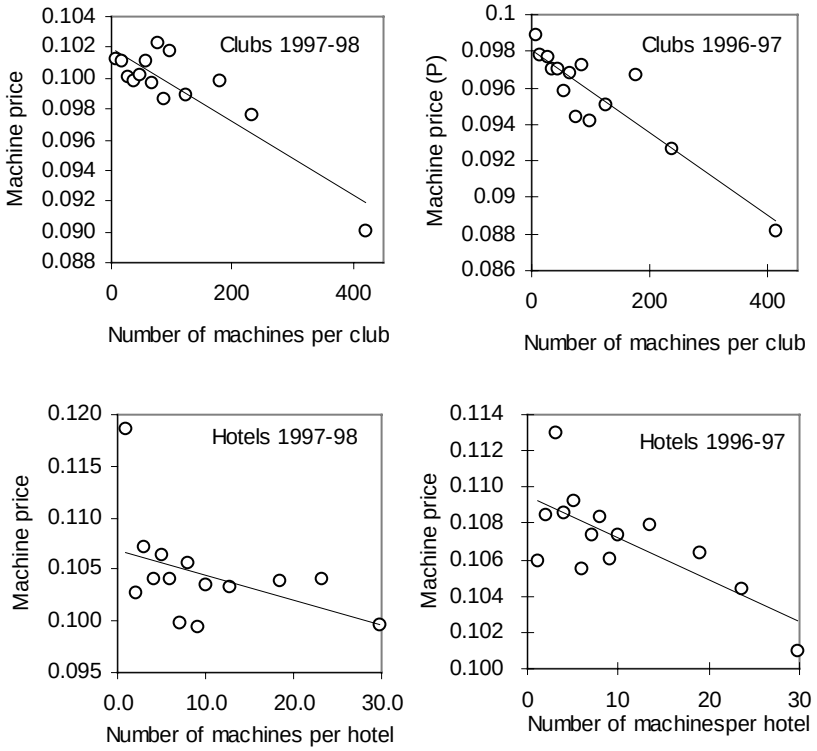
Effect on prices

One potential source of distortion stemming from mutuality are prices which depart from market values. For instance, in 1997, in New South Wales, poker machine payouts in clubs averaged 90.6 per cent, while those in hotels paid out an average of 89.5 per cent (DGR 1998a). This means that in those clubs poker machine services were on average 11 per cent cheaper in clubs than in hotels. However, unlike hotels, clubs have no cap on the number of poker machines they may install, so that the average number of machines in clubs is much greater than in hotels. This points to the possibility of scale advantages in operating gaming machines, so that it may be that the price difference reflects the combination of hotel-specific venue caps and differences in scale, rather than the influence of mutuality.

Indeed, the Commission found a highly significant relationship between price and the number of machines in hotels and clubs in 1996-97 (figure 21.4). Price differences, controlled for the size of the venues, were much smaller than 11 per cent. For venues with 30 machines the price difference was around 5 per cent, while if the cap on machines in hotels were to be relaxed, it appears likely that the price differential would fall even further, and may disappear (or go the other way). This

suggests that the major reason for the more attractive odds on gaming machines in clubs was not mutuality itself, but the fact that clubs, unencumbered by venue caps, could reap some advantages associated with scale.

Figure 21.4 **Prices for playing gaming machines in New South Wales clubs and hotels**[a]



a The machine price is equal to one minus the odds. For example, on a 90 per cent payout machine, the price is 10 cents per dollar of turnover. An assessment was made of the relationship between number of machines per venue and the price. In all cases the relationship was a statistically significant inverse one. The best statistical representation of the data for both venue types and years was:

$$\text{Price} = \underset{(118.8)}{0.0981\ \text{Clubs}_{1996\text{-}97}} + \underset{(123.3)}{0.1019\ \text{Clubs}_{1997\text{-}98}} - \underset{(5.1)}{0.000023\ M_{clubs}} + \underset{(122.0)}{0.1095\ \text{Hotels}_{1996\text{-}97}}$$

$$+ \underset{(119.4)}{0.1068\ \text{Hotels}_{1997\text{-}98}} - \underset{(4.0)}{0.00024\ M_{hotels}} \qquad N=56,\ \bar{R}^2 = 0.81$$ (t's in parentheses).

where Clubs_t and Hotels_t are 'dummy' variables that are equal to 1 if the observation is a club at time t or a hotel at time t respectively. M is the number of machines per venue. The hypothesis that the 'scale' effects for hotels and clubs were the same could be rejected, but not the hypothesis that the 'scale' effects for each separate venue form were constant over the two years. However, there was a statistically significant upward shift in gaming machine prices for clubs from 1996-97 to 1997-98, and a small, but statistically significant, fall in hotel gaming machine prices over his period. The 'scale' effect was significantly larger for hotels than clubs.

Data source: Department of Gaming and Racing, *Gaming Analysis 1996-97 and Gaming Analysis 1997-98*, March 1998 and February 1999; and Commission calculations.

Both Clubs Queensland (sub. D273) and the CCCANZ (sub. D226) disputed that it was economies of scale which resulted in the difference in payout prices. They said

that prior to 1 April 1997 hotels in New South Wales were only able to offer machine gaming via Approved Amusement Devices and that gaming duty on these machines was based on machine turnover and not on revenue. This meant that player returns offered by hotels were lower than those offered by clubs where the poker machines were subject to a revenue tax. With the introduction of poker machines to hotels on 1 April 1997 turnover tax was replaced by revenue tax. Figures from the NSW Department of Gaming and Racing now indicate that the average loss rate for hotel players for the quarter ended March 1999 was 10.24 per cent and to club players for the quarter ended February 1999 was 10.09 per cent (a modest 1.5 per cent difference).

Analysis of the *annual* data for 1997-98, which should be subject to less volatility than quarterly data, also confirms that the price gap between hotels and clubs has fallen (figure 21.4). The Commission found that returns to player appear to have risen in hotels, while they have fallen in clubs. However, there remains a statistically significant relationship between the odds and the number of machines per venue, which holds over both 1996-97 and 1997-98 and for both venue types (figure 21.4). These results suggest that mutuality has probably played a minor role in the disparity of gaming machine prices between the two venue types. The disparity has, in any case, narrowed significantly.

What of other prices, such as for bar services and meals? With regard to price discounting and cross-subsidisation, Clubs Queensland said that while:

> … there may be isolated cases of this activity amongst its members, however, on an industry-wide basis, there is no evidence to support the assertion that clubs engage in below-market pricing and cross-subsidisation (sub D273, p. 32).

However, a survey of prices charged by hotels and clubs in the Brisbane metropolitan area undertaken by KPMG Consulting on behalf of Clubs Queensland (sub. D273) appears to show some price differences. With regard to beer and spirits the survey found average full strength 10 ounce beer prices to be 4 per cent less in clubs than in hotels, average reduced alcohol 10 ounce beer prices to be 4.5 per cent less in clubs than in hotels, and basic mixed spirit 7 ounce prices to be 5.9 per cent less in clubs than in hotels. However, the survey found that 'special' discounted prices are generally lower in hotels than in clubs. The survey did not cover meal prices in hotels and clubs as meals are a less homogeneous product and prices much more difficult to compare.

The Commission accepts that there are likely to be many clubs which do not engage in cross-subsidising services. Nevertheless, those club annual accounts examined by the Commission show operating results for meals and bar services consistent with cross-subsidisation and below market prices for these services. However, these

results could also be an indication of inefficient production due to lack of pressure on management to produce services at minimum cost.[4] Clubs also tend to provide free or cheap auxiliary services, such as coffee and tea, meeting rooms, and exercise classes.

Cross-subsidisation of one good by another is not necessarily inefficient if it is a commercial decision made to maximise overall profits (and is not anti-competitive). And hotels are also likely to cross-subsidise services if that is seen to be at their advantage. For instance, it is generally accepted within the community that the 'counter meals' served in hotels may be cross-subsidised by bar prices. However, the concern in the case of mutuality is that the taxpayer is an unwitting participant in an arrangement whereby club members receive goods at below market prices. Of course, it is possible that many members of the public may still value clubs sufficiently to approve the allocation of tax revenue for such purposes.

Effect on investment

While some of the surplus of clubs may be dissipated through subsidised food, bar or other services, clubs still make large surpluses which cannot be distributed to members as cash dividends. These surpluses from gaming machines must end up in investment, either in upgrading club facilities or commercial expansion into areas not usually associated with club activities. The Australian Hotels Association (NSW) stated:

> Many clubs have entered the commercial world by operating businesses in accommodation, gymnasiums, hair dressing salons, butcher shops, cinemas and a range of activities that have sent many small businesses in the State of NSW to the wall ... (sub. 68, p. 10).

The most rapid expansion of clubs appears to be occurring in those states where there is no limit on the number of poker machines that clubs can install — that is, New South Wales and the ACT. In 1997, members' equity in a number of the large clubs in New South Wales increased by more than $1 million, and in a small number by more than $5 million (various annual reports). As catering, bar and other services are often operated at a loss, it seems clear that it is the poker machine surpluses which are financing the capital expenditure by those clubs.

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[4] ABS survey data (Cat. no. 8687, June 1999) suggest that price margins on bar services and other purchases tend to be *lower* in bars than clubs. If the prices of inputs are the same, this suggests that average prices are actually lower in hotels than clubs. However, around 50 per cent of the sales of alcohol and other beverages from pubs is for consumption outside the premises (ie bottle shops) where margins would be very low. If account is taken of this, it appears that margins on sale of beverages for consumption on the premises is higher in hotels than clubs — which is consistent with cross-subsidisation from funds earned from gambling surpluses.

The Commission was unable to obtain information about club capital expenditure by state. However, in 1997-98 clubs in New South Wales accounted for 77.3 per cent of club gross income, the average income per club being $1.68 million, compared with the average for other Australian clubs of $0.69 million (ABS 1999a). Total capital expenditure Australia-wide in 1994-95 was $714.5 million (ABS 1996b). It is likely that the majority of that expenditure occurred in New South Wales.

Whether expanded investment has adverse effects is dependent on whether the pre-tax rates of return are comparable to investments made elsewhere in the economy. If they are, there are no impacts on efficiency. However, for a variety of reasons it appears likely that the investments made by clubs will be less efficient than those made by fully taxable commercial enterprises:

- Some of the investments are in club facilities, whose costs are not represented in the prices of the goods and services sold on the premises. For example, the Australian Hotels Association (NSW) said:

  > The massive amount of money has not been put back into the servicing the community, charitable community organisations or research into problem gamblers and like issues. These vast billions have gone into bigger and better marble staircases within the clubs and the branching out of many clubs into other businesses (transcript, p. 305).

- While Clubs Queensland (sub. D273, pp. 45–7) denies that this is the case, the governance arrangements in clubs may be weaker than those in most private commercial businesses. This is not to suggest that club boards might engage in dishonest practices. However, small business owner managers have direct and powerful incentives to make investments which maximise their income, while the managerial performance of public companies is subject to self-interested scrutiny by shareholders, and disciplined by the threat of takeover. In contrast, while club members do have some controls over club boards, they have weaker incentives to demand the best rates of returns on investment since they can only benefit through improved club facilities (and at some point, the value of incremental improvements in facilities is lowly valued by members), rather than through cash dividends.

- Even if current investments made by clubs achieve competitive pre-tax rates of returns, this implies that the surpluses must continue to rise (because they are untaxed). Without recourse to cash dividends, club managers must reinvest the surpluses. To avoid significant inefficiency, the clubs would, over the long run, have to become diversified conglomerate businesses, with investments in disparate industries across Australia. If they do not pursue this strategy, then the clubs would saturate investment in the hospitality industry — with inevitably lower rates of return on those assets than alternatives. In this sense, diversification by clubs into areas in which they formerly were not involved may

be preferable on efficiency grounds than if they invested in a narrow range of assets related only to traditional club hospitality — though this would take such clubs far away from the purposes for which they were established. Moreover, there are equity problems associated with unfettered expansion of clubs — whether in the hospitality industry or wider.

In the current regulatory environment, the bulk of resource allocation effects are confined to New South Wales. However, no one fully anticipated the expansion of club facilities that occurred in New South Wales or fully appreciated its consequences. A similar expansion is conceivable in other states, depending on machine capping and taxation policies, widening the resource allocation effects of mutuality.

Recent data from the ABS suggest annual operating profits before taxes of clubs with gambling facilities are over $0.5 billion dollars (compared with $30.1 million for clubs without gambling facilities). Surpluses are also growing rapidly (at an average 6.9 per cent per annum from 1994-95 to 1997-98). Over a number of years, therefore, it can be expected that the club industry will make investments of many billions of dollars. If these assets earn a rate of return just two percentage points below the competitive market rate, that represents a loss to society of $20 million per year for every billion dollars of assets. It is therefore conceivable that as the industry grows further, there may be efficiency costs of over $100 million dollars per year.

In summary, the Commission considers that the exemption of club mutual income from tax, combined with the inability to distribute surpluses to members, has the potential to result in excessive capital allocation in club facilities and other investments.

Effect on equity

Equity encompasses many issues, but here it is defined in its more narrow sense that either:

- people on the same income are treated equally by the tax system (horizontal equity); and
- people on higher incomes pay higher taxes than people on lower incomes (vertical equity).

Equity is therefore largely concerned about who gets what.

In 1956, when the New South Wales Government authorised registered clubs to operate gaming machines, it did so on the basis that the profits derived from gaming

would go back into club amenities and the community. Much later, in Queensland regulations also favoured clubs to ensure that profits from gaming machines would be returned to the community. In effect, most jurisdictions now have community benefit levies in place, or some other kind of arrangements to ensure that some proportion of club profits are used for the benefit of the wider community, as well as that of club members (sub. 41, p. 14). In Queensland and South Australia, community benefit funds are raised within the state gaming taxation arrangements. But in New South Wales, a system of Community Development and Support Expenditure was put in place in 1998, under which expenditure of 1.5 per cent of gaming machine revenue must be spent on approved projects by clubs with surpluses in excess of $1 million per annum. And in Victoria, under self-regulating gaming machine industry codes of practice, clubs make an annual contribution of $5 per gaming machine to fund the costs of the Gaming Independent Complaints Resolution process and the self exclusion process for problem gamblers.

Apart from these more formal arrangements, clubs also make voluntary contributions to their local communities. The Council of Community Clubs of Australia and New Zealand said the value of community support provided in 1996-97 by the New South Wales club industry alone was around $155 million (sub. 63). In a later submission (sub. D226, p. 15) it said this figure was derived from a survey undertaken by Pannell Kerr Forster on behalf of the New South Wales Government and the Registered Clubs Association. The CCCANZ said the amount of $155 million consisted of 39.2 per cent (or around $60.8 million) in cash support to external parties, and 15.7 per cent (or around $24.2 million) in non-cash support to external parties. Non-cash support takes several forms including the provision of capital equipment and maintenance, club facilities, and the services of club employees. CCCANZ provided the information presented in table 21.6, which shows that community support by New South Wales clubs to external organisations was16.9 per cent of operating profit in 1997.

CCCANZ illustrated the club movement's contributions to the promotion of tourism by noting that the Registered Club Association donated $250 000 to the Sydney 2000 Olympic Bid. It also pointed to the Royal Perth Yacht Club hosting the Challenge for the America's Cup. Penrith Rugby League Club said in the 12 months before the introduction of the Club Community Benefit Levy it donated $1.3 million in community support. Further, it said:

> For the past few years, Panthers has averaged donating over 20% of its annual profit to a range of worthwhile causes with the main emphasis on charities and junior sport. Note that this figure excludes all donations to our NRL team. (sub. D268, p. 3).

Penrith City Council (sub. D244) said registered clubs fulfil many of the community service obligations that Council or other service providers are unable to deliver. For

instance local clubs provide facilities, free of charge, for the meetings and other functions of service organisations and charities, and contribute to the maintenance of sports facilities, as well as being a major source of local employment. It said further, that under the *Liquor and Registered Clubs Legislation Amendment (Community Partnership) Act 1998*, Council and six registered clubs have formed a partnership, which distributed around $12 million to community welfare, community development, social services and employment assistance projects in the 12 months to 30 November 1998. It concluded its submission by saying:

> If Penrith is to meet the social, environmental and economic needs of a large and vibrant urban community, we will rely upon registered clubs playing an active role in supporting community and recreation endeavours, while also offering diverse leisure and entertainment facilities to satisfy expanding community needs. Our view is that registered clubs play a valuable role in the life of our City and Council's Strategic plan places substantial emphasis on our partnership with those clubs (sub. D244, p. 4).

Table 21.6 **Community support by New South Wales clubs as a proportion of operating profit, 1997**

per cent

	Metropolitan clubs	*Country clubs*	*Total*
Cash in house	4.8	11.9	7.0
Cash to external parties	5.8	19.8	10.7
Non-cash in house	15.5	8.9	10.9
Non-cash to external parties	3.9	7.2	6.2
Total	**30.0**	**47.8**	**34.8**

Source: CCCANZ, sub. D226, p. 16.

In a joint submission, the Club Managers Association Australia and Leagues Club Association of New South Wales said the community role played by registered clubs is not fully acknowledged by many commentators, and:

> The fact remains, however, that the 'club' plays an important role in the lives of literally millions of people, particularly in New South Wales. Clubs provide community support in-house to members and community groups as well as support to external organisations. In many municipalities clubs relieve the financial pressures on councils to provide social, sporting and cultural infrastructure. This contribution is particularly valuable in provincial towns, regional centres and the rapidly growing urban fringes of sprawling Australian cities (sub. 41, p. 14).

Clubs Queensland said that in addition to gaming taxes and levies to the Queensland Government, it provides around $35 million in cash support annually to sporting groups, charities and welfare organisations and the general public. In addition to this it provides in-kind support equivalent to approximately $44 million. This equated to 7.6 per cent of gaming machine revenue for cash contributions and 9.7 per cent of gaming machine revenue for in kind-contributions, summing to

discretionary contributions to the community in total of 17.4 per cent of gaming machine revenue.

The Commissioner for ACT Revenue has provided estimates of community contributions for the ACT (table 21.7). These suggest total contributions on a self-assessed basis by clubs for the year 1998-99 of around 8.4 per cent of player losses, an increase of around half a percentage point over the previous year. The ACT Government has been working towards a more stringent test of what constitutes an acceptable community contribution by clubs and it considers only those contributions it categorises as primary contributions to be contributions to the broader and general community, as distinct from those of benefit to club members. Primary contributions constituted a little over 3 per cent of gross gaming machine revenue in 1998-99, or close to 5 per cent of net gaming machine revenue. The extent of community support provided by clubs in the ACT has been subject to criticism. Tax increases and the requirement for minimum community contributions were announced by the ACT Government in the 1999 budget.[5]

Clearly, whatever estimates are most accurate, clubs do provide benefits to their local community and very substantial ones to their members. Mutuality, by protecting club incomes from taxation, provides a major funding source for these benefits.

However, it is important to emphasise that the cash flows to members and local communities facilitated by mutuality are funded from the tax system. The forgone taxation revenue implies lower levels of government expenditure.[6] This raises the question of whether the types of club expenditure funded by the tax forgone represent a better investment for Australians as a whole than those made by the governments. Expressed another way, in the absence of mutuality would Australians support subsidies of around a hundred million dollars per year to clubs?

As noted above, clubs provide resources for local communities (much of it in support of community sporting and recreational activities), invest in larger and more pleasant club facilities with more amenities, and invest in a range of other activities less directly linked to clubs as community organisations (such as large accommodation projects). This expenditure supports a narrower base of activities than government expenditure (for example, health, education and welfare) and lacks the assessment of competing needs characteristic of government budget processes.

[5] Media release, Chief Minister, 4 May 1999.

[6] Or higher Commonwealth taxes elsewhere in order to meet expenditure needs, with consequent equity effects on those who bear this tax burden, and with efficiency costs associated with a narrower tax base which bears higher tax levels.

In this sense, it is likely that investments by clubs generate less equitable outcomes than expenditures made by governments.

Table 21.7 **Community contributions by ACT clubs, 1998-99**

	Category	*Total contributions*	*Share of gross gaming machine revenue*[a]	*Share of net gaming machine revenue*[b]	*Share of total contributions*
	Primary contributions	$	%	%	%
1	Charity	1 343 580	0.91	1.45	10.90
2	Sports	2 005 018	1.36	2.16	16.27
3	Non-profit	575 171	0.39	0.62	4.67
4	In-kind	581 578	0.40	0.63	4.72
5	Public asset	112 463	0.08	0.13	0.90
	Sub-total	**4 617 810**	**3.14**	**4.99**	**37.46**
	Secondary contributions				
6	Associated organisations	2 288 586	1.56	2.47	18.57
7	Infrastructure assets	4 542 592	3.09	4.90	36.85
8	Political/union	878 083	0.60	0.95	7.12
	Sub total	**7 709 261**	**5.25**	**8.32**	**62.54**
	TOTAL	**12 327 072**	**8.39**	**13.31**	**100**

a Gross gaming machine revenue is defined as total money inserted into machines less winnings to players. **b** ACT Revenue Office estimates.

Source: Commissioner for ACT Revenue, 1999.

On the other hand, others would argue that clubs are integral parts of a local community and have the detailed knowledge of local needs to be able to channel resources into activities which the local community highly values. The CCCANZ (sub. D226) said it recognises that a central perspective is necessary for deciding on cross-regional priorities, but that Australia's three tiers of government make centralisation complex, cumbersome and costly in terms of administration and compliance costs, reducing the funds available. It also said that political considerations rather than need can result in politically marginal areas receiving benefits at the expense of communities in other areas providing the taxes. CCCANZ argued that the current system provides a balance between local priorities and central priorities, and:

> Club members are a part of the local community and reflect the values and understand the issues of their community. Their boards are elected democratically. Their boards reflect the wishes of the membership in providing the support donations to groups and individuals in their community (sub. D226, p. 18).

Penrith Rugby League Club said:

> It makes a lot of sense for Clubs to be able to allocate funds in their own areas. They are best placed to know where the funds are best used. They can respond immediately to urgent requests. A central body administering a pool of funds, would not have detailed knowledge of the needs of the Penrith area. In order to obtain that knowledge, they would need to build an infrastructure of some size and the cost of that bureaucracy would impact on, and eat into, the amount of allocations (sub. D268, p. 3).

The Australian Hotels Association (NSW) (sub. 137) also raised a separate equity issue concerning providers of capital. It said the application of the mutuality principle to club poker machine surpluses is inequitable as it results in some gaming establishments (clubs) being favoured over others (hotels) and a competitive advantage for clubs.[7] It is certainly true that the mutuality principle does not treat hotels and clubs *equally*. However, the differential tax treatment between clubs and hotels has been in place a long time, and there is no evidence to suggest that the rates of return on capital in hotels are permanently reduced by the advantages afforded clubs by mutuality.[8] On the contrary, there is evidence that the value of capital invested in hotel assets in New South Wales has been increasing rapidly since gaming machines were introduced in hotels. And if the favourable tax treatment of clubs were to be abolished, hotels would be at an advantage for a period, compared to the situation as it exists currently. But any increased returns to hotels would soon be competed away through greater investment in hotel assets.

In its draft report the Commission said that if rates of return on hotel capital were reduced due to the favourable tax treatment of clubs, hotel owners would no longer find it profitable to invest in hotel assets and capital would move out of hotels into higher performing assets elsewhere. The Australian Hotels Association (NSW) disputed that statement. It said this represented an unrealistic appreciation of the issues:

> All sorts of market imperfections (imperfect knowledge, imperfect access etc) prevent capital from being totally mobile. Our hotel owners cannot be put into a box of 'capital users'. In many cases generations of families have owned and operated the same hotel. It is almost unbelievable that the argument should be put that if the Government taxes one group of people at a much higher tax rate than other people engaged in the same activity then it is not acting inequitably. The fact that capital providers can go elsewhere doesn't remove the inequity created by the Government (sub. D208, p. 60).

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[7] Sentiments which were echoed by a report by the House of Representatives Standing Committee on Banking, Finance and Public Administration, entitled *Taxing Relaxing* (March 27, 1995).

[8] ABS statistics suggest that operating profit margins in hotels with gambling facilities were around 8.9 per cent in 1997–98 compared to 9.6 per cent in clubs. It does not seem likely that sales to assets ratio of hotels are lower than that of clubs, which implies that, if anything, rates of return on assets are likely to be currently higher in hotels than clubs (for venues with gambling facilities).

Where clubs are expanding into areas of economic activity previously untouched by club entrepreneurship, such as hairdressing, butcher shops, motels and holiday accommodation, and cinemas, they may undermine the profitability of those enterprises, and generate inequitable capital losses for existing owners. For example, Forresters Resort (sub. 157, p. 4) said gambling surpluses enabled clubs to compete with existing businesses at subsidised rates. CCCANZ (sub. D226) commented on the concern expressed by the Commission in the draft report about clubs entering into competition with commercial enterprises. It said that in the quoted example of a club purchasing a butcher shop, the shop in question was facing closure and club members had sought the club's support to keep it open, and there was no evidence to show that any other butcher in the region had been materially affected by the club's decision to keep the shop open. Furthermore, it said:

> Clubs have different arrangements for what might be called ancillary business services for members. In many cases it is treated as non-mutual income and therefore treated appropriately under income tax rules (sub. D226, p. 27).

It remains the case that, any commercial activity operated by a club, whether on a mutual or a non-mutual basis, does not need to make a profit, enabling it to undercut prices charged by commercial enterprises, if it so wishes.

Summary of concerns

Clubs play a pivotal role in Australian communities. However, the preferential regulatory and taxation treatment of gambling in clubs by some state governments, has provided a substantial source of income to clubs. This, combined with the virtual protection of this income from tax by the mutuality principle, has led to a more significant expansion of club assets and price subsidisation of club services than otherwise would have been possible. This, in turn, can have adverse impacts for economic efficiency and equity, concerns which are likely to intensify as the relevant segment of the club industry expands further in the future. The benefits that clubs bestow on local communities are unlikely to outweigh these impacts.

21.7 Can anything be done?

The first point to emphasise is that the principle of mutuality is not, by itself, the *source* of the problems identified above. Mutuality has had unintended consequences for equity and efficiency when some segments of the club industry gained access to the potential for substantial profit growth from gaming machines.

Nor does the fact that, in this context, the mutuality principle poses some threats to efficiency and equity, mean that policy could effectively remedy these without either high transactions costs or other adverse effects. In particular, one suggested 'reform' — the taxation of all club income as corporate income — would be unlikely to be at all effective at realising the objectives of fairness or efficiency, unless the inability of clubs to distribute surpluses to members was also amended. Nothing requires any entity to make a profit. Clubs forced to pay income tax on any surpluses would find ways of avoiding large surpluses by:

- subsidising other goods and service to a greater extent, with even more profound effects on price distortions and greater (if transitory) costs to competitors; and
- possibly borrowing heavily to expand their businesses, offsetting interest charges against income.

This posts a warning that attempts to solve one set of problems can perversely create a fresh and even worse set of difficulties.

Notwithstanding this, there are a number of options for change. They are assessed below against the following criteria:

- investment distortions;
- price distortions;
- equity, including to members, owners of competing businesses and to the local community; and
- their feasibility.

Tax poker machine surpluses?

The Australian Hotels Association (NSW) (sub. 137) proposed that gaming income from both members and non-members be quarantined from other club income and taxed. It considered gaming income to be the heart of the problem to be solved by treating it as non-mutual income. There is already the prospect of this being realised in Victoria, where clubs do not own the gaming machines. The ATO's assessment is that club poker machine surpluses are not mutual income, consistent with the tax treatment of commissions from keno and TABs.

Effect on investment and pricing

Quarantining the tax to machine surpluses removes the ability of the club to offset machine surpluses with other trading losses (such as interest burdens or cross-subsidised prices on other goods). However, it leaves one avenue for subsidisation

still open — the prospect of better odds for gaming machines. Clubs would have an incentive to somewhat reduce the price of playing, since this would provide a tax-free benefit to members. This would tend to increase the attractiveness of playing the machines somewhat, and have all the uncertain effects on problem gambling that have been discussed in chapter 19.

Taxing surpluses would reduce the scope for unfettered expansion of clubs, but it provides little or no incentive for improved governance.

Effect on equity

The Licensed Clubs Association of Victoria said that if gaming income is quarantined for clubs and not for other venues supplying poker machine services, clubs might pay a higher rate of tax than other venues with the same gaming income. This would occur because other venues would be able to write off inadvertent losses from other activities against poker machine surpluses, while clubs could not. Moreover, under dividend imputation, the returns of other businesses are ultimately taxed in the hands of shareholders at their marginal personal tax rates, not at the corporate rate. Accordingly, any tax rate on gaming machine surpluses, should arguably be below the corporate tax rate.

However, even if a lower tax rate were implemented, this would fail to take account of the differing marginal tax rates among members — everyone is being implicitly taxed at the same rate. It is not clear that there is any workable system for taking account of this, without adding significant additional complexity to the tax system.

If clubs increase their payout, those members (and non-members) who mainly visit the clubs to play the poker machines would benefit. The reduced ability of clubs to cross-subsidise other club services would mean a reduced benefit to those members (and non-members) who use those services. The effect on equity would depend on the socioeconomic composition of each group (but would probably represent a gain, given evidence on the parallel issue of regressivity discussed in chapter 19).

As with demutualisation, clubs would reduce contributions to the community. However, here also the Government would have increased funds for its welfare programs.

Feasibility

There would be no or few administrative barriers, as the clubs already prepare poker machine profit and loss accounts and the ATO already processes club tax returns. There would however be some implementation issues. These might include:

- the possible exclusion of clubs with less than a threshold level of poker machine profits;
- the determination of eligible gaming machine-related expenses which could be deducted from gaming machine revenue to determine the taxable base;
- legislation to exclude poker machine surpluses derived from members from mutual income; as well as
- legislation to quarantine poker machine profits for tax purposes so that they cannot be reduced by losses incurred on other activities.

Clubs Queensland (sub. D273, p. 50) was of the view that this option would be unworkable, because:

- it penalises all clubs, whatever their size;
- it would not address any of the issues raised by the Commission;
- it is likely to lead to the adoption of tax minimisation strategies; and
- it would impose an administrative burden and additional compliance costs on both the clubs and the government, possibly resulting in further inefficiencies.

CCCANZ termed this option 'partial demutualisation' and agreed with Clubs Queensland who said that the imposition of income tax on member activities would cause clubs to reassess their operations to minimise the tax burden, and would increase administrative costs.

Should gaming machines only be available on a commission basis?

In most Australian states, gaming machines are owned by the clubs. However, this is not true in Victoria or Tasmania, where a third party owns the machines, and clubs are provided with commission income. Other gambling forms — such as keno and TABs — also provide commission income to clubs throughout Australia. Under the current tax system, commission income is regarded as external income by the ATO and is subject to corporate income tax. Accordingly, one measure for bringing gaming machines into line with the treatment of other gambling forms in clubs is to have them provided by a third party (not necessarily along the lines of the Victorian model, which has its own defects). This would render all gaming income as taxable.

Effect on investment and pricing

The impacts on investment and prices would be similar to the option above, except that clubs would not have the ability to lower prices, since the machines would be owned by a third party.

Equity

Equity effects are again similar to the previous option, except that there would be no anticipated benefit for people on lower incomes who use gaming machines, because prices would not be likely to fall.

Feasibility

Adoption of the measure would not require amendment of any existing tax laws. However, it would require considerable restructuring of gaming machines in states other than Victoria and Tasmania, with significant structural adjustment costs. Depending on how it was implemented it might also generate some of the anti-competitive problems present from having one or a few owners of poker machines. The Australian Hotels Association would not support such an approach:

> Such an arrangement potentially leads to problems associated with the third party provider exerting considerable pressure on establishments that wish to offer gambling services.
>
> If the allocation of gaming machines is entirely dictated by the licensed third party there is likely to be frustration with venues not being able to access gambling facilities while their competitors are able to offer the service (sub. D231, p. 94).

Clubs Queensland (sub. D273, p. 51) said this option would be inappropriate as well as unworkable, because:

- it could result in an anti-competitive market, increasing the market power of gaming operators;
- it would divert gaming revenue from the community sector to the private sectors; and
- it would contravene the recent amendments to Queensland's *Gaming Machine Act 1991*.

Introduce a higher revenue tax rate on gaming machines in clubs?

This is again similar to the option of taxing the surplus on gaming machines, but would involve a state (consumption) tax rather than an income tax.

Effect on investment and pricing

The impacts on investment and prices would be similar to the first option above, except that, unlike the quarantined income tax approach, the price of playing gaming machines would tend to rise rather than fall. If clubs operated in a perfectly

competitive environment, then patrons would bear the full burden of the tax. However, as noted in section 21.6, it appears likely that clubs, at least in New South Wales, earn 'super' profits, typical of an incompletely competitive market. This implies that the extent to which prices will rise is indeterminate. Since governments already apply price regulations, it is possible that an increased state tax could be combined with a price cap set at a level which reduces any price increase.

The advantage of increasing the tax rate on gross gaming machine revenue in clubs, rather than an income tax, is that it can both redress some of the adverse impacts of mutuality *and* extract (at least some of) the rents that appear to be earned by clubs. If most of the rents were removed, it would cut substantially the flow of funds that underlie price subsidisation and excess club investment. This option does not affect mutuality as a principle — rather it removes the source of the 'super' profits that are the source of the problem.

Equity

Equity effects are similar to the previous option.

Feasibility

It would require minimal legislative change and in principle could be readily implemented by those state governments who were concerned by the inefficiencies in the current tax treatment of clubs. Tax changes have occurred in the past. For example, the rate of tax levied on clubs' gaming machine revenue of under $2.5 million increased on 1 February 1998 in New South Wales.

Furthermore, state governments could decide, depending on the very different contexts of their local club/hotel markets, what tax rate would be appropriate. In New South Wales it would be feasible to levy higher tax rates, in keeping with the existing, arguably overly generous treatment afforded clubs, whereas in Victoria and Tasmania no change may be required.

The Australian Hotels Association supported this option, saying that it believed that the Australian clubs sector should be taxed at the same rate as hotels when offering gaming services. It added:

> The large differential between each state as well as each type of venue in the State should be addressed and placed high on the priority of State and Territory Governments throughout Australia (sub. D231, p, 94).

CCCANZ (sub. 226, p. 29) said increased taxation would have an adverse impact on the viability of clubs and their contributions to the local community. It said a

financial analysis had shown that more than 20 per cent of clubs in New South Wales would become unprofitable of financially marginal under tax equalisation. However, if such an increase were to be implemented, a phasing in of the higher tax rates over a number of years would allow clubs to prepare for the change. Clubs Queensland (sub. D273, p. 51–2) gave the following reasons for not supporting this option:

- there is no evidence that increasing taxes results in increased prices for gambling and reduced demand;
- there is no evidence that funds are distributed better by governments than the community sector; and
- clubs are best placed to distribute funds to the community as they have local knowledge, and no political bias.

Limit the number of poker machines permitted in clubs?

The problems occasioned by the treatment of gaming machine income under mutuality appear to arise mainly in those states where unlimited numbers of poker machines are permitted in clubs, and particularly New South Wales. One option, proposed by Star City, would be to limit the number of poker machines permitted in clubs in New South Wales (sub. 33, p. 3).

Effect on investment and prices

Depending on the limit set, it would tend to reduce the flow of funds to investment and cross-subsidised goods and services — reducing the distortions associated with these. By reducing the economies of scale associated with large gaming machine venues, it could be expected that costs would rise, and some (but not all) of these would be recovered from consumers through higher prices.

The impact of caps would encourage the formation of more clubs, partly circumscribing the intent of the policy. However, there are limits on the number of bodies which could pass the appropriate tests for club status.

Effect on equity

Higher prices would fall on gaming machine players, though the magnitude of such price increases is likely to be relatively modest. There would also be fewer poker machines available and in some cases this might create crowding. This might be beneficial in the case of problem gamblers, but result in costs for recreational players who have to wait to play.

Feasibility

There would be a number of implementation issues. Firstly, any such measure can only be implemented by state governments. This is an advantage as it recognises the diversity of the club/hotel markets across Australia and could take account of any existing regulations that affect these venues.

Secondly, the case for venue caps as a way of reducing the flow of concessionally taxed gaming machine revenues into club coffers is greatest in New South Wales, but the transitional costs of any cap which credibly reduced those flows would be substantial. Setting machine numbers at existing levels for any club would have a modest impact on the problems related to clubs' mutual status — caps would have to be more akin to those operating in Victoria (105) or South Australia (40) to have a real impact.

Any realistic plan would thus require a gradual phasing down of machine numbers for those clubs with machine numbers which significantly exceeded any relevant cap. This reflects the fact that many of these clubs would have financial commitments which depended on poker machine surpluses. At the end of May 1998, for example, clubs in New South Wales with over 100 machines accounted for 11.9 per cent of clubs, but for 50.8 per cent of machines and 66.2 per cent of machine revenue[9] — underlining the magnitude of any transition to a cap of under 100 machines.

The Australian Hotels Association (sub. D231, p, 96) said the numbers of poker machines allowed to operate in clubs is a major concern. If the numbers were to be limited, however, clubs currently offering gaming facilities in excess of the limit should be able to continue to operate but subject to full taxation. Clubs Queensland (sub. D273, p. 52) did not object to a limit provided it is not a state-wide cap, as this would result in a shift of machines from smaller to larger clubs. In commenting on the fact that caps already exist in Queensland, it added that further capping of hotels would help to address the continued dilution of the concept of community-owned gaming in the state. CCCANZ said caps were a very blunt and inefficient method of addressing the Commission's concerns and it could foresee severe problems for clubs which are planning, or which already have commitments with regard to investments. It also said:

> Capping will reduce consumer benefit because access limitations will lead to queuing effects and possibly price effects such as lower payouts (sub. D226, p. 28).

[9] Department of Gaming and Racing, *Registered Clubs — Quarterly Gaming Analysis May 1998*, January 1999.

Demutualisation?

An extreme option, which would represent a fundamental shift in the approach to Australian clubs, would be enforced demutualisation of relevant clubs. Demutualisation involves a change in the corporate form of an organisation that results in members surrendering their rights to participate mutually in any common fund that constitutes the organisation. Upon demutualisation there is effectively a distribution or allocation of any accumulated mutual surplus, with former members receiving tradeable shares in the new entity or an equivalent cash payment. The new entity is taxed on its profits and the former members, who become shareholders, would receive franked dividends.

Effect on investment and prices

Pressure from shareholders for a return on their investment would place the new entity on a par with other commercial enterprises as regards investment and pricing decisions, as well as create pressure for efficiency in production.

In normal corporate entities, shareholders are not the exclusive or even dominant consumers of the goods and services of the entity of which they are owners. They wish any surpluses to be paid to them. However, in the case of demutualised clubs, the initial group of shareholders would also be the dominant customers. Might not they still wish to see subsidised services to members because these provide untaxed benefits? This is unlikely over the medium or longer run, because:

- members who use the club less frequently — and there are many of these — will prefer a dividend to subsidies on services they rarely consume;
- members with zero or low marginal tax rates, can obtain bigger benefits from cash dividends (which they can use to buy anything) than implicit 'dividends' hypothecated only to club services; and
- clubs have used their surpluses to invest in assets other than club facilities, and many members will prefer some dividend, rather than reinvestment of all retained earnings.

For these reasons, demutualisation appears to stem all the inefficiencies associated with price subsidisation or excess investment associated with current policy settings.

Effect on equity

Currently the more often members use club services the more they contribute to the surplus. As member attendance and individual expenditure are not recorded (and

could, in any case, not easily be done), some other basis for the allocation of shares would have to be devised. The most likely one would be to initially allocate equal shares to all members. Some windfall gains to those members who rarely visit the club would be inevitable and inequitable.

Fewer funds would be available for community contributions. The CCCANZ said that if clubs were to be taxed as companies and pay fully franked dividends this would entail a fundamental shift in the overall philosophy of being a club member and would:

> ... result in a decline in funds available for non-financial benefits available to members and non-members using the club's facilities and for support of the community at large (sub. 142, p. 23).

Indeed, the Club Managers Association Australia and Leagues Club Association of New South Wales argued that the concessional taxation treatment conferred on clubs recognised the contribution clubs make to local communities. However, abandonment of mutuality would not preclude tax deductible donations, which would still apply to a very wide range of charitable and other community groups. Moreover, taxing club surpluses does not necessarily reduce funds available for community purposes, as the Government would have increased tax revenue to fund improved education, health and social infrastructure in Australian communities. The people who would benefit — the incidence of these contributions — would however be different than under current club community contribution arrangements.

With regard to taxation, the shareholders of the demutualised club would receive franked dividends. The imputation system would ensure that those shareholders earning high incomes would pay a larger amount of tax on these dividends than those on low incomes.

Feasibility

Demutualisation is currently a voluntary process. Members are most likely to vote for demutualisation if they expect to gain access to significant capital gains or dividend streams. Currently there are taxation anomalies associated with demutualisation, particularly in the area of capital gains tax, which would deter such voluntary demutualisation (because taxpayers would be subject to double taxation). In its 1997-98 Budget, the Commonwealth Government announced its intention to develop a generic framework for determining the tax consequences of transactions associated with the demutualisation of non-insurance organisations.[10]

[10] The taxation treatment for demutualisation of insurance organisations is already covered by specific provisions contained in the *Income Tax Assessment Act 1936.*

Subsequently, in February 1999, the Government released a draft of proposed amendments to the *Income Tax Assessment Act 1936* to deal with demutualisation of mutual entities other than insurance companies. When implemented, this legislation will ensure, inter alia, that the capital gains tax provisions will not apply to the surrender of a membership interest, and that on the issue of demutualisation shares, no amount is included in a member's assessable income.

Further legislative changes would be required were demutualisation to become compulsory. Moreover, the transition costs of demutualisation may be high, relative to any gain, for smaller clubs. Some participants commented that while the mutuality principle should not apply to the large licensed clubs, it should not be 'abolished' altogether. In a study prepared for the Australian Hotels Association (NSW), Firmstone & Feil said:

> The principle of mutuality currently applies to many organisations which rightly benefit from its application. Apart from bodies corporate, small church groups and 'non-commercial' clubs all benefit from mutuality. It is an important principle and should not be abolished by statute (attachment to sub. 137, p. 1).

Prof McGregor-Lowndes said it would have an adverse impact on many small non-profit organisations if mutuality were no longer to apply, and:

> ... it is important that [the abolition of the mutuality principle] not be broad-brush, and be targeted specifically at clubs ... otherwise [it] will bring a whole range of non-profit and community organisations into the tax system ... I want to impress upon you that to broadly say mutuality ought to go by the wayside is not appropriate ... (transcript, p. 100).

This suggests that it would be necessary to set a threshold for any demutualisation. The threshold could be based on the number of poker machines, on total assets or on turnover. Senator Andrew Murray, took the view that:

> The loophole in the mutuality principle must be reformed. The large super clubs continue to dominate, adding to the concerns of not only private business but also smaller clubs that are, in fact, operating within their original charter and are within their right to claim the mutuality principle exemption (sub. D276, p. 2).

He suggested a turnover of $1 million might be an appropriate threshold (p. 3). But while any regulation concerned with demutualisation would apply Australia-wide, it would be irrelevant in those states where the clubs for one reason or another remained small enough to stay below the threshold.

Thresholds, however pose their own problems for efficiency and equity. Clubs just under and over the threshold are treated very differently. The existence of thresholds might lead to complex club structures in which a super club breaks into an apparently large number of small cooperating sub-clubs operating at the same

site, each one under the legal threshold for demutualisation. This would require countervailing measures, and inevitably leads to more complex regulation.

With regard to administrative feasibility, the larger clubs already produce professionally executed accounts, scrutinised by auditors. And clubs might elect no longer to distinguish between members and non-members, as there would be no taxation advantage from doing so. In the case of the ATO, there would be no additional complexity, as the mechanics for dealing with business taxes are already in place.

The Australian Hotels Association (sub. D231, p. 96) supported demutualisation provided small, legitimate sporting or cultural clubs were not disadvantaged, and suggested a threshold based on either turnover or gaming machine numbers. CCCANZ did not support this option, for the same reasons it did not support quarantining and taxing gaming machine income. Clubs Queensland (sub. D273, p. 53) considered demutualisation inappropriate for the following reasons;

- this would go against the concept of community-owned gaming;
- it would result in a purely profit-driven club industry;
- in such an environment, self-regulated responsible gaming strategies would be more difficult to implement.

Conclusion

The Commission has outlined a number of possible options for dealing with the problems that arise when mutuality is combined with a substantial and growing source of revenue to clubs — in this case, gambling. All have some advantages, but none are free of limitations. The Commission has rated the various options in table 21.8. In doing so, judgments have been made about difficult issues like equity. In particular, the Commission has judged that tax revenues collected by governments have more equitable outcomes in principle than if the same amount of money is collected by a club that then distributes resources to its members and to community purposes of its choosing. Participants from the club movement disagreed with this judgment, as did Penrith City Council.

Of the options, the one which appears to offer the most scope for remedying the distortions is the imposition on clubs of a higher rate of state tax on gambling. This would need to occur only in some states, recognising the different contexts of clubs in different jurisdictions. But any such move would need to involve phasing to minimise transitional losses on existing investments.

Table 21.8 **Effects of current club structure and options for reform**[a]

Criteria	*Current club structure*	*Demutual-ise clubs*	*Tax poker machine income*	*Gaming machines only available on a commission basis*	*Increase tax rates on poker machine revenues*	*Limit number of poker machines*
Efficiency in Investment decisions	●	●●●●●	●●●	●●●	●●●●●	●●●
Efficiency in pricing decisions	●●	●●●●●	●●●	●●●	●●●●●	●●●
Equity						
• for the wider community	●●	●●●	●●●●	●●●●	●●●	●●●
• for other businesses	●●●	●●●●	●●●●	●●●●	●●●●	●●●●
Feasibility	n/a	●	●●●	●	●●●●●	●

a The dots represent a rating from ● (low) to ●●●●● (high).