

**THE NSW CLUB INDUSTRY**

**AND**

**THE PRINCIPLE OF MUTUALITY**

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*“On the evidence presented to it, the Committee concludes that the application of the mutuality principle has benefited some clubs to a degree where they are able to compete unfairly with businesses which do not have a similar taxation advantage. In this respect mutuality, as it applies to clubs which engage in substantial commercial activity, is inconsistent with the equity criterion of good taxation, and requires review.”*

(House of Representatives Standing Committee on Banking, Finance and Public Administration, “Taxing Relaxing”, March 1995, para. 3.56)

# THE NSW CLUB INDUSTRY AND THE PRINCIPLE OF MUTUALITY

## EXECUTIVE SUMMARY

The principle of mutuality holds that there is no gain if an item is derived by a taxpayer from him or herself.

The principle is best illustrated by example. Suppose there is a block of six units and each owner contributes \$1,000 to the body corporate during the year, a total of \$6,000. The body corporate spends, say, \$4,000 on insurances, cleaning, repairs and so on. No one would seriously argue that the \$2,000 “surplus” is income which should be taxed. It is instead a surplus of capital. The principle of mutuality applies so as to prevent unspent contributions of capital being subjected to tax.

The principle of mutuality currently applies to many organisations which rightly benefit from its application. Apart from body corporates, small church groups and “non-commercial” clubs all benefit from mutuality. It is an important principle and should not be abolished by statute.

The principle of mutuality also applies to clubs engaged in substantial commercial activity. These clubs do not deserve to benefit from what has become a substantial income tax concession.

In our opinion, the heart of the problem is the gaming activities of the clubs. The major clubs have become substantial gaming establishments and generate massive profits. The clubs’ gaming activities are already subsidised by State governments through relative tax subsidies. The large profits generated by clubs are not applied for the benefit of the community, but are instead used to lower the prices of food and beverages. In this way, the massive tax benefits given to clubs are simply applied for the benefit of members and non-members alike.

If gaming is the heart of the problem, then gaming is the heart of the solution. In our opinion, the simple solution is to treat gaming income as non-mutual income. There is ample justification for doing so. This measure would result in additional Federal income tax payable of \$160m.

1. The turnover of large clubs is driven by gaming which comprises, on average, more than 80% of total revenue. This stands in stark contrast to member subscriptions which comprise, on average, 1.5% of total revenue.
2. The level of cross-subsidisation between gaming and non-gaming services is enormous, resulting in artificially depressed prices for food and beverages, and little or no income tax payable on such services.
3. Hotels and pubs cannot hope to compete with this level of gaming-driven cross-subsidisation. The average club restaurant trading profit is -9%. The pub benchmark is 40-45%.
4. Income tax as a proportion of operating profit for large clubs is about 10%, compared to the 36% company tax rate. However, income tax as a proportion of profit is only 2.73% if cross-subsidies are factored out of the equation.
5. The rationale for giving tax subsidies to clubs is that the clubs give something back to the community. However, an analysis of eleven major clubs has revealed that, in each case, the clubs took more from the community than they gave back. The eleven clubs surveyed made over \$81m net profit from gaming, yet returned only \$6m to the community. The community contributions did not even match the State gaming tax subsidies.
6. The large clubs have no significant barriers to entry as members. The average cost of membership is little more than \$10 and clubs have little economic incentive to differentiate between members and non-members. There is no difference between members and non-members in the price of gaming services.
7. Income tax subsidies to large clubs are in substance enjoyed by members and non-members alike, and are effectively given to the public at large - the very opposite of mutuality.
8. Gaming revenue from members is not in the nature of an unspent contribution to the capital of the club; it represents a substantial profit from a commercial activity.

9. Gaming is different because the ability to profit at all depends upon a licence from government. It follows that governments can impose terms and conditions on that licence - including the withdrawal of tax concessions.
10. It is inequitable to favour one class of gambler over another or to favour one gaming establishment over another.
11. It is inefficient to favour one gaming establishment over another because it distorts the way the gaming dollar is spent, causing patrons to shift spending from hotels to clubs for tax reasons alone (delivered through subsidised prices).
12. Substantial social equity issues arise if governments allocate scarce public resources to providing gaming tax subsidies rather than health, education and legal aid.
13. The proposed solution is equitable, efficient and simple.
14. The proposed solution does not affect the many organisations which enjoy income tax exemption, such as genuine sporting clubs.
15. The proposed solution does not affect those co-operatives and mutual insurance associations which are already the subject of a specific statutory regime.
16. The proposed solution does not affect body corporates, church groups, non-profit associations, and the many clubs which do not provide gaming services.
17. The proposed solution does not even affect the non-gaming activities, commercial or otherwise, of the large clubs.
18. The proposed solution will not affect the already modest level of community contributions made by clubs, which could easily be funded out of after-tax profits. Should this not be the case, which is doubted, the Government could arrange ex-gratia payments on a case by case basis. In other words, targeted assistance rather than general tax subsidies.

## MUTUALITY

The principle of mutuality holds that there is no gain if an item is derived by a taxpayer from him or herself.

This paper is not directed to those clubs which have statutory exemption from income tax, such as genuine sporting clubs, nor to those clubs to which the principle of mutuality has no application.

This paper is directed to those clubs which engage in substantial commercial activity yet pay little or no income tax. These are the so-called “super clubs” which have become, in substance, large taxpayer-subsidised gaming clubs.

### *Mutuality irrelevant to Many Organisations*

For many organisations, the principle of mutuality is irrelevant because they have a statutory exemption from income tax:

- religious, scientific, charitable, or public educational institutions;<sup>1</sup>
- trade unions or employers’ or employees’ associations;<sup>2</sup>
- non-profit societies, associations or clubs established for musical purposes, or for the encouragement of music, art, science, or literature;<sup>3</sup> and
- non-profit societies, associations or clubs established for the encouragement or promotion of a game or sport.<sup>4</sup>

### *Mutuality displaced in other organisations*

For other organisations, such as certain co-operatives<sup>5</sup> and mutual insurance associations,<sup>6</sup> the mutuality principle has been displaced by statute.

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<sup>1</sup> *Income Tax Assessment Act* (“ITAA”) 1936, s.23(e).

<sup>2</sup> ITAA 1936, s.23(f).

<sup>3</sup> ITAA 1936, s.23(g)(ii).

<sup>4</sup> ITAA 1936, s.23(g)(iii).

<sup>5</sup> ITAA 1936, s.199.

<sup>6</sup> ITAA 1936, s.121.

### ***Mutuality and Members' subscriptions***

In the context of clubs, Professor Parsons has noted<sup>7</sup> that club subscriptions applied for the collective benefit of all members in the provision of club facilities gives “an appearance of gain to the club which is overcome only by treating the club’s apparent gain as a gain to each member. The effect of the payment of subscriptions by all members is that each member’s interest in the club is increased by a like amount, and there is, in substance, a receipt from a member to be applied for the benefit of that member. The club’s interests are identified with the interests of the members from whom the subscriptions are received”.<sup>8</sup>

As recently as 1992, a writer in the respected Australian Tax Review said that mutuality “has always seemed a quaint relic spawned of yesteryear’s *Bohemians Club* . . . and more an item of intellectual curiosity than immense practical application.”<sup>9</sup>

In the *Bohemians Club v Acting Federal Commissioner of Taxation*<sup>10</sup>, the High Court considered whether the mutuality principle applied to Australian clubs. The year was 1914. “The Bohemians” was a club in Melbourne, described by the Chief Justice, Sir Samuel Griffith, as a “social club of the usual kind”.

The funds of the club were derived in great part from the annual subscriptions of its members, which in the year in question amounted to £2,200. At the close of the year’s operations there remained unspent a sum of £96, which the Commissioner treated as taxable income of the club.

The Chief Justice, with whom Justices Barton and Powers agreed, held that the annual subscriptions of club members were not taxable income of the club. His Honour said:

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<sup>7</sup> Parsons, *Income Taxation in Australia*, LBC, 1985, para 2.49.

<sup>8</sup> *Glasgow Corp. Water Commissioners v IRC* (1875) 1 TC 28 at 50 per Lord Deas; *New York Life Assurance Co v Styles* (1889) 14 App. Cas 381 at 393-4, per Lord Watson.

<sup>9</sup> FM Gilders, *A Matter of Mutual Interest* [1992] Australian Tax Review 77.

<sup>10</sup> (1918) 24 CLR 334.

*“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.”<sup>11</sup>*

The Bohemians club is indeed a quaint relic of yesteryear by comparison with the large commercial clubs of today. As might be expected, it is the commercial activities of the clubs which account for turnover, not member subscriptions.

A report by Arthur Andersen<sup>12</sup>, commissioned by the AHA (NSW), provides a detailed analysis of 11 NSW clubs. Although the report deals with the 1994 tax year, its findings are still relevant today. For the eleven clubs surveyed, members’ subscriptions accounted for just 1.5% of turnover.<sup>13</sup>

<b>Club</b>	<b>Revenue</b>	<b>Member Subscriptions</b>	<b>Subscriptions as a % of revenue</b>
Canterbury RSL	15,213,965	128,846	0.85%
Canterbury Leagues	31,180,584	262,529	0.84%
Club Marconi	20,215,885	178,997	0.89%
Gosford RSL	10,169,722	68,115	0.67%
Tweed Heads G C	4,561,393	18,257	0.40%
Matraville RSL	4,565,792	43,722	0.96%
Eastern Leagues’	18,932,489	509,879	2.69%
Blacktown Workers’	26,152,710	311,656	1.19%
Rooty Hill RSL	32,822,903	376,628	1.15%
Harbord Diggers’	10,669,676	646,373	6.06%
Revesby Workers’	16,719,506	312,608	1.87%
Average			1.49%

<sup>11</sup> Id. at 337.

<sup>12</sup> Arthur Andersen, Analysis of Selected Registered Clubs’ Financial Statements, June 1995, set out as Attachment A.

<sup>13</sup> Revenue figures are *understated* because some clubs record figures on a ‘net’ basis. Club subscriptions as a percentage of revenue would actually be lower than 1.49%.

Even the description “super-club” is apt to mislead since many clubs are, in substance, large gaming houses, with revenue from gaming machines averaging 80% of turnover.

<b>Club</b>	<b>Poker Machine Revenue</b>	<b>Total Revenue</b>	<b>Poker Machine %</b>
Canterbury-Bankstown	\$37,340,461	\$42,576,514	87.7%
Marrickville RSL	\$13,338,195	\$15,568,981	85.7%
Bankstown District SC	\$25,962,205	\$31,044,739	83.6%
North Sydney Leagues	\$20,956,297	\$25,172,866	83.2%
Dee Why RSL	\$13,458,650	\$16,594,334	81.1%
Cabra-Vale Servicemens'	\$20,166,807	\$25,086,845	80.4%
Western Suburbs Leagues'	\$17,331,322	\$22,077,649	78.5%
Manly Warringah RL	\$16,004,542	\$20,695,735	77.3%
Canterbury-Hurlstone Park	\$16,620,428	\$22,318,994	74.5%
Burwood RSL	\$11,951,318	\$16,104,302	74.2%
Eastern Suburbs Leagues	\$18,397,453	\$25,385,219	72.5%

Source: Registered Clubs Quarterly Gaming Analysis  
NSW Department of Gaming and Racing  
1996/1997 Financial Year (refer Attachment B)

### ***Mutuality and Receipts from Non-Members***

In *Carlisle and Silloth Golf Club v Smith*,<sup>14</sup> the English Court of Appeal considered the taxation treatment of “an ordinary members’ golf club” which permitted visitors to use the club premises and to play golf on payment of certain green fees. Cozens-Hardy MR stated, at 80:

*“It seems to me that there is a real difference between moneys received from members and applied for the benefit of members and moneys received by the club from strangers. I cannot draw any distinction between gate moneys, which might be, and I believe sometimes are, received by a golf club, and green moneys. In each case the club would be assessable.*

*Whether there have been any profits or gains is a matter of fact; and the answer will depend upon the mode in which the expenses of maintenance and other outgoings ought to be attributed to the visitors.”*

In *Fletcher v Income Tax Commissioner*, Lord Wilberforce in the House of Lords asked the question: “At what point then does the relationship of mutuality end and that of trading begin?”, and answered<sup>15</sup>

*“What is, and always has been, of significance is not the fact of membership or non-membership but the nature of the transactions: if these were trading transactions, the addition of membership makes no difference.”*

By 1965, the High Court regarded the issues as settled. In *Revesby Credit Union Co-operative Ltd v FCT*<sup>16</sup>, 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 . . . Furthermore, any contributions to the fund derived from sources other than the contributor’s payments, such as interest from the investment of part of the fund, or income from a business activity conducted by the members, cannot be taken into account in computing the surplus.”<sup>17</sup>*

The nature of the transactions undertaken by the large clubs is principally gaming of a trading or commercial character. It is unreal to regard the money put into gaming machines as a “fund for a common purpose”, with any winnings being “a mere repayment of the contributor’s own money”.

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<sup>14</sup> [1913] 3 KB 75. See also *Adelaide Racing Club Inc v FCT* (1964) 114 CLR 517.

<sup>15</sup> [1972] AC 414 at pp. 422 and 424.

<sup>16</sup> (1965) 112 CLR.

<sup>17</sup> *Id.* at 574-575.

## CROSS-SUBSIDISATION

The level of cross-subsidisation between gaming and non-gaming services is enormous. The level of cross-subsidisation becomes obvious when the net profit returned by clubs from poker machines is compared to their net operating profit (before community contributions and income tax).

<b>Club</b>	<b>Poker Machine Net Profit</b>	<b>Net Operating Profit</b>	<b>Other Services Net Profit (loss)</b>
Rooty Hill RSL	\$14,407,449	\$5,124,525	(\$9,282,924)
Canterbury Leagues	\$16,973,167	\$8,607,107	(\$8,366,060)
Club Marconi	\$7,586,963	\$970,688	(\$6,616,275)
Canterbury RSL	\$5,973,388	\$751,695	(\$5,221,693)
Revesby Workers'	\$6,373,310	\$1,777,400	(\$4,595,910)
Eastern Leagues	\$8,774,339	\$6,263,442	(\$2,510,897)
Gosford RSL	\$2,883,438	\$1,244,842	(\$1,638,596)
Tweed Heads G C	\$537,961	(\$700,420)	(\$1,238,381)
Matraville RSL	\$1,911,877	\$790,646	(\$1,121,231)

The "other services" referred to in the above table are predominantly bar and restaurant services. Pubs and others operate in the same market and cannot hope to compete with this level of cross-subsidisation.

<b>Trading Activity</b>	<b>Departmental Profit (Club Average)</b>	<b>Departmental Profit (Pub Benchmark)</b>
Bar Trading	7%	40 - 45%
Restaurant Trading	-9%	40 - 45%

## INCOME TAX PAID BY CLUBS

A survey of 28 leading clubs in NSW<sup>18</sup> revealed that income tax as a proportion of operating profit was, on average, 10.09%. This is in stark contrast to the 36% company tax rate.

	<b>Operating Profit before income tax</b>	<b>Income Tax Paid</b>	<b>Tax / OPBT</b>
Total for 28 clubs	\$79,888,076	\$8,057,404	10.09%
Average	\$2,852,431	\$287,764	10.09%

These figures actually *understate* the income tax concessions enjoyed by large clubs because they fail to take into account how gaming profits cross-subsidise the non-gaming services provided by clubs.

A more realistic picture might emerge if you factor cross-subsidies out of the equation. One way to do this is by assuming that all non-gaming services at least break even. In this way you can focus on the income tax paid relative to net profit from gaming activities. Once the cross-subsidies from gaming services are factored out of the equation, income tax as a proportion of profit is only 2.73%, compared to a company tax rate of 36%.

	<b>Gaming Net Profit</b>	<b>Income Tax Paid</b>	<b>Tax / GNP</b>
Totals for 17 clubs <sup>19</sup>	\$205,824,638	\$5,615,272	2.73%
Average	\$12,107,332	\$330,310	2.73%

<sup>18</sup> Using figures available from the Department of Gaming and Racing for the financial year ended 30 June 1997, set out as Attachment B.

<sup>19</sup> Gaming net profit figures were available for 17 only of the 28 clubs surveyed.

## COMMUNITY CONTRIBUTIONS

Tax subsidies to large clubs are often said to be justified by the contributions made by clubs to the community. However, the financial contributions made by clubs to the community are relatively modest compared to the net profit made from poker machines. The eleven clubs surveyed by Arthur Andersen made over \$81m net profit from gaming, yet returned some \$6m, or 7% of gaming machine profit, to the community. Four clubs returned less than 2% of their gaming profit to the community. The Blacktown Workers Club made over \$11m in gaming profits, but returned nothing to the community.

<b>Club</b>	<b>Poker Machine Net Profit</b>	<b>Community Contributions</b>	<b>Contributions / Profit</b>
Blacktown Workers'	\$11,290,377	\$0	0.0%
Rooty Hill RSL	\$14,407,449	\$215,071	1.5%
Matraville RSL	\$1,911,877	\$32,983	1.7%
Canterbury RSL	\$5,973,388	\$104,679	1.8%
Gosford RSL	\$2,883,438	\$76,253	2.6%
Harbord Diggers'	\$7,621,131	\$256,829	3.4%
Revesby Workers'	\$6,373,310	\$223,189	3.5%
Club Marconi	\$7,586,963	\$520,301	6.9%
Canterbury Leagues'	\$16,973,167	\$2,616,766	15.4%
Eastern Leagues'	\$8,774,339	\$1,752,550	20.0%
Tweed Heads G C	\$537,961	\$222,517	41.4%
<b>Totals</b>	<b>\$81,360,012</b>	<b>\$6,021,138</b>	<b>7.4%</b>

It has been estimated that \$309m would be added to NSW State revenue done in 1998/99 if the club rate was set at the same level as the hotel rate.<sup>20</sup> Our earlier paper, "The NSW Club Industry - A Net Community Benefit?", has already highlighted that, in financial terms, the large clubs take more from the community than they give back. This paper is set out as Attachment C.

<sup>20</sup> The NSW Club Industry - Good Samaritans or Just Good Profit, AHA (NSW) submission to the Independent Pricing and Regulatory Tribunal, August 1998.

## **LARGE CLUBS LACK A MUTUAL CHARACTER**

For the “super club” gaming establishments, facilities enjoyed by members and non-members are virtually identical, whether for gaming, beer or food. That is hardly surprising. The average cost of membership for such clubs is little more than \$10.<sup>21</sup> There is no significant barrier to entry as a club member and little economic incentive for clubs to differentiate between members and non-members. In particular, there is no difference in the “price” of gaming and other services used by members and non-members.

The mutuality principle affords substantial income tax relief for the large commercial clubs which is enjoyed by members and non-members alike. However, the mutuality principle was only ever intended to provide relief to members on their capital contributions. It was never intended to provide taxation relief to non-members in the provision of services - that is the very opposite of mutuality.

## **REVENUE IMPLICATIONS**

We estimate that treating gaming income as non-mutual income would raise an additional \$160m in federal income tax. The basis of our estimate is set out below.

We mentioned above that a survey of 17 clubs revealed a gaming net profit of \$206m, with total income tax paid less than \$6m. However, the gaming net profit does not appear to take into account clubs’ general overhead expenses, some of which would be attributable to gaming activities. For the purposes of calculation, we have conservatively attributed 50% of general overhead expenses to gaming activities.

We have analysed the relationship between gaming net profit and general overhead expenses by reference to eight of the eleven clubs surveyed by Arthur Andersen (three clubs had insufficient or low integrity data).

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<sup>21</sup> Arthur Andersen, Analysis of Selected Registered Clubs’ Financial Statements, June 1995, set out as Attachment A.

<b>Club</b>	<b>Poker Machine Net Profit</b>	<b>General Expenses (x 50%)</b>	<b>Poker Machine Net Net Profit</b>
Canterbury RSL	\$5,973,388	\$2,539,781	\$3,433,607
Canterbury Leagues	\$16,973,167	\$4,586,015	\$12,387,152
Club Marconi	\$7,586,963	\$3,594,691	\$3,992,272
Gosford RSL	\$2,883,438	\$1,216,467	\$1,666,971
Matraville RSL	\$1,911,877	\$614,881	\$1,296,996
Eastern Leagues	\$8,774,339	\$1,680,640	\$7,093,699
Rooty Hill RSL	\$14,407,449	\$4,876,796	\$9,530,653
Revesby Workers'	\$6,373,310	\$5,575,869	\$797,441
<b>Totals</b>	<b>\$64,883,931</b>	<b>\$24,685,140</b>	<b>\$40,198,791</b>

Accordingly, gaming net profit should be reduced by some 32% to take into account general overhead expenses, and arrive at a "net net" profit. Further, the income tax currently paid by clubs should be "added back" to avoid double counting.

Gaming net profit (17 clubs)	\$206m
General expenses (38% of gaming n.p.)	<u>(\$ 78m)</u>
Gaming net net profit	\$128m
Income tax @ 36%	\$46m
Add back income tax paid	<u>(\$ 6m)</u>
Additional Income Tax	<u>\$ 40m</u>

We assume, conservatively, that club gaming in NSW is double that of the 17 clubs surveyed. We assume further that club gaming in Australia is double that in NSW. Accordingly, the total additional income tax from treating gaming income as non-mutual income would be in the order of \$160m.

## CONCLUSION

We conclude that, as a matter of taxation policy, and for the reasons given throughout this paper, tax subsidies to large gaming clubs offend the principles of equity and efficiency. It is inequitable for the government to favour one class of gambler over another or to favour one gaming establishment over another. It is inefficient because it distorts the way in which the gaming dollar is spent, causing patrons to shift spending from hotels to clubs for tax reasons alone (delivered through subsidised prices).

The heart of the problem is the gaming activities of clubs, and it follows that this must be the heart of the solution. The most equitable, efficient and simple solution is to treat gaming income as non-mutual income. This solution gets to the heart of the problem. At the same time, the many clubs and organisations which rightly benefit from the mutuality principle will continue to do so.