

# Royal Flying Doctor Service of Australia - Submission to Productivity Commission

## Competitive Procurement

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### 1 Executive summary

The RFDS submits:

- (a) it is appropriate that income tax exemptions are excluded in Commonwealth Government procurement decisions, as they are unlikely to significantly distort resource allocation and would introduce a separate layer of distortions;
- (b) that it would be unfair to only regulate one facet of the many advantages and disadvantages that NFPs and for-profit organisations each have in government tendering, in comparison to the other. To attempt to create a level playing field between NFPs and for-profit organisations without addressing all aspects, or recognising the level of advantage that other non-financial benefits give to for-profit organisations, will have significant negative ramifications for the NFP sector and their ability to provide the essential services to Australia;
- (c) such an adjustment would be difficult to quantify on an accurate basis, complicate the assessment process and potentially introduce other distortions; and
- (d) that if the Commission decides that tax savings should be taken into account in procurement decisions, the Government should be duty bound to make sufficient enquiries to establish if the tax savings have any impact on the bid details submitted by the NFP.

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### 2 RFDS submissions - initial and further

#### 2.1 Initial submission

The RFDS made an initial submission on 29 May 2009, addressing a number of the Commission's request for comments.

The initial submission also includes information about the RFDS's activities and organisational structure.

#### 2.2 Further submissions

In response the Commission's call for further submissions, the RFDS has chosen to make further submissions in relation to three issues:

- (a) Competitive neutrality;
- (b) Competitive procurement; and
- (c) Portable long service leave.

The RFDS has made its further submissions separately.

This submission is on the issue of **competitive procurement**.

In particular, the RFDS is responding to the call for comments in Section 8.2 “*on whether the procurement guidelines should explicitly require that tax expenditures should be considered in Commonwealth Government procurement decisions*”.

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### **3 Income tax concessions**

The RFDS agrees with the Commission’s conclusion that the income tax exemptions “*are unlikely to significantly distort resource allocation*”, as the desire to maximise profit is substantially the same whether the organisation is for-profit or not-for-profit.

Accordingly, the RFDS submits that it is appropriate that income tax exemptions are excluded in Commonwealth Government procurement decisions.

The RFDS further submits that any adjustment for income tax would unnecessarily complicate the assessment process and would also introduce a separate layer of distortions.

If the income tax position of potential suppliers was to be taken into account, the tender evaluation would need to take account of

- (a) Suppliers who were companies with a current income rate of tax of 30%;
- (b) Suppliers who are individuals and for whom a progressive rate of tax applies;
- (c) Suppliers who were trusts or partnerships where the tax liability will be that of the final beneficiary / partner, and the rate can vary between partners and beneficiaries;
- (d) For some trusts, the trustee may have no access to the personal information of the beneficiary so the tax rate applicable to that beneficiary may be information which the trustee may not even be aware of;
- (e) Suppliers who are part of corporate groups where the ultimate income tax liability is dependent on the trading result of the whole group;
- (f) Suppliers who have losses, from either a prior year or the current year,
- (g) Not for profits who are not income tax exempt but rather are required to pay income tax under the principle of mutuality;
- (h) Government departments and government enterprises that are income tax exempt;
- (i) Government owned enterprises who are exempt from paying income tax to the Australian Tax Office but who are subject to the tax equivalents programme; and

- (j) Which year of tax should the consideration be based on – is it the year prior /at the time of the evaluation or should it be the future rate of tax that may or may not be payable for the year (s) during which the tender income will be received.

The RFDS submits that any adjustment will introduce a new layer of distortion.

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## 4 FBT and payroll tax concessions

Without looking at any other factors, some might argue that NFPs who enjoy FBT and payroll tax concessions and who have a significant labour component in their tender, would, all other things being equal, have a financial advantage over any for-profit competitor. (For the purpose of this discussion that advantage is primarily the items noted at Section 8.3 in the third last paragraph regarding exemptions from fringe benefit tax and payroll tax).

The comments set out below are on the assumption that the FBT and payroll tax concessions remain available to selected NFP's in accordance with current arrangements.

However, the RFDS reaffirms its earlier submission that, to conclude that all NFPs obtain a net advantage (or even an unfair advantage) over their for-profit competitors due to these tax concessions ignores many other factors.

As discussed at length in the RFDS's further submission on **competitive neutrality**, the RFDS submits that it would be unfair to only regulate one facet of the many advantages and disadvantages that NFPs and for-profits each have in comparison to the other.

For example, as has been acknowledged on many occasions, there are a number of advantages enjoyed by for-profits which are not readily available to NFPs, such as access to capital (both on and off market), corporate structures which minimise other risks and taxes payable, economies of scale (given NFPs are more likely to be smaller, community based operations).

Taking away a financial advantage enjoyed by NFPs, without addressing the advantages enjoyed by for-profits would have a significant and substantial detrimental impact on NFPs.

The RFDS submits that such an adjustment would be difficult to quantify on an accurate basis, and potentially introduces other distortions. We shall deal with the fringe benefits tax and payroll tax separately.

### **Fringe Benefits Tax ("FBT")**

The RFDS as a public benevolent institution is currently able to treat as exempt those taxable fringe benefits up to \$30,000 grossed up value. The RFDS is aware that for hospitals, operated by government and by charities the exempt fringe benefits cap is limited to \$17,000.

The Commonwealth Government legislated to provide a formal structure and establish the above caps, which have remained at the same level since the legislation was introduced.

The RFDS submits that fringe benefits are provided to employees under two headings namely:

- (a) Those benefits that are necessarily incurred by the organisation in the conduct of its affairs. An example may be housing benefits provided to employees in a remote location. Generally these benefits will be provided independent of the salary negotiations for an employee whether or not the NFP is subject to FBT.
- (b) Benefits provided to employees as part of a salary package, including salary sacrifice. An example may be a car that is primarily for the private use of the employee, the full cost of which is taken into consideration in determining his / her salary.

For the first category of benefits, the NFP enjoys a saving of FBT and it is able to reinvest this saving into its activities.

For the second category of fringe benefit, the FBT saving is traditionally shared between the NFP employer and the employee, with an overall saving to the NFP.

The RFDS submits that it believes that for-profit entities have other advantages that are not available to NFP's:

- (c) A for-profit entity can offer a more flexible remuneration package that can include bonuses tied to the economic performance /value of the enterprise, a measure that is not appropriate for NFP's.
- (d) A for-profit entity can offer a more flexible remuneration package that can include employee share schemes based on the issued share capital of the enterprise – NFP's cannot offer any employee share scheme arrangements.
- (e) As a general rule NFP's have limitations on the remuneration that can be paid to employees. These limitations are based on the expectations of the broader community that place salaries and wages paid to executives and other employees of NFPs under greater scrutiny and question than those paid to the for-profit counterparts.
- (f) For-profit enterprises do not have any such limitation, other than governance and shareholder restrictions applicable to the enterprise – a for-profit enterprise can structure a package as it deems necessary to attract and retain its key personnel.

The concession assists the NFP's to attract staff in the first instance and to assist the NFP's to provide some compensation to the NFP employee for restrictions that apply within a NFP.

NFP's do monitor and calculate the level of fringe benefits provided so that the NFP can remain within the FBT exemption restrictions.

### **Payroll Tax**

The individual entities that comprise the RFDS are classified as public benevolent institution and under current legislation consequently are exempt from payroll tax in each state.

Exempt status is offered to public benevolent institutions and other selected categories of NFP.

Not all NFP's are exempt from payroll tax.

## **Payroll tax and FBT**

Further, if the Commission were to recommend that these tax benefits be taken into account in Government procurement decisions, the RFDS suspects that the manner by which this would be done would be to provide some form of financial adjustment to the tender price submitted by the NFP on the pretext of neutralising the tax benefit.

The RFDS submits that any adjustment for these taxes would unnecessarily complicate the assessment process and would also introduce a separate layer of distortions.

If the payroll tax and FBT exemption position of NFP compared to potential suppliers was to be taken into account, the tender evaluation would need to take account of:

- (g) If the Government is to apply an adjustment to the NFP tender price, then the Government body making that adjustment should therefore be duty bound to ensure that for-profit tenderers have correctly calculated their payroll tax liability. If no such review is undertaken there is a risk that the adjustment is penalising the NFP.
- (h) To make such determinations the Government body undertaking the procurement comparison will need to be expert on payroll tax in the applicable jurisdiction(s) allowing for the fact that the rules differ slightly between each state for tax free threshold, inclusions and rates.
- (i) If the Government body undertaking the procurement comparison instead required the NFP to calculate the payroll tax saving that it enjoys, this will require the NFP to understand the intricate details and calculate the tax payable for a tax which it is not required to pay, again requiring knowledge across each state in which the NFP has some activity.
- (j) How is the payroll tax adjustment to be calculated – is the payroll tax adjustment that amount that would be payable by the NFP on that part of its activities or is the payroll tax adjustment that amount that would be payable by the NFP on the project that is the subject of the tender.
- (k) For-profit entities that are small in size and consequently remain below the level of wages at which payroll tax applies will have an advantage over competing NFP entities that are above the payroll tax threshold.
- (l) Small NFP's that are below the payroll tax threshold will have an advantage over competing NFP entities that are above the payroll tax threshold.
- (m) For-profit entities that have structured themselves in a manner so that they do not pay payroll tax or pay less payroll tax by mechanisms such as business owners who do not draw a salary or draw only a minimal salary and derive the balance of their income from ownership returns such as dividends, trust distributions and share of partnership income. NFP's do not have this opportunity as any surplus must be retained in the NFP and by the force of law cannot be distributed to members.
- (n) For-profit entities that have structured themselves in a manner so that they do not pay payroll tax or pay less payroll tax than might be applicable if investigated by the various payroll tax authorities.

- (o) An example: The RFDS in Queensland employs 350 people so would pay payroll tax if it were not a Public Benevolent Institution. Government tenders are often for individual health projects that may involve a small number of people. If the particular project only required say five health officers, the wages component of that project may be below the level where payroll tax applies if that project was the only activity. What payroll tax adjustment applies – the nil amount if the project was a stand alone, or the 4.75% of wages if the RFDS Queensland entity was actually paying payroll tax.
- (p) To make determinations the Government body undertaking the procurement comparison will need to apply different adjustments for NFP's that are FBT exempt and NFP's that are FBT rebateable as each category produces different tax outcomes.

Consequently the RFDS submits that if such an adjustment were to be included in the procurement evaluation process, such adjustment process will:

- (q) require many calculations of payroll tax;
- (r) require detailed calculations of the FBT amounts that would be applicable under the salary sacrifice arrangements;
- (s) need substantial verification process to ascertain whether the amounts that are shown or estimated are correct or relevant;
- (t) introduce a new layer of distortion; and
- (u) absorb so much time on the part of the NFP tenderers and the government procurement team that there is a real risk that so much focus will be put into this adjustment calculation that the real objective of the tender being reviewed will suffer from a reduced focus.

The RFDS also submits that if the Commission were to recommend that these tax benefits be taken into account in Government procurement decisions, that other factors should also be mandated to be taken into account, by those same governments in their procurement decisions, including:

- (v) An NFP returns its surplus to the community

There is a benefit to the broader community from selecting a NFP which returns any surplus back to both the local community and to the community at large, rather than to shareholders.

- (w) For-profits' ability to access low interest capital

For capital asset acquisitions that may be required as part of a tender, a for-profit can use loan funds which carry little or no interest expense payable to the shareholder source whereas a NFP can only use its own reserves or loans from financial institutions

- (x) For-profits ability to use other assets to reduce cost of finance

For capital asset acquisitions that may be required as part of a tender, a for-profit can use directors' personal guarantees and assets held in those directors and other entities to reduce the rate of interest expense on borrowings, whereas a NFP cannot use directors guarantees but only its

own reserves or loans from financial institutions. (Note: Directors of most NFP's are subject to annual election processes and they have no personal benefit from the NFP so it is not appropriate for them to guarantee a debt that they can neither control nor benefit from.)

(y) Focus on cost

In almost all tender applications, there is a statement to the effect that the particular government is not bound to accept the lowest tender and can accept none if it so concludes.

A focus on the payroll tax and FBT exemption implications increases the risk that the Government procurement processes will use price as the key determinant rather than value for money spent.

(z) FBT exemption fixed cap amounts

The Commonwealth Government introduced legislative based caps on the FBT exemption amounts, effective 1 April 2000.

The FBT cap is the grossed up amount of the benefit, ensuring as best it can, that the FBT exemption amount is a pre tax salary equivalent.

Where the cap is exceeded, the effective rate of tax that applies is the top marginal rate of income tax.

These caps are not indexed. and have not changed since they were introduced in 2000. Consequently, the effect of inflation will continue to erode the purchasing value of these exemptions, reducing any competitive advantage that may be argued as being applicable to the FBT exemptions.

(aa) Detailed contract analysis

There should be an assessment of whether the existence of any tax savings that the NFP may enjoy has had any effect on the tender price submitted by the NFP.

The NFP may have submitted a price that would be no different whether or not it enjoyed the tax savings whatever they may be.

Those tax savings may represent a bonus to the NFP.

If this is the case then no commercial advantage has been sought or obtained.

However, if the government then seeks to apply an adjustment to the NFP tender price for those tax savings, that government is then applying a penalty against the NFP in a situation where no adjustment is warranted.