CATHOLIC HEALTH
Australia

Catholic Health Australia

Response to the Treasury Consultation Paper of 27 May 2011 on not-for-profit tax concessions

5 July 2011

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About Catholic Health Australia

21 public hospitals, 54 private hospitals, and 550 aged care facilities are operated by different bodies of the Catholic Church within Australia. These health and aged care services are operated in fulfilment of the mission of the Church to provide care and healing to all those who seek it. Catholic Health Australia is the peak member organisation of these health and aged care services. Further detail on Catholic Health Australia can be obtained at www.cha.org.au.

Executive Summary

All revenue generated by not-for-profit organisations that utilise Commonwealth tax exemptions should be applied to an altruistic purpose.

This policy intent was announced by the Government in the 2011/12 Federal Budget. Catholic Health Australia (CHA) endorses this policy intent, and notes it is consistent with the practices of Catholic health and aged care organisations that on any given day care for one in ten of all Australians occupying a hospital or aged care bed.

All revenue[1] generated by Catholic public hospitals, private hospitals, medical research centres, pathology services, residential aged care homes, community aged care services, home nursing services, and other social outreach services are ultimately applied to altruistic purposes.

It is perhaps because all revenue generated by the CHA network of health and aged care services is applied to altruistic purposes that the Consultation Paper states at paragraph 35 that not-for-profit hospitals will not be affected by the reforms proposed. It is perhaps because of this that the Government has also confirmed the CHA network of health and aged care services *"are highly unlikely to be adversely impacted"*[2] by the reforms.

The Consultation Paper contains several options which if not designed in an appropriate manner, may result in an unintended consequence of removing revenues from not-for-profit health and aged care organisations through income tax or the loss of tax concessions. This removed revenue would otherwise have been applied to altruistic purposes.

The propositions in the Consultation Paper that give rise to such risks are principally triggered by the absence of a certain definition as to what "profits" of "unrelated commercial activities of not-for-profit" organisations might be. Further risks are found in the propositions that would:

- Tax earnings retained in "commercial undertakings," as proposed at paragraph 3;
- Remove fringe benefits tax concessions where a "loss" is incurred, as considered at paragraph 115;
- Utilise a revenue threshold as a test to determine if an activity is commercial and subject to tax, as considered in paragraph 47;
- Create new compliance costs and additional reporting to government through a need for corporate restructuring to set up new entities or by requiring new accounting procedures as outlined at paragraph 52;
- Apply "level playing field" or competitive neutrality principles to "commercial undertakings" in circumstances where a level playing field may actually not exist, as considered first in paragraph 34;
- Exempt taxation from distributions from commercial undertakings only when payment is made to a deductible gift recipient entity, as considered in paragraph 56.

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[1] Some entities within the CHA network enter into joint venture arrangements with for-profit entities. Income derived by a CHA network entity from a joint venture is applied to altruistic purposes, where as income derived by a joint venture partner may not be applied to an altruistic purpose.

[2] Correspondence of Assistant Treasurer to CHA CEO of 5 July 2011

This submission outlines below how these and other considerations detailed in the Consultation Paper would interact with the CHA network in order to inform how legislation may be drafted so as to achieve the policy intent expressed by the Government that there be no adverse impact of these reforms on Catholic health and aged care services.

CHA makes this submission as part of the wider submission of the Australian Catholic Bishops Conference (ACBC). In particular, we endorse the proposal made in the ACBC submission that ideally the Australian Charities and Not-for-Profit Commission should be first established, to then oversee the codification of the common law definition of "charity", and that then legislation relating to future access to tax concessions could be best considered.

Much of the submission that follows, and that of the ACBC, is based on an assumption that future definitions of "charity", "commercial activity" and "profits" will not depart from common law definitions on which Catholic health, aged care, and other services and functions currently operate.

Section 1: Definitions

The Consultation Paper offers no definition of "unrelated commercial activities of not-for-profits". The CHA network operates in a not-for-profit but highly commercial manner, with entrepreneurship a key to its success. Indeed, one of the social teachings of the Catholic Church is good stewardship of scarce human and financial resources. This teaching of good stewardship of resources today sees the CHA network involved in some 75 hospitals and 550 aged care services that together employ near to 40,000 people.

As part of the operation of this large network of health and aged care services, car parks, pathology services, food catering, linen provision, commercial procurement, health fund negotiations, leasing of commercial premises, property development, and joint venture activities are undertaken as components of furthering altruistic purposes. A definition of "unrelated commercial activities of not-for-profits" that in some way captured any of these activities within a new tax regime would diminish the opportunity for the CHA network to achieve its mission purpose.

The Consultation Paper creates uncertainty as to what an unrelated commercial activity may be by a partial listing of some activities that would be exempt, such as not-for-profit hospitals, op-shops, child care centres, and disability employment services (at paragraph 35). The partial listing of these activities gives rise to the question as to what activities would be included on a list of unrelated commercial activity to be subjected to income tax, noting that the Consultation Paper does list other options within Appendix 3.

It is unlikely that a definition of unrelated commercial activities of not-for-profits can be easily agreed. Any definition capable of meeting the needs of the entire not-for-profit sector is likely to be highly complex, open to unintended consequences, and likely to inhibit entrepreneurship which is key to not-for-profit organisations being able to diversify their revenue streams to attend to their different mission priorities.

A definition of unrelated commercial activities may in fact not be needed. What is commercial and unrelated in the eyes of one not-for-profit entity may not be to another. Instead, the formal expression in the foreshadowed legislation of a principle requiring all revenues to be ultimately applied to altruistic purposes may be sufficient to meet the policy intent of the Government without needing to place a new constraint on diverse and vibrant not-for-profit organisations.

Should Government wish to proceed with the articulation of a specific definition, the CHA network favours the ruling in *Word Investments* where as paragraph 29 of the Consultation Paper states the High Court held the relevant question was if activities were "carried on in furtherance of a charitable purpose" as opposed to if the activities themselves were "intrinsically charitable."

Applying a future definition that codified the decision in *Word Investments* to the CHA network, current hospital and aged care revenue as derived from governments, patients, and residents would not be subject to either taxation or loss of Commonwealth tax concessions. Nor would revenues derived from pathology services, cafeteria income, rental from rooms leased to medical specialist, or car parking levies be subjected to tax or loss of concessions, because where as some would argue a car park and these other activities are not "intrinsically charitable," they are unquestionably "carried on in furtherance of a charitable purpose."

Section 2: Earnings and losses

CHA network hospitals and aged care services operate with intent to produce financial surpluses that are applied to the mission or altruistic purpose. The services are never operated to profit, and in most cases surpluses are modest but are nonetheless a result of varying commercial activities.

Surpluses resulting from activities within the CHA network are used to fund various altruistic activities such as drug and alcohol counselling services, Indigenous and international medical services, family counselling, and homelessness support programs. The full extent of social outreach programs funded from surpluses within the CHA network is extensive. Surpluses are also accumulated over time in order to permit the expansion of health and aged care service offerings, provision for replacement of increasingly sophisticated and expensive medical and aged care equipment, and the eventual upgrade of hospital and aged care facilities and properties.

Victorian public hospitals are required to attract twenty percent of their total funding requirement through their own initiatives, with the State Government funding only eighty percent of annual operating expenditure. Catholic owned and operated public hospitals in that State are therefore actively encouraged by the State Government to initiate commercial activities that include car parks, cafes, flower and retail shops, fundraising drives, foundations, and commercial lettings through property development and management in order to secure sufficient funds for ongoing hospital operations. Similar practices are pursued in other States where Catholic owned and operated public hospitals are located. Retention of earnings forms part of the necessary business planning for these public health services.

The Consultation Paper proposes at various points, the first being at paragraph 3, to consider the taxation of earnings and the removal of tax concessions where a commercial activity of a not-for-profit organisation retains its earnings.

Earnings by hospital and aged care services and earnings from the more commercially oriented activities they are involved in, such as property management and car parks that further altruistic purposes are regularly retained. Earnings retention can in practice occur over a number of years, where retained earnings may be purposefully accumulated for future capital upgrade or service expansion.

The purpose of the retained earnings in such circumstances is ultimately for fulfilment of an altruistic outcome. If legislation were drafted to bring income tax or a loss of tax concessions to an entity in such a circumstance, the policy intent of the Government would not be achieved.

Such an outcome would hinder the ability of a not-for-profit hospital or aged care service to build up sufficient capital for redevelopment or service expansion. Recognising further that constitutions or rules of CHA network hospitals and aged care services do not permit the payment of a dividend, even were earnings are retained they may only lawfully be applied to the altruistic purpose described as being the organisation's purpose.

Somewhat similarly, paragraph 115 of the Consultation paper raises the option of removing fringe benefits tax concessions where a "loss" is incurred. The intent of such a provision appears to be a policy aspiration for not-for-profits to operate commercially and return regular surpluses, both for the good of the mission of an organisation but also possibly for the garnering of additional tax revenue. Organisations incur loses from time to time. In recent years, many residential aged care services have incurred losses in part due to recognised regulatory deficiencies related to the operation of the Commonwealth *Aged Care Act* (1997). To impose a new penalty of removing tax concessions would only compound difficulties for an organisation reporting a loss, and the proposal is not one that should be actively pursued.

Section 3: Thresholds, Payments, and Compliance

The Consultation Paper at paragraph 48 confirms the reforms will not apply to small scale or low risk commercial activities. CHA does not oppose this proposition. By inference, large scale activities would be affected.

Paragraph 47 expands on this inference by proposing "the level of annual turnover in commercial activities will have a bearing in the question as to whether the commercial activity is really ancillary." This raises the proposition that the scale of an activity carried out by a not-for-profit organisation that is in "furtherance of a charitable purpose" but not of it self "intrinsically charitable" could be relevant in the foreshadowed legislation to determining if income tax would be applied and tax concessions removed.

The scale of health and aged care organisations is large. Indeed, public policy requirements for greater operational efficiency and better quality outcomes is one of the key drivers of the ever increasing scale of both hospital and residential aged care services.

The setting of a revenue threshold that did not sufficiently make allowance for the large and growing scale of health and aged care service delivery would lead to some or all parts of the CHA network being captured by income tax and the loss of tax concessions. Such an outcome would be inconsistent with stated Government policy, and the setting of income thresholds should be accordingly avoided.

Paragraph 56 proposes the notion of exempting from income tax distributions from commercial undertakings only when payment is made to a deductible gift recipient entity. This in theory sounds reasonable, but in practice may produce unintended consequences. Whilst all entities operating within the CHA network can demonstrate their altruistic purpose, not all have or require deductible gift recipient status. The status is obtained principally when donor receipts for tax purposes are offered as part of encouraging donations to be made to the altruistic purpose. Many entities of the CHA network have no need to issue tax deductible receipts for donations, and requiring payments to be made only to altruistic entities holding such status would unlikely have a significant material impact, but it would create unwarranted administration and compliance barriers.

The Consultation Paper at question 8 makes reference to likely "compliance costs" involved in introducing the proposed measures. It also asks how organisations with commercial activities should be structured.

In order for changes to structures of not-for-profit entities to be justified, and for new compliance costs to be imposed, both a robust public benefit and benefit to the organisation should be demonstrated. The case for both public benefit and organisational benefit is not made in the discussion paper, and has not been made by the Government to date. In fact, the benefit of the likely structural changes that could be required by the reforms are likely to be derived solely by Government who will obtain new oversight of the activities of not-for-profit bodies. The possible structural changes and new compliance costs will not benefit health and aged care service delivery or the wider mission of the CHA network.

The Consultation Paper acknowledges the absence of an agreed compliance regime at this point, so it is difficult to assess the potential costs that would be incurred by a CHA network health or aged care organisation in order to comply with the foreshadowed legislation.

Any change in compliance will inevitably place some financial impost on all not-for-profit bodies, particularly given the stated intention of Government that in the case of CHA network services that they will not be captured by the taxation components of the mooted reforms. In this circumstance, the proposals appear to propose a heavy burden for many not-for-profit bodies undertaking commercial activities solely to further their Mission, in circumstances where Government does not intend to tax their revenue or remove their concessions.

Requiring so many not-for-profit bodies to meet new compliance costs for reporting on commercial activities in order to levy income tax or remove tax concessions from a small number of entities asks if the cost and imposition leads to a commensurate public benefit. A more targeted approach that pursued entities inappropriately diverting funds derived from commercial activities to non-Mission related recipients would seem a more sensible and less heavy handed approach.

Section 4: Other Considerations

The nature of hospital and residential aged care services gives rise to a set of considerations possibly not common to other parts of the not-for-profit sector.

It is common for groups of not-for-profit health and aged care companies within the CHA network to be organised in connection with a single property holding company to facilitate raising bank finance. Such a practice enables a bank to segregate assets over which it takes a security in order to monitor its loan to asset valuation ratio and other lending criteria. Grouping properties together also makes it easier to raise a consolidated line of finance at a cheaper cost than a myriad of smaller lines.

A property holding company can repay a finance obligation by renting properties to the operating company. With rent covering the interest and principal of a loan, the profit and loss account will show a rental income of say $100 to cover interest of say $50 to leave an accounting surplus or "profit" of $50, which in time may be used to repay the principal repayments of the loan. There exists potential for this "profit" to be seen as an unrelated commercial activity and subject to income tax, when in practice it is a means of financing property to be used in the delivery of an altruistic purpose.

Similarly, a number of trusts exist within the CHA network to manage revenue and assets for the ultimate benefit of an altruistic purpose. Some trusts are established by their own State statutes. One illustration is that of a trust that holds property where the income from that property derived from rent, car park income, and retail outlets is passed to a hospital for its use. Not every dollar earned by this particular trust is passed to the hospital, as the trust collects and retains some surpluses to fund the acquisition of further rental properties and the refurbishment of others in order to maximise its eventual cash flows and the degree to which it is able to assist the hospital. There is a potential that this particular trust, or others like it, may either become liable to pay income tax or may be forced to pay all its annual surplus which would then prevent it from maintaining and enhancing its capital stock, leading to its eventual decline.

It is common for Church related not-for-profit companies to provide management services in relation to aged care and health services owned by other related Church bodies. Without these contracts that are common in the CHA network, many aged care homes would have been forced into closure in recent years, putting a further burden on the aged care system. Foreshadowed new activity rules may deem these management contracts an unrelated commercial activity and therefore exposed to income tax, when in fact they are little more than another way of an organisation fulfilling an altruistic purpose by managing, and deriving revenue from, the oversight of another entity's altruistic purpose.

The Consultation Paper makes regular reference to seeking to achieve a level playing field without express mention being made to what a level playing means or relates to. It may be that the Treasury is making reference to the competitive neutrality principles of National Competition Policy, but this is not clear. It may be that reference to a level playing field is in part irrelevant to the broader considerations of the Consultation Paper as competitive neutrality policies aim to promote efficient competition between public and private businesses.

Specifically, they seek to ensure that government businesses do not enjoy competitive advantages over their private sector competitors simply by virtue of their public sector ownership. The Consultation paper does not make it clear as to what role this policy has in relation to tax treatment of not-for-profit bodies, and nor does it consider a disadvantage that may be created if a not-for-profit was subject to a new tax regime in circumstances where government owned enterprises were providing comparable human services without being subject to the same tax regime.

Finally, Paragraph 81 raises the prospect of an "expansion or change" in a commercial activity giving rise to changed tax status. The discussion in the paper is not clear, but it would be easy to interpret that any new commercial activity created after 10 May 2011 by a not-for-profit organisation, or an activity that undergoes significant change after this date may be subject to a new tax regime. Our understanding is that the policy intent is not to limit expansion of services with clear altruistic purposes. To achieve this intent, the implementation of the proposal at Paragraph 81 should reflect an ongoing ability for any enterprise able to demonstrate a new or changed activity that properly contributes to altruistic purposes would continue to be free from the new tax regime.