

Implications of the GST for Charities

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Glossary of Terms

‘GST-free’ or ‘zero-rated’ removes all tax from a good or service provided by a registered entity.

‘input taxed or GST-exempt’ does not file a GST return and so any input tax paid is not refundable. The organization is taxed indirectly through the GST inclusive prices of its purchases of goods and services.

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Executive Summary

With implementation of the Howard Government's Goods and Services Tax (GST) only four months away, fierce debate continues over the effect the new tax will have on charities.

The Prime Minister has given a guarantee that charities will be no worse off under the GST. This paper argues that the Prime Minister's guarantee can be met only if substantial changes are made to the definition of what constitutes a charity and its 'non-commercial' activities.

The paper examines both the charities' claims that costs of the tax on their income earning activities, including compliance costs, will drastically reduce their ability to finance charitable services and the Government's response that exemptions, tax deductions and the removal of wholesale sales tax will negate the impact of the GST.

The paper traces the complex considerations of the impact on charities of the GST by a Senate Committee, the Vos Report, the Government's GST deals with the Australian Democrats and the Australian Taxation Office's subsequent Charities Consultative Committee.

The majority report of the Senate Inquiry forecast dire consequences for charities from the new tax without offering solutions other than a rejection of the GST; a minority report backed the Government view that charities would see running costs fall as a result of the new package.

This paper argues:

- The present common law definition of charity is outdated and arbitrary and discriminates against some types of charitable activity. There is a need for informed public debate on what constitutes a charity.
- Present policy is based on the 'soup kitchen' view of charity and fails to provide for modern charities' need to finance their mission through 'business like' activity.
- Arguments to date have concentrated excessively on achieving 'competitive neutrality' between charities and for-profit businesses. Preventing tax avoidance by 'sham' charities is a more appropriate focus for GST policy than achieving competitive neutrality.
- The Government's recognition of the sale of goods below market value as the only pricing strategy for charities fails to acknowledge the voluntary element in charitable enterprises and is in fact inaccurate. Many sales by charities are deliberately at or above market value. The policy of taxing all 'commercial' fundraising activities or events is contradictory, as 'non-commercial' pricing strategies or 'cut-price' sales would not be effective at fundraising. Many charities' products or services are produced by volunteers. The Government has ignored the donation element in purchases from charities.

- Charities draw into economic usage resources that would not otherwise be available for productive use, especially volunteer contributions of time and goods. Little consideration has been given to the demonstrably negative impact of taxing these volunteer contributions.
- Scant understanding exists at Government level of the diversity of the charities sector and the potential the GST has to impose severe financial costs on some charities contrary to the Government's genuine intention to shield them from impact.
- Throughout the debate there has been little recognition of the extent to which charities fill the role of government – and more cheaply than government – and of the extent to which the new tax would curtail this role.
- Weakening the financial capacity of charities through application of an inappropriate GST regime will result in net fiscal costs as activities formerly conducted by charities will need to be replaced by governments.

The likely outcome of present policy is that charities will be substantially worse off from the GST. They will pay tens of millions of dollars in GST because they are not 'GST-free'. Both the Government and charities must face unpalatable choices between competing priorities. But with genuine commitment and understanding of the sector, and community clarification of what a 'charity' now means, there is no fundamental reason why the Prime Minister's intention that charities will be no worse off cannot be met.

1. Introduction

With the GST just four months away, fierce debate continues about how the new tax will affect charities. The Prime Minister has given a personal commitment that charities will be ‘no worse off’ under the GST.¹ According to the Government, charities may even be better off. Smaller charities can choose to stay outside the system. Charities will pay GST only on ‘commercial activities’ and can use special administrative provisions to avoid charging GST. Unlike in other countries, charities can choose to be within the GST system and claim refunds of tax paid on their inputs, thereby reducing their costs. Together with GST-free treatment of some activities, this is said to maintain ‘an effective tax-free status’ for the sector. On this view, fears of adverse effects reflect ignorance or lack of understanding of how the GST works. On the other side, however, charities respond that GST on their income earning activities, and the high initial and ongoing compliance costs, will disastrously reduce their ability to finance charitable services, or engage volunteers in their efforts.

This discussion paper examines the key issues in this debate. Section 2 shows that the main starting point for designing a GST on charities must be to develop a definition of a charity that is appropriate and relevant to modern Australian society. Without a clear consensus based on widely held community values about what defines ‘charitable’ activity, the GST will replicate deficiencies in existing income tax treatment of the non-profit sector, while also giving rise to an inappropriate policy emphasis on ‘competitive neutrality’ goals for the GST.

The policy approach and the main features of the GST pertaining to charities are outlined in Section 3. Using available financial data on the sector, this section analyses the financial impact of the GST on charities under different scenarios. It contrasts the financial implications of ‘GST-free status’ for the sector with likely effects of implementing existing policy, as well as with the possible results of a more realistic, ‘unintended consequences’ scenario.

The final section, Section 4, discusses whether preventing ‘unfair competition’ between charities and businesses should be a major tax policy objective for this sector, and considers the implications for appropriate design of the GST on charities. It also identifies further changes which are likely to be necessary to give effect to the Prime Minister’s promise.

The paper concludes that the present approach to applying the GST to charities presents both practical and moral dilemmas. Furthermore, both the Government and charities must face unpalatable choices between competing priorities in adapting the GST to charities, and in charities adapting to it.

¹ Australian Democrats, A Fairer Tax System. Delivered, Issues Sheet 999 Charities, 28 May 1999.

2. What is a charity?

‘When I use a word,’ Humpty Dumpty said in a rather scornful tone, ‘it means what I choose it to mean, neither more nor less.’

(Lewis Carroll, *Through the Looking Glass*, 1872)

The implications of the GST for charities depend on the scope of the term ‘charities’. The existing definition of ‘charity’ for tax purposes creates numerous problems of tax administration. Using the same definitions as the basis for applying the GST will lead to similar problems. It will also produce a misplaced emphasis by tax administrators on achieving ‘competitive neutrality’ because the broader and looser the definition of a charity and the scope for ‘unfair competition’ by ‘pseudo-charities’, the more restrictive must be the definition of charities’ non-commercial activities. This in turn has significant implications for whether the GST adversely affects the operations of charities. The main starting point for designing a workable GST on charities must therefore be to develop an appropriate and agreed definition of ‘a charity’.

The original ANTS package of August 1998 proposed that ‘charitable activities’ be GST-free and ‘non-profit organisations’ with a turnover below \$100,000 would not have to register. Religious services were also to be GST-free, although religious items for uses in private devotion were taxable. The approach to designing the GST on charities reflected a traditional view of their pricing policies and income sources, and focussed on the potential for their ‘commercial activities’ to harm for-profit businesses:

Charities, public benevolent institutions, community groups and religious organisations operate differently from business. They often do not charge for the goods and services they supply, or impose only a nominal charge. Much of their funding and inputs are provided as donations. Their charitable activities will be GST-free. To avoid unfair competition with business, the commercial activities of these bodies will be taxable. Membership of registered organisations (for example, local sporting clubs) will be taxable, but donations (which are not payments in return for services) will not be taxable. In practice many community organisations will be below the \$100,000 threshold and their memberships will not be taxed.

This approach to the GST on non-profit and charitable organisations mirrors that in the Fightback! package, which also gave considerable weight to preventing ‘unfair competition’.²

Increased public attention to the regulation and taxation of charities in the last decade provides the more recent context for this approach to GST on charities. Public disquiet about accountability of charities led to calls from the early 1990s for reformed regulatory regimes. The income tax deductibility of gifts to charities has also come under scrutiny in recent years, because of tax avoidance, and there have been suggestions that some non-profit organisations have been abusing the Fringe Benefit

² McGregor-Lowndes 1992.

Tax (FBT) concessions available to the sector.³ Most recently, the Industry Commission in its *Inquiry into Charitable Organisations* examined concerns about their taxation treatment from the perspective of preventing ‘competitive advantage’ and ensuring ‘a level playing field’.⁴

The Government’s policy was initially vague about what constituted ‘a charity’ or ‘charitable activities’. The Vos Tax Consultative Committee therefore took ‘charitable activities’ to refer to non-commercial activities conducted by charities eligible for income tax deductibility. It warned however, that this definition could produce anomalies between charities that had gift deductibility status and those that did not.

Hence by early 1999 the Government had extended its policy of GST-free treatment of ‘non-commercial activities’ to include ‘all income tax exempt charities’ as well as all gift-deductible entities. The *ANTS (Goods and Services Tax) Act 1999* applies the GST-free status to the non-commercial activities of ‘a charitable institution, a trustee of a charitable fund, or a gift deductible entity’. Accompanying legislation will provide for a new system of endorsement of charitable organisations as a deductible gift recipient (DGR) and/or income tax exempt charity (ITEC).

The term ‘charitable’ is said to have the same meaning for GST as for income tax.⁵ However, difficulties arise from using this definition of a charity because the common law definition of charities used for income taxation has a technical legal meaning which is quite different from its everyday meaning.

As a result the *ANTS (Goods and Services Tax) Act 1999* definition appears to exclude some non-profit entities and activities that might commonly be considered ‘charitable’. However, the wider meaning of ‘charity’ in taxation law will also cover some gift deductible entities and income tax exempt bodies that would probably not commonly be viewed as charitable. These anomalies will inevitably generate pressures to extend the categories of organisations whose non-commercial activities attract GST-free status.

A critical risk of using this wider income tax definition of which entities can claim GST-free status for their ‘non-commercial activities’ is therefore that the need to protect the revenue will in such circumstances induce an overly restrictive definition of the ‘non-commercial’ activities of charities.

These issues are examined more fully below, before exploring the financial implications for charities in Section 3.

³ Krever 1991; McGregor-Lowndes 1995b; McGregor-Lowndes 1998; Gjems-Onstad 1993b; Business Review Weekly 3 September 1999, ‘Taxing times ahead for charities’.

⁴ Industry Commission 1995

⁵ ATO 1999.

2.1 An ‘income tax exempt charitable organisation’?

Charitable organisations are presently exempt from income tax.⁶ The meaning of ‘charitable’ has been determined by the courts rather than by legislation. An organisation is considered to be ‘charitable’ if conducted on a not-for-profit basis, and established to benefit the community, or some section of it, through:

- the relief of poverty or sickness or the needs of the aged;⁷
- the advancement of education;⁸
- the advancement of religion;⁹
- other purposes beneficial to the community.¹⁰

This definition of charities excludes many non-profit organisations, including sporting, recreational and social clubs, those carried on for their members’ common interests, or community service organisations having ‘significant membership purposes’. For example, trade unions and employer associations, various clubs, associations and societies encouraging music, art, sciences and literature, games or sports, animal races, or community service organisations like Apex, Lions or Rotary would be considered not to be charitable and liable for GST on their income.

On the other hand, the common law definition might include the promotion of industry, commerce and arts, and the provision of leisure and recreational activities. It would also apparently include organisations established for ‘public works including the beautification of towns, law report preparation, relief of rates and taxes, the preservation and benefit of animals, promoting vegetarianism, and even the promotion of good housewifery’.¹¹ Such bodies, although perhaps not commonly perceived as charities, have been seen by the courts as ‘charitable’ in nature.

2.2 A gift deductible entity?

Under income tax law, gifts made to ‘public benevolent institutions’, and certain other organisations and categories of bodies are tax-deductible. While the original ANTS package envisaged charitable activities being conducted only by gift-deductible

⁶ Verick and Lamerton 1991.

⁷ Organisations likely to be charitable under this test are ‘hospitals and nursing homes, relief agencies, disaster response organisations, youth and women’s refuges, drug rehabilitation, refugee welfare centres, soup kitchens, organisations that supply low cost furniture, clothing and housing to the poor’. Charities Consultative Committee (1999).

⁸ Includes ‘schools, colleges, universities, research and scientific institutes, scholarship trusts, school building funds and parents and friends associations.’

⁹ Includes ‘churches, synagogues and other religious congregations, seminars, religious orders, organisations for building or repairing religious buildings, maintaining clergy, spreading religious doctrine or practice.’

¹⁰ These may be beneficial to the community: ‘preserving defence and public order, relieving stress due to natural disasters, providing community facilities such as a museum, library, hall, garden or fire service, promoting art or culture such as through music and drama, promoting health, for example through educating the public about disease, protecting animals, scouts.’ However, see also McGregor-Lowndes 1995c, p126.

¹¹ McGregor-Lowndes 1995c.

entities which were charitable, the current legislation refers to ‘gift-deductible entities’. This means political parties are ‘charities’ for GST purposes, as the relevant section of the Act includes donations to a registered political party. Their ‘non-commercial’ activities, such as providing meals or accommodation ‘on the house’, are likely to be GST-free.

‘Public benevolent institution’ is not defined in legislation, its meaning being determined by common law. The term was intended to replace the historic concept of a charity around the time of the Great Depression of the 1930s. The aim was to reflect more accurately than the common law definition, the objective of alleviating suffering in the community.¹²

However, the meaning has been defined mainly through appeals by the taxation authorities, with the term being even more narrowly interpreted by the courts. A public benevolent institution has been held to be one which,

- has as its object the relief of poverty, sickness, suffering, distress, misfortune, destitution or helplessness;
- is carried on without the purpose of private gain for particular persons
- is established for the benefit of a section of class of the public
- offers relief without discrimination to every member of that section of the public which the organisation aims to benefit
- gives aid directly to those in need: and
- ensures that its non-benevolent activities are minor and ancillary to its basic operation.¹³

This definition is also used to help determine eligibility for sales and fringe benefits tax exemptions.

As a result of the narrow and distinctive meaning given by the courts to the ‘public benevolent’ phrase, the difference in wording between the income tax exempt and gift deductibility provisions has led to inconsistencies and anomalies in its application to some organisations. Rather than change the common law definition by statute or regulation, parliament passed new sections extending deductibility individually to organisations that had failed to satisfy the common-law definition of a public benevolent body. Organizations included as ‘gift-deductible’ range from the RSPCA to Australian College of Obstetricians and Gynecologists, Productivity Promotion Council, Australian Sports Foundation, Australian National Travel Association, Industrial Design Council of Australia, Registered political parties, Universities, Museums, Art galleries.

A benign view of this process would point to the need to ensure the definition of charity keeps up with changes in community values and the environment in which charities operate. Nevertheless, ‘those who may argue that the political pressures in

¹² Carney and Hanks 1991.

¹³ McGregor-Lowndes 1995c.

this area are trivial just have to review the list of specific PBI [public benevolent institutions] organisations and how they obtained that status'.¹⁴

The apparent inclusion of political parties as 'charities' under the GST gives some force to this cynical view of the political process.

2.3 A charity is ... 'whatever I say it is'

Differences in the definition of charity and public benevolent institution have created excessive complexity and administrative cost. They also unreasonably favour some charitable organisations and activities over others in their access to fiscal support for fundraising or lowering input costs. The common law definition of a charity or PBI was found by the Industry Commission to be biased against some types of charitable activity and charitable organisations, such as single-purpose, preventative, self-help or advocacy organisations. In particular, the concentration on direct assistance to the poor which is inherent within the definition of PBI, 'works against contemporary approaches to social problems such as preventative community programs, research, advocacy, social policy formulation and coordination.'¹⁵

The planned GST regime will lock in their relative disadvantage.¹⁶

As shown above, the current definition of a charity for GST purposes includes many entities which would not reflect contemporary public understanding of charity or charitable activity. It would for example, count many fundraising activities of registered political parties as 'charitable', but membership subscriptions for the Australian Council of Social Services as 'commercial'.

Such common law meanings reflect outdated and inflexible concepts of charities' role and operations in today's society. As there is no mechanism for revising such definitions in line with the changing environment in which charities operate, the ANTS approach risks freezing charitable activity into an unviable and increasingly irrelevant range of activities, and discouraging innovative approaches by the sector. This is reinforced by the rigid scope and confining definitions of GST-free activity which arise from the dated notions of what a *bona fide* charity does. As a result, revenue-raising activities which the courts have held to be essential for charities' purposes to function today¹⁷ will be deemed 'non-charitable' and therefore taxable under the GST.

Scrutiny of the GST regime applying to charities has underlined the serious shortcomings in the present legal definition of charity and its application in modern society. The diversity and complexity of charity structures and potential for

14 McGregor-Lowndes 1995a.

15 McGregor-Lowndes 1995b.

16 To avoid these difficulties and distortions, the Productivity Commission created the term 'community social welfare organisations' (CSWOs) to cover a subset of tax-exempt 'charities' which excluded 'religious' and 'education' activities, and included public benevolent institutions involved in providing 'human services'. However, this approach has been shown to be fraught with difficulty, and unlikely to provide a way forward through the current morass. (See McGregor-Lowndes 1995b and McGregor-Lowndes 1995c).

17 See Carney and Hanks 1991.

difficulties with the GST has been further highlighted by the process of registering Gift Deductible and Tax Exempt Entities.¹⁸

As McGregor-Lowndes commented, 'The charity boundary is characterised by fuzzy borders caused by strained legal logic, perverted and competing public policy demands, historical misappropriation and inconsistent legislative intention.'¹⁹

Some smaller non-profits which fall outside of the definition of charities will fall below the \$100,000 and choose to be input taxed under the GST. Some will restructure their operations to avoid GST on their fundraising and other revenue generating activities. However, some will face significant additional tax liabilities as a result of the GST. Where activities of bodies which are not obviously 'charitable' according to the everyday meaning of the word are granted GST-free status, it would be surprising if the less favoured non-profit bodies did not seek, through either legal or political avenues, to achieve comparable status.

The problem is that clear policy has not been formulated: 'Some difficult questions need to be posed and debated in public'.²⁰

Such questions struck at the heart of the nature of the welfare state and civil society, and include,

what activities or groups should the State favour with taxation exemptions and subsidies? and 'by what state process should this question be regularly reviewed. Do all activities which advance civil society deserve the benefits, or just those that replace or complement the State's social welfare obligations? Does one kick-start the stalled judicial interpretation of past definitional concepts through quasi-judicial bodies such as a Charities Commission or by statutory definition?

The administrative process envisaged for endorsing charities, while potentially producing more consistent determinations of charitable status, and more effective anti tax-avoidance strategies, may be excessively vulnerable to the exercise of political influence. The tax-appeal context in which such determinations are made are also unlikely to produce more socially relevant and less fiscally driven definitions of charity, or to respond effectively to the changing social and economic conditions in which charities operate. This points to the need for the regulation of non-profits and charities and determination of their individual tax status, to be more transparent and independent of direct political pressure.

Those most familiar with non-profit law consider there is ample evidence of the need for reform of the definition of charities. The obstacles to consistent application of the GST to charities will remain until there is a clear policy.

According to Lyons,

What seems needed is a wide ranging and extensive public discussion aimed at obtaining agreement about what sort of organisations pursuing what sort of

18 Charities Consultative Committee, 1999.

19 McGregor-Lowndes 1995c.

20 McGregor-Lowndes 1995b.

purposes should be able to give tax deductibility to donors (and enjoy other tax concessions). This should be followed by an attempt to enshrine the agreement in statute and to redraft those sections of taxation law to reflect the modern world. The term charity needs to be confined to the history books.²¹

It would be ironic if the 'A New Tax System' were to enshrine the anachronistic common-law definition of charities in the 21st century tax system, while public policy has sought for several decades to update such tax law relics of previous centuries' attitudes and values.

There is an urgent need for a broad public inquiry into the definition of a modern charity and its activities, because, as Gjems-Onstad has pointed out, 'a discussion of value-added tax [GST] is not a matter only of money; it touches the basic relationship between the government and the non-profit organisations in a modern society'.

²¹ Lyons 1995.

3. Which activities of charities are GST-free?

Difficulties in defining a charity are one factor leading the Government towards a narrow definition of the ‘commercial activities’ of charities. Another important factor, evident in the original ANTS package as quoted above, is the Government’s perception that charities do not charge for the goods they supply, while most fundraising is from donations or grants. While this accords with the larger, well-established charities, it does not accurately reflect the diverse funding sources and activities of the sector as a whole. The larger ‘household name’ charities tend to have greater access to government grants and widely publicised fundraising appeals. As a result, this section shows that the proposed GST regime could result in severe financial costs on some charities, while providing few difficulties or even gains for those conforming to the ‘traditional’ pattern. Even if the sector as a whole gains, some charities or categories of charities may suffer substantial financial losses from the GST.

3.1 The policy intent

3.1.1 *The ANTS package*

In Section 2, we observed the Government’s statement in its 1998 ANTS package that ‘charities’ are different from businesses because they rarely impose more than a nominal charge, if any, for the goods and services they supply, and receive much of their fundraising and inputs as donations. On this view, the extent of charities’ ‘commercial activities’ was minimal, and GST charged on their supplies of goods and services would be insignificant. The intention was, that with charities recouping most input taxes, and substantially funded by GST-free donations and stable levels of grants, charities would be no worse off, or even better off. That is, they would remain effectively GST-free.

Soon after releasing its tax package, the Government appointed the Vos Tax Consultative Committee to help define the scope of the ‘non-commercial activities of charities’ and other GST-free areas. The Committee’s terms of reference gave a heavy weighting to ‘competitive neutrality’ requiring it, *inter alia*, to ‘ensure businesses and charitable organisations are treated on an equivalent basis where they provide similar goods and services on a commercial basis to consumers’.

The Vos Report recommended a very narrow interpretation of the scope of ‘non-commercial activities’. As the Government’s policy was to ‘avoid unfair competition with other businesses’, only supplies by a ‘tax deductible body’ of ‘donated second hand goods’, or supplies ‘for nominal or insubstantial consideration’ should be GST-free.²² The Committee considered that where the services provided have no commercial equivalent, ‘then it is appropriate for them to be GST-free’.

Despite its apparent concern to treat businesses and charities equally, the Committee advised against including the value of volunteer worker contributions to value-added

²² By this, the Committee meant the price should be less than 50% of the normal market value of the supply.

in GST calculations, for fear of encouraging pressures for income tax recognition of expenses incurred in volunteer work.

The Vos Report did acknowledge that charities undertook substantial fundraising activities including some 'business-like activities', simply to raise funds to support their benevolent activities. However, government policy on the GST made clear that the ultimate purpose or end of an activity should not determine the commercial/non-commercial distinction. In the interests of a simple tax system, the status of the recipient or the purpose of the supply should be irrelevant to suppliers, and 'fundraising' or commercial activities of charities must generally be taxable. The Committee emphasised that donations and activities like fees or contributions which raise money 'and yet are not fundraising or commercial activities' would be GST-free.

Various charities raised concerns about policies during the Senate Inquiry into The New Tax System.

The Majority Report of the Senate Inquiry forecast dire consequences for charities, without offering solutions other than rejecting a GST:

The Government's tax package threatens a two hundred-year tradition of charitable and not-for-profit service to the community. Any tax which threatens the Girl Guides, the Boy Scouts, and the Surf Lifesavers is a tax that is not good for the community. For the first time, the charitable and not-for-profit sector will lose its tax-free status given in recognition of the services they provide to the community.

Taxing the charitable sector will undermine an important part of the fabric of our society. It is simply, Un-Australian.²³

The Report argued the GST turned charities into 'tax-collectors', requiring complex and costly administrative and compliance procedures. The threat to charities would result in cuts to their essential services, and an extra load on the Government. The Prime Minister's exhortations for 'the corporation sector to become more philanthropic' was drawn in ironic contrast with his Government 'threatening the activities of charitable organisations by taxing their memberships, fundraising and the local Church fete and lamington stall'.

Government Senators presented a Minority Report²⁴ which concluded to the contrary that

GST-free treatment of the non-commercial activities of charitable institutions is generous by international standards and will see the running costs of the sector fall due to the industry cost reductions in the Government's tax package.

The Minority Report argued that commercial activities of charities should be treated the same as commercial activities of ordinary businesses 'to ensure ordinary businesses aren't put at a competitive disadvantage'. Concerns about GST applying to charities' income earning activities were said to be ill informed.

²³ Senate Community Affairs Reference Committee 1999c.

²⁴ Senate Community Affairs Reference Committee 1999b, Minority Report.

Government representatives were confident that applying GST to grants and the sponsorships and endorsements received by charities would have no net effect on charities' income. Grants were not payments for goods or services and so remained outside the GST. Nevertheless, 'as some payments by governments were called grants but were in fact payments for providing services', these would be subject to GST. In this case, however, they argued that the transaction would be one between two registered entities and would have no net GST implications.

On sponsorships, government representatives likewise cited the Vos Report. Sponsorships were subject to GST, being 'in the usual sense .. payments for services. That is, sponsorships are payments in return for the service of advertising or other benefits'. However, the attraction of using the charity as an advertising vehicle would not be reduced – all sponsorships would be subject to GST, and so the attractiveness of using a charitable entity as compared with another entity was unchanged. Again, 'the net financial position of the sponsor will not be affected because the transactions will be taking place between two GST-registered entities'.

As a result, the net position of both the government and the charity would be the same as if there were no GST.

Although the Vos Report had cited the Government view that membership fees were payments in return for services, government members advised the Senate that memberships would not always be taxable. In particular, 'where a membership of a charity falls within the definition of a non-commercial supply', it would be GST-free: 'if a member of a SIDS [Sudden Infant Death Syndrome] organisation is entitled to counselling services and the membership fee is less than 50% of the commercial value of the counselling, the membership will be GST-free'.

If there was a commercial value to membership, as in the case of membership of a chamber of commerce and industry, commercial value GST would apply;

But to a community organisation where basically you do not have a commercial value attached, but it is more a token gesture of support for which you get a newsletter in return, or something like that, as I understand it, there is no GST.

Regarding fundraising by charities, the policy position was that donations given to non-profit organisations did not give rise to any GST liability. This was so even when something was given in return like a red nose on SIDS day or a poppy on ANZAC Day provided it is something of insubstantial value.

In fact, it was argued, the costs of such fundraising would fall. In the case for example, of the SIDS red noses,

The cost to the SIDS Council of the red noses will decrease as a result of the removal of direct and embedded WST [wholesale sales tax]; SIDS would be able to claim input tax credits to offset the GST liability on their purchases; and the donations in return for the red noses will be GST-free.

That is, the GST would remove the impact of indirect taxes on charities:

Industry cost reductions will result in lower operating costs for these bodies. They will also benefit from the GST-free treatment of their non-commercial supplies of goods or services. All GST participants who are in a net refund position will be able to choose a monthly tax period and thereby get a refund at the beginning of next month.²⁵

The Government recognised that even though the sector would benefit from input tax credits, charities would face substantial compliance costs. As the Vos Report had recommended, the Government agreed GST startup costs borne by charities were a legitimate call on the \$500 million available to assist small and medium enterprises.²⁶

The Vos Committee had also noted concerns that the GST would have an adverse cash flow effect on entities supplying largely GST-free supplies. However, the Government accepted the Committee's judgement that cash flow problems would be minimal provided the Government ensured refunds are paid promptly.

Overall, the Government Senators concluded that:

The Government's approach to the GST treatment of charities provides a simple and fair system that ensures genuine charitable activities are GST-free but also that charities do not get an unfair price advantage over businesses through poorly targeted concessions. The Government also wants to ensure the system is simple for charities to administer and that they can benefit, where possible, from obtaining input tax credits. In Australia, charities who register for GST will be able to claim input tax credits for GST paid on all their inputs, and will only be required to charge GST on goods and services sold at a commercial price. Goods and services sold at non-commercial rates will be GST-free. Non-commercial activities are:

- supplies that are less than 50% of the market value; or
- supplies that are less than 50% of the cost to the charity of providing the supply; or
- supplies of donated second hand goods.

3.1.2 Late 1999 amendments

Despite government confidence that charities would not be adversely affected, the Democrats' Report raised concerns at potential 'serious damage to the charitable sector'.²⁷ The Democrats argued that to hold the Government to its stated intention of not harming the charitable sector, 'all activities of charities should be GST-free', 'unless they were clearly commercial'. Relief should also be extended to all income tax exempt not-for-profit organisations.

With the announcement in mid 1999 that the Democrats would support a modified ANTS package, the Government promised to assist charitable and non-profit organisations to establish how they would be affected, and to implement the GST.²⁸

²⁵ Senate Community Affairs Reference Committee 1999c.

²⁶ Senate Community Affairs Reference Committee 1999b, Minority Report.

²⁷ Senate Community Affairs Reference Committee 1999a, Democrats Supplementary Report.

²⁸ Lees 1999, Media Release: 'Democrats: "In principle" agreement on tax reform', 28 May.

The Government also committed to further consultations with the Democrats on the GST impact on charities or any problems arising in the application of rulings to charities.

The Charities Consultative Committee (CCC) established in August 1999 by the Prime Minister examined some of the above issues.²⁹ An announcement by the Treasurer in October 1999 ameliorated some compliance cost difficulties, by allowing small independent units of non-profit organisations to opt for being input taxed rather than grouped with its main organisation.³⁰ However, a number of issues remained outstanding at the end of November 1999.

These difficulties arose mainly from government policy, and could not be resolved administratively:

- continuing uncertainty about the definition of a charity;
- governments' intentions not to fully gross up grants for GST;
- conceptual limitations of the market value rules for the non-commercial test;
- difficulties for the disability sector's business services (including sheltered workshops);
- monthly lodgement requirements imposing high compliance costs for charities having non-standard accounting years;
- charities' lack of access to income tax deductibility and other concessions for GST implementation and compliance costs.

On 9 December, the Government and the Democrats announced agreement on further changes to the GST for charities.³¹ These measures were intended to address outstanding issues identified by the CCC:

- (Commonwealth) government grants to charities would be increased by a full 10% to account for any GST change, without discounting for assumed cost savings to charities from tax reform;
- the threshold at which 'units' of charities and not-for-profit organisations had to register for GST would be raised from \$50,000 to \$100,000, permitting 'most fundraising activities' to be treated as a separate entity;
- the benchmark test for GST-free non-commercial activities would be increased to cover those sold at up to 75% of total cost;
- the Treasurer would seek 'a more generous ruling' from the ATO to ensure journals and newsletters produced by non-profit groups and not commercially sold were GST-free;
- charities with non-standard accounting years could remit GST quarterly;
- charities would be allowed to claim input tax credits for reimbursing the costs of volunteers;

²⁹ Charities Consultative Committee 1999.

³⁰ Treasurer 1999, Press Release: 'GST Flexibility for Non-Profit Organisations', 29 October.

³¹ Woodley 1999, Media Release: 'Democrats win better tax deal for charities', 9 December.

- financial supplies between charitable and church groups (i.e. loans to schools) would be GST free rather than input taxed.

3.2 The ‘commercial’ activities of charities’

As a result of the ANTS legislation and changes announced on 9 December 1999, GST-free supplies include ‘charitable activities’, and ‘non-commercial activities of charities’. Activities of charities that are GST-free are therefore limited to:

- charitable activities provided for no cost;
- non-commercial supplies, defined as those sold for less than 50% of the GST-inclusive market value of the item, or less than 75% of the cost of the supply;
- supplies of accommodation sold for less than 75% of the GST-inclusive market value of the supply or less than 75% of the cost of providing the accommodation;
- supplies of donated second hand goods (not reprocessed); and
- raffles and bingo.

To refer to charitable services which are provided free as being ‘GST-free’ is somewhat disingenuous, as charging GST on goods or services provided *gratis* would cost the charities 10% of \$0. The main issue is therefore the very limited scope of the definition of ‘non-commercial supplies’. The difficulty of defining the ‘market value’ of charities activities, and in distinguishing ‘donations’ from ‘membership subscriptions’, from ‘fundraising’, or from ‘sponsorships’, underscores the profound issues raised by the ‘commercial’ and ‘non-commercial’ distinction which remains the foundation stone of the Government’s GST policy for charities.

The wide interpretation that is implied for ‘commercial activities’ means most income earning operations of charities are, in principle if not in practice, subject to GST. That is

- most grants;
- most fundraising activities other than ‘donations’;
- the income of sheltered workshops and similar special employment enterprises;
- various unsubsidised user fees or charges;
- membership subscriptions to charities;
- cash or in kind sponsorships and endorsements.

Only where such goods or services are supplied at substantially less than market value, or below cost are they defined as ‘charitable’ activities. However, as Uniting Community Services Australia observed in its submission to the Senate GST inquiry:

the proposed definition of non-taxable activities of charitable organisations [of supplies being significantly less than the cost of supply or market value] is predicated on the ill-conceived notion that the differences between charitable and commercial enterprises is related to the price charged.

ACROD also argued that a charity may provide goods and services at or above market value without it being a commercial business operation:

As redistributive agents in the community, charities naturally seek to collect money from those who can afford to pay more and direct resources to those in need. The above-market value transactions are the opposite side of the coin to below market transactions.

Indeed a 'fundraising' activity which supplies goods or services at less than their market value is unlikely to be a good fundraiser for charities, and provides a greater competitive challenge to 'for-profit' businesses than selling at above market value.

The root of the problem is the Government's policy of categorising charities' revenue-earning activities as 'commercial' or 'non-commercial' depending on the price at which it is supplied. Despite the earlier flexibility suggested by government Senators, the policy subjects receipts from memberships and most fundraising and sponsorship to GST. The alternative for charities is to exploit the special 'flexibility' allowed for fundraising by non-profits and charities, and be input-taxed, or hide behind the façade of equal treatment created by special administrative arrangements announced in December 1999 for measuring the cost of supplies by charities.

The difficulties caused by this policy are the greatest for organisations with least dependence on government grants, and which have sought to ensure their autonomy by expanding other sources of income, including memberships, in line with government policy. It is argued below that the practical difficulties in applying 'market' concepts to the sector's activities mean the Government's policy intention of leaving charitable activities unaffected by the GST is unlikely to be realised. Each major aspect is considered briefly in turn below, with comments on how the changes announced early in December 1999 alter the picture.

3.2.1 Grants

In principle, the argument that the GST will not adversely affect the real value of government grants is correct. While the GST may not reduce grants in the theoretical circumstances envisaged by the Government and its advisors, there are valid concerns that grants to charities will fall.

Commonwealth Government departments were initially directed to increase grants to take account of GST for services delivered after 1 July 2000, but to discount this allowance for the effects of abolishing WST and state taxes.

Charities challenged the rationale for adjusting grants for WST or other tax-reform related price reductions as the sector was presently largely exempt from these taxes and would not experience the same cost savings as their business competitors. The real value of grants and appropriations to the charitable sector could therefore fall as a result of the implementation of the GST.

Although the Commonwealth Government has now agreed all departments should pass on a full 10% for GST in the value of grants, charitable organisations receive grants from governments other than the Commonwealth. State or local government

entities have made no commitment to fully gross up their grants to maintain the real value.

Some local governments also make minor grants to small-scale charitable activities in their local area or region. Such grants can be a particularly important source of funding for smaller charitable bodies in rural areas or small towns. The mechanism for ensuring local (and State) governments can maintain the real value of such grants post-GST is not clear, not least because of the consequences of the GST and related federal financial arrangements for local governments' fiscal situation,³² but also because many of such smaller charitable entities may not register for GST

Governments are also not the only source of grants for 'charitable' activities. GST compliance costs or input taxing may thus reduce the funds available for distribution by small charitable trusts or other non-profit entities such as clubs which may choose not to register for GST because of the compliance costs.

Since only the value of Commonwealth government grants is protected, taxing grants impacts very unevenly on the charitable sector. Those most assisted will be the charities having greatest access to Commonwealth government grants. Charities obtaining local or state government grants, or grants from private charitable funds gain no such guarantees of GST compensation from their donors.

3.2.2 *Fundraising*

Apart from raffles and bingo, or supply of second hand donated goods, most revenue-raising events and activities by a GST registered charity will be taxable. The fundamental contradiction is that to be considered 'non-commercial' the goods or services must be sold at well below the market value or at substantially less than cost. Thus restricted, such charitable activities or events are unlikely to be effective 'fundraisers'!

The more flexible interpretation of 'donations' and 'fundraising' implied by government representatives during the Senate inquiry has been ruled out by the ATO's strict definition of 'gifts'. The Government's policy, as reflected in the ANTS (GST) legislation, is that 'as gala events are generally payments in return for services or rights they would therefore be subject to GST'. The donation component of a fundraising dinner would also not be separately considered as a gift.

All supplies by charities of 'new' goods or services also remain, in principle, subject to GST. This includes fundraising activities such as chocolate drives, book clubs, trivia nights, fetes, or cake stalls, unless supplied at substantially below the market value. Again, such pricing restrictions would make such activities unattractive as fundraising projects. While the 50% of market value test threshold for non-commercial supply has recently been raised to 75% in some circumstances, the basic difficulty remains.

A 'solution' put forward in the December agreement between the Government and the Democrats is for charities' fundraising activities such as fetes, to be 'hived off' into separate GST accounting 'units'. This reduces the severe compliance problems that

³² ALGA 1999.

would have resulted for some fundraising activities from the existing policy. However the proposed solution means the separate sub-entity undertaking the activity could not claim input tax credits. That is, it would be input taxed. The legal liability such arrangements impose on those managing the activity may also be a difficulty.³³ An alternative might be to make the ‘sporadic’ or irregular fundraising activities of charities GST-free, as in the UK.

However, raising funds is acknowledged to be essential to a charity achieving its main purpose in income tax law. The appropriate solution is to make all such activities by charities which are pursuing their defined and legitimate charitable mission GST-free.

3.2.3 Sheltered workshops and client fees

Difficulties arise in distinguishing ‘commercial’ from ‘non-commercial’ supplies where charities’ pricing policies for goods or services include cross-subsidising disadvantaged clients or employees. This is a major issue in the case of sheltered workshops or some community housing programs. However, it also arises more generally where revenue-earning activities such as membership subscriptions are used to cross-subsidise provision of services to non-members or disadvantaged groups.

Despite recognising that charities engage in ‘business-like’ activities to raise funds for their charitable purpose, the Government’s emphasis on avoiding ‘unfair’ competition means that it is mainly activities of the ‘soup kitchen’ or ‘opportunity shop’ character which qualify as GST free. A sheltered workshop charity’s business service or community housing or crisis accommodation organization may fail the ‘below market value’ test for ‘non-commercial supplies’ simply because the charitable aspects of its activities are not reflected by the price it charges its customers. For a sheltered workshop, for example:

the output may be sold at market price but the labour is not engaged at arm’s length: the labour is furnished by clients of the charity who are unable to secure employment in a regular commercial business.³⁴

While the proposed amendment of the market value rule to 75% eases this requirement, this approach still fails to recognise the variety of valid pricing strategies used by charities. While some charitable organisations pay their workers more than their productivity or (labour) market value, others will pay less. ‘Market value’ is not the relevant consideration in the relationship. Accommodation or housing may be provided at various prices to a variety of needy clients, some of whom can nevertheless afford to pay close to market value. Charging at or above market value has a valid relation to achieving charities’ mission, which fundamentally must include financing its activities, and redistributing resources and opportunities from the advantaged and/or altruistic to the poor, the disadvantaged and the needy.

3.2.4 Membership

Charities argued to the Senate Inquiry that memberships were not simply a fee for service, but rather a way of making a contribution and expressing support for an

³³ Charities Consultative Committee 1999.

³⁴ ACROD, 1999.

organisation.³⁵ With signs already appearing of a downward trend in volunteering, some organisations feared the flow-on effect of taxing memberships on the supply of volunteers. Taxing the fundraising of charities was also anticipated to reduce individuals' willingness to volunteer, as the fruits of their efforts would go partly to the government.³⁶

The possibility that some membership subscriptions were substantially a 'donation' to a charitable cause was recognised during the Senate Inquiry by government representatives as noted above. It was stated such memberships would not be taxed.

Notwithstanding that view, the ATO has ruled that

For anything to be considered a gift, it must be unfettered, that is there must be no obligations to do anything in recognition of the gift and no expectation on the part of the donor to receive anything in return for the donation. The definition of gift is contained in Division 30 ITAA 1997.³⁷

According to the ATO, 'a payment made for a consideration however inadequate falls outside the concept of a gift.' This ruled out memberships being treated as gifts, although a charity might be able to demonstrate that the membership fee is less than 50% of the GST inclusive market value or cost of the membership rights.

The recent changes include raising the 'commercial' benchmarking test to 75% of the cost of supply. This is said to make virtually all membership fees GST-free, as charities can also now include all organisational running costs in calculating their costs of supply. While applying the GST to charities in this way may achieve effective GST-free status for these activities, such ad hoc administrative solutions to problems created by an inappropriate definition of 'commercial activity' increases complexity, and increases compliance costs. They also reduce transparency, by masking the fact that charities are, in fact, taxed differently from other non-profit and for-profit organisations, some of whom may have a valid claim to contribute to civil society by encouraging membership.

At the same time, such *ad hoc* solutions fail to acknowledge the basic principle that such supplies, including those at 'market value' or above, are an intrinsic element of charities' income earning activities, and essential to their purpose.

Supplies of labour inputs to charities can also be at, or below the market value, and may contribute in either case to achieving the charitable purpose. The present approach fails to recognise that such volunteers would be unlikely to contribute their services to a 'for-profit' entity if their efforts profit government revenues rather than the charity and its clients. In particular, the receipts of a charity for services such as membership reflect both the donation of money to the organisation by members, and the value of membership created at least in part by donations of time by volunteers.³⁸

35 Senate Community Affairs Reference Committee 1999c.

36 Senate Community Affairs Reference Committee 1999c.

37 Charities Consultative Committee 1999.

38 See ACROD 1999 and Diabetes Australia, quoted at Community Affairs Committee, p21.

It is likely that where a portion of the 'profit' from such volunteer activities accrue to government in the form of GST revenues, it will reduce voluntary contributions of time and effort to charities, as well as donations, as discussed further in Section 4.

On these grounds, appropriate taxation of charities requires including some estimate of the imputed value of volunteer time in the cost of supplying services. Implicitly, this is done in Canada where charities' supplies of goods and services are GST-free if all functions are performed exclusively (90% or more) by volunteers.³⁹ It can also be achieved simply by making the legitimate activities of a charity GST-free as recommended above.

3.2.5 Sponsorships and endorsements

As is the case for many grants, the Government's policy remains that virtually all sponsorships are a payment for a service and are therefore a 'taxable supply' of charitable organisations.

Sponsorships usually require the recipient to do something, for example, providing naming rights or advertising. The provision of these rights is a taxable supply. The sponsor will generally be entitled to input tax credits where it has been made as part of carrying out their enterprise.

Also,

where a corporation makes a payment to a charity which offsets their costs on the basis the charity acknowledges the corporate sponsor in some way, the value of the 'in-kind' sponsorship would be the basis for the consideration for the supply.⁴⁰

If sponsorships are viewed as simply a market transaction between two GST registered entities, it is true sponsorships would be unaffected by GST. However, in some cases this will not be true because of the complex motivations and informal arrangements that would fall under this definition. For example, sponsorships could fall where:⁴¹

- the sponsors are in input taxed industries, such as in the banking, insurance or residential building sector, which cannot reclaim the GST paid on such sponsorships or advertising costs;
- the sponsors are individuals, family trusts or other small non-registered entities which cannot claim input tax credits;
- the sponsorship is essentially a donation by an individual or business entity wishing to support the charitable cause, in return for a 'token' consideration of some kind which is essentially a courtesy acknowledgement of the donor; and/or

³⁹ Gjems-Onstad 1993a.

⁴⁰ Charities Consultative Committee, 'The Resolved Issues and Questions as at November 1999'.

⁴¹ For example, see Community Affairs Committee, p20, ACROD submission, Smith Family.

- the compliance costs of formalising an informal ‘sponsorship’ arrangement, which might for example, be in-kind assistance to a charity in the form of some photocopying, are sufficient to discourage some marginally committed sponsors.

Again, the best solution to these obstacles to charities’ revenue raising is to make GST-free the sponsorship arrangements of genuine charities.

3.3 Financial characteristics of the charities sector

Despite the traditional view of a charity as reliant on donations for income, and providing services free or for nominal charge, this does not represent the financial reality of the charities sector. Basing the design of the GST on charities on this presumption is biased against the smaller, more recently formed charities, local and regional charities, those which have least access to Commonwealth government grants, and those which develop innovative fundraising techniques.

The key feature of the sparse available data on ‘charities’ or ‘charitable activities’ is the diversity of their financial and economic structures and activities. Without separate estimates of non-profit activity in Australia’s National Accounts, the main sources of financial and economic data on charities are unofficial. While these provide a reasonable broad picture of the non-profit sector or the charitable sub-sector, they rely on surveys which may systematically exclude numerous small organisations or those receiving no government funding. Analysis of the effects of the GST using this data is also hazardous because of the particular focus, scope and definitions used, which may differ from those of interest for tax policy.

The 1995–96 survey by the Centre for Australian Community Organisations and Management (CACOM) found non-profit organisations⁴² spent around \$27 billion pa, around 6% of GDP. The non-profit sector also around 11% of private sector employees and 7% of the total workforce, although the labour intensity of activities appears to vary substantially. For example, labour costs accounted for most operational spending in highly labour-intensive ‘community services’ and ‘human services’ activities, while in ‘health’, ‘education and research’, and ‘religious’ fields, labour may account for only around 50% of operational spending.

The ‘health’ and ‘education and research’ fields represented about 40% of expenditures by the non-profit sector.⁴³ A further 40% of the non-profit sector is accounted for by ‘leisure’ activities including sport, recreation, social clubs, arts and culture, and ‘interest organisations’ such as business, trade and professional associations, trade unions, political parties, lobby and advocacy organisations (Table 1).⁴⁴

Around \$2.8 billion of the non-profit sector’s revenues come from donations, with about half going to religious organisations. Volunteers were found to have contributed around 374 million hours of work to the sector.

⁴² Only those having employees. An unknown number have no employees.

⁴³ Health and education services, whether for-profit or not-for-profit, are largely GST-free under the ANTS (GST) legislation.

⁴⁴ Some of these organisations are not counted as ‘charitable organisations’ for GST purposes, and their fundraising or fee-for-service activities will be either subject to GST or input taxed.

The Industry Commission Inquiry into Charitable Organisations in 1995 estimated the size of the community social welfare organisation (CSWO) sub-sector⁴⁵ at around \$5 billion in 1993–94. The 95 million hours of voluntary time donated to the sector were worth around \$1.4 billion (valued at \$15 per hour). The Industry Commission estimated there are around 11,000 CWSOs in Australia.⁴⁶

The Industry Commission also examined the financial structure of the CSWO sector. Government funding accounted for \$2.7 billion, or 56% of the sector's income, with fundraising a further \$581 million (12%). The sources of income also varied greatly within the sector (Appendix Tables 2.1–2.3).

These Industry Commission figures for CSWOs are not an exact measure of charities or charitable activities as defined for GST purposes. The CSWO sub-sector corresponds neither to the definitions of charities in income tax law, or in the *ANTS (GST) Act 1999*. It is not clear to what extent the financial structure and characteristics of the CSWO sector will differ from that for charities as defined for GST purposes.

However, these figures provide an approximate basis for a broad assessment of the effects of the GST on charities. Together with detailed organisation specific data also collected by the Commission, these estimates are used below, along with data on labour use from the CACOM study, to analyse the financial effects on the charities sector.

3.4 Will charities be worse off?

The Government's stated intention is that charities will not be worse off under the GST. Such a 'GST-free' scenario for the sector would see a zero GST liability on receipts, and an input tax credit of \$70–\$230 million (Table 4.1). However, as noted above, its view that the present policy will achieve this goal rests on certain assumptions about the typical structure and activities of charities, and about conditions in the 'market' in which they operate. Whether those assumptions are valid depends on a number of unknowns, not all controlled by the Commonwealth Government. In particular, the effect on the charities sector as a whole or on particular charitable organisations depends on the following interrelated factors:

- Its funding mix, especially the share of receipts derive from revenue raising activities other than free or subsidised supplies or donations;
- The labour intensity of operations;
- Whether the charity is a non-profit body or one whose charitable activities are unregistered, and are input taxed;
- The extent to which income earning activities such client fees or fundraising incur GST;
- The extent to which grants it receives from private, or non-Commonwealth government bodies are grossed up to compensate for GST;
- Its ability to pass on price increases;

⁴⁵ See footnote 16.

⁴⁶ Receiving some government funding; an unknown number of mainly smaller organisations do not receive government funding.

- The ‘consumer’ response to GST inclusive price increases for goods and services supplied by charities.

Many of these issues remain unclear, being the subject of legislative amendments, depending on future ATO rulings, or as yet undetermined administrative practice. Nevertheless, the broad effects of the GST on charities are analysed below. The analysis assumes that the Government’s policy intention (as reflected in its legislation and public statements to end December 1999) is for ‘fundraising’ and ‘client fees’ to be GST-free, all grants to at least maintain their real after tax value, while all other receipts by charities are for taxable supplies.

While the Government’s view that charities will be no worse off is shown to be plausible, it may not be the most likely outcome. There are significant risks that the Government’s policy intent will not be realised, in particular because of the wide range of income sources tapped by charities and because of the variety and complexity of its funding structure and ‘customers’ or clients.

In addition cash flow effects and compliance costs will have adverse effects unless the sector obtains a cash flow or other advantage to offset its ongoing GST compliance costs.

These issues are examined in turn below.

3.4.1 Effects on charities’ input costs

Non profit organisations with turnover below \$100,000 can opt not to register for GST and thereby avoid tax compliance costs and paying GST on their sales but unregistered entities will be ‘input taxed’. That is, their costs will rise to include the net effects of indirect tax reform on the cost of their non-labour inputs.

The community sector is expected to save an average 2.5% on costs due to abolition of sales tax and other indirect taxes.⁴⁷ This is well below that for the business sector (3.6 to 4.4%) because the charitable sector previously received input tax concessions for sales tax, and state stamp duties and bank taxes, worth around \$306 million.⁴⁸

Cost savings will not be experienced by unregistered entities, which will not be able to claim refunds of GST on their inputs, and therefore face cost increases averaging around 7%.

It can be reasonably assumed that the CSWO sector spends all its income, as a non-profit organisation is restrained from accumulating or distributing its profits. As noted earlier, the Industry Commission estimated the income of the sector to be \$4.7 billion in 1993–94 with a mix of sources as set out in Tables 2.1 to 2.3.

The labour share of CSWO sector costs is unknown, but it appears to be very labour intensive. On the basis of the CACOM estimates of non-profit employment and ABS

⁴⁷ Charities Consultative Committee Report, 1999. This assumes suppliers pass on all cost savings.

⁴⁸ The Industry Commission estimated these tax expenditures saved the sector around \$220 million p.a. in tax liabilities in 1992–93. Current projections of those estimates by the AIHW (1999) put the value of the community sector’s sales tax exemption at \$167 million p.a. and that for the state taxes at \$139 million p.a. respectively.

estimates of labour costs for the ‘health and community services’ sector, it seems plausible to assume labour costs account for at least 75% of operational expenditures of CSWOs. That is, the non-labour cost share of input costs is around 25%. An alternative assumption which is more applicable to health, education and research and religious activities is for a non-labour input cost share of around 50%.

On this basis, input tax credits for the CSWO sector would be between around \$70–\$233 (Tables 4.1 to 4.3).⁴⁹ The greater the labour cost share of expenditures, the lower the input tax credits accruing to the sector. A zero-effective tax rate on the sector is implied by ‘GST-free status for all charities’ sources of receipts and GST registration of all charities (Table 4.1). No GST would be payable and all GST paid on inputs would be refundable.

While too much emphasis should not be placed on tax expenditures estimates, which are fraught with measurement and conceptual difficulties, the above nevertheless suggests that GST input tax credits available to charities will be worth much less than input tax concessions previously estimated for the CSWO sector.

Furthermore the effective GST rate on charities also depends on its effect on receipts.

3.4.2 Effects on charities’ revenues

Table 3 estimates the financial impact of GST on charities based on the CSWO sector data and funding categories reported by the Industry Commission in its study. This estimate assumes the Government’s policy intent is met, as above.

It takes the financial structure of the CSWO sector as indicative of the funding mix for charities. It also assumes the GST where applicable is fully passed onto prices for consumers, and there is no effect on consumer behaviour of any increase in prices. Input tax credits of \$117 million reflect the assumption that the sector is very labour intensive, with labour costs equal to 75% of expenditures.

On this basis, the sector would have gross GST liabilities of \$320 million, but experience a net gain in income as a result of the GST, depending on the funding mix (Table 4.2). This arises mainly because of the importance of grants, which are assumed in Table 3 to overcompensate the sector being grossed up for GST by 10%.⁵⁰ However, public revenues would include around \$50 million pa in net GST collected from charities. This represents an effective tax on the sector’s operations.

This overall picture of the GST on charities also masks considerable differences in the effects on different charities and charitable sub-sectors because of the diversity of their income sources.

In the example above, some individual CSWOs gain substantially while others, which rely to a greater degree on non-traditional income sources, experience only minor

⁴⁹ That is, for ‘fundraising’ and ‘client fees’ to be GST-free, grants to at least maintain their real after tax value, while all other receipts by charities are for taxable supplies (the average funding mix is for the sector as a whole (Table 2.1).

⁵⁰ The Commonwealth will raise its grants by 10% to cover GST, but it accounts for only around half the non-government welfare sector’s grants (AIHW 1999).

gains.⁵¹ Those reliant on state or local government grants are vulnerable to cuts in real funding levels if grants are not fully grossed up for the GST.

These concerns are magnified, however, if it is recognised that the Commonwealth Government's policy intent may not be achieved. If for example, around 50% of client fees or fundraising incur GST, and public donations to or purchases from a charity fall due to the higher 'price of giving' or cost of purchasing charities' products, the sector could face severe real income losses depending on their funding mix (Tables 4.1 to 4.3).

For example, overseas estimates suggest donations fall by between 15–30% for a 10% rise in the 'price of giving', (that is, in the cost to the donor of making a donation of a given after-tax value).⁵² If sales by charities fell by around 15% due to a GST-induced rise of 10% in the 'price of giving' (i.e. the price of a charity's products), individual charities could face losses ranging up to 11% as a result of the GST. The most severe losses would occur in organisations relying on revenue sources other than Commonwealth government grants. The average real loss of income for the sector would be 3% or more, with the sector contributing some \$110 million to public revenues despite refunds of around \$117 million. The sector would face a significant effective tax burden.

If charities were unable to pass on the tax to their 'clients' or 'consumers', as is likely, the real income loss for the sector would be even higher. Such a blow to charities' capacity to finance their activities would be in addition to the burden of GST compliance costs, considered below.

3.4.3 *Compliance costs*

A major concern for charitable organisations has been the compliance costs of the GST. Many organisations face an acute dilemma – register for the GST and incur substantial compliance costs in order to recoup input tax credits, or remain unregistered and suffer the substantial loss from being input taxed. Charities face considerable costs simply in ascertaining whether or not it is financially beneficial for their organisation to register. However, GSTStart assistance programs only apply to those that do register. They are also directed at initial implementation, rather than ongoing compliance costs for charities.

Key issues for the charities sector have been;

- the severity of the impact in view of the fact that most charities, unlike small businesses, have previously not been subjected to taxation, and therefore have to put in place completely new financial control and accounting systems for the GST;

⁵¹ For example, this would include Bedford Industries Rehabilitation Association Inc, Care Australia, the Nursing Mothers' Association of Australia, and Wesley Mission Sydney. Also adversely affected although to a lesser extent, are the Salvation Army (Southern Command), and smaller charities as a group. Of course, the actual effect would be depend on the labour intensity of the operation, with less severe effects for the less labour intensive activities.

⁵² Freebairn 1994; IC 1995.

- the high initial and ongoing compliance costs for charities of even quarterly GST returns, and especially the effects of placing additional demands on the skills and time of volunteers;
- adverse effects on cash flows for charities registered for GST due to delay in recouping input tax credits following quarterly returns.

There is no research on the magnitude of initial or start up costs of GST, even for businesses.⁵³

The accepted estimate of ongoing compliance costs averages \$1195 pa in gross terms, or \$130 per GST registrant, after allowing for various offsets to costs of compliance.⁵⁴ However, charities have argued that these offsets will not be available to the sector, which is not subject to income taxation, and is largely exempt from WST and many state taxes. Being exempt from income taxation charities therefore cannot access the substantial government funded assistance provided in the form of tax deductions for GST related expenses.

Furthermore, the financial systems of organisations in the sector have formerly been geared to their own needs rather than for tax accounting purposes.

This means both that the initial costs borne by charities of complying with the GST are greater than for businesses, and that the ongoing burden on sector finances will also be considerably higher. This clearly makes charities worse off than under present arrangements.

The Senate Inquiry was given a long list of additional costs that the GST may require.⁵⁵ The total transition and compliance cost for the Catholic health and age care sector has been estimated by Arthur Anderson at \$29 million. Catholic Social Services estimate a compliance cost of between \$6000 and \$80,000 per agency. St Vincent De Paul has argued that its compliance costs will total \$2–4 million, while the Council for Homeless Persons Australia estimates one off and transition costs of \$6 million for SAAP services.⁵⁶ The Salvation Army, which is mainly GST-free, estimates start up costs exceeding \$1 million simply to establish systems to claim an expected input tax credit on its sizeable nationwide operations.⁵⁷

It is not clear how many charitable organisations will register for the GST. While the compliance costs of registration will discourage some, for many the attraction of refunds on input tax credits is compelling. While the ATO is already aware of some 30,000 gift deductible entities, and Industry Commission research suggests around 11,000, the ATO has noted the potential for as many as 200,000 entities to register for

⁵³ Pope 1999.

⁵⁴ Tax deductibility of around one fifth of compliance costs (\$260), the effects of abolishing WST (\$520), state taxes (140), and the cash flow benefits of the GST (\$145) reduced this gross cost to a net compliance cost of \$130 per registrant or \$210 million (Pope 1999).

⁵⁵ Senate Community Affairs Reference Committee 1999.

⁵⁶ Senate Community Affairs Reference Committee 1999.

⁵⁷ Personal communication, 19 November 1999.

GST.⁵⁸ How many will do so, and the total compliance costs for the charities sector, will depend in part on how charities use the flexibility provided to avoid GST by administrative restructuring and any possible efficiency gains from improved financial administration associated with the new systems.

A minimum indication of total ongoing compliance costs is gained by assuming that all 11,000 CSWOs identified by the Industry Commission choose to register. In this case, assuming gross compliance costs of around \$1200 per entity per annum, the total cost to the sector is more than \$13 million. Similarly, if the 30,000 or so entities known to the ATO choose to register, the costs to the sector would be \$36 million annually. Costs would rise commensurately as the number of registrations increased towards 200,000.

Some relief from compliance costs is provided by changes announced in October 1999, which as noted above permit non-profit entities to choose between grouping and branching.

However, unregistered entities will be input taxed if they branch, and with existing input tax concessions erased, the cost of a range of inputs for these smaller units could increase by around 7%. Such cost increases will in any case be experienced by the many smaller charitable entities with financial operations too small to warrant incurring registration costs.

The compliance cost difficulties remain acute even with recent concessions regarding monthly lodgments which had been required for the third of the sector using non-standard accounting periods. While such organisations will now be able reduce compliance costs by lodging quarterly, in doing so, those entitled to a net refund of GST will lose the cash flow benefits of lodging more frequently.

3.4.4 Cash flow effects

Notwithstanding the heavy compliance burden faced by charities, the sector will gain no offset in the form of cash flow benefits. This treats the sector less generously than business.

For the business sector, the cash flow advantage of collecting GST on sales is a substantial offset to compliance costs. However, the charitable sector is assumed by the Government to be eligible in aggregate for a net refund of GST. Hence, the cash flow effect would be negative. Charities would need to carry the cost of GST on their inputs for at least a month until they receive the refund from the ATO. Rather than benefiting from the cash flow effects of the GST, charities would experience decreased cash flow.

This problem is said to be exacerbated by the very tight budgets with which charities operate. For example, the Motor Neurone Diseases Association of Victoria, with a budget of \$475,255 p.a., estimated it would need an additional \$15,683 pa to fund the interest cost of paying GST on its inputs until refunds were processed by the ATO.⁵⁹

⁵⁸ Commonwealth of Australia, Committee Hansard, Senate Economics Legislation Committee, 17 November 1999, pE34.

⁵⁹ Senate Community Affairs Reference Committee 1999c.

On the Commonwealth Government's favourable assumptions as above, the sector would be carrying the cost of around \$120 million p.a. of GST paid on their inputs. While cash flow costs can be reduced by lodging monthly rather than quarterly returns, this would substantially increase compliance costs. These cash flow costs of quarterly returns at an interest cost of around 5% represent around \$5 million and would be higher if labour intensity or other factors produced higher input tax credits than estimated. Such effects will vary greatly within the sector, where some may have an input tax credit and others will not. In reality charities may have a net GST liability because of the (supposedly nominal) inclusion of GST on government grants, and hence some may benefit from these cash flows.

However, the only consistent solution to the problem of compliance costs for charities is for the sector to be directly compensated for its compliance costs. This would recognise the substantial value of 'tax expenditures' available to businesses liable for income tax, and the inappropriateness of relying on cash flow effects and GSTStartUp assistance to offset such costs for charities.

3.5 Broader economic impact of the ANTS tax package

Changes to personal income taxation which accompany the GST will have some implications for the level and direction of gift deductible donations. This will affect some charities more than others. The income tax cuts and other compensation for the GST may also have implications for charities as a whole.

As charitable giving is 'income elastic', increased disposable incomes resulting from the compensation package could be expected to increase the flow of donations to charitable activity. Offsetting this however, is the effect of reduced marginal tax rates on higher income earners, which will reduce the tax benefit of charitable giving.

The net effect is not clear. However, an increase in the overall level of donations from the income effect will benefit some types of charities more than others. Any change in the pattern of charitable giving across the higher and lower income groups will also have implications for the type of charitable activities supported.⁶⁰

Similarly, the effect of the tax changes on the supply of volunteers is ambiguous because of two offsetting effects. Contributions of volunteer time might increase with greater after tax incomes and potential for leisure. However, any greater incentives for employment arising from lower effective marginal income tax rates would reduce the potential supply of volunteer time available for charitable activities.

More broadly, it might be argued that the effects of the tax package on disposable incomes should offset the effects on charities' receipts. However, this depends on relative price changes, which may switch demand away from previously untaxed charitable products, or on charities' ability to pass on the GST to the various purchasers of their products, issues discussed further in Section 4 below. It also ignores the connection between government and charitable activities. If charitable giving is 'price elastic', and the GST effectively taxes the sector, there will be a fall in resources of time and money to the sector. Because charities do many things that governments would otherwise hold responsibility for, tax-financed grants would be

⁶⁰ Industry Commission 1995; Krever 1991.

needed to offset these falls. That is, taxing the sector would not be 'treasury efficient'.⁶¹

⁶¹ Industry Commission 1995.

4. How should GST apply to charities?

As demonstrated above, the design of the GST is underpinned less by revenue concerns than by the principle of preventing ‘unfair competition’ between businesses and non-profit organisation, and therefore classifying most of charities’ revenues as commercial. However, it is suggested here that undue weight has been given to ‘competitive neutrality’, with little sensitivity or understanding of constraints on fundraising or revenue earning activities of charities in the social, economic and fiscal environment of recent decades. Even if ‘tax concessions’ for charities produces economic distortion and efficiency costs, charitable activity produces both social and economic gains which may well offset any presumed efficiency costs. Furthermore, charities are in a different ‘market’ to businesses. Their purposes are more akin to those of governments than those of businesses. While discouraging tax avoidance by bogus charities is an entirely appropriate focus for GST policy design, aiming for ‘competitive neutrality’ and ‘fair-competition’ between charities and businesses is not. There are no compelling reasons why protecting the economic interests of ‘for profit’ business and their shareholders necessarily takes precedence over protecting social capital created outside the market economy, or the interests of clients or members of charitable organisations.

4.1 Why charities acting like businesses should not be treated like them

The GST is intended to be a ‘neutral’ revenue-raising instrument. Hence the principle underpinning the Prime Minister’s commitment on charities and the GST is a reasonable one; the GST should not inhibit collectively but privately organised social and humanitarian activities (many of which parallel activities of government) that improve social wellbeing, and contribute to a civil society.

However, the GST is a relatively new tax, and there is as yet no consistent and widely accepted theory of how it should deal with non-profit organisations and charities.⁶² There is also no theoretical answer to who really pays the tax. The price-elasticity and the possibility of charities’ customers or clients substituting the taxable good or service may therefore have great impact on the extent to which the charity or the client/customer actually bears the tax.

Because of the fundamentally different perspective and operation of the GST compared to traditional taxes such as the income tax or WST, the tax-exempt status of charities is altered as an unintended by-product of tax reform.⁶³ Adjusting the design of the tax to accommodate the charitable sector, including through zero-rating some activities or granting tax-free status to activities conducted by charities, may create distortions and administrative complexity. However, neither of these is an absolute principle of tax policy,⁶⁴ and must be balanced against social objectives. Even

⁶² Gjems-Onstad 1993b.

⁶³ Unlike the income tax, the GST is a tax on activities or transactions rather than on entities. As the former falls on net profit, it typically does not encompass non-profit organisations either legally or practically. This is not the case for the GST, which in principle is a tax on end consumption. Under a GST effective tax-free status for an organisation may only be obtained by being part of the system, as only a registered entity eligible for input tax credits can avoid being taxed as an end ‘consumer’.

registered charities will end up paying some GST on inputs which is not deductible, or being charged GST which cannot be passed forward onto clients. The practical policy problem is therefore how to design a system which does not reduce the capacity of charities to pursue their missions.

To do this requires not only understanding how a GST works, but also how the charitable sector works. Again, economic theory can offer little guidance to policymakers here: a recent review concluded that there is no sound basis for policy in existing economic theories of the non-profit sector, with theory still unable to distinguish grants from exchange.⁶⁵

As discussed in Sections 2 and 3 above, the premise underpinning the present GST treatment of charities is that where they act like businesses, their activity should be taxed as for businesses. This is aimed at minimising economic distortion or ‘unfair competition’ – the ‘competitive neutrality’ objective.

However, there are a number of key features of charitable organisations which make the ‘competitive neutrality’ objective inconsistent with the principle of no reduction in capacity

4.1.1 Purpose

Charities, in the terms used by economists, are important providers of ‘public goods’, and ‘redistribution’. Playing a role which is similar in some ways to that of governments, charities may thus substitute for, complement, or even compete against, government provision of goods and services.⁶⁶ While non-profit organizations maybe efficient and/or socially desirable ways of organizing some important activities in a ‘civil society’ charities are distinguished by their altruistic and compassionate focus on helping others.

A key characteristic of the collective public goods provided by governments and charities is that they are privately unprofitable because of the difficulties of excluding those who do not pay from the benefits of provision.⁶⁷ The purpose of charities is distinctive partly because it involves providing goods or services which the market fails to provide in sufficient quantities or qualities,⁶⁸ or to those in need.

⁶⁴ Arguments for tax neutrality in the treatment of charities commonly assume that their activities are mainly in competition with, or substitute for, the activities of the market ‘for-profit’ sector. However, there is no empirical evidence of the scale of such supposed economic distortions due to input tax concessions in Australia. Although it provided no evidence for its conclusion, the Productivity Commission in 1995 argued concessions to charities for sales tax, financial institutions duties and other indirect taxes distorted the allocation of economic resources because the sector could compete for resources on more favourable terms than for-profit businesses.

⁶⁵ Steinberg 1997.

⁶⁶ ACROD. There is a close historical relationship between declines in the charitable sector’s ability to meet perceived social needs, and the growth of government and the Welfare State.

⁶⁷ Freebairn 1994.

⁶⁸ In some cases, charities provide services which people are reluctant to purchase from ‘for-profit’ enterprises because of their lack of trust that service quality will not be critically compromised by the profit motive. See Steinberg 1997.

Thus, as one charity submitted to the Senate GST inquiry,

to assume charities compete for market share is fallacious. Services provided by charities are generally those that do not generate a profit but address market failure and meet the need of the disadvantaged people.⁶⁹

Because of their close ties with the community and relative independence from government, and their lack of access to the government's coercive taxing powers, charities are said to be more likely to experiment with innovative service delivery programs or income earning activities than government organisations.⁷⁰ To the extent that charities activities are initiated on a private and voluntary basis, their diverse activities can also provide a counterbalance to the sometimes inappropriate exercise of power through government lobbying, and a form of 'insurance' against errors and inadequacies in government policy and program delivery.⁷¹ Although in practice, charities do not always reflect democratic, progressive or pluralistic values,⁷² a strong and active charitable sector helps protect pluralism and diversity.⁷³ The mission of 'helping others' is a foil against 'market' values of self-interest and profit-seeking encroaching on non-market areas of human activity, and such institutions represent key elements in the process of social capital formation.

4.1.2 *Financing*

Important universal features of a charity include its non-profit purpose. Non-profit organisations are legally restricted from distributing profits or using them in ways which do not relate to their charitable purpose. Because their purpose is not profit-making, their access to capital from borrowing or share issues is very limited. As observed above, the collective goods typically provided by charities, while socially valuable, are usually privately unprofitable because the price charged consumers will be insufficient to cover the costs of provision.

Their sources of income may also be limited by ethical considerations related to their mission – for example, an environmentalist organisation rejecting donations from a pesticide manufacturer, a religious hospital rejecting revenue opportunities from conducting pregnancy terminations, or a breastfeeding support organisation refusing to seek sponsorship from a formula company.⁷⁴

Traditionally, part or most of charities' income has come from voluntary contributions. However, the 19th century pattern of an organisation which raises its money from donations, and expends it on direct provision of free services to the disadvantaged is increasingly obsolete.⁷⁵ Charities have increasingly been forced into

⁶⁹ UCSA p8.

⁷⁰ Krever 1991.

⁷¹ Industry Commission 1995.

⁷² Carney and Hanks 1991.

⁷³ Industry Commission 1995; Krever 1991.

⁷⁴ Cordes, Weisbrod Burton 1998.

⁷⁵ Weisbrod 1998.

such new income earning activities by the economic, political and social environment in which they now operate:⁷⁶

- donations have declined;
- competition for ‘the charity dollar’ has increased due to growth in the number and diversity of charitable organisations.
- funding from governments has fallen;
- calls on charitable services have risen due to social, economic and demographic factors and the changing role of the state in social welfare service delivery.

In response to this environment, charities have sought new sources of funding, expanding user fees, and developing innovative techniques and activities for raising money from customers and donors. As charitable fundraising has become more extensive, businesses have become more aware of the profit potential in market niches developed by charities as funding sources. Changes in government policy such as contracting out of social service provision have also brought charities into more visible competition with for profit businesses.

Despite their more business-like activities, these charitable organisations are not simply for-profit businesses in disguise. As Weisbrod has commented:

More public pressure is being placed on non-profits to increase their commercial activities in response to government cutbacks. At the same time, pressure is also mounting for nonprofits to avoid increasing their entanglements. Society cannot have it both ways. We cannot expect non-profits to increase output if their access to revenue is restricted.⁷⁷

While a charity may produce the same or similar goods or services to a for-profit enterprise, its ‘market’ may be quite different. Charities also use their commercial opportunities in different ways than for-profit businesses. Pricing policies may be used to achieve the organization’s mission as well as generate revenue, while revenues are used to support mission-oriented activities. For example, non-profit organisations will set their prices to ensure access by geographically or socially disadvantaged groups. Even where it sets the same price as a for-profit enterprise, the profit is being used to cross-subsidise below market price provision of the same service to the needy. It has been shown that non-profits mainly look to their own members.⁷⁸

Customers’ purchases from charities may also reflect quite different motivations from a purely commercial exchange between an individual and a private firm. An important ‘consideration’ may be that the profit goes to the charity concerned. While the payment may provide some benefit to the purchaser, this may or may not be valued, and may or may not be accessed. One example is a payment for an item sold by a charity which might equally well be purchased elsewhere but is purchased from a charity which the consumer wants to ‘support’, that is ‘donate to’. Another example

⁷⁶ Weisbrod 1998; Young 1998; Industry Commission 1995

⁷⁷ p173.

⁷⁸ Young 1998.

would be a payment for membership of a charitable organisation which includes access to various ‘services’ to members such as a newsletter. A membership subscription is likely to be seen largely as a ‘donation’ supporting the organisation or the cause it supports, by members who would not otherwise purchase its newsletter or access its services.

Nevertheless, charities increased involvement in the market sector, greater professionalism, and growing commerciality has made charities look more like businesses, resulting in private firms claiming they are victims of ‘unfair competition’ and seeking to restrict charities commercial activities.

It is difficult to see how else charities can finance their activities. As Weisbrod comments:

.. non-profits’ mission, in any industry, is not to do what private firms would otherwise do. ... in the case of hospitals, the social mission is to care for the indigent, to undertake research that generates widespread knowledge, and to provide such community-benefit services as education about drugs and maternal nutrition – not simply to provide services for paying customers. In the case of universities, the social mission is the provision of basic research, education of the poor, and dissemination of information. ... From one source or another, such collective goods – socially valuable but privately unprofitable – must be financed.

4.1.3 *Resource use*

Another key feature of charitable endeavour is that they draw substantially on voluntarily supplied labour, as well as ‘capital’ donated for altruistic motives. These resources would not otherwise be available to for-profit firms, as volunteers would want to reward cared-for clients or ‘causes’ rather than shareholders. For example parents would be unlikely to help maintain school playground equipment through ‘working bees’ or fundraise for new creche toys if these activities enhanced business profits and share values rather than community-owned assets. Hence, the utilisation of volunteer labour and donated funds through the charitable sector amount to a significant economic output gain, as well as being a key distinguishing feature of charitable activity.

For example, in 1992, the Australian Bureau of Statistics estimated the economic value of volunteer labour contributed by households at \$18 billion annually. The CACOM survey found volunteers contributed around 374 million hours of work to the non-profit sector, while the Industry Commission estimated 95 million hours of voluntary time were donated to the CSWO sub-sector. This is worth around \$1.4 billion valued at wages of \$15 per hour. This compares with estimates of the imputed value of voluntary welfare assistance provided through community service organisations of at least \$1.1 billion in 1997.⁷⁹

⁷⁹ AIHW 1999.

The charitable sector thus produces significant economic efficiency gains due to the resulting increased capacity of society to mobilise these ‘free’ labour resources.⁸⁰

A further important consequence of government taking a share of the profit surplus produced by volunteers in the form of GST on charities is that donations of volunteer labour time will be reduced. The effect may be comparable to the effect of taxing donations of cash. If the ‘supply elasticity’ of donated labour is as responsive to changes in the after-tax benefit of the donation to the charity as a cash donation is to changes in the after tax price of giving’,⁸¹ the effect on volunteer labour may be substantial. If the ‘price-elasticity’ of volunteer labour supply was as high as estimates of the price elasticity of charitable donations in the US, a GST taking 10% of the ‘profit’ from the marketed production of volunteer labour could reduce volunteers’ donation of time and effort by as much as 30%. Assuming an effective 10% tax on a volunteer-provided service and a price elasticity of 1.15 (the lower range of US estimates) donations of labour would fall by 15%. Even this conservative estimate of the responsiveness of giving to its after tax value would be an enormous blow for the non-profit sector, representing an economic loss valued at over \$210 million pa for the CSWO sub-sector alone.

4.2 Implications

These observations have a number of implications:

- Charities are not in the same ‘business’ as a ‘for profit’ business, having different purposes, using different modus operandi and supplying different client or customer needs. Their ‘business’ is more akin to that of governments, and their pricing strategies are unlikely to bear any systematic relation to the cost of their services.
- Charities may produce public goods and services and redistribute at a lower economic cost than governments because funding of their activities is voluntary rather than through coercive taxation which produces economic efficiency losses (the ‘excess burden of taxation’)
- Charities draw into economic production resources of capital and especially contributions of volunteer labour which would not otherwise be available for productive use or meeting social needs. They thereby generate substantial economic as well as social gains.

It follows from this that:

- Charities like governments should have effective GST-free status so as not to discourage charitable *vis a vis* government provision. Just as National Competition Policy is based on a ‘level playing field’ between government and private business enterprises, which prevents governments using regulatory powers to gain market share from the private business sector, it can be argued that it is unethical for governments to expand its role in the provision of social goods and redistribution

⁸⁰ ‘Free’ in the sense that their opportunity cost is zero, if they were not used in voluntary work they would not be used for economically productive purposes.

⁸¹ Freebairn 1994; Industry Commission 1995.

at the expense of charitable provision by exploiting its power to tax.⁸² Just as churches being funded by government to provide employment services alters their relationship, so too does a tax on the non-profit sector reduce its capacity to function as an effective independent critic of government policies or as an alternative service provider, if it makes it beholden to government for compensatory grants or tax ‘concessions’. Furthermore, one role of charities is to encourage moral and legal behaviour. If the effective GST burden on charities is unjustifiably increased as a result of tax reform, it will tempt organisations to behave unlawfully or unethically in their dealings with the tax authorities. This brings them into fundamental conflict with the principles of ethical behaviour implicit in their mission.

- Weakening the financial capacity of charities through application of an inappropriate GST regime will result in net fiscal costs as activities formerly conducted by charities will need to be replaced by governments. If this process results in charities becoming more dependent on government grants, this will leave charities worse off. Weakening charities’ financially will have high economic costs because it will require economically costly increases in taxation to finance it, and because it will not engage the volunteer labour and other resources that are incorporated in charitable endeavours. It will also have high social costs because of the role that charitable activity plays in building social cohesion and individuals’ sense of community involvement and responsibility, and in encouraging unselfish behaviour and caring attitudes towards others.
- The revenue-raising activities of charities are essential to their purpose and cannot be distinguished from their provision of ‘charitable services’.⁸³ Charities have no incentive to forego income-earning opportunities by undercutting the market. Paying GST on any of their legitimate income earning activities risks diminishing charities’ ability to achieve their purpose. Despite this disruption to charities, their contribution to overall revenue is inconsequential. The critical issue then, is to ‘draw a line in the sand’ on what constitutes a charity, make charities’ legitimate activities GST-free, and then to prevent tax avoidance by effective monitoring and regulation of charities’ activities. Where such ‘lines in the sand’ should pass must be determined in a democratic, transparent, and accountable way through legislation passed in parliaments. It should not be through lengthy and costly court appeal processes, or extensive administrative interpretation and exercise of discretion on special flexibility for charities.
- Even if it results in ‘competitive non-neutrality’ with for-profit businesses, granting tax-free status to charities is unlikely to be economically distorting or costly once account is taken of the productive gains from the additional resources available only through charitable endeavours. In any case, an adverse social impact is an equally valid consideration for policymakers in deciding to make charities effectively GST-free. Furthermore, ‘unfair competition’ is a concept applicable to relations between for-profit businesses owned by shareholders. Charities do not have shareholders. The ‘beneficiaries’ of charities are their

82 ACROD, citing Brennan G. and Buchanan J. M 1980. *The power to tax: analytical foundations of a fiscal constitution*, Cambridge University Press, and Breton A. 1996. *Competitive governments: an economic theory of politics and public finance*, Cambridge University Press.

83 Young 1998.

clients, customers or volunteers and members. It would be a bizarre approach to 'social justice' and redistribution for the financial interests of shareholders in 'for-profit' companies to override the interests of these 'beneficiaries' of charitable enterprises in the name of 'fair competition'.

5. Conclusion

The Government appears genuinely concerned to avoid disadvantaging charities with its tax reforms and has some grounds for its belief that non-profit organisations are treated generously under its GST compared to countries where they are input taxed.

However, the current policy approach fails because it is anachronistic. Present policy lacks understanding of modern charities' financial operations, relies on a flawed concept of charities' pricing strategies, does not account for the diversity of the sector and is based on incomplete and inconsistent definitions of charities' activities.

Although increased involvement in the market sector, greater professionalism and growing commercialism has made charities' financial operations look more like for-profit businesses, charities are usually undertaking tasks that would otherwise be a responsibility of government. They must finance their operations somehow. The excessive focus in the proposed GST on taxing their so-called 'commercial' activities, in particular the overriding emphasis on preventing 'unfair competition', must be balanced by recognition of charities' imperative to raise funds and by acknowledgement of the substantial economic losses arising from discouraging charitable endeavours.

Charities finance the provision of services at a lower economic cost than governments because their funding is generated voluntarily, without the disincentives of taxation. If charities cannot finance their activities, governments are often compelled to take their place, through raising taxes. Charities engage volunteer labour and donations that would otherwise be unavailable for productive activity and are a net economic gain. Non-profit activities often help build 'social capital'. The interests of private shareholders in 'fair competition' should not override the need to nurture the non-market institutions of civil society or protect charities' disadvantaged clients.

In particular to define a modern charity, as the Government does, by one market strategy – selling goods below market value – is outmoded and highly contradictory. It is essential to treat other pricing strategies and business-like activities as legitimate and core activities of charities. Making charities' supplies at or above market value 'GST-free' would acknowledge that many purchases from charities include an element of donation. This would also recognise that saleable value created by volunteer labour or donations of inputs should not be subject to GST. Charities have no incentive to 'spoil' a commercial market by fundraising at below market prices, or to undervalue the contribution of their volunteers.

A key feature of the sparse available data on charities is the diversity of their financial and economic structures and activities. The overall picture of a benign impact of the GST on charities masks considerable differences in the effects on different charities and charitable sub-sectors because of the diversity of their income sources and variety and complexity of their funding structures and clients. The Government's intent that no charity will be worse off under its GST is at significant risk because of a failure to come to grips with this diversity.

Many charitable organisations clearly and accurately foresee reduced operations because of the substantial real tax burden and compliance costs they soon will face. Paying taxes to the government reduces the surplus charities can distribute to their ‘shareholders’ – the disadvantaged – or means a heavier load on its members or supporters. This tax obstacle to serving the needy or subscribing to a charitable endeavour contrasts sharply with the policy of leaving GST-free all share subscriptions to companies like BHP, Mobil or Westpac, motivated by personal profit, rather than public-spiritedness.

A starting point for remedying deficiencies in the current GST is establishing a definition of charity that accords both with the modern conceptions of charitable activity and with the financial circumstances in which charities presently exist. The critical issue is to draw a line in the sand on what constitutes a charity, make all of a charity’s legitimate activities GST-free and then prevent tax avoidance by effective monitoring and regulation of charities’ activities.

This debate on meaning might be initiated by asking what, if anything, distinguishes non-profit organisations such as clubs, industry or professional lobby groups, or political parties, from welfare or environmental advocacy groups, animal welfare societies, family support groups and operators of emergency accommodation, sheltered workshops and ‘soup kitchens’. Is a charity about:

- caring for others,
- mainly voluntary endeavours,
- ‘standing in’ for government, or even challenging it, or
- profiting to exist rather than existing to profit?

To obtain this definition, a process of wide public debate and inquiry is needed to gather information, improve understanding and clarify public values about charities so that GST design issues can be dealt with appropriately and without harm to genuine charitable activity.

If worse comes to worst, a review of the GST’s impact on charities in a year’s time could stop any damage before it becomes fatal to charities’ financial health.

In conclusion, the GST places the Government and charities both ‘between the devil and the deep blue sea’, but for different reasons. For government the dilemma is to choose between protecting financially fragile and socially valuable charitable activities from harm, and relentless pursuit of the economic chimera of competitive neutrality. For charities, the issue is whether pursuing their mission is harmed more or less by registering for GST, and by sacrificing their financial autonomy for good relations with their government sponsors.

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Appendix Tables

Table 1 The non-profit sector, 1995-96

<i>Field of Activity</i>	<i>Operational expenditure, \$ million</i>
Health (inc nursing homes)	4,200
Education and research	6,600
Community Services	3,700
Other Human Services (housing, legal, employment)	700
Religion	1,000
Leisure (sport, recreation, social clubs, arts and culture)	7,300
Interest organisations (business, trade and professional associations, trade unions, political parties, lobby and advocacy organisations)	3,000
Other	500
Total	27,000

Source: Lyons 1998 (cited in ACOSS (1998) 'New data shows the size and diversity of the non-profit sector', *Impact* August, p.5.

Table 2.1 Sources of recurrent income - all government funded CSWOs 1993-94, %

	<i>Govt funding</i>	<i>Fundraising</i>	<i>Client fees</i>	<i>Other income</i>
Aged care (excluding HACC svcs)	54%	4%	41%	1%
Disability services (excluding HACC svcs)	59%	15%	8%	18%
Multi-service (large)	47%	17%	11%	25%
Other organisations	70%	8%	8%	14%
Overseas aid	25%	61%	0%	14%
Employment	80%	7%	7%	7%
Total	56%	12%	21%	11%

Source: Industry Commission 1995

Table 2.2 Sources of recurrent income - 50 largest CSWOs 1993-94, %

	<i>Govt funding</i>	<i>Fundraising</i>	<i>Client fees</i>	<i>Other income</i>
Aged care	60%	3%	29%	8%
Disability services	50%	19%	10%	21%
Multi-service (large)	47%	17%	11%	25%
Other organisations	na	na	na	na
Overseas aid	22%	56%	0%	23%
Employment	na	na	na	na
Total	48%	18%	14%	19%

Source: Industry Commission 1995

Table 2.3 Sources of recurrent income - smaller CSWOs 1993-94, %

	<i>Govt funding</i>	<i>Fundraising</i>	<i>Client fees</i>	<i>Other income</i>
Aged care	52%	4%	44%	0%
Disability services	65%	13%	6%	16%
Multi-service (large)	na	na	na	na
Other organisations	70%	8%	8%	14%
Overseas aid	29%	67%	0%	3%
Employment	80%	7%	7%	7%
Total	60%	9%	24%	6%

Source: Industry Commission (1995)

**Table 3.1 Financial impact of GST on CSWOs sector -
'government policy intent'***

'RECEIPTS'		<i>Grants</i>	<i>Client fees</i>	<i>Fundraising</i>	<i>Other income</i>
% of receipts deemed 'commercial' activity		100%	0%	0%	100%
Receipts before GST, \$m	4782	2677	1004	573	526
Assumed demand response to 10% price rise		0	0	0	0
Assumed rise in GST inclusive price, %		10	8	8	8
Non taxable output	1578	0	1004	574	0
GST inclusive value of taxable output including assumed demand response		3511	2946	0	565
GST payable on receipts from 'taxable supplies', \$m – excluding on grants		319 [\$51]	268	0	51
'PAYMENTS'					
Before GST, expenditures, \$m		4782			
Non-labour share of input expenditures, \$m		0.25			
Before GST cost of acquisitions, (non labour expenses)		1196			
After GST cost of acquisitions, assuming 2.5% fall in costs, and 10% GST		1282			
FINANCIAL EFFECTS OF GST					
Input tax credits		117			
Net GST payable, \$m		203			
Net receipts after GST, \$m		4887			
Change in net receipts, %		2%			

*Assumes funding mix in Table 2.1 for total CSWO sub-sector.

Table 3.2 Financial impact of GST on CSWOs sector - 'realistic scenario'*

'RECEIPTS'		<i>Grants</i>	<i>Client fees</i>	<i>Fundraising</i>	<i>Other income</i>	
% of receipts deemed 'commercial' activity		100%	50%	50%	100%	
Receipts before GST, \$m	4782	2678	1004	573	526	
Assumed demand response to 10% price rise		0	-15%	-15%	-15%	
Assumed rise in GST inclusive price, %		9	8	8	8	
Non taxable output	789	0	502	287	0	
GST inclusive value of taxable output including assumed demand response		4121	2919	459	262	481
GST payable on receipts from 'taxable supplies', \$m – excluding on grants		375	265	42	24	44
		[110]				
'PAYMENTS'						
Before GST, expenditures, \$m		4782				
Non-labour share of input expenditures, \$m		0.25				
Before GST cost of acquisitions, (non labour expenses)		1196				
After GST cost of acquisitions, assuming 2.5% fall in costs, and 10% GST		1282				
FINANCIAL EFFECTS OF GST						
Input tax credits		117				
Net GST payable, \$m		258				
Net receipts after GST, \$m		4652				
Change in net receipts, %		-3%				

*Assumes funding mix in Table 2.1 for total CSWO sub-sector.

Table 4.1 Impact of the GST on charities - 'GST-free status'*

<i>Funding mix</i>	<i>Grants 100%</i>	<i>Fees or Fundraising 100%</i>	<i>Other income 100%</i>	<i>Grants 50%, Fees or Fundraising 50%</i>	<i>Grants 50%, Other income 50%</i>
<i>Labour intensity</i>					
0.15 Input tax credits, \$ mill	70	70	70	70	70
Net GST payable, \$ mill	-70	-70	-70	-70	-70
% income change	1	1	1	1	1
0.25 Input tax credits, \$ mill	117	117	117	117	117
Net GST payable, \$ mill	-117	-117	-117	-117	-117
% income change	2	2	2	2	2
0.4 Input tax credits, \$ mill	186	186	186	186	186
Net GST payable, \$ mill	-186	-186	-186	-186	-186
% income change	4	4	4	4	4
0.5 Input tax credits, \$ mill	233	233	233	233	233
Net GST payable, \$ mill	-233	-233	-233	-233	-233
% income change	5	5	5	5	5

*This scenario assumes GST-free status for all activities of CSWOs as defined in Industry Commission 1995.

4.2 Impact of the GST on charities - ‘government policy intent’*

Funding mix	<i>Grants 100%</i>	<i>Fees or Fundraising 100%</i>	<i>Other income 100%</i>	<i>Grants 50%, Fees or Fundraising 50%</i>	<i>Grants 50%, Other income 50%</i>
<i>Labour intensity</i>					
0.15 Input tax credits, \$ mill	70	70	70	70	70
Net GST payable, \$ mill	408	-70	397	169	403
% income change	1	1	-1	1	0
0.25 Input tax credits, \$ mill	117	117	117	117	117
Net GST payable, \$ mill	362	-117	351	123	356
% income change	2	2	0	2	1
0.4 Input tax credits, \$ mill	186	186	186	186	186
Net GST payable, \$ mill	292	-186	281	53	286
% income change	4	4	2	4	3
0.5 Input tax credits, \$ mill	233	233	233	233	233
Net GST payable, \$ mill	245	-233	234	6	240
% income change	5	5	3	5	4

*This scenario assumes all grants are taxable but increase by 10%, all fees or fundraising including donations is GST-free, all other income of charities is taxable, and prices are increased by 8% for GST.

Table 4.3 Impact of the GST on charities - 'realistic scenario'*

<i>Funding mix</i>	<i>Grants 100%</i>	<i>Fees or Fundraising 100%</i>	<i>Other income 100%</i>	<i>Grants 50%, Fees or Fundraising 50%</i>	<i>Grants 50%, Other income 50%</i>
<i>Labour intensity</i>					
0.15 Input tax credits, \$ mill	70	70	70	70	70
Net GST payable, \$ mill	408	129	327	268	368
% income change	1	-7	-15	-3	-7
0.25 Input tax credits, \$ mill	117	117	117	117	117
Net GST payable, \$ mill	362	82	281	222	321
% income change	2	-6	-14	-2	-6
0.4 Input tax credits, \$ mill	186	186	186	186	186
Net GST payable, \$ mill	292	12	211	152	251
% income change	4	-5	-13	0	-5
0.5 Input tax credits, \$ mill	233	233	233	233	233
Net GST payable, \$ mill	245	-35	164	105	205
% income change	5	-4	-12	1	-4

*This scenario assumes 50% of fundraising and fees are taxed, and a 15% fall in demand for fee for service, fundraising products and donations, and other income-generating activities.