Law Council
OF AUSTRALIA

Legal Practice Section

2 November 2018

Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA ACT 2600

By email: economics.reps@aph.gov.au

Dear Sir/Madam

Inquiry into the implications of removing refundable franking credits

1. The Charities and Not-for-profits Committee of the Legal Practice Section of the Law Council of Australia (**Charities Committee**)[1] welcomes the opportunity to provide this submission to the Standing Committee on Economics' Inquiry into the implications of removing refundable franking credits. The Charities Committee is comprised of lawyers and academics with specific expertise in the area of the law of charity and associated tax concessions.

2. The Charities Committee recommends that the Standing Committee expressly refer in its report to charities and other not-for-profits (**NFPs**) and to the impact of any reforms for those charities and NFPs. That is because charities and other NFPs would be materially affected by the removal of refundable franking credits. These entities receive over $1 billion of refunds per year. The potential fairness reasons for restricting refunds to high income/low tax retirees also do not apply. Further, reducing refunds for charities and other NFPs will reduce the public benefit that they provide for the community and may thus require a replacement direct government grant. Reducing refundable credits for other recipients may also impact on charities and NFPs, for instance by reducing the pool of donations.

3. The material impact from removing refundable franking credits for charities and certain other NFPs was recognised in 2013 by the Not-for-profit Sector Tax Concession Working Group which recommended retaining the current arrangements.[2]

[1] The Law Council of Australia is a peak national representative body of the Australian legal profession. It represents the Australian legal profession on national and international issues, on federal law and the operation of federal courts and tribunals. The Law Council represents 60,000 Australian lawyers through state and territory bar associations and law societies, as well as Law Firms Australia.
[2] Not-for-profit Sector Tax Concession Working Group, *Fairer, Simpler and More Effective Tax Concessions for the Not-for-profit Sector* (Final Report, 2013) 17.

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The significance of refundable franking credits for charities and other NFPs

4. The terms of reference do not expressly refer to charities or other NFPs. However, registered charities and other NFPs that are endorsed (generally, in their own right) as deductible gift recipients or specifically listed as deductible gift recipients are potentially able to receive refunds of franking credits.[3]

5. Charities and NFPs are significant recipients of refundable franking credits. The Tax Expenditures Statement 2017 identified franking credit refunds for charities and other NFPs in 2015-16 amounting to $1.16 billion, albeit this includes refunds for Australia's Future Fund.[4] The Australian Tax Office's *Taxation Statistics 2015-16* dataset indicates that this dropped to $1.11 billion in 2016-17 and that almost 5,200 entities claimed franking credits.[5]

6. These franking credits can arise on frankable distributions made by entities other than companies, but which are treated as companies for tax purposes. For example, certain unit trusts are deemed to be public unit trusts and so taxed as companies in circumstances where a tax exempt entity (such as a charity) is beneficially entitled to 20 per cent or more of the income or property.[6]

7. Reducing refundable credits for non-charity recipients may also impact on charities and NFPs, for instance by reducing the funds that those other recipients have available to make donations.

Irrelevance of fairness reasons for charities and other NFPs

8. It appears that key reasons for changes having been suggested are reasons of equity or fairness.[7] In essence, the argument appears to be that:

   (a) **Horizontal equity**: Australians (or their superannuation fund) over preservation age who have retired may be able to receive a large tax-free income and hence still receive a full refund of franking credits, unlike other Australians earning a similar size, but taxable, income.

   (b) **Vertical equity**: Wealthier Australians tend to hold, directly or indirectly (through their superannuation fund), larger equity investments and hence receive greater dividend income and franking credits than less wealthy Australians, who tend to receive lower/no dividend income and hence lower/no refundable franking credits.

9. Those equity reasons are inapplicable to charities and other tax concession NFPs because income tax is typically only imposed on entities as proxies for individuals – it is the equity impact at the level of those individuals that is relevant and:

   (a) It has been suggested that charities and other NFPs are formed for public benefit, not private individual benefit – so there are no relevant individuals and

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[3] *Income Tax Assessment Act 1997* (Cth) subdiv 207-E.
[4] Treasury, *Tax Expenditures Statement 2017* (January 2018) 65 (Table B52).
[5] Australian Tax Office, *Taxation Statistics 2015-16* <data.gov.au/dataset/taxation-statistics-2015-16/resource/0eb02b18-411a-4cf0-b671-74015b13b7b5?inner_span=True>.
[6] *Income Tax Assessment Act 1936* (Cth) s 102P(2)(a).
[7] See, eg, the Australian Labor Party's policy released in March 2018.

hence charities and NFPs should not have to bear income tax,[8] including tax collected at the level of a company in which they hold shares.

(b) Even if charities and NFPs are viewed as flow-through entities to the people who they assist or to whom they otherwise provide benefits, there are no practical mechanisms in place to identify and evaluate the equity implications.[9] That is, it is not feasible to identify the income types and levels of charity benefit recipients and it would also typically be incredibly difficult to arrive at a proxy rate of tax to apply at the charity level so as to reflect the tax rates at the level of individual benefit recipients.

The need for replacement direct government funding if refundable franking credits are removed for charities

10. It is also fairly broadly accepted that income tax exemption is provided to charities and other NFPs in order to support the achievement of 'public benefit', often linked to the notion that the concessions are subsidies, to induce charities and other NFPs to produce public benefits such as health care, education and welfare,[10] as well as process benefits.[11] Thus, tax concessions are viewed as an alternative to providing direct government grants.

11. If charities and other NFPs lose their refundable franking credits, then unless government is willing to accept a reduction in the level of public benefit produced by charities and other NFPs, the government would need to replace lost refundable franking credits with some form of direct government grant.

12. The mechanics of any direct government grant would require material consultation with the sector.

13. If the Government is concerned about the revenue implications of increasing levels of refundable franking credits for charities and other NFPs, it is suggested that the concern would be better dealt with by considering whether those franking credits could be better targeted to certain charities and NFPs. That is a process that would require consultation along the lines of that conducted by the Not-for-profit Sector Tax Concession Working Group when it considered the targeting of DGR concessions.

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[8] Cf Not-for-profit Sector Tax Concession Working Group, *Fairer, Simpler and More Effective Tax Concessions for the Not-for-profit Sector* (Final Report, 2013) 2.

[9] Cf Boris Bittker and George Radhert, 'The Exemption of Nonprofit Organizations from Federal Income Taxation (1976) 85(3) *Yale Law Journal* 299, 307-13; Richard Krever, 'Tax Deductions for Charitable Donations: A Tax Expenditure Analysis' in Richard Krever and Gretchen Kewley, *Charities and Philanthropic Organisations: Reforming the Tax Subsidy and Regulatory Regimes* (Australian Tax Research Foundation, 1991) 1, 3-5.

[10] See, eg, Evelyn Brody, 'Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption' (1998) 23(4) *Journal of Corporations Law* 585, 590; Joyce Chia, Matthew Harding, Ann O'Connell and Miranda Stewart, 'Taxing Not-for-profits: A Literature Review' (Not-for-profit Project, Melbourne Law School, 28 February 2011) 15-22.

[11] See, eg, John Simon, Harvey Dale and Laura Chisolm, 'The Federal Tax Treatment of Charitable Organizations' in W Powell and R Steinberg (eds), *The Nonprofit Sector: A Research Handbook* (Yale University Press, 2nd ed, 2006) 267, 274-5; Rob Atkinson, 'Theories of the Federal Tax Exemption for Charities: Thesis, Antithesis, and Syntheses' (1997) 27(2) *Stetson Law Review* 395, 403.

Contact

14. For further comment or clarification on any of the matters raised in the submission please contact Jennifer Batrouney QC, Chair, Charities and Not-for-Profits Committee on (T) 03 9225 8528 or at (E) Jennifer_batrouney@vicbar.com.au.

Yours sincerely

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