



nsw Federation of
Housing Associations inc

**Submission on the
Commonwealth Government's
consultation paper
Better targeting of not-for-profit tax concessions**

July 2011

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1. The NSW Federation of Housing Associations

The NSW Federation of Housing Associations (the Federation) is the industry peak body for housing associations in NSW.

Housing associations are not-for-profit community housing providers whose principal business is managing and developing long-term housing for low and moderate income households. All such organisations are registered as Class 1, 2 or 3 community housing providers in NSW. They manage over 85% of the tenancies managed by registered community housing providers in NSW. There are also a large number of providers of shorter term or crisis housing, in particular specialist homelessness services.

There are 27 housing associations in NSW; all of which are members of the Federation. In addition we have 69 other, associate and affiliate, members providing housing related services or who are housing associations in other jurisdictions.

Housing associations manage 29,000 tenancies, the majority of which have been funded through Housing NSW and more recently, the National Building Economic Stimulus. This is currently almost 20% of social and affordable housing in NSW, the remainder of which is publicly managed. However, with ongoing transfers of properties from the public sector to the community housing sector, and with the government objective of increased borrowing (including that supported by NRAS), the sector is growing rapidly.

Community housing is an entirely commercial activity, with the main income source being rents charged to tenants, rather than government grants. Moreover, community housing providers aim to increase the supply of housing provided at less than market prices by borrowing and by entering into partnerships with other organisations, including for-profit entities.

There is a critical shortage of rental housing in Australia that is affordable and available to low and moderate income households. This gives rise to social exclusion and disadvantage. The growth of a not-for-profit sector whose mission is to meet the needs of such households is central to the public policy response to this problem.

The Federation provides a range of services to support the development and performance of housing associations and the wider social housing system in six core areas:

- **Representation and sector co-ordination** – this is our fundamental role as the peak industry body for housing associations in NSW. We provide a voice for members, and enable them to work together as a mutually supportive sector and to articulate and pursue their common aspirations.
- **Research and sector development** – this supports the members' directions and aspirations with effective research and policy development on key issues affecting the development of the sector

- **Relationships and alliances** – this ensures that associations are promoted and well-known to all other stakeholders who might help our development, and to allow associations to play their part in the wider community sector
- **Training** – this is our most prominent direct service to members and others in the social housing sector. We are a Registered Training Organisation. Through our Centre for Training in Social Housing, our accredited vocational training and other short courses support and build the capacity of organisations and the careers of workers in the sector. In addition we deliver the training for public sector staff employed by Housing NSW and in the ACT and Tasmania. We broker access to high level courses for senior managers and association directors in partnership with bodies such as the UTS Graduate School of Management and the Australian Institute of Company Directors.
- **Supporting organisations** – the Federation directly supports individual members, their boards and management, in their work as housing providers. This ranges from free advice provided through our Housing Hotline for front line staff, to advice on strategic planning, organisational reviews, tenant participation, through to intensive organisational change with organisations experiencing management difficulties.
- **Good practice resources** – through our Good Practice Unit, we also support our members and other providers by developing and continually updating resources on good practice social housing management. It includes the series of Housing Hints (produced in partnership with the Aboriginal Housing Office), Across the Board bulletins for directors of housing associations, comprehensive Good Practice Guides, and a good practice data base.

Particularly through our Centre for Training in Social Housing and Good Practice Unit, the Federation has become recognised as one of the leading experts in community housing management in country.

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2. The consultation paper

The consultation paper seeks views on possible approaches to implement the Government's decision, announced in the 2011-12 Budget, that it will reform the tax concessions provided to NFP entities to ensure they are targeted only at those activities that directly further an NFP's altruistic purposes. This will be achieved by limiting income tax concessions to profits generated by the unrelated commercial activities of NFPs, that are directed to the NFP's altruistic purpose

The consultation paper identifies the objectives of the Government as:

- ensure government assistance is directed to support NFPs' altruistic purposes,
- deliver a level playing field between small, large and NFP businesses.
- protect community assets from unnecessary commercial risks

In addition, a number of exclusions from and other transitional arrangements for the policy have been announced:

- small-scale and low-risk unrelated commercial activities will not be affected by the reforms
- the reforms will not affect the passive income of NFPs
- the 50,000 National Rental Affordability Scheme allocations will be unaffected by the tax changes
- the reforms will not disturb the taxing arrangements associated with mutual income and the principles of mutuality.
- initially only new unrelated commercial activities that commence after 10 May 2011 will be subject to the new arrangements
- NFP entities with existing unrelated commercial activities will initially be able to continue to use their tax concessions to support these activities, with the intention of phasing these out over time
- NFP entities that have entered into government service delivery contracts as of 10 May 2011 will be allowed to use their tax concessions in support of that contract

The matters on which advice is sought are:

- the scope of 'unrelated business' and 'primary (or 'altruistic') purpose'
- methods by which the Government could implement this reform
- Transitional arrangements

The importance of the issues for community housing providers

The discussion paper deals with matters of critical importance to the community housing sector. Community housing providers deliver services, the vast majority of which are commercial. The business is largely funded by rents, some management fees and in growing number of cases, cross subsidy from housing developments. Their activities include housing development – an activity that is undertaken with all the commercial disciplines.

Significant government subsidies are provided, but these may be in the form of investment incentives such as NRAS, capital funding and indirect subsidies provided to tenants through Rent Assistance – as well as a tax subsidies from local, State and Commonwealth governments.

At the same time, the delivery of social housing is crucially linked to leveraging off the provision of housing and the need to ensure sustainable income streams to maintain the housing service, to provide a suite of ancillary services to increase social inclusion and create pathways for tenants into social and economic participation. Providers also establish close (usually formal) partnerships with support providers to enable tenants with a range of high and complex needs to sustain their tenancies and receive the support services they need.

All housing g associations in NSW have PBI status and a number of new entrants are church based aged care or disability service providers. The importance of the tax concessions available to providers to the viability of their service provision – particularly FBT and GST exemptions – was detailed in our submission to the Henry Tax Review.

While it is significant for our sector that the reforms do not apply to the first 50,000 NRAS incentives, this indicates the possible in-principle impact they could have on community housing providers.

With this in mind, it is essential that this exclusion be extended to any future rounds of NRAS incentives rather than the current tranche of 50,000.

The discussion paper also must be understood in the context of other government arrangements. In particular, the regulation applied to community housing providers in NSW, and the proposed national regulation framework currently being developed by Housing Ministers. Three aspects of this regulatory framework are relevant in this context:

- The regulation of community housing organisations provides proportionate risk based oversight of the viability of providers that is the most effective way to ensure that the public subsidies – including the charitable tax subsidies – are not put at inappropriate risk
- The regulation requires providers to maintain a suitable level of surplus to manage commercial risk
- The regulation requires providers to undertake the appropriate level of gearing (and use of surplus) to increase the supply of community housing.

However, while the policy and regulatory environment for a sector that is currently expanding to meet a critical social need for low cost housing and to meet Government policy objectives, provides strong assurance of both the management of risk and the public benefit of the activities of the sector, on the face of it, its activities are not caught by the current exclusions since they are neither small scale or inherently low-risk.

For these reasons we strongly recommend that the *sector wide* implications for the public policy of substantial future growth community housing sector be considered.

Brief submission

In our submission the Federation will make a number of in-principle observations and respond to a small number of the most immediately relevant consultation questions.

In addition to our responses in this submission, we endorse the recommendations of the more extensive submission made by the national industry body for the sector – the Community Housing Federation of Australia.

3. Principles and issues

The Federation believes that the following principles and issues should guide the approach taken to the taxation of unrelated commercial activities by not-for-profit entities:

Compliance costs should be minimised

The purpose of the creation of a single national regulator for the not-for-profit sector was to reduce the regulatory burden and compliance costs. This test should also guide the approach taken to the taxation of unrelated commercial activities. It would be extremely inappropriate if this element of the overall reforms to the administration of charities in Australia, undercut the overriding objective of the reforms.

The current proposals clearly add to the compliance costs under all options for future entity structures – either through the creation of separate entities that may nonetheless be required to work closely together utilising a whole new layer of detailed commercial arrangements, or through the substantial additional reporting envisaged under options 3.

The tax treatment of ‘unrelated commercial activities’ should be proportionate to the risk that the income from such activities will not be applied to altruistic purposes

The discussion paper identifies three objectives for the changed approach to unrelated commercial activities:

- government assistance is directed to support NFPs’ altruistic purposes,
- delivering a level playing field between small, large and NFP businesses.
- protect community assets from unnecessary commercial risks

In effect all three come down to assurance that assistance is directed to support the altruistic purpose.

If the third objective was interpreted to mean that activities supported by charitable tax concessions should be low risk, it would violate the basic principle that value is created through well-managed risk, rather than risk avoidance. All enterprise carries risk; and the greater value of ‘social enterprises’ depends on taking risk and managing it effectively, rather than minimising it. However, it is unrealistic to believe that tax treatment will play any role in improved risk management other than by the completely inefficient mechanism of forcing all risk to be structurally insulated. The appropriate test is whether the risk provides social benefit – that is, furthers the altruistic purpose.

Similarly, the creation of a level playing field between for-profit and not-for-profit businesses is entirely not an end in itself. Rather, the issue is whether the commercial advantage enjoyed by a tax-advantaged NFP delivers a community benefit – that is, furthers the altruistic purpose.¹

The objective ‘that the benefits derived from tax concessions are directed to the altruistic purpose’ is therefore the overriding objective.

¹ In fact, the tax treatments available to for-profit enterprises frequently outweigh the benefits available to NFPs through their charitable tax status. See CHFA submission on the discussion paper.

On the face of it, it is highly unlikely that commercial activities will be undertaken unless these generate related benefits or sufficient income to support the altruistic purpose. This is because the inability to distribute profits, which is a condition of being a NFP, means there is very limited incentive to undertake commercial activities for any other purpose. The risk of an organisation's activities (and associated tax benefits) being disproportionately skewed to unrelated commercial activities is therefore low.² As a result, the measures to address this risk should also be proportionate to this risk.³

Relating the definition of "unrelated commercial activity" to the risk that such activity will not support the NFPs' altruistic purpose

The proposed tax treatment employs the concept of 'unrelated commercial activities' to identify those earnings, the surpluses from which must be shown to have been expended on the altruistic purpose. The altruistic activities, or related activities (including those that are of a commercial nature) are not in scope.

The definition of an 'unrelated commercial activity' is therefore central. In order to minimise the compliance burden (including options involving establishing and dealing with separate entities), and because of the very low risk that surpluses from any activities will not be applied to the altruistic purpose, such a concept should be restricted to those activities that bear very little relationship to the altruistic activities, and are structured in such a way as to substantially increase the risk that the application of tax benefits will be absorbed by these activities rather than applied to support the altruistic purposes.

The determination of 'taxable income' from unrelated commercial activities must reflect the nature of those activities

The Federation supports the principle that surpluses not ultimately applied to the charitable purpose should be taxed.

The discussion paper proposes that taxable income from unrelated activities is surplus income from that activity that is not expended on the altruistic purpose. However, it is not a simple matter to determine when such surpluses should be applied to the charitable purpose. This will relate to the nature of the activities (*both* related and unrelated) and the timeframes and capital requirements of these activities.

Some core charitable activities, such as the development of housing to relieve housing related poverty, may take a number of years to complete. Similarly, the ability to partner to provide social housing services as part of government Public Private Partnerships is dependent on having a sufficiently strong balance sheet to carry risk. Finally, the provision of social housing requires providers to have a life-cycle asset plan, fully funded through reserves and projected cash-flow. In all these cases, strong balance sheets (that is retained surpluses) and activities with multi-year time frames are the nature of the altruistic activity for which the tax concessions are provided.

² In fact, the measure proposed will not address an unrelated commercial activity dominating the altruistic one. It will only address the *timeliness* with which surpluses are applied to the altruistic purpose or the extremely rare eventuality that surpluses are increased indefinitely without being applied.

³ In fact, were such activities to be structurally separated and undertaken by a for profit entity, the incentive to raise capital and distribute profits to shareholders will increase (as shown by the rationale advanced for demutualisation by entities such as the NRMA); with the result that the income available to be distributed to the charity to support its altruistic activities will be reduced.

A fundamental principle should also be that every NFP – particularly one engaged in commercial social enterprises – must retain sufficient surpluses, and a strong enough balance sheet, to manage risk. From an accounting point of view, this is not a matter of various provisions⁴, but of the strength of the balance sheet or cashflow required to manage business risks. In order to meet the government objective that its support should not be subjected to unnecessary commercial risk, requires that retained earnings be proportionate to the nature of the business being undertaken.

Compliance must not commence before required systems can be established

The new arrangements for either the taxation of unrelated commercial activities should not be effective until such time as all NFPs have had an opportunity to implement the new systems or structures needed to comply. They should therefore not apply to the tax year, any part of which falls before it is reasonable to expect NFPs to have implemented such systems or arrangements. They could not therefore apply to the 2011-12 financial year.

⁴ The projected expenditure on cyclical asset management which is fundamental to a viable social housing operation, cannot be shown as a provision. There have been some attempts to employ a notion of 'restricted cash' but this is not a standard accounting treatment.

4. Consultation questions

The scope of ‘unrelated business’ and ‘primary (or ‘altruistic’) purpose’

1. *What should be the scope of a related business, unrelated business, primary purpose or non-primary purpose test?*

The primary purpose of community housing providers is usually the relief of poverty by providing housing and related services to relieve housing stress.

The scope of this purpose has been interpreted more or less narrowly at various times. A narrow interpretation would be limited to the provision of assistance to households for only as long as they remain in poverty. A more sensible interpretation would be the provision of such assistance to households or individuals within the household who would be vulnerable poverty or exclusion without such assistance. Moreover, the latter objective is increasingly been taken to include the provision of housing to households who would experience housing stress or exclusion from access to employment or other forms of social participation were they to pay a market rent for housing.

The difficulty in matching the public policy importance placed on such activities with a narrow interpretation of primary purpose has led to the exclusion of activities undertaken through the NRAS.

More generally, it is the Federation’s view that the heads of charity (primary purposes) should be reviewed to include the provision of affordable housing in the way described above.

However, if the provision of ‘affordable housing’⁵ is not interpreted as part of the primary purpose of community housing charities, it is reasonable that its provision be seen as a related activity.

Similarly, the viability of projects to develop social and affordable housing will often depend on the sale of part of such developments into the general market. Again, it is reasonable that this activity is treated as a related activity, rather than adding the complexity of either a structural separation of entities undertaking the project or of the significant compliance costs associated with reporting on the internal cross-subsidy within a single project.

Bearing these objectives in mind, the Federation supports the use of the Canadian Revenue Agency’s definition of ‘related business’ linked to and subordinated to the primary purpose:

- business activities that supplement or are necessary for the effective operation of charitable programs;
- off-shoot or sale of by-product;
- use of excess capacity (assets or staff);
- and sale of items that promote the charity or its objects.

⁵ Housing provided at sub-market rents to households low and moderate income households who would experience housing stress or be excluded for social or economic participation if they were to pay market rents.

We believe that the first three of these clearly cover the development and affordable housing activities of community housing providers. However, we stress that these should not be interpreted as relatively small scale or low risk activities (which could be a characteristic of more typical examples).

We would also support the four factors indicating ‘subordinate to the charitable purpose’:

- the size of the business relative to the charity’s operations,
- the integration of the business into the charity’s operations,
- whether the charitable goals continue to dominate the entity’s decision-making, and
- that the organisation operates for an exclusively charitable purpose

Similarly, we believe that the development and management of affordable housing activities described above also meet the Australian definition of an activity ‘incidental or ancillary to a charitable purpose if it tends to assist, or naturally goes with, the achievement of the charitable purpose.’

2. Should there be a small-scale threshold, and if so, what would be the appropriate threshold?

In addition to the definition of ‘related activities’ above, we believe there may be a role for a small-scale threshold to simplify the assessment of related activities. While many community housing providers are large scale organisations with substantial turnover, the vast majority are small to very small.

Methods by which the Government could implement this reform

5. Which option do you prefer and why? Would we need to proceed with more than one option?

To the extent that community housing activities are taken to fall into ‘unrelated commercial activities’, our preference is for organisations to be able to choose between the creation of separate entities or reporting of the application of earnings from unrelated commercial activities.

Both options have substantial compliance costs. In the case of the first there will be high up-front costs and a lower ongoing costs of maintaining separate cost centres between entities and the cost of managing related party arrangements. The latter is particularly true because of the close integration of most activities.

However, our main concern is the proposed constraints of the reporting under Option 3. For most potentially unrelated activities – and for the activities undertaken for the primary purpose, the time frames within which surpluses generated by unrelated activities could be applied are longer than a single tax year.

Moreover, a substantial balance sheet is required to ensure (a) that maintenance can be provided over at least a 20 year period, (b) that risk can be prudently managed, and (c) that development can be undertaken most effectively by, for example, by land banking until such time as an appropriate development project can be put together.

It is crucial therefore, that a longer time frame for expenditure be provided and that the requirement be net of all legitimate levels of retained earnings.