8 July 2011

Manager
Philanthropy and Exemptions Unit
Personal and Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

Submission in response to the Consultation Paper titled "Better targeting of not-for-profit tax concessions" on behalf of various public universities

This submission has been prepared by Ernst & Young on behalf of various public universities. Each of these public universities may be adversely impacted, to varying degrees, by the Federal Government's announcement on 10 May 2011 to limit various federal tax concessions in relation to unrelated commercial activities undertaken by not-for-profit (NFP) enterprises.

The various public universities (collectively referred to as "the Universities") participating in this submission are as follows:

Australian Catholic University
Charles Sturt University
Macquarie University
Southern Cross University
The Australian National University
The University of Newcastle
The University of Sydney
University of Canberra
University of New England
University of New South Wales
University of Queensland
University of Technology Sydney
University of Western Sydney
University of Western Australia
University of Wollongong

Ernst & Young and the Universities welcome the opportunity to respond to the proposals announced on 10 May 2011 and the Consultation Paper released on 27 May 2011.

This submission is divided into two parts:

1. Appendix A outlines the unique position and objects of the public university sector and provides reasons as to why it is fundamentally inappropriate for the proposed NFP tax reforms to apply to the sector.

2. Appendix B addresses the specific questions raised in the Consultation Paper from the perspective of the public university sector.
We look forward to discussing this submission further with Treasury at your earliest convenience. Representatives of the Universities and Ernst & Young would be available to meet with representatives from Treasury during the week commencing Monday 18 July (if this would be suitable, please contact me to agree a suitable time and location).

In addition, given the principles based approach favoured, we would welcome the opportunity to work with Government to develop a framework which provides guidance and clarity as to the practical application of the proposed reforms to the public university sector. In this regard, Ernst & Young would draw on our experience in assisting the UK HM Revenue & Customs with implementing recent similar reforms to the UK university sector.

If there is any aspect of this submission on which Treasury would like more information, please contact me (02 9248 4459), Morris Maroon (02 9248 5701), Jason Wrigley (02 9248 5303), Russell Phillips (03 9655 2696) or Richard Czerwik (03 9288 8408).

* * * * *

Yours faithfully

Justin Power
Tax Partner

Encl.
Appendix A

Unique issues and objects of the public university sector

This part of the submission raises issues relevant to the public university sector that do not fit neatly into the consultation questions raised in the Consultation Paper, including the fundamental proposition that the NFP tax concession reforms ("the proposed reforms") should not apply to the public university sector.

a) Public universities established and supervised by Commonwealth, State or Territory governments should maintain tax concessions on an equivalent basis to other Government enterprises

Public universities which are established and regulated by Commonwealth, State or Territory governments should be recognised as a special class of NFP entity.

Public universities are generally income tax exempt either under item 1.4 of section 50-5 of the Income Tax Assessment Act 1997 (ITAA 1997) (as a public educational institution), or item 1.1 of section 50-5 (as a charitable institution), which reflects the public educational activities of the universities and their intrinsic connection with the NFP sector.

Public universities that are established and regulated by Commonwealth, State or Territory governments have generally obtained tax exemptions equivalent to other types of government bodies and enterprises, whose tax exemption recognises the special relationship of the entity with the relevant level of government.

Consequently, public universities established and regulated by either State or Territory governments should continue to secure equivalent tax exemptions provided to other State and Territory bodies, such as the exemption for certain State/Territory bodies under Division 1AB, Subdivision A, Part III of the Income Tax Assessment Act 1936 (ITAA 1936). It is significant that current income tax exemptions provided to other State/Territory bodies and enterprises do not exclude amounts referable to "unrelated commercial activities" or any other equivalent concept, and there is no current proposal for this to change.

Accordingly, we submit that the proposed reforms should not apply to public universities which are established and regulated by Commonwealth, State or Territory governments. Furthermore, the proposed reforms should also not apply to controlled entities of public universities which are established and regulated by Commonwealth, State or Territory governments.

b) Public universities are closely regulated and the proposed reforms are not required as an integrity measure

We understand and appreciate that the proposed reforms have a purpose of ensuring that there is greater transparency and that Government tax concessions are appropriately directed to the charitable activities of the NFP sector: this is supported by the Government's announcement of the establishment of the Australian Charities and Not-for-profits Commission as the national regulator of the NFP sector.

We submit that the public university sector is already very closely regulated by Commonwealth, State and Territory governments. Additional regulation also applies to the various sources of
education and research funding provided by the Commonwealth, State and Territory governments. In this regard, public universities must report to the following regulators:

- The Commonwealth Finance Minister
- The relevant State Minister of Education
- Australian Securities and Investments Commission
- The relevant Ombudsman
- The relevant State or Commonwealth Treasury
- The relevant State or Commonwealth Auditor-General
- Independent Commission Against Corruption
- Australian Research Council
- National Health and Medical Research Council
- Department of Innovation, Industry, Science and Research
- Department of Education, Employment and Workplace Relations
- Department of Families, Housing, Community Services and Indigenous Affairs
- Australian Universities Quality Agency
- Tertiary Education Quality and Standards Agency

Public universities are also subject to State and Federal scrutiny through the application of laws, regulations and by-laws imposed on the public university sector. Examples of specific legislation regulating the public university sector include:

- Each public university's enabling Act
- Relevant Freedom of Information Act or the Government Information (Public Access) Act
- Relevant State Records Act
- Education Services for Overseas Students Act
- Higher Education Funding Act

Accordingly, no additional transparency in the public university sector would be gained from the proposed reforms and therefore they are unnecessary as a further regulatory measure for the public university sector.

c) NFP tax concession reforms are inconsistent with other Government objectives for public universities

Public universities contribute significantly towards the provision of higher education and the advancement of knowledge (by way of research activities) in Australia. Accordingly, taxing public universities would be inconsistent with the Government's broader innovation policy. In this regard, the Department of Innovation, Industry, Science and Research states that its key priority is to:

"encourage the sustainable growth of Australian industries by developing a national innovation system that drives knowledge creation, cutting-edge science and research, international competitiveness and greater productivity. The department is committed to developing policies and delivering programs, in partnership with stakeholders, to provide lasting economic benefits ensuring Australia's competitive future. The department also works to boost innovation by Australian industry and improve social and economic benefits for the Australian community."

The proposed reforms would tend to deter public universities from seeking revenue from commercial ventures and increase their reliance on Government funding. Accordingly, this is likely to have a direct and significant impact on the ability of public universities to develop long term funding strategies to meet their core objectives.
If the proposed reforms were applied to public universities in a manner which required the universities to increase the number of separate entities to operate unrelated commercial activities, this would be contrary to the recent report by the NSW Auditor-General (Peter Achterstraat). He recommended to the NSW Parliament that NSW universities should reduce the number of subsidiaries in order to save on compliance costs, minimise the risk of financial loss and avoid reputational damage.

d) Deductible gift recipient status should continue for public universities

We submit that the Government should reconsider its proposal to deny deductible gift recipient (DGR) status to NFP entities that are carrying on unrelated commercial activities, as the proposal is draconian and inequitable.

DGR status is an important aspect of fundraising for public universities and their controlled entities. We submit that the proposal should not apply to public universities or their controlled entities that are, or would be, entitled to be registered as DGRs. It would be inequitable to effectively impose a requirement for public universities to restructure their long standing university activities in order to maintain DGR status notwithstanding that their income tax status may not be affected for the reasons stated above and throughout this submission.

This is a critical issue for the public university sector and we would welcome the opportunity to work with Treasury to remedy this important aspect of the proposed reforms.

Given the arguments outlined above, we submit that it is fundamentally inappropriate for the proposed reforms to apply to the public university sector.
Appendix B

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

As previously indicated, we submit that it is fundamentally inappropriate for the proposed reforms to apply to public universities and the public university sector.

However, if the Government considers that the proposed reforms should apply to public universities, we submit that a “core” objects or purposes test would be appropriate in determining the type of activities that should continue to enjoy existing tax concessions in comparison to the treatment of “unrelated commercial activities”.

The scope of the core purpose test should not be defined by reference to a single, primary or dominant purpose, as this would disadvantage NFP entities that conduct a wide range of different types of charitable activities. This is particularly relevant to the public university sector. Without this fundamental safeguard, public universities may be compelled to restructure so that only one primary (tax exempt eligible) activity is conducted in each NFP entity, which would impose an enormous compliance burden on each public university for no discernable benefit to the community.

Core objects of public universities

Most public universities in Australia are established by an Act of Parliament which sets out their “core” objects, functions and powers. Where the public university is not established by an Act of Parliament, the “core” objects, functions and powers of the public university are set out in its constitution. Ordinarily, a public university’s “core” objects and functions would include the following:

a) The provision of facilities for education and research of a university standard
b) The encouragement of the dissemination, advancement, development and application of knowledge informed by free inquiry
c) The provision of courses of study or instruction across a range of fields, and the carrying out of research, to meet the needs of the community
d) The participation in public discourse
e) The conferring of degrees, including those of Bachelor, Master and Doctor, and the awarding of diplomas, certificates and other awards
f) The provision of teaching and learning that engage with advanced knowledge and inquiry
g) The development of governance, procedural rules, admission policies, financial arrangements and quality assurance processes that are underpinned by the values and goals of the university and that are sufficient to ensure the integrity of the university’s academic programs
h) Providing essential community services and facilities

As the above indicates, public universities have varied and wide-ranging core objects and functions. In many cases, particularly with public universities based in regional areas, the core objects and functions may extend to supporting the community in which the university operates. Given the importance of these objects and functions, we submit that each of these should be considered “core purposes” of the public universities for the purpose of the proposed reforms.

For your information, we have provided below a non-exhaustive list of common activities undertaken by a public university in pursuit of its core objects:
• Provision of education
• Services primarily provided to students and university staff (i.e. food outlets, car parks, medical centres, training facilities, sporting clubs/gyms, library, unions, hotels etc)
• Student accommodation
• Property (university infrastructure and student accommodation) development and maintenance
• Research and professional services (including consultancy and testing)
• Investment portfolios
• Administrative functions
• Operation of commercial activities by students in furtherance of their tertiary studies
• Commercial exploitation of intellectual property

Accordingly, we submit that the scope of the core purpose test should be broad enough to encompass the above and similar types of core activities such that these would not be considered unrelated commercial activities.

The scope of the core purpose test should be broad enough to include:

• Activities directly related to any of the core objects, functions and powers outlined in the organisation’s constituent documents; and

• Activities which are incidental or ancillary to the core objects, functions and powers outlined in the organisation’s constituent documents.

We submit that activities should be deemed to be incidental or ancillary to a core purpose where the activity is undertaken to utilise spare capacity from resources primarily used to further the core objects of the public university. This would address any issues associated with restructuring unrelated commercial activities into a separate entity (i.e. in accordance with Options 1 and 2 considered in Question 4 below) where the relevant asset is used for both core purposes and incidental or ancillary purposes. For example, where a lecture theatre or other facility is primarily used for the provision of education during the university term and is hired out for conferences or other functions during the university holidays.

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

The Consultation Paper indicates that relief will be provided to very small scale activities of NFP entities. In view of the potentially onerous and complex provisions that will be required to give effect to the proposed reforms, it is critical that meaningful de minimis thresholds be available to exclude relatively small-scale activities undertaken by the public university sector.

We propose that the Government implement three (3) small-scale threshold exemptions as follows:

i. Where the total revenue of the public university, excluding Government funding, bequests and student fees, is below a prescribed dollar amount;

ii. Where the total revenue generated by the particular unrelated commercial activity is below a prescribed dollar amount;

iii. Where the total revenue generated by the public university’s unrelated commercial activities is below a prescribed percentage of total revenue of the university (including its wholly owned subsidiaries).

Appropriate threshold amounts and prescribed percentages should be agreed upon following further consultation with the Government.
3. **Is there an alternative principle that could be used to provide a small-scale or low-risk activity exemption?**

As indicated in Question 1, the determination of what is an unrelated commercial activity should be determined by reference to the “core” purposes of the NFP entity (which necessarily satisfy underlying tax exemption eligibility requirements).

If such an approach is not adopted, then in addition to implementing small scale/low risk dollar thresholds discussed in Question 2 above, the proposed reforms should also expressly exempt certain public university sector activities on the basis that they should be recognised as small scale or low risk.

By way of example, this exemption should apply to exclude the following public university activities:

- Fundraising activities
- Any activities undertaken by student unions or other student associations
- Activities associated with sporting endeavours on public university property
- Gains derived from the disposal of property previously used, or acquired with a view to being used, for public university purposes
- Services primarily provided to students and university staff (i.e. food outlets, car parks, medical centres, training facilities, sporting clubs/gyms, library, unions, hotels etc)

The question as to whether an activity is small scale or low risk should be determined by reference to the particular circumstances of the respective public university.

4. **Would there be any unintended consequences resulting from any of these options?**

Our experience of similar measures introduced in other jurisdictions indicates that there is likely to be a number of unintended consequences arising from these measures. In order to minimise these, we submit that all three options contained in the Consultation Paper should be available at the discretion of the NFP entity. Flexibility for public universities is preferred as any single option will be insufficient to deal with the various commercial and technical complexities likely to arise.

We make the following comments in relation to each option:

**Option 1 (Unrelated commercial activity in a separate entity taxed like a normal company)**

The Consultation Paper suggests that Option 1 will be the least complex option to administer and is likely to impose a lower compliance burden than both Options 2 and 3. The Consultation Paper also suggests that Option 1 may quarantine commercial risks arising out of unrelated commercial activity to the particular subsidiary undertaking that activity.

In our view Option 1 gives rise to a number of significant burdens and complexities, particularly for public universities:

a) Option 1 will require all unrelated commercial activities of NFP entities to be transferred into separate entities. There may be legal and/or regulatory restrictions on the ability of public universities to transfer assets (used for unrelated commercial activities) into a new subsidiary. Such restrictions may arise in the following examples:

   - Where a public university holds a non-assignable licence to operate a certain form of business and cannot transfer the licence to a subsidiary;
- Where the conditions attached to a bequest limits the public university's ability to transfer the object of the bequest;
- Where State, Territory or Commonwealth laws do not permit the transfer of certain land or property used in unrelated commercial activities.

b) A number of tax and commercial disadvantages may arise. These include (but are not limited to), the imposition of income tax (including capital gains tax (CGT)), stamp duty, goods and services tax (GST) and other restructure costs associated with the potential sale/transfer.

As a minimum, the proposed reforms should provide relief (or compensation) for any income tax, CGT, stamp duty and GST liabilities arising out of the restructure.

c) Funding and cash flow difficulties are likely to arise. Under Option 1, public university subsidiaries which engage in unrelated commercial activities would be considered tax-paying entities. Accordingly, they would be required to remit PAYG instalments to the Australian Taxation Office throughout the financial year, notwithstanding that all of their profits may be distributed to assist the core purposes of the university. This would give rise to cash-flow difficulties as any entitlement to a refund of tax paid (i.e. refund of franking credits) would only be available, in the hands of the shareholder (another entity), after the distribution has been made. Subsidiaries (which engage in unrelated commercial activities) that distribute amounts to NFP entities that are ineligible for refundable tax offsets for franked distributions (Division 67 of the ITAA 1997) would be permanently disadvantaged under Option 1.

d) The Consultation Paper is silent as to the tax implications that may arise where the public university invests or loans funds to its wholly owned subsidiary in order to fund the development of its unrelated commercial activity. Based on our experience in other jurisdictions, a charity may lose access to part or all of its tax concessions where it invests in subsidiary trading companies at either start-up or subsequent stages. We strongly recommend that such investment activities should not result in a public university losing access to its tax concessions.

e) The Consultation Paper is silent in relation to the operation of the tax consolidation regime and the ability of NFP subsidiary entities to form a tax consolidated group. We strongly recommend that the Government include measures to ensure NFP subsidiaries are eligible to form a tax consolidated group to enable, amongst other things, tax losses of a NFP subsidiary to be offset against taxable profits of related NFP subsidiaries.

f) We also recommend the Government clarify the application of the loss recoupment tests to the NFP sector to ensure start-up and early stage losses are available to offset against future taxable income.

Option 2 (Profits arising from unrelated commercial activities in a separate entity taxed if retained at the end of the year)

Option 2 will also require unrelated commercial activities of NFP entities to be transferred into separate entities with similar restructuring costs and impediments as Option 1.

This option will be necessary for NFP entities that are ineligible for refundable tax offsets for franked distributions (Division 67 of the ITAA 1997) to alleviate the problem with Option 1, unless the range of entities eligible for such offsets is extended, as a consequential amendment as part of these reforms.
Option 2 would need to cater for distributions of profits arising out of unrelated commercial activities to NFP entities by way of simple payment, gift and/or other form of distribution such as a dividend.

The major issue faced by NFP entities under Option 2 would be the practical difficulty of calculating profits arising out of unrelated commercial activities before year end in order to determine the amount that must be distributed before year end. A necessary enhancement to this option would be to allow the separate entity a period of six months after the end of the year to calculate and distribute profits arising out of unrelated commercial activities to a NFP entity.

**Option 3 (NFP entities can undertake unrelated commercial activities subject to tax in the NFP entity)**

Option 3 may be necessary in circumstances where a public university is unable to restructure any unrelated commercial activities for various reasons, such as those referred to above at Option 1.

Under this option, it will be critical that the relevant provisions allow a NFP entity undertaking unrelated commercial activities within the entity to be able to achieve a consistent outcome to Option 2, that is, if the profits of unrelated commercial activities are applied by the NFP entity to its core purposes within the required time frame (again, we recommend a period of six months from the end of income year), then no income tax will arise in relation to those profits.

As indicated previously, in the public university sector, many of the resources that may be used for unrelated commercial activities may also be used to carry out core purpose activities. Accordingly, determining the taxable profit associated with each unrelated commercial activity a public university may undertake during the income year is likely to be an extremely complex compliance exercise. It will be time consuming and costly to trace how resources are applied to each unrelated commercial activity and, in some cases, it may be impossible due to a lack of information or unsophisticated reporting systems.

If Option 3 is adopted by a public university, we again stress that the university's DGR status should not be impacted by the presence of any unrelated commercial activity. Public universities are reliant on donations from the public and private sector and the removal of its DGR status would be detrimental to their on-going viability or require increased Government funding.

5. **Which option do you prefer and why?**

As indicated above, in order to minimise unintended consequences resulting from these reforms, we submit that all three options contained in the Consultation paper be available as elective options for NFP entities, including the suggested enhancements discussed above.

6. **Would we need to proceed with more than one option?**

Yes. Please refer to the response to Question 4 and 5 above.

7. **Would assistance be required to transition to the new arrangements?**

Yes. Due to the lack of clarity in how the proposed reforms will apply to the public university sector, at a minimum, the sector will require clear guidelines in the legislation, explanatory memorandum and from the Australian Taxation Office on how the new arrangements are to be applied practically. Once provided, the public university sector will be better placed to advise on the assistance required to transition to the new rules.
At a minimum, assistance is likely to be required from the Government in the form of additional funding and/or expert personnel to transition effectively to the new arrangements.

8. **What costs will need to be borne by the entity?**

The following is a list of potential costs likely to be borne by public universities to comply with the proposed reforms:

- Costs associated with changes and upgrades to accounting and reporting systems
- Advisors to assist in resetting strategic goals, funding models, management processes, etc
- Consultancy fees to assess how the new arrangements will apply to their organisation
- On-going compliance costs
- Hiring new staff and up-skilling existing staff to undertake new compliance work
- Costs arising from industrial action taken by university staff in respect of the impact of the proposed reforms

In addition to the above, if the proposed reforms require the public universities to restructure their unrelated commercial activities into a separate entity, the following costs are likely:

- Legal fees
- Consultancy fees
- Accounting and tax (direct and indirect taxes)
- Valuation costs
- Transaction taxes (including stamp duty)
- Compliance costs
- Payroll tax issues

9. **What are the implications of longer versus shorter transitional periods?**

*Substituted Accounting Period NFP Entities*

If the proposed reforms apply to the public university sector, we submit that the start time for the proposed reforms (including start time for the transitional period) should be 1 July 2013.

If the entity has a substituted accounting period, the proposed reforms should commence from the beginning of the first income year following 1 July 2013.

This is in line with the start time for the proposed definition of “charity” for Australian tax purposes and will give the public university sector sufficient time to understand, plan and put in place systems necessary to satisfy the proposed reforms.

If unrelated commercial activities are to be subject to income tax, the public university sector would prefer that all unrelated commercial activities be subject to taxation from the same date (i.e. 1 July 2013). This would reduce the complexities and compliance costs associated with identifying “new activities” as contemplated at Question 12 of the Consultation Paper.

If the Government proceeds with a shorter transitional period, the following difficulties are likely to arise:

- Public universities may not have sufficient time to implement the changes required to comply with the proposed reforms, such as restructuring unrelated commercial activities, implementing new reporting systems and training in-house staff;
• Unexpected issues with the application of the proposed reforms to the public university sector may not be identified and rectified by the Government prior to the end of the transitional period.

Accordingly, if a transitional period is legislated, the public university sector would prefer a longer transitional period to apply.

10. Would identification of the existing activity be by reference to the overall business or to particular activities? Provide examples including an explanation of the nature of the activity/activities

As stated in Question 9, the public university sector would prefer that all unrelated commercial activities be subject to taxation from the same date (i.e. 1 July 2013). However, if the Government chooses to commence taxation of new activities earlier than existing activities, this question needs to be considered together with Question 12 (identifying a new activity), to ensure that a consistent approach is adopted.

To minimise uncertainty and complexity, we submit that an overall business approach should be used to ascertain whether an activity is an “existing” activity or a “new” activity. However, we submit that the “same business test” (SBT) contained in section 165-210 of the ITAA 1997 would be too onerous a test to apply in these circumstances. The SBT in its current form is a loss integrity measure designed to prevent loss trafficking and requires a number of stringent, specific tests to be satisfied, in order to utilise the losses. That SBT is not appropriate in the context of determining eligibility for tax concessions for the NFP sector.

However, a modified version of the SBT in section 165-210 may be suitable. The modified version of the SBT should exclude the “new transaction” and “new business” tests contained in subsections 165-210(2), (3) and (4) of the ITAA 1997.

Application of the SBT modified in the manner above, would support our recommendation that identification of the existing activity be by reference to the overall business rather than to particular activities. By way of example, if a university already had numerous food outlets on university grounds prior to 10 May 2011, and a further food outlet was opened on university grounds after this time, this should not be considered a “new activity” but rather the “organic growth” of the existing activity for the purposes of the proposed reforms.

11. Should activities intended to be carried on or contracted to enter into before 7:30 pm (AEST) on 10 May 2011 be included? How would these be evidenced?

No. New activities commenced by a NFP entity after 7.30pm (AEST) on 10 May 2011 should be considered “existing activities” (and therefore should not fall under the proposed reforms) where the entity was “practically committed” to these activities before that time.

Broadly, the date/time an entity will be “practically committed” to undertake an activity should be evidenced by the following documents:

• If a contract exists, the date of execution of that contract;
• If no contract exists, documentary evidence of the entity’s practical commitment (e.g. board approval) to undertake the activity.

Where no such evidence exists, the Commissioner of Taxation should be given a discretion not to apply the proposed reforms where, based on an objective assessment of the relevant facts, the
Commissioner is reasonably satisfied that the public university was "practically committed" to undertake the activity before 7:30pm (AEST) on 10 May 2011.

12. What should be the test for identifying new activities?

This question needs to be considered together with Question 10 (identifying an "existing" activity), to ensure that a consistent approach is adopted. Please refer to our comments and recommendations in response to Question 10.

13. What is an acceptable time limit for allowing tax concessions for existing government service delivery? Why?

Universities enter into various State and Federal Government service delivery agreements, including agreements with the Department of Education, Employment and Workplace Relations and the National Health and Medical Research Council.

We submit that tax concessions should continue to apply to these and other existing government service deliveries throughout the duration of the contract (including any extensions of the term of those contracts). This would ensure that there is no adverse impact on overall service delivery and no loss of commercial viability.

14. Will the continuation of the 'rule of books' model in Division 57 in Schedule 2f of the ITAA 1936 achieve an appropriate transition from exemption to taxable status?

No. Division 57 sets out the process for determining the value of assets and liabilities upon a tax exempt entity becoming taxable. Division 57 also contains rules in respect of derivation and incidence that override the general rules.

A practical issue that arises from Division 57 is that a close examination of each account is necessary to determine its tax effect. This will be time-consuming and involve significant compliance costs.

In addition, Division 58 of the ITAA 1997 may also give rise to issues. Division 58 sets out the process for determining the starting cost and current written down value of depreciable assets that were either:

- Held by a tax exempt entity that is now taxable; or
- Held by a tax exempt entity and then sold to a taxable entity.

Under Division 58, there are two methods for determining the starting cost of a depreciable asset. These are the:

- Notional written down value method ("NWDV method")
- Un-deducted pre-existing audited book value method ("PABV method")

Under Division 58, the following practical issues arise:

- Many of the long established public universities may not have sufficient records to trace the original acquisition cost of many of their assets as required by the NWDV method;
- Even where the records exist, the cost of ascertaining that information may be prohibitive;
- The university may not have had audited accounts as at the prescribed date and therefore cannot use the PABV method under the current provisions;
- The unusual nature of many assets employed by universities may mean that there is no prescribed effective life for a particular asset. Under the current legislation, there is no option to self assess the effective lives of depreciating assets; and
- The university may not have sufficient information to use either method.

Division 57 and Division 58 contain an extremely complicated set of rules and the application of these rules will be beyond the capability and resources employed by many public universities. Accordingly, the Government should consider implementing a less complex set of rules. Alternatively, if the Government does rely on the "rule of books" model in Division 57 and Division 58, concessions will need to be available for the public university sector.

15. Are there any other factors to consider in transferring a taxable function or activity of an exempt entity to a separate entity?

As indicated in our response to Question 4 and Question 8, the following issues must be considered when transferring a taxable function/activity of a public university to a separate entity:

- Legal fees
- Consultancy fees (including issues arising from the governing document of the entity)
- Accounting and tax (direct and indirect taxes)
- Valuation costs
- Transaction taxes (including stamp duty)
- Compliance costs
- Payroll tax issues
- Costs associated with changes and upgrades to accounting and reporting systems
- Hiring new staff and up-skilling existing staff to undertake new compliance work
- Costs arising from industrial action taken by public university staff in respect of the impact of the proposed reforms

To alleviate the compliance costs associated with these reforms, the Government should also allow a refundable tax offset or an immediate deduction for capital expenditure incurred by public universities relating to the implementation of the proposed reforms and any related restructuring costs.

16. Other Issues

Passive income exemption

The Consultation Paper states that "the reforms will not affect the passive income of NFP entities" (at paragraph 5). At paragraph 37, the Consultation paper further states that "The reforms will also not affect the passive investment activities of NFP entities". At page 36 of the Consultation Paper, there is a section titled "passive investments" which provides five examples of passive investments held by charities to raise funds to further charitable purposes.

We support the proposed exclusion of passive income/passive investment activity from the proposed reforms.

It is unclear whether the proposed exclusion would operate by reference to type of income (i.e. passive income) or by reference to the type of activity (i.e. passive investment activity) and how the
relevant concept may be defined. Whichever approach is taken, the definition of the relevant concept needs to be drafted broadly to suitably accommodate the wide range of passive income that may be derived by entities in the NFP sector.

We would tend to support an exclusion determined by reference to the type of income rather than an activity based test. A passive income test may be relatively simpler to define and easier to practically administer. For example, the definition of "passive income" in section 6(1) of the ITAA 1936 could be a suitable precedent. It covers the following:

"Passive income, in relation to a taxpayer, in relation to a year of income means:

a) dividends (within the meaning of this section) and non-share dividends paid to the taxpayer in the year of income; or
b) unit trust dividends (within the meaning of Division 6B or 6C) paid to the taxpayer in the year of income; or
c) a distribution made to the taxpayer in the year of income that is taken to be a dividend because of section 47; or
d) an amount that is taken to be a dividend paid to the taxpayer in the year of income because of section 47A or 108 or Division 7A of Part III; or
e) interest income derived by the taxpayer in the year of income; or
f) annuities derived by the taxpayer in the year of income; or
g) income derived by the taxpayer by way of rent (within the meaning of Part X) in the year of income; or
h) royalties derived by the taxpayer in the year of income; or
i) an amount derived by the taxpayer in the year of income as consideration for the assignment, in whole or in part, of any copyright, patent, design, trade mark or other like property or right; or
j) profits of a capital nature that accrued to the taxpayer in the year of income; or
k) passive commodity gains that accrued to the taxpayer in the year of income; or
l) an amount included in the assessable income of the taxpayer of the year of income under section 102AAZD, 456, 457 or 459A;

but does not include:

m) an amount that arose from an asset necessarily held by the taxpayer in connection with an insurance business actively carried on by the taxpayer; or
n) an amount included in the taxpayer's assessable income under Division 83A of the Income Tax Assessment Act 1997 (about employee share schemes)."

For the avoidance of doubt, proceeds in relation to a CGT event that occurs to an asset which was used, or intended to be used, to produce passive income for the NFP entity should also be excluded from taxation under the proposed reforms.