Balancing Act

Issue 13

Legal and tax affairs for the non-profit industry

June 2009

The urge to merge

Issues for not-for-profits to consider

In this issue...

MAKINSON & d'APICE

LAWYERS

The urge to merge

Merger is often considered a dirty word in the not-for-profit sector. It implies aggressive and predatory behaviour which is anathema to a sector that has assembled itself to dispense benefits to a society. A "merger", in the commercial sense, denotes 'hostility', 'takeovers' and 'targets'. This is contrary to the image most people have of the not-for-profit, or third, sector, as being conciliatory, collaborative and philanthropic. Nevertheless, despite the distaste some within the sector may have at being paralleled with commercial enterprises, as the global financial crisis rolls on and the balance sheets of many not-for-profit organisations[1] (**NFPs**) become increasingly strained, "merging" may the bitter pill that a shrewd board or committee will have to swallow to continue to secure and pursue its organisation's mission.

"Two NFPs may decide that each would be better off working together and sharing resources"

But just how bitter is that pill? Some literature suggests that mergers amongst NFPs are broadly viewed in the context of collaboration and partnership[2] and they are just another form of joint working, such as joint ventures, partnerships on projects or sharing resources.[3] It is not only floundering NFPs that may seek suitable merging partners; healthy organisations may also seek out opportunities to formally combine resources with organisations having a similar mission.[4] So, what makes one board accept merging as a natural step in the evolution of an NFP, whilst others sputter and choke at the "M" word? I would suggest that education, information and legislation are all barriers to how merging in the third sector can open up new opportunities for NFPs to better deliver their objects to their respective subjects.

What is a merger?

A merger occurs where two things combine to make a single thing. It is, perhaps, that the result of a merger is one NFP where two used to exist, that is cause for concern for many boards and committees, particularly if they consider their own organisation to be the weaker of the coalescing entities. The UK Charities Act 2006 defines a merger in two ways:

- where two organisations agree to merge and one of the organisations transfers all of its property to the other and then ceases to exist; or
- where two organisations agree to merge and both transfer all of their property to a new organisation, following which, both original organisations cease to exist.

In Australia, NFPs are presented with the same options, albeit slightly more complicated depending upon where or how each of the NFPs has been incorporated.

Australian merger options

An Australian NFP may incorporate under the Associations Incorporation legislation in its relevant state or territory, or it may elect to register under the *Corporations Act* 2001

(Continued on page 2)

The urge to merge

(Continued from page 1)

(Cth). This presents the following merging options:

1. one incorporated association may agree to transfer all of its property to another incorporated association and then cease to exist;
2. two incorporated associations may decide to merge to form a new incorporated association, following which, both original organisations cease to exist;
3. an incorporated association and a public company limited by guarantee may decide to merge and, depending on the state/territory legislation, may form a new public company limited by guarantee (whereby both original organisations cease to exist); or the incorporated association may transfer its property to the public company limited by guarantee (whereby the original incorporated association ceases to exist); or
4. two public companies limited by guarantee may decide to merge.

Benefits of a merger

The urge to merge arises when two NFPs decide that each would be better off working together and sharing resources, than forging on alone. What drives the decision makers of each organisation to reach this conclusion is, typically, a direct response to a financial crisis. However, this is not the only driver. Mergers may also occur when there is a change in leadership or when there is a major shift within an industry. The allocation of Government grants may also trigger the decision to merge.[5] Whatever the trigger, the decision to merge, as with any other major decision made by an NFP, should always be taken in order to provide a better service to those people the NFP was established to serve.

The benefits of merging can be grouped into three areas: protecting and investing in a valuable asset; efficiency savings; and exploiting synergies.[6]

1. Asset protection & investment

As most mergers occur as a means of rescuing a failing NFP, it implies that protecting something valuable is a key reason for merging.[7] It may be a brand that requires the protection of a merger for its continued survival or perhaps a community service. If an NFP is financially unable to invest in its asset, be it a brand or service for example, a merger with another NFP with a similar mission is a valid strategy to ensure not only the survival of that asset but, perhaps, even the improvement of the asset.

2. Efficiency savings

There are definite and obvious savings advantages that arise following a merger between two organisations. In a UK Charity Commission survey, 54% of respondents reported that a prime motivation for merging was to increase efficiencies.[8] With around 700,000 NFPs in Australia, there is considerable duplication occurring between NFPs.

Merging can deliver opportunities to exploit economies of scale by centralising some of an NFP's administrative functions, for example, membership database maintenance, accounting, publishing and organising events.[9]

If information about the activities of Australia's NFPs was more readily available and more easily accessible, and could be relied upon as being accurate, NFPs would be better able to identify merger opportunities in overlapping markets and take advantage of the potential savings such a move could deliver.

3. Exploiting synergies

As well as providing prospects for exploiting economies of scale, a

(Continued on page 8)

Legislaction — Federal

The Commonwealth Government has, in recent days, finally responded to the report prepared by the Senate Standing Committee on Economics on its inquiry into "Disclosure Regimes for Charities and Not-For-Profit Organisations". The Committee published its report in response to the Inquiry on 4 December 2008. A full copy of this report and the response are available at http://www.aph.gov.au/senate/committee/economics_ctte/charities_08/index.htm.

You will immediately notice the brevity of the response. In many instances the responses to the individual recommendations are, in fact, shorter than the recommendations themselves. Further, the response to each key recommendation appears to be substantially the same. Each response seems to note the intent of the recommendation and proceed to state that the issues mentioned in that particular key recommendation will, somehow or other, be considered in other reviews which are currently taking place in the third sector in Australia, such as the Henry Review and the Productivity Commission's Review.

The Commonwealth Government has not expressly committed itself to any of the recommendations. The only recommendation it has clearly agreed to is the first recommendation which deals with standardising the terminology used in the third sector. The response also refers to the Council of Australian Government's Business Regulation Competition Working Groups' (COAG BRCWG) agenda for the year, which apparently will discuss some of the issues mentioned in the recommendations.

There does not appear to be any specific program for the ongoing discussion of the key recommendations. The response only refers to the programs of the Henry Review, the Productivity Commission's Review and the agenda of COAG BRCWG for the year 2009. There are only six months remaining within this calendar year, and yet there does not appear to be any program in place beyond December 2009. Further, the response does not refer to any ongoing deadlines by which the Commonwealth Government is to respond to each of the key recommendations beyond its short response to date.

The response, in our opinion, is somewhat anti-climactic and the third sector will, once again, be required to wait for any actual reforms to occur.

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Actions speak louder than *Word*(s)

The most relevant announcement for the non-profit sector within the 2009 Federal Budget was from the Assistant Treasurer, Chris Bowen, on the Government's interim response to the High Court of Australia's decision in *Federal Commissioner of Taxation v Word Investments* (***Word***) on 3 December 2008.

This decision confirmed that an entity conducting a business to raise funds for a charity may also have a charitable purpose.

Government response

The Government intends to overturn the decision to prevent charities and other income tax exempt entities from directing funds to overseas projects outside the current restrictions.

One of the current requirements for charitable institutions to obtain tax exempt status is to have a 'physical presence' in Australia and incur its expenditure and pursue its objectives principally in Australia. 'Expenditure', for these purposes, includes distributions for charitable purposes and is incurred in Australia when a liability in Australia is discharged or where money is paid in Australia.

> ***"An entity conducting a business to raise funds for a charity may also have a charitable purpose."***

The proposal is for an amendment to the 'in Australia' requirements above in Division 50 of the *Income Tax Assessment Act* 1997, which will ensure that the place of expenditure is analysed before tax exempt status is granted. This proposed change will be subject to public consultation and will take effect from the date of Royal Assent of the amending legislation.

The Court's approach to the 'charitable institution' definition was also identified by the Government for further consideration, as it raised issues in relation to competitive neutrality. According to the High Court decision, although the commercial fundraising activities of Word were not intrinsically charitable, they were charitable in character because they were carried out in furtherance of a charitable purpose.

However, it was noted that any reforms to the charitable sector are pending the outcome of the Henry Review into Australia's future tax system and the Productivity Commission's inquiry into the contribution of the not-for-profit sector. The Government acknowledged that it would be pre-emptive for it to determine the most appropriate reform for the charitable sector while these specialised reviews were being conducted.

Australian Tax Office (ATO) response

The ATO released a Decision Impact Statement on 26 May 2009 to state its response to this decision.

The ATO accepts that the principles considered by the High Court have equal application to the possible characterisation of an entity as a religious institution, a scientific institution or a public educational institution. Accordingly, the High Court decision in *Word* will be taken into account by the ATO in determining the status of entities seeking exemption as one of these institutions. Nevertheless, the outcome in each claim for exemption will depend on an examination of the objects of the entity and the application of those objects in its activities.

The ATO advised that Taxation Ruling TR 2005/21[1] and Taxation Ruling TR 2005/22[2] will be amended as some of the views expressed in these rulings are contrary to the views expressed in this decision. In addition, Taxation Ruling TR 2000/11[3] will be amended to include a discussion of the Court's views and a number of ATO documents will be reviewed.

1 Income tax and fringe benefits tax: charities (as at 21 December 2005).
2 Income tax: companies controlled by exempt entities (as at 21 December 2005).
3 Income tax: endorsement of income tax exempt charities (as at 28 June 2000).

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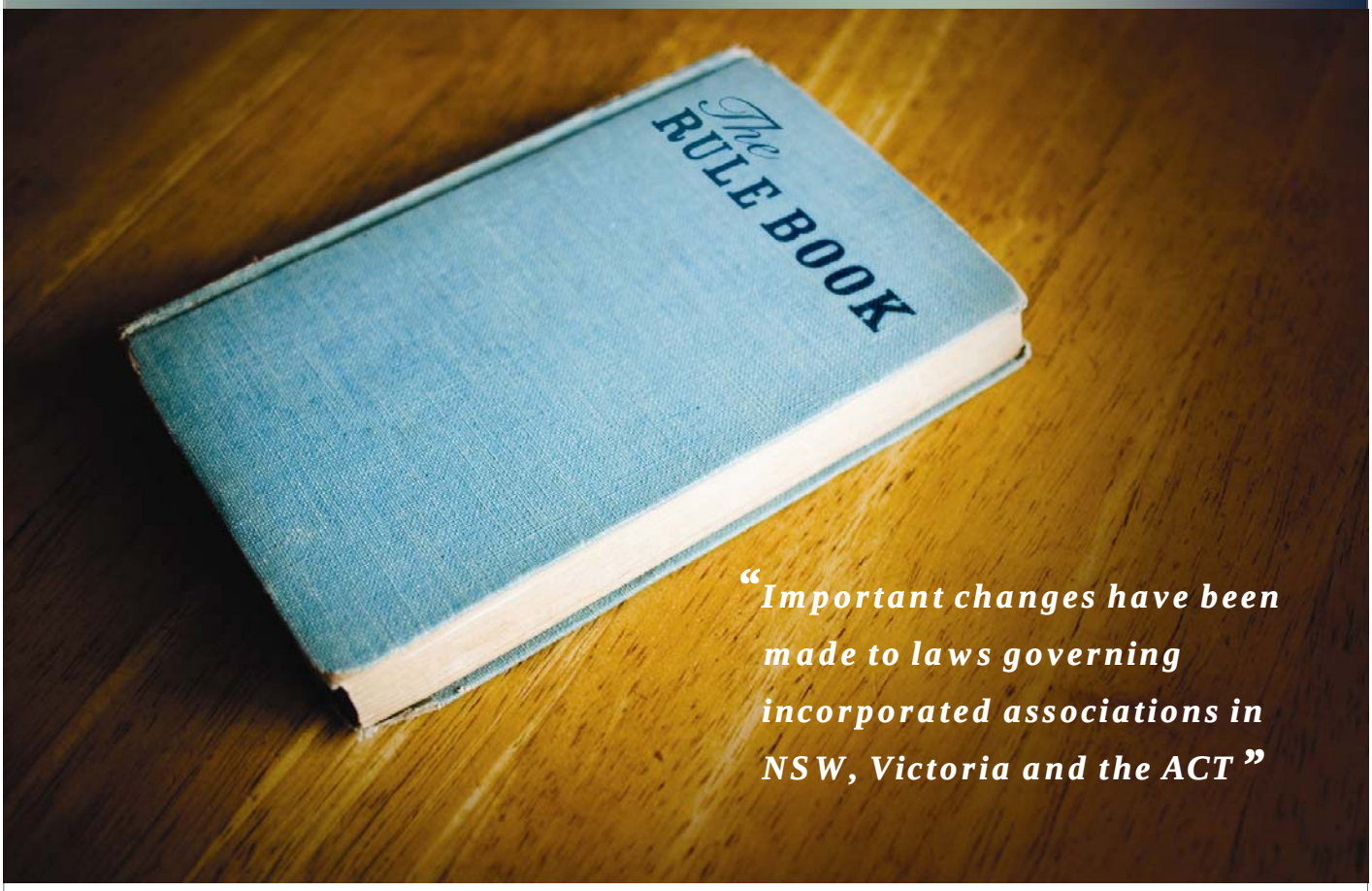

"Important changes have been made to laws governing incorporated associations in NSW, Victoria and the ACT"

Legislative changes to the law governing associations

Incorporated associations throughout Australia operate subject to the applicable state legislation governing associations in the State or Territory within which the association was incorporated. The distinct State legislation allows for the creation and dissolution of certain types of associations and regulates the conduct of their affairs.

With approximately 70,000 incorporated associations in New South Wales and Victoria alone, it is important that the legislation governing the operation of incorporated associations is kept current so as not to become unnecessarily arduous or dated. New South Wales, Victoria and the Australian Capital Territory have all, to varying degrees, recently introduced new or amending laws aimed at modernising, simplifying, and/or enhancing the law relating to associations.

New South Wales

The Associations Incorporations Bill 2009 was assented to on 7 April 2009 and is likely to come into effect during late 2009. When the Bill is proclaimed, it will repeal the *Associations Incorporation Act* 1984 (NSW) (**1984 Act**) and be known as the *Associations Incorporation Act* 2009 (NSW) (**New Act**). Until that time however, the 1984 Act remains in place and incorporated associations should continue to operate in accordance with that Act.

(Continued on page 6)

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Legislative changes to the law governing associations

(Continued from page 5)

Some important changes that the Bill proposes include:

Financial reporting

The New Act introduces a two-tiered system to financial reporting which distinguishes between large (Tier 1) and small (Tier 2) associations. The purpose of the distinction is to enable tighter reporting and auditing requirements to be imposed on Tier 1 associations. Tier 1 associations will be required to have their financial statements audited annually, while Tier 2 associations will be exempt from this requirement. The New Act does, however, provide the Commissioner for Fair Trading with the power to exempt certain Tier 1 associations from the auditing requirements, and conversely, the power to direct certain Tier 2 associations to be subject to the auditing requirements.

The 'two tiers' will be distinguished by a financial threshold which will be set out in the regulations. A threshold of $200,000 in gross annual receipts is currently being considered, however the regulations have not as yet been drafted. The public will be given the opportunity to comment on the draft regulations when they are released later this year.

Disclosure of interests

The New Act imposes a duty on committee members to disclose any potential conflict of interest in a matter to be considered at a committee meeting and must not (unless otherwise determined by the committee) be present during any deliberation or take part in any decision by the committee in relation to that matter.

Other administrative changes

- Australian residency — The association's public officer must be a resident of NSW and at least three of its committee members must reside in Australia.
- Flexibility for meetings — Associations will be able to hold a postal ballot to pass a resolution and/or permit a meeting to be held at more than one venue using technology that accommodates this, where the association's constitution so allows.
- Constitution — The term 'constitution' will be substituted for the term 'rules'.
- Common seal — An association will no longer be required to sign documents under a common seal.
- Document handover — Outgoing public officers and committee members must hand over all records and documents relating to the association within 14 days of ceasing to hold office.
- Penalty notice — Offences under the New Act can be dealt with by way of a penalty notice.
- Association's name — An association can be ordered to change its name where an association's name is deemed unacceptable.

Victoria

The *Associations Incorporation Amendment Act* 2009 (Vic) (**Amendment Act**) was assented to on 7 April 2009 and certain sections of that Act came into effect on 8 April 2009. Other sections of the Amendment Act will not come into operation until a fixed date, or where no such date is fixed, on 1 December 2011. The Amendment Act amends the *Associations Incorporation Act* 1981 (Vic) .

Some important changes that the Amendment Act introduces include:

Public officer

The role of the 'public officer' and the 'secretary' have merged and been replaced with 'Secretary'. As this change will require changes to the rules of an association, it will have a delayed date of effect.

Oppressive conduct

A member of an incorporated association will have the right to apply to the Magistrates' Court of Victoria for an order preventing an incorporated association from engaging in oppressive conduct. 'Oppressive Conduct' is defined as conduct that is unfairly prejudicial to, or unfairly discriminatory against, a member of an incorporated association or is contrary to the interests of the members of the incorporated association as a whole.

(Continued on page 7)

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LAWYERS

Legislative changes to the law governing associations

(Continued from page 6)

Document handover

Like the New Act in NSW, the Amendment Act prescribes a deadline by which outgoing office holders and committee members must hand over documents relating to the association once they cease to hold office. They must do so within 28 days of ceasing to hold office.

Removal of auditor

Auditors can now be removed from office by resolution of members at a general meeting.

Statutory manager

The Registrar can, after investigation of the affairs of an incorporated association, appoint a statutory manager to that association, where the Registrar considers it is in the best interests of the association, its members or the public. All committee members cease to hold office on such an appointment and the statutory manager will have a range of powers to deal with the affairs of the incorporated association.

Voluntary cancellation/administration

Small incorporated associations which meet certain requirements (including having gross assets of less than $10,000) will now be allowed to apply to the Registrar for the voluntary cancellation of its registration (therefore removing the need to appoint a liquidator). The voluntary administration provisions of the *Corporations Act* 2001 (Cth) (with certain amendments) will now apply to incorporated associations.

Distribution of assets

The surplus assets of an incorporated association are now prevented from being distributed to members on winding up, unless the member is a body corporate which itself cannot distribute assets to its members.

Minutes of meeting

The rules of an incorporated association must now require that accurate minutes of meetings are prepared and kept, and provide members with access to the minutes of general meetings. As this change will require changes to the rules of an association, it will have a delayed date of effect.

"Associations must ensure that they can and will comply with the changes in the law"

Australian Capital Territory

The Associations Incorporation Amendment Bill 2009 will, when passed, amend the *Associations Incorporation Act* 1991 (ACT) (**1991 Act**). The Bill only proposes one amendment to the 1991 Act. That change will allow a person whose address is contained in any document lodged with the Registrar-General to request (in writing) that that person's address be kept confidential and the Registrar-General must ensure that this occurs.

Conclusion

The changes outlined above will impact upon all of those associations within New South Wales, Victoria and the ACT which are incorporated. If you are an incorporated association or you are an association or group considering incorporation, you should review the new laws carefully to ensure that you can and will comply with the changes. The above summary does not include all changes that have been made to the law regulating associations. If you would like any further information in relation to the changes, please feel free to contact us.

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The urge to merge

(Continued from page 2)

merger can also create opportunities for NFPs to exploit links and contacts and to share knowledge and skills in order to be better equipped to achieve the ultimate mission of both original NFPs. 'Synergy', in the context of mergers, has been described as:

> "*…the notion that the value of [an NFP] formed by the union of two organisations is greater than the sum of its parts.*"[10]

The merger of two NFPs may give the new organisation greater authority and robustness in negotiations with governments or potential corporate donors or sponsors. A stronger influence may be created merely by increasing in size and a stronger brand is helpful for income generation.[11]

Objections to mergers

Of course, mergers are not a panacea for the financial pressures that many NFPs experience. Mergers are costly and, if proper due diligence is not conducted prior to embarking on this course, a merger may merely result in large expenditure for little or no return. Again, the central question has to be whether the merger will increase the service delivered to the intended beneficiaries.

Loss of representation

There is often concern, when the idea of a potential merger is first floated by the managing body of an NFP, that the absorption of smaller organisations by larger, more powerful entities will threaten the ability of communities to represent themselves.[12] It is believed that small, niche groups are more responsive to the needs of their beneficiaries. This is, however, a belief that is not necessarily based on corroborated data.

"*The name of the new NFP will be important to retain brand recognition*"

The 'perfect' size of an NFP depends entirely on its functions. Irrational prejudices about the size of an NFP should be displaced by considerations on what would be most effective to deliver the best services to the beneficiaries. For example, community-based issues may be better served by smaller, local organisations. However, where large-scale investment is required, for instance in areas such as medical research, a larger organisation that is able to invest greater sums of money or that has greater lobbying power, is likely to be more efficacious.

Loss of brand

Naturally, for the organisation being absorbed (or both organisations, if a new NFP is being established as a result of the merger), there is concern that hard-earned, valuable brands may be lost or irreparably damaged following a merger.[13]

The importance of an NFP's brand cannot be overstated. It is an NFP's brand that gains the public's trust and attracts both philanthropists and beneficiaries. Public perception and confidence in an NFP is not easily won and it is not unreasonable for NFPs to want to jealously guard against losing what, in effect, legitimises their existence.

However, whilst there is always a risk of brand damage, if thorough and attentive due diligence has been undertaken, case studies have shown that the value of a brand, even where it is entirely subsumed into another organisation, can still be retained.[14] In the UK, when the larger National Society for the Prevention of Cruelty to Children merged with a charity called ChildLine, each was careful to ensure that the distinct and unique brand of the smaller ChildLine was preserved.[15]

(Continued on page 9)

The urge to merge

(Continued from page 8)

Taxation implications

It is prudent, before making preparations to merge, for each organisation to consider the tax implications that may arise as a result of this action. In particular, stamp duty and capital gains tax (CGT) advice should be sought prior to any formal steps being taken towards merging. For example, CGT may apply due to the disposal of a CGT asset. The state or territory stamp duty legislation must be reviewed to discover whether an exemption from stamp duty applies.

Further, the tax status of the merging organisations must be considered. If the organisation is an exempt entity pursuant to section 50 of the *Income Tax Assessment Act* 1997 (Cth), a capital gain will be exempt from income tax.

This is a complex area and one that should be given proper consideration and expert determination.

> *"There are a range of factors that NFPs should consider carefully before deciding to implement a merger"*

Other major merger issues

Unlike in the for-profit arena, mergers in the third sector are not generally an aggressive strategic attack in which the law of 'survival of the fittest' applies and the result is, necessarily, the annihilation of the 'target' organisation. Mergers invariably fail in the third sector where one or both of the parties see the merger as something to be won or lost;[16] where personal conflicts, ideological differences or resistance from staff or beneficiaries exist.[17] Third sector mergers must be a collaborative project undertaken by willing participants. The most important reason to merge is to enable each of the merging NFPs to tap into the complementary strengths of the other.[18] For this reason a merger is best considered before it becomes a necessity.

Deciding to merge, prior to the ravages of a global economic crisis taking hold, affords organisations the luxury of having time to carefully consider all of the issues which are often submitted as the predominant reasons not to merge. For example, the name of the new NFP will be important to retain brand recognition and relationships with the public. The direction of the new organisation, its goals, its constitution and objects, can all be allocated time for adequate consideration. Governance issues and human resources must also deliberated and decided upon.[19]

Naturally, an important issue for consideration is whether the benefits anticipated to be gained, outweigh the costs that will inevitably be incurred. It can be difficult to assign a financial value to exploiting synergies or determining just how improved economies of scale will directly translate into benefits to those who are served by the NFP.[20]

The legalities

As mentioned above, the process by which the merging of two NFPs is undertaken is a costly exercise. Many of the costs arise as a direct result of obstacles caused by the legislative framework of the third sector in Australia.

Unlike the corporations law, there is no single, national piece of legislation governing the sector. Consequently, decisions will have to be made at the commencement of the process as to the current and future activities of the NFP in order to determine

(Continued on page 10)

The urge to merge

(Continued from page 9)

the appropriate corporate vehicle to employ.

Where two incorporated associations decide to merge, a decision has to be made as to where the new NFP will be incorporated. For example, if it is foreseen or intended that it will carry on its activities across state/territory boundaries, registration as a public company limited by guarantee under the *Corporations Act* 2001 (Cth) is appropriate.

The law relating to how NFPs may merge depends upon where the original NFPs are incorporated. The differences between the legislation of the states and territories can be quite distinct. For example, in New South Wales, the process for two incorporated associations to merge is set out in section 46 of the *Associations Incorporation Act* 1984, however, the Western Australian legislation is silent on this matter.

The *Associations Incorporation Act* 1987 (WA) does however, along with the corresponding South Australian legislation, provide for an incorporated association to merge with an existing public company limited by guarantee. In the other states and territories, the activities of an incorporated association can only be transferred to a newly created public company limited by guarantee, that is, the association becomes the public company limited by guarantee. Realistically, then, in the states and territories other than South Australia and Western Australia, a genuine merger between an incorporated association and a public company limited by guarantee is not possible. To untangle the knot of legislation, particularly where the NFPs are incorporated under different legislation, be it state/territory or Commonwealth legislation, it is recommended that legal advice be sought early in the decision making process.

Conclusion

Just as changes to the economic climate and the technologies and methodologies employed in doing business are forcing corporations to consolidate and merge, so too will NFP managing bodies have to look closely and carefully at undertaking mergers.[21] Despite there being an absence of the obvious incentives that exist for corporations to merge, that is increased dividends or shareholdings, etc, NFPs will need to begin their considerations on whether to merge before the next crisis seizes them. To this end, the third sector needs to be provided with:

- more opportunities to access information on the activities of other NFPs;
- education for board and committee members on the benefits of merging (as well as the risks); and
- streamlined legislation that reduces the costs of undertaking a merger and encourages the merging of NFPs to create a stronger, more effective sector.

To play an active part in the world that emerges after the global economic crisis, the third sector must innovate and refresh and face up to the realities of the social and economic changes that will, of necessity, occur.[22] An openness and a readiness to merge will give NFPs the flexibility they will require in order to maintain their relevance, legitimacy and, above all, to deliver the essential services that are provided by NFPs and that underpin a civil society.

Claire Russell is a solicitor at Makinson & d'Apice.

1 This article focuses on incorporated organisations only.
2 Cabinet Office Strategy Unit (UK), "Private action, public benefit: providing flexibility for charities to evolve and merge", (2002).
3 Copps, J, "What place for mergers between charities?", New Philanthropy Capital, June 2009.
4 Taylor, R.W, "Tying the Knot: Association Mergers", ASAE & The Center for Association Leadership, December 2000, downloaded from http://www.asaecenter.org/PublicationsResources on 2 June 2009.
5 Copps, above n 3, p 6.
6 Ibid.
7 Ibid.
8 Ibid.
9 Peacock, J, "The Case for Single-Entity Associations", NFP Analysts, 7 June 1999, at http://www.nfp.net.au/mgnt/Single_Entity.htm downloaded on 2 June 2009.
10 Copps, above n 3, p 6.
11 Ibid, p 7.
12 Ibid.
13 Ibid, p 8.
14 Ibid.
15 Ibid.
16 Taylor, above n 4.
17 Copps, above n 3, p 13.
18 Taylor, above n 4.
19 Ibid.
20 Copps, above n 3, p 13.
21 Taylor, above n 4.
22 Copps, above n 3, p 23.

Balancing Act

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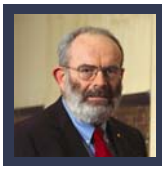

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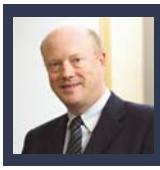

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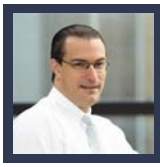

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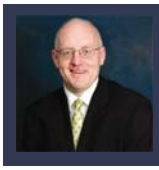

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Issue 12, March 2009

- When is a gift no longer a gift?
- Legisl*action* — Federal
- Fundraising at a time of crisis — opportunity or risks?
- Legisl*action* — States & Territories

Issue 11, December 2008

- A new era for charities and non-profits
- Tax Office not appealing the decision in *Victorian Women Lawyers' Association*
- Senate report released
- Does your organisation undertake trading activities?
- Improving the integrity of PPFs
- Charities reminded to conduct annual self-reviews
- ATO compliance program 2008–09

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