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THE RELEVANCE OF THE MUTUALITY PRINCIPLE WITHIN THE NONPROFIT SECTOR

Natalie Love, School of Accountancy, Queensland University of Technology

Abstract

The mutuality principle is a common law concept based on the proposition that a person's income consists only of funds derived from external sources and that funds derived from internal sources are, therefore, not assessable for income tax purposes. The mutuality principle is enjoyed by numerous entities within the Australian non-profit sector to access tax exemptions. The Ralph Report into taxation suggested a significant review and reformulation of the mutuality principle. However, following a recent Federal Court decision, the Commonwealth Government acted to preserve the mutuality principle by legislative amendment. It is contended that any new taxation provisions prompted by the Ralph Report should not lose sight of the fact that mutual entities play a socially desirable role through charitable, sporting, recreational and community services.

KEYWORDS: mutuality principle, non-profit entity, tax exemption.

INTRODUCTION

On 21 September 1999, the Commonwealth Government released its blueprint, including objectives and principles, for the purposes of reforming the Australian taxation system (Treasurer's Press Release No. 58 1999). The Review of Business Taxation Report (1999) – known as the Ralph Report – contained recommendations to reform the little-known common law principle of 'mutuality', which applied to some non-profit organisations. The mutuality principle is a common law concept based on the proposition that a person's income consists only of funds derived from external sources and that funds derived from internal sources are, therefore, not assessable for income tax purposes. This often applied fully or in part to the activities of members' clubs, associations, sporting and pastime organisations, as well as cooperatives.

Recommendation 5.6 of the Review of Business Taxation report stated that the mutuality principle should be included as an integral part of the taxation system and be given explicit effect in taxation law, rather than be left to the common law. The inclusion of legislative provisions for the apportionment of expenditure between taxable and non-taxable income was also suggested. The Ralph Report provided no explanations or reasons for the recommendations and, to date, the Government has not publicly expressed its views on the proposal (Treasurer's Press Releases No. 58 1999; Treasurer's Press Releases No. 74 1999).

The Full Federal Court decision of *Coleambally Irrigation Mutual Co-operative Limited v FCT* [2004] FCAFC 250 decided that the mutuality principle did not apply when the members of the mutual entity were not entitled to receive a distribution of profits on the winding-up of the entity. The Commonwealth Government bowed to intense pressure to introduce legislative amendments to ensure the mutuality principle

continued in its present form (Assistant Treasurer's Press Release No. 46 2005). *Tax Laws Amendment (2005 Measures No. 6) Act 2005*, made retrospective to 1 July 2000, ensured the taxation status of non-profit entities relying on mutuality was not adversely affected by the Federal Court's decision in *Coleambally*. However, it did not take the opportunity for a fuller review of the principle, as recommended by the Ralph Report.

This article examines the mutuality principle as it applies to Australian non-profit organisations and seeks to identify principles which should be considered in any legislative formulation of it. It first examines the extent of the principle in Australia and its utility. A brief survey of other jurisdictions' statutory formulation of mutuality is conducted to place Australia within a context. The article then identifies the tenets undergirding the principle of mutuality that should be considered in any statutory formulation.

INCOME TAX MUTUALITY AND ITS USE

The paucity of data generally on the Australian non-profit sector contributes to our lack of understanding about the use of the mutuality principle and its importance to non-profit organisations. Australian tax expenditures which measure the cost to government of income exemptions, deductions and concessions involving the non-profit sector, produced annually by the Australian Department of the Treasury, do not measure the tax foregone by the common law principle of mutuality. This is because it falls outside the definition of a tax expenditure as it is conceived of as technically not an 'exemption from a tax impost', but as not forming part of the definition of income in the first place.

Lyons (2001) estimates that between 500,000 and 700,000 non-profit organisations exist in Australia. It is unknown how many of these might rely on the principle of mutuality, but it is likely to include many cooperatives (3000) and a significant, but unknown, proportion of the recreation, leisure and interest membership clubs which are part of about 120,000 incorporated associations (Lyons 2001: 21). Most of these associations have limited members and economic activity, but there are a number of large sporting clubs with machine gaming facilities which attract public attention.

The smaller associations are coming to be appreciated for their ability to build valuable social capital, particularly in regions outside the major capitals and contribution to civil society (Cox 1995; Falk & Kilpatrick 2000; Onyx 2003; Leonard & Onyx 2004; Onyx, Osburn & Bullen 2004). Passey (2004), in a study of New South Wales incorporated associations, found significant volunteering and greater social and economic role of small incorporated associations in rural and western New South Wales.

Sporting clubs with large membership bases operating gaming machines have attracted attention because of their economic size and public interest in gaming revenues, with a number of Government reports seeking to quantify the revenue lost to the taxation system by the mutuality principle (Parliament of the Commonwealth of Australia 1991; Parliament of the Commonwealth of Australia 1995; Productivity Commission Report 1999; The Allen Consulting Group 2000; KPMG 2000).

The Federal Treasurer stated on 13 December 1996 that clubs in NSW had paid no income tax on income totalling more than \$138 million from gambling activities alone (Senate Hansard Report 1997: 1375). These organisations represent a growing section of the taxation base for both Federal and State Governments. For State Governments, 11.7% of total revenue comes from poker machines, and while only 36% of entities operating licensed clubs are non-profit organisations, they derive 68.5% of the total gross profit earned within the industry (Productivity Commission Report 1999: 21.10). However, many are completely tax-free with the adoption of the principle of mutuality.

The enquiry by the Productivity Commission into Australia's Gambling Industries noted that in 1997–1998 the operating profits of clubs with gambling facilities were about sixteen times bigger than the profits derived by clubs without gambling facilities (Productivity Commission Report 1999: 21.10). It also found that some clubs currently obtain 80% or more of their total revenue from gaming machines. Based on the clubs' operating profits of \$561 million for the 1997–1998 financial year (Productivity Commission Report 1999: 21.10), the Commission estimated that the Government would have collected an additional \$202 million in taxation revenue if the clubs had been taxed at the company rate on their total profits. However, this figure may be underestimated as the operating profits derived from bar and catering trading are usually artificially low due to subsidies provided from the profits generated from the gaming activities (Productivity Commission Report 1999: 21.11). The results of a survey of 150 clubs in Queensland, New South Wales and Victoria showed that 23% of the clubs had not paid any income tax in recent years on revenues totalling \$80 million (Arthur Andersen 1996).

These substantial surpluses are then used to subsidise the cost of goods and services provided on the club's premises that are significantly below the normal market value, or reinvested into the club's facilities as capital expenditure rather than reducing operating expenses. The Gambling enquiry noted that in 1994–1995 capital expenditure by licensed clubs amounted to \$714.5 million in NSW alone (Productivity Commission Report 1999: 21.13, 21.17).

The expansion of facilities and business activities of these clubs appears not to have been appreciated when the licensed club industry gained access to substantial revenue from gaming operations mixed with a larger income-tax-free environment (Productivity Commission Report 1999). In *Tweed Heads Bowls Club v FCT* 92 ATC 2087, Dr Gerber stated that 'in short, a whole new industry has sprung up within the Club industry to organise and tap this new-found lode' (2097) and a range of interest groups (including hotel competitors and anti-gambling activists) continually bring to government's attention this tax-free status. Licensed clubs are not without political influence, as demonstrated by the promise of both major federal political parties immediately prior to the 2004 federal election to reverse the decision in the Coleambally case. Any legislative reform of the principle of mutuality will generate significant debate around the treatment of licensed clubs with gaming revenues, but may affect a significant number of smaller member clubs, which are in a much more vulnerable financial state and have little political voice.

INTERNATIONAL COMPARISONS

While the UK (where the doctrine was first established by the courts, still relies significantly on the common law doctrine of mutuality) the USA, New Zealand and Canada have all adopted a regulatory framework. The approach adopted in the USA and Canada has been to remove the complexity of the mutuality principle by considerably reducing its application through the introduction of threshold requirements that must be satisfied before the principle can apply. For example, a tax exemption is provided to social clubs that meet very strict requirements as to the source of their income. Over a twelve-month period, at least 75% of the club's total gross receipts must be derived from its members or through investment income. In other words, the legislation deems the existence of a profit-making purpose when a significant portion of the club's revenue is derived from the general public. In the UK, the trading profits of mutual entities remain tax-exempt if the profits are applied solely towards the tax-exempt purpose of the entities (*Taxation Act 1970* (UK), s360(1)(e)). However, certain activities that would normally fall within that exemption are explicitly made taxable, such as fundraising activities (*Taxation Act 1970* (UK), s256).

In Australia there are no such comparable statutory concepts, and the introduction of legislation similar to that in the above jurisdictions would seriously limit the application of the mutuality principle in Australia.

The article now considers the common law basis of the mutuality principle as it exists in Australia and then suggests a series of organising principles that can be drawn from the common law decisions about the principle. It is important that this basis is considered in any statutory reformulation of the mutuality principle, and the focus is not solely on seeking to bring large sporting clubs with gaming revenues within the formal taxation regime.

THE BASIS OF THE PRINCIPLES OF MUTUALITY

The application of the mutuality principle has been recognised and has continued to evolve over time from legal precedents originating in the UK, where limited legislative enactments have not denied but supported the application of the principle. The mutuality principle is a common law concept based on the proposition that a person's income consists only of funds derived from external sources; that is, from sources other than the person themselves. Any income derived from oneself is not taxable for income tax purposes.

The mutuality principle was developed in the late 1800s at a time when individuals had to rely on their ability to self-insure for the provision of sickness and death benefits, as the insurance business had not yet evolved into an economically viable industry. Mutual organisations were created with the explicit purpose of providing insurance to their members whilst not deriving assessable profits or gains for their members. It is widely reported that the first authoritative recognition of the principle is to be found in *Styles (Surveyor of Taxes) v New York Life Insurance Company* (1889) 2 TC 460. This was the first reported case dealing with the concept of mutuality in relation to self-insurance; other subsequent major UK cases include *The Equitable Life Assurance Society of the US v Bishop* [1900] 1 QB 177 and *Jones v*

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The South-West Lancashire Coal Owners' Association Ltd [1927] AC 827. However, the concept of mutuality was legally argued in a court of law some fourteen years earlier in *The Glasgow Corporation Waterworks Acts v IRC* (1875) 1 TC 28. The courts held that the concept of mutuality was based on an association of persons who had joined together, not to derive profits or gains but to achieve, through their mutual contributions, a purpose or benefit in which all members could participate or were entitled to do so. These organisations were established on the basis of a legal relationship between the members that gave rise to mutual rights and obligations by the entity towards its members. It is the nature of the legal relationship and the resulting rights that define the mutual character of the entity.

From that time onwards in English law, the term 'mutual organisation or association' has been applied to define a group of individuals, known as members, who have formed a reciprocal relationship with each other to either become their own insurers or for some other common purpose. To date, these entities continue to exist in many sectors of the community and play a significant role. Modern forms of mutual entity cover a wide range of activities, such as recreation, sports, community services and investments.

Australia has inherited large amounts of English common law, including the principle of mutuality. The Australian Commissioner of Taxation originally sought to limit the application of the mutuality principle by making a distinction between the underlying concepts of taxation in the UK and Australia. Under UK taxation laws 'profits' are subject to tax, whereas in Australia taxation is based on the concept of 'income' (*Income Tax Assessment Act 1997* (Cth); *Income Tax Assessment Act 1936* (Cth)). Australian courts have consistently found that the mutuality principle, which evolved from UK legal precedents, applies equally within the context of Australian taxation laws (*The Bohemians Club v FCT*; *Revesby Credit Union Co-operative Limited v FCT*; *Social Credit Savings & Loans Society Ltd v FCT*).

While Australian income tax legislation has since its inception exempted certain non-profit organisations from being taxable – such as charitable institutions and funds, and public religious and educational institutions – it has made no statutory reference to the principle of mutuality. Mutual entities did not derive any income within the definition of the term as used in the income tax legislation. When ascertaining the taxable income, if any, of mutual entities, the current taxation system relies on the general provisions of the Act and, more specifically, on the definition of the terms 'assessable income' (*Income Tax Assessment Act 1997* (Cth), ss 6-1(1), 6-5(1) and 6-10(2)) and 'exempt income' (*Income Tax Assessment Act 1997* (Cth), ss 6-15(2) and 6-20(1)). Therefore, in the absence of any explicit statutory provisions providing for the contrary, mutual income is not subject to income tax by virtue of the mutuality principle itself and not because it is 'exempt' from income tax.

In Australia, some entities have been excluded from the application of the mutuality principle by specific income tax provisions, including life assurance companies, life insurance companies, specific friendly societies, certain co-operatives, mutual insurance companies and credit unions. Perhaps this is a policy option for dealing with large sporting clubs whose activities are dominated by gaming activities. However, the mutuality principle continues to apply to all non-profit mutual entities to the extent that it has not been displaced by statutory provisions in the Act.

The UK courts have developed the general law relating to the mutuality principle, but – as is usual with common law development – it is often piecemeal because of the intermittent nature of cases and unique factual situations. The concepts that underlie the application of the mutuality principle have often been addressed in isolation to each other, based on the specific legal arguments raised in a particular court case. As the interrelationship between the various concepts has been overlooked, it often results in decisions that raise more questions than they resolve; see, for instance, the recent case of *Coleambally Irrigation Mutual Co-operative Limited v FCT* [2004] FCAFC 250. The statutory enactment of the mutuality principle could remove areas of inconsistency and ambiguity.

The article now turns to consolidation into a consistent framework of the piecemeal common law decisions and underlying principles of mutuality, which could inform any attempt to produce a statutory codification of the principle of mutuality.

THE FRAMEWORK OF THE MUTUALITY PRINCIPLE

Over the years, the mutuality principle has been the subject of substantial legal litigation. A considerable body of legal precedents has built up in relation to the principle and its application, from which the underlying concepts regarding the application of the mutuality principle can be established. This process of drawing together the principles from the cases from England and Australia into a consistent and logical set of concepts is essential for any attempt at a statutory codification.

These concepts may be summarised as follows:

(a) The members must share a common purpose. (See, for example, *Styles (Surveyor of Taxes) v New York Life Insurance Company*; *The Equitable Life Assurance Society of the US v Bishop*; *Jones v The South-West Lancashire Coal Owners' Association Ltd*; *Municipal Mutual Insurance Ltd v Hills*; *Ayrshire Employers Mutual Insurance Association Ltd v IRC*; *Revesby Credit Union Co-operative Limited v FCT*; *Social Credit Savings & Loans Society Ltd v FCT*; *Sydney Water Board Employees' Credit Union Ltd v FCT*; *FCT v Australian Music Traders Association*.)

The concept of mutuality is based on an association of persons who have joined together not for trade or profit but to achieve, through their mutual contributions, a common purpose or benefit in which all the members participate or are entitled to do so. That common purpose or benefit must be the main purpose for which the association is established in the first instance. Subsidiary purposes or benefits are permissible only as long as they are ancillary to the main purpose.

(b) The common fund gives effect to the common purpose. (See, for example, *Revesby Credit Union Co-operative Limited v FCT*; *Brookton Co-operative Society Ltd v FCT*; *The Waratahs Rugby Union Football Club v FCT*; *Cronulla Sutherland Leagues Club Ltd v FCT*; *St Mary's Rugby League Club Limited v FCT*; *Taxpayers' Association of NSW v FCT*.)

There must be a common fund created for the common purpose to which all members contribute and participate on a voluntary basis. The contributions to the common fund give effect to the purpose for which the entity was established.

(c) The members have ownership and control of the common fund at all times. (See, for example, *RACV v FCT*; *The Waratahs Rugby Union Football Club v FCT*; *Cronulla Sutherland Leagues Club Ltd v FCT*; *Tweed Heads Bowls Club v FCT*; *Terranora Lakes Country Club Limited v FCT*; *St Mary's Rugby League Club Limited v FCT*; *Taxpayers' Association of NSW v FCT*.)

The common fund is not the beneficial property of the mutual entity. As contributors to the common fund, members are the owners of the common fund even though the entity, in effect and as a matter of practicality, has possession of the fund as agent or trustee for the members. The effective control of the fund would generally be established through voting rights granted under the entity's constitution. If the common fund is owned or controlled by anyone other than its contributors the mutuality principle has no application.

(d) The contributors to the common fund are the only participants in the fund. (See, for example, *Styles v New York Life Insurance Company*; *IRC v Eccentric Club Limited*; *British Broadcasting Corporation v Johns*; *Revesby Credit Union Co-operative Limited v FCT*; *Social Credit Savings & Loans Society Ltd v FCT*; *Sydney Water Board Employees' Credit Union Ltd v FCT*; *FCT v Australian Music Traders Association*.)

The principle cannot apply unless, at any given point of time, there is complete identity between the contributors and the participants. The individuals who are contributing to the common fund must be identical to the individuals who participate or are entitled to participate in any distribution of the mutual surplus fund from the entity. However, it is not necessary for all the members of the entity to participate in all the activities equally as long as they are eligible or entitled to participate on equal terms or to participate equally at all times. The reference to 'identity' is applied within the context of a class of individuals and not to individual persons.

(e) The membership interests in the common fund may consist of different classes. (See, for example, *IRC v Eccentric Club Limited*; *The Waratahs Rugby Union Football Club v FCT*; *Tweed Heads Bowls Club v FCT*; *St Mary's Rugby League Club Limited v FCT*.)

Equal contributions to the common fund are not an essential feature of the mutuality principle. There can be different classes of membership with varying rates of subscriptions and different entitlements to the facilities. Members with full membership are those members who control the common fund and have the same rights, privileges and obligations. Where associated persons have been allocated the same rights (but not the same obligations) as full members, they are not members for the purpose of the mutuality principle. Different classes of membership may include full members, visitors, temporary members, honorary members and so on.

(f) The mutual relationship is for the collective benefit of all the members. (See, for example, *The Waratahs Rugby Union Football Club v FCT*; *Cronulla Sutherland Leagues Club Ltd v FCT*; *FCT v Australian Music Traders Association*; *Tweed Heads Bowls Club v FCT*; *Terranora Lakes Country Club Limited v FCT*; *St Mary's Rugby League Club Limited v FCT*.)

The mutuality principle applies to entities which are carried on for the benefit of their members as a whole but not for the profit or gain of their members severally or individually. If the object of the entity is the provision of gains or profits to the individual members, the mutuality principle cannot apply. All the contributions to the common fund must be applied by the entity for the collective benefit of all the members in line with the common purpose.

(g) The members may receive ancillary benefits. (See, for example, *IRC v Eccentric Club Limited*; *British Broadcasting Corporation v Johns*; *Cabramatta Golf Club Ltd v Commissioner of Land Tax (NSW)*.)

The mutuality principle continues to apply even though some ancillary functions or purposes may indirectly and incidentally benefit the members; for example, when membership of a particular association is beneficial to the members' career prospects. The question to be addressed is whether the activities undertaken by the entity are mainly directed towards its common purpose and only incidentally for the benefit of the individual members, or whether these activities are directed exclusively towards the individual members' personal interest and benefit.

(h) The membership interests in the common fund cannot be sold or transferred. (See, for example, *IRC v Eccentric Club Limited*; *Social Credit Savings & Loans Society Ltd v FCT*; *RACV v FCT*; *The Waratahs Rugby Union Football Club v FCT*; *FCT v Australian Music Traders Association*; *North Ryde RSL Community Club Ltd v Commissioner of Taxation*.)

A membership interest continues to exist only during the term of the membership with the entity. It effectively becomes extinguished on the death of the member or on the expiration of the membership. Therefore, the membership interest in the entity cannot be sold or transferred, whether or not for consideration.

(i) Surplus funds may be distributed to the members as mutual income. (See, for example, *Styles v New York Life Insurance Company*; *The Bohemians Club v FCT*; *Municipal Mutual Insurance Limited v Hills*.)

Any surplus in the common fund, in excess of the members' contributions, which is returned to the members, is not assessable income to the members. A return of surplus contributions does not constitute a distribution of profits accruing to the members. It is, in essence, a repayment of the members' own money or a refund of the unused portion of the members' contributions.

(j) Surplus of funds must be distributed to the members on a proportional basis. (See, for example, *British Broadcasting Corporation v Johns*; *Revesby Credit Union Co-operative Limited v FCT*; *FCT v Australian Music Traders Association*.)

Any surplus returned to the members are divided between the current members only at the date of distribution in either the proportion of the amounts contributed or equally between all the members unless provisions are made to the contrary in the constitution.

(k) Distributions of surplus funds to non-members are not mutual income. (See, for example, *Revesby Credit Union Co-operative Limited v FCT*; *Sydney Water Board Employees' Credit Union Ltd v FCT*.)

When the recipients of the surplus funds are not members of the entity, any distributions of funds is not mutual income in the hands of the non-members. Such surplus is deemed to constitute gains and profits arising from trading activities undertaken by the entity with the non-members.

(l) The constitution of the mutual entity may include nonprofit clauses. (See, for example, *Sydney Water Board Employees' Credit Union Ltd v FCT*; *RACV v FCT*; *FCT v Australian Music Traders Association*.)

While it is not obligatory, a written constitution assists in demonstrating the mutuality status of the entity. (See, for example, *The Waratahs Rugby Union Football Club v FCT*; *Cronulla Sutherland Leagues Club Ltd v FCT*; *Tweed Heads Bowls Club v FCT*; *Terranora Lakes Country Club Limited v FCT*.) Where an entity's constitution provides for a distribution of profits or gains during its lifetime (see, for example, *IRC v Eccentric Club Limited*; *Cronulla Sutherland Leagues Club Ltd v FCT*) or on winding up (see, for example, *British Broadcasting Corporation v Johns*; *Cronulla Sutherland Leagues Club Ltd v FCT*; *FCT v Australian Music Traders Association*), which will not involve a benefit to its members, the operation of the mutuality principle is not affected. However, the mutuality principle makes a distinction between a surplus resulting from mutual and non-mutual sources.

(m) Trading activities undertaken by the entity may be mutual or non mutual in character. (See, for example, *The Bohemians Club v FCT*; *British Broadcasting Corporation v Johns*; *Revesby Credit Union Co-operative Limited v FCT*; *Social Credit Savings & Loans Society Ltd v FCT*.)

The mutuality principle does not exclude all profits and gains derived by the mutual entity from being classified as income under ordinary concepts and therefore as assessable income. Receipts from non-mutual sources, such as the undertaking of commercial trading activities, are assessable income to the entity. The nature and substance of a transaction determines the character of any profits derived as either mutual income (and therefore non-assessable) or non-mutual income (and therefore assessable). The status of the parties to the transaction with the entity (that is, whether there is a membership relationship) is irrelevant. If the transactions are non-mutual in nature, the resultant surplus is taxable whether the transactions are with members or non-members. It depends entirely on whether it is a transaction entered into for commercial purposes.

CONCLUSION

The Ralph Report made a recommendation to review the appropriateness of the application of the mutuality principle and placed the statutory codification of this principle on the legislative agenda. This article has made an initial contribution to this policy debate by identifying the underlying concepts, which provide for the framework to any statutory codification of the mutuality principle.

While the design of the legislative proposal should not only ensure that it is technically sound and complies with the aims of any taxation review process – equity, efficiency and simplicity – it also needs to consider its implications for small membership-based non-profit organisations.

Although definitive research is lacking on the actual number and economic contribution of such organisations, there is enough evidence from academic research that points to the crucial role these organisations play in our civil society and particularly their contribution to social capital. The clash of powerful interest groups around the taxation status of a number of high-profile sporting clubs with gaming facilities should not overwhelm lawmakers' consideration of the relatively invisible, but probably important, smaller membership organisations.

The enshrinement of the mutuality principle into the taxation legislation should not be perceived merely as an opportunity to attack the taxation status of sporting clubs with gaming revenue, which may be opposed by other commercial or social pressure groups. It should be seen as an opportunity to reform the law for the benefit of Australia in a fair and equitable manner and to continue to provide a tax concession for mutual entities that play a socially desirable role through charitable, sporting, recreational and community services in the creation of social capital and a vibrant civil society.

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