



## WEEKLY COMMENT: FRIDAY 22 AUGUST 2014

1. Last week I commenced looking at the new rules applying to deregistered charities as enacted in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* ("the Employee Allowances Tax Amendment Act 2014"), which received the Royal assent on 30 June 2014. This week I look at how the tax rules will apply to a deregistered charity and the effect of deregistration on donee status.
2. As noted last week, the new rules are explained in the *Commentary to the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill* ("the Commentary") pages 61-72 and in *Tax Information Bulletin* Vol. 26 No. 7 (August 2014), pages 65-69 ("the TIB Item").

### How the general tax rules will apply to non-exempt charities

3. The general tax rules will apply to non-exempt charities upon cessation of tax-exempt status. Last week I looked at the extension of the tax-exempt status of compliant deregistered charities to the **day of final decision** – i.e. to include the "grace period". For a non-compliant charity there is no grace period, and the income tax exemptions cease on the day it ceases to comply with its rules contained in the register.
4. The day on which the income tax exemptions in s. CW 41 and CW 42 cease to apply is referred to as the **date of cessation**. This is the date from which the general tax rules commence to apply to a deregistered charity. New s. HR 11 applies on and after the date of cessation and sets out the how the initial tax base is to be determined:
  - (a) *Establishing cost of property*: For the purposes of the (Income Tax) Act, for the person, the cost of premises, plant, equipment, and trading stock is the value that would be used at the date of cessation under the Act if s. CW 41 or CW 42 never applied;
  - (b) *Consideration for financial arrangements*: For the purposes of the Act, the consideration for a financial arrangement of the person is the value calculated as follows, based on consideration paid and received before the date of cessation, and income and expenditure under the financial arrangements rules before the date of cessation:  
$$\text{(Consideration received plus expenditure) minus (Consideration paid plus income)}$$
  - (c) *Prepayments*: For the purposes of the Act, the person is treated as having the unexpired portion of expenditure under s. EA 3 (prepayments generally) and the unpaid amount under section EA 4 (accrued holiday pay and other deferred employment income) that the person would have had if s. CW 41 or CW 42 never applied. The unexpired portion is available for deduction under sections DB 50 and DB 51 in the income year that contains the date of cessation.

5. For the purpose of applying s. HR 11, the person may use information from their annual returns contained on the register of charitable entities under the *Charities Act 2005*, if they have no other information that is more readily available.
6. New s. HR 11 applies to the tax base calculations in the year the entity becomes a tax-paying entity but may also apply for each subsequent income year that the deregistered charity ceases to meet the requirements to derive exempt income under sections CW 41 or CW 42. Section HC 31 has been consequentially amended so that it no longer applies to a charitable trust that has lost its charitable status. Instead, s. HR 11 will apply to all charities which come into the tax base.
7. There are two examples in the *Commentary*, which have been replicated in the TIB Item. Both examples concern a charity which has been non-compliant since inception in 2008. Therefore, the date of cessation coincides with the date of inception. It was eventually deregistered in 2013:
  - (a) The first example sets out the determination of the depreciable cost base under new s. HR 11 of office furniture acquired at inception in 2008 for a GST-exclusive cost of \$50,000. The deregistered charity is required to include the office furniture in its depreciable assets at the cost of \$50,000 and, commencing from the 2008 income year, depreciate the furniture annually at the depreciation rate for office furniture of 19.2%.
  - (b) The second example sets out the opening consideration for a financial arrangement that is a loan of \$100,000 made by the deregistered charity at an interest rate of 10% per annum. The opening consideration in 2008 is \$100,000 and interest must be accrued annually at 10% on the compounding principal – i.e. interest in 2008 is calculated on \$100,000, interest in 2009 is calculated on \$110,000 etc.

#### **Requirements for deregistered charities with accumulated assets**

8. A new s. HR 12 has been inserted, under which the value of a deregistered charity's net assets (assets minus liabilities) will be subject to income tax if a deregistered charity continues in existence. The policy rationale is that the tax concessions should only be available to *bona fide* charities and deregistered charities should be held to account for the assets and income they have built up while they enjoyed the benefit of the tax concessions.
9. However:
  - (a) Deregistered charities will be given 12 months to apply any assets or income to charitable purposes before the imposition of any tax (apparently intended to encourage deregistered charities to distribute their accumulated assets and income to charitable purposes within 12 months of being deregistered); and
  - (b) An adjustment will be permitted for any donated assets as such assets were not funded by non-taxed income or through a tax-preferred source.
10. The application date of the new rules is:
  - (a) On and after 1 April 2015; or
  - (b) On and after 14 April 2014, if the person is removed from the register of charitable entities before 1 April 2015 because section 32(1)(f) of the *Charities Act 2005* applies (i.e. the entity has voluntarily been removed from the register).

11. The date on and after which taxable income arises under the new rules is referred to as the **end date** - the day of final decision. However, the new rules will not apply if the person:
  - (a) Meets the requirements to derive exempt income under some other exemption (i.e. other than the charitable exemptions in s. CW 41 and CW 42) in subpart CW; or
  - (b) Is re-registered on the register of charitable entities (the **register**) under the *Charities Act 2005* within 1 year of the end date.
12. This protects entities that are exempt from income tax under an exemption other than the charitable exemption and entities that re-registered as charities.
13. Under new s. HR 12, the person has an amount of income, derived on the day that is a year after the end date, equal to the greater of zero or the value of net assets that the person held on the end date. However, certain assets are carved out:
  - (a) Assets distributed or applied in the year after the end date, for charitable purposes; and
  - (b) Assets distributed or applied in the year after the end date, in accordance with the person's rules contained on the register; and
  - (c) Assets received from the Crown:
    - (i) To settle a Treaty of Waitangi claim; or
    - (ii) In accordance with the *Maori Fisheries Act 2004*; and
  - (d) Assets, other than money, gifted or left to the person when the person met the requirements to derive exempt income under s. CW 41 or CW 42.
14. Under new s. CV 17, the income under s. HR 12 is deemed to be derived in the income year that contains the day 1 year after the day of final decision. Note, however, that the income is calculated based on net assets held on the end date, subject to the above-listed exclusions (and not on net assets held 1 year after the end date).
15. For the purposes of s. HR 12, **net assets** means the assets of the person held on the end date, less the liabilities of the person on the end date. In the TIB Item an example of a liability would be the amount of tax which the entity would be liable to pay in relation to past years if it ceased to comply with its rules at some point before deregistration. Another example given is of legal costs which have not been paid incurred by the entity in disputing the decision to deregister it.
16. The example given in the *Commentary* and the TIB Item is of a charity with net assets of \$3,150, including donated land valued at \$3,000, which is deregistered on 1 June 2013:
  - (a) The taxable net assets (excluding the donated land) amount to \$150, less any assets and income distributed for charitable purposes within 12 months of the date of deregistration; and
  - (b) The taxable net assets will be returned in the income year that contains 1 June 2014, the day 1 year after the day of final decision – in the example, the entity has a July balance date, so the \$150 will be included as income in the 2014 income year.

### **Effect of deregistration on donee organisation status**

17. As explained in *Weekly Comment* 9 August 2013, a “donee organisation” is defined in s. YA 1 as an entity described in s. LD 3(2). The description of a “donee organisation” in s. LD 3(2) contains a new paragraph (ab) so as to include:
- (ab) An entity that no longer meets the other requirements in s. LD 3(2) to be a donee organisation for the period starting on the day it fails to meet those other requirements and ending on the later of:
    - (i) The day the entity is removed from the register of charitable entities under the *Charities Act 2005*; or
    - (ii) The day on which all reasonably contemplated administrative appeals and Court proceedings, including appeal rights, are finalised or exhausted in relation to the person's charitable status.
18. If a deregistered charity no longer qualifies for donee organisation status, donors will no longer be entitled to tax relief on their donations. Under the law as it previously stood, this would have happened at the point at which the entity no longer satisfied any of the requirements to be a donee organisation. This could have been in the past, which would have given rise to retrospective consequences for donors. The amendment will mean that a deregistered charity is continued to be treated as a donee organisation until the later of the two dates referred to in paragraph 17 above. Therefore, monetary gifts that meet the requirements of a “charitable or other public benefit gift” in section LD 3(1) made to registered charities can still qualify for donations tax relief even if that entity is later deregistered.
19. Other points in the *Commentary* worth noting are:
- (a) A deregistered charity may still qualify for donee organisation status if it meets the other donee organisation requirements.
  - (b) Donations tax relief provided in the past could still be reversed in circumstances where:
    - (i) A donor had knowledge at the time of claiming the relief that the entity did not satisfy any of the requirements to be a donee organisation; or
    - (ii) The donor was involved in fraud in relation to the donation and the donee organisation; or
    - (iii) The requirements substantiating that a *bona fide* monetary gift has been made are not met under general law.
  - (c) Officials expected work on guidelines on the various limbs of s. LD 3 – i.e. what constitutes “benevolent”, “philanthropic”, “cultural” or “charitable” purposes – to be completed by mid-2014, however no guidelines have been issued as yet.
20. It is stated in the Officials’ Report that the protection afforded donors by this amendment does not extend to all entities on the list of approved done organisations on Inland Revenue’s website. Further work on this point is required, which is to be carried out as part of the current tax review of donee organisations on the Government’s tax policy work programme.



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