



WEEKLY COMMENT: FRIDAY 9 AUGUST 2013

1. This week I look at *Clarifying the tax consequences for deregistered charities – An officials' issues paper* ("the Charities Deregistration IP") released in July 2013. Submissions need to be made by 23 August 2013.
2. I have discussed charities in general and other changes in the sector previously:
 - In *Weekly Comment* 4 July 2012 I discussed the change from the Charities Commission to the Charities Registration Board administered by the Department of Internal Affairs – Charities Services. At the same time I discussed what is a charitable purpose.
 - In *Weekly Comment* 24 May 2013 I discussed the changes relating to charities and other non-for-profit entities in the Financial Reporting Bill as reported from the Commerce Committee. At the same time I discussed the audit proposals for charities released by the Ministry of Business, Innovation & Employment in February 2013.

The requirements for registration

3. To be registered as a "charitable entity" an entity must meet the requirements in section 13 of the *Charities Act 2005*. It must:
 - (a) Be established and maintained for exclusively charitable purposes. A "charitable purpose" is defined in section 5(1) of the *Charities Act* and includes:

...every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community;
 - (b) Not be carried on for the private financial benefit or profit of an individual;
 - (c) Restrict its distributions upon winding-up to charitable purposes;
 - (d) Have a legal name that is not misleading or offensive; and
 - (e) Have proposed officers that are qualified by virtue of section 16 of the *Charities Act 2005*.
4. In *Weekly Comment* 4 July 2012 I noted that the current common law definition of "charitable purpose" established by the courts remains as the legal test for whether an organisation is charitable or not. I discussed the four recognised charitable purposes: the advancement of religion, the advancement of education, the relief of poverty, and other matters beneficial to the community.

5. Section 41 of the *Charities Act* also requires all registered charities to file an annual return with Charities Services, comprising a complete annual return form and financial accounts.
6. It is noted in the Charities Deregistration IP that Charities Services assesses the eligibility of entities to remain registered, and may open an investigation:
 - (a) In response to specific information: such as a complaint, a media report, a Court judgment, or determined by Charities Services to be medium to high-compliance risk; or
 - (b) Because of information provided by the entity itself: which can include changes to its rules or its winding up clause, spending unrelated to its charitable purpose, or the provision of a private financial benefit to someone.

Charities-related tax concessions

7. The tax concessions, which are administered by Inland Revenue, are:
 - (a) An income tax exemption;
 - (b) A fringe benefit tax exemption; and
 - (c) Tax deductions to company donors and tax credits for individual donors to approved “donee” organisations.
8. To be eligible for the income tax exemption, a charity must be a “tax charity”, which is defined in s. CW 41(5) of the *Income Tax Act 2007* as:
 - (a) The trustees of a trust, a society, or an institution, registered as a charitable entity under the *Charities Act 2005*;
 - (b) The trustees of a trust, a society or an institution who, before 1 July 2008, commenced the process of registering with the Charities Commission but had not completed its registration; or
 - (c) The trustees of a trust, a society, or an institution that are non-resident and carrying out their charitable purposes outside New Zealand, and which is approved as a tax charity by the Commissioner in circumstances where registration as a charitable entity under the *Charities Act 2005* is unavailable.
9. It is noted in the Charities Deregistration IP that in general, a registered charity will be treated by Inland Revenue as qualifying for the tax exemption:
 - (a) On its non-business income under s. CW 41; and
 - (b) On business income – derived directly, or indirectly through a separate entity – that:
 - (i) Is applied to charitable purposes within New Zealand (the “in New Zealand” requirement); and
 - (ii) No person with some control over the charity’s business activities is able to divert business income to their advantage (the “no direct control” requirement).
10. Under s. CX 25 of the *Income Tax Act 2007* a “charitable organisation” that provides fringe benefits to its employees will in general not need to pay FBT unless:

- (a) The employee receives the benefit mainly in connection with their employment; and
 - (b) The employment involves a business whose activity is outside a charity's benevolent, charitable, cultural or philanthropic purposes.
11. A "charitable organisation" for FBT purposes is essentially a "donee organisation", as described in the next paragraph below.
12. Donors who make cash donations to a "donee organisation" are entitled to tax concessions contained in s. DB 41 (the company donation deduction), s. DV 12 (the Māori authority donation deduction) and s. LD 3(2) (the individuals' donation tax credit).
13. A "donee organisation" is defined in s. YA 1 as:
- (a) An entity described in s. LD 3(2), which states that a donee organisation includes any society, institution, association, organisation, or trust that is not carried on for the private pecuniary profit of an individual, and whose funds are applied wholly or mainly to charitable, benevolent, philanthropic, or cultural purposes within New Zealand; or
 - (b) An entity listed in Schedule 32, which contains a list of 80 organisations whose charitable purposes are largely carried out overseas.

Grounds for deregistration

14. Grounds for deregistration are discussed in Chapter 4 of the Charities Deregistration IP. Section 32 of the *Charities Act* sets out the grounds for deregistration. Charities Services may deregister a charitable entity if:
- (a) It is no longer "qualified for registration" as a result of failing to meet its ongoing registration requirements.
 - (b) There has been a "significant or persistent failure" to comply with its obligations under the *Charities Act* or any other *Act*. The obligations specified in the *Charities Act* include the duty:
 - (i) Of telephone and internet collectors to disclose the charity's registration number when asked for it (section 39);
 - (ii) To notify changes to the Charities Unit (section 40);
 - (iii) To provide annual returns that include both a complete annual return form and financial accounts (section 41); and
 - (iv) To assist Charities Services when it asks for information while carrying out its functions (section 51).
 - (c) There has been a "significant or persistent failure by any one or more of the officers of the entity to meet their obligations under the *Charities Act*;
 - (d) It has engaged in "serious wrongdoing": s. 4(1) of the *Charities Act 2005* defines "serious wrongdoing" as:
 - (i) Unlawful or a corrupt use of the funds or resources of the entity;

- (ii) An act, omission, or course of conduct that constitutes a serious risk to the public interest in the orderly and appropriate conduct of the affairs of the entity;
 - (iii) An act, omission, or course of conduct that constitutes an offence; or
 - (iv) An act, omission, or course of conduct by a person that is oppressive, improperly discriminatory, or grossly negligent, or that constitutes gross mismanagement.
- (e) It has requested that it be deregistered.
15. Charities Services considers that the types of activities that may constitute a serious risk to the public or oppressive and discriminatory or grossly negligent to include:
- (a) Persistent failure to keep proper financial records;
 - (b) Filing financial reports that are largely inaccurate;
 - (c) Inability to account for the way public donations are used;
 - (d) Presenting largely inaccurate information to the public about the charity's purpose or activities;
 - (e) Money laundering;
 - (f) Allowing funds to be used to assist illegal activities or terrorism;
 - (g) Making or allowing private financial profit;
 - (h) Persistently working outside the rules of the charity; or
 - (i) Knowingly allowing an officer who does not qualify in terms of the *Charities Act* to remain as an officer, unless a waiver has been granted.
16. Under s. 33 of the *Charities Act*, Charities Services must give the entity notice in writing of its intention to remove it from the Register. The notice must include the reason and give the entity at least 20 working days after the date of the notice to reply with an objection. If Charities Services proceeds to deregister the entity, it will advise it in writing, fully explaining the decision. It is noted that:
- (a) A deregistration decision applies going forward. It is not possible to set an effective date of deregistration retrospectively.
 - (b) The details shown on the Register after an entity has been deregistered are: the name of the charity and its registration number; the reason for deregistration; and the effective date of deregistration.
 - (c) In all cases when a charity wishes to go back on the Register after it has been deregistered, it will need to follow the application process in full.

Tax consequences of deregistration

17. The tax consequences of deregistration are currently covered in s. HC 31. This section applies to trusts, and provides that income derived on or from the date on which the charitable trust loses its charitable status will be subject to tax. A calculation must be made,

on the date the charitable trust lost its charitable status, in order to establish the cost price of property and to determine any consideration for financial arrangements.

18. It is noted that s. HC 31:

- Provides a useful model for formulating rules to clarify how the general tax rules, including the various entity regimes, could apply to deregistered charities; and also
- Provides a useful model for formulating rules for establishing the opening values of any depreciable property or consideration for any financial arrangements held by a deregistered charity when it becomes a tax-paying entity.

19. Another section that provides for the consequences of a change in charitable status is s. HF 9. This section provides for the consequences of a change in entity status for the purposes of the Māori authority rules. In general, any retained earnings, accumulated profits and capital reserves held by the trust or company on the date of change will not be subject to tax when it is subsequently distributed.

20. The FBT exemption will cease to apply if the requirements of s. CX 25 are not met – i.e. the employment consists of the carrying on by the organisation of a business whose activity is outside its benevolent, charitable, cultural or philanthropic purposes.

21. Inland Revenue can reverse donation tax relief claims of donors who have made cash donations to a deregistered charity. It is noted that in practice, this requires Inland Revenue to approach each donor for evidence of the amount and circumstances of their gift, which can be onerous.

22. The existing provisions apply from the date the entity is removed from the Charities register.

23. Where an entity is deregistered and is subsequently re-registered, under current tax law the deregistered charity is required to file tax returns for any periods of non-registration.

Problems identified with the current tax consequences

24. The following problems with the current consequences for deregistered charities have been identified:

- (a) Section HC 31 does not apply to trusts that never had a charitable purpose;
- (b) There is no provision equivalent to s. HC 31 that applies to incorporated entities, so it is unclear how incorporated bodies should transition to the general rules;
- (c) Section HF 9 exempts all previously accumulated charitable income, but this may not be appropriate if the entity never had a charitable purpose;
- (d) Where an entity has never had a charitable purpose, the taxing provisions should arguably apply from the date of establishment, not the date of deregistration;
- (e) The requirement for a temporarily deregistered charity to file tax returns gives rise to complexity and costs; and
- (f) There are no restrictions on how a deregistered charity should deal with its accumulated income (that was exempt from income tax); in Australia, for example, all charitable amounts must be transferred to another donee organisation.

Suggested solutions

25. The suggested solutions to the identified problems are set out in Chapter 6 of the Charities Deregistration IP. It is proposed that the suggested rule changes will apply from the 2014-15 income year.
26. The s. HC 31 model is to be used to clarify how the general tax rules will apply to deregistered charities, and how opening values are to be established for depreciable property and for financial arrangements.
27. It is acknowledged that the FBT exemption could continue to apply after deregistration, as long as the deregistered charity continues to have a benevolent, cultural or philanthropic purpose, or meets the requirements to be added to Schedule 32. Registration per se is not a requirement for the FBT exemption to apply.
28. There are also no changes proposed to the consequences for donors. Officials consider it appropriate that Inland Revenue should continue to have the discretion to make decisions on whether to reverse donation tax relief claims in deregistration situations.
29. The key area where changes are proposed is the timing of when the taxing provisions would commence to apply:
- (a) Deregistered charities would be subject to tax on income earned from the effective date of deregistration when:
 - (i) A charity that came into existence after 1 July 2008 has been deregistered by Charities Services (for a reason other than not having a charitable purpose); or
 - (ii) Charities Services (or its predecessor) initially formed a view that the entity was charitable in purpose but later changed its mind; (however, it is proposed that Charities Services and Inland Revenue should retain the ability to enquire into deregistration situations);
 - (b) Deregistered charities would be subject to tax on income earned from the date on which the entity was found not to have a charitable purpose when:
 - (i) A charity that came into existence after 1 July 2008 is deregistered because it was found by Charities Services or the Courts not to have a charitable purpose; or
 - (ii) A charity that came into existence after 1 July 2008 has voluntarily deregistered and Inland Revenue has found the entity not to have had a charitable purpose;
 - (c) Deregistered charities would be subject to tax on income earned from 1 July 2008 when:
 - (i) Before 1 July 2008 Inland Revenue had confirmed that the charity was entitled to the charities-related income tax exemption *and* Charities Services (or its predecessor) has either declined its application or deregistered the charity, after 1 July 2008; or
 - (ii) Before 1 July 2008 the charity made a self-assessment that it was eligible for the charities-related income tax exemption *and* Charities Services (or its predecessor) has either declined its application or deregistered the charity after 1 July 2008; (such charities might be required, however, to provide evidence to Inland Revenue that they were eligible for the charities-related income tax exemption before 1 July 2008).

30. Finally, it is noted that “a mix of both legislative and operational measures may be required, and that Inland Revenue and Charities Services may need to work closely together to ensure a robust process for deregistered charities. This might involve giving Charities Services a wider range of tools to apply during the deregistration process. This could include, for example, the ability to set a retrospective date of registration such as to deal with broken periods of registration in appropriate circumstances.”

A handwritten signature in black ink that reads "Arun David". The signature is written in a cursive, slightly slanted style.

Arun David, Director,
DavidCo Limited