

# Tax and charities

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*A government discussion document on taxation issues  
relating to charities and non-profit bodies*

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## **FOREWORD**

We would like to acknowledge the enormous contribution the voluntary and charitable sector makes to New Zealand society. New Zealanders are indebted to these groups for the work they do in the community, especially in the welfare, health and education spheres.

One of the main forms of government assistance to this sector is to exempt charities from paying income tax. We are issuing this discussion document because we want to ensure that this assistance is as well targeted as it could be. Over our years in politics we have had many approaches from groups within the sector, concerned that in some cases the tax exemption is being inappropriately used, or that some groups do not have access to it. They have often asked that the definition of “charity” for tax purposes be narrowed or modernised. Your views are therefore sought on whether the present definition is appropriate for New Zealand in the 21st century, or whether, and how, it should be modernised.

At present, we do not have enough information about how much money the government spends on this tax exemption, or which groups benefit most from it. We are particularly interested in feedback on the information-gathering, or reporting, proposals. With better information about which organisations are benefiting from the charitable tax exemption, and to what extent, we will be in a much better position to judge whether government assistance through the tax system could be better targeted.

This discussion document contains a range of proposals for updating the definition of “charitable purpose” and improving the accountability of organisations receiving government assistance. It draws on the excellent work contained in the 1989 report of the Working Party on Charities and Sporting Bodies and the 1999 report on Tax Compliance from the Committee of Experts.

It also raises other taxation issues in relation to charities and, in one case, other non-profit bodies. For example, it looks at how the trading operations of charities are taxed, and at other ways charities are assisted through the tax system, such as allowing income tax rebates or deductions for donations to charities. In the final chapter, the discussion document provides solutions to the current uncertainties for charities and other non-profit bodies in relation to GST.

These are important issues, and the government looks forward to receiving your submissions.

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## Part I

# Charities and the tax system

*This first part of the discussion document describes the government review of charities and tax-related issues, and the nature of government support of charities through the tax system. It then summarises the proposals put forward in the discussion document.*



# **Chapter 1**

## **PURPOSE OF THE REVIEW**

### **This review**

- 1.1 This discussion document has been issued as part of the consultation stage in a review undertaken by government of the tax treatment of charities. The charitable sector receives assistance through the tax system in the form of the exemption from income tax (section CB 4(1)(c) and (e) of the Income Tax Act 1994); the donations rebate for giving by individuals (section KC 5(1)); the company donation deduction (section DJ 4), and the exemption from gift duty for gifts to a charity (section 73(1) of the Estate and Gift Duties Act 1968). The government's intention is to maintain at least the same level of assistance to charities through the tax system as it currently provides. However, it recognises that if that assistance is not appropriately targeted, the available resources may be spread too thinly.
- 1.2 In determining whether assistance is appropriately targeted, two potential problems are the scope of the current application of the exemption, and the relevance, today, of the possibly archaic definition of "charitable purpose".
- 1.3 In addressing these problems, and indeed in determining whether these problems are real or merely perceived, this review focuses on three areas: whether the definition of "charitable purpose", which derives from English law at least 400 years old, remains appropriate to New Zealand society in the 21st century; whether the level of information provided to the government by charities is appropriate; and some specific tax issues affecting the sector. These areas are covered in this document in Parts II, III and IV, respectively.
- 1.4 It is important to note that this review deals mainly with charities, and only with issues that relate to taxation. Thus, apart from the GST issues discussed in the last chapter, it does not deal with other tax-exempt organisations. Nor does it deal with governance issues, except to the extent of reporting for tax purposes, as discussed in Part III. The discussion on the definitional issues is intended to apply only for tax purposes, so would not affect other areas of law such as the Charitable Trusts Act 1957 and the Perpetuities Act 1964.

### **Other reviews**

- 1.5 The last major review of the law of charities in New Zealand was undertaken by the Working Party on Charities and Sporting Bodies in 1989. The major recommendation of that review was that a Commission for Charities be established, to increase accountability of charities to the public. This discussion document does not deal with the range of issues covered by that working party as many of them are outside the scope of the present review. However, the working party did make several recommendations in relation to direct tax matters, including that the income tax exemption be retained, and

that the limits on deductions and rebates be regularly adjusted. Those issues are discussed in this document.

- 1.6 The appropriateness of the current broad tax exemption for charities and other non-profit organisations, as well as their ability to earn business income free of tax, were also discussed by the Committee of Experts on Tax Compliance. The committee was particularly concerned about the issue of competitive advantage, given the ability of charities to earn business income free of tax.
- 1.7 Work is being undertaken in other areas that is potentially relevant to this review. It includes the Tax Review 2001, which will look at the use of the tax system to influence behaviour; the government review of gaming; and the Community and Voluntary Sector Working Party, which reported in April 2001.

## **Chapter 2**

### **GOVERNMENT ASSISTANCE TO THE CHARITABLE SECTOR THROUGH THE TAX SYSTEM**

- 2.1 This chapter discusses the nature of the charitable sector, and the reasons the government supports the sector through the tax system.

#### **The purpose of charities**

- 2.2 Organisations within the charitable sector take many forms, including companies and trusts. They use three main forms of fund raising: direct gifts, such as donations and other philanthropic giving; income from passive investment such as bank deposits; and income from business activity. The forms of charitable provision are direct grants or gifts of money, and the provision of goods and services for nil, or nominal, consideration.
- 2.3 The New Shorter Oxford English dictionary defines “charity” as, among other things:
- “a trust, foundation, organisation, etc., for the benefit of others, especially of those in need or distress”.
- 2.4 Examples of common charities in New Zealand today are churches, universities, play centres, welfare organisations, food banks and night shelters. The functions of these organisations indicate they have a wider purpose than that suggested by the dictionary definition. It could be said they are providing goods and services that are in some way “collective” in their benefit. In other words, they provide goods and services that confer a benefit to society over and above the benefits that the recipient or supplier may get from the arrangement. Organisations that exist primarily to provide a benefit to owners or members are not regarded as charitable, even if some residual funds are used in the provision of collective goods and services.<sup>1</sup>
- 2.5 Although governments are the main suppliers of collective goods and services, some people will want to see more of certain goods and services being provided. Typically, they use the charitable sector as the main vehicle to provide them.
- 2.6 The charitable sector is perceived to be altruistically focused, reinforced by the fact that charities do not normally have shareholders and often rely upon volunteers. These factors may be an advantage in the minds of donors when they are deciding what type of entity to support. Often donors have little information about the uses to which their donations are put, partly because

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<sup>1</sup> These concepts are reflected to some extent in the current tax rules applying to charities, which prohibit private pecuniary profit; require a organisation to exist for *exclusively* charitable purposes; and require the benefit to be available to an appreciably large section of the community.

they are not the ultimate beneficiaries of the goods or services provided by the entity to which they have donated. In these circumstances, donors may feel more confident that a non-profit or charitable organisation will not take advantage of the lack of information about what happens to their funds to provide a lower than promised quality of output. However, these factors do not by themselves form a justification for governments subsidising such entities. The question therefore remains – why do governments subsidise the charitable sector, and in particular, why do they do so through the tax system?

### **Government support for greater private provision**

- 2.7 Subsidising charities enables governments to further their social objectives, including by means of increasing support to disadvantaged members of society. One of the reasons governments provide subsidies to the private sector rather than simply increasing state provision is that it can result in a better targeting of resources. The donations people make to a charity provide an effective indicator of the extra goods and services people feel are needed. Subsidising charities also ensures that those members of society who do not donate to charities but who nevertheless benefit indirectly from charities are contributing through their general tax payments.

#### ***Support through the tax system***

- 2.8 In the case of charities, the subsidy takes the form of an exemption from income tax that allows spending on charitable purposes to be made out of untaxed income. Further, the source of some of those funds that are spent is subsidised by the rebate or deduction for donations made to charities.
- 2.9 As already noted, a common feature of charities is that they provide a benefit to society over and above any benefit received by the recipient or supplier of the relevant goods or services. For example, the benefit to society of a charity running a soup kitchen is greater than the value of the meals provided there. This is what economists call a “positive externality”. The presence of an externality is one of the few justifications for the use of subsidies through the tax system. A subsidy can be used to give some recognition to the supplier for the extra benefit that those activities provide to society generally.
- 2.10 Even so, there are several problems with using the tax system to recognise these extra benefits, and some of these problems are noted later. However, in the case of charities, these are mitigated to some extent by the fact that no private pecuniary profit can be made from charitable activities (and therefore from the tax exemption).

2.11 In respect of the donations subsidy, empirical studies<sup>2</sup> suggest that subsidies to donors encourage charitable giving, which is generally regarded as socially desirable behaviour. The government could provide its support directly to charities through grants. However, this would not provide a direct incentive for individuals to donate, and might result in less effective targeting of government assistance, particularly if the government grants were not matched to donations.

#### ***Concerns about using the tax system to support charities***

- 2.12 Despite the advantages of using the tax system to support charities, there are a number of issues that governments need to take into account when using the tax system to provide this kind of support.
- In granting tax concessions, governments forgo tax revenues. This means that governments need to raise money from other sources, such as through increasing tax rates on non-exempt companies, goods and individuals, to reach their total tax revenue targets.
  - Government subsidy by way of a tax exemption can encourage growth in inefficient ways. For example, even though the subsidy may result in more output of a particular good or service, the resources redirected to the subsidised activity to produce the extra output might have been used to greater effect in another activity. Thus there can be a net loss to society from a subsidy, although the size of any loss (or indeed gain) is difficult to quantify in a world of imperfect information.
  - Unlike other forms of government expenditure, a subsidy through the tax system is not subject to direct control by the government. An exemption on income tax allocates tax expenditure in proportion to an organisation's income, not according to its needs or worth; a donation deductible from a donor's income results in both the amount and the recipient of the tax expenditure being chosen by the donor.
  - Unlike other forms of tax expenditure, there is no direct ministerial scrutiny of the use to which the tax subsidy is put. In New Zealand, there is no formal process for registering charities, and there is ministerial involvement only when Parliamentary approval is required for donee status because the charity intends to operate overseas. Even in those cases, there is no government monitoring of whether a charity is continuing to meet the charitable purposes for which it was established.
  - Moreover, the assistance granted to charities through the tax system is not transparent and, as such, disguises the total level of expenditure on different parts of the government's programme.

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<sup>2</sup> See discussion in chapter 11.

2.13 In light of these concerns, governments need to ensure that the support they have decided to give through the tax system is appropriately targeted, is transparent and has the scope for some ministerial or official review. These questions are a particular focus of the review and this discussion document.

### ***International comparisons***

- 2.14 Most countries provide support to charities through the tax system in one form or another. The appendix compares the current rules in New Zealand with the rules applying in the United Kingdom, Australia, the United States and Canada. These countries use definitions of “charitable purpose” that are similar to our own and provide similar assistance through the tax system. But all have significantly more developed registration and reporting arrangements, with approved registration being a common feature for those entities seeking tax assistance. In the United Kingdom, charities come under the purview of a Charities Commission. In the other cases, the arrangements are administered as part of the tax system, through their respective tax authorities.
- 2.15 Specific features of some of these countries are also discussed in subsequent sections of this discussion document as the proposals in relation to reporting and the definition of “charitable purpose” are outlined.

### **Summary of proposals**

- 2.16 This discussion document contains more than one proposal for both the definition of “charitable purpose” and for increased reporting by charities. That is because the government’s decision on the definition of “charitable purpose” will be influenced by feedback on reporting issues. Broadly, if the definition of “charitable purpose” can be modernised or narrowed, less stringent reporting would be required. However, if the definition cannot be modernised without affecting entities which the government considers should be supported, increased monitoring might be required, so that both the government and the public can see that their money is being spent to best effect.

## PROPOSALS

### Defining “charitable purpose” – two options

#### *1. Use the same definition but with safeguards*

The first option is to leave the current definition unchanged, subject only to any liberalisation of the public benefit test, and the safeguards discussed below.

#### *2. Replace the existing definition with a new, general definition assisted by detailed guidelines on how it should be applied, with specific approval required.*

This approach is a modernisation of the current law. It would encompass all of the traditional charitable purposes (relief of poverty, etc.) outlined in chapter 3, but expressed in terminology more fitting to 21st century society. Specific approval would be required before charitable status would be granted. Given that this is a broad definition, it would need to be accompanied by a set of guidelines that could be used in applying the definition.

#### *Safeguards*

Both of these options would be subject to some reporting requirements. They would also be subject to the public benefit test, and could be subject to a discretion or override by the government (on the recommendation of the Minister of Finance) in order to allow it to better target its support. The provisions of section CB 4 of the Income Tax Act 1994 would be amended to require an entity not only to be established for charitable purposes, but to continue to carry out those charitable purposes in order to remain eligible for the tax exemption. All charities would have to register with the government before the tax exemption was available, in accordance with a specified procedure to be developed.

### Reporting requirements

#### *Registration*

The charitable tax exemption would be available only to those charities that have registered as such. This could also involve a specific approval process.

#### *Supply of information*

Charities would file annual accounts (audited when appropriate) and, possibly, tax returns. The annual accounts should be publicly available.

### ***Regular monitoring***

The government envisages that the activities of charities would be regularly monitored (by either the Inland Revenue Department, another government department or an independent body) to ensure that the charitable objects for which their tax exemption was granted were, in fact, being pursued.

### **Specific tax issues**

#### ***Trading operations***

Trading operations of charities would be subject to income tax but with an unlimited deduction for distributions made to the charity that owns the trading operation.

#### ***Charitable purposes outside New Zealand***

The criteria for donee status (section KC 5(1)) for overseas charitable purposes (see paragraph 10.3) would be standardised by applying those same criteria to the income tax exemption (section CB 4(1)(c) and (e)).

#### ***Rebates and deductions for donations to charities***

Rebates for donations by individuals would be increased in line with inflation since 1990, and the company deduction rules in the Income Tax Act 1994 would be simplified by removing the limit for each donation made, and allowing deductions for close companies that are listed on a recognised exchange.

#### ***Fringe benefit tax***

The exemption from fringe benefit tax for fringe benefits provided to employees of charities would be removed.

#### ***Superannuation schemes for the benefit of employees of charities***

The issue of whether superannuation schemes for the benefit of employees of charities should have charitable status is raised for discussion.

#### ***GST***

To remove existing uncertainties, GST input tax credits would be allowed to GST registered charities and other non-profit bodies in relation to all their activities, other than the making of exempt supplies.

## **Outcome of consultation process**

- 2.17 Any legislation resulting from this review is proposed to be included in a taxation bill later this year. We envisage the changes taking effect from the beginning of the income year following enactment.

## **Communicating your views**

- 2.18 The government invites you to provide your views on the proposals in this discussion document. Although the document identifies specific issues for consultation, the government is interested in your views on any of the issues raised. Submissions should be made by 31 July 2001 and can be provided either in written form or electronically.

- 2.19 Written submissions should be addressed to:

The General Manager  
Policy Advice Division  
Inland Revenue Department  
PO Box 2198  
WELLINGTON

The electronic address is [policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz).

- 2.20 Please note submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you feel there is any part of your submission which you consider could be properly withheld under that Act (for example, for reasons of privacy), please indicate this clearly in your submission.



## Part II

# The relevance of the definition of “charitable purpose”

*This part of the discussion document deals with the issue of whether the definition of “charitable purpose” is relevant in the 21st century. It outlines the current law on what constitutes a charity before discussing problems with the current law and possible solutions.*



## **Chapter 3**

### **CURRENT LAW**

- 3.1 Whether an entity, be it a trust, incorporated society or a limited liability company qualifies as a charity entitled to tax concessions depends on whether it meets the following tests:
- It must have been established exclusively for charitable purposes.<sup>3</sup>
  - It must have been established for the benefit of the community as a whole or an appreciably significant section of it (“the public benefit test”). The courts have exempted charities for the relief of poverty from the public benefit test.
  - The charitable purposes cannot be carried on for the private pecuniary profit of any individual.
- 3.2 Furthermore, in the case of a business, the exemption from income tax is not available to the extent the charitable purposes are outside New Zealand. Nor is it available if a person associated with the charity is able to receive some financial benefit from it.

#### **Charitable purposes**

- 3.3 “Charitable purpose” is defined in section OB 1 of the Income Tax Act 1994, as including:
- “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”.
- 3.4 The categories of relief of poverty, education, religion or other community benefits are known as the four “heads” of charity, and are based on the Charitable Uses Act 1601 (sometimes also known as the Statute of Elizabeth).<sup>4</sup> But they are not defined in any legislation. Instead their meaning is to be found in court decisions both in New Zealand and the United Kingdom.

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<sup>3</sup> This discussion document deals only with the definition of “charitable purpose” for income tax purposes, but it is relevant to note that similar concepts apply in other contexts. These include the Charitable Trusts Act 1957 and the Perpetuities Act 1964.

<sup>4</sup> In fact, the preamble to the Statute of Elizabeth itself is strikingly similar to the fourteenth century poem, “The Vision of Piers Plowman”, and some commentators have suggested that the drafter of the statute probably drew upon that poem.

## **Historical influences**

- 3.5 The Charitable Uses Act 1601 was a regulatory tool which provided for commissioners to investigate the misuse of funds that had been endowed for the benefit of charitable causes. The preamble to the Charitable Uses Act listed the following as examples of charitable purposes:
- “The relief of aged, impotent and poor people; the maintenance of sick and maimed soldiers and mariners, schools of learning, free schools and scholars in universities, the repair of bridges, ports, havens, causeways, churches, sea-banks and highways; the education and preferment of orphans; the relief, stock or maintenance for houses of correction; the marriage of poor maids, the supportation, aid and help of young tradesmen, handicraftsmen and persons decayed; the relief or redemption of prisoners or captives; and the aid or ease of any poor inhabitants concerning payment of fifteens, setting out of soldiers and other taxes.”
- 3.6 One of the historical influences on the definition was the Mortmain Act 1736, which operated to invalidate any legacies of money or land to charitable purposes if strict procedures were not followed. That Act appeared to have a distorting influence on the definition of “charitable purposes” throughout the eighteenth and nineteenth centuries, as testators’ families challenged legacies made to entities or purposes outside the family circle. The courts, in order to protect the families’ interests, found more and more purposes to be charitable so that the Mortmain Act could apply to them, and potentially invalidate legacies that had not complied with the required procedures.<sup>5</sup>
- 3.7 The Mortmain Act lost its influence on the development of the law of charities when it was liberalised in the late nineteenth century. However, the courts have continued to develop the law on what constitutes “charitable purposes”.
- 3.8 In looking at the definition of “charitable purpose”, it needs to be borne in mind that the definition has two purposes. At common law a trust for a purpose (as opposed to a trust for a person) is valid only if it is charitable. The courts have therefore found a purpose trust to be charitable wherever possible, in order to avoid the consequences of invalidity. In this way, the definition of “charitable purpose” has broadened over the years. In the tax context, however, the definition of “charitable purpose” provides a threshold for tax relief. At present, “charitable purpose” has the same meaning in both contexts, but an option is to explore whether that need be so.

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<sup>5</sup> See Chesterman *Charities, Trusts and Social Welfare* (Weidenfeld & Nicolson, 1979) at 55-56.

- 3.9 The first major decision to consider the meaning of charitable purpose in the income tax context was *Commissioners for Special Purposes of the Income Tax v Pemsel*<sup>6</sup> (“*Pemsel’s case*”). The judgment of Lord Macaghten embedded into law the four categories of charitable purposes (or heads) of charity. *Pemsel’s case* held that for the purposes of exemption from income tax the definition of “charitable purpose” should be the legal and technical definition deriving from the Charitable Uses Act 1601.<sup>7</sup> Subsequent cases have refined what comes within each category. It is beyond the scope of this discussion document to do any more than canvas these cases briefly. This is done by reference to New Zealand cases, and English cases where relevant to New Zealand law.

### **Case law in relation to the four categories of charitable purpose**

#### ***Relief of poverty***

- 3.10 It has been held by the courts that “poverty” does not mean utter destitution. It simply means a need of some sort, either for a home, or for the means to provide for some necessity.<sup>8</sup>
- 3.11 This category of charitable purpose also encompasses relief of the aged and impotent described in the preamble to the Charitable Uses Act. In *Re Bingham*,<sup>9</sup> it was held that a gift for the care of aged women was charitable under this category. It seems necessary, in this context, that some element of “need” associated with aging (for example, illness, infirmity or poverty) be present.
- 3.12 More recently, the New Zealand High Court held in *D V Bryant Trust Board v Hamilton City Council*<sup>10</sup> that a retirement village in Hamilton which charged rentals for units at well below market rates so that it was available to the elderly of moderate means was a charity. It was accepted that the trust that ran it was a substantial benefactor to the people of the Waikato and did not confer private benefits to any person.

#### ***Advancement of education***

- 3.13 The courts have interpreted the category of advancement of education liberally. It has been said that education is not restricted to the narrow sense of schools and universities, and includes increasing and promoting the appreciation of arts and culture. Thus, the promotion of choral singing has been held to be charitable in the United Kingdom. In New Zealand it has been held by the Court of Appeal in *CIR v New Zealand Council of Law*

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<sup>6</sup> [1891] AC 531

<sup>7</sup> The dissenting minority in *Pemsel* were of the view that, for a taxing act, the words “charitable purposes” should be restricted to their “ordinary and natural” meaning, which was purposes for the relief of poverty.

<sup>8</sup> *IR Commrs. v Baddeley* [1955] AC 572 at 585.

<sup>9</sup> [1951] NZLR 491

<sup>10</sup> [1997] 3 NZLR 342

*Reporting*<sup>11</sup> that the publication of law reports by the Council of Law Reporting (a non-profit body) is a charitable activity under this head. More recently, the High Court held in *Educational Fees Protection Society Inc v CIR*<sup>12</sup> that an incorporated society that had as its objectives the payment of the fees of school pupils on the death of a parent was charitable under this head.

- 3.14 Sporting purposes are not charitable in themselves.<sup>13</sup> However, sporting purposes have historically been charitable when undertaken through an educational facility. In *IR Commrs v McMullen*<sup>14</sup> the House of Lords held as charitable under the education head a trust to improve the sporting facilities available to students. The definition in New Zealand is broadened by section 61A of the Charitable Trusts Act 1957, under which it is charitable to provide, in the interests of social welfare, facilities for recreation or leisure time occupation.

### ***Advancement of religion***

- 3.15 With respect to the advancement of religion, there is no distinction in case law between one religion and another or one sect and another, so the advancement of any religious doctrine could be considered charitable. The advancement of religion simply means the promotion of spiritual teaching in a wide sense. In *Centrepoint Community Growth Trust v CIR*<sup>15</sup> Tompkins J found that the trust, which had as one of its purposes the advancement of the spiritual education and humanitarian teaching of Herbert Thomas Potter, was charitable as being a trust established for the advancement of religion. For the purposes of the law, the criteria of religion are the belief in a supernatural being, thing or principle and the acceptance of certain canons of conduct in order to give effect to that belief.
- 3.16 This category includes a wide variety of activities associated with religion, such as the repair of churches, and the installation and building of stained glass windows and spires. It has also been held by the court that this charitable purpose includes a superannuation fund established to provide an annuity to ministers of religion in their retirement.<sup>16</sup> The fund's objectives were the protection of its ministers of religion, by ensuring that they were provided with sufficient income throughout their life in accordance with their lifelong commitment to the church. The retired ministers who received a financial benefit were an integral part of the structure and workings of the church and without them the church would cease to exist.

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<sup>11</sup> [1981] 1 NZLR 682

<sup>12</sup> (1991) 13 NZTC 8,203

<sup>13</sup> *Re Nottage* [1895] 2 Ch 649, where a gift for the encouragement of yacht racing was held not charitable. *Re Nottage* was applied in *Laing v Commissioner of Stamp Duties* [1948] NZLR 154. In that case it was held that although sporting activities may result in greater physical fitness, and the indirect benefits to the public may be more highly valued, the purposes were still not within the analogy of the Charitable Uses Act 1601 (43 Eliz 1, c 4).

<sup>14</sup> [1980] 1 All ER 884

<sup>15</sup> [1985] 1 NZLR 673

<sup>16</sup> *Presbyterian Church of New Zealand Beneficiary Fund v Commissioner of Inland Revenue* [1994] 3 NZLR 363.

### ***Any other matter beneficial to the community***

- 3.17 As would be expected, the fourth category of the *Pemsel* classification has the greatest variety of activities and purposes that have been considered charitable. It was held by the majority of the New Zealand Court of Appeal in *CIR v Medical Council of NZ*<sup>17</sup> that the Medical Council, which is a statutory body established, among other things, to maintain a formal system of registration of medical practitioners, was a charitable body. The court held that the purpose of the Medical Council was the protection of the public by ensuring that only those persons properly qualified could practise medicine. Perhaps more importantly, the court confirmed that the correct approach today is that objects that are beneficial to the community or are of public utility are *prima facie* charitable under the fourth category unless there are good reasons why they should not be.
- 3.18 Within this category, all manner of activities, including protection of animals, rehabilitation of prisoners, increasing the efficiency of the armed forces and promoting cremation as a means of disposing of the dead, have been held to be charitable. Political activities have been held not to be charitable.

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<sup>17</sup> [1997] 2 NZLR 297

## **Chapter 4**

### **WHY REVIEW THE DEFINITION OF “CHARITABLE PURPOSE”?**

- 4.1 Two main factors are behind the government’s interest in reviewing the definition of “charitable purpose”: that the charitable tax exemption may be too widely available, and it may be out of date. It may be that these problems are problems of perception only. The government has little information about the scope and cost of the tax exemption, so it is difficult to tell whether these problems are at the margin or are more general. For this reason, the reporting proposals discussed in chapter 8 are key.
- 4.2 Some sectors of the community have expressed concern that the charitable tax exemption is too widely available, and may be being used by some businesses to gain an advantage over their competitors. In that respect, it could be argued that the legal concept of a charity is now somewhat remote from the popular perception that a charity connotes “worthy” causes. These causes might involve the giving of assistance to less fortunate members of society, or providing for other activities that have clear and discernible benefits to the community as a whole. It is unlikely that in the public’s mind, the New Zealand Council for Law Reporting and the Medical Council, for example, would be considered charitable in the same way as, say, the Salvation Army or the Red Cross.
- 4.3 Furthermore, a definition used to make decisions about what is, in effect, government expenditure, and that is based on law up to 400 years old, should be reviewed in the light of the needs of New Zealand in the 21st century. The government is concerned to ensure that tax assistance is directed to those charitable purposes and activities that have broad-based community acknowledgement and support, and that those in greatest need of those resources have access to them. The fiscal privileges accorded to charities make it imperative that the definition of “charitable purpose” accords with society’s current objectives.
- 4.4 Other factors are that:
  - Concerns have been expressed that in some cases the benefit to society provided by an organisation is incidental to some other purpose it has undertaken.
  - As a technical matter, the definition of “charitable purpose” refers only to organisations *established* exclusively for charitable purposes. There is an argument that because of this, there is no legislative authority to challenge the tax exemption of an organisation that was established for, but no longer pursues, the relevant charitable purposes.

## Chapter 5

### OPTIONS FOR CHANGING THE DEFINITION

- 5.1 The definition of “charitable purpose” could be reformed in several ways, ranging from minimal to radical change. This chapter discusses two possible options: maintain the current broad definition but incorporate safeguards or use a new, broader definition with built-in safeguards. The government has also considered the possibility of using a radically limited definition, an approach described in detail below. However, because a large number of existing charities would no longer qualify as a charity for tax purposes if this definition were adopted, the government has decided not to proceed with this approach.
- 5.2 As discussed in chapter 1, both the options require some reporting requirements to be introduced. Reporting issues are discussed in Part III.

#### **Option 1: Maintain the current definition but with safeguards**

- 5.3 This option recognises the difficulty of rewriting the current definition of “charitable purpose” completely, despite its acknowledged problems as identified in chapter 4. A reason for no change would be to avoid the uncertainty and the transitional problems that a new definition would create.

#### *Proposal*

- 5.4 The four categories of “charitable purpose”, as are currently applied in New Zealand, would remain central to the definition. However, the tax exemption would be available only to registered charities (see chapter 8), and the wording of section CB 4 of the Income Tax Act 1994 would be amended so that an entity need not only be established for charitable purposes, but also must continue to carry out these charitable purposes for as long as it claims the tax exemption.
- 5.5 A variation could involve the government (on the recommendation of the Minister of Finance) having the ability to override any registration and to deregister a charity. This would be in keeping with recognising the tax exemption as an expenditure decision by the government and would allow the government to target those entities undertaking activities that it wishes or does not wish to support. To ensure that any such changes could be made within a reasonable timeframe and were transparent, they could be promulgated by Order in Council, and gazetted, and apply from the beginning of the following tax year.

### ***Advantages***

- 5.6 The advantages of maintaining the status quo in respect of the four categories of charitable purpose are simply that a large body of law already exists on what is a charitable purpose, and the rules have been relatively stable, although developing, for a long time. It would also avoid the transitional problems that would arise with a new definition. Some charities may have the power in their trust deeds to amend their trust purposes. There is otherwise no power to vary the purposes of a charitable trust unless it has become impossible, impractical, or inexpedient to carry them out (Charitable Trusts Act 1957, section 32).
- 5.7 The advantage of allowing the government the power to deem a particular entity not to be charitable is that it would allow decisions about government resources to be made in a manner consistent with evolving views on what constitutes a charitable purpose.

### ***Disadvantages***

- 5.8 The definition would still be wide, although the problems identified in chapter 4 could be managed to some extent by the registration process, and/or the government's discretion or override.

### ***Option 2: Replace the existing definition with a new, general definition assisted by detailed guidelines on how the definition should be applied, with specific approval required.***

- 5.9 The specific references to poverty, education and religion would be removed but the entities covered by those categories could still qualify under the new definition on a case-by-case basis, subject to specific approval. This option would involve the same breadth of definition in general terms but would be quite different in its manner of operation, in particular because a specific approval would be required.
- 5.10 An example of generalised wording would be:

“A charitable purpose means a humanitarian purpose that, when viewed objectively, makes a direct positive contribution to the well-being of society as a whole.”
- 5.11 The reason for adopting this approach would be to move away from existing case law, which may have expanded the boundaries of what is charitable to such an extent that it is now too easy to become a charity. One issue would be to ensure that the definition would be sufficiently different that the courts could not continue to apply the current case law. This definition would implicitly or explicitly be subject to the public benefit test.

- 5.12 A set of detailed guidelines would be required to give the general definition meaning and focus. The guidelines could be set by Order in Council and in that respect, could be more readily varied over time as the public perception of what is a charitable purpose changes.
- 5.13 Because specific approval would be needed before charitable status was conferred, responsibility for this would have to be undertaken by either a government department or some other body. The decision-maker would have to have regard to all relevant guidelines. In all but the most clear-cut cases, it would be a matter of fact and degree as to whether, after taking into account the relevant guidelines, a particular purpose was charitable. It would, of course, be up to each applicant to show the relevant benefit to society. The specific approval process is also discussed in chapter 8.
- 5.14 Possible guidelines could cover:
- whether and to what extent the stated purpose complements or supplements the government's measures on providing housing, food, education and other basic necessities of life;
  - whether and to what extent the stated purpose promotes education;
  - whether and to what extent the stated purpose promotes culture or the arts;
  - whether and to what extent the stated purpose propagates any religion or any set of beliefs, and if so, the nature of the principles, tenets or teachings sought to be promoted;
  - whether and to what extent the stated purpose provides support for people requiring health care or suffering some kind of disability, distress or suffering; and
  - whether and to what extent the stated purpose is directed to the protection and rescue of animals.
- 5.15 The government override discussed in option 1 could also be applied to this option.

### *Advantages*

- This option would not immediately exclude a great number of current charities from the tax exemption.
- It retains the flexibility of the fourth *Pemsel* category, although it requires that the charitable purpose makes a genuine contribution to the enhancement of society's welfare.
- It does away with the current *Pemsel* categories, thereby ensuring that no one purpose could claim to be *prima facie* charitable just because it falls within any one of those categories.

- It provides transparency of decision making by the promulgation of guidelines which the decision-maker is required to have regard to.
- A specific approval process would increase certainty for an organisation that it qualifies as a charity for tax purposes.
- A specific approval process, by covering both applications for income tax exemption and donee status,<sup>18</sup> would reduce compliance costs.

### ***Disadvantages***

- Given that there is criticism that the current definition is too wide and uncertain, this option could be criticised as being no better.
- Some of the guidelines could be criticised as being vague and difficult to apply.
- Given that there would be a specific approval process, the information required from applicants to determine if they meet the definition could be considered onerous.
- If the decision-maker were to be an independent body there could be high costs involved in setting up and maintaining such a body to grant specific approvals.
- The transitional costs could be high as existing charities become subject to the new rules.

### **Alternative approach: Limit the definition to the relief of poverty, illness, distress or other suffering**

- 5.16 The government has also considered the approach of defining a charitable purpose to be the relief of poverty, illness, distress or other suffering. This is a similar concept to that outlined in the dictionary definition referred to in chapter 1. In essence, this limits the definition to only one of the categories of charitable purpose under current law. As is the case under current law, this definition would not be subject to the public benefit test.
- 5.17 The range of entities that would qualify for charitable status would narrow dramatically, and it is likely that a large number of entities now accepted as charitable under current law would not qualify under these criteria. Significantly, entities such as independent schools and affiliated organisations, universities and religious organisations (unless they form separate entities that have the purposes of the relief of poverty and other hardship) would not qualify.

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<sup>18</sup> A donee organisation within section KC 5(1) of the Income Tax Act 1994.

5.18 This approach could be modified by defining charitable purpose by reference to the concept of “needs”, rather than the possibly more restrictive concept of “poverty”. A possible alternative definition could incorporate some phrases from section 61A of the Charitable Trusts Act 1957 and could provide that:

“charitable purpose means any purpose –

- (a) that improves the conditions of life of persons, who, by reason of their youth, age, infirmity, disablement or social or economic circumstances, are in need of any such assistance; or
- (b) that relieves any illness, suffering or other hardship.”

5.19 The definition might also incorporate the following phrases, based on section 38 of that Act:

“Without in any way limiting the generality of [the definition of charitable purpose] purposes that improve the conditions of life of those persons requiring the assistance include –

- (a) the supply of the material needs of those persons;
- (b) the education, counselling and teaching of life-skills of those persons;
- (c) the provision of housing, shelter and food for those persons.
- (d) the provision of health and medical services for these persons.”

### ***Advantages***

- From the point of view of targeting government support of charities, narrowing the definition would mean that more resources were available to support those organisations that fall within it.
- There is already a body of law in relation to “poverty” with which people are familiar, and the relief of illness, distress and other suffering have traditionally been “charitable” under the current definition.
- This approach reflects the popular perception that charities are organisations having as their goal the alleviating of hardship and the provision of aid and assistance to the suffering and the needy.

### ***Disadvantages***

- A significant number of entities that are currently charities and the public has long acknowledged to be charitable (such as schools and churches) would fall out of the definition, except to the extent they were providing for the relief of poverty, and would have to adjust their expenditure to compensate for having to pay tax. This in turn means that there would be less money for those particular purposes, which by and large the community continues to support.

- There could be confusion over the fact that many entities would remain charities for other purposes, say, for the purpose of the Charitable Trusts Act 1957, but would not be “charitable” for tax purposes.
- 5.20 Given these significant disadvantages, the government has decided not to proceed with this approach.

### **Blood ties, contractual arrangements and the public benefit test**

- 5.21 The public benefit test must be satisfied before an entity qualifies as a charity, except in the case of a charity for the relief of poverty. Although the question of whether the public benefit test is satisfied is considered on the facts of each case, the courts have developed a number of general tests for determining whether the group benefiting constitutes the public or an appreciably significant section of the public. Through cases such as *Re Compton*<sup>19</sup> and *Oppenheim v Tobacco Securities*<sup>20</sup> it has been established that the number of beneficiaries must not be negligible. In addition, even if the number of beneficiaries is large, if those beneficiaries are determined on the basis of a personal relationship such as blood or contractual ties, the entity will not be for the public benefit. Rather it will be for the benefit of private individuals and, therefore, not charitable.<sup>21</sup>
- 5.22 The House of Lords (Lord Cross) in *Dingle v Turner*<sup>22</sup> has questioned the *Re Compton* and *Oppenheim* tests, suggesting that the existence of a personal connection such as blood ties or a contract should not be determinative of whether an entity provides a public rather than a private benefit. Rather, consideration should also be given to the nature of the entity and the charitable purpose for which it was established, the number of beneficiaries and the degree of connection between the beneficiaries. Although the *Re Compton* and *Oppenheim* tests have continued to be applied in the English courts, Lord Cross’s comments have been noted with approval in two recent New Zealand cases.<sup>23</sup> Consequently, there is now a degree of uncertainty in New Zealand as to whether trusts for the benefit of persons who are determined by either a blood or contractual relationship will satisfy the public benefit test.

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<sup>19</sup> [1945] 1 All ER 198

<sup>20</sup> [1951] 1 All ER 31

<sup>21</sup> In Oppenheim’s case a gift for the education of the children of the employees and former employees of the company and its subsidiaries failed to qualify as a charity because the employees of a firm were not a public class. This was in spite of the fact that at the testator’s death the number of employees exceeded 110,000.

<sup>22</sup> [1972] AC 601

<sup>23</sup> *New Zealand Society of Accountants v CIR* [1986] 1 NZLR 147, *Educational Fees Protection Society Incorporated v CIR* (1991) 13 NZTC 8,203.

5.23 The inability of an entity to qualify for charitable status when its beneficiaries are determined on the basis of bloodlines has been raised by the Maori community as a major concern, although it is by no means an issue limited to Maori. Although Maori authorities often provide benefits of a charitable nature to iwi and hapu, they might not qualify for an exemption because their benefit extends to a specified group of people connected by blood ties. This issue is being considered as part of the government review of the taxation of Maori authorities.

*Proposal*

- 5.24 One proposal likely to emerge from the government's review of the taxation of Maori authorities is that an entity will not cease to be eligible for charitable status by reason only of the fact that its purpose is to benefit a group of people connected by blood ties. Other factors such as the nature of the entity, the number of potential beneficiaries, and the degree of relationship between beneficiaries would then have to be considered in determining whether an entity benefited a sufficient section of the public.
- 5.25 Although this proposal is especially relevant to iwi and hapu-based entities, it would apply to both Maori and non-Maori entities. Entities would no longer be prevented from having access to the charitable tax exemption solely because the potential beneficiaries might be related in some way. Submissions received in relation to this proposed change to the public benefit test will be considered in relation to both the review of the taxation of charities and the review of the taxation of Maori authorities.

**Specific issues for consultation**

Submissions are sought on these options, and the following issues, in particular:

- Do you consider that the current definition of “charitable purpose” is too wide?
- Do you consider the definition remains appropriate to New Zealand society in the 21st century?
- If the current, or a new, definition were modified by guidelines, are those expressed above at option 2 appropriate?
- Do you agree that the public benefit test should be liberalised to cover blood ties and contracts?



## Part III

# Reporting requirements for charities

*The government considers that some level of reporting requirements must be introduced so it can measure the effectiveness of its tax assistance to charities. Because of the lack of reporting requirements, there is no means by which the government can measure the cost of the income tax exemption, nor monitor the nature or activities of those entities benefiting from it. Accordingly, this part of the discussion document focuses on reporting requirements. It outlines what reporting arrangements currently exist for charities, the reasons for requiring more reporting and the proposed new reporting arrangements.*



## **Chapter 6**

### **CURRENT LAW AND PRACTICE**

- 6.1 This chapter summarises the reporting requirements and other arrangements that can currently apply, in law or in practice, to certain charities.

#### **Accounting**

- 6.2 No specific accounting standard applies to the preparation of accounts of charities or non-profit organisations in New Zealand. Nevertheless, any member of the Institute of Chartered Accountants of New Zealand preparing or auditing accounts for a charity is required to comply with generally accepted accounting principles. The Institute has issued a research bulletin on Financial Reporting by Voluntary Sector Entities (R-120, January 1999), setting out reporting guidelines for voluntary sector entities.

#### **Tax**

- 6.3 As a matter of practice, most entities seeking charitable status will submit their founding documents to Inland Revenue for its view as to whether or not the entity is charitable at law. It should be noted, however, that this is neither required, nor is the Inland Revenue view binding, except when a binding ruling is obtained. Whether an entity is a charity for tax purposes is ultimately a matter for the courts. Thus it is possible for a charitable entity to exist and derive untaxed income without the government being aware of this.
- 6.4 If an organisation has donee status, those who make donations to it may claim rebates or tax deductions for them. Again, in practice, many organisations seek confirmation of this from Inland Revenue. The definition of “donee organisation” (in section KC 5 of the Income Tax Act 1994) is wider than that of a charity and includes any organisation,
- “the funds of which are applied wholly or principally for any charitable, benevolent, philanthropic or cultural purposes in New Zealand.”
- 6.5 Because donee status is limited to purposes within New Zealand, organisations with purposes outside New Zealand must seek and obtain specific legislative approval (see section KC 5(1)(ae) to (bv)).

6.6 Several provisions in the Tax Administration Act 1994 potentially apply to charities:

- Section 32 requires all gift-exempt bodies<sup>24</sup> to keep sufficiently accurate records, in English, to enable the Commissioner of Inland Revenue to determine both the sources of donations made to them and the application of those funds.
- The Commissioner has the power under section 58 to require gift-exempt bodies to furnish a return showing the source and application of their funds (whether derived or actually received).
- There is a general power in section 80 for the Commissioner to require any person, whether a taxpayer or not, to furnish any return the Commissioner considers necessary for the purposes of the Tax Administration Act or the Income Tax Act.
- Under section 89, if the Commissioner has reason to believe that the funds of a gift-exempt body are being applied for a purpose that is not charitable, benevolent, philanthropic or cultural, the Commissioner will inform the Minister.

### **Charitable Trusts Act**

6.7 The trustees of a charitable trust can, if they wish, incorporate as a board under the Charitable Trusts Act 1957. The big advantage of doing so is perpetual succession in that property is held in the name of the board and does not have to be transferred to new trustees when the membership of the board changes. Complaints about charities can be made to the Attorney-General, who has the power under section 58 of that Act to inquire into the management and administration of any charity, whether or not the trustees are a corporate body. Under section 60 of the Act, any member of the public can sue to enforce the charitable purposes of the trust.

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<sup>24</sup> A gift exempt body is an organisation within section KC 5(1) of the Income Tax Act 1994, and any other person issued with a certificate of exemption from resident withholding tax under subsections (1)(i) or (1)(j) of section NF 9 of the Act. Those subsections apply to persons deriving exempt income under:

- section CB 3(a) and (b) – (public and local authorities);
  - section CB 4(1) – various exempt persons including charities;
  - section CB 5(1)(i) and section CB 9(e) – various categories of exempt income;
- and to non-profit bodies earning less than the \$1000 limit provided in section DJ 17.

## **Chapter 7**

### **WHY INCREASED REPORTING IS NECESSARY**

- 7.1 Because current arrangements contain no obligatory reporting requirements for charities, it is possible for an entity to claim charitable status, and have access to the taxpayer subsidy without the government having knowledge of this, without any monitoring of the entity's activities or the use of the funds it raises. This situation raises the following two concerns for the government.

#### **Cost of the subsidy**

- 7.2 There is no means by which the government can know how much it is spending on the charitable tax exemption, although information is available about the amount of rebates claimed.
- 7.3 A government decision to not collect tax from a certain sector of society can be regarded as similar to a government expenditure decision. Ideally, then, the government should be in a position to know how much of taxpayers' money is being "spent" as a result of such a decision. Although many charities register under the Charitable Trusts Act, or submit their documentation to Inland Revenue, there is no complete list of organisations benefiting from the tax exemption, or information about the extent to which they are benefiting. Further, the government does not know how much of the subsidy is being spent on charitable purposes outside New Zealand (see chapter 10). If this information were available to the government, it is possible that more accurate targeting of government assistance could take place.

#### **Accountability**

- 7.4 Apart from random Inland Revenue audits and the provisions of the Charitable Trusts Act, there is no process for monitoring whether entities are pursuing the charitable purposes for which they were set up.
- 7.5 Inland Revenue has a role in monitoring charities to ensure that section CB 4 of the Income Tax Act is being complied with. However, regular monitoring would involve extremely pro-active audit activity on the part of Inland Revenue, as no information is available to the department on which it can make a decision to conduct an audit.
- 7.6 When the government contracts with voluntary organisations or others to provide services in the community, some form of reporting is always required. The level of reporting varies from sector to sector. It sometimes involves detailed, itemised budgets, and in some cases focuses more on outputs produced. The level of reporting can also depend on the amount of funding involved. Generally, the government expects audited accounts to be

provided to ensure that public money is being used for the purposes for which it was intended. No such accountability is required for the charitable tax exemption to be accessed.

- 7.7 As part of this accountability question, it is not always clear whether profits of commercial operations carried on by, or owned by charities are distributed to the charitable purposes for which the entity was established.
- 7.8 If a charity is raising funds by means of conducting a profitable business activity, this in theory is no different from raising funds by any other means. However, if profits are not being distributed to charitable purposes but being re-invested into the business, it may be that the charitable purposes are not being met (see chapter 9).

## Chapter 8

### OPTIONS FOR CHANGE

- 8.1 This chapter details several proposals for improving reporting requirements for charities. They include registration, filing annual audited accounts (possibly to be made public), filing tax returns and other regular monitoring.
- 8.2 Administration of any of the reporting requirements discussed here could be undertaken by Inland Revenue, another government department, or an independent body. It may be that a party other than Inland Revenue would be in a better position to undertake this administration, given that the secrecy provisions of the Tax Administration Act 1994 would inhibit transparency. In some cases, if Inland Revenue were the appropriate body, the Tax Administration Act might have to be amended to avoid this problem.

#### **Registration**

- 8.3 At present, there is no requirement that a charitable entity be registered as such.

#### *Proposal*

- 8.4 It is proposed that in order to qualify for the various tax subsidies, an entity would have to officially notify the government, by means of a set procedure, that it considers itself to be a charity for tax purposes. Under this proposal, there would be no formal approval process, although the entity might be required at a later stage to demonstrate that it meets charitable purposes. This process would not, however, preclude application to Inland Revenue for informal confirmation that the founding documents *prima facie* demonstrate charitable purposes.
- 8.5 Registration could be with Inland Revenue, another government department or an independent body. However, the list of registered charities should be publicly available, so if the register were maintained with Inland Revenue, it should not be subject to the usual Inland Revenue secrecy provisions.
- 8.6 This registration requirement would apply to existing as well as new charities. For existing charities, there could be a period within which registration must take place, say, one year, before the tax exemption would be withdrawn.
- 8.7 The registering body would have power to de-register a charity if it were found not to be pursuing its stated charitable purposes, or if it had failed to meet other obligations imposed upon it (for example, if charities were required to file tax returns, or annual accounts, and had failed to do this).

### ***Advantages***

- 8.8 The government and the public would have access to better information about the number and type of entities benefiting from the tax exemption.

### ***Disadvantages***

- 8.9 The only real disadvantage of registration requirements would be increased compliance costs, although they should be one-off and not particularly onerous. Many charities already seek Inland Revenue's view as to their charitable status or donee status.

### **Approved registration**

- 8.10 As an alternative, the government has considered a procedure which is common overseas, whereby registration would be approved before the tax subsidies were available. This approach was referred to, together with its advantages and disadvantages, in chapter 5 when discussing the option of replacing the current definition of "charitable purpose" with a new, general definition. But it could be applied to any of the definition options.
- 8.11 The approval requirement would apply to existing as well as new charities, which would raise transitional issues that would have to be dealt with.
- 8.12 Essentially, approved registration would involve an assessment of whether the purposes for which the entity was established were charitable, and would likely be binding on both the charity and Inland Revenue. Because of the binding nature of the decision, it would have to be administered by an independent body. Issues would then arise as to the funding, composition and role of such a body. The role of the courts would be confined to that of judicial review of the decision-making process. It would also likely involve on-going monitoring by that body of the activities of the charity.

### **Annual accounts**

- 8.13 As noted earlier, most organisations receiving government funding are required to provide audited annual accounts, for accountability of the public money they receive. Given that the tax subsidies are a form of public funding, in principle those taking advantage of them should also be required to provide accounts. Even with a registration process in place, some form of continuous monitoring is important, to ensure continued adherence to the relevant charitable purposes.

### *Proposal*

8.14 Each registered charity should be required to prepare audited annual accounts. These should be filed with an appropriate body, and made publicly available. The accounts would be in accordance with New Zealand accounting standards, and should, at a minimum, show all amounts actually distributed to charitable purposes, both in New Zealand and overseas.

### *Advantages*

8.15 If these accounts were required to be made public, not only would the government have information about how the tax forgone had been spent, but the public would have access to information about how its donations had been spent.

### *Disadvantages*

8.16 As with registration, the only disadvantage of this proposal is increased compliance costs for charities. However, many charitable organisations prepare accounts already and, in fact, some make these public.

### *Possible threshold*

8.17 For some smaller charities, preparation and auditing of annual accounts may give rise to disproportionate compliance costs. It may be that an income threshold should be introduced for those smaller charities that should not be required to comply to the same extent. For these smaller charities, it may be that a simple income and assets statement would be sufficient.

## **Tax returns**

### *Proposal*

8.18 Charities would file an annual income tax return with Inland Revenue. The Commissioner already has power, under section 58 of the Tax Administration Act, to require “gift-exempt” organisations to file returns, although this provision is rarely used. The return could require details of:

- income – amounts and sources;
- expenditure – including details of amounts distributed to charitable purposes (including amounts distributed overseas);
- assets and liabilities; and perhaps
- remuneration bands for senior staff.

### ***Advantages***

- 8.19 The advantage of filing annual income tax returns, over and above any requirement to provide accounts, would be that more accurate information about the amount of tax forgone would be available to the government. The administration costs involved in Inland Revenue reviewing the accounts of all charities to extract this information are likely to be higher than the compliance costs involved for charities in filing a tax return, given that they would be preparing annual accounts.

### ***Disadvantages***

- 8.20 Again, compliance costs are the only disadvantage. The government has considered whether smaller charities (say, those who would not have to file audited accounts) should be exempt from this requirement. However, if those smaller charities were to prepare an income and asset statement, it might not be unduly onerous to convert that information into a tax return.

### **Other forms of regular monitoring**

- 8.21 The purpose of the charitable tax exemption is to subsidise spending on charitable purposes. If profits are not being distributed to the relevant charitable purpose, the objective of the tax exemption is not being met.
- 8.22 The government envisages that the activities of charities would be regularly monitored to ensure that an organisation was charitable at law and was applying its funds for charitable purposes. A charity that was accumulating significant funds, for example, could be asked to explain the reasons for such accumulation.
- 8.23 A list of registered charities, combined with information from annual accounts and returns would enable the design of a better-targeted audit programme by Inland Revenue. One option is to tie the provision of tax returns to an Inland Revenue audit programme so that only those that are audited would be required to file returns. This approach has recently been adopted in the United Kingdom. This approach would not require legislative change in New Zealand, given section 58 of the Tax Administration Act.
- 8.24 Although this discussion assumes that regular monitoring would be conducted by Inland Revenue, it would be possible for this activity to be undertaken instead by another government department or an independent body. If registration were to involve specific approval, the body that undertook that approval process could also undertake other functions such as auditing.

### **Specific issues for consultation**

- Should registration be subject to a formal approval process?
- If so, what would be an appropriate time frame in which to require existing charities to obtain approval?
- Should audited annual accounts of charities be made publicly available?
- Should there be an income threshold for smaller charities? At what level of income should any such threshold be set?
- Should tax returns be required only on a regular sample basis?
- Should regular monitoring be undertaken by Inland Revenue as part of an audit programme, or by some other body?



## Part IV

# Specific income tax issues

*This part covers a range of specific issues that have been raised from time to time. All relate to aspects of the Income Tax Act 1994 and in some cases are interconnected with the definition and reporting issues discussed earlier. The specific issues are:*

- *the tax treatment of trading operations run by charities;*
- *what limits should apply to charities with purposes outside New Zealand;*
- *the level of assistance to individual and corporate donors;*
- *whether imputation credits should be refunded;*
- *recognition of fringe benefits provided to employees of charities; and*
- *the status of superannuation schemes for employees of charities.*



## Chapter 9

### CHARITIES' TRADING OPERATIONS

- 9.1 Many charities raise funds through trading activities. The scale of these activities can vary considerably, from a fete stall to a large-scale business, and in some cases the activities are carried out by an entity separate from the charity. The income earned from these activities is tax-exempt; in other words, it is treated the same as any other income earned by a charity, on the basis that the profits from the activities will be ultimately used for charitable purposes.
- 9.2 A criticism often levelled at this exemption is that it provides the trading activity with a competitive advantage over its tax-paying competitors. One element of a firm's normal cost structure, income tax, is not present in the case of the charity-run trading operation. It is argued that this "lower" cost could be used by a large-scale entity to undercut its competitors, in order to improve its market share or to deter new entrants.
- 9.3 Any one type of cost, however, cannot be looked at in isolation. Because the tax-exempt entity can generally earn tax-free returns from all forms of investment,<sup>25</sup> the "after tax" return it expects from a trading activity is correspondingly higher than that of its taxed competitors. Therefore an income tax-exempt entity cannot rationally afford to lower its profit margins on a trading activity, as alternative forms of investment would then become relatively more attractive.
- 9.4 On this basis, the tax-exempt entity will charge the same price as its competitors. The tax exemption merely translates to higher profits and, hence, higher potential distributions to the relevant charitable purpose. Consequently, funding the charitable activity from trading activities is no more distortionary than sourcing it from "passive" investments, such as interest on bank deposits, or from direct fund raising.
- 9.5 In the short term, a large-scale tax-exempt entity could try to use its "deeper pockets" to eliminate competitors by temporarily lowering its prices, although there is no real evidence to suggest that this is occurring.
- 9.6 A charity could have a competitive advantage, however, if it were to accumulate its tax-free profits back into the capital structure of its trading activities, enabling it, through a faster accumulation of funds, to expand more rapidly than its competitors. We consider that this is the real competitive advantage that trading activities owned by charities have over their competitors. This competitive advantage potentially applies to other forms of income earned by charities, although there is more scope for that

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<sup>25</sup> An exception is investment in domestic equity, as imputation credits are non-refundable (see chapter 13).

advantage to create distortions within the market in which a charity is trading than in other markets.

- 9.7 Further, it is possible that some benefit of the tax-free gains could be captured by individuals involved in the trading operation. This is contrary to the principles supporting the income tax exemption for charities. At present, however, a charity loses its tax exemption if a person who is in a position to influence remuneration or other financial benefits paid by a charity receives such remuneration or benefits.<sup>26</sup>

## **Proposal**

- 9.8 Trading operations owned by charities would be subject to tax in the same way as other businesses, but with an unlimited deduction for distributions made to the relevant charitable purposes. Donations made to other charities would be subject to the same deduction limits as other companies (see chapter 11). Because the competitive advantage arises only from the ability to grow a business faster by accumulating pre-tax funds, this proposal might not be necessary if accumulations were monitored. As noted earlier in the discussion on reporting requirements, although there need not be specific limits on accumulations, the accumulation of funds could lead to questions from the monitoring authority as to why this was happening.

## **Advantages**

- 9.9 If a trading operation of a charity were being used as a means of raising funds for distribution to the relevant charitable purposes, the income would effectively be exempt, as the deduction for funds distributed appropriately would cover the relevant income. Although this rule could be circumvented by distributing and then immediately reinvesting funds, this would show up in the accounts of the charity. This could raise questions as to whether the charity was as a matter of fact pursuing its charitable objectives (see chapter 3).

## **Disadvantages**

- 9.10 Removal of the exemption and its replacement with a deduction for distributions made to a parent charity would impose compliance and administrative costs, although charities should have information on their income and distributions readily available. This could be a problem particularly for charities with small-scale trading activities, in which case a turnover threshold could be introduced, below which the activity would not be taxed.

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<sup>26</sup> In its 1989 report, the Working Party on Charities and Sporting Bodies made a number of recommendations aimed at tightening section CB 4(1)(e) (section 61(27) of the Income Tax Act 1976) (see pages 37-41 of the report).

### **Specific issues for consultation**

- Would the alternative of limits on accumulations of profits of businesses run by charities be preferable?
- Given that accumulation problems might also arise with passive investment activities, would you prefer to see the proposed rules apply to investment as well as trading activity?
- What level of threshold might be appropriate for small-scale trading activities?

## **Chapter 10**

### **CHARITIES WITH PURPOSES OUTSIDE NEW ZEALAND**

- 10.1 At present, the general rules that provide donors with rebates and deductions for their donations cover only charitable purposes within New Zealand. Specific parliamentary approval is required on a case-by-case basis for charities whose charitable purposes extend outside New Zealand. The over forty organisations that have such approval are listed separately in section KC 5(1) of the Income Tax Act 1994.
- 10.2 Reasons for this restriction are a combination of concern about to what purposes donations might be put, as well as acknowledging that the tax assistance is a specific government expenditure decision and should be consistent with New Zealand's overseas aid programme.
- 10.3 Accordingly, over the years a set of criteria has been established for approving organisations seeking donor status with charitable purposes outside New Zealand. The funds have to be applied towards either:
  - the relief of poverty, hunger, sickness or ravages of war or natural disaster; or
  - the economy of developing countries (recognised as such by the United Nations); or
  - raising the educational standards of a developing country.
- 10.4 Specifically excluded have been charities formed for the principal purpose of fostering or administering any religion, cult or political creed.
- 10.5 The rules differ in respect of the income tax exemptions. Under section CB 4(1)(e) of the Income Tax Act, funds from business activities of a charity in New Zealand must be applied to charitable purposes within New Zealand.<sup>27</sup> However, there is no such restriction on the tax exemption under section CB 4(1)(c), the general income tax exemption for charities. There seems to be no good reason for treating one form of funding differently from another.

#### **Proposal**

- 10.6 The approaches to all forms of tax assistance to charities with overseas purposes would be standardised. The criteria currently used in respect of donee status, described earlier, would be applied in determining eligibility for both the income tax exemptions and for donee status.

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<sup>27</sup> If the funds are used for purposes both within and outside New Zealand, the Commissioner of Inland Revenue can apply apportionment so that only part of the income is tax-exempt.

- 10.7 This means that in respect of the general income tax exemption (CB 4(1)(c)), the eligibility criteria would be tightened, because income applied for some overseas purposes would no longer be eligible for the exemption. However, the eligibility criteria would be liberalised in respect of a charity's business activities (CB 4(1)(e)) because income applied for some overseas purposes would then be eligible for the exemption.
- 10.8 For a charity to comply with this requirement, the overseas charitable purposes of the organisation would have to be approved, as currently happens with donee organisations.
- 10.9 All charities would be required to report how much they were distributing overseas. If a charity did not meet the criteria in relation to its overseas purposes, but was also undertaking charitable purposes within New Zealand, the amount of income that would be exempt would be determined by apportionment.
- 10.10 There is no intention to tax the donation income of an entity when it becomes taxable in respect of income it applies overseas.

### **Advantages**

- 10.11 A common set of criteria would apply to both the tax exemption and the rebate and deduction rules for donations. Also, charities operating as a business would receive increased support as they would be eligible for the exemption in respect of income applied for some overseas purposes.

### **Disadvantages**

- 10.12 Charities currently operating overseas might receive less government support (as they could be taxed on some part of their income) if they did not meet the criteria. As well, obtaining approval would create compliance costs for those charities currently operating overseas.

#### **Specific issues for consultation**

- What would be the best method for approving organisations with overseas charitable purposes?

## Chapter 11

### **THE TAX TREATMENT OF DONATIONS MADE BY INDIVIDUALS AND COMPANIES**

- 11.1 Governments provide assistance to charities in respect of the donations they receive in several ways:
- a deduction of the donation from the donor's income;
  - a tax rebate, credit or refund at a fixed rate; and
  - a grant to charities, either directly or, for example, by matching donations received.
- 11.2 In New Zealand, donations of money made by individuals and companies are subsidised through the tax system. Individuals receive rebates, while companies are able to claim deductions. Both forms of assistance are capped. The issues that have been raised in relation to this assistance are whether the incentives are appropriate and sufficiently flexible.
- 11.3 A rebate or deduction effectively provides the donor with more after-tax income and reduces the cost of donating relative to the price of other goods and services consumed by the donor. This is an advantage of providing a tax subsidy to encourage charitable giving, since it may lead to an increase in the level of donations made.<sup>28</sup>
- 11.4 A problem with using the tax system in this way, however, is that government revenue that is forgone is determined by the donor's tax rate and the amount donated. As a result, support may be biased towards the charitable purposes chosen by higher income earners, and the government is left with no control over the aggregate amount of support it provides.
- 11.5 In the case of the individual rebate, this is mitigated by the rebate being allowed at a fixed 33 cents in the dollar only, and the limit on the amount of donation eligible for the rebate. Likewise, in the case of the company deduction, the company rate is fixed at 33 cents in the dollar, and the amount of the donation eligible for the deduction is capped.

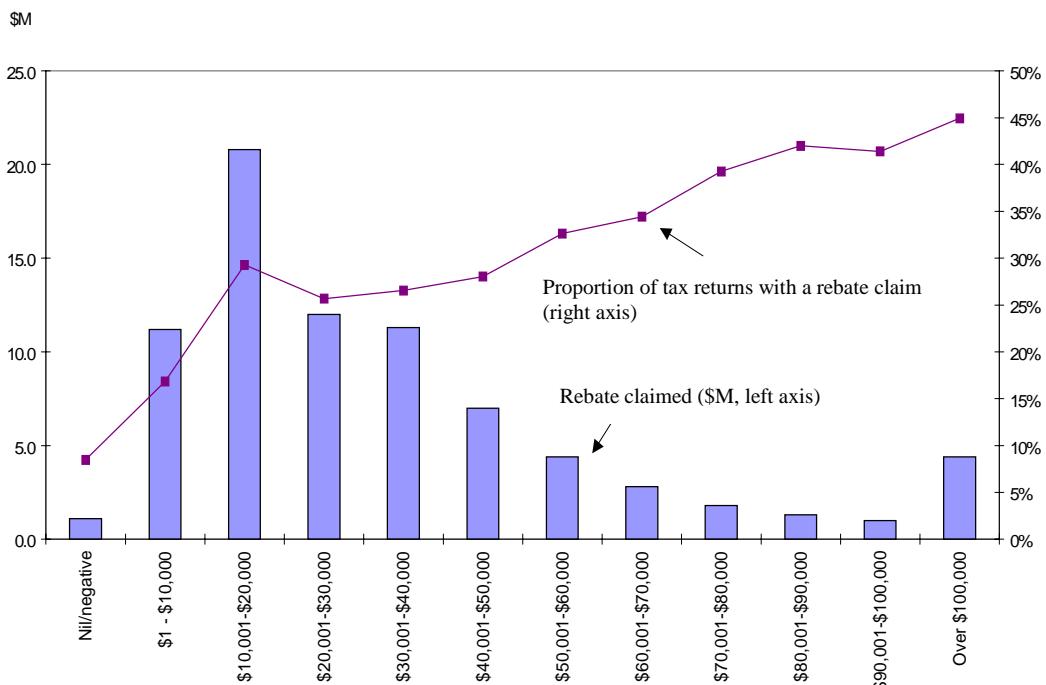
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<sup>28</sup> See, for example, the following empirical studies:

- Feldstein M (1975) "Income tax and charitable contributions: Aggregate and distributional effects", *National Tax Journal* 28(1) 81-100;
- Brown E (1987) "Tax incentives and charitable giving – evidence from new survey data", *Public Finance Quarterly* 15(4) 386-396; and
- Clotfelter CT (1985) "Federal tax policy and charitable giving", *National Bureau of Economic Research*, University of Chicago Press.

11.6 Figure 1 shows the wide variety of income groups in New Zealand that claim the rebate. Even though the proportion of income earners who claim a rebate increases as income increases (from around 20 percent at \$10,000 to nearly 50 percent at \$100,000), those with annual taxable incomes under \$40,000 claimed 70 percent of the total rebates.

FIGURE 1: 1999 DONATIONS REBATE BY TAXABLE INCOME



### Rebate limit for donations – individuals

11.7 At present, individuals can claim a tax rebate at a set 33 cents in the dollar up to a maximum of \$1,500 of donations made to “donee organisations”. Donee organisations are those entities that meet the requirements in section KC 5(1) of the Income Tax Act, which include all charities. Donations must be in cash in order to qualify.

#### *Proposal*

11.8 Since it was set over ten years ago the \$1,500 limit would be raised in line with inflation since 1990. This would increase the limit to \$1,800 per individual per year, making for a maximum rebate of \$600. There should be legislative authority for this limit to be amended by regulation, which would facilitate future adjustments for inflation.

## **Other matters considered**

- 11.9 The government also considered whether donations other than in cash should also be eligible for the rebate. However, to allow this would lead to increased compliance costs for taxpayers, and administrative costs for Inland Revenue, as it would give rise to questions as to the valuation of the donated goods and services. When rebates are available for non-cash donations, complex valuation rules are required, and anecdotal evidence from other jurisdictions suggests this can give rise to tax planning opportunities. Even when values are readily identifiable, the outcome of donating goods or services needs to be the same as when the goods or services are sold and the proceeds donated. For example, tax on the sale of a revenue account asset should not be avoided by donating that asset. Because of these complexities, the rebate would not be extended to non-cash donations.
- 11.10 Nor does the government favour introducing “payroll giving”. Payroll giving is a scheme in the United Kingdom that involves donors electing in advance for regular donations to be deducted from their salary and wages on a before-tax basis. The same result can be achieved in New Zealand by donating from after-tax salary and wages and claiming a rebate from Inland Revenue. Payroll giving, although it would eliminate the need to claim a rebate in some cases, would have compliance costs for the employer. It would involve administrative costs for Inland Revenue, since levels of rebates claimed would have to be matched against payroll giving to ensure that the rebate limits were adhered to.

## **Deduction limit for donations – companies**

- 11.11 At present, companies other than close companies<sup>29</sup> can claim a deduction for donations to donee organisations up to the prescribed annual limits in section DJ 4 of the Income Tax Act. Those limits are:
- a maximum *to any one donee* of 1 percent of net income of the company or \$4,000, whichever is greater; and
  - an *aggregate* maximum of 5 percent of net income of the company or \$1,000, whichever is greater.
- 11.12 It can be argued that no deduction for charitable donations should be available to companies, as individual shareholders should be able to decide directly to which charities they want to donate out of the income they earn from their holding. This would not preclude companies undertaking tax deductible sponsorship or advertising, because there is either a direct or indirect benefit to the shareholder. However, because the government is committed to assisting the charitable sector the current deduction will be retained.

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<sup>29</sup> A company controlled by five or fewer people, as defined in section OB 1 of the Income Tax Act 1994.

11.13 As with the rebate for donations by individuals, the government also considered whether donations by companies could be made in a form other than cash. For the same reasons, the government does not favour extending the deduction to cover non-cash donations.

***Proposal***

- 11.14 The current limits would be simplified by removing both the limit on donations to any one donee and the aggregate limit of \$1,000. This would leave companies free to donate up to 5 percent of net income (calculated before taking account of the donation) to donee organisations in any one year. There have been recent calls for further taxpayer subsidy of donations made to educational institutions by companies. Liberalising the donation deduction rules in this way should facilitate such giving.
- 11.15 The removal of the \$1000 limit could limit the deduction available to companies with net income of less than \$20,000. However, companies with net income below this level are unlikely to be making significant donations. Further, in practice many of those companies will be closely held companies that are not entitled to the deduction.
- 11.16 The government also proposes that this deduction be extended to close companies provided they are listed on a recognised stock exchange.<sup>30</sup> The close company restriction is designed to protect minority shareholders, as well as to provide some level of protection to the tax base. The current restriction is unnecessary in the case of companies listed on the stock exchange, given directors' fiduciary duties to shareholders, and the public scrutiny and disclosure requirements to which listed companies are subject.
- 11.17 In line with proposals likely to emerge from the review of the taxation of Maori authorities, Maori authorities would be able to deduct donations to donee organisations in the same way. At present, they are allowed a deduction only for donations to Maori associations.

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<sup>30</sup> "Recognised exchange" is a defined term in section OB 1 of the Income Tax Act 1994.

## Chapter 12

### OTHER INCOME TAX ISSUES

#### **Imputation**

- 12.1 Charitable organisations that receive dividends with imputation credits attached cannot use those credits. The reason is that charities are exempt from tax, so do not have tax liabilities against which they might apply the tax credits. Because imputation credits are not refundable, the benefit of imputation credits is effectively lost to charities. This means, in effect, that their income from domestic equity is taxed.
- 12.2 The same problem does not arise in respect of active domestic investment, overseas equities or debt. When a charity owns a business outright, that business's profits are exempt from tax. In the case of debt, charities are eligible to obtain a certificate exempting them from resident withholding tax on interest. In respect of offshore equity investments, the issue of imputation credits does not arise.
- 12.3 This means that charities are discouraged from investing in domestic equity. One way of resolving this would be to allow charities, and possibly other exempt or loss-making entities that cannot use imputation credits, a refund of the tax paid on their behalf by the company (represented by the imputation credit).
- 12.4 As discussed at Part I, this review is intended to be broadly fiscally neutral. Because the cost of such a measure is potentially high, significant savings would have to be made in other areas of the tax treatment of charities before such a measure could be considered. Moreover, the issue would have to be considered in the wider context of any initiatives in relation to the treatment of other exempt entities and non-residents.
- 12.5 For these reasons, the government does not intend to address this issue at present. Once the government has more information on charities' activities, it will be in a better position to assess the relevant fiscal cost.

#### **Fringe benefit tax**

- 12.6 Section CI 1(m) of the Income Tax Act 1994 provides that benefits provided to employees of charitable organisations are not subject to fringe benefit tax, although this exemption does not apply to employees of businesses run by charities. It is proposed that the existing exemption from fringe benefit tax be removed.

- 12.7 Employees of tax-exempt organisations are taxed on their employment income. Fringe benefit tax is a substitute for the income tax that would be paid by an employee on remuneration received in monetary form. There is no reason that employees of charities should be exempt from tax on remuneration paid in kind. It follows, therefore, that there is no reason that the charities employing those people should be exempt from fringe benefit tax if they choose to remunerate their staff by payment in kind.
- 12.8 This view is consistent with a recommendation of the Committee of Experts on Tax Compliance.

### **Superannuation schemes for employees of charities**

- 12.9 A similar issue, also raised by the Committee of Experts, is the tax treatment of superannuation schemes for the benefit of employees of charities. In the case of *Presbyterian Church of New Zealand Beneficiary Fund*,<sup>31</sup> the court held that the income earned by a fund to provide an annuity to retired ministers was exempt from tax. This was on the basis that by providing financial security for retired ministers who were an integral part of the church, the fund fostered the charitable purpose of the employer.
- 12.10 The Committee of Experts recommended that the Income Tax Act be amended to clarify that superannuation schemes for the benefit of employees of charities should not have charitable status. The basis for this recommendation is that income earned by such schemes accrues to the benefit of the individual employees and is equivalent, from a policy perspective, to salary and wages, which are taxed.
- 12.11 This issue is intertwined with the definition of “charitable purpose” and, as such, may be implicitly addressed under the options outlined earlier for that definition. Alternatively, the issue may need to be addressed more explicitly, as recommended by the Committee of Experts.

#### **Specific issues for consultation**

- Should superannuation schemes for employees of charities have charitable status?

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<sup>31</sup> [1994] 3 NZLR 363. See also discussion in chapter 3 on “Advancement of religion”.



## Part V

### GST

*This final part of the discussion document looks at GST as it affects all non-profit bodies, including charities.*



## Chapter 13

### GST ISSUES

- 13.1 Charities and other non-profit bodies carry on a wide range of activities. If they are registered for GST purposes they must generally account for GST in relation to those activities much like any other business. They may claim credits (input tax credits<sup>32</sup>) for GST incurred on goods and services they acquire, and must charge GST (output tax) on goods and services they supply, in relation to those activities. The current legislation is, however, unclear with regard to the activities of charities and other non-profit bodies involving non-taxable supplies, such as collecting donations.
- 13.2 This chapter contains proposals to provide certainty for charities and other non-profit bodies in claiming credits for expenses incurred in making non-taxable supplies and determining the supplies for which they must charge GST.

#### Current treatment

- 13.3 The Goods and Services Tax Act 1985 does not specifically define “charities” for the purpose of GST. Instead the Act includes a definition of “non-profit bodies” which includes all charities as well as other non-profit bodies. Table 1 sets out the activities of charities and other non-profit bodies and their current GST treatment.

TABLE 1: GST AND NON-PROFIT BODIES

Activity	Example	GST treatment
<b><i>Taxable supplies</i></b>		
Making supplies for payment	Premises for hire to the public for social functions	Credits allowed GST charged
<b><i>Exempt supplies</i></b>		
Selling donated goods and services	Second-hand goods stall operated by a charity	No credits allowed No GST charged <sup>33</sup>
<b><i>Other non-taxable supplies</i></b>		
Collecting donations	Donations collected as a result of a TV advertising campaign	Credits are being allowed No GST charged

<sup>32</sup> An input tax credit is defined in section 3A of the Goods and Services Tax Act 1985 as tax charged under section 8(1). Section 8 imposes goods and services tax on supplies. Registered persons are entitled to claim input tax credits for the GST incurred on goods and services acquired for the principal purpose of making taxable supplies.

<sup>33</sup> The supply of donated goods and services by a charity is specifically treated as an exempt supply under the GST Act.

- 13.4 Table 1 shows that in relation to non-taxable supplies, other than exempt supplies, credits are being allowed in relation to activities for which no GST is charged. However, it is not clear from the legislation whether or not this practice is correct.

### ***Taxable supplies***

- 13.5 A person who carries on an activity involving the supply of goods and services in exchange for payment may register for GST purposes. Therefore charities and other non-profit bodies making taxable supplies are entitled to register for GST purposes and be subject to the normal GST rules, meaning they are able to claim credits on goods and services acquired but are required to pay GST on goods and services supplied. If a person or entity has a turnover of greater than \$40,000 in any 12-month period it is required to register for GST. A charity or other non-profit body that carries on a taxable activity but makes supplies for less than \$40,000 may register for GST purposes if it wishes. In practice, many non-profit bodies carrying on taxable activities have registered voluntarily.

### ***Exempt supplies***

- 13.6 Registered persons charge GST on goods and services they supply but are able to claim credits for the GST incurred in relation to goods and services acquired in making supplies. Non-registered persons or persons supplying only exempt goods and services do not charge GST on these supplies and are not entitled to credits for the related GST they incur.

### ***Non-taxable supplies***

- 13.7 Under the current GST legislation there is some doubt as to whether credits are available in relation to activities that do not involve the supply of goods and services in exchange for payment (non-taxable supplies). For example, although fund-raising activities are a necessary aspect of sustaining the income of a charity or other non-profit body, genuine donations are a gift rather than a payment for the supply of goods and services and, for this reason, are not subject to GST.

### **Current practice**

- 13.8 Inland Revenue's policy is to deny credits for expenditure relating to exempt supplies but to allow credits for expenditure relating to taxable and non-taxable supplies. Most charities and other non-profit bodies incur expenditure in excess of the value of their taxable supplies, which results in their receiving refunds of GST rather than paying GST. The government considers that the uncertainty as to whether or not current practice is correct is undesirable. It is therefore proposed that the legislation be amended to make it clear.

- 13.9 Clarification is also needed as to which supplies of charities and other non-profit bodies attract GST.

## Proposals

### *Claiming credits*

- 13.10 The GST Act would be amended to clarify that GST-registered charities and other non-profit bodies are entitled to claim credits in relation to all their activities. These activities would include the collection of donations, but exclude supplies of donated goods and services or any other supplies which are specifically treated as exempt supplies. The definition of “input tax” would be amended to specifically allow charities and other non-profit bodies to do this. This will provide much needed certainty for charities and other non-profit bodies in relation to their GST obligations.

### *Charging GST*

- 13.11 In the GST Act, an “unconditional gift”,<sup>34</sup> such as a donation, is excluded from the definition of “consideration” (payment), and so does not provide the necessary linkage to a supply. Hence GST is not payable in respect of genuine donations.
- 13.12 The Court of Appeal in *Commissioner of Inland Revenue v New Zealand Refining Co Ltd* established that “a linkage between supply and consideration is requisite to the imposition of the tax.”<sup>35</sup> This indicates that the exclusion for unconditional gifts is unnecessary as genuine donations would not have a sufficient linkage with a supply to meet the definition of consideration. The definition of “consideration” should be amended accordingly by removing the unnecessary reference to “unconditional gift”. In making the distinction between what is and what is not an unconditional gift, reliance will, therefore, be on the ordinary principles set out in the GST legislation (that is, whether there is a link between the supply and the consideration) rather than on the legislative definition of “consideration”, which has proved at times to be difficult to interpret.

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<sup>34</sup> “Unconditional gift” means a payment voluntarily made to any non-profit body for carrying on or carrying out the purposes of that non-profit body and in respect of which no identifiable direct valuable benefit arises or may arise in the form of a supply of goods and services to the person making that payment, or any other person where that person and that other person are associated persons; it does not include any payment made by the Crown or a public authority.

<sup>35</sup> (1997) 18 NZTC 13,187 at 13,193

- 13.13 Genuine donations to charities do not involve a taxable supply of goods or services, and no GST should be charged. This also includes donations given in exchange for an item such as a sticker or flower, where there is no fixed minimum charge required for the item to be given. However, any payment which is in return for a supply of goods or services would be viewed as consideration for a supply and not a genuine donation. When a basic minimum charge is stipulated in return for goods and services, such as a voucher booklet offering a variety of discounts, the supply should be subject to GST by reference to that minimum charge. To the extent that an amount in excess of the stipulated amount is provided to the charity or non-profit body, that excess would be a genuine donation and not subject to GST.
- 13.14 Clarifying in the legislation the requirement for a link between consideration and supply would necessitate a review by Inland Revenue of its policy in this area. This could include more detail as to the type of donations that are regarded as consideration for a supply. This would make it easier for charities and other non-profit bodies to identify which supplies should have a GST component, and which supplies should not have a GST component.

#### **Specific issues for consultation**

- Do you agree that GST registered charities and other non-profit bodies should be able to claim input tax credits for expenses incurred in making non-taxable supplies?
- Do you agree with the proposed removal of the definition of “unconditional gift”, placing reliance on the ordinary principles set out in the GST legislation?

# Appendix



## International comparisons

	<b>Definition</b>	<b>Type of govt tax assistance</b>	<b>Registration</b>	<b>Annual accounts</b>	<b>Returns</b>	<b>Other monitoring</b>	<b>Requirements on trading activities</b>	<b>Information publicly available</b>
<b>New Zealand</b>	The entity must have been established exclusively for charitable purposes and for the benefit of the community or an appreciably significant part of it.	Charities exempt from income tax.  Donors able to reduce their income tax.	None at present.	None at present.	None at present.	Little on-going auditing.	All income is exempt from income tax when applied to charitable purposes within New Zealand.	None.
<b>United Kingdom</b>	Equivalent to NZ	Charity exempt from income tax.  Donors able to reduce taxable income.  Gifts by individuals are made net of tax which charities can reclaim from Inland Revenue.	Obligatory unless an exempt charity (e.g. universities, grant-maintained schools, places of worship).  Has to be approved by Charities Commission.  Decisions appealable to the courts. Once registered, notification of changed circumstances is required.	Provided to Commission as part of required annual report.  Prescribed format (companies have separate rules).  Required to be audited if over 100,000 pounds.	Only those selected for audit sample are required to file return with Inland Revenue.  Previously, all registered charities were required to file annual returns.	Auditing by Inland Revenue.  Accumulation of funds leads to enquiries from Inland Revenue.  Commission can institute inquiries regarding charities either as a class or individually.	Subject to exemptions, including direct relationship and de minimis turnover tests, trading activities of a charity are taxed but entity is able to deduct donations to parent charity.	Register of registered charities.  Annual reports.
<b>Australia</b>	Equivalent to NZ	Charities exempt from income tax.  Donors able to reduce their income tax.	From 1 July 2000, charities have required formal endorsement by Australian Tax Office (ATO). Separate endorsements for income tax exemption and donee status – different criteria apply.  Replaced self-assessment and confirmation by ATO.  Decisions appealable to the courts.	No formal requirements.	No formal requirements.	ATO reviews from time to time whether an entity is continuing to meet the requirements for endorsement.	None.	Entities that have donee status, through Australian Business Register.
<b>United States</b>	Broadly comparable. Also includes 'lessening the burdens of government' such as gifts or donations to a government unit.	Charities exempt from income tax.  Donors able to reduce their income tax.	Tax exemption required from Inland Revenue Service (IRS) or the Tax Court, unless gross receipts do not exceed \$25,000 or are a church, hospital, or educational entity. Material changes in circumstances result in automatic loss of tax exemption.	Have to be kept and be available for inspection by IRS. Private foundations have more stringent requirements because of concerns of influence of founders.	Yes, unless gross receipts less than \$25,000 or a church or related entity.  Short-form return for those with gross receipts between \$25,000-\$100,000.  Returns filed with IRS.	Auditing by IRS.	Related activity test. Unrelated activities are taxed. Related are exempt.	List of organisations to which donations are deductible.  Requests for tax exemption.  Three most recent annual returns.
<b>Canada</b>	Equivalent to NZ	Charities exempt from income tax.  Donors able to reduce their income tax.	Yes, if wish to claim tax benefits. Has to be approved by Canada Customs and Revenue Agency (CCRA). Covers both income tax exemption and donee status.  Decisions appealable to the courts. Once registered, required to notify of changed circumstances.	Have to be provided to CCRA by all registered charities.	Have to be provided to CCRA by all registered charities.	Audited by CCRA. Disbursement quota, although can temporarily accumulate funds for large projects subject to CCRA approval.	Yes. Private foundations cannot engage in business activities.	List of registered charities. Information pertaining to registration or deregistration.  Financial statements, at discretion of charity.  Annual returns (in respect of revenue, expenses, assets, liabilities, remuneration, activities and purpose).

