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INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

# Charities – Business income exemption

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This interpretation statement considers the extent to which business income a charitable entity derives is exempt from tax under s CW 42.

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

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# Summary | Whakarāpopoto

1. Income a tax charity derives can broadly be classified as either "business income" or "non-business income". Both types of income can be exempt (non-taxable) if a tax charity meets the requirements of ss CW 41 and CW 42.

2. A tax charity that derives business income must apply s CW 42 to work out the extent to which that income is exempt. For all other income a tax charity applies s CW 41. The main difference between the two sections is that business income is subject to additional restrictions compared with non-business income. These restrictions could result in some, or all, of a tax charity's business income not being exempt, whereas generally all of a tax charity's non-business income is exempt.

3. Those additional restrictions in s CW 42 are as follows:

- If a tax charity's charitable purposes are not limited to New Zealand, income derived from the business in the relevant annual period must be split reasonably between its charitable purposes in New Zealand and those outside New Zealand. Only the part that a tax charity apportions for tax purposes to its charitable purposes in New Zealand is exempt income (which this statement refers to as the "territorial restriction").
- The business income is not exempt if a person with some control over the business is able to direct or divert an amount derived from the business to the benefit or advantage of a person other than the charity (or charities) for whose benefit the business is carried on, except for a purpose of the charity (or charities) (which this statement refers to as the "control restriction"). If a tax charity breaches the control restriction, all of the business income it derives is taxable.

4. Many tax charities do not derive income from a business. Other tax charities derive income from a business but have no overseas charitable purposes. This statement provides guidance on how s CW 42 applies to tax charities that derive income from a business and have charitable purposes in and outside New Zealand. For example, a tax charity that:

- carries out its charitable purposes in New Zealand and elsewhere, or

- carries out its charitable purposes in New Zealand but also donates funds overseas from time to time or occasionally, in response to an unexpected event such as a natural disaster that occurs outside New Zealand.

5. In summary, the statement draws the following conclusions:

- Many charities engage in activities on a continuous and ongoing basis, commit time, money and effort to those activities, and conduct a large volume of transactions, with the intention of making a surplus. Charities carrying on this type of activity are carrying on a business.
- "Surplus" refers to a surplus of income (money or money's worth) over cost and is determined in accordance with ordinary commercial principles. A charity can be in business even though the object of the business is directed to charitable ends, not private pecuniary gain.
- Section CW 42 applies to income derived from a business carried on exclusively for the charitable purposes of one or more charities. The business may be carried on by:
    - a registered charity ("directly"); or
    - another entity ("indirectly").[1]
- Income from a business includes income from a charity's trade or business activities (including income derived from a business of investment) and other income sufficiently connected to a charity's business operations.
- A charity carrying on a business might receive a payment described as a "gift", "donation" or "koha". Whether such a payment is income from a charity's business is a question of fact. A charity carrying on a business can receive a gift that is not business income on the basis the gift is unrelated to the charity's business activity and prompted by the payer's intention to progress the charity's charitable purpose or is capital in nature, or both. In many cases, a gift, donation or koha a charity receives will not be business income.
- For the exemption in s CW 42 to apply to a charity's business income, **all** of the following requirements must be satisfied:
    - The entity actually conducting the business must be a registered charity. If the entity conducting the business is not a registered charity, all the income from the business is taxable. This outcome extends to the situation where a trading trust with only a charitable beneficiary (or beneficiaries) distributes business income to a charitable beneficiary. If the trading trust is not a registered charity the business income a charitable beneficiary

[1] For a discussion of the need for that other entity to be registered as a charitable entity under the Charities Act 2005 if business income is to be exempt under s CW 42, see from [78].

derives as beneficiary income from the trading trust is not exempt under s CW 42.

  - The charity deriving the income must carry out charitable purposes in New Zealand. A charity carries out its charitable purposes in New Zealand if at least one of its purposes is a charitable purpose in New Zealand. It is a question of fact as to where a charity carries out its charitable purposes.
  - The charity deriving the income must be a "tax charity". The definition of "tax charity" includes a registered charity. This statement focuses on tax charities that are registered charities.
  - The tax charity must not breach the control restriction.
- If a tax charity's rules restrict its charitable purposes to New Zealand and its charitable purposes are in fact limited to New Zealand, all of the business income it derives is exempt from tax (subject to the tax charity satisfying the control restriction).
- Where a tax charity's rules do not restrict its charitable purposes to New Zealand but 100% of its charitable purposes are directed to New Zealand, the tax charity can, in certain situations, treat all of its business income as exempt (subject to the tax charity satisfying the control restriction).
- Where a tax charity has only overseas charitable purposes, its business income is fully taxable.
- A tax charity that donates to charitable purposes outside New Zealand is carrying out charitable purposes outside New Zealand. This includes where a tax charity donates to the overseas charitable purposes of a charity listed in sch 32. Where a tax charity donates to charitable purposes outside New Zealand, it should treat a reasonable proportion of the business income it derives in the annual period in which it made the donation as taxable.
- The focus of the territorial restriction is on a tax charity's charitable purposes. A tax charity that carries out charitable purposes both in New Zealand and outside New Zealand must split its business income relative to its charitable purposes in New Zealand and outside New Zealand. It is important to split business income in this way because only the part apportioned for tax purposes to the charitable purposes in New Zealand is exempt income.
- A tax charity has the burden of proving that any split of its business income is reasonable. A tax charity's split of business income between charitable purposes in New Zealand and outside New Zealand does not need to be exact to the last dollar, but must reflect what an objective person would consider is reasonable in the circumstances.
- This statement describes a number of possible approaches to splitting business income. A tax charity can take a different approach provided it results in a

reasonable split of business income between its charitable purposes in New Zealand and outside New Zealand.

- Once a tax charity determines an approach to splitting its business income, it can use that same approach each year. Unless it makes material changes to the way it operates, a tax charity should apply its chosen approach consistently over time.
- In some cases, a tax charity deriving business income subject to s CW 42 will also derive other amounts not subject to s CW 42 (eg non-business income and capital amounts). The Commissioner's view is that it is not reasonable for a tax charity to treat all of its business income as exempt on the basis that it funds its charitable purposes outside New Zealand with amounts that are not business income.
- Where a tax charity treats some or all of its business income as exempt based on its intention to carry out charitable purposes in New Zealand and this intention then changes, the outcome is that the tax charity is carrying out charitable purposes outside of New Zealand. Where a tax charity carries out charitable purposes outside New Zealand, the Commissioner expects the amount of business income that is not exempt under s CW 42 will increase.
- A change of intention does not necessarily mean a tax charity's split of business income in a prior period was unreasonable. A tax charity has the burden of proving that its split of business income is reasonable. If this burden is not satisfied, a tax charity's return from the prior period may be re-opened (or if it did not file a return in the prior period, it may be required to file a return) and a greater amount of its business income treated as taxable.
- The outcome of applying the territorial restriction is that a proportion of a tax charity's business income (but not particular income amounts) is assessable income and a proportion is exempt income. Depending on the level of a tax charity's deductible business expenditure in the relevant annual period, a tax charity might have a profit or loss from its business activity.
- A tax charity can split its deductible business expenses on the same basis that it splits its business income between its charitable purposes in and outside New Zealand.

# Introduction | Whakataki

6. Section CW 42 contains the business income exemption for tax charities. This exemption has been in place for a long time. However, the wording of the section has changed over time.
7. This statement seeks to clarify:

- aspects of the interpretation of s CW 42 the Commissioner is aware have caused uncertainty; and
- how the territorial restriction in s CW 42 applies (for a summary of the territorial restriction see [3]).

8. This statement will interest a tax charity that:
   - derives income from a business carried on exclusively for charity; and
   - has charitable purposes that are not limited to New Zealand.

9. For example, this statement will be of interest to a tax charity that:
   - carries out its charitable purposes in New Zealand and elsewhere, or
   - carries out its charitable purposes in New Zealand but also donates funds overseas from time to time or occasionally, in response to an unexpected event such as a natural disaster that occurs outside New Zealand.

## About this statement

10. This statement consists of three parts. Part One considers what income is subject to s CW 42. In particular, it considers:
    - what carrying on a "business" requires ([21] to [30]);
    - what income is "from a business", including how to interpret the words "directly or indirectly" in s CW 42(1) ([31] to [66]); and
    - how to determine when a business is carried on "by, or for, or for the benefit of" a charity ([67] to [76]).

11. Part Two considers the requirements that a charity must satisfy for the income it derives under Part One to be exempt from tax. These requirements are:
    - the entity carrying on the business must be a registered charity ([78] to [79]);
    - the charity must carry out its charitable purposes in New Zealand ([80] to [92]);
    - the charity must be a "tax charity" ([93] to [94]); and
    - the tax charity must not breach the control restriction ([95] to [97]).

12. Part Three considers how the territorial restriction applies to a charity that derives income under Part One and meets the requirements in Part Two. To do so, it considers:
    - when a tax charity's charitable purposes are limited to New Zealand ([100] to [109]);
    - general principles that apply when splitting business income ([110] to [113]);

- approaches to splitting business income ([114] to [127]);
- funding overseas purposes with amounts that are not business income ([128] to [133]);
- changes in charitable purpose ([134] to [139]); and
- approaches to splitting deductible business expenses between taxable and exempt income ([140] to [146]).

13. Section CW 42 does not apply to income derived by a:
    - council-controlled organisation, other than a council-controlled organisation operating a hospital as a charitable activity; or
    - local authority from a council-controlled organisation, other than from a council-controlled organisation operating a hospital as a charitable activity on behalf of the local authority.

14. This statement does not consider these exclusions from the business income exemption.

15. This statement also does not consider the control restriction in any detail. If a tax charity breaches the control restriction, all the business income that it derives will be taxable. As the control restriction always applies, it is important that a tax charity that derives business income monitors its compliance with the control restriction on an ongoing basis. For a summary of the control restriction, see from [95].

16. Inland Revenue has discussed the control restriction in other publications. For example, see OS 22/04: Charities and donee organisations – Part 1: Charities, *Tax Information Bulletin* Vol 34, No 10 (November 2022).

## Terms and examples in this statement

17. This statement refers variously to a "charity", a "registered charity" and a "tax charity".

18. The particular term this statement uses in any given context depends on which part of s CW 42 it is considering. Broadly, income is subject to the test in s CW 42 if it is derived from a business carried on by, or for, or for the benefit of a "charity". Section CW 42 exempts that income only if a "registered charity" carries on the business and a "tax charity" derives the income. This statement offers the following glossary to help readers to understand these terms before discussing them in more detail later:
    - **charity** is a trust for charitable purposes or a society or institution (which includes a company) established and maintained exclusively for charitable purposes and not carried on for the private pecuniary profit of any individual;
    - **registered charity** is an entity registered as a charitable entity under the Charities Act 2005;

- **tax charity** is a charity that is a registered charity or a non-resident entity the Commissioner approves as a tax charity; and
- **trust, society or institution of a kind referred to in s CW 41(1)** is a charity (see above definition of "charity").

19. This statement provides examples to illustrate how s CW 42 applies. The examples do not reflect existing or past charitable entities; they are illustrative only.

# Part One: Determining what income is subject to s CW 42

20. Section CW 42 applies to income an entity derives directly or indirectly from a business carried on by, or for, or for the benefit of a charity. Before s CW 42 applies, there must first be a person who is carrying on a "business". While not covering when a person is in business in any detail, this statement briefly discusses this question below for completeness.

## Carrying on a business

21. Section YA 1 defines "business" as including "any profession, trade, or undertaking carried on for profit". The leading case on what constitutes a business is *Grieve v CIR* (1984) 6 NZTC 61,682 (CA). In *Grieve*, the Court of Appeal held that whether a taxpayer is in business involves a two-fold inquiry as to the:
    - nature of the activities carried on; and
    - intention of the taxpayer in engaging in those activities.

22. In *Grieve,* Richardson J identified six factors relevant to determining whether a taxpayer is carrying on a business. These factors are the:
    - nature of the activity;
    - period over which they engage in the activity;
    - scale of operations and volume of transactions;
    - commitment of time, money and effort;
    - pattern of activity; and
    - financial results.

23. Richardson J went on to say that it may also be helpful to consider whether the operations involved are of the same kind and are carried on in the same way as those that are characteristic of ordinary trade in the line of business in which the venture is

conducted. However, in the end, the crucial factors are the character and circumstances of the particular venture.

24. How a charity reports revenue from its trading activities for accounting purposes does not determine whether it is carrying on a business for tax purposes.

25. The words "for profit" in the context of the definition of "business" refer to a surplus of income (money or money's worth) over cost, determined in accordance with ordinary commercial principles (see *Grieve*). A surplus will arise from a trading activity even if the charity reinvests the surplus into the trading activity or uses it to carry out charitable purposes.

26. Many charities engage in activities on a continuous and ongoing basis, commit time, money and effort to those activities, and conduct a large volume of transactions, with the intention of making a surplus. Charities carrying on this type of activity are carrying on a business, as s YA 1 defines that term. This is the conclusion even though the object of the business is directed to charitable ends, not private pecuniary gain.

27. Some charities carrying on trading activities related to their charitable purpose might think they are not in business because their intention in carrying on those activities is to achieve their charitable purpose (not to make a profit). However, that position is not correct. Case law shows that it is possible to be in business even though the trading activity is related to the charity's charitable purpose (see *Brighton College v Marriott* [1925] All ER 600). A charity will be carrying on a business if the nature of its activities are sufficient to support the concept of business and it seeks a surplus.

## Extended definition of business for trusts

28. A registered charity may not satisfy the business test in s YA 1 but will in certain cases be treated as carrying on a business for the purposes of s CW 42.

29. Under s CW 42(3), a trustee is treated as carrying on a business for the purposes of s CW 42 where **all** of the following apply:

- The trustee derives rents, fines, premiums or other revenues from an asset of the trust.
- The asset was disposed of to the trust by:
    - a settlor or trustee of the trust; or
    - if the trust is a shareholder in the company carrying on the business, a shareholder or director of the company carrying on the business; or
    - a person associated with a settlor, trustee, shareholder or director.
- The person who disposed of the asset to the trust retains or reserves an interest in the asset, or the asset will revert to them.

30. The extended definition of "business" means the tax treatment of rental income derived from an asset disposed of to a trust in the circumstances described above is determined under s CW 42, not s CW 41.

## Amounts that are income "from a business"

31. Where a person is carrying on a business, a question arises as to what income is from the business. The answer is important because income from a business is subject to s CW 42 (whereas other income is subject to s CW 41). As discussed at [3], s CW 42 has additional restrictions compared to s CW 41.

32. The opening words of s CW 42(1) state:

> *Exempt income*
>
> (1) Income derived directly or indirectly from a business carried on by, or for, or for the benefit of a trust, society, or institution of a kind referred to in section CW 41(1) is exempt income if—
>
> …

33. To answer the question at [31], it is necessary to consider the meaning of "directly or indirectly" in the context of s CW 42 and whether these words extend the application of the section to income not usually considered to be income from a business.

### Meaning of "directly or indirectly"

34. The Act does not define the individual words "directly" or "indirectly" or the phrase "directly or indirectly". The *Oxford English Dictionary* defines "directly" as "without the intervention of a medium or agent; immediately; by a direct process or mode". It defines "indirectly" as "by indirect action, means, … agency or instrumentality; through some intervening person or thing, in an indirect way or manner".[2]

35. The ordinary meaning of "directly or indirectly" contrasts something that arises in a direct way or manner with something arising in an indirect way or manner.

36. Although the words "directly or indirectly" are placed between the words "income derived" and "from a business" in s CW 42(1), the Commissioner's view is that the words "directly or indirectly" relate to the phrase "by, or for, or for the benefit of" and reflect that a business may be carried on by:[3]

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[2] *Oxford English Dictionary* (online version, Oxford University Press, March 2022, accessed 29 August 2022).

[3] For a discussion of the meaning of "for" and "for the benefit of" a charity, see from [71].

- a charity ("directly"); or
- another entity ("indirectly").

37. The reasons for this view are as follows:
    - The words "directly and indirectly" were introduced into a predecessor of s CW 42 in 1940 at the same time as the exemption was extended to apply to income from a business carried on for charity. Prior to this time, the exemption applied to income derived by a charity only.[4]
    - There is nothing to indicate the words "directly or indirectly" were introduced for the purpose of capturing income not usually considered to be income from a business.

38. The outcome of this view is that a more direct relationship is required between an amount of income and a business carried on for charity in order for that income to be subject to s CW 42.

39. The significance of the words "directly or indirectly" has changed because of the enactment of s CW 42(1)(aa). The effect of s CW 42(1)(aa) (discussed at [78]) is that business income subject to s CW 42 is exempt from tax only if the entity carrying on the business is a registered charity. We anticipate that in most cases where income is subject to s CW 42, the income will be derived from a business a registered charity is carrying on (ie directly).

## Income from trade or business activities

40. Section CW 42 applies to income a charity derives from its trade or business activities. Example | Tauira 1 illustrates this situation.

[4] Following the amendment in 1940, s 78k of the Land and Income Tax Act 1923 exempted income derived "directly or indirectly from any business carried on by or on behalf of or for the benefit of" a charity. Section CW 42(1) refers to a business carried on "by, or for, or for the benefit of" a charity. The word "for" replaced "on behalf of" when the Income Tax Act 2004 was enacted. Among other changes, the 2004 Act rewrote Part C of the Income Tax Act 1994. The changes to ss CW 34 and CW 35 of the 2004 Act (now ss CW 41 and CW 42) were intended to clarify the law and did not reflect a change in policy. For this reason, we consider that in the context of s CW 42 "for" means the same as "on behalf of".

**Example | Tauira 1 – Income from a charity's business activity**

Pet Welfare Centre Ltd is a registered charity. Its charitable purpose is to provide shelter to lost and abandoned animals in New Zealand and Australia. To raise funds for its charitable purpose, Pet Welfare Centre Ltd runs an opportunity shop that sells used furniture and clothing.

Pet Welfare Centre Ltd should apply s CW 42 to determine the extent to which the income it derives from selling used furniture and clothing is exempt from tax.

41. Some charities carry on more than one business. Income of a charity not derived from the trade or business activities of one business may be derived from a separate business. Example | Tauira 2 illustrates this situation.

**Example | Tauira 2 – Charity carrying on two businesses**

Pet Welfare Centre Ltd from **Example | Tauira 1** also carries on a business of manufacturing and selling dog treats.

Pet Welfare Centre Ltd is carrying on two businesses – the opportunity shop and the manufacture and sale of dog treats.

Pet Welfare Centre Ltd should also apply s CW 42 to determine the extent to which the income from the manufacture and sale of dog treats is exempt from tax.

## Other amounts a charity may receive

42. In some cases, a charity carrying on a business receives amounts other than from its trade or business activities – for example, interest, dividends, rent and/or donations.[5] A question arises as to which section (s CW 41 or CW 42) applies to these amounts.

43. Some charities have suggested that:

- s CW 41 applies to passive income (broadly, income that comes in without a recipient's active effort or work, such as interest and dividends); and
- s CW 42 applies to active trading income such as income received from providing goods or services to customers.

44. Sections CW 41 and CW 42 do not refer to "passive" or "active" income. Section CW 42 applies to income derived "from a business". The Act does not define what amounts of

[5] Rent refers to rental income that is not income a trust derives from a business under the extended business definition in s CW 42(3). See the discussion from [28].

income are derived from a business. What amounts of income are derived from a business is a matter of fact that must be determined by the charity.

45. The *Oxford English Dictionary* defines "from" as "denoting derivation, source, descent, or the like".[6] Case law has considered what the words "from the business" mean in the context of a predecessor provision of s CB 1(1). Under s CB 1(1), an amount a person derives from a business is income of the person. As s CW 42 applies to income derived from a business, we consider the case law is relevant here.

46. In *CIR v City Motor Service Ltd; CIR v Napier Motors Ltd* [1969] NZLR 1,010, the Court of Appeal concluded that "from the business" must mean from the current operations of the business. An amount is not income "from a business" just because it is related in some way to the business. The question is whether, having regard to the nature of the business and its relationship with the particular amount, it can be said that some part of the business activity gives rise to or produces that income. It follows that a charity can derive business income and other income that is not itself from a business. Example | Tauira 4 and Example | Tauira 5 illustrate this situation.

### Investment income

47. Income derived from a business of investment will be income from a business and subject to the test in s CW 42. Whether investment income constitutes income from a business depends on the particular circumstances and nature of the business.

48. An investment activity does not need to be a charity's sole or even its principal activity to constitute a business (see *CIR v Stockwell* (1992) 14 NZTC 9,190 (CA)). Case law does not support a presumption against finding that a charity (being a non-individual) is carrying on a business of investment.

49. Case law offers some guidance on factors that are relevant to determining whether investment activities constitute a business. Relevant cases include *Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)* 5 TC 159, *National Distributors Ltd v CIR* (1987) 9 NZTC 6,135 (HC) and *Rangatira Limited v CIR* [1997] 1 NZLR 129 (PC).

50. There is a difference between carrying on a business and simply realising an investment (*Californian Copper Syndicate*).

51. When considering whether a business of investment existed the court in *National Distributors* stated that the continuity and extent of the activity are important, if not dominant, considerations in determining whether a taxpayer is in business. In arriving

[6] *Oxford English Dictionary* (online version, Oxford University Press, March 2022, accessed 29 August 2022).

at a decision as to whether the activities (in that case, the buying and selling of shares) constituted a business, the court said that matters likely to assist were whether:

- the switching of shares has taken place as an integral part of the taxpayer's investment business so that it amounts to a dealing in shares;
- the taxpayer has regularly or continuously monitored the share portfolio;
- there was any system according to which shares were sold;
- the sales were frequent and part of the taxpayer's normal operations in the course of making profits; and
- the sales and purchases were on a large scale.

52. The court concluded the taxpayer's share transactions were not the carrying on of a business. This was because the share sales were intermittent and unsystematic and were made in relation to inflationary trends (rather than for profit).

53. In *Rangatira* a company invested on a long-term basis in shares in established, well-performing companies. Over time, it sold these shares and often made profits on the sales. The Privy Council decided the taxpayer's activities had not changed from an investment holding company to a business of dealing in shares. The number and frequency of the transactions (41 sales during a 7-year period) would not, by themselves, have been sufficient to conclude the company was in the business of dealing in shares.

54. Where a charity is a trust, the trustees may have a duty to invest trust property prudently. It might be thought that, as a result of a trustee's duty to invest prudently under s 30 of the Trusts Act 2019, the trust's investment activities constitute a business for tax purposes.

55. Section 30 of the Trust Act 2019 states:

> *30 Duty to invest prudently*
>
> When exercising any power to invest trust property, a trustee must exercise the care and skill that a prudent person of business would exercise in managing the affairs of others, having regard, in particular,—
>
> (a) to any special knowledge or experience that the trustee has or that the trustee holds out as having; and
>
> (b) if the person acts as a trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

56. The Commissioner considers the duty of trustees to invest trust property prudently does not automatically result in a charitable trust's investment activities being a business. Section 30 provides that a trustee should exercise the care and skill that a

prudent person of business would exercise, it does not require that the investment activity be carried on as a "business" as that term is defined in s YA 1. As discussed from [21], whether a particular activity amounts to a business is a matter of fact and degree.

57. In some cases, investment income a charity derives will still be business income even though the charity is not carrying on a business of investment. Investment income that is so closely connected to a charity's business will constitute income from that business (and therefore be subject to s CW 42). Example | Tauira 3 illustrates this situation.

**Example | Tauira 3 – Interest income that is business income**

Cooks for Good Ltd is a registered charity. Its charitable purpose is to advance religious education. To raise funds for its charitable purpose, it runs a café that sells food and drink. Cooks for Good Ltd has an interest-bearing business on-call account that it uses to deposit the takings from the café and pay for the café's expenses.

The income from selling food and drink and the interest income on the business on-call account are both income from the business.

The interest income is closely connected to Cooks for Good Ltd's business as the ordinary day-to-day transactions of the business give rise to or produce the interest income. The interest income is effectively paid on the takings from the café when they exceed the café's expenses.

58. A charity can derive business income and investment income that is not itself from a business. Example | Tauira 4 and Example | Tauira 5 illustrate when a charity's investment income is not derived from a business.

**Example | Tauira 4 – Interest income that is not business income**

Cooks for Good Ltd from **Example | Tauira 3** receives a donation from a member of the public to progress its charitable purpose of advancing religious education. Cooks for Good Ltd deposits the donation into its interest-bearing on-call account.

Any interest income earned on the donation is not income from the business. No part of the business activity gives rise to or produces the interest.

Cooks for Good Ltd is responsible for demonstrating that the interest income is not derived from a business.

Cooks for Good Ltd could demonstrate the interest income on donations was not income from the business if it deposited donations into a bank account separate from its business on-call account.

**Example | Tauira 5 – Interest income that is not business income**

Cooks for Good Ltd has a large credit balance in its business on-call account. To earn a higher interest rate, it decides to put an amount on term deposit.

In this situation, the interest income earned on the term deposit is not income from a business.

Although the interest income on the term deposit relates to the business (in the sense that the funds put on term deposit came from the café), no part of the business activity (the running of the café) gives rise to or produces the interest income.

The interest will be exempt income of Cooks for Good Ltd under s CW 41.

The same outcome would arise if, for example, Cooks for Good Ltd invested its business surplus in a rental property.

## Gifts, donations or koha

59. A charity carrying on a business might receive payments described as “gifts”, “donations” or “koha”. The label given to such payments does not determine their character or whether they are income derived from a charity’s business.

60. Case law shows that voluntary payments of money may be business income if they are received in relation to, or as a product of, the business activity.

61. In *Hayes v FCT* (1956) 96 CLR 47, the High Court of Australia considered when a "gift" would be income in contrast to a "mere gift". Fullagar J stated (at 54):

> A voluntary payment of money or transfer of property by A to B is prima facie not income in B's hands. If nothing more appears than that A gave to B some money or a motor car or some shares, what B receives is capital and not income. But further facts may appear which show that, although the payment or transfer was a "gift" in the sense that it was made without legal obligation, it was nevertheless so related to the employment of B by A, or to services rendered by B to A, or to a business carried on by B, that it is, in substance and in reality, not a mere gift but the product of an income-earning activity on the part of B, and therefore to be regarded as income from B's personal exertion.

62. 'Mere gifts' do not relate to any activity or occupation of the donee of an income-producing character and have no significant character except as expressions of a desire to benefit the donee (*Hayes*).

63. Whether or not a particular payment received is business income depends on its quality in the hands of the recipient. All the relevant circumstances of the payment must be taken into account. These circumstances may include the purpose for which the payment was made, the terms on which it was made and whether the charity provides any consideration in return for the gift.[7]

64. Simply because a gift could be described as supplementing a charity's trading receipts or assisting it to carry out its trade does not determine whether it is business income.

65. It is possible for a charity to receive a gift that is not a product of its business activity because the payment is unrelated to the charity's business activity and prompted by the payer's intention to progress the charity's charitable purpose or is capital in nature (eg, a gift to a charity running a private hospital to build a new hospital wing), or both. In many cases, gifts a charity receives will not be business income.

66. For further information on the factors that support a conclusion that a gift is or is not business income, see IS xx/xx - Income – when gifts are assessable income (Draft interpretation statement, Inland Revenue 2023) taxtechnical.ird.govt.nz/consultations/2023/pub00433.[8]

[7] *Murray v Goodhews* [1978] 2 All ER 40.

[8] This item is in draft and represents the Commissioner's preliminary, though considered, view. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

## Determining when a business is carried on by, or for, or for the benefit of a charity

67. Section CW 42(1) applies to income derived "directly or indirectly" from a business carried on "by, or for, or for the benefit of" a charity.

68. This statement discussed the meaning of the words "directly or indirectly" from [34]. The words "directly or indirectly" relate to the words "by, or for, or for the benefit of" and reflect that a business may be carried on by:

    - a charity ("directly"); or
    - another entity ("indirectly").

69. Where a charity is carrying on a business, the income it derives from the business will be subject to s CW 42. The business will be carried on "by" a charity that is either a trust for charitable purposes or a society or institution established and maintained exclusively for charitable purposes and not carried on for the private pecuniary profit of any individual.

70. Where the entity carrying on the business is not a charity, a question arises as to whether that business is carried on "for, or for the benefit of" a charity. Only income derived from a business carried on "for, or for the benefit of" a charity is subject to s CW 42.

### Meaning of "for" and "for the benefit of" a charity

71. The Act does not define the terms "for" or "benefit". The *Oxford English Dictionary* defines these terms as follows:[9]

    > **for** 1 in favour of. 2 affecting or with regard to. 3 on behalf of or to the benefit of. 4 having as a purpose or function. 5 having as a reason or cause … 7 representing
    >
    > **benefit** an advantage or profit gained from something … receive an advantage; profit

[9] *Concise Oxford English Dictionary* (12th ed, Oxford University Press, 2011).

72. The words "for" and "for the benefit of" do not have strict legal meanings but are used as part of a description of a wide variety of relationships where one person acts as auxiliary to or a representative of another person.[10] The particular meaning intended depends on the context in which the words are used and how they are used in that context.[11] The courts have considered the application of s CW 42. The cases indicate that a business will be carried on "for, or for the benefit of" a charity if the business is carried on exclusively for charitable purposes and not for the private pecuniary profit of any individual (see *Calder Construction Co Ltd v CIR* [1963] NZLR 921 (SC) and *Latimer v CIR* (2002) 20 NZTC 17,737 (CA)). In *Latimer*, the court stated the operations of a business must be wholly devoted to making money for charitable purposes. Example | Tauira 6 and Example | Tauira 7 illustrate this exclusivity requirement.

73. For discussion of the requirement for the entity carrying on the business to be a registered charity if the business income is to be exempt under s CW 42, see from [78].

## Business carried on for one or multiple charities

74. The opening words of s CW 42(1) refer to income derived from a business carried on by, or for, or for the benefit of **a** trust, society or institution (singular). A question arises as to whether the section is limited to income from a business carried on by, or for, or for the benefit of a single charity.

75. Unless the context requires a different interpretation, words in the Act in the singular include the plural and words in the plural include the singular.[12] The Commissioner considers nothing in the context of s CW 42 requires the section to be restricted to situations where a business is carried on by, or for, or for the benefit of a single charity.

76. This view is supported by case law that shows that a business can be carried on for or for the benefit of more than one charity. In *Calder,* the Supreme Court considered the application of s 86(1)(o) of the Land and Income Tax Act 1954 (now s CW 42). The court contemplated the section applying to a business carried out for several charities. Wilson J stated at 926:

> Having thus unequivocally and irrevocably declared itself a trustee to carry on business for charitable purposes in New Zealand, it comes squarely within the provisions of para. (o) in that capacity and is not deprived of that character by the powers which it has reserved to itself of applying part of its income to reserves or development and of paying over the income "from time to time" instead of at stated times. But, even if those powers were sufficient to deprive it of the character of a trustee carrying on the business in trust

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[10] *Case X26* 90 ATC 256.

[11] *Dale v Mitcalfe* (1928) 13 TC 41 and *Case X26*.

[12] Section 19 of the Legislation Act 2019.

for charitable purposes, **its business is certainly, in my opinion, carried on in trust for those purposes both on behalf of and for the benefit of the trustees of the Calder Foundation and the other charities referred to in its memorandum of association.** [Emphasis added]

**Example | Tauira 6 – Business carried on exclusively for charitable purposes**

The Right On Trust was established to carry on business exclusively for two registered charities (the Right Direction Trust and the New Direction Trust). The trustees of the Right On Trust determine the timing and amount of distributions to the Right Direction Trust and the New Direction Trust.

Right On Trust's business income is subject to s CW 42. This outcome arises because the business is carried on exclusively for charitable purposes (the charitable purposes of the Right Direction Trust and the New Direction Trust, for whose benefit the business is carried on). The business is carried on exclusively for charitable purposes even though more than one charity benefits from the Right On Trust's business.

The extent to which Right On Trust's business income is exempt depends on whether the further requirements of s CW 42 are satisfied.

**Example | Tauira 7 – Business not carried on exclusively for charitable purposes**

Sue and Son Computing Ltd carries on business in New Zealand. Sue and Son Computing Ltd has multiple shareholders, including Sue, her son and Fighting Poverty Ltd. Fighting Poverty Ltd is a registered charity.

Sue and Son Computing Ltd pays a dividend to its shareholders, including Fighting Poverty Ltd.

Sue and Son Computing Ltd's business income is not subject to s CW 42. This outcome arises because Sue and Son Computing Ltd is not established and maintained exclusively for charitable purposes. Sue and Son Computing Ltd's business income will be taxable.

Whether the dividend received by Fighting Poverty Ltd is subject to s CW 41 or CW 42 depends on whether it is income derived from a business carried on by Fighting Poverty Ltd (see the discussion from [47]).

# Part Two: Requirements for business income to be exempt

77. This part discusses the requirements a charity must satisfy for business income it derives as described under Part One to be exempt from tax. The requirements (set out in s CW 42(1)(aa) to (c)) must all be satisfied for business income to be exempt. Section CW 42(1) states:

> *Exempt income*
>
> (1) Income derived directly or indirectly from a business carried on by, or for, or for the benefit of a trust, society, or institution of a kind referred to in section CW 41(1) is exempt income if—
>
> (aa) the entity carrying on the business is, at the time that the income is derived, registered as a charitable entity under the Charities Act 2005; and
>
> (a) the trust, society, or institution carries out its charitable purposes in New Zealand; and
>
> (b) the trustee or trustees of the trust, the society, or the institution is or are, at the time that the income is derived, a tax charity; and
>
> (c) no person with some control over the business is able to direct or divert an amount derived from the business to the benefit or advantage of,—
>
> (i) (if subparagraph (ii) does not apply, a person other than the trust, society, or institution except for a purpose of the trust, society, or institution:
>
> (ii) if a trust, society, or institution (the **operating entity**) is carrying on the business for or for the benefit of another trust, society, or institution (the **controlling entity**), a person other than the operating entity or the controlling entity except for a purpose of the operating entity or the controlling entity.
>
> Subsections (3) to (8) expand on this subsection.

## The entity carrying on the business must be a registered charity

78. Business income to which s CW 42 applies is exempt from tax only if the entity actually conducting the business is a registered charity (s CW 42(1)(aa)). Registration under the Charities Act 2005 carries with it a number of reporting obligations that improve transparency and promote public trust and confidence in the charities sector. The requirement that the entity carrying on the business is a registered charity was introduced so every entity claiming the business income exemption is subject to the

public reporting requirements that arise when a charitable entity registers as a charity.[13]

79. Example | Tauira 8, Example | Tauira 9 and Example | Tauira 10 illustrate the effect of this requirement on the business income exemption.

**Example | Tauira 8 – Business income derived by an entity that is not a registered charity**

The D&P Cat Rescue Trust, a registered charity, incorporated DEB Cat Rescue Ltd to carry on business exclusively for its benefit.

The D&P Cat Rescue Trust's charitable purposes are limited to New Zealand. DEB Cat Rescue Ltd is not itself a registered charity.

DEB Cat Rescue Ltd derives business income of $15,000 in the 2022/23 income year from a business of selling animal beds and pet accessories.

DEB Cat Rescue Ltd is taxable on the business income of $15,000. This outcome arises because DEB Cat Rescue Ltd (the entity carrying on the business) is not a registered charity at the time the income is derived. Even though the income is derived from a business carried on exclusively for charitable purposes in New Zealand (the charitable purposes of the D&P Cat Rescue Trust), to be exempt s CW 42 requires that the entity carrying on the business is a registered charity.

Any dividend income the D&P Cat Rescue Trust receives from DEB Cat Rescue Ltd is subject to s CW 41, not s CW 42. This outcome arises because the dividend income is not business income of the D&P Cat Rescue Trust.

[13] Minister of Revenue, *Commentary on the Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Bill* (Inland Revenue, June 2018).

**Example | Tauira 9 – Business income distributed to a registered charity by an entity that is not a registered charity**

Help Our Community Ltd is a registered charity. Its charitable purpose is providing palliative care for people in the greater Christchurch area.

The trust deed of the JR Ranch Trust provides that it carries on its business for the exclusive benefit of the charitable purposes of Help Our Community Ltd. The JR Ranch Trust is not a registered charity.

The JR Ranch Trust derives business income of $85,000 in the 2022/23 year from its commercial rental business. The JR Ranch Trust distributes all the income from the business as beneficiary income to Help Our Community Ltd and as a result Help Our Community Ltd, not the JR Ranch Trust, derives the business income.

The beneficiary income derived by Help Our Community Ltd is subject to the test in s CW 42 (and not s CW 41). This outcome arises because the beneficiary income is income derived from a business carried on exclusively for charitable purposes. This outcome arises even though the business income is derived by an entity (Help Our Community Ltd) different to the entity conducting the business (JR Ranch Trust).

Help Our Community Ltd is taxable on the business income of $85,000. As in **Example | Tauira 8**, this outcome arises because the JR Ranch Trust (the entity carrying on the business) is not a registered charity at the time the income is derived. This outcome arises even though the income is derived by a registered charity (Help Our Community Ltd) from a business carried on exclusively for charitable purposes in New Zealand (the charitable purposes of Help Our Community Ltd).

**Example | Tauira 10 – Business income distributed to a registered charity by an entity that is a registered entity**

The facts in this example are the same as in **Example | Tauira 9** except that the JR Ranch Trust is also a registered charity.

The $85,000 will be exempt income of Help Our Community Ltd (subject to it satisfying the control restriction). This outcome arises because its charitable purpose is limited to New Zealand.

This outcome arises because the income is derived by a registered charity (Help Our Community Ltd) from a business carried on by a registered charity (the JR Ranch Trust).

# The charity carries out charitable purposes in New Zealand

80. Business income to which s CW 42 applies is exempt from tax only if the charity deriving the income carries out its charitable purposes in New Zealand (s CW 42(1)(a)). Before considering what is required for a charity to satisfy this requirement, it is necessary to consider the meaning of "charitable purpose" and "in New Zealand".

## Meaning of "charitable purpose"

81. "Charitable purpose" is defined in s YA 1:

> **charitable purpose** includes every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community, and—
>
> (a) the purpose of a trust, society, or institution is charitable under this Act if the purpose would meet the public benefit requirement apart from the fact that the beneficiaries of the trust, or the members of the society or institution, are related by blood:
>
> (b) a marae has a charitable purpose if—
>
> (i) the physical structure of the marae is situated on land that is a Māori reservation referred to in Te Ture Whenua Māori Act 1993 (the Māori Land Act 1993); and
>
> (ii) the funds of the marae are not used for a purpose other than the administration and maintenance of the land and of the physical structure of the marae, or are used for a purpose that is a charitable purpose

82. The charitable purpose test is the same as the test in the Charities Act 2005.

## Meaning of "in New Zealand"

83. In most cases it will be clear from the rules of a charity whether it has charitable purposes "in New Zealand". However, there can be situations where what makes up the boundaries of the country are in issue.

84. The Act defines "New Zealand" inclusively (but not exhaustively) in s YA 1 as including the continental shelf and the water and air space above the continental shelf that is beyond New Zealand's territorial sea (subject to some limitations).

85. To find a definition of "New Zealand" in terms of what it would commonly be thought of as including, it is necessary to refer to s 13 of the Legislation Act 2019, which provides:

> **New Zealand** or similar words referring to New Zealand, when used as a territorial description,—
>
> (a) means the islands and territories within the Realm of New Zealand; but
>
> (b) does not include the self-governing State of the Cook Islands, the self-governing State of Niue, Tokelau, or the Ross Dependency

86. The Legislation Act 2019 applies to the Income Tax Act 2007 unless the latter provides otherwise or the context of the legislation requires a different interpretation (s 9 of the Legislation Act 2019). In the Commissioner's view, the Income Tax Act 2007 does not provide otherwise and, for the purposes of s CW 42, does not indicate a different context in terms of overriding the effect of s 9 of the Legislation Act 2019.

87. In the Commissioner's view, the Legislation Act 2019 definition of "New Zealand" applies to s CW 42. Importantly, the definition in s 13 of the Legislation Act 2019 does not include the Cook Islands, Niue, Tokelau or the Ross Dependency in the meaning of "New Zealand".

88. This means "New Zealand" in s CW 42 includes what is commonly understood to be included in this geographical term. That is, it includes the North, South, Stewart, Chatham and Kermadec Islands and all other territories, islands and islets in the geographical areas set out in the New Zealand Boundaries Act 1863 (UK) and the preamble of the Kermadec Islands Act 1887.

## Carrying out charitable purposes in New Zealand

89. The Commissioner's view is that a charity carries out its charitable purposes in New Zealand if at least one of its purposes is a charitable purpose in New Zealand. A charity's rules and where its purposes are actually carried out are relevant in

determining whether a charity has a charitable purpose in New Zealand. Whether a charity has a charitable purpose in New Zealand is a question of fact.

90. The New Zealand courts considered whether a charitable entity's charitable purposes were in or outside New Zealand in *Case T50* (1998) 18 NZTC 8,346 (TRA). This case considered provisions in earlier income tax legislation corresponding to what is now s CW 42. The case law indicates the following principles are relevant to the question of where a charity's charitable purposes are carried out:

- The geographical location of where a charity's funds are spent or paid does not determine whether its charitable purposes are for purposes in or outside New Zealand.
- Spending money outside New Zealand for charitable purposes in New Zealand is not sufficient to consider a charity to be carrying out charitable purposes outside New Zealand. Conversely, spending money in New Zealand for charitable purposes overseas is not sufficient to consider a charity to be carrying out charitable purposes in New Zealand.
- A charity can carry out its charitable purposes by making a donation to a charitable object. In determining whether a donation is for purposes in or outside New Zealand, a New Zealand court might look at:
  - the charitable purposes of the recipient of the donation;
  - any agreement or understanding between the parties as to the use of the donated funds; and/or
  - how the recipient of the donation actually uses the donated funds.

91. Example | Tauira 11 illustrates the situation of a charity with a charitable purpose in New Zealand.

**Example | Tauira 11 – Charity with a charitable purpose in New Zealand**

The WH Homes Trust is a registered charity. Its trust deed provides that its charitable purpose is improving the lives of children in New Zealand and the Pacific Islands. It does this by helping people to build warm and healthy homes.

The trust carries on a commercial rental business. The income from this business funds its charitable purposes.

In its 2022/23 year, the WH Homes Trust derives business income of $150,000, which it accumulates.

In prior years, the trust assisted in building homes in New Zealand and the Pacific Islands.

The WH Homes Trust is working out whether the business income it derives in its 2022/23 year is exempt under s CW 42. In particular, whether it satisfies the requirement in s CW 42(1)(a) that it carries out its charitable purposes in New Zealand.

The WH Homes Trust has a charitable purpose in New Zealand and accordingly satisfies the requirement in s CW 42(1)(a). Its trust deed provides that it has a purpose of improving the lives of children in New Zealand and it has helped people to build warm and healthy homes in New Zealand.

As the charitable purposes of the WH Homes Trust are not limited to New Zealand, it needs to consider what proportion of its business income derived in the 2022/23 year is taxable. For further discussion of how a charity does this, see from [110].

92. Business income derived by a charity with only overseas charitable purposes is fully taxable.

## The charity must be a "tax charity"

93. Under s CW 42(1)(b), the charity seeking to apply the exemption in s CW 42 to business income it derives must be a "tax charity". "Tax charity" is defined in s CW 41(5) and includes registered charities and non-resident charitable entities (non-resident tax charities) the Commissioner approves as tax charities:[14]

> *Definition*
>
> (5) **Tax charity** means,—
>
> (a) a trustee, a society, or an institution, registered as a charitable entity under the Charities Act 2005:
>
> (b) a trustee, a society, or an institution (the entity), that—
>
> (i) has started, before 1 July 2008, to take reasonable steps in the process of preparing an application for registering the entity as a charitable entity under the Charities Act 2005; and
>
> (ii) intends to complete the process of preparing an application described in subparagraph (i); and
>
> (iii) has not been notified by the Commissioner that the entity is not a tax charity:

[14] For information on how to apply for an exemption as a non-resident tax charity, see "Te tono i tētahi aweretanga hei kaupapa atawhai kainoho-tāwāhi: Apply for an exemption as a non-resident charity" (webpage, Inland Revenue, last updated 15 November 2022).

(c) a trustee, a society, or an institution, that is or are non-resident and carrying out its or their charitable purposes outside New Zealand, and which is approved as a tax charity by the Commissioner in circumstances where registration as a charitable entity under the Charities Act 2005 is unavailable:

(d) a person who is removed from the register, in the period starting with the day they are registered on the register and ending with the earlier of the following days:

(i) the day on which the person does not comply with the person's rules contained in the register:

(ii) the day of final decision

94. For the purposes of this statement, the relevant part of the "tax charity" definition is the requirement that the trust, society or institution be registered as a charitable entity under the Charities Act 2005. This statement does not consider how s CW 42 may apply to business income derived by a non-resident tax charity. The Commissioner assumes most non-resident tax charities do not carry on business in New Zealand. If a non-resident tax charity derives business income, it is likely to be fully taxable as a result of the non-resident tax charity's overseas charitable purposes.

## Control restriction

95. Section CW 42(1)(c) requires that no person with some control over the business can direct or divert income from the business to the benefit or advantage of a person other than the charity (or charities) for whose benefit the business is carried on, except for a purpose of the charity (or charities). It follows that a charity does not breach the control restriction when it is able to divert amounts from its subsidiary's business to its own (charitable) benefit.[15]

96. Section CW 42(5) to (9) expands on the control restriction with further detail on when:

- a person is treated as having some control over the business and able to direct or divert amounts from the business; and
- a benefit or advantage arises to a person.

97. As discussed at [15] this statement does not consider the control restriction in detail. If a tax charity breaches the control restriction, all of the business income it derives is taxable. As the control restriction always applies, it is important that a tax charity that derives business income monitors its compliance with the control restriction on an ongoing basis.

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[15] *Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Bill* (Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill, June 2015), at 94.

# Part Three: The territorial restriction

98. As described from [80], for a tax charity's business income to be exempt under s CW 42, at least one of its purposes must be a charitable purpose in New Zealand. However, where a tax charity's charitable purposes are not limited to New Zealand, s CW 42(4) requires it to identify a basis for splitting its business income relative to its charitable purposes in New Zealand and those outside New Zealand. Only the part apportioned for tax purposes to the charitable purposes in New Zealand is exempt income.

99. Section CW 42(4) states:

> For the purposes of subsection (1)(a), if the charitable purposes of the trust, society, or institution are not limited to New Zealand, income derived from the business in a tax year is apportioned reasonably between those purposes in New Zealand and those outside New Zealand. Only the part apportioned to the New Zealand purposes is exempt income.

## No apportionment required if a tax charity's charitable purposes are limited to New Zealand

100. If a tax charity's charitable purposes are limited to New Zealand, all the business income it derives is exempt from tax (subject to it satisfying the control restriction). A tax charity's charitable purposes are limited to New Zealand if:

- its rules state its purposes are limited to New Zealand; and
- its charitable purposes are in fact limited to New Zealand.

101. In *CIR v Dick* (2001) 20 NZTC 17,396 (HC), the court looked to the trust deed of the foundation to determine whether its charitable purposes were limited to New Zealand. The court concluded that nowhere in the trust deed was it stated that the purposes of the foundation were limited to New Zealand, so the territorial restriction applied.[16]

102. In some cases, a tax charity's rules will not contain a territorial restriction to New Zealand but 100% of its charitable purposes are directed to New Zealand. In these cases, a tax charity can treat all the business income it derives in the relevant annual period as exempt (subject to the tax charity satisfying the control restriction) if:

- in that period and all prior periods, the tax charity has carried out its charitable purposes only in New Zealand; and

[16] On appeal of *Case T50* (discussed at [90]).

- the tax charity does not intend to extend its charitable purposes outside New Zealand in the future.

103. Example | Tauira 12 illustrates a situation where a tax charity's charitable purposes are limited to New Zealand.

**Example | Tauira 12 – Charitable purposes limited to New Zealand**

The Ongoing Education for Good Trust (OEGT) is a registered charity. Its trust deed states its purpose is to provide guidance and emotional support to people seeking to re-enter the education system. Funding for its charitable activities comes from several sources, including a coffee van business.

OEGT works out of offices in Wellington. Using relationships built with local schools and through local advertising, it provides guidance and emotional support to people in Wellington and the surrounding areas.

OEGT does not intend to extend its charitable purposes outside New Zealand. The plan for the future operation of OEGT shows that it intends to continue to focus on providing guidance and emotional support to people in Wellington and the surrounding areas.

OEGT can treat all of the income it derives from its coffee van business as exempt (subject to it satisfying the control restriction) on the following basis:

- It has carried out its charitable purposes only in New Zealand.
- It does not intend to extend its charitable purposes outside New Zealand in the future.

If OEGT's intentions change, it will need to apply a reasonable basis for splitting its business income between its charitable purposes in New Zealand and those outside New Zealand to determine the amount of business income that is exempt.

104. Conversely, if a tax charity's charitable purposes are in fact limited to overseas purposes, despite its rules not limiting its charitable purposes to overseas, all of its business income derived in the relevant annual period is fully taxable. Example | Tauira 13 illustrates this situation.

**Example | Tauira 13 – Overseas charitable purposes only**

The Storylight Trust is a registered charity. Its trust deed states its purpose is to increase computer literacy by providing computers to communities in need. Funding for its charitable purpose comes from its farming business.

Since it was established, the Storylight Trust has provided computers to communities in the Pacific Islands only. Further, the Storylight Trust has no intention to provide computers to communities in New Zealand in the future.

The Storylight Trust must treat all of the income it derives from its farming business as taxable income on the following basis:

- It has carried out its charitable purpose overseas only.
- It does not intend to carry out charitable purposes in New Zealand in the future.

If the Storylight Trust's intentions change, some of its business income may be exempt in the future.

### Tax charity donations for charitable purposes outside New Zealand

105. In some cases, a tax charity that previously has carried out charitable purposes only in New Zealand will carry out charitable purposes outside New Zealand. These situations often arise where a tax charity makes a donation in response to an unexpected event such as a natural disaster that occurs outside New Zealand.

106. As discussed at [90], a tax charity can carry out its charitable purposes by making a donation to a charitable object. The Commissioner considers a tax charity that donates to charitable purposes outside New Zealand is itself carrying out charitable purposes outside New Zealand and will need to determine a reasonable basis for splitting its business income between its charitable purposes in and outside New Zealand for that period.

107. It has been suggested that a charity does not carry out charitable purposes outside New Zealand as a result of donating to a charity listed in sch 32 ("sch 32 entity"). The confusion arises from an incorrect assumption that the special donation tax credit status given to a sch 32 entity somehow extends to the classification of a charity's donation to those entities.[17]

108. When determining whether a donation a tax charity makes is for purposes in or outside New Zealand, the charitable purposes of the recipient of the donation are relevant. Where the recipient of the donation is a sch 32 entity, its charitable purposes are likely to be carried out entirely, or mostly, outside New Zealand. It follows that in most cases where a tax charity donates to a sch 32 entity, the tax charity will be carrying out charitable purposes outside of New Zealand.

109. Example | Tauira 14 and Example | Tauira 15 illustrate the principles described above.

**Example | Tauira 14 – Donation by a charity to a charitable object**

The Forever Good Books Trust is a registered charity. Its trust deed provides that its charitable purpose is to advance education and make education more effective and accessible. It provides study materials and books to people in its local area, particularly in impoverished areas. Its trust deed permits the trustees to provide support to other registered charities whose work advances education.

In response to a humanitarian crisis in Tonga, the Forever Good Books Trust makes a $10,000 donation to Learning for Good Ltd. Learning for Good Ltd is a New Zealand incorporated company and a registered charity. Learning for Good Ltd's charitable purpose is to advance education in Tonga.

It follows that the Forever Good Books Trust carries out charitable purposes in and outside New Zealand. This outcome arises because the Forever Good Books Trust has donated for a charitable purpose outside New Zealand. Even though the Forever Good Books Trust has donated to a New Zealand company that is a registered charity, the donation is to advance education in Tonga.

**Example | Tauira 15 – Donation by a charity to a sch 32 entity**

The GAP Trust is a registered charity. Its charitable purpose is to promote religion, and its activities include providing religious services to its local community in New Zealand.

[17] The availability of tax benefits for a donation is limited to charities whose funds are applied wholly or mainly to charitable purposes in New Zealand (see s LD 3(2)(a)). Charities whose charitable purposes are outside New Zealand (or mostly outside New Zealand) and who want their donors to be eligible for the donation tax credit must be approved for overseas donee status and listed in sch 32.

In response to an overseas humanitarian crisis the GAP Trust donates an amount to an overseas charity listed in sch 32. The purposes of the overseas charity are limited to outside New Zealand.

That the GAP Trust's donation is to a charity listed in sch 32 does not prevent the conclusion that the GAP Trust is, as a result of the donation, carrying out charitable purposes outside of New Zealand.

It follows that the GAP Trust carries out charitable purposes outside New Zealand. This outcome arises because the GAP Trust has donated for a charitable purpose outside New Zealand.

## General principles for splitting business income

110. Where a tax charity's charitable purposes are not limited to New Zealand, the income derived from the business in the relevant annual period must be "apportioned reasonably between those purposes in New Zealand and those outside New Zealand".

111. The Commissioner considers that the focus of the territorial restriction is on a tax charity's charitable purposes. This view is supported by the words of the section and by case law (*CIR v Dick*) and is consistent with the purpose of s CW 42 to exempt business income a tax charity derives to the extent that its charitable purposes are directed towards New Zealand. It follows that the territorial restriction is **not** about identifying whether a tax charity uses, spends or applies its business income to its charitable purposes in New Zealand or outside of New Zealand.

112. A tax charity is required to identify a basis for splitting its business income relative to its charitable purposes in New Zealand and outside New Zealand. Section CW 42(4) does not provide any guidance on how a tax charity works out what proportion of its charitable purposes it carries out in New Zealand relative to those outside New Zealand. In the absence of any specific guidance, a tax charity should be guided by the following general principles:

- A tax charity's split of its business income between charitable purposes in and outside New Zealand does not need to be exact to the last dollar, but it must reflect what an objective person would consider is reasonable in the circumstances (*Buckley & Young v CIR* (1978) 3 NZTC 61,271 (CA) and *Omihi Lime Co Ltd v CIR* [1964] NZLR 731 (HC)).
- Whether the split of business income in the relevant annual period is reasonable depends on the relevant facts and circumstances.

- All relevant factors need to be considered when determining a reasonable basis for splitting business income. The taxpayer has the burden of proving the split of its business income is reasonable (*Buckley & Young)*.

113. Accordingly, a tax charity has some flexibility in how it approaches splitting its business income.

## Approaches to splitting business income

114. The purpose of s CW 42 is to exempt business income a tax charity derives to the extent its charitable purposes are directed towards New Zealand. A tax charity that needs to apportion its business income should have this focus in mind when considering a basis for splitting its business income between its charitable purposes in and outside New Zealand.

115. A number of possible approaches to splitting business income are described from [117]. A tax charity can take an approach that is different to those described, provided it results in a reasonable apportionment of business income between its charitable purposes in and outside New Zealand.

116. The Commissioner's view is that once a tax charity determines an approach to splitting its business income, it can use that same approach each year. Unless it makes material changes to the way it operates, a tax charity should apply its chosen approach consistently over time.

### Level of support provided to each purpose

117. In *CIR v Dick*, the court concluded that one reasonable basis for splitting business income is to examine the actual level of support provided to each purpose during the relevant annual period. In that case, the court examined the application of the foundation's funds to its charitable purposes.

118. However, a tax charity can determine the level of support provided to each purpose in several ways. For example, it could determine the level of support based on time spent on each purpose or the level of resources dedicated to each purpose. Example | Tauira 16 illustrates one way of splitting business income based on the application of a tax charity's funds to its charitable purposes.

**Example | Tauira 16 – Splitting business income based on donated funds**

The Feeding the World Trust is a registered charity. Its trust deed states that its charitable purpose is to reduce food poverty among children. It does this by providing donations to charitable entities that run programmes to produce food for or provide it to children in areas where children are receiving inadequate food.

Funding for its charitable activities comes from its second-hand clothing business and donations from the public.

At the end of each year, the Feeding the World Trust donates its surplus funds (business income and donations) to various other charities.

The Feeding the World Trust works out that in the current year, it donated 75% of its funds to an organisation that runs a school breakfast club for several New Zealand schools. It donated the remaining 25% of its funds to an organisation that runs school breakfast clubs in Australia.

One reasonable way of splitting its business income in the current year is to treat 75% of the business income as exempt and 25% as taxable, on the basis that 75% of its donations were for charitable purposes in New Zealand and 25% for overseas purposes.

## Application of funds to charitable purposes in New Zealand

119. As described at [117], in *CIR v Dick* the court examined the application of the foundation's funds to its charitable purposes. Interestingly, the extent to which a registered charity applies its funds to its charitable purposes within New Zealand is also relevant in the context of s LD 3(2)(a).

120. To qualify as a donee organisation under s LD 3(2)(a), an entity must be:

> a society, institution, association, organisation, or trust that is not carried on for the private pecuniary profit of an individual, and whose funds are applied wholly or mainly to charitable … purposes within New Zealand:[18]

121. Some registered charities deriving business income will have "donee organisation" status and will be familiar with s LD 3(2)(a) and the Commissioner's position on how this section applies. The Commissioner's position on what is the meaning of "wholly or mainly" applying funds to specified purposes within New Zealand is set out in IS 18/05: Income tax – donee organisations – meaning of wholly or mainly applying funds to specified purposes within New Zealand, *Tax Information Bulletin* Vol 30, No 10 (November 2018): 25 and IS 18/05 FS: *Fact sheet – Applying the "safe harbour" approach* (Inland Revenue, 2018).

[18] The scope of s LD 3(2) is not limited to organisations whose funds are applied wholly or mainly to charitable purposes within New Zealand. Section LD 3(2) also applies to organisations whose funds are applied wholly or mainly to benevolent, philanthropic or cultural purposes within New Zealand. However, as s CW 42 is limited to business income derived by a tax charity, this interpretation statement focuses on how the test in s LD 3(2)(a) applies to charities.

122. Broadly, to determine if the "wholly or mainly" requirement in s LD 3(2)(a) is satisfied, an entity following the approach in IS 18/05 looks at the funds (cash on hand) it applies over a discrete period of time, such as a year, and then from year to year to determine what percentage of those funds is applied to, in this case, charitable purposes in New Zealand.

123. A tax charity applying the approach in IS 18/05 is required to consider how its funds are put to use. Tax charities commonly apply funds by spending them on goods or services in the course of carrying on some activities, accumulating them for future spending or donating them to another organisation. A tax charity must identify objectively whether a sufficient relationship exists between the purposes served by the actual or proposed activity and advancing charitable purposes in New Zealand.

124. In the Commissioner's view, a tax charity can use this approach to determine the extent to which its charitable purposes are carried out in New Zealand, thereby providing a reasonable basis to split its business income relative to its charitable purposes in and outside New Zealand.[19] Example | Tauira 17 illustrates this approach.

**Example | Tauira 17 – Splitting business income based on the percentage of funds calculated to satisfy the "wholly or mainly" requirement**

ASJ Hope Ltd is a company established to provide food to people who need assistance following disasters. ASJ Hope Ltd provides food parcels in New Zealand, Australia and the Pacific Islands. ASJ Hope Ltd is a registered charity and is on Inland Revenue's list of approved charities.

ASJ Hope Ltd funds its operations through donations from the public, funds from the investment of donations and income from its bookshop business.

In its 2022/23 year, based on the approach outlined in IS 18/05 it determines that it has applied 79% of its total funds to charitable purposes in New Zealand.

ASJ Hope Ltd derives business income of $18,000 in its 2022/23 year.

ASJ Hope Ltd treats 79% of its business income ($14,220, being 79% of $18,000) as exempt and 21% ($3,780, being 21% of $18,000) as assessable income. The outcome of this approach is that in 2022/23, $14,220 of its $18,000 business income will be exempt.

[19] The tax charity must use the current year calculation of the proportion of funds applied to New Zealand, not the revised calculation based on the current year and 2 preceding years which a tax charity is able to use in the context of s LD 3(2)(a) in certain circumstances.

### Split based on historical purposes

125. Section CW 42 is a test applied annually to business income derived in the relevant annual period. However, a tax charity carries out its charitable purposes on a continuing basis over its lifetime.

126. There may be situations where a tax charity can, based on an analysis of where it has carried out its charitable purposes in the past (New Zealand versus overseas), determine a percentage split that reasonably reflects the extent to which it carries out its charitable purposes in New Zealand. The tax charity could then use the same percentage to split business income it derives in future years.

127. A tax charity that took this approach would need to assess, annually and over time, whether the percentage it was using remained reasonable.

## Funding overseas purposes with amounts not subject to the test in s CW 42

128. A tax charity that derives business income in the relevant annual period may, in that same period, derive other amounts that are not subject to the test in s CW 42 (eg non-business income and capital amounts). In some cases, these other amounts are equal to or more than the amount a tax charity directs to its charitable purposes outside New Zealand in the relevant annual period.

129. It has been suggested that a tax charity should be able to apply its non-business income or capital receipts to overseas purposes and only once these amounts are exceeded, apply the territorial restriction to business income. The arguments in support of this approach are that it reduces compliance costs and provides greater certainty.

130. However, the Commissioner's view is that where a tax charity has charitable purposes in and outside New Zealand, a reasonable split of business income is one that results in a reasonable amount of business income being taxable. The reasons for this view are as follows:

    - Section CW 42(4) does not require a direct connection between a tax charity's business income and its charitable purposes in or outside New Zealand. The focus of s CW 42(4) is on charitable purposes. The purpose of s CW 42 is to exempt business income a tax charity derives to the extent that its charitable purposes are directed towards New Zealand.
    - It is likely the policy intent of s CW 42 is not achieved if a tax charity with New Zealand and overseas charitable purposes can treat all of its business income as exempt solely on the basis that it also derives other amounts not subject to s CW 42.

131. Further support for this view comes from the obiter comments of the High Court in *CIR v Dick*. In that case, Glazebrook J accepted the Taxation Review Authority's findings that all of a charitable foundation's donations made so far were for purposes in New Zealand. The court concluded that on this basis an historical apportionment (no apportionment) would be fair and reasonable if there was no indication the foundation intended to extend its purposes outside New Zealand. Glazebrook J went on to consider the position if the foundation carried out charitable purposes outside New Zealand in the future. Glazebrook J states at [25]:

> If an apportionment based on the historical distribution pattern is made but the trust funds are in the future applied for purposes outside New Zealand apportionment would then be justified to take the changed position into account. This would be apportionment either of current income or (to the extent possible) the reopening of returns and apportionment of past business income.

132. The Commissioner considers this statement indicates that the court expected the foundation would, as result of carrying out charitable purposes outside New Zealand, have taxable business income.

133. Example | Tauira 18 illustrates the Commissioner's view.

**Example | Tauira 18 – Charity with charitable purposes in and outside New Zealand that derives business income and other amounts**

The Panther Trust is a registered charity. Its trust deed provides that its charitable purpose is to benefit youth in the community by providing financial assistance to further education through team sporting activities. Its trust deed further provides that any charitable purposes that the Panther Trust carries out outside of New Zealand will be funded from amounts other than business income.

In the 2022/23 year, the Panther Trust derives business income of $200,000 and a non-taxable capital gain on the sale of one of its buildings of $150,000.

In 2022/23 it provides grants to several New Zealand schools and donates $100,000 to an organisation that provides grants to schools in Fiji to purchase sporting equipment.

The Panther Trust is unsure whether it needs to split its business income of $200,000 between its charitable purposes in and outside New Zealand given that its donation to charitable purposes in Fiji is less than the amount of capital gain it derived in the year.

The Panther Trust carries out charitable purposes in New Zealand and outside New Zealand (in Fiji). Accordingly, it must split its business income between its charitable purposes in New Zealand and those outside New Zealand. A

reasonable split of business income is one that results in a reasonable amount of business income being taxable.

In this case it may be reasonable for the Panther Trust to treat 71.5% of its business income as exempt and 28.5% as taxable on the basis that 28.5% of the funds it received in the year ($100,000/$350,000) were donated for overseas purposes.

## Change in charitable purposes

134. In some cases, a tax charity will split its business income based on its intention to carry out charitable purposes in or outside New Zealand. An issue arises as to what a tax charity should do if that intention changes.

135. For example, the Commissioner understands it is common for a tax charity to accumulate money with the intention of directing that money towards charitable purposes in the future. The reason for accumulating money varies; for example, it may be to:

- build up money to carry out a large project;
- establish a pool of money that the tax charity will use to make donations or grants in the future; or
- re-invest into the business so the tax charity potentially has more money available to carry out its charitable purposes in the future.

136. The High Court in *CIR v Dick* recognised that the retention of funds is a complicating factor when a charity's method for splitting its business income between charitable purposes in and outside New Zealand is based on the charity's historical application of its funds (see the discussion of that decision at [117]). The High Court states that if the charity made an apportionment based on the historical distribution pattern, but applied the trust funds in the future for purposes outside New Zealand, an apportionment would be justified to take that changed position into account. This could be apportionment of either current income or "(to the extent possible) the reopening of returns and apportionment of past business income".

137. A question arises as to the circumstances in which a change of intention would require a prior period return to be re-opened (or if the tax charity did not file a return in the prior period, would require it to file a return).

138. The Commissioner's view is that a change of intention does not necessarily mean a split of business income in a prior period is no longer "reasonable". Where a tax charity treats some or all of its business income as exempt on the basis of its intention to carry out charitable purposes in New Zealand and this intention changes, the

outcome is that the tax charity is carrying out charitable purposes outside of New Zealand. Where a tax charity carries out charitable purposes outside New Zealand, the Commissioner expects the amount of business income that is not exempt under s CW 42 will increase.

139. A tax charity has the burden of proving that its split of business income is reasonable. For example, a tax charity that carries out charitable purposes overseas but has exempted all its business income under s CW 42 will need to satisfy the Commissioner that its split of business income under s CW 42(4) in prior periods was reasonable. If a tax charity cannot satisfy this burden, its prior period return may be re-opened (or if it did not file a return in the prior period, it may be required to file a return) and a greater amount of its business income treated as taxable.

## Splitting deductible business expenses between taxable and exempt business income

140. As this part has described, a tax charity must split its business income based on its charitable purposes in and outside New Zealand (and only that part apportioned for tax purposes to the charitable purposes in New Zealand is exempt income). Under s DA 2(3), a deduction is denied for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income.

141. The outcome of applying the territorial restriction is that a proportion of a tax charity's business income (but not particular income amounts) is assessable income and a proportion is exempt income. A question arises as to how a tax charity determines whether it has incurred its deductible business expenditure in deriving its assessable income or exempt income. Before considering this issue, it is useful to discuss what is meant by "deductible business expenditure".

### Deductible business expenditure

142. Under s DA 1(1)(b), a person is allowed a deduction for an amount of expenditure or loss to the extent they incur it in the course of carrying on a business for the purpose of deriving income. For expenditure or loss to be incurred in the course of carrying on a business a sufficient relationship must exist between the expenditure and the business that is being carried on (*CIR v Banks* (1978) 3 NZTC 61,236 (CA) and *Buckley & Young*). The type of expenditure and its relevance to the income-earning process are significant factors to consider in deciding whether that relationship exists. This includes looking at how the tax charity earns its business income and the factual situation at the time the expenditure is incurred.

143. Example | Tauira 19 illustrates where expenditure is not sufficiently related to a tax charity's business.

**Example | Tauira 19 – Expenditure that is not deductible business expenditure**

The Triple C Trust is a registered charity. To raise funds for its charitable purposes (the relief of poverty in New Zealand and Australia) it runs a sports equipment rental business.

The Triple C Trust also seeks donations from the public. It does this via a website which explains who the Triple C Trust is and what its charitable purposes are. People who wish to donate are able to do so via the website by pushing the "Donate Now" button.

In the 2022/2023 income year the Triple C Trust incurs $60,000 of expenses in running its sports equipment rental business and website hosting costs of $600.

The $60,000 of expenses incurred by the Triple C Trust in running its sports equipment rental business are deductible business expenditure. However, as the Triple C Trust did not incur the website hosting costs in the course of carrying on its sports equipment rental business, those costs are not deductible business expenditure.

144. Even where a deduction is available under s DA 1, it may be disallowed under the limitations to deductibility. The limitation most likely to apply to business expenditure is for capital expenditure in s DA 2(1). Whether expenditure is of a capital nature is a factual question that will need to be considered in each case.

145. Depending on the level of a tax charity's deductible business expenditure in a relevant annual period, a tax charity might have a profit or a loss from its business activities.

## Splitting deductible business expenditure

146. The Commissioner considers that a tax charity can split its deductible business expenses on the same basis that it split its business income between its charitable purposes in and outside New Zealand. Example | Tauira 20 illustrates this approach.

**Example | Tauira 20 – Splitting deductible business expenditure on the same basis as business income**

The Triple C Trust from Example | Tauira 19 needs to work out how much tax it should pay on its business income.

The Triple C Trust derived business income of $85,000 in its 2022/23 year and works out that a reasonable basis for splitting its business income between its charitable purposes in and outside New Zealand is 50:50.

The Triple C Trust works out that it incurred deductible business expenses of $60,000 in its 2022/23 year.

The Triple C Trust splits its business income of $85,000 between its charitable purposes in New Zealand ($42,500, being 50% of $85,000) and those outside New Zealand ($42,500, being 50% of $85,000). It splits its deductible business expenses of $60,000 on the same basis. The Triple C Trust can claim deductible expenses of $30,000 (50% of $60,000) against its assessable business income of $42,500 which, results in:

- $12,500 of taxable income; and
- $42,5000 of exempt income for which no expense deductions are available.

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*In draft form these items may not be relied on by taxation officers, taxpayers, or practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.*

Send feedback to | Tukuna mai ngā whakahokinga kōrero ki Public.Consultation@ird.govt.nz

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