

EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY

External consultation

Deadline for comment: **1 February 2021**

Please quote reference: **PUB00359a**

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QUESTION WE'VE BEEN ASKED > GENERAL ISSUES

Charities business exemption – when it must be used

Issued: **Issue date**

Publication number QB XX/XX

This Question We've Been Asked considers the situations in which a charitable entity needs to use the business income exemption in s CW 42 (which contains additional territorial and control restrictions) rather than in s CW 41.

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

Key provisions

Income Tax Act 2007 – ss CW 41 and CW 42

Question

In what situations does a charitable entity need to use the business income exemption test in s CW 42 (which contains additional territorial and control restrictions) rather than the exemption test in s CW 41?

Answer

A charitable entity must use the business income exemption test in s CW 42 to work out whether income it derives from a business is exempt if:

- the charitable entity is carrying on the business; or
- another charitable entity (the operating entity) is carrying on the business “for, or for the benefit of” the charitable entity (the controlling entity).

A business will be carried on by an operating entity for, or for the benefit of a controlling entity if all the rights to the income and capital of the business held by the operating entity are held for the benefit of the controlling entity.

Key terms

Charitable entity – A trust, society or institution of a kind referred to in s CW 41(1) that is also a tax charity as defined in s CW 41(5).

Control restriction – A restriction whereby income will not be exempt if a person with some control over the business is able to direct or divert money away from the charity (s CW 42).

Controlling entity – A charitable entity that is the recipient of income derived from a business carried on by an operating entity.

Operating entity – A charitable entity that carries on a business and pays income derived from the business to a controlling entity.

Territorial restriction – A restriction whereby income can be exempt only to the extent that the charity carries out its charitable purposes in New Zealand (s CW 42).

Explanation

1. When working out whether income derived by a charitable entity is exempt, it is first necessary to identify the correct test to apply. Two sections in the Act exempt income derived by a charitable entity: ss CW 41 and CW 42.

2. If income is derived from a business that is carried on by, or for, or for the benefit of, a charitable entity, the charitable entity must use the test in s CW 42 to work out whether the income is exempt. For other income, the test in s CW 41 must be used. The main difference between the tests is that under s CW 42 exemption is subject to the territorial and control restrictions.

Business carried on by the charitable entity

3. Where a charitable entity is carrying on a business itself, the charitable entity must use the business income exemption test in s CW 42 to determine whether income derived from the business is exempt.

Business carried on by a separate charitable entity

4. Where a charitable entity (the operating entity) is carrying on a business for, or for the benefit of, a separate charitable entity (the controlling entity), two charitable entities may be seeking an exemption.
5. The operating entity must use the business income exemption test in s CW 42 to determine whether income derived from the business is exempt because it is carrying on the business.
6. Whether the controlling entity must use s CW 42 for income that it derives indirectly from a business carried on by an operating entity depends on whether the business is being carried on "for, or for the benefit of" the controlling entity. Uncertainty exists about the situations that are captured by this test.
7. For a business to be carried on by an operating entity "for, or for the benefit of", a controlling entity, any rights to the income and capital of the business held by the operating entity must be held for the benefit of the controlling entity. A business will not be carried on by an operating entity for, or for the benefit of, a controlling entity if the controlling entity does not have any right to the income and capital of the business. This is illustrated in Example 1.
8. To determine whether rights to the income and capital of the business held by the operating entity are held for the benefit of the controlling entity, the constitution of the operating company, the terms of any trust that may apply to the business property owned by the operating company, and any other relevant documents or circumstances must be considered. Additionally, for the exemption in s CW 42 to apply, the control restriction must not apply.

9. The controlling entity could own the operating entity (directly or indirectly), but ownership is not necessary for the business to be carried on by the operating entity “for, or for the benefit of” the controlling entity. The operating entity may carry on the business in trust for the controlling entity (provided any rights to the income and capital of the business held by the operating entity are held solely for the benefit of the controlling entity). An operating entity, acting as a trustee, will not carry on a business for, or for the benefit of, a controlling entity if the controlling entity is merely a discretionary beneficiary. The relevance of ownership is illustrated in Example 2.
10. Merely deriving income that is indirectly sourced from a business is not enough for the business to be carried on for, or for the benefit of, a charitable entity. This means, for example, that voluntary donations one charitable entity receives from another charitable entity that derived the amounts from a business will not necessarily be subject to s CW 42 (for the first mentioned charitable entity).
11. The above views are consistent with case law, including *Calder Construction Co Ltd v CIR* [1963] NZLR 921 (SC), *CIR v NTN Bearing-Saeco (NZ) Ltd* (1986) 8 NZTC 5,039 (HC) and *Latimer v CIR* (2002) 20 NZTC 17,737 (CA). These cases considered provisions in earlier income tax legislation corresponding to what is now s CW 42. These cases are authority for the proposition that the income and the capital of the business must ultimately be applied to the charitable entity for which the business is being carried on.
12. Where income a controlling entity derives is not derived from a business carried on for, or for the benefit of, the controlling entity, the controlling entity can instead use s CW 41 (which does not include the territorial and control restrictions).
13. This answer is subject to the general anti-avoidance provision in s BG 1. Section BG 1 could potentially apply if an expectation or understanding (whether or not enforceable) existed between a controlling entity and an operating entity that all, or substantially all, of the income of the business would be donated to the controlling entity.

Exempt income under ss CW 41 and CW 42

14. A charitable entity could have income derived from a business that is subject to s CW 42 and other income that is subject to s CW 41.
15. Note that income associated with a business will be business income even if the income is passive income. For example, interest or dividends derived from a business bank account or from the investment of business reserves will be income derived from the business, so will be subject to s CW 42.
16. A charitable entity might carry on a business itself as one of the ways it funds its charitable purposes. Some of the other ways in which it derives income may have no

association with the business. This income will be subject to s CW 41. For example, the charitable entity may have a property, which is not used in the business and which generates rental income. The charitable entity might also have interest or dividend income derived from investing donations. To prove that such income is not associated with the business, the charitable entity should separately identify this income in its accounting system.

17. For a controlling entity, income received from an operating entity (which carries on a business for, or for the benefit of, the controlling entity) that is subject to s CW 42 will be clearly distinguishable from other income derived by the controlling entity. This is illustrated in Example 2.
18. An operating entity may be set up for the sole purpose of carrying on a business for a controlling entity. It may be that for an operating entity like this, all its income will be associated with the business and, therefore, will be business income subject to s CW 42.

Examples

Example 1: Whether controlling entity needs to use s CW 42

Facts

Sustainable Timber Trust has a charitable purpose of promoting the use of sustainable timber in the furniture industry. Sustainable Timber Trust carries out its charitable purposes in New Zealand and Australia, with resources divided evenly between the countries.

The Sustainable Timber Trust also owns Home Composting Solutions Ltd, which is a charitable company with a purpose of promoting home composting in New Zealand. Home Composting Solutions Ltd runs a business selling home composting equipment. The profits from this business are mostly used for promoting home composting and providing educational materials about composting. Home Composting Solutions Ltd's constitution also allows it to make donations to other charities, and Home Composting Solutions Ltd sometimes donates income made from the business to the Sustainable Timber Trust.

The Sustainable Timber Trust needs to work out whether the donations it receives from Home Composting Solutions Ltd are exempt, but it is not sure whether it needs to use s CW 42 to work this out. It is concerned that the income is indirectly derived from a business and that exemption might be restricted because it carries out some of its charitable purposes in Australia.

Tax treatment

The Sustainable Timber Trust does not need to use s CW 42 to work out if the income is exempt. It can use s CW 41 instead. This means it does not need to worry about the Australian charitable purposes.

Home Composting Solutions Ltd does not carry on its business for, or for the benefit of, the Sustainable Timber Trust. The Sustainable Timber Trust does not have any right to the income or capital of the business run by Home Composting Solutions Ltd. Home Composting Solutions Ltd carries on the business for its own purposes and makes the donations to Sustainable Timber Trust voluntarily.

Example 2: Relevance of ownership and non-business income

Facts

Paladin Property Ltd carries on a property management business. Paladin Property Ltd is registered as a charitable entity under the Charities Act 2005. Paladin Property Ltd's constitution states that its purpose is to carry on business to raise funds for the Hatchery Trust. Paladin Property Ltd's constitution specifies that it may reinvest income into the business, but distributions of income may be made only to the Hatchery Trust. The constitution also specifies that distributions of capital may be made only to the Hatchery Trust.

The Hatchery Trust is established and maintained exclusively for charitable purposes (replenishing native fish species) and is not carried on for the private pecuniary profit of any individual. The Hatchery Trust is also registered as a charitable entity under the Charities Act 2005.

Old Book Ltd is the sole shareholder of Paladin Property Ltd. As a result of Paladin Property Ltd's constitution, Old Book Ltd does not have any right to the income or capital of Paladin Property Ltd. Old Book Ltd is owned by an accounting firm that sometimes provides services to the Hatchery Trust.

In the current income year, the Hatchery Trust receives a distribution of \$50,000 from Paladin Property Ltd. The Hatchery Trust also receives \$350 of interest on a term deposit and \$2,000 of dividends from investments in the share market.

Tax treatment

The Hatchery Trust needs to use s CW 42 to work out if the \$50,000 received from Paladin Property Ltd is exempt. This is because Paladin Property Ltd carries on the property management business for the Hatchery Trust. Provided the territorial and control restrictions do not apply, the \$50,000 will be exempt income of the Hatchery Trust.

The \$2,350 of interest and dividends derived by the Hatchery Trust is exempt income under s CW 41.

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

References

Legislative references

Income Tax Act 2007 – ss BG 1, CW 41, CW 42

Case references

Calder Construction Co Ltd v CIR [1963] NZLR 921 (SC)

CIR v NTN Bearing-Saeco (NZ) Ltd (1986) 8 NZTC 5,039 (HC)

Latimer v CIR (2002) 20 NZTC 17,737 (CA)

About this document

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