

ISSUES PAPER

Charities – business income exemption

A Tax Counsel Office discussion document

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Issues Paper IRRUIP17

This Issues Paper discusses the interpretative and practical issues a charity may face when applying s CW 42 to income it derives from a business carried out exclusively for charity. The matters discussed in this paper will be of particular interest to charities with charitable purposes in and outside New Zealand.

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

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About this document

Issues Papers are issued by the Tax Counsel Office where there is sufficient uncertainty around a particular issue, and it would be helpful to hear from interested parties before we prepare any public statement.

Issues Papers represent the Commissioner’s initial views on a particular tax issue. They are intended to stimulate discussion and invite feedback from interested parties, and they help us gain a better understanding of the issues, including practical concerns taxpayers have.

Inland Revenue officers, taxpayers and practitioners cannot rely on Issues Papers, as they are not authoritative statements of the Commissioner’s stance on the issues covered. Views presented in an Issues Paper do not change the Commissioner’s current position or practices.

If an Issues Paper results in the issue of a draft public statement, public consultation will occur in the usual manner.

LET US KNOW WHAT YOU THINK

We want to know what you think about our initial views presented in this issues paper.

We would like to know:

- if you think the initial interpretation of the relevant tax laws is correct
- if you have practical concerns about the interpretation
- if you think the result is correct from a tax policy perspective (that is, whether the tax law needs changing)
- your ideas on how to administer the tax laws.

More specific questions may appear in the body of the paper.

Email your thoughts to Public.Consultation@ird.govt.nz

Deadline for comment: **17/02/2023**

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Introduction

1. The Commissioner is aware that aspects of the interpretation of s CW 42 have given rise to uncertainty. This Issues Paper discusses the interpretative and practical issues a charity may face when applying s CW 42 to its business income.
2. Two sections in the Act exempt income derived by a charity that is a “tax charity”: ss CW 41 and CW 42. Broadly, a tax charity that derives income from a business must use the test in s CW 42 to determine the extent to which that income is exempt. For other income, the tax charity must use the test in s CW 41. Both tests are annual tests applied to income a tax charity derives in the relevant annual period.
3. The main difference between the tests is that income that falls within s CW 42 is subject to additional restrictions compared with income that falls within s CW 41. Those additional restrictions 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 those purposes in New Zealand and those outside New Zealand (referred to in this paper as the “territorial restriction”). Only the part

apportioned for tax purposes to the charitable purposes in New Zealand is exempt income.

- The business income is not exempt if a person with some control over the business is able to direct or divert money away from the charity (referred to in this paper as the “control restriction”). If the control restriction is breached, all of the business income a tax charity derives is taxable.
4. The issues discussed in this paper will be of most interest to 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.
 5. For example, this paper will be of particular interest to a tax charity that carries out its charitable purposes in New Zealand and elsewhere or that 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 occurring outside New Zealand.
 6. This paper does not consider the control restriction in any detail. In most cases, the entity applying the test in s CW 42 to its business income will be a registered charity. One requirement for approval as a registered charity is that the entity is not carried on for the private profit of any individual. For this reason, we expect that in many cases the control restriction will be satisfied.
 7. However, the Commissioner has a duty to apply the tax legislation, so may, despite registration, consider whether the control restriction is satisfied. If the control restriction is breached, all the business income that a tax charity derives will be taxable. Therefore, it is important for a tax charity to consider the application of the control restriction.
 8. Inland Revenue has discussed the control restriction in other publications, for example, [OS 22/04: Charities and donee organisations – Part 1: Charities](#) (Operational Statement, Inland Revenue, 2022).
 9. Examples are used in this paper to explain concepts and demonstrate our initial views. The examples are not intended to reflect existing or past charitable entities; they are illustrative only.

Purpose and scope of this Issues Paper

10. This paper seeks your comments on the issues set out at [15].

11. The issues arise from the wording of s CW 42, which is capable of more than one interpretation. The different interpretations result in significant differences in the income subject to s CW 42 and whether income subject to s CW 42 is exempt or taxable.
12. This paper sets out the different views that can be taken for each issue. It offers tentative conclusions, bearing in mind the legislative wording and the purpose of s CW 42 to exempt business income derived by a tax charity to the extent its charitable purposes are directed towards New Zealand. Although the issues are considered separately in this paper, they are interrelated. How parts of s CW 42 are interpreted affects how other parts of the section apply.

Key terms

13. This paper refers variously to a “charity”, a “registered charity” and a “tax charity”. The use of different terms in the paper could be confusing.
14. The particular term used depends on which part of s CW 42 is being considered. 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 the business is carried on by a “registered charity” and derived by a “tax charity”. While these terms are discussed in more detail in the paper, the following glossary is intended to assist by describing these terms in a general way:

charity describes 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

registered charity is an entity registered as a charitable entity under the Charities Act 2005

tax charity describes a charity that is a registered charity or a non-resident entity approved as a tax charity by the Commissioner

trust, society, or institution of a kind referred to in s CW 41(1) describes a charity (see above definition of “charity”)

Summary of issues and initial conclusions

15. The issues addressed in this Issues Paper are:
 - What income is “from a business”?

- When is a business carried on by, or for, or for the benefit of a charity?
 - What is the effect of the requirement that the entity carrying on the business be a registered charity?
 - When does a charity carry out charitable purposes in New Zealand?
 - When is a charity a “tax charity”?
 - When does a tax charity need to apply the territorial restriction?
 - How does a tax charity apply the territorial restriction?
16. These issues and our conclusions are summarised at [17] to [56]. More detail about the issues is at [71] to [240].

What income is “from a business”?

17. The test in s CW 42 applies to “[i]ncome derived directly or indirectly from a business” carried on by, or for, or for the benefit of a charity. A question arises as to what income is “from a business” and do the words “directly or indirectly” extend the test in s CW 42 to income not usually considered to be income from a business?
18. What amounts are income “from a business” is important as it determines whether an amount of income a charity derives is subject to the test in s CW 41 or s CW 42.
19. We consider the words “directly or indirectly” in s CW 42(1) refer to the carrying on of the business, not the derivation of income. The outcome of this view is that a more direct relationship is required between an amount of income and a business in order for that income to be subject to the test in s CW 42.
20. Income derived 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.
21. Whether a gift is income from a charity’s business is a question of fact. Gifts received by a charity are unlikely to be business income where the business is unrelated to the charity’s charitable purposes. Gifts received by a charity carrying on a business related to its charitable purposes are not necessarily business income.

When is a business carried on by, or for, or for the benefit of a charity?

22. Section CW 42 applies to business 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

What is the effect of the requirement that the entity carrying on the business be a registered charity?

23. Income derived from a business carried on exclusively for charitable purposes is exempt only if the entity actually conducting the business is a registered charity (s CW 42(1)(aa)).
24. This requirement is satisfied if a registered charity carries on business in partnership with an entity that is not a registered charity.
25. If the entity carrying on 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 charitable beneficiary is taxable on the beneficiary income.

When does a charity carry out charitable purposes in New Zealand?

26. Business income derived from a business carried on exclusively for charitable purposes is exempt only if the charity deriving the income carries out charitable purposes in New Zealand. It is a question of a fact whether a charity’s charitable purposes are in or outside New Zealand.
27. A charity’s rules and where its purposes are actually carried out are relevant in determining whether a charity carries out a charitable purpose in New Zealand.
28. We consider a charity carries out its charitable purposes in New Zealand if at least one of its purposes is a charitable purpose in New Zealand.
29. Business income derived by a charity with only overseas charitable purposes is taxable.

¹ 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 is discussed further at [133].

When is a charity a “tax charity”?

30. Income derived from a business carried on exclusively for charitable purposes is exempt only if the income is derived by a “tax charity”. The definition of “tax charity” includes a registered charity (s CW 41(5)).
31. This paper focuses on tax charities that are registered charities.

When does a tax charity need to apply the territorial restriction?

32. A tax charity is required to split the business income it derives between its charitable purposes in New Zealand and those outside New Zealand, if its charitable purposes are “not limited to New Zealand”. If a tax charity’s charitable purposes are in fact limited to New Zealand, the business income it derives is exempt from tax.
33. We consider a tax charity’s charitable purposes are limited to New Zealand if:
 - the tax charity’s rules state that its purposes are limited to New Zealand; and
 - its charitable purposes are in fact limited to New Zealand.
34. In some situations, a tax charity’s charitable purposes will in fact be limited to New Zealand, despite the tax charity’s rules not containing a territorial restriction to New Zealand. In this situation, we consider it is reasonable to treat all of a tax charity’s business income derived in the relevant annual period as exempt if:
 - in that period and all prior periods, the tax charity has carried out its charitable purposes only in New Zealand;
 - nothing indicates that the tax charity’s purposes are intended to extend outside New Zealand in the future.
35. 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 should be treated as taxable.

How does a tax charity apply the territorial restriction?

36. 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” (s CW 42(4)).

37. The focus of the territorial restriction is on a tax charity's charitable purposes. 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.
38. It follows that the territorial restriction is not about identifying whether business income is used, spent or applied to a tax charity's charitable purposes in New Zealand or outside of New Zealand.
39. This view is supported by the words of the section, case law (*CIR v Dick* (2001) 20 NZTC 17,396) 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.
40. Section CW 42(4) contemplates the split of business income but does not provide guidance on how a tax charity works out what proportion of its charitable purposes are carried out in New Zealand and outside New Zealand.
41. A tax charity's split of its business income between charitable purposes in New Zealand and those 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.
42. Whether the split of business income in the relevant annual period is reasonable depends on the relevant facts and circumstances. The taxpayer has the burden of proving the split of its business income is reasonable.
43. 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 purpose in mind when considering a basis for splitting its business income between its charitable purposes in and outside New Zealand.
44. Case law indicates 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 (*CIR v Dick*).
45. A tax charity could determine the level of support provided to each purpose in several ways. For example, the level of support could be based on time spent on each purpose, the level of resources dedicated to each purpose, the application of funds to each purpose or as stated in the tax charity's rules.
46. A tax charity carries out its charitable purposes on a continuing basis over its lifetime. In some situations where a tax charity is splitting business income it derives in the relevant annual period between its charitable purposes in New Zealand and those

outside New Zealand, it must consider its charitable purposes in the relevant annual period as well as past and intended future charitable purposes.

47. We are interested in feedback on whether a tax charity should be able to split its business income based on:
 - the percentage of funds (cash on hand) it applies to charitable purposes in New Zealand in the relevant annual period. This approach is used by certain entities (including registered charities) with “donee organisation” status for the purpose of determining if the “wholly or mainly” requirement in s LD 3(2)(a) is satisfied;
 - an average of its charitable purposes directed to New Zealand over a number of years.
48. Splitting business income between a tax charity’s charitable purposes in New Zealand and those outside New Zealand is likely to be more difficult where a tax charity accumulates money. This difficulty arises because the tax charity has not directly used its money to carry out its charitable purposes, either in or outside New Zealand.
49. A question that arises is whether it is reasonable for a tax charity to treat all of its business income as exempt if it can demonstrate that none of its business income was directed towards charitable purposes outside New Zealand. For example, a tax charity that separates its business income from other amounts and tracks the use of its business income and other amounts.
50. We are interested to hear about situations where a tax charity has taken this view and the arguments in support of this view.
51. Our initial view is that this approach is not reasonable. The focus of s CW 42(4) is on a tax charity’s charitable purposes, not on how business income is used, spent or applied. 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 arguable that 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 the test in s CW 42.
52. In some cases, a tax charity that previously carried out charitable purposes in New Zealand only will carry out charitable purposes outside New Zealand. The Commissioner understands this situation arises, for example, where a tax charity makes a donation in response to an unexpected event such as a natural disaster that occurs outside New Zealand. We consider a tax charity that donates to charitable purposes outside New Zealand is carrying out charitable purposes outside New Zealand. A tax charity should treat some of the business income it derives in the relevant annual period in which the donation is made as taxable. We are interested in understanding

how prevalent this situation is and how tax charities in this situation have applied the territorial restriction in s CW 42(4).

53. 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. We consider that if a tax charity treats some or all of its business income as exempt on the basis of an intention to carry out charitable purposes in New Zealand and this intention changes, the amount of business income that is taxable should increase.
54. We are still considering in what circumstances a change of intention would require a prior period return to be re-opened (or if no return was filed in the prior period, a return to be filed). Our initial thoughts are that a change of intention does not necessarily mean that a split of business income in a prior period is no longer "reasonable". However, in some cases, the re-opening (or filing) of a prior period return will be necessary to achieve the purpose of s CW 42.
55. 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, exempt income. A question arises as to how a tax charity determines whether its deductible business expenditure is incurred in deriving its assessable income or its exempt income.
56. One approach is for a tax charity to split its net income from the business (business income less deductible business expenses) between its charitable purposes in New Zealand and outside New Zealand. Alternatively, a tax charity could split its deductible business expenses on the same basis that it splits its business income between its charitable purposes in New Zealand and outside New Zealand. We are interested in receiving feedback on these (and other possible) approaches.

Background

57. The charitable exemption for business income has been in place for a long time. Despite this, uncertainty exists about how the exemption operates.
58. Many charities do not derive income from a business. Some charities derive income from a business but have no overseas charitable purposes. Some charities derive income from a business and have charitable purposes in and outside New Zealand. This paper explores some of the issues these charities face when working out how to apply the business exemption.
59. Before considering the issues (listed in [15]), we discuss:
 - the legislative history of the provision

- income specifically excluded from the provision.

Legislative history

60. The charitable exemption from income tax dates back to the first Act to tax income in New Zealand – the Land and Income Assessment Act 1891. The 1891 Act exempted the land of:

[p]ublic charitable institutions constituted under the Hospitals and Charitable Institutions Act 1885, and charitable institutions not carried on for gain or profit.

61. As originally enacted, the 1891 Act did not contain an exemption for income (only for land) of such institutions. However, following an observation by a Member of Parliament in the house when the Bill was passed, the 1891 Act was amended in 1892 to include an exemption for:

[a]ll mortgages held, and all income received or derived, by or on behalf of any public charitable institution, whether formed under “the Hospitals and Charitable Institutions Act, 1885,” or any other Act for the time being in force, or howsoever formed, if carried on for any public charitable purpose, and not for any gain or profit.

62. No substantive debate occurred in the General Assembly about why charities should be exempt from income tax; this was simply introduced as a matter of historical precedence.²

63. The requirement for a charity to apportion its income between its charitable purposes in and outside New Zealand appears to have been first included in the Land and Income Tax Act 1916. Section 84(k) of the 1916 Act exempted income:

derived by trustees in trust for charitable, religious, educational, or scientific purposes of a public nature within New Zealand, or derived by any society or institution established exclusively for such purposes and not carried on for private pecuniary profit:

Provided that if the aforesaid purposes are not limited to New Zealand the Commissioner may apportion the income in such manner as he deems just and reasonable between such purposes within New Zealand and the like purposes out of New Zealand, and may allow to the trustees, society, or institution a partial exemption accordingly:

64. The proviso to s 84(k) of the 1916 Act did not appear in the preceding Act, the Land and Income Assessment Act 1908.³ Due to the age of the exemption, it is difficult to locate further background material. However, *New Zealand Parliamentary Debates*

² M Gousmett, “The history of charitable purpose tax concessions in New Zealand: Part 1” (2013) 19 NZJTL 139, at 151–152.

³ Nor do any of the amending Acts repealed by the 1916 Act appear to have introduced the proviso to s 84(k) of the 1916 Act.

(Hansard) notes when the Land and Income Tax Bill (which became the 1916 Act) was introduced, most of the changes (other than those matters specifically discussed, of which the above proviso was not one) were administrative amendments requiring no further explanation.⁴ It may have been that Inland Revenue was, as a matter of administrative practice, already denying the exemption where charitable purposes were carried out overseas.

65. The charitable exemption from income tax was substantially amended in 1940. Following the amendments, s 78(k) of the Land and Income Tax Act 1923 provided the exemption for business income now contained in s CW 42.⁵ Section 78(k) of the 1923 Act exempted from tax:

Income derived directly or indirectly from any business carried on by or on behalf of or for the benefit of trustees in trust for charitable, religious, educational, or scientific purposes of a public nature within New Zealand, or derived directly or indirectly from any business carried on by or on behalf of or for the benefit of any society or institution established exclusively for such purposes and not carried on for private pecuniary profit:

Provided that if the aforesaid purposes are not limited to New Zealand the Commissioner may apportion the income in such manner as he deems just and reasonable between such purposes within New Zealand and the like purposes out of New Zealand, and may allow to the trustees, society, or institution a partial exemption accordingly:

66. In *Calder Construction Co Ltd v CIR* [1963] NZLR 921 (SC), Wilson J referred to the 1940 (and 1944⁶) amendments to s 78(k) of the 1923 Act, describing the provision (at page 925) as “so enlarged and altered as to bear only slight resemblance to its initial form”.
67. Following the 1940 amendments, a charity was not required to apportion its non-business income between its charitable purposes in New Zealand and outside New Zealand. A new provision was enacted to provide an exemption for income not referred to in s 78(k) of the 1923 Act (non-business income). Section 78(jj) of the 1923 Act (now s CW 41) exempted:

Income (not being income of the kind referred to in paragraph (k) hereof) derived by trustees in trust for charitable, religious, educational, or scientific purposes of a public nature, or derived by any society or institution established exclusively for such purposes and not carried on for private pecuniary profit:

⁴ New Zealand Parliamentary Debates, Volume 176 (June 16 to July 11, 1916) at p 210

⁵ Among other changes, the Income Tax Act 2004 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, not change policy. For this reason, we consider the current wording of s CW 42 (which refers to a business carried on “for” a charitable entity) has the same meaning as a business carried on “on behalf” of a charitable entity.

⁶ The Land and Income Tax Amendment Bill 1944 substituted the words “charitable, religious, educational, or scientific purposes of a public nature” for “charitable purposes in s 78(jj) and (k) of the 1923 Act.

68. Due to the age of these amendments it is difficult to locate further background material.
69. The purpose of the income tax exemption for charities was discussed in *Tax and Charities* (June 2001), a government discussion document on taxation issues relating to charities and non-profit bodies. The document states that subsidising charities enables governments to further their social objectives, including by way of increased support to disadvantaged members of society. The exemption for business income was described as requiring funds from business activities to be applied to charitable purposes within New Zealand.⁷
70. Almost from the beginning the charitable exemption from income tax was limited to the extent of a charity's charitable purposes in New Zealand. In light of this history, we consider the purpose of s CW 42 is to provide relief from taxation on business income only to the extent a charity's charitable purposes are directed towards New Zealand.

Income excluded from the business income exemption

71. 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.
72. This paper does not consider these exclusions from the business income exemption.

Introduction to issues 1 and 2

73. The first two issues considered relate to the opening words of s CW 42(1):

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—

⁷ [Tax and Charities](#) (discussion document, Policy Advice Division, Inland Revenue, June 2001), at [2.7] and [10.5].

74. Similar wording is used in s CW 41(3) to describe income excluded from the test in s CW 41:

Exclusion: business income

- (3) This section does not apply to an amount of income derived from a business carried on by, or for, or for the benefit of a trust, society, or institution of a kind referred to in subsection (1).

75. The interpretation of the opening words of s CW 42(1) is important. How the opening words of s CW 42(1) are interpreted determines whether an amount of income a charity derives is subject to the test in s CW 41 or s CW 42. As discussed at [3], income that falls within s CW 42 is subject to additional restrictions that may result in some, or all, of the income being taxable.
76. Before s CW 42 applies, there must first be a person who is carrying on a “business”. This paper does not address when a person is in business in any detail. The carrying on of a business is briefly discussed for completeness.

Carrying on a business

77. “Business” is defined in s YA 1 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.
78. 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 the activity is engaged in;
 - scale of operations and volume of transactions;
 - commitment of time, money and effort;
 - pattern of activity; and
 - financial results.

79. 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 that carry on this type of activity are carrying on a business, as that term is defined in s YA 1. This is the conclusion even though the object of the business is directed to charitable ends, not private pecuniary gain.

Extended definition of “business” for trusts

80. Section CW 42 extends the definition of “business” in certain situations. Under s CW 42(3), a trustee of a trust for charitable purposes 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 the 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.
81. 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, even if the trustee does not satisfy the business test in s YA 1.

Issue 1 – What income is “from a business”?

82. Section CW 42(1) applies to “[i]ncome derived directly or indirectly from a business” carried on by, or for, or for the benefit of a charity. The first issue considers what income is “from a business”, including whether the words “directly or indirectly” extend the test in s CW 42 to income not usually considered to be income from a business.

Income from trade or business activities

83. We consider it is clear that income derived from a charity's trade or business activities is subject to the test in s CW 42. Example 1 illustrates this situation.

Example 1 – Income from a charity's business activity

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

The income derived from selling used furniture and clothing is subject to the test in s CW 42.

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

Example 2 – Charity carrying on two businesses

Pet Welfare Centre Ltd from Example 1 also carries on a business of buying and selling shares. It derives dividends and amounts from the sale of shares.

Pet Welfare Centre Ltd is carrying on two businesses – the opportunity shop and dealing in shares.

The dividends and amounts from the sale of shares are income from the business of buying and selling shares, so are subject to the test in s CW 42.

Other amounts received by a charity

85. 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 donations.⁸ A question arises as to whether these other amounts are subject to the test in s CW 42.

⁸ 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 at [80].

86. Section CW 42 applies to income derived from a business. The Act does not define what amounts of income are derived from a business. The *Oxford English Dictionary* defines “from” as “denoting derivation, source, descent, or the like”.⁹
87. Case law has considered what is meant by the words “from the business” 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.
88. 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. The question is whether the amount is derived from the current operations of the business or is merely connected to the fact the business exists. The answer depends on the nature of the business and its relationship with the particular amount.

Investment income

89. Income derived from a business of investment will be income from a business and subject to the test in s CW 42. This situation is illustrated in Example 2.
90. In other cases, it is possible for investment income to be so closely connected to a business that it constitutes income from that business (so is also subject to the test in s CW 42). An example of investment income with this connection might be short-term interest returns from circulating capital. Whether investment income constitutes income from a business depends on the particular circumstances and nature of the business.
91. However, we accept that a charity can derive business income and investment income that is not itself from a business. The onus is on the taxpayer to demonstrate investment income is not derived from a business. Evidence that a charity separates its business funds from its investment funds will be relevant.

Gifts or donations

92. A charity carrying on a business might receive payments described as “gifts” or “donations”. However, the label given to such payments does not determine their character or whether they are income derived from a business carried on by, or for, or

⁹ *Oxford English Dictionary* (online version, Oxford University Press, March 2022, accessed 29 August 2022).

for the benefit of a charity. A question arises as to whether these payments are income from a business subject to the test in s CW 42.

93. Case law indicates that voluntary payments of money may be business income if they are a product of a charity's business activities (*G v CIR* [1961] NZLR 994).

94. 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.

95. 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*).

96. Gifts are unlikely to be a product of a charity's income-earning business activities where the business is unrelated to the charity's charitable purposes (for example, a café run by a charity whose charitable purpose is to provide aid to the sick). The payments would usually be received by a charity in recognition and support of its charitable purposes (being the provision of aid to the sick), not in relation to the business of providing food and beverages to customers.

97. A question arises as to how gifts are treated where a charity carries on a business related to its charitable purposes (for example, a medical clinic providing health services to promote public health).

98. One view is that where a charity carries on a business related to its charitable purposes, gifts can be described as supplementing the income derived from the business or assisting to meet the running costs of the business. It is arguable the gifts are for or to support the provision of the products or services provided by the charity, so are part of the charity's income-earning business activities.

99. The second view is that it is possible for a charity carrying on a business related to its charitable purposes to receive gifts that are not a product of its income-earning activity because the payments are capital in nature or relate more closely to a charity's charitable purposes or both.

100. Our initial view is that the second view is the stronger view. Case law indicates that for a payment to be a product of an income-earning activity it must be possible to point to an activity that can fairly be said to have produced that receipt (*Hayes*). 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. This 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.¹⁰
101. While the motive of the donor in making the payment is not a decisive consideration, in certain cases, it is relevant. We consider that even where the business is related to a charity's charitable purposes, a payer's primary motivation can be to recognise and support the charitable purposes of the charity.

Meaning of “directly or indirectly”

102. The opening words of s CW 42(1) include the words “directly or indirectly”. A question arises as to whether these words extend the test in s CW 42 to income not usually considered to be income from a business. The first issue, therefore, considers the meaning of “[i]ncome derived directly or indirectly from a business ” in the context of s CW 42(1).
103. The meaning of s CW 42 is to be ascertained from its text and in the light of its purpose and its context (s 10 of the Legislation Act 2019).

Ordinary meaning of “directly or indirectly”

104. The Act does not define the individual word “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”. “Indirectly” is defined as “by indirect action, means...agency or instrumentality; through some intervening person or thing, in an indirect way or manner”.¹¹
105. The ordinary meaning of “directly or indirectly” contrasts something that arises in a direct way or manner from something arising in an indirect way or manner.

¹⁰ *Murray v Goodhews* [1978] 2 All ER 40.

¹¹ *Oxford English Dictionary* (online version, Oxford University Press, March 2022, accessed 29 August 2022).

Meaning of “directly or indirectly” in the context of s CW 42

106. The first view is that the words “directly or indirectly” relate to the words “[i]ncome derived” and were intended to extend the income subject to the test in s CW 42. The outcome of this view is that the test in s CW 42 applies to an amount of income that is directly or indirectly related to a business. For example, under this view s CW 42 would apply to rental income derived by a charity from a commercial rental property purchased with money surplus to their business, irrespective of whether the charity carried on a property rental business.
107. The alternative view is that the words “directly or indirectly” relate to the words “by, or for, or for the benefit of” and reflect the extension of the section, in 1940, to income from a business carried on for charity.
108. We consider the alternative view is the better view.
109. As discussed at [67], the words “directly or indirectly” were introduced into s CW 42 at the same time the exemption was extended to income derived from a business carried on, on behalf of (for) or for the benefit of a charity. We have not found anything to indicate the words “directly or indirectly” were introduced for the purpose of capturing income not usually considered to be income from a business.¹²
110. We consider the background supports the view that the words “directly or indirectly” relate to the words “by, or for, or for the benefit of”, not the words “[i]ncome derived”. This interpretation is considered further as part of issue 2, from [114].
111. In some situations, the first view could result in business income being subject to the test in s CW 42 twice: first, by a charity (Charity A) that derives the income directly from the business and second, by a charity (Charity B) that derives income indirectly from Charity A’s business. This situation is illustrated in Example 3.

¹² 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 3 – Income derived from a business

Paladin Property Ltd is a registered charity carrying on a property management business. It was established to carry on business for the exclusive benefit of another registered charity, the Hatchery Trust. The Hatchery Trust's charitable purposes are carried out 50% in New Zealand and 50% outside New Zealand.

In its 2021/22 income year, Paladin Property Ltd derives income of \$50,000 from the provision of property management services. It distributes \$10,000 to the Hatchery Trust. The distribution is funded from its business profits.

The test in s CW 42 applies to the \$50,000 derived by Paladin Property Ltd "directly" from the property management business.

The outcome of the first view is that the \$10,000 derived by the Hatchery Trust "indirectly" from the property management business is also subject to the test in s CW 42.

112. The purpose of s CW 42 is to provide relief from taxation on business income to the extent a charity's charitable purposes are directed towards New Zealand. The first view is likely to result in more tax being paid on business income than Parliament intended. For example, consider the situation illustrated in Example 3. The application of s CW 42 would result in 50% of the business income derived by Paladin Property Ltd (\$25,000, being 50% of \$50,000) and 50% of the business income derived by the Hatchery Trust (\$5,000, being 50% of \$10,000) being taxable. In total, only \$20,000 of the \$50,000 business income would be exempt (40%).

Summary of initial conclusions

113. Our initial conclusions are summarised below.

- The words “directly or indirectly” in s CW 42(1) refer to the carrying on of the business (by, or for, or for the benefit of a charity), not the derivation of income.
- The test in s CW 42 applies to income derived “from a business”.
- Income from a business includes income derived from trading or business activities and other income sufficiently connected to a charity’s business operations.
- Income derived from a business of investment is income from a business.
- A charity can derive business income and investment income that is not itself from a business. The onus is on the taxpayer to demonstrate that investment income is not derived from a business.
- Gifts are unlikely to be income from a business where the business is unrelated to a charity’s charitable purposes.
- Gifts received by a charity where the business is related to a charity’s charitable purpose are not necessarily income from a business. Whether a gift is income derived from a business is a question of fact.

Issue 2 – When is a business carried on by, or for, or for the benefit of a charity?

114. 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. The second issue considers when a business is carried on “by, or for, or for the benefit of” a charity.

115. The meaning of the words “directly or indirectly” was considered at [106]. As seen, the words “directly or indirectly” relate to the words “by, or for, or for the benefit of” in

s CW 42(1) and reflect the extension of the section, in 1940, to income from a business carried on for charity.

116. We consider the test in s CW 42 applies to income derived from a business carried on exclusively for the charitable purposes of one or multiple charities.¹³ The business may be carried on by:
- a charity (“directly”); or
 - another entity (“indirectly”).
117. Where a charity is carrying on the business, that business should be exclusively for charitable purposes. This outcome arises because the charity will be 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.
118. Where the entity carrying on the business is not a charity, a question arises as to when 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 the test in s CW 42.
119. We note that 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 further below at Issue 3) is that business income subject to the test in s CW 42 is exempt from tax only if the entity carrying on the business is a registered charity. We anticipate that most cases where the test in s CW 42 applies, the income will be derived from a business carried on by a registered charity (ie, directly).
120. The meaning of “for” and “for the benefit of” are discussed next.

Meaning of “for” and “for the benefit of” a charity

121. The terms “for” or “benefit” are not defined in the Act. The *Oxford English Dictionary* defines these terms as follows:¹⁴

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

¹³ This paper refers to a business carried on “exclusively” for the charitable purposes of one or multiple charities. We are not making any observation on the ability of a charity with non-charitable purposes to qualify for registration as a charitable entity where the non-charitable purpose is merely ancillary to a charitable purpose (see s 5 of the Charities Act 2005).

¹⁴ *Concise Oxford English Dictionary* (12th ed, Oxford University Press, 2011).

benefit an advantage or profit gained from something ... receive an advantage; profit

122. The words “for” and “for the benefit of” do not have strict legal meanings but are used in conjunction with a wide variety of relationships where one person acts as auxiliary to or a representative of another person.¹⁵ The particular meaning intended depends on the context in which the words are used and how they are used in that context.¹⁶

Business carried on exclusively for charitable purposes

123. The courts have considered the application of s CW 42. The cases indicate that for a business to be carried on “for, or for the benefit of” a charity, the business must be carried on exclusively for charitable purposes (see *Calder 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. The court stated it would be difficult, if not impossible, to treat part of the income as having been earned for one purpose and part for another purpose.
124. The application of s CW 42 to income derived from a business carried on by a tax charity in partnership with a non-charitable entity was considered in [QB 21/03: Charities business exemption – business carried on in partnership](#) (Inland, Revenue 7 May 2021). The Commissioner’s view is that the exclusivity requirement discussed above applies only to the charity’s partnership share of the income and capital of the business. Accordingly, income derived from a business carried on by a charity in partnership with a non-charitable entity can be exempt under s CW 42.

Business carried on for one or multiple charities

125. The opening words of 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.
126. 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.¹⁷ We consider 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.

¹⁵ *Case X26 90* ATC 256.

¹⁶ *Dale v Mitcalfe* (1928) 13 TC 41 and *Case X26*.

¹⁷ Section 19 of the Legislation Act 2019.

127. Case law also indicates 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 page 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 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]

128. Examples 4 and 5 illustrate the application of s CW 42.

Example 4 – 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.

The income derived from the business carried on by the Right On Trust is subject to the test in 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 purpose is exclusively charitable even though more than one charity benefits from the Right On Trust’s business.

Example 5 – Business not carried on exclusively for charitable purposes

Sue and Son Computing Ltd carries on business in New Zealand. Sue and Son Computing Ltd have 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 the test in 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 income is subject to s CW 41 or s CW 42 in Fighting Poverty Ltd's hands depends on whether it is income derived from a business carried on by Fighting Poverty Ltd (see the discussion at Issue 1).

Summary of initial conclusions

129. Our initial conclusions are summarised below.

- The test in s CW 42 applies to income derived from a business carried on exclusively for charitable purposes.
- The business may be carried on by:
 - a charity ("directly"); or
 - another entity ("indirectly").¹⁸
- A business can be carried on by, or for, or for the benefit of one or multiple charities.

Introduction to issues 3 to 5

130. As described above, the test in s CW 42 applies to income derived from a business carried on exclusively for charitable purposes. Whether some or all of that income is exempt depends on whether the requirements in s CW 42(1) are satisfied.

¹⁸ 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 is discussed further at [133].

131. This section considers the first three requirements of s CW 42(1) (set out in paras (aa), (a) and (b)). The control restriction in s CW 42(1)(c) is then briefly discussed for completeness. As discussed at [6] and [7], this paper does not consider the control restriction in any detail.
132. 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.

Issue 3 – What is the effect of the requirement that the entity carrying on the business be a registered charity?

133. Business income subject to the test in s CW 42 is exempt from tax only if “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” (s CW 42(1)(aa)). This requirement applies for the 2020/21 and later income years.

134. 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 public sector. The requirement that the entity carrying on the business be 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.¹⁹
135. A question arises as to how this requirement affects the scope of the business income exemption.
136. We consider the words of s CW 42(1)(aa) are clear. Business income subject to the test in s CW 42 is exempt only if the entity actually conducting the business is a registered charity.
137. As a result of the introduction of s CW 42(1)(aa), many entities carrying on business exclusively for charitable purposes became registered charities. An outcome of registration was continued access to the business income exemption in s CW 42. Without registration, income derived by an entity from a business carried out exclusively for charity, is taxable.
138. The effect of this requirement on the business income exemption is illustrated in Examples 6 to 9.

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

Example 6 – Business income derived by a registered charity carrying on business in partnership with a non-charity

The Falcon Trust is a registered charity whose charitable purposes are limited to New Zealand. The trust runs a chocolate shop and café business in partnership with a local company that specialises in hand-made chocolates. The trust and local company have a 50% partnership share.

The income derived from the business by the Falcon Trust (calculated with reference to its 50% partnership share) will be exempt under s CW 42 provided the control restriction does not apply.

This outcome arises because the income is derived from a business carried on by a registered charity (the Falcon Trust). This outcome arises even though the business is being carried on in partnership with a non-charity.

Example 7 – 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 2020/21 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 was 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), s CW 42 requires that the entity carrying on the business is a registered charity.

Example 8 – 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 its local community (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 2020/21 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.

The beneficiary income derived by Help our Community Ltd is subject to the test in s CW 42. 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 different to the entity that carried on the business.

Help Our Community Ltd is taxable on the business income of \$85,000. As in Example 7, 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 9 – 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 8 except the JR Ranch Trust is a registered charity.

The \$85,000 will be exempt income of Help Our Community Ltd.

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).

139. We expect the outcomes of Examples 7 and 9 are well understood by taxpayers. The outcome in Example 8 may be less well understood.
140. In Example 8, all of the business income is taxable despite being derived by a registered charity with New Zealand charitable purposes (Help Our Community Ltd). This outcome arises from the clear requirement in s CW 42(1)(aa) that the entity carrying on the business be a registered charity and accordingly subject to public reporting obligations for such entities. Had JR Ranch Trust registered as a charity (or Help Our Community Ltd carried on the business directly) the business income would be exempt (subject to the control restriction being satisfied).

Summary of initial conclusions

141. In summary, income derived from a business carried on exclusively for charitable purposes is exempt only if the entity actually conducting the business is a registered charity. This requirement is satisfied if a registered charity carries on business in partnership with an entity that is not a registered charity.
142. Business income subject to the test in s CW 42 is taxable if the entity carrying on the business is not a registered charity. 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 charitable beneficiary is taxable on the beneficiary income.
143. Income derived from a business carried on by a registered charity is exempt if the remaining requirements of s CW 42 considered below, are satisfied.

Issue 4 – When does a charity carry out its charitable purposes in New Zealand?

144. Income derived from a business carried on by a registered charity is exempt if “the trust, society, or institution carries out its charitable purposes in New Zealand” (s CW 42(1)(a)). This requirement raises two questions:
- Who is the “trust, society or institution” referred to in s CW 42(1)(a)?
 - What is required for a charity to satisfy the requirement that it carries out its charitable purposes in New Zealand?
145. Before considering these questions we discuss the meaning of “charitable purpose” and “in New Zealand” for completeness.

Meaning of “charitable purpose”

146. “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

147. The charitable purpose test is the same as the test in the Charities Act 2005. Ultimately, it is a question of a fact whether a charity’s charitable purposes are in or outside New Zealand.

148. 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;
- how the recipient of the donation actually uses the donated funds.

149. Example 10 illustrates the principles described above.

Example 10: 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.

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 Forever Good Books Trust has donated to a New Zealand company that is a registered charity, the donation is to advance education in Tonga.

Meaning of “in New Zealand”

150. We expect that in most cases it will be clear whether a charity's charitable purposes are “in New Zealand”. However, in some situations what makes up the boundaries of the country can be relevant.
151. The Act defines “New Zealand” inclusively (but not exhaustively) in s YA 1 as including certain things such as 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).

152. To find a definition of New Zealand in terms of what it would commonly be thought of as including, it is necessary to look 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
153. 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, it does not indicate a different context that would override the effect of s 9 of the Legislation Act 2019.
154. We consider the definition of New Zealand in the Legislation Act 2019 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.
155. 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).

Who is the “trust, society or institution” referred to in s CW 42(1)(a)?

156. Income derived from a business carried on by a registered charity is exempt if “the trust, society, or institution” carries out its charitable purposes in New Zealand.
157. In the context of income derived from a business carried on by a registered charity, we consider that the “trust, the society, or institution” referred to in s CW 42(1)(a) is the charity seeking to apply the exemption in s CW 42 to the business income it derives.
158. As seen in Examples 6 and 9, business income could be derived from a business the registered charity carries out or a business carried on by a separately registered charity that distributes business income as beneficiary income.

When does a charity carry out charitable purposes in New Zealand?

159. We consider 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. Whether a charity has a charitable purpose in New Zealand is a question of fact. 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.
160. This situation is illustrated in Example 11.

Example 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 2021/22 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 2021/22 year is exempt under s CW 42 and 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 splitting the business income derived in its 2021/22 year between its charitable purposes in and outside New Zealand (discussed below at Issue 7).

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

Summary of initial conclusions

162. Our initial conclusions are summarised below.

- It is the charitable purposes of the charity that derives the business income that is relevant in determining whether the requirement (that the charity carries out its charitable purposes in New Zealand) is met.
- 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 carries out a charitable purpose in New Zealand.
- 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.
- If a charity has only overseas charitable purposes, any business income derived by that charity is taxable.

Issue 5 – When is a charity a tax charity?

163. In addition to the requirement in s CW 42(1)(aa) that the entity carrying on the business be a registered charity, s CW 42(1)(b) requires that “the trustee or trustees of the trust, the society, or the institution is or are, at the time that the time is derived, a tax charity”.

164. Consistent with our view at [157] we consider that in the context of income derived from a business carried on by a registered charity, “the trustee or trustees of the trust, the society, or institution” referred to in s CW 42(1)(b) is the charity seeking to apply the exemption in s CW 42 to the business income it derives.

165. “Tax charity” is defined in s CW 41(5) as follows:

Definition

- (1) **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;
 - (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

166. The definition of tax charity includes registered charities and non-resident charitable entities the Commissioner approves as tax charities (non-resident tax charities).²⁰
167. For the purposes of this paper 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.
168. This paper does not consider how s CW 42 may apply to business income derived by a non-resident tax charity. We assume 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 taxable as a result of the non-resident tax charity's overseas charitable purposes.

²⁰ 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 14 October 2020).

Summary of initial conclusions

169. Income derived from a business carried on exclusively for charitable purposes is exempt only if the income is derived by a “tax charity”. The definition of tax charity includes a registered charity.
170. This paper focuses on tax charities that are registered charities.

Control restriction

171. 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:
- if the point below does not apply, a person other than the trust, society, or institution except for a purpose of the trust, society, or institution; or
 - 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.
172. The purpose of the above is to ensure the control restriction is not breached when a charity is able to divert amounts from its subsidiary business to its own (charitable) benefit.²¹
173. Section CW 42(5) to (9) expands on the control restriction providing 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.
174. As discussed at [6] and [7], this paper does not consider the control restriction in detail.
175. If the control restriction is breached, all of the business income derived by a tax charity 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 on-going basis.

²¹ [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](#) (Inland Revenue, June 2015), at 94.

Introduction to issues 6 and 7

176. The outcome of applying the requirements described at issues 4 and 5 is that business income derived by a tax charity is exempt to the extent that at least one of its purposes is a charitable purpose in New Zealand. 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 (the territorial restriction). Only the part apportioned for tax purposes to the charitable purposes in New Zealand is exempt income.
177. This section considers when a tax charity needs to apply the territorial restriction and if the territorial restriction applies, how a tax charity applies that restriction.

Issue 6 – When does a tax charity need to apply the territorial restriction?

Charitable purposes limited to New Zealand

178. Where a tax charity's charitable purposes are not limited to New Zealand, the business income it derives must be split reasonably between those purposes in New Zealand and those outside New Zealand.
179. 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.
180. If a tax charity's charitable purposes are limited to New Zealand, the business income it derives is all exempt from tax. A question arises as to how to determine whether a tax charity's charitable purposes are limited to New Zealand.
181. A tax charity's charitable purposes are limited to New Zealand if:
- the charity's rules state its purposes are limited to New Zealand; and
 - its charitable purposes are in fact limited to New Zealand.
182. This view is supported by case law. As discussed at [148], whether a charity's charitable purposes were in New Zealand or outside New Zealand arose in *Case T50*. The case considered the application of s 61(27) of the Income Tax Act 1976. Section 61(27) (now s CW 42) states:

(27) Income derived directly or indirectly from any business carried on by or on behalf of or for the benefit of trustees in trust for charitable purposes in New Zealand, or derived directly or indirectly from any business carried on by or on behalf of or for the benefit of any society or institution established exclusively for such purposes and not carried on for the private pecuniary profit of any individual:

Provided that if the aforesaid purposes are not limited to New Zealand the Commissioner may apportion the income in such manner as he deems just and reasonable between such purposes within New Zealand and the like purposes out of New Zealand, and may allow to the trustees, society, or institution a partial exemption accordingly:

...

183. On appeal, the High Court in *CIR v Dick* (2001) 20 NZTC 17,396 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 proviso applied.
184. The proviso to s 61(27) of the 1976 Act gave the Commissioner the discretion to split business income between charitable purposes in New Zealand and those outside New Zealand. This discretion was removed from the 2002/03 income year as part of the move to a self-assessment regime. A question arises as to whether the decision in *CIR v Dick* is relevant to the interpretation of s CW 42(4) given the differently worded provisions. The change to the proviso was not a policy change, so we consider the decision in *CIR v Dick* is still relevant to the interpretation of s CW 42.
185. 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. A question arises as to whether it is reasonable for a charity in this situation to treat all of its business income as exempt.
186. We consider it is reasonable for a tax charity to treat all the business income it derives in the relevant annual period as exempt if:
- in that period and all prior periods, the tax charity has carried out its charitable purposes only in New Zealand; and
 - the tax charity does not intend to extend its charitable purposes outside New Zealand in the future.
187. A situation where it is reasonable to treat all of a tax charity's business income as exempt is illustrated in Example 12.

Example12: Charitable purposes limited to New Zealand

The Ongoing Education for Good Trust 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.

The Ongoing Education for Good Trust 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.

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

The Ongoing Education for Good Trust can treat all of the income it derives from its coffee van business as exempt 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 the Ongoing Education for Good Trust'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 subject to tax.

188. 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 should be treated as taxable.

Summary of initial conclusions

189. In summary, we conclude that a tax charity's charitable purposes are limited to New Zealand if:
- the tax charity's rules state that its purposes are limited to New Zealand; and
 - its charitable purposes are in fact limited to New Zealand.

190. In some cases, a tax charity's charitable purposes will in fact be limited to New Zealand despite the tax charity's rules not containing a territorial restriction to New Zealand. In these cases, it is reasonable for a tax charity to treat all the business income it derives in the relevant annual period as exempt if:
- in that period and all prior periods, the tax charity has carried out its charitable purposes only in New Zealand; and
 - nothing indicates the tax charity's purposes are intended to extend outside New Zealand in the future.
191. 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 should be treated as taxable.

Issue 7 – How does a tax charity apply the territorial restriction?

General principles for splitting business income

192. 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".
193. The focus of the territorial restriction is on a tax charity's charitable purposes. 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.
194. It follows that the territorial restriction is not about identifying whether business income is used, spent or applied to a tax charity's charitable purposes in New Zealand or outside of New Zealand.
195. This view is supported by the words of the section, 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.
196. Section CW 42(4) does not provide any guidance on how a tax charity works out what proportion of its charitable purposes are carried out in and outside New Zealand. In the absence of any specific guidance, we consider 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 v CIR*).

197. These principles give a tax charity some flexibility in how it approaches splitting its business income.

Approaches to splitting business income

198. As described earlier, 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 and outside New Zealand.
199. We describe a number of possible approaches to splitting business income below. We are interested in feedback on these approaches and people's views on other possible approaches to splitting business income between a tax charity's charitable purposes in and outside New Zealand.
200. 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. However, a tax charity could 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. An example of splitting business income based on the application of a tax charity's funds to its charitable purposes is illustrated in Example 13.

Example 13: 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 or provide food 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 tax 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 purposes in New Zealand and 25% were for overseas purposes.

201. 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. Accordingly, we consider that in some situations a tax charity splitting its business income must consider not only its charitable purposes in the relevant annual period but also its past and intended future charitable purposes (*CIR v Dick*).
202. An example of splitting business income based on a tax charity's past and intended future charitable purposes is illustrated in Example 14.²²

²² See also [210] and Example 16 that considers whether a tax charity should be able to split business income based on an average of its charitable purposes directed to New Zealand over a number of years.

Example 14: Splitting business income based on a charity's rules

The Abbott Trust is a registered charity. Its trust deed states that its purpose is to advance religion. The Abbott Trust does this by providing donations to entities that promote the teaching and study of religious studies. Its trust deed states it must apply its funds to carry out charitable purposes in and outside New Zealand equally.

Funding for its charitable purposes comes solely from its business of manufacturing and selling confectionary.

In some years, it applies more funds to charitable purposes in New Zealand, and in other years, it applies more funds to charitable purposes outside New Zealand. To ensure compliance with its trust deed, the Abbott Trust keeps track of how it is applying its funds to its charitable purposes so that, over time (in this case, on average over a 5-year period), it donates equally to entities that promote the teaching and study of religious studies in New Zealand and outside of New Zealand.

The Abbott Trust splits its business income in each year on an equal basis - 50% to its charitable purposes in New Zealand and 50% to its charitable purposes outside New Zealand.

203. As described above, 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 relevant in the context of s LD 3(2)(a).
204. 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:²³
205. 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

²³ 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, the paper focusses on how the test in s LD 3(2)(a) applies to charities.

[Interpretation Statement: IS 18/05: Income tax – donee organisations – meaning of wholly or mainly applying funds to specified purposes within New Zealand](#) (Inland Revenue, 2018) and [Interpretation Statement IS 18/05: Fact sheet – Applying the “safe harbour” approach](#) (Inland Revenue, 2018).

206. 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.
207. 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.
208. The question arises as to whether this approach could be used to determine the extent to which a tax charity’s 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. An example of how this approach might work is illustrated in Example 15.

Example 15: Splitting business income based on the percentage of funds calculated for the purpose of determining whether the “wholly or mainly” requirement is satisfied

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 the Inland Revenue donee list.

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

In its 2021/22 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 2021/22 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 2021/22, \$14,220 of its \$18,000 business income will be exempt.

Feedback sought: We are interested in whether this is a reasonable basis to split business income under s CW 42.

209. In the context of s LD 3(2)(a) Inland Revenue administers the wholly or mainly requirement on a “safe harbour” basis of “75% or more”. If a registered charity fails to meet the safe harbour of 75% in any year, Inland Revenue will accept a revised calculation based on the current year and two preceding years. This allows some year-on-year variation for exceptional years.
210. We are interested in feedback on whether a tax charity should be able to split its business income based on an average of its charitable purposes directed to New Zealand over a number of years. As with any approach to splitting business income the outcome should reasonably reflect the extent to which a tax charity directs its purposes towards New Zealand. Example 16 illustrates how this approach might work.

Example 16: Splitting a tax charity’s business income based on average of charitable purposes directed to New Zealand in past 4 years

	Year 4	Year 3	Year 2	Year 1	Current year
Proportion of charitable purposes in New Zealand	100%	0%	80%	30%	52.5%

211. Example 16 uses a 4 year time period²⁴ but we are interested in feedback on factors that might be relevant to a tax charity in determining a reasonable time period.

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

212. 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 (for example, 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.

213. A question arises as to whether it is 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. This question is illustrated in Example 17.

²⁴ See also Example 14 that referred to a tax charity monitoring its charitable purposes over a 5 year period.

Example 17: Charitable purposes outside New Zealand funded from amounts that are not business income

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.

In the 2021/22 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 2021/22 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.

Feedback sought: In this situation, should the Panther Trust be able to treat all of its business income (\$200,000) as exempt on the basis that the capital amount it received is greater than the amount of its donation for overseas charitable purposes?

214. One view is that it is reasonable for a tax charity to treat all its business income as exempt because that is the income being directed towards New Zealand.
215. An alternative 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 some business income being taxable.
216. Our initial position is that the alternative view is the better view.
217. As discussed at [193], s CW 42(4) does not require a connection between a tax charity's business income and its charitable purposes in or outside New Zealand. The focus of s CW 42 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.
218. It is arguable that 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 the test in s CW 42.

219. The view that it is reasonable for a tax charity to treat all its business income as exempt is based on all of a tax charity's business income being "used" for its charitable purposes in New Zealand. We are interested to hear about situations where a tax charity has taken this view and the arguments in support of this view. The difficulty we see with this view is that the focus of s CW 42(4) is on charitable purposes, not how business income is "used", "spent" or "applied".

One-off donations for charitable purposes outside New Zealand

220. 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. The Commissioner understands this situation often arises where a tax charity makes a donation in response to an unexpected event such as a natural disaster that occurs outside New Zealand. A question arises as to how s CW 42 applies in this situation.
221. As discussed at [148], a tax charity can carry out its charitable purposes by making a donation to a charitable object. We consider that a tax charity that donates to charitable purposes outside New Zealand is itself carrying out charitable purposes outside New Zealand. A tax charity should treat some of the business income it derives in the relevant annual period in which the donation is made as taxable.
222. A tax charity will need to determine a reasonable basis for splitting its business income between its charitable purposes in and outside New Zealand for that period.
223. We are interested in understanding how prevalent this situation is and how tax charities in this situation have applied the territorial restriction in s CW 42(4).

Change in charitable purposes

224. 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. A question arises as to what a tax charity should do if that intention changes.
225. For example, we understand 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 accumulated 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.
226. Splitting business income between charitable purposes in and outside New Zealand is likely to be more difficult where a tax charity accumulates money. This difficulty arises because the tax charity has not directly used its money to carry out its charitable purposes, either in or outside New Zealand.
227. The High Court in *CIR v Dick* recognised that the retention of funds is a complicating factor when considering how to split business income between charitable purposes in and outside New Zealand. In that case, a foundation had historically distributed its funds to achieve charitable purposes in New Zealand but had retained some funds. The court concluded that splitting business income based on the historical distribution pattern would be fair and reasonable in the absence of evidence of any intention to extend the foundation's purposes outside New Zealand.
228. While the court was not required to conclude on the point, it went on to consider how a change in intention might affect the split of business income between charitable purposes in and outside New Zealand. The court concluded the Commissioner would be justified in taking the changed position into account, either in the current year or in past years. Glazebrook J stated:
- [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.
229. We consider that if a tax charity treats some or all of its business income as exempt on the basis of an intention to carry out charitable purposes in New Zealand and this intention changes, the amount of business income that is taxable should increase.
230. We are still considering in what circumstances a change of intention would require a prior period return to be re-opened (or if no return was filed in the prior period, a return filed). Our initial thoughts are that a change of intention does not necessarily mean a split of business income in a prior period is no longer "reasonable". However, we consider that in some cases re-opening (or filing) a prior period return will be necessary to achieve the purpose of s CW 42 (for example, where a tax charity treats all of its business income as exempt based on its intention to carry out charitable purposes in New Zealand but on ceasing its business activities, determines it will carry out its charitable purposes overseas).
231. We are interested in feedback on this initial view.

How does a tax charity split its deductible business expenses between taxable and exempt business income?

232. As seen, 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).
233. As discussed at [200] when considering the split of business income between charitable purposes in and outside New Zealand a tax charity might look at how it has spent its money to determine where its charitable purposes are carried out. The question of whether a tax charity's deductible business expenditure is incurred in deriving assessable or exempt income is different to the question of how it spends its money to further its charitable purposes.
234. Where a tax charity must split its business income based on charitable purposes, 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, exempt income. This raises a question of how a tax charity determines whether its deductible business expenditure is incurred in deriving its assessable income or exempt income.
235. Before the introduction of the global/gross approach,²⁵ a tax charity likely took a 'net' approach to applying s CW 42(4). Under this approach, a tax charity first works out its net income from the business in the relevant annual period (business income less deductible business expenses). Then, a tax charity works out a basis for splitting its net income between its charitable purposes in and outside New Zealand.
236. The outcome of this approach is that a charity does not need to consider how to split its deductible business expenditure between its charitable purposes in and outside New Zealand. This 'net' approach is illustrated in Example 18.

²⁵ The global/gross approach was introduced by the Taxation (Core Provisions) Act 1996.

Example 18: Apportioning using a net approach

The Triple J Family Trust is a registered charity. It carries on a sports equipment rental business.

As the Triple J Family Trust has charitable purposes in and outside New Zealand, it needs to work out how much tax it should pay on its business income.

Triple J Family Trust derived business income of \$85,000 in its 2021/22 tax year. It works out that it incurred deductible business expenses of \$60,000 in that year, resulting in a net profit from its business in 2021/22 of \$25,000.

Triple J Family Trust works out that a reasonable basis for splitting its business income between its charitable purposes in and outside New Zealand is 50/50.

Triple J Family Trust treats \$12,500 (50% of \$25,000) as taxable income.

237. A 'net' approach can be contrasted with a global/gross approach. Under this approach a tax charity first works out a basis for splitting its gross income from the business in the relevant period. Then, a tax charity works out a basis for splitting its deductible business expenses between its assessable and exempt income.
238. The Act provides that a person is allowed a deduction for an amount of expenditure or loss to the extent to which the expenditure or loss is incurred by them in the course of carrying on a business for the purpose of deriving their assessable income (s DA 1(1)(b)(i)). A deduction is denied for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income (s DA 2(3)).
239. One approach would be to split a tax charity's deductible business expenses on the same basis that it split its business income between its charitable purposes in and outside New Zealand. This approach is illustrated in Example 19. Arguably this approach is technically more accurate in terms of the legislation and in this case leads to the same outcome as the 'net' approach illustrated in Example 18.

Example 19: Splitting deductible business expenditure on same basis as business income

The Triple J Family Trust from Example 18 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 also splits its deductible business expenses of \$60,000 on the same basis.

The Triple J Family Trust is able to claim deductible expenses of \$30,000 (50% of \$60,000) against its assessable business income of \$42,500, resulting in \$12,500 of taxable income.

240. We are interested in feedback on these (and other possible) approaches to apportioning a tax charity's deductible business expenses where s CW 42 results in a proportion of its business income being taxable. Our initial view is that any approach taken results in some of a tax charity's deductible business expenditure being deductible and some being non-deductible with no difference under a net or gross basis. However, we acknowledge the changes to the legislation and are interested in how these have been interpreted in practice.

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