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Charities business exemption – business carried on in partnership

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This Question We've Been Asked considers whether income derived by a charitable entity from a business will be exempt under s CW 42 if the business is carried on by a charitable entity in partnership with a non-charitable entity.

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

Key provisions

Income Tax Act 2007 – s CW 42

Question

Can income derived by a charitable entity from a business be exempt under s CW 42 if the business is carried on by a charitable entity in partnership with a non-charitable entity?

Answer

Yes. Income can be exempt if other requirements (such as the control and territorial restrictions) are satisfied.

Key terms

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

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

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

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

Partnership – A partnership as defined in the Act, which includes a limited partnership.

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

Explanation

1. Uncertainty exists about whether income derived by a charitable entity from a business will be exempt under s CW 42 if the business is carried on in partnership with a non-charitable entity.
2. The uncertainty arises because of statements made in cases (discussed in [4] to [6]), which suggest a need for a business to be carried on exclusively for a charitable entity, if income derived from the business is to be exempt. It is not clear how this requirement applies in the context of a business carried on in partnership with a non-charitable entity.

3. It is noted that the exclusivity issue is not answered by the tax treatment of partnerships set out in s HG 2. Although a partner of a partnership is treated under s HG 2 as carrying on the business carried on by the partnership, it does not follow that other partners are to be ignored. Each of the partners are treated as carrying on the business carried on by the partnership. Therefore, the question remains whether the participation of a non-charitable partner raises an issue in terms of exclusivity.
4. *Calder Construction Co Ltd v CIR* [1963] NZLR 921 (SC) is authority for the proposition that a business carried on for, or for the benefit of, a charitable entity can accumulate income in the business rather than distributing it each year, provided the resulting assets of the business are ultimately applied to the charitable entity. In this context, the court stated (at 925) that "it is the business which must be carried on in trust for charitable purposes". It might be argued that this statement is authority for a requirement – of general application – that a business must be carried on exclusively for charitable purposes.
5. *CIR v NTN Bearing-Saeco (NZ) Ltd* (1986) 8 NZTC 5,039 (HC) is another case sometimes referred to in this context. It highlights the importance of having a constitution that clearly provides for the application of both the income and the capital of a business to the charitable entity.
6. In *Latimer v CIR* (2002) 20 NZTC 17,737 (CA), the court stated that the operations of a business must be wholly devoted to making money for charitable purposes. The court stated that 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. As in *Calder*, *Latimer* suggests a business must be carried on exclusively for charitable purposes for s CW 42 to apply.
7. However, the context of these cases is different from the scenario considered in this item. None of these cases involved a business being carried on in partnership with a non-charitable entity.
8. The different context is significant. The court in *Latimer* stated that in most situations it would be difficult, if not impossible, to treat part of the income as having been earned for one purpose and part for another. This may be true in many situations. However, where a business is carried on by a charitable entity and a non-charitable entity in partnership, the income and capital of a business is allocated in accordance with each partner's partnership share. In this partnership situation, allocation is possible and not particularly difficult. Further, the purposes of the charitable entity and non-charitable entity can be compatible as they will generally both have an immediate intention of making a profit from the business.

9. It is considered that a court, if presented with the partnership scenario, is likely to accept that the exclusivity requirement suggested in the above cases applies only to the charitable entity's partnership share of the income and capital of the business.
10. This interpretation is consistent with the ordinary meaning of the words in s CW 42, which do not contain any exclusivity language. Based on the ordinary meaning, income can be derived from a business carried on by a charitable entity, despite the business also being carried on by a non-charitable entity.
11. Therefore, the Commissioner's view is that income derived from a business carried on by a charitable entity in partnership with a non-charitable entity can be exempt under s CW 42. This is illustrated in Example 2.
12. For the avoidance of doubt, in determining whether income derived by a charitable partner is exempt, for the "tax charity" requirement in s CW 42 to be satisfied it is sufficient for the charitable partner to be a tax charity. The partnership does not need to be a charitable entity (if that is possible).
13. This answer also applies where the business is being carried on by a charitable entity (the operating entity) in partnership with a non-charity and the charitable entity is doing so for, or for the benefit of, another charitable entity (the controlling entity).
14. This answer applies to general and limited partnership situations. This means that the charitable entity that is carrying on the business might be a limited partner (under s HG 2 each partner in a partnership – including a limited partnership – are treated as carrying on the business carried on by the partnership). Also note that the exemption of income in this situation will be subject to s CW 42, even though the limited partner may be only a passive investor in the partnership.

Examples

Example 1: Charitable entity carrying on a business on its own

Facts

The Takahē Trust is a charitable entity dedicated to the preservation of the takahē, a native New Zealand bird. The trust runs a small gift shop and cafe business. The profits from the business are used to fund preservation activities.

Tax treatment

The income derived from the business will be exempt under s CW 42 provided the territorial and control restrictions do not apply.

Example 2: Charitable entity carrying on a business in partnership

Facts

The Takahē Trust (from Example 1) decides to partner with a local catering company so it can focus more on takahē. The trust and the catering company each have a 50% partnership share.

Tax treatment

The income derived from the business by the Takehē Trust (calculated with reference to its 50% partnership share) will be exempt provided the territorial and control restrictions do not apply.

References

Legislative references

Income Tax Act 2007 – ss CW 41(1) and (5), CW 42

Case references

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

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

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

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