

15 February 2021

Public Consultation
Inland Revenue
Wellington

By email: PublicConsultation@ird.govt.nz

Re: Charities business exemption – PUB00359a: when it must be used and PUB00359b: business carried on in partnership

The New Zealand Law Society | Te Kahui Ture o Aotearoa (**Law Society**) welcomes the opportunity to comment on exposure draft items *PUB00359a: Charities business exemption – when it must be used* and *PUB00359b: Charities business exemption –business carried on in partnership (draft items)*.

The Law Society's Tax Law Committee have provided general comments below on the approach taken in the draft items and have also set out specific comments in relation to each of the draft items.

1. Comprehensive rather than piecemeal guidance in relation to charities preferable

1.1 We support the intent of the two draft items to clarify specific aspects of the application of the business income tax exemption for charities under section CW 42 of the Income Tax Act 2007 (**Act**), but also note that it would be preferable for such matters to be addressed as part of more comprehensive technical guidance in relation to the Commissioner's approach to charities matters.

1.2 Matters relating to the application of the business income tax exemption for charities were to be covered in a proposed detailed operational statement regarding the tax treatment of charities, issued for consultation as exposure draft ED0207a *Charities and Donee Organisations, Part 1: Charities*. That detailed operational statement was proposed to replace the existing, outdated item *Operational Statement OS 06/02 Interaction of tax and charities rules*.

1.3 If that detailed operational statement or equivalent guidance is still to proceed, we consider that the matters covered in the draft items should be incorporated into (or at least cross-referenced in) that operational statement or equivalent guidance.

1.4 Alternatively, a more comprehensive item on the business income tax exemption for charities would be warranted, as charities would benefit from guidance on other aspects of the exemption, including:

- the scope of the reference to income derived *directly or indirectly* from a business carried on by, or for, or for the benefit of a tax charity;

- application of the ‘territorial restriction’, including apportioning business income where a tax charity’s purposes are not limited to New Zealand (which the Law Society notes is covered by item PUB00392 on the latest public guidance work programme, but this item is not yet allocated) and the effectiveness of ring-fencing business income for a tax charity’s New Zealand purposes; and
- application of the ‘control restrictions’, which is usefully addressed in Operational Statement OS 06/02 but as noted that item is outdated (predating the Act and certain changes to the ‘control restriction’ provisions).

2. PUB00359a: Charities business exemption – when it must be used

2.1 This item focuses on the issue of determining whether an amount derived by a tax charity constitutes “income derived directly or indirectly from a business carried on by, or for, or for the benefit of” the tax charity (as referred to in section CW 42(1) of the Act), in which case the amount will only be exempt income if the requirements of the charity business income exemption under section CW 42 of the Act are met.

2.2 We consider that the following aspects of the draft item should be reviewed and addressed:

- The draft item should explain that in many cases, the issue above may not be a material issue for a tax charity because the tax charity is limited to charitable purposes in New Zealand (or income is clearly attributable to such purposes) and there is no issue of any breach of the so-called ‘control restrictions’ set out in section CW 42, in which case an amount of income derived by the tax charity will be exempt whether section CW 41 or section CW 42 applies.
- The term “business” is not included in the key terms or discussed in any detail in the draft item. The item should include, or cross-reference, a discussion of the term “business”. See, for example, the discussion at paragraphs 32 to 37 of BR Pub 17/06 *Fringe benefit tax – charitable and other donee organisations*, 28 April 2017.
- At paragraph 10 of the draft item (referring to voluntary donations) and in the examples (in relation to Home Composting Solutions Ltd’s ‘donation’ to Sustainable Timber Trust in Example 1 and Paladin Property Ltd’s ‘distribution’ to the Hatchery Trust in Example 2), the draft item should address the Commissioner’s position on the issue of whether, and if so on what basis, the donations/distributions described in the item are ‘income’ in the hands of the recipient charitable entity. It is not clear that the donations/distributions described would be income, and no exemption issue would arise at all in relation to non-income receipts.
- The reference to the general anti-avoidance provision in section BG 1 of the Act at paragraph 13 of the draft item appears to be erroneous, or at best unhelpful, and the paragraph should either be deleted or reviewed and redrafted. The circumstances cursorily described in paragraph 13 might simply indicate that the amounts at issue are income derived from a business carried on by the operating entity for or for the benefit of the controlling entity, so that section CW 42 applies on its terms, without recourse to any anti-avoidance provision. Also, no issue of ‘avoidance’ would arise if the so-called ‘territorial’ and ‘control’ restrictions set out in section CW 42 would not be breached and the amounts would be exempt whether section CW 41 or section CW 42 applies.

- 2.3 Example 1 (Sustainable Timber Trust/Home Composting Solutions Ltd) should be reviewed. In particular:
- It would seem unrealistic, and potentially *ultra vires*, for a charitable trust focused on promoting the use of sustainable timber in the furniture industry to own a charitable company focused on a different purpose of promoting home composting and running a business to generate profits that are principally used for the latter purpose. The basis for the company to make occasional donations to the trust in these circumstances is also unclear.
 - If the company's purposes were aligned with, or a subset of, the trust's purposes, would the Commissioner then consider such occasional donations by a charitable company to its shareholder charity to be 'income', and if so would the Commissioner consider that section CW 42 rather than section CW 41 applies to that income? Example 3 in draft item PUB00359b seems to suggest that if such donations were to be viewed as 'income' then the Commissioner would consider that section CW 42 applies, but this should be addressed in item PUB00359a.
 - As noted above, the example also does not address the issue of whether, and if so on what basis, the Commissioner considers that the occasional donations by the company to the trust in the example would be 'income'.

2.4 Example 2 (Paladin Property Ltd/Hatchery Trust) also appears to be a relatively unusual example and does not address the issue of whether, and if so on what basis, the company's distributions to the non-shareholder trust would be 'income'.

3. PUB00359b: Charities business exemption – business carried on in partnership

- 3.1 This item confirms the Commissioner's position that business income derived by a tax charity from a business carried on in partnership with a non-charity can be exempt under section CW 42 of the Act.
- 3.2 We agree with that position, but also consider that the issue is relatively straightforward, taking into account the transparent tax treatment of partnerships under subpart HG of the Act (referred to only briefly and in general terms at paragraph 7 of the draft item), and that the "uncertainty" referred to in paragraphs 1 and 2 of the draft item is, at best, overstated. For this reason, we consider that a standalone item on the issue may not be warranted.
- 3.3 If the Commissioner considers that a standalone item is warranted, the item should more clearly refer to and place greater weight on the transparent tax treatment of partnerships under the Act.
- 3.4 For the avoidance of doubt, such a standalone item could also expressly note that in the partnership scenario it is only the charitable entity partner, not the partnership itself, that needs to be a "tax charity" for the exemption to apply (and in this respect the partnership scenario differs from the operating entity/controlling entity scenario referred to at paragraph 11 of draft item PUB00359b).

4. Further Assistance

- 4.1 We hope these comments are helpful and if further discussion would assist, please contact the Tax Law Committee convenor Neil Russ through the Law Society's Law Reform and Advocacy Advisor Emily Sutton (emily.sutton@lawsociety.org.nz).

4.2 In particular, changes to address the Commissioner's approach to the term "business" and the income/non-income characterisation of the donations/distributions, and to the examples in the items, may warrant further consultation before the items are finalised.

Yours faithfully

A handwritten signature in cursive script, appearing to read "Arti Chand".

Arti Chand
Vice President