

SUBMISSION TO THE TREASURY, *RESTATING AND STANDARDISING THE SPECIAL CONDITIONS FOR TAX CONCESSION ENTITIES (INCLUDING THE 'IN AUSTRALIA' CONDITIONS)* (EXPOSURE DRAFT, 17 APRIL 2012)

BY THE NOT-FOR-PROFIT PROJECT, UNIVERSITY OF MELBOURNE LAW SCHOOL
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INTRODUCTION

The University of Melbourne Law School's Not-for-Profit Project is a three-year research project funded by the Australian Research Council which began in 2010. This project is the first comprehensive Australian analysis of the legal definition, taxation, and regulation of not-for-profit organisations (NFPOs). Further information on the project and its members is attached to this submission as Appendix A.

This submission details our concerns with the provisions in the revised Exposure Draft of the Tax Laws Amendment (2012 Measures No. 4) Bill 2012 ('Revised Exposure Draft'), as explained by the accompanying Explanatory Material and Fact Sheet. (References in this submission to paragraphs refer to the corresponding paragraphs in the Explanatory Material). We previously made a submission in response to the original Exposure Draft released in 2011, and where our comments from that submission remain relevant, we have made those points again in this submission.

We begin by welcoming the Government's decision to revise the Exposure Draft in light of the significant concerns raised by the original Exposure Draft. We acknowledge that a number of our earlier concerns are addressed by the revision, including in particular:

- The unintended consequences of the definition of 'not-for-profit' proposed in that Draft;
- The prohibitions on donations to entities that do not have deductible gift recipient (DGR) or income tax exempt (ITE) status;
- Clarification of the application of the 'in Australia' conditions to income tax exempt entities that operate funds with DGR status;
- Inclusion of a mechanism to except certain environmental organisations from the

Melbourne Law School

The University of Melbourne Victoria 3010 Australia

T: +61 3 8344 6164 **F:** +61 3 9347 2392 **E:** post@law.unimelb.edu.au **W:** www.law.unimelb.edu.au

T: +61 3 8344 6164 **F:** +61 3 9347 2392 **E:** post@law.unimelb.edu.au **W:** www.law.unimelb.edu.au

‘in Australia’ conditions, albeit with no provision for other organisations that may have approval for activities overseas;

- Inclusion of a mechanism to except other Australian income-tax exempt entities from the ‘in Australia’ conditions; and
- Modification of the requirement to comply with all governing rules to ensure that procedural irregularities do not undermine an entity’s not-for-profit status.

We welcome the fact that Treasury has listened to the sector, and other stakeholders, with regard to the difficulties in the earlier Exposure Draft. Nevertheless, we retain some significant concerns about both the policy and drafting of the revised Exposure Draft.

We begin by addressing the **substantive policy issues**, including: the very restrictive nature of the conditions compared to the treatment of international activities in other countries; the adequacy of the justifications of the measure; and the interaction of this measure with the other not-for-profit reforms, including in particular the establishment of the Australian Charities and Not-for-Profits Commission (ACNC). We also address the lack of awareness of the sector of the implications of this measure, and the regulatory burdens imposed by the measures.

We then address the **framing of the measure**, in legal terms, including: the qualitative nature of the test; the fit between the policy and the design of the test; the differing thresholds between deductible gift recipients (DGRs) and income tax exempt entities; the provisions for accounting for donations; and the conditions imposed on the provision excluding government grants and some gifts from the operation of the ‘in Australia’ requirement. We also raise some continuing concerns with the definition of not-for-profit entities, the requirement to comply with governing rules, as well as some apparent drafting errors.

In our view, the underlying policy of this measure **adopts an unduly insular view of the appropriate role of the NFP sector** that fails to reflect both the globalising nature of the world and the national interest in engaging with this world. It also results in **one of the most geographically restrictive regimes of tax concessions** in the developed world, which does not appear to be sufficiently recognised.

Our first preference, therefore, would be for this measure to be **replaced by a more sophisticated and targeted approach through regulation** of overseas activities, as is done elsewhere. We note in this regard the absence of discussion of the interaction of this measure with the establishment of the ACNC. In discussions of countries’ responses to the nexus between charities and terrorism, we note that the approach of the Charity Commission of England and Wales (the Charity Commission) of developing a counter-terrorism strategy and providing guidance to charities has been praised as ‘best practice’ internationally. It would be a lost opportunity for this measure, which at its heart involves

supervision of the activities and governance of NFPs, to operate independently of the ACNC. Further, it would also contradict the Government's policy of reducing the regulatory burden on the sector.

We recognise that the ACNC will not initially have responsibility for non-charitable NFPs. Nevertheless, we consider that it is more coherent to **confer on the ACNC powers to supervise the international engagement of charities**, and in the interim **require other tax-exempt NFPs to report to the ATO on its international activities in line with the policy developed by the ACNC** in this regard. Such an approach would enable proportional regulation, would involve greater consultation with the sector, and would strike a balance between facilitating the international engagement of the sector and ensuring that funds are not used overseas inappropriately.

We recognise that this would be a significant departure from the existing policy. We also therefore make other, less preferred, recommendations to ameliorate the effect of the current policy while achieving the implicit aims of the current policy. These include the following:

- **Prohibiting DGRs from merely 'passing on funds' for the use of entities overseas.** This would merely reverse the effect of the *Word Investments* decision, and is in line with US (and Canadian) prohibitions on mere 'conduits';
- International activities and operations should not undermine the tax-exempt status of the NFP entity entirely. A more proportionate response would be to provide **that tax concessions do not apply to the extent that such income is used overseas**. For example, New Zealand provides that business income that is used for purposes overseas (not, however, 'overseas activities') is not eligible for income tax exemption.
- Reframing the conditions so that the requirement is not as to where they operate or pursue their purposes, but rather whether their **purposes or activities are principally 'in the interests of Australia'**. This could be defined to include: where their beneficiaries are in Australia or Australian;¹ where the purpose is to benefit Australian society;² or where their purpose relates to overseas beneficiaries or purposes, that this purpose promotes international engagement that is in the broader interest of Australia.³ This would better effect the purposes of ensuring that the aims

¹ The first condition ensures that those entities serving migrants and refugees in Australia would remain eligible. The second condition would remedy the situation where a Canadian entity seeking to provide scholarships to Australians (an example given in the Explanatory Material) would not be tax-exempt unless, it appears, it had employees in Australia administering the scheme.

² This would cover organisations that do not aim to benefit individual groups, but rather Australian society more generally, such as arts and culture.

³ A similar requirement exists in Germany.

are broadly to benefit the Australian community, while recognising that international engagement may well be of benefit to the Australian community.

- To the extent that entities engage in or fund overseas activities, there is a common **regulatory requirement that they have adequate governance processes** to ensure oversight of those activities or expenditure. This approach is reflected in part the measure, where oversight requirements are included as conditions for certain parts of the sector. However, to the extent that these can be enforced, we recommend that they are enforced by the ACNC to the extent that it has jurisdiction, and that the ATO adopt an equivalent policy for other tax-exempt NFPs.

We have made other recommendations throughout this submission, which for the sake of convenience we collate in Appendix B.

SUBSTANTIVE CONCERNS

RESTRICTIVE NATURE OF THE CONDITIONS COMPARED TO THE POSITION IN OTHER COUNTRIES

We note that, in contrast to some of the other aspects of the not-for-profit reform, the accompanying material for this measure has not referred to comparative practice or to ‘best practice’ with reference to comparable countries. Appendix C sets out in more detail a comparative overview of the treatment of foreign activities and foreign NFPs in other jurisdictions. As we observed in our earlier submission, the present policy imposes **some of the highest barriers to cross-border philanthropy in the world**.

Barriers to cross-border giving have been the topic of considerable research. As long ago as 1963, the European Cultural Foundation called for “[n]ew efforts in the direction of fiscal assistance to donors and the extension of fiscal privileges to international charitable organizations”.⁴ In 1969, the International Fiscal Association concluded that there is “hardly an objection to a removal of such obstacles”, although several rules may be necessary to enable this.⁵ More recently, the topic has gained momentum with increasing restrictions as a result of anti-terrorist measures, and also in Europe as a result of the growing interactions in the European Union and case law of the European Court of Justice.

There are four key issues in relation to the taxation treatment of foreign activities and NFPs:

1. Can domestic entities undertake activities overseas? That is, do overseas activities affect the tax exemptions of a domestic entity?

⁴ Quoted in Ineke A Koele, *International Taxation of Philanthropy: Removing Tax Obstacles for International Charities* (International Bureau of Fiscal Documentation, 2007) 13.

⁵ Quoted in *Ibid* 14.

2. Can entities incorporated overseas access income tax exemption?
3. Can donors access tax deductions for contributions to a domestic entity that conducts operations overseas (are tax deductions available for donations for foreign activities?)
4. Can donors access tax deductions for contributions to a foreign entity?

1. Overseas activities of domestic NFPs

There are only a small handful of countries that impose limitations on the overseas activities of NFPs. Most comparable jurisdictions, including the US, the UK, Canada and the vast majority of European States do not condition income tax exemption on domestic operations. There are a few exceptions to this general principle, principally Austria and Germany. However, Germany does allow tax exemption for charities whose overseas activities may contribute to the reputation of Germany abroad, and Austria's geographical limitation applies only to entities established outside the European Union and the European Economic Area (as discussed below).

An interesting example is New Zealand. New Zealand does not impose any geographical limitation in respect of non-business income. However, the income tax exemption only applies to business income if the entity has charitable purposes in New Zealand. Importantly, this rule is directed to whether the purposes are 'New Zealand purposes', rather than the activities being conducted in New Zealand. Further, if an entity has both New Zealand and foreign charitable purposes, the business income is apportioned on a reasonable basis and the income tax exemption applies only to the extent the business income is apportioned to the New Zealand purposes.

Therefore, **the proposed measure, which restricts income tax exempt entities to both operating and pursuing its purposes 'principally in Australia', will be one of the most stringent restrictions on the engagement of NFPs internationally in the world.** In particular, we note that, unlike the New Zealand example, the conduct of overseas entities does not merely disentitle the entity from tax exemption in respect of the 'foreign' aspect of their activities, but rather imperils their tax-exempt status itself. Combined with the qualitative nature of the 'in Australia' test, **this will create a very significant disincentive to engage in any international charitable activities.**

2. Income Tax Exemptions for Foreign NFPs

The picture in respect of tax exemptions for foreign NFPs is more mixed. In many countries, including the US, the UK, New Zealand, foreign NFPs that would otherwise be entitled to exemption can access income (and probably other) tax exemptions.

The practice in Europe varies. Many of the Western States (Belgium, Denmark, Poland, the Netherlands, Sweden, Switzerland) also permit foreign-based NFPs access to tax exemptions provided they meet the other conditions for tax exemption. The key exceptions are Austria,

France, and Germany. A number of other countries require either formal registration or the establishment of a branch in that jurisdiction. Some others restrict such access to entities based in other EU or EEA countries (Bulgaria, the Czech Republic, Ireland). A number of European jurisdictions, typically those who entered the EU later, do not grant such access.

However, European law restricts in important ways the capacity of States to deny tax exemptions to equivalent NFPs based in other EU/EEA jurisdictions (which explains the nature of some of the restrictions). The European Court of Justice has held that in some circumstances this will violate European treaties that establish the freedom of movement of capital.⁶

As well, income tax exemptions may be available to NFPs under bilateral taxation treaties. For example, the US has provisions allowing tax exemption to equivalent entities in respect of Canada, Mexico and Germany.⁷

3. Gift Deductions for Donations to Domestic NFPs that Operate Overseas

Many jurisdictions do impose geographical limits in respect of deductions available for donors. However, a distinction is often made between tax deductions for entities incorporated in the home State and those incorporated elsewhere.

In contrast to Australia, many major jurisdictions permit domestic NFPs to donate overseas, although there are some restrictions. The United Kingdom allows charities to donate overseas. Its guidance states that, to qualify as 'charitable expenditure', expenditure overseas must be either to pay a foreign supplier of goods or services in the ordinary course of the charity's activities, or the charity should take reasonable steps to ensure that the payment is applied for charitable purposes.

The US does allow tax deductions for domestic NFPs that donate overseas, which is subject to a test as to whether the domestic NFP exercises real discretion and control over the expenditure (in which case tax deductions are allowable) or whether it is merely a conduit for funds earmarked for particular activities (in which case they are not). The former are commonly known as 'friends of' organisations.

In Canada, two issues may arise. First, where a charity uses an intermediary to carry out its charitable activities overseas, transferring resources to the intermediary may cause difficulties if the NFP does not either 'direct or control' the use of its resources, or fails to meet other conditions including investigating the status and activities of the intermediary. Further, a charity cannot act as a conduit by transferring money or property to a foreign entity without any direction or control.

⁶ *Persche v Finanzamt Lüdenscheid (C-318/07)* [2009] ECR I-359. For an extensive discussion, see Sabine Heidenbauer, *Charity Crossing Borders: the Fundamental Freedoms' Influence on Charity and Donor Taxation in Europe* (Kluwer Law International, 2011).

⁷ Koele, *International Taxation of Philanthropy*, above n 4, 146–148.

In contrast, New Zealand restricts its tax credits and deductions for donations geographically, i.e. 'within New Zealand'. Organisations that do not qualify, however, may set up special funds for New Zealand purposes that are eligible for tax deductions and credits.

4 Donations to Foreign NFPs

Again, the picture here is mixed. For some jurisdictions, including the US, donations to foreign NFPs are not deductible. In other jurisdictions, including the UK, donations are tax-deductible but generally speaking the receiving organisation must be registered or formally recognised and meet equivalent conditions.

The Position under the Bill

By requiring both income tax exempt entities and DGRs to operate principally or solely, and pursue its purposes principally or solely in Australia (and, in the case of DGRs, to be established in Australia), the Australian Government is **proposing some of the most geographically restrictive conditions on NFPs in the world**. This is not acknowledged in any of the accompanying material or discussion concerning this measure.

The measure is by some way more restrictive than comparable restrictions in most major jurisdictions, in the following ways:

- The restrictions apply to the international activities of domestic NFPs, unlike in most countries;
- The restrictions effectively preclude domestic entities wishing to retain gift deductibility status from expending money overseas, unlike most countries;
- The restrictions apply in relation to the place of establishment, the place of activities, and the place of carrying out the purposes, unlike most restrictions which generally refer to one or two of these elements;
- The restrictions do not merely affect entitlement to tax exemption in respect of foreign activities, but instead imperil the tax-exempt status of the entire entity;
- The restrictions impose a cumulative and qualitative test of being 'in Australia', unlike most restrictions which require one or more conditions to be satisfied independently.

Recommendations

1. We recommend that the policy should be considered again in light of comparable practice which is significantly less restrictive than that proposed. In particular, we recommend that consideration should be given to removing the restriction on overseas activities by domestic NFPs.

ADEQUACY OF JUSTIFICATION OF THE 'IN AUSTRALIA' REQUIREMENT

In our previous submission, we expressed reservations concerning the adequacy of the underlying justifications for these measures. Three justifications are set out in the Explanatory Material: first, the idea that entities must be operated “for the broad benefit of the Australian community” (see [1.2]); second, to address tax avoidance by entities shifting untaxed funds overseas (see [1.7], [1.47]); and third, to mitigate the risk of terrorist financing and money laundering (see [1.8], [1.48]-[1.49]). However, the policy implicit in these justifications has not been properly consulted upon or discussed.

'For the Benefit of the Australian Community'

There are two difficulties with this justification. First, as we stated in our previous submission, our view is that in the current global era, the underlying policy of confining the benefits of tax concessions to Australia is unduly parochial. Second, it does not necessarily follow that in order to benefit the Australian community all income must be expended domestically (as we discuss later).

In relation to the first point, most commentators are agreed that this justification is “completely archaic”. Indeed, even in 1969 it was argued that such restrictions “constitute ... an obstacle to the furthering of interests which in the present world are no longer nationally bound”.⁸ In our globalised world, it is difficult to argue that only entities benefiting Australians should receive tax concessions. This parochial view is also out of step with other Australian Government policies, such as our commitment to foreign aid and international development. It is particularly regrettable that this measure is being introduced after the recent Budget delayed the promise of meeting the foreign aid targets set by the Millennium Development Goal.

It is true that the current measure specifically excepts international affairs DGRs from the second and third ‘in Australia’ conditions under s 30-80(4) (although it is well-known that it is difficult and time-consuming to obtain endorsement as an overseas aid fund under this category). However, in our view international affairs are not best conceptualized as a well-known exception to the underlying policy of benefiting Australians, but rather illustrate the artificiality of the distinction between ‘benefit to Australia’ and ‘public benefit’ generally.

We note that the Explanatory Material to the Exposure Draft Bill does not appear to understand the practical context in which the NFP sector operates internationally. International statistics illustrate the growing importance of international activities and funding. For example, the US Foundation Center reports that in 1982, the share of grant

⁸ Ibid 8. See also similar criticisms by Harvey P Dale, ‘Foreign Charities’ (1995) 48 *Tax Lawyer* 655; Joannie Chang, Jennifer I Goldberg and Naomi J Schrag, ‘Cross-Border Charitable Giving’ (1997) 31 *University of San Francisco Law Review* 563; David E Pozen, ‘Remapping the Charitable Deduction’ (2006) 39 *Connecticut Law Review* 531.

dollars and the share of grants by foundations being expended internationally amounted to less than 5%, compared to 2008 when the share of grant dollars was close to 25% and the share of grants just under 10%.⁹ In 2008, nearly \$US7 billion was granted overseas by US foundations.¹⁰ Private philanthropy from OECD countries grew from approximately \$YS5 billion in 1991 to \$US53 billion in 2008. Importantly, international giving in 2008 in the US spanned a wide range of causes, although health dominated with 39% of total dollars. Apart from health, 20% of total dollars was donated to causes that would not be excepted from ‘in Australia’ conditions.¹¹

In discussions with sector representatives, we have heard how common it is for organisations that are primarily domestic to engage in activities overseas. Entities often assist or contribute to sister organisations overseas, or individuals club together to help a particular charity with which they have some knowledge. Cultural institutions engage in international collaborations; university academics travel overseas to collaborate, exchange and teach. We are concerned that this measure **does not properly consider the diversity, breadth and extent of the international activities of NFPs**, and that its practical implications are more extensive than intended.

It is also important to have regard to the history of ‘in Australia’ requirement. As we discussed in our previous submission, a historical analysis of the provisions show that ‘benefit to Australians’ was not the original meaning of the ‘in Australia’ test, and indeed (as in other countries) there were no ‘in Australia’ conditions imposed on income tax exempt entities, as opposed to DGRs, until 1997. As we also noted, Parliament had an opportunity to rectify this situation following *University of Birmingham v Federal Commissioner of Taxation* (1938) 60 CLR 572, when the High Court held that an overseas charity was eligible for income tax exemption in Australia, but did not do so. Further, the distinction between income tax exempt entities and DGRs in this context was expressly approved in 1952 by the Commonwealth Committee of Taxation.¹²

We also drew attention to the fact that, although the DGR provisions did include an ‘in Australia’ requirement from the beginning, this appears to have relied upon the predecessor Victorian provision which required the entity to be ‘situated in Victoria’, but did not otherwise confine the scope of activities of the organisation. Further, the original charitable deduction provision existed alongside a deduction for gifts to public funds “established in any part of the King’s Dominions or in any country in alliance with Great Britain for any purpose connected with the current war”. Together with the longstanding deductions

⁹ Foundation Center, *International Grantmaking Update: A Snapshot of US Foundation Trends* (December 2010) 2 <http://foundationcenter.org/gainknowledge/research/pdf/intl_update_2010.pdf>.

¹⁰ Ibid 3.

¹¹ Ibid 5.

¹² Commonwealth Committee on Taxation, *Report on Exemption of Income of Certain Bodies and Funds* (Reference No. 25) (Parliamentary Paper, No 136, 12 August 1952), [7].

available for various organisations involved in international affairs, disaster funds, and for defence forces,¹³ this clearly demonstrates that the **tax concessions have not traditionally been restricted to a parochial notion of ‘benefit to the Australian public’**. Nor has charity law ever attempted to confine ‘benefit’ to the public territorially.¹⁴

In any event, we would argue that there is a **poor fit between policy and design**, if the policy is intended to ensure tax concessions are restricted to those organisations for the ‘benefit of the broader Australian community’. There is not necessarily a straightforward connection between establishment and operation in Australia, and benefit *to* Australia. For example, one of the overseas activities discussed in the examples in the Explanatory Material is the activity of arranging an exhibition to an overseas museum (Example 1.15). This would be an ‘overseas activity’ that would not preclude DGR status as it is ‘minor’ or ‘incidental’. Nevertheless, the circulation of art exhibitions as part of reciprocal arrangements is clearly ‘of benefit to Australia’ even though it involves overseas activities. Similarly, the activities of academics overseas—in the form of study, collaborations, partnerships and other engagement—is of benefit to Australia by (for example) enhancing reputation, and improving and transferring knowledge and networks. If one is to prefer the interests of Australians over those overseas, the appropriate **policy should not focus on whether the activity is conducted in Australia but rather whether the purposes are in the interests of Australia**. This would encompass a broader understanding of how entities may benefit Australians.

For example, the proposed test would exclude overseas entities whose purpose is to benefit Australians. The Explanatory Material gives as an example a Canadian charity whose purpose is to provide educational scholarships to Australians. In our view, this already accords with the policy of benefiting Australians, whether or not the entity then establishes an office in Australia or hires employees in Australia. One aspect of the ‘in the interests of Australia’ test should therefore include whether the purpose is to benefit Australians.

We would emphasise, however, that this should not be restricted to benefiting citizens of Australia. If the purpose is to benefit migrants or refugees in Australia, for example, this would equally be in the interests of Australia. Another aspect therefore is whether the purpose is to benefit those in Australia. We also suggest that it is in the ‘interests of the Australian community’ where the entity’s purposes are to benefit Australian society, broadly conceived. For example, the purpose of arts or culture organisations may be to enrich Australian society generally, rather than to benefit particular groups of people in Australia.

Finally, we suggest that it is also in the ‘interests of the Australian community’ where an organisation’s purposes or activities are to **promote international engagement that is in the**

¹³ See item 5.1.2 of s 30-50.

¹⁴ G E Dal Pont, *Law of Charity* (LexisNexis Butterworths, 2010) [3.53].

broader interests of Australia. For example, organisations designed to foster ties between Australia and China are clearly in the interests of Australia. Human rights organisations and development organisations that aim to assist those overseas are, in our view, still acting in a way so as to promote the broader interests of Australia in promoting Australian values of human rights and equality. This is clearly seen where overseas aid organisations facilitate the Australian Government's broader foreign aid agenda, which is also in the interests of Australia.

Recommendations

2. We recommend that the policy of restricting benefits geographically be reconsidered in light of globalisation, our moral obligations to fellow humans, and our interests in international engagement.
3. If a policy of restricting benefits geographically is adopted, it should extend more broadly to a concept of entities whose purposes or activities are 'in the interests of Australia'. This would include where there is a benefit to those in Australia or Australians, where the purpose is to benefit Australian society more generally, or where the organisation promotes international engagement that is in the broader interests of Australia.

Tax Avoidance and Money Laundering

The Explanatory Material justifies this measure in addition in relation to concerns over tax avoidance, terrorism and money-laundering ([1.7]-[1.8]). The concern here appears to be the lack of government oversight when monies are expended overseas.¹⁵

Even if one accepts the rationale, however, it does not justify simply excluding all foreign entities and restricting foreign activities. Typically, oversight is met in other jurisdictions by requiring reporting, registration with the domestic authority, establishment of a local branch,¹⁶ and/or imposing upon either the domestic donor or the domestic entity obligations of proof or oversight.¹⁷

While we would not necessarily endorse some of the intrusive regimes that have been adopted elsewhere in the world, we observe that other jurisdictions have not imposed geographical restrictions in order to address the challenges of terrorism and money-laundering. This is a measure that is both over-inclusive (catching many legitimate entities) and under-inclusive (not catching entities that fund terrorism in Australia or which launder

¹⁵ Pozen, 'Remapping the Charitable Deduction' above n 8, 594–595; Koele, *International Taxation of Philanthropy*, above n 4, 9.

¹⁶ I. Koele, 'Tax Privileges of NPOs and Their Benefactors: A Landlocked Privilege' [2004] *The Tax Treatment of NGOs The Hague: Kluwer Law International* 323, 327.

¹⁷ Ibid 326.

money in Australia), and is not likely to prevent the mischief as those engaged in such activities are not likely to cease simply because they are denied tax concessions.

Instead, other regimes have generally adopted models based on **better oversight by funding entities**—in the US, by the way of Treasury guidelines and in the UK, in the form of operational guidance and a counter-terrorism strategy. Given the establishment of the ACNC and the many criticisms of the US Treasury Guidelines, we suggest that a better measure for addressing terrorism should be through development of policy by the ACNC to guide the sector as to better compliance.

We note that, to some extent, this is the intention behind some of the provisions in the Exposure Draft, which would allow prescription on the basis that the entity has, among other things, governance processes that ensure legal compliance and oversight of funding entities. In our view, a better process would be to provide that **entities accessing tax concessions must report to the ACNC with regard to funding overseas entities and conducting overseas activities according to policies developed by the ACNC**, and utilise the existing powers and sanctions of the ACNC to address concerns regarding terrorism and money-laundering.

We appreciate that this option will not be available to non-charitable NFPs, at least in the interim. To remedy this problem, however, it would be better to impose a condition that the **entity must report to the ATO with regard to funding entities overseas or conducting overseas activities (using the same policy developed by the ACNC)** in the interim. To the extent that the entity is complicit in terrorism or money-laundering, it would either fall foul of the proposed requirement in this proposal that its purposes are not that which entitle it to tax exemption, or could be appropriately referred to prosecutors in respect of criminal charges.

Recommendations

4. We recommend that the 'in Australia' conditions be replaced by requirements on charities to report overseas funding or activities to the ACNC, which will supervise such activities in accordance with the development of an appropriate policy in consultation with the sector. In the interim, other tax-exempt NFP entities should be required to report to the ATO in accordance with the same policy, and appropriate action can be taken by the ATO to revoke its status under the definition of 'not-for-profit', or by referral to appropriate agencies responsible for the enforcement of criminal laws.

THE AWARENESS OF THE SECTOR OF THE IMPLICATIONS OF THE 'IN AUSTRALIA' REQUIREMENTS

We reiterate our general concern, expressed in the earlier submission, that these changes have been insufficiently flagged to the NFP sector. This concern has been substantiated in some of the discussions we have had with NFP representatives. Some proposed changes, such as the definition of not-for-profit, may affect NFPs that do not operate overseas, who may therefore be unaware of this measure. Other organisations may operate mostly in Australia but engage in multiple incidental activities overseas that may be affected. As we discuss below, the measure appears to underestimate the breadth and extent of overseas activities conducted by the not-for-profit sector. Finally, as with much of the not-for-profit agenda, we are aware that many smaller organisations are simply unaware or only vaguely aware of the entire process of not-for-profit reform.

This concern is amplified by the broad definition of 'overseas activities' encompassed in the measure. One of the examples given in the Explanatory Material considers purchases of books overseas as an overseas activity. Given the global nature of trade, it is easy to see how many Australian-based organisations may not realise that this constitutes 'overseas activities' that may be relevant to their income tax exemptions.

Finally, we express concern that this measure will commence from Royal Assent and apply to the income years immediately following ([1.121], [1.123]), with an exception only when changes to governing rules are required to meet the new definition of 'not-for-profit' ([1.124]). Our understanding is that these conditions are intended to be passed in the current financial year, namely by 30 June 2012. Given that most NFPs are likely to be planning any overseas activities already for 2012-2013 and that the new 'in Australia' conditions may require adjustment of, and accounting for, such activities, we recommend that there should be a longer transitional period. We note that such provision has been made for entities to amend governing rules (at [1.124]) in relation to the definition of 'not-for-profit', although whether sufficient publicity has been given to this requirement is an issue. Further, we raise for consideration the question of whether satisfying the not-for-profit definition will create difficulties for organisations that have been created by wills, legislation or letters patent, and suggest that this be provided for in the transitional provisions as well.

Recommendations

5. We recommend that, given the lack of awareness of the impact of this measure, **the measure (or, at the least, its implementation) should be delayed by at least a year** to enable NFPs to assess the impact of the measure on their operations, to be properly consulted, and to enable them to comply with the measure.

6. We recommend that the **Australian Taxation Office alert NFPs more widely to the impact of this measure**, preferably at the time it informs them of the transfer of some of its functions to the ACNC.
7. We recommend a provision to **except from the requirements to change governing rules entities that are not readily capable of changing their governing documents**, such as organisations created by wills, legislation or letters patent.

REGULATORY BURDENS

The Revised Exposure Draft and Explanatory Material do not address the regulatory duplication that will occur as a result of the imposition of such conditions with the pending establishment of the ACNC. The intention behind the establishment of the ACNC is to provide a 'one stop shop'. However, if charities will still be required to submit evidence of all their overseas activities to the ATO as well, this will clearly compromise the policy intention.

This is particularly problematic because, as already noted, **at heart the 'in Australia' conditions are attempting to address concerns that are properly dealt with as a matter of governance and regulation**. This is clearly evident in the conditions upon entities that will be excepted from the conditions, which are entirely regulatory. As we have stated previously, such issues should be left to the ACNC rather than the ATO.

The issue of regulatory duplication also has the potential to undermine support from the sector for the establishment of the ACNC. For many entities, the promise of **reducing the regulatory burden** is the key benefit of the ACNC. We understand that other elements of the reform package, such as the unrelated business income tax, are already undermining support for the ACNC and the government's not-for-profit reform agenda. We consider that this measure will further undermine such support.

We assume, also, that in the lead-up to the establishment of the ACNC the section of the ATO that previously dealt with such assessments has been considerably reduced. As a result, **we question whether the ATO has the administrative capacity to adequately police these conditions**, particularly given their qualitative nature. It will no longer be an assessment of the financial report and the expenditure allocated overseas, which would be relatively quick, but rather a more in-depth assessment of purposes, activities, and other connections to Australia.

THE FRAMING AND LEGAL TERMS OF THE 'IN AUSTRALIA' CONDITIONS

In addition to our concerns about the adequacy of the substantive policy of this measure, we also have some concerns about the framing and drafting of the proposed new conditions and provisions.

THE QUALITATIVE NATURE OF THE 'IN AUSTRALIA' CONDITIONS

The key 'in Australia' conditions envisaged in the revised Exposure Draft remain the same as in the earlier Exposure Draft. For income tax exempt entities, the entity must 'operate principally in Australia' and 'pursue its purposes principally in Australia' (proposed s 50-50(2)). DGRS are required to be 'established in Australia', 'operate solely in Australia' and 'pursue its purposes solely in Australia'.

The new qualitative requirement of 'operating' solely or principally in Australia stands in contrast with the current quantitative requirement of 'incurring expenditure' in Australia. We note that while there are already some entities required to 'pursue their objectives' principally in Australia, the standardised condition will also extend the application of this qualitative test to other entities.

The application of a broader "operate" condition, replacing the "expenditure" condition in the current law, has the potential to better reflect the variety of circumstances and activities of NFPs to achieve their tax-exempt purposes. The qualitative nature of the new requirement does increase the capacity of the Commissioner of Taxation to consider "a wider range of circumstances" than mere expenditure ([1.56]).

However, as presently drafted, and discussed in the Explanatory Material, we consider that there is **significant scope for confusion in application and interpretation** of the proposed condition. This shift also increases the discretion of the Commissioner of Taxation and consequently **creates a high degree of uncertainty for income tax exempt entities**.

This is largely because of the variety of different words and tests used in the legislation and in the Explanatory Material. It appears at times that the government appears to be relying on the words in the Explanatory Material to achieve its interpretive goals with respect to the terms of the proposed provision. We suggest that this is likely to lead to uncertainty and may run counter to current interpretive trends, in which a Court will seek to interpret the text of the statute, purposively and in light of the statute as a whole and in light of the purpose and history the relevant provision, but without necessarily relying much on accompanying explanatory material.

This is exacerbated by the fact that the 'factors' in the Explanatory Material will not be set out in the legislation. If the government wishes to indicate and rely on a list of factors as relevant to the "operate" in Australia condition, such as those listed in [1.54] of the Explanatory Material, it would be better to **state these factors in the legislation itself** in a provision that requires "all facts and circumstances" of the relevant tax-exempt entity to be taken into account. Such a list could be inclusive and enable consideration of "other" relevant factors.

The lack of clarity in the legislation itself will lead to uncertainty for NFPs in seeking to apply this condition and so is likely to lead to **increased compliance costs** because of the need to

take into account a variety of circumstances that are likely to change from year to year. This increased fuzziness may also make **enforcement of the 'in Australia' conditions more resource-intensive** on the part of both the entity and the Commissioner of Taxation. Given the limitation of resources, it is also likely that this increased enforcement cost will lead to patchy enforcement and the risk of arbitrariness.

USE OF EXAMPLES

We recognise that, in order to address this, the Explanatory Material contains a range of examples to illustrate the intended operation of this condition, as well as an inclusive list of factors that will be considered. As noted above, these factors are not listed in the legislation itself.

However, we suggest that it is not clear that the government's stated outcome from the application of the "operates" test in the Examples in the Explanatory Material follows clearly from the terms of the legislation, or what the outcome would be if the facts of some of these Examples were to be adjusted slightly.

The Explanatory Material introduces new terms to describe entities that are not in the legislation. The terms "activity based entity" and "conduit" entity are not to be found in the legislation. Nevertheless, in our view, **the examples only illustrate the difficulty of applying the test** in practice and the distortions that might result.

We are reasonably comfortable with the analysis and suggested outcome concerning the meaning of "operates" in **Examples 1.1, 1.2 and 1.3**. However, if the facts in these examples were adjusted, would the outcome be sufficiently predictable?

If, for example, the sporting program in **Example 1.2** had directed 60% of its money to the Brazilian operation, would this mean it fails the 'in Australia' conditions? If so, does this mean that for one income year (for example, where the Brazilian operation is being established), the entity will not meet the 'in Australia' test, but the next year it might? Does **Example 1.2** create or imply a 50% safe harbour for an entity's expenditure on Australian or overseas operations? This is, perhaps, a good idea, and could give a bright line indicator for the sector. However, we recommend that for clarity, such a safe harbor should be stated in the legislation.

In **Example 1.3**, the 'overseas' activity is that of purchasing books from overseas. This is presumably expenditure incurred overseas, and so this example brings to the fore the current condition of 'expenditure incurred' which is to be replaced by the broader 'operate' test. In a globalising economy, the fact of some expenditure incurred overseas would seem to be relatively minor; whether the books are purchased overseas or in Australia can hardly be the key question on which tax exemption is based. If, for example, the entity purchased the majority of its books overseas in order to effect cost savings, would this mean it no longer met the 'in Australia' test, even though it was more effectively fulfilling its purposes

in Australia or for the benefit of Australia? We would suggest that this should still not disqualify the entity under this condition, depending on the weighing up of other relevant conditions about its operation.

We are even less clear as to whether the outcomes in **Examples 1.4, 1.5 and 1.6** follow in a predictable way from the terms of the legislation, and these examples are also confusing.

In Example 1.4, if the facts were changed so that the Australian branches exercised a degree of autonomy, would it meet the 'in Australia' conditions? If so, would this effectively create incentives to 'decentralise' institutions (with large ramifications for the governance of multinational organisations and ensuing cost implications)?

In Example 1.5 (dealing with Canadian organisations providing scholarships to Australians), would the entity still meet the test if it did not employ Australians or establish a separate Australian entity? If not, this appears to distort the choices made regarding resources by multinational organisations. For example, it could easily be more resource-effective for the Canadian organisation to utilise its own employees to manage the program, but this would create a tax incentive to the contrary. Nevertheless, the ultimate benefit to Australians would clearly remain.

It is not clear exactly how **Example 1.5** is distinguishable from **Example 1.4** apart from the separate entity status of the Australian subsidiary. Presumably in **Example 1.4**, the 500 people who attend each seminar are Australians, who are thereby "benefited". This distinction smacks of a somewhat political analysis. This example also places a lot of emphasis on international control of the organisation. Clearly, control is relevant. However, if it is intended that control should be the key factor, this should be stated expressly or listed as a factor in the legislation?

Similar issues also arise in respect of **Example 1.7** (dealing with a division of an overseas aid agency). Again, here it appears the key distinguishing factor would be the establishment of a separate entity in Australia. It is not clear that a court would place as much emphasis on separate entity status in Australia as the Explanatory Material seems to suggest through the drafting of these examples. Further, from a policy perspective, in our view the existence of a separate entity has little relevance to the ultimate benefit to Australia of such activities.

The reliance on the analogy with a "permanent establishment" in the Explanatory Materials ([1.58]) is also likely to generate uncertainty. This is a concept that is not likely to be familiar to most NFP entities as it relates primarily to multinational businesses. The reliance on this analogy is also unclear, in light of the significant emphasis that the government appears to be placing on the existence of a separate legal entity in Australia (see **Examples 1.4 and 1.5**). Such an emphasis would appear to directly contradict the concept of a "permanent establishment" (in which a "division" or "branch" of an international organisation would have sufficient connection with Australia to be treated as taxable here).

A related point is the reference to an activity through an “agent”. The point in [1.60] of the Explanatory Material, that there would not be a sufficient connection to Australia if only an “agent” is used in Australia, or an investment property owned in Australia, also seems to be an assertion that does not necessarily follow from the terms of the legislation. Might this depend on the scale and type of activity conducted by the agent, and the scale of the property investment (and use of the invested assets or funds)? It is usual for the activities of agents to be attributed at law to the principal, in which case it would be open to a court to find that activities of an Australian agent were sufficient to indicate that an organization established overseas “operates” in Australia.

The statement regarding agents appears again to arise from the international business tax context about permanent establishments (where specific provisions in double tax agreements establish the importance of dependent or independent agents in establishing a permanent establishment). A court would not necessarily apply such an approach here without clear legislative guidance. Regarding the issue of investment property in Australia, does [1.61] in the Explanatory Materials contradict [1.60] as it states that the assets of an entity in Australia are relevant to characterising whether it “operates” here?

Overall, these examples **do not reflect the policy intent of ensuring ‘benefit to the Australian community’**. There is either no, or merely a marginal, benefit to Australia because management or control is located in Australia, or because one person is employed in Australia, or because the purchase of items necessary to fulfill a purpose is made from an overseas supplier. Further, these factors will distort resource allocation by income tax-exempt entities and increase compliance costs.

The uncertainty caused by this more wide-ranging test is also likely to create incentives to be over-cautious by not-for-profit entities, and therefore will likely **inhibit engagement with overseas activities**. If, for example, one was advising the entity in Example 1.2, it is likely that you would suggest, in an abundance of caution, that they minimise their activities in Brazil to ensure that they did not fail the ‘in Australia’ conditions.

CONDUIT ENTITIES

We generally support the proposed new requirement to take into account the activities and purposes of the recipient entity of funds from a “conduit” entity. However, this will add complexity in some cases and increase substantially the administrative obligations on some NFP entities, for example this is illustrated in **Example 1.9**. The term “conduit” is not in the legislation—it could increase clarity to use the same terminology in the legislation and in the Explanatory Material.

More generally, the explanation in the Explanatory Material on conduit entities is confusing. For example, in the sentence in [1.78], it is unclear what is meant by “one or both elements of the test respectively”. The discussion in paragraph [1.80] is also confusing.

Overall, the inhibiting effect of the new condition is likely to be even more pronounced because the ‘tipping point’ between operating ‘principally’ or not has an **all-or-nothing consequence** with very serious ramifications—namely, the loss of any entitlement to tax exemption. We contrast this, for example, to the New Zealand provision exempting business income of charities from income tax (non-business income is not subject to any ‘in New Zealand’ condition). That provision requires the entity to ‘carry out’ its charitable purpose in New Zealand, but to the extent that it also carries out charitable purposes overseas, the business income is “apportioned reasonably” between the New Zealand and the overseas purposes, and the exemption is applied only to the New Zealand income.¹⁸ In our view, this is a preferable approach if the policy of ‘benefiting Australian society’ is to be adopted.

Recommendations

8. We recommend that, if the underlying policy is adopted, the legislation should state more clearly what is required in the concept of ‘operates’ and the other ‘in Australia’ conditions, rather than leaving this to discretion.
9. We recommend that, if the condition is adopted, better guidance should be given in the Examples as to the relative weighting of factors.
10. We recommend that, if the underlying policy is adopted, the legislation should simply reduce the income tax exemption to the extent that the purposes or activities are not in Australia, rather than jeopardising the tax-exempt status of the entire entity.

DIFFERENT TEST FOR DGRs

Another issue is the justification for the higher ‘in Australia’ threshold for DGR status. Although this continues previous policy, the justification for this is not expressly stated in the Explanatory Material. However, we assume that one reason for this may be that the extra cost of this type of tax relief entitles the Government to demand a greater benefit to ‘Australia’, or that DGR status is assumed to be linked to a higher risk of tax avoidance.

We question both of these suggested reasons. We agree that DGR status may be seen as desirable for entities to obtain and that it provides greater tax relief presumably because of greater public benefit (although we note that this is not necessarily reflected in the current patchwork of entitlements). Nevertheless, there are several difficulties with that argument. First, as noted above, there is likely to be benefit in activities conducted overseas for Australians, which is not captured in the draft requirements. As is also discussed above, it is far from clear that Australians conceive of ‘public benefit’ so narrowly that they would agree that (for example) a charity for the blind in Australia is necessarily more beneficial than a

¹⁸ *Income Tax Act 2007* (NZ) CW 42(4).

charity to perform eye surgery in poor countries. Indeed, given the health systems in such countries there is a very good argument that the latter charity addresses a greater human need.

Third, we question whether an organisation that ‘principally’ operates in Australia is necessarily of lesser benefit than one which ‘solely’ operates in Australia. For example, an organisation that seeks to defend the environment which operates solely in Australia is not necessarily more beneficial than a similar organisation which (for example) chooses to spend some of its money overseas on activities such as advocating for changes to international laws regulating the environment.

Finally, as we have previously noted in other submissions, DGR status may be sought for reasons other than for tax-deductible donations, such as to access philanthropic funding, to comply with government grant criteria, or for enhanced legitimacy. In this context, entities may be forced to choose between (for example) access to philanthropic funds and changing its activities to fit within the higher ‘in Australia’ threshold.

In relation to whether there is a higher risk of tax avoidance, we assume that this would be because donors would use DGRs to access tax deductions. However, this risk will vary greatly between different DGRs and if it is a tax avoidance issue, it appears that a targeted tax avoidance measure may be more appropriate. Alternatively, if this is the real concern, then a prohibition on DGR ‘conduits’ (as is done in the US) may be more appropriate, although this is far from a problem-free test.

The differing thresholds between DGRs and income tax exempt entities, in our view, creates **needless complexity and confusion**. Many income tax exempt entities operate DGR funds and will be required to operate to both thresholds. Differing thresholds will distort decisions about where activities should be allocated and whether DGR status is preferred.

Recommendations

11. We recommend that, if the underlying policy is adopted, **the differing thresholds between DGRs and income tax exempt entities should be harmonised**. This will reduce the complexity and confusion caused.
12. If the differing threshold is designed to address tax avoidance, then this should be addressed **either by tax avoidance measures or by prohibiting ‘conduit’ DGRs**, rather than imposing a strict ‘in Australia’ requirement on all DGRs.

ACCOUNTING FOR DONATIONS

While we welcome the removal of the prohibition of entities donating to entities that are either not DGRs or income tax exempt entities, we are concerned about the suggestion that the “income tax exempt entity must satisfy itself about how the entity it has donated money

or property to uses this property” if it is donating to a non-income tax exempt entity ([1.71], s 50-50(4)) and similarly if a DGR donates money or property to a non-DGR ([1.119], s 30-18(3)).

We note that this requirement is not express in the Exposure Draft, which instead merely requires the use of those donations to be taken into account for the purposes of the ‘in Australia’ conditions. There is a significant difference between these two statements. First, the suggestion seems to imply an obligation on income tax exempt entities and DGRs to ‘trace’ money donated to other organisations even where those other organisations operate solely in Australia for Australian purposes. Such an interpretation clearly extends well beyond the purpose of the ‘in Australia’ conditions.

Second, the legislation does not directly impose an obligation upon the income tax exempt entity or DGR itself an obligation to trace the money, but rather would take into account the use of that money in determining whether the ‘in Australia’ conditions were fulfilled.

In our previous submission, we also observed that there are many practical and legal reasons which may affect an organisation’s decision to seek endorsement as an income tax exempt entity or as a DGR. The present requirements would create another incentive for organisations to undergo the difficult and resource-intensive process of obtaining DGR status even where they do not seek public funds, in addition to the existing incentive to gain access to private philanthropic funding. The reason for this is that, all else being equal, a DGR is likely to prefer funding a DGR for whom it does not have to account to the ATO in respect of overseas activities, in contrast to funding a non-DGR which may have minor or incidental overseas activities for which the DGR has to account and which may imperil its own status as a DGR (given the uncertainty of the ‘minor or incidental’ restriction). It may similarly distort the funding choices of income tax exempt entities.

We understand that the policy intent is to prevent circumvention of the ‘in Australia’ conditions by way of donating money to another entity not under similar obligations. Nevertheless, there is a more direct way of achieving this aim than the approach adopted in the current Exposure Draft. The legislation could instead provide that, where an entity donates money or property to another entity which will use the money or property for overseas activities, the receiving entity must itself satisfy the same ‘in Australia’ conditions as applies to the funding entity, unless the receiving entity is not required by the legislation to fulfil them. This would create a level playing field for funding (which could also take into account other ‘in Australia’ factors such as management or control, compared to non-income tax exempt entities which could not), and would allow the receiving entity to rely on other ‘in Australia’ factors such as management or control to offset the use of the money overseas. There is a precedent in the legislation already for this in s 50-60, as noted in our previous submission. Further, s 50-60 also provides a safeguard by requiring that the donation be to an entity that, to the “best of the trustee’s knowledge”, satisfies those requirements. We recommend that a similar safeguard be included here.

Such a provision would also be enhanced if, as suggested, the differing thresholds between DGRs and income tax exempt entities were harmonised. As we discussed in our previous submission, we do not see why DGRs should not donate money to income tax exempt entities, which already provide a public benefit. As discussed above, we do not see any real rationale for the distinction between the 'sole' and 'principal' threshold in Australia conditions.

We also note the discussion in [1.76]-[1.77] regarding the need for a charity to make gifts which pursue its own purposes as a charity. This issue is one of charity law which will be regulated by the ACNC, and should not be conflated with the present provision.

Recommendations

13. If the underlying policy for the condition is adopted, we recommend that where a DGR or income tax exempt entity donates money to another entity, **that entity must meet the same 'in Australia' requirements as apply to the funding entity**, unless it is expressly excluded from meeting such requirements. In such a provision, we recommend that a **safeguard should be adopted to protect innocent donating entities**, where 'to the best of its knowledge' the other entity meets the 'in Australia' conditions.

PRESCRIBED INSTITUTIONS

While we welcome the re-inclusion of existing powers to prescribe institutions that are not required to fulfil the 'in Australia' conditions in proposed s 50-51(2)(c), (d)), as well as specifically in relation to environmental DGRs (s 30-18(5)), we question the mechanisms employed.

It is well-known that **the present process of obtaining ITE or DGR status by specific listing is very time-consuming, labour-intensive and in important respects a result of political power**. Similar comments apply to the listing of environmental organisations and overseas aid funds under the Register. These same features will apply to the process of 'prescription' under proposed s 50-51(2). This is reinforced by the statement that any such prescription would "be made only in exceptional circumstances" ([1.82], [1.100]), at the discretion of the Governor-General in Council and subject to disallowance in Parliament ([1.100]). We note also that there are no legislative conditions for such prescription, although some general factors expected to be considered are set out in [1.100]. This establishes a resource-intensive mechanism which will repose power in a virtually unchecked executive, replicating the same problems in the existing ITE and DGR process for specific listing.

We also note also the disparity between DGRs and income tax exempt entities in this respect. We question why, under the DGR regime, only environmental organisations may be

'prescribed' as exempt from certain 'in Australia' conditions. In contrast, the power to prescribe exceptions is not restricted by category for income tax exempt entities. We also note that a decision to prescribe an environmental organisation for this purpose is a reviewable determination (see proposed s 30-19) based on requirements to be set out in regulations ([1.114]), in contrast to the general power of prescription for income tax exempt organisations.

It is **unclear why environmental organisations are singled out**. They are not the only type of DGR that are subject to endorsement by other Departments (see, eg, overseas aid funds, subject to approval by AusAID, or cultural funds subject to approval by the Office for the Arts in the Department of Prime Minister and Cabinet). While we recognise that environmental organisations are likely to need to conduct activities overseas, there may well be other organisations that will, by their nature, be required to conduct activities overseas. For example, Amnesty International is a listed DGR which is likely to pursue purposes offshore, given its advocacy in international organisations. We see no reason why there should not be a similar general power to prescribe in relation to DGRs, and why the general power in relation to both should not be based on explicit criterion set out in regulations, with a right of review.

Recommendations

14. If the underlying policy is adopted, we recommend that **there should be a general power for both DGRs and income tax exempt entities to be excluded specifically from complying with the 'in Australia' conditions**. Such a power should be conditioned on explicit criteria set out in regulations, with a right of review.

GOVERNMENT GRANTS AND GIFTS

While we acknowledge that much of s 50-75 (disregarding government grants and non-deductible gifts) has been reinstated in s 50-50(5) of the Revised Exposure Draft, we remain concerned about the restrictiveness of the re-drafted provision.

We note that the re-drafted provision limits the effect of the existing provision in three ways. First, it requires the entity to meet new regulatory conditions before the provision has effect (discussed below). Second, it removes s 50-75(2) which deals with the distribution of gifts from other funds. Third, and importantly, it restricts the effect of the provision to gifts that are not tax-deductible (unlike the existing provision).

The effect of this last limitation would be to preclude a DGR entity from, for example, initiating a disaster relief appeal (where such an appeal is not approved by the Minister under ss 30-85 or 30-86) unless it indicated that such donations would not be tax-deductible. In our view, the **effect of this last limitation clearly exceeds the concern about conduit entities and adopts an unduly insular view of benefit to the Australian community** (as discussed above).

Melbourne Law School

The University of Melbourne Victoria 3010 Australia

T: +61 3 8344 6164 **F:** +61 3 9347 2392 **E:** post@law.unimelb.edu.au **W:** www.law.unimelb.edu.au

Recommendations

15. Proposed s 50-50(5) should be redrafted so as to enable DGR entities to conduct legitimate appeals for overseas purposes without jeopardising their tax status.

REGULATORY CONDITIONS

A related issue is the regulatory criteria which is proposed to support these changes in the Explanatory Material. While we note that the language in the Explanatory Memo is not suggested as legislation, we have some comments on the drafting of the suggested criteria.

As noted above, the Revised Exposure Draft conditions the application of s 50-50(5) (now s 50-75) upon the entity meeting certain criteria set out in regulations. At [1.69], the Explanatory Material sets out the following expected criteria:

- Demonstration that overseas activities or use of money or property outside Australia “is effective in achieving the entity’s purpose”;
- Demonstration that the entity must “comply with all Australian and foreign laws, Australia’s international treaty obligations, and uphold the high reputation of Australia and the not-for-profit sector”; and
- Demonstration of “current and appropriate governance arrangements for the proper monitoring of any overseas activities undertaken by both it and any in-country partners”.

These criteria are similar to those expected to apply to environmental organisations which are prescribed as not required to fulfill the ‘in Australia’ conditions (see [1.115]). These include:

- A “genuine need” to conduct activities in order to further its purpose;
- Demonstration that those overseas activities “are effective in achieving its purpose”;
- Demonstration that it “effectively interacts and coordinates activities with its in-country partner”;
- A requirement to comply with “all Australian and foreign laws, Australia’s international treaty obligations, and uphold the high reputation of Australia and It’s not-for-profit sector”; and
- Demonstration of “current and appropriate governance arrangements for” monitoring overseas activities and “any in-country partners to ensure that any money and property is being used in a proper and effective manner.”

Our first point is that these criteria are regulatory, and satisfaction of these should be assigned to the ACNC rather than to the ATO, as discussed above.

Our second point is that much of this language is questionable. ‘Effectiveness’, for example, is a highly contestable concept. We also suggest that a “genuine need” is too prescriptive. Instead, the test should be whether conducting overseas activities is “reasonably directed at further its purpose”. The requirement to “uphold the high reputation of Australia and its not-for-profit sector”, in our view, is both entirely too subjective for legislation and would appear to prevent Australian NFPs from criticising Australian Government policies (for example) in international fora directly relevant to their purposes.

We also note that the requirement to comply with all Australian and foreign laws and treaty obligations is an impossible requirement, because it is highly likely that at least some of the foreign laws will be incompatible with either Australian law or treaty obligations. For example, Australia’s treaty obligations include a raft of human rights obligations which are directly contradicted by the laws of many of the States in which not-for-profits wish to engage in. Australian law may also be incompatible with its treaty obligations. We recommend that entities should only be required to comply with Australian laws and, to the extent to which they are compatible, Australian treaty obligations and foreign laws.

Recommendations

16. We recommend that **further thought be given to the regulatory conditions for excluding the application of ‘in Australia’ conditions**, in particular the use of the terms ‘effectiveness’, ‘genuine need’ and ‘upholding the reputation of Australia’.
17. We recommend that the condition in relation **to compliance with laws should refer to Australian laws**, and to the extent that they are compatible Australian treaty obligations and foreign laws.

DEFINITION OF NOT-FOR-PROFIT ENTITY

We welcome the significant changes to the definition of ‘not-for-profit entity’, which largely accord with our recommendations in the previous submission. However, the phrasing does not include the term ‘individual members’, as we had recommended.

This recommendation was made to replicate the phrase considered by the Full Federal Court in the case of *Commissioner of Taxation v Co-operative Bulk Handling Limited* [2010] FCAFC 155. The Court concluded that an entity could be ‘not carried on for the purpose of profit or gain to individual members’ even where the members derived a benefit or gain, as long as that gain was not produced *by reason of individual membership*. Although the members in that case received particular benefits from the existence of that organisation,

those benefits were similarly open to non-members.¹⁹ As we noted, the omission may cause uncertainty and have the unintended effect of reversing the Court's decision in *Co-operative Bulk Handling*. If this effect is intended, then it should be clearly stated.

An alternative phrasing which would capture this intention is that used in proposed s 5 of the Exposure Draft of the Charities Bill 2003, which referred to 'purposes of profit or gain to particular persons, including owners and members'.

Another difficulty with the definition is the use of the term 'entity'. As there is no further definition, current s 960-100 of the *Income Tax Assessment Act 1997* (Cth) will apply. This **definition does not cover funds**, other than superannuation and approved deposit funds. This is a **highly significant omission**, particularly given the diverse contexts in which the new definition is intended to be used. **We recommend that the new definition expressly include funds.**

Finally, we also suggest that the phrase 'genuine compensation' be re-framed as 'genuine and reasonable', which allows some objective assessment of the level of compensation.

Recommendations

18. The definition of not-for-profit should include reference to '**individual** owners and members', or refer to profit or gain 'for particular persons' to ensure the effect of the Federal Court's decision in *Co-operative Bulk Handling* is preserved.
19. The new definition of 'not-for-profit entity' should be expressly extended to **funds**.
20. The new definition should exclude 'genuine and **reasonable** compensation'.

REQUIREMENT TO COMPLY WITH GOVERNING RULES

We acknowledge that Treasury has modified the previous requirement that ITE entities comply with "all governing rules" in proposed s 50-50(3), so that compliance is now required only with "all the substantive requirements" in its governing rules. Further, para (b) now requires that the income and assets are used solely not only for the purposes for which the entity is established, but also for which the entity is "operated and for which it is entitled to be exempt from tax".

We do not feel, however, that this modification cures the problem we identified in our earlier submission. First, as pointed out in our earlier submission, the **ACNC should be in charge of issues relating to governance**, not the ATO. The ACNC will be established in a way that enables it to take proportionate action in relation to governance. Where appropriate, it may result in the loss of 'not-for-profit status', which itself will trigger a loss of tax

¹⁹ *Commissioner of Taxation v Co-operative Bulk Handling Limited* [2010] FCAFC 155, [94].

exemption. To the extent that it is intended to apply to entities not initially within the jurisdiction of the ACNC, we suggest that it be imposed as a condition only to the extent that the entity is not regulated by the ACNC.

Second, para (a) means that any breach of a ‘substantive’ requirement, or an inadvertent use of income and assets for other purposes, will result in the loss of all tax exemptions. As noted in our previous submission, in a context where there are many volunteer and part-time directors in the sector, there are likely to be many situations in which such people innocently and/or unwittingly breach the governing rules, or apply income and assets to purposes that, while not strictly authorised by their rules, are broadly similar to those purposes. **This provision continues to take no account of the severity, frequency, innocence or significance of the breach.**

We note that the explanation of ‘substantive’ in [1.86] of the Explanatory Material is meant to refer to those relating to an entity’s object and purpose and those relating to an entity’s not-for-profit status. We have no difficulty in requiring entities, not otherwise subject to regulation by the ACNC, to continue to pursue the purposes for which it has been granted tax exemption. This is already captured in para (b). In relation to rules governing its not-for-profit status, we note that the proposed definition of not-for-profit entity already imposes a continuing obligation in respect of the non-distribution clauses (“is prohibited from distributing, and does not distribute” ...). We are not sure what other breaches of governing rules are intended to be captured therefore by para (a). Further, in our view, the tax exemption is granted because of the purposes and the not-for-profit status of the entity. **Breaches of governing rules that do not touch these should not disentitle an entity from tax exemption.**

The explanation in [1.86] about rules of “core” importance to the entity’s operation does not really assist in the interpretation of “substantive” rules. We also question the intention in [1.83], which refers to ‘inappropriate conduct’ short of pursuing an alternate purpose. We are unclear as to what kinds of conduct are envisaged here as disentitling exemption, even where there is no pursuit of alternate purposes. More generally, as we also noted in our earlier submission, the provision as it stands is **virtually unenforceable**, since it would require the ATO to monitor every act of an income tax exempt entity that may breach a substantive rule of their governing rules.

In relation to the extension of para (b), we note that the explanation of this addition is that entities are “expected to operate in a manner consistent with those rules and purposes to remain eligible” (at [1.84]). Again, in our view, this is properly a matter for the ACNC and not the ATO. While we understand that the concern may be to replicate those powers in relation to entities that will not initially be under the jurisdiction of the ACNC, we would prefer that this be imposed as a special condition separate from the definition of ‘not-for-profit entity’, which would apply only to entities that are not regulated by the ACNC.

Recommendation

21. Proposed s 50-50(3) should not be included in the forthcoming Bill. Instead, a condition should be imposed on entities that are not subject to the jurisdiction of the ACNC that the **entity continues to pursue the purposes for which it is entitled** to tax exemption.

DRAFTING ERRORS

There appears to be a significant error in the drafting of s 30-18. Although the Revised Exposure Draft repeals the existing 'in Australia' special condition in s 30-15, there does not appear to be a provision imposing s 30-18 in its place. Section 30-18 itself does not expressly require that the conditions stated therein must be fulfilled in respect of any particular entity. It is somewhat unclear therefore when, and to which entities, s 30-18 is to apply.

22. The Revised Exposure Draft should be amended so that s 30-18 replaces the repealed 'in Australia' condition in the table set out in s 30-15.

We also note that there appears to be errors in translating s 65J of the *Fringe Benefits Tax Assessment Act 1986* into a table as proposed in item 64 of the Exposure Draft. Items 3 and 4 in the table refer to 'Special conditions' that the 'institution is not an institution of the Commonwealth, a State or Territory unless it' and then includes existing conditions. Rather, the special conditions should be prefaced (as is done in item 1) by: "The charitable institution is not a rebatable employer for the year of tax", and one of those special conditions should be that the institution is "other than an institution of the Commonwealth, State or Territory" (as the legislation currently provides).

23. Items 3 and 4 of the table in item 64 amending the *Fringe Benefits Tax Assessment Act 1986* (Cth) should be amended so that the **special conditions refer to whether the charitable institution is a rebatable employer** rather than whether it is an institution of the Commonwealth, State or Territory, and that it is a special condition that the institution is "not an institution of the Commonwealth, a State or Territory".

We note that draft s 30-18(3) appears to contain a typo, as the words "into account" are repeated.

24. Draft s 30-18(3) needs to be amended to remove duplication of 'into account'.

CONCLUSION

This submission has addressed a range of important issues raised by the Revised Exposure Draft. While we acknowledge the efforts to address some of the major concerns we

expressed in the previous submission, we consider that there are still issues with the Revised Exposure Draft.

We hope these issues will be reconsidered in light of our submission. Please feel free to contact us if you wish to discuss any matters further, or would like access to any of the material to which we have referred. Our contact details are listed in Appendix A. We look forward to engaging further with Treasury.

APPENDIX A: NOT-FOR-PROFIT PROJECT, MELBOURNE LAW SCHOOL

A group of academics from the University of Melbourne Law School is undertaking the first comprehensive and comparative investigation of the definition, regulation, and taxation of the not-for-profit sector in Australia (the Not-for-Profit Project). The Australian Research Council is funding this project for three years, beginning in 2010. The project aims to identify and analyse opportunities to strengthen the sector and make proposals that seek to maximise the sector's capacity to contribute to the important work of social inclusion and to the economic life of the nation. In particular, the project aims to generate new proposals for the definition, regulation and taxation of the not-for-profit sector that reflect a proper understanding of the distinctions between the sector, government, and business.

The project investigators of the Not-for-Profit Project are:

Professor Ann O'Connell

+61 3 8344 6202 | a.o'connell@unimelb.edu.au

Ann is a Professor at the University of Melbourne and carries out research in taxation, including in relation to the NFP sector. She is also Special Counsel at Allens, Arthur Robinson, a member of the Advisory Panel to the Board of Taxation, a Visiting Fellow at the Centre of Tax Law, Cambridge, and a member of the ATO Public ruling Panel.

Professor Miranda Stewart

+61 3 8344 6544 | m.stewart@unimelb.edu.au

Miranda is a Professor at the University of Melbourne and carries out research and teaching in tax law and policy at the Law School. She is an International Fellow of the Centre of Business Taxation at Oxford University and is on the Tax Committee of the Law Council of Australia. She has previously worked at New York University School of Law, US and as a solicitor and in the Australian Taxation Office.

Associate Professor Matthew Harding

+61 3 8344 1080 | m.harding@unimelb.edu.au

Matthew is an Associate Professor at the University of Melbourne. His published work deals with issues in moral philosophy, fiduciary law, equitable property, land title registration, and the law of charity. Matthew has also worked as a solicitor for Arthur Robinson & Hedderwicks (now Allens, Arthur Robinson).

Dr Joyce Chia

+61 3 9035 4418 | j.chia@unimelb.edu.au

Joyce is the Research Fellow on the Not-for-Profit Project. She has worked at the Australian Law Reform Commission, the Federal Court of Australia, and the Victorian Court of Appeal.

More information on the project can be found on the website of the [Melbourne Law School Tax Group Not-for-Profit Project](#).

APPENDIX B: RECOMMENDATIONS

1. We recommend that the policy should be **considered again in light of comparable practice** which is significantly less restrictive than that proposed. In particular, we recommend that consideration should be given to removing the restriction on overseas activities by domestic NFPs.
2. We recommend that the policy of restricting benefits geographically be **reconsidered in light of globalisation, our moral obligations to fellow humans,** and our interests in international engagement.
3. If a policy of restricting benefits geographically is adopted, it should extend more broadly to a concept of **entities whose purposes or activities are 'in the interests of Australia'**. This would include where these are to benefit those in Australian or Australians, where the purpose is to benefit Australian society more generally, or where the organisation promotes international engagement that is in the broader interests of Australia.
4. We recommend that the 'in Australia' conditions be **replaced by requirements on charities to report overseas activities or funding to the ACNC**, which will supervise such activities in accordance with the development of an appropriate policy in consultation with the sector. In the interim, other tax-exempt NFP entities should be required to report to the ATO in accordance with the same policy, and appropriate action can be taken by the ATO to revoke its status under the definition of 'not-for-profit', or by referral to appropriate agencies responsible for the enforcement of criminal laws.
5. We recommend that, given the lack of awareness of the impact of this measure, the measure (or, at the least, its implementation) **should be delayed by at least a year** to enable NFPs to assess the impact of the measure on their operations, to be properly consulted, and to enable them to comply with the measure.
6. We recommend that the Australian Taxation Office **alert NFPs more widely** to the impact of this measure, preferably at the time it informs them of the transfer of some of its functions to the ACNC.
7. We recommend a provision to **except from the requirements to change governing rules entities that are not readily capable of changing their governing documents**, such as organisations created by wills, legislation or letters patent.
8. We recommend that, if the underlying policy is adopted, the legislation should **state more clearly what is required in the concept of 'operates' and the other 'in Australia' conditions**, rather than leaving this to discretion.

9. We recommend that, if the condition is adopted, **better guidance should be given in the Examples** as to the relative weighting of factors.
10. We recommend that, if the underlying policy is adopted, the legislation should **simply reduce the income tax exemption to the extent that the purposes or activities are not in Australia**, rather than jeopardising the tax-exempt status of the entire entity.
11. We recommend that, if the underlying policy is adopted, **the differing thresholds between DGRs and income tax exempt entities should be harmonised**. This will reduce the complexity and confusion caused.
12. If the differing threshold is designed to address tax avoidance, then this should be addressed **either by tax avoidance measures or by prohibiting 'conduit' DGRs**, rather than imposing a strict 'in Australia' requirement on all DGRs.
13. If the underlying policy for the condition is adopted, we recommend that where a DGR or income tax exempt entity donates money to another entity, **that entity must meet the same 'in Australia' requirements as apply to the funding entity**, unless it is expressly excluded from meeting such requirements. In such a provision, we recommend that a **safeguard should be adopted to protect innocent donating entities**, where 'to the best of its knowledge' the other entity meets the 'in Australia' conditions.
14. If the underlying policy is adopted, we recommend that **there should be a general power for both DGRs and income tax exempt entities to be excluded specifically from complying with the 'in Australia' conditions**. Such a power should be conditioned on explicit criteria set out in regulations, with a right of review.
15. Proposed **s 50-50(5) should be redrafted** so as to enable DGR entities to conduct legitimate appeals for overseas purposes without jeopardising their tax status.
16. We recommend that **further thought be given to the regulatory conditions for excluding the application of 'in Australia' conditions**, in particular the use of the terms 'effectiveness', 'genuine need' and 'upholding the reputation of Australia'.
17. We recommend that the condition in relation **to compliance with laws should refer to Australian laws**, and to the extent that they are compatible Australian treaty obligations and foreign laws.
18. The definition of not-for-profit should include reference to **'individual owners and members'**, or refer to profit or gain 'for particular persons' to ensure the effect of the Federal Court's decision in *Co-operative Bulk Handling* is preserved.
19. The new definition of 'not-for-profit entity' should be expressly extended to **funds**.

20. The new definition should exclude 'genuine and **reasonable** compensation'.
21. Proposed s 50-50(3) should not be included in the forthcoming Bill. Instead, a condition should be imposed on entities that are not subject to the jurisdiction of the ACNC that the **entity continues to pursue the purposes for which it is entitled** to tax exemption.
22. The Revised Exposure Draft should be amended so that s 30-18 replaces the repealed 'in Australia' condition in the table set out in s 30-15.
23. Items 3 and 4 of the table in item 64 amending the *Fringe Benefits Tax Assessment Act 1986* (Cth) should be amended so that the **special conditions refer to whether the charitable institution is a rebatable employer** rather than whether it is an institution of the Commonwealth, State or Territory, and that it is a special condition that the institution is "not an institution of the Commonwealth, a State or Territory".
24. Draft s 30-18(3) needs to be amended to remove duplication of 'into account'.

APPENDIX C: COMPARATIVE OVERVIEW

CANADA

Tax exemptions—Domestic entities and foreign activities

Canadian charities can carry out activities abroad through its staff or an intermediary, or can make gifts to qualified donees (organisations that can issue official donation receipts for gifts). However, the guidance of Canada Revenue Agency (CRA) notes that there are three conditions that must be met when transferring resources to a non-qualified donee which is an intermediary: the nature of the property can only be reasonably used for charitable purposes; both parties understand and agree the property is to be used for specified charitable activities; and it is reasonable for the charity to have a strong expectation that the organisation will use the property for those activities, based on an investigation into the status and activities of the receiving donee. (These do not apply where the transfer is directly to proper beneficiaries of the charity.)

Otherwise, when an entity acts through an intermediary overseas, the charity must direct and control the use of its resources. The test of direction and control is whether charity is the one that “makes decisions and sets parameters on significant issues related to the activity”.²⁰ The CRA recommends adopting measures such as creating a written agreement, communicating a detailed description of the activity, monitoring and supervising the activity, segregating funds for agency relationships, and making periodic transfers of resources based on demonstrated performance.²¹

Charitable contribution credits—domestic entities

A charity that receives donations and funnels money without ‘direction or control’ to an organisation to which a Canadian taxpayer could not make a gift and acquire tax relief is a ‘conduit’, and this jeopardizes the charity’s registered status.

A charity cannot be registered solely to support the activities of a non-qualified donee.. However, if the non-qualified donee’s activities are at least partly charitable, the applicant could carry out the portion of charitable work and have the non-qualified donee act as an intermediary, subject to the ‘direction and control’ requirement. This requirement also applies even for branches of foreign organisations. The CRA accepts that charities with a head body which transfers small amounts (the lesser of 5% of the total expenditures or

²⁰ Guidance to help charities (and applicants for charitable status) with foreign activities comply with the Income Tax Act., Canada Revenue Agency, Government of Canada, *Canadian Registered Charities Carrying Out Activities Outside Canada* (8 July 2010) [7] <<http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/tsd-cnd-eng.html>>.

²¹ Ibid [7.1].

\$5,000) to a head body, and has access to internationally produced material, will not generally require further substantiation of benefits for the charity.

Charitable contribution credits—foreign entities

The tax legislation includes as part of its list of qualified donee prescribed universities outside Canada, the United Nations and its agencies, and certain charitable organisations outside Canada to which Her Majesty in right of Canada has made a gift. There are currently 13 entities on this [list](#).

Under new measures proposed in the 2012-2013 Budget, new requirements will apply to foreign charities that are the recipient of gifts from Her Majesty in right of Canada. It is proposed that foreign qualified donees will be restricted to organisations carrying on disaster relief activities, providing urgent humanitarian aid, or carrying on activities in the interests of Canada.

Terrorism

Under the *Charities Registration (Security Information) Act* and the *Income Tax Act*, A charity's status may be revoked if it operates in such a way as to make its resources available, either directly or indirectly, to **listed entity** as defined in subsection 83.01(1) of the *Criminal Code*; or to any other entity (person, group, trust, partnership, or fund, or an unincorporated association or organization) that engages in terrorist activities or activities in support of them. It is also subject to general anti-terrorist legislation.

Canada Revenue Agency has produced a [checklist](#) to help Canadian charities identify vulnerabilities to terrorist abuse. The checklist includes: awareness of the listed individual and entities and laws dealing with terrorism; understanding of the background and affiliations of those involved in the organisation; awareness of CRA guidance; understanding of oversight and verification controls; knowledge of sources and ultimate beneficiaries of resources; and written agreements with overseas operators.

NEW ZEALAND

Tax exemptions—Domestic entities and foreign activities

Non-business income is not subject to any geographical limitation. Business income must be carried on for charitable purposes “within New Zealand”, but if an organisation pursues only part of its purposes in New Zealand, the amount is apportioned between the domestic and foreign purposes, and that relating to foreign purposes is taxed. Importantly, however, the test turns upon where the charitable purposes are directed, *not* where the charity pursues its activities.²²

²² International Bureau of Fiscal Documentation, *The Tax Treatment of Cross-border Donations: Including the Tax Status of Charities and Foundations*. (International Bureau of Fiscal Documentation, 1994) 14.

Tax exemptions—Foreign entities

A 'tax charity' specifically includes an approved non-resident trust, society and institution carrying out its purposes outside New Zealand.²³ The Charities Commission will consider registration of a foreign entity if it has a strong connection with New Zealand, and otherwise fulfils the required criteria for registration. Other foreign entities may apply for tax exemption, for which Inland Revenue apply the following criteria:

- The organisation is not resident in New Zealand.
- The organisation is recognised as being charitable in its own home or domestic jurisdiction.
- The organisation's purposes are charitable under the tests for a charity, i.e.
 - for the relief of poverty,
 - for the advancement of education,
 - for the advancement of religion,
 - for any other matter beneficial to the community.
- The organisation provides a public benefit and does not apply its funds for private pecuniary profit.²⁴

Charitable contribution credit and deduction

New Zealand imposes geographical limitations in respect of charitable contributions. Tax credits (for individuals) and deductions (for companies) are available in respect of donations either to those listed in Schedule 32 of the *Income Tax Act 2007* (Cth) or if the entity fulfils one of the following criteria:

(a) 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, benevolent, philanthropic, or cultural purposes within New Zealand:

(b) a public institution maintained exclusively for any 1 or more of the purposes within New Zealand set out in paragraph (a):

(bb) a Board of Trustees that is constituted under Part 9 of the Education Act 1989 and is not carried on for the private pecuniary profit of any individual:

²³ *Income Tax Act 2007* (NZ) s CW 41(5)(c).

²⁴ *Guidelines for Non-resident Charities (Charitable Organisations)* (10 June 2011) Inland Revenue (New Zealand) <<http://www.ird.govt.nz/charitable-organisations/chart-orgs-non-res-charities/>>.

(bc) a tertiary education institution that is established under Part 14 of the Education Act 1989 and is not carried on for the private pecuniary profit of any individual:

(c) a fund established and maintained exclusively for the purpose of providing money for any 1 or more of the purposes within New Zealand set out in paragraph (a), by a society, institution, association, organisation, or trust that is not carried on for the private pecuniary profit of an individual:

(d) a public fund established and maintained exclusively for the purpose of providing money for any 1 or more of the purposes within New Zealand set out in paragraph (a).²⁵

Organisations may, however, set up funds for New Zealand purposes and receive tax deductions in respect of those.

UNITED KINGDOM

Tax exemptions—Domestic entities operating overseas

There is no limitation on domestic entities operating overseas. However, the Charity Commission for England and Wales (the Charity Commission) provides guidance on issues charities working internationally should consider.²⁶

Tax exemptions—Foreign entities

After the commencement of the *Finance Act 2010*, the United Kingdom enables the same tax reliefs applicable to charities in the United Kingdom to be applied to charitable entities established in EU states or in a ‘relevant territory’ (Iceland or Norway), to comply with European Union law.²⁷

Gift Aid—Domestic and foreign entities

Gift Aid is dependent upon the definition of ‘charity’, which is now consistently defined.²⁸ There are no additional geographical restrictions. As the Gift Aid system depends on the registration of a ‘charity’, other EU-resident entities can access Gift Aid if they meet the conditions for tax exemption but not entities in non-EU countries.

Terrorism

The Charity Commission has remained central to counter-terrorism, and has recently revised its [Counter-Terrorism Strategy](#). This takes a four-strand approach: building awareness of the

²⁵ *Income Tax Act 2007* (NZ), LD3.

²⁶ The Charity Commission for England and Wales, *Charities Working Internationally Index Page* <http://www.charitycommission.gov.uk/Charity_requirements_guidance/Your_charitys_activities/Working_internationally/Charities_working_internationally_index.aspx?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+CharityCommissionUpdates+%28Charity+Commission+updates%29>.

²⁷ *Finance Act 2010* (UK) Sch 6, Pt 1, it 2 (inserting a ‘jurisdiction condition’ on a consistent definition of charity for tax purposes).

²⁸ *Finance Act 2010* (UK) Sch 6, Pt 1, it 1.

risks, safeguards and governance processes in the sector; monitoring higher-risk activities and analyzing trends and profiles; co-operating with regulators domestically and internationally; and intervening robustly in certain cases. In the previous year, the Charity Commission investigated 16 terrorist cases. The Charity Commission also provides an [online toolkit](#) which provides guidance to trustees on managing the risks.

The Charity Commission's work in this space has been praised widely. Sidel notes that the

“British approach has, at least in part, relied on charity regulators as partners and, often but not always, ‘first responders’ in the anti-terrorist enterprise ... The Charity Commission ... has played a core role in investigating, resolving, and where necessary collaborating in prosecuting ties between charities, terrorism, and terrorist finance.”²⁹

He concludes:

The Charity Commission has played an exceptionally useful role in England in cooperation with police and security forces, bringing to bear a detailed knowledge of the sector and of individual charitable organizations based on years of reporting and experience. ... This maintenance of a central role for a charity regulator, combined with the intensive focus on a small number of organisations suspected of terrorist finance links, has arguably resulted in both better targeting and better information for British law enforcement than for some of its international counterparts.³⁰

UNITED STATES³¹

Income tax exemption—Foreign entities

Foreign charities are eligible for income tax exemption.³² However, few foreign charities apply because of the cost of legal expenses and reporting requirements, the limited amount of US-source income, and because recognition does not carry with it a right to receive deductible gifts.³³

Charitable contribution deduction—domestic entities and overseas activities

A domestic entity can use the funds to pursue activities overseas, and indeed all its employees, activities and assets can be overseas, without jeopardizing individuals' charitable contribution deduction for income tax.³⁴ However, contributions by corporations to charity

²⁹ Mark Sidel, *Regulation of the voluntary sector: freedom and security in an era of uncertainty* (Routledge, 2010) 36.

³⁰ Ibid 50.

³¹ For a detailed account, see Koele, *International Taxation of Philanthropy*, above n 4.

³² Internal Revenue Service, *Revenue Ruling 66-177* (No 1966-1 CB 132).

³³ Pozen, 'Remapping the Charitable Deduction' above n 8, 541, fn 41.

³⁴ *Bilingual Montessori School v Commissioner* 75 TC 480 (Tax Court, 1980).

are generally deductible only if the gift is to be used within the US or its possessions,³⁵ but the restriction does not apply where the recipient is itself a corporation.³⁶

Charitable contribution deduction—foreign entities

Individuals or corporations can access the charitable contribution deduction in respect of income tax only if the donee is “created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States.”³⁷

There are exceptions, however, under bilateral tax treaties for entities incorporated in Canada, Mexico, or Israel, to the extent that the donor has income from sources in that country.³⁸

There are ways in which this rule is tempered so international activity and philanthropy is not inhibited. First, as noted above, US charities can freely engage in activities abroad. Second, US charities can also re-donate received funds to foreign charities. However, corporate deductions are not available if the donee uses or sends the funds abroad, unless the donee is also a corporation.³⁹ Importantly, too, tax deductions are not available if the US entity is as a mere ‘conduit’, that is, where the US entity has no discretionary authority and must transmit earmarked funds to the foreign charity (as opposed to a right to review and approve grants to the foreign entity or where the foreign entity is a controlled subsidiary). The test is whether “the organisation has full control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out its functions and purposes”.⁴⁰ Tax deductibility may be available even where the entity gives funds only to a particular named entity (known as a ‘friends of’ organization).⁴¹

Gift and estate tax deductions

In respect of deductions for gift tax, there is no requirement that the donee be established in the US. However, the donee must be domestic and non-corporate donees must use the gift exclusively in the US.⁴² In respect of deductions for gift tax, there is also no requirement that the donee be established in the US, but charitable bequests by foreign donors to

³⁵ Internal Revenue Code sec 170(c)(2). This limitation does not apply to small business corporations.

³⁶ Bruce R Hopkins, *The Law of Tax-Exempt Organizations* (John Wiley & Sons Inc, 2007) 997.

³⁷ *Internal Revenue Code*, § 1.501(a) s 170(c)(2)(A).

³⁸ Koele, *International Taxation of Philanthropy*, above n 4, 146–148.

³⁹ Internal Revenue Service, *Revenue Ruling 69-180* (No 1969-1 CB 65). The exception for corporate donees has never been explained and is thought to be a drafting error: Pozen, ‘Remapping the Charitable Deduction’ above n 8, 241, fn 43.

⁴⁰ Internal Revenue Service *Revenue Ruling 66-79* (No 1966-1 CB 48, 51).

⁴¹ Internal Revenue Service, *Revenue Ruling 74-229* (No 1974-1 CB 142); Internal Revenue Service, *Revenue Ruling 66-79* (No 1966-1 CB 48,).

⁴² *Internal Revenue Code* US Code, , § 170 s 2522(b)(2)–(3).

trustees are limited to domestic use.⁴³ The gift must fall within the purposes of the US entity and the US entity must exercise ongoing scrutiny unless it can show that the foreign donee meets the terms of the income tax exemption section in the US Internal Revenue Code.

Anti-Terrorist Guidelines

The US Treasury has developed voluntary best practices for those engaging in foreign grant-making or operations.⁴⁴ These guidelines recommend maintaining and publishing a current list of branches, subsidiaries and/or affiliates receiving resources and services from the charity. In relation to supply of charitable resources, the charity is responsible for determining that the recipient has the ability to accomplish the charitable purpose and protect its resources from diversion to non-charitable purposes, including any activity that supports terrorism; should sign a written agreement as to the terms of the grant with the recipient; should commit to ongoing monitoring of the grantee and funded activities; and is responsible for correcting misuse of resources and terminating the relationship with the grantee. In relation to supply of charitable services, the guidelines require the charity to be responsible for adopting appropriate measures to reduce the risk its assets would be used for non-charitable activities, including any activity that supports terrorism, and impose sufficient auditing or accounting controls to trace services or commodities between delivery by the charity and/or service provider and use by the grantee. The guidelines suggest that charities should obtain certain information about the potential recipient before distributing funds or in-kind items, conduct 'basic vetting' of recipients and their key employees, and review financial and programmatic operations.

These Guidelines were revised after sector criticism of the original 2002 Treasury Guidelines concerned about the "potentially unachievable due diligence requirements".⁴⁵ As a result, sector representatives convened to develop an alternative framework, known as the '[Principles of International Charity](#)'. These Principles emphasise, inter alia, that charitable organisations, while they must comply with US and foreign laws, are "non-governmental entities that are not agents for enforcement of US or foreign laws or the policies reflected in them"; that the responsibility for observing laws and adopting and implementing practices "ultimately lies with the governing board"; that an "organisations commitment to the charitable use of its assets must be reflected on the part of the provider"; and that fiscal responsibility usually requires ensuring the recipient can achieve the charitable purpose and protect resources from diversion, creating a written agreement, ongoing monitoring of the

⁴³ Ibid s 2106(a)(2)(A)(ii).

⁴⁴ US Department of the Treasury, *Anti-Terrorist Financing Guidelines: Voluntary Best Practices for US.-Based Charities* (November 2005) <http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/guidelines_charities.pdf>.

⁴⁵ Sidel, *Regulation of the voluntary sector*, above n 50, 17.

recipient, and seeking correction of misuse of resources; and that charities must “safeguard its relationship with the communities it serves”.⁴⁶

EUROPE

The European Foundation Centre provides an excellent comparative resource of elegal regimes governing the tax exemption of public benefit entities.⁴⁷ Apart from extended country profiles, these include helpful comparative charts, from which we draw the following summary, together with the account given in Sabine Heidenbauer, *Charity Crossing Borders: The Fundamental Freedoms’ Influence on Charity and Donor Taxation in Europe* (Kluwer Law International, 2011). As discussed extensively there, European Union law has had a significant impact on the availability of tax reliefs across Europe.

Tax exemptions—Domestic entities and foreign activities

In the vast majority of European States, activities abroad do not put the tax-exempt status of a public benefit foundation at risk.⁴⁸ Austria is apparently an exception, although a fuller account reports that since January 1998, the “Austrian Federal Tax Code no longer confines attainment of charitable purposes to Ausrian territory – the charitable entity is free to unfold its purposes abroad without losing its charitable status.” Previously, the entity was required to carry out “exclusively and directly the fulfillment of those stated purposes mainly in Austria, unless the purpose pursued is to aid the Third World.”⁴⁹

Germany requires that the exemption must advance idnviduals with their domicile or habitual abode in Germany, or that the activites of the entity may contribute to the reputation of the Federal Republic of Germany.⁵⁰ The situation in Latvia is unclear, with some suggestion that it would be difficult to obtain public benefit status if all activities were performed abroad.⁵¹

In Portugal, the notion of a legal entity of public utility depends upon the entity pursuing aims of general interest for domestic benefit within a national or local scope.

⁴⁶ See generally Sharon P Light, ‘The Principles of International Charity: An Effective Alternative to the Voluntary Guidelines’ (2005) 72 *International Dateline* <http://www.cof.org/files/Documents/Newsletters/InternationalDateline/2005/legaldimension_Sharonlight.pdf>.

⁴⁷ Heidenbauer, *Charity Crossing Borders*, above n 6, 42, fn 177.

⁴⁸ The States to which this applies include: Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, Greece, Hungary, Ireland, Italy, Lithuania, Luxembourg, the Netherlands, Poland, Romaia, Slovakia, Slovenia, Spain, Sweden, United Kingdom, Switzerland, Turkey and the Ukraine.

⁴⁹ International Bureau of Fiscal Documentation, *The Tax Treatment of Cross-border Donations*, above n 22, 5.

⁵⁰ Heidenbauer, *Charity Crossing Borders*, above n 6, 42–43.

⁵¹ Ibid 43. However, the European Foundation Centre says it does not jeopardise the status, but the exemption does not apply to activities abroad.

Tax exemptions—Foreign entities

In relation to the tax treatment of foreign-based foundations, the picture is more mixed. In eight countries, foreign-based foundations are not entitled to similar tax benefits.⁵² In other countries, registration under domestic law or a local branch is required.⁵³ In some cases, this is available only to other EU or EEA states,⁵⁴ or is based on reciprocity.⁵⁵ In other cases, they are entitled to exemption if they pursue similar purposes to those already exempt.⁵⁶ In only two cases, Germany⁵⁷ and France, is there a requirement to have a public benefit purpose in the domestic State.

In Belgium, foreign charities are subject to non-resident tax to the extent they have Belgian sourced income. As Belgian charities cannot pursue profit-making activities without losing tax-exempt status, a foreign entity's taxable base would largely correspond with that of domestic charities.⁵⁸

Charitable contribution deduction—domestic entities

GERMANY

Charitable deductions are available to a German philanthropic organisation, even if it pursues all of its objectives abroad. The organisation may have its seat of management elsewhere, as long as it is incorporated in Germany.⁵⁹ The organisation must, however, specify the amount of the donation it will expend abroad and whether this expenditure will be through activities conducted directly or through supporting other organisations.⁶⁰

Donations to German feeder organizations are tax deductible if certain requirements are met, including: 1) the governing documents must include a purpose of distribution to foreign philanthropic organisations; 2) for certain entities, specification of the receiving entity; 3) the receiving entity must be a corporation and provide translated organizational

⁵² Latvia; Lithuania; Luxembourg; Malta; Romania; Slovenia; Turkey; the Ukraine. However, Lithuania is also reported to allow tax exemptions in relation to entities with a permanent presence in the country: Ibid 44. Further, in practice Malta appears to apply a permanent presence requirement: Ibid 45.

⁵³ Estonia; Finland; Slovakia; Spain. Cyprus, Hungary and Poland also apparently require approval and the activities must be pursued through a branch: Heidenbauer, *Charity Crossing Borders*, above n 6, 44–45.

⁵⁴ Bulgaria; the Czech Republic; the United Kingdom; and Ireland (subject to a waiting period). However, in respect of Bulgaria, it is also reported that if there is a branch with permanent presence this is entitled to equivalent tax status: Ibid 44. .

⁵⁵ Greece.

⁵⁶ Austria; Belgium; Denmark; the Netherlands; Poland; Sweden; the United Kingdom; Switzerland. However, entities resident in non-EU/EEA countries are only granted preferential treatment if the charitable purposes are pursued on Austrian territory: Heidenbauer, *Charity Crossing Borders*, above n 6, 47.

⁵⁷ However, this requirement is not referred to in other accounts, which state that Germany restricts tax benefits to EU or EEA resident foundations: Ibid 47–48.

⁵⁸ Ibid 43.

⁵⁹ Koele, *International Taxation of Philanthropy*, above n 4, 201.

⁶⁰ Ibid 200.

documents; and 4) there must be proof that the foreign corporation engages in activities that would have been exempt from tax if that corporation were resident in Germany.⁶¹

THE NETHERLANDS

Donations are deductible to Dutch organisations even where the public benefit is to serve a foreign population and to advance a cause not necessarily approved of by the Dutch, provided it did not support violence.⁶² This is subject to proof that it is pursuing exempt purposes, but there is no specification of how this is to be proved.⁶³

However, the definition of 'gift' means that if the Dutch entity acts merely as a conduit for an earmarked international purpose, then it is arguable that no gift has occurred.⁶⁴

Charitable contribution deduction—foreign entities

In relation to tax deductible donations, 10 European countries do not allow donations to foreign-based public-benefit organisations.⁶⁵ In most of the other countries, donations are allowed to EU/EEA resident foundations,⁶⁶ but there are generally rules requiring the receiving organisation to be recognized or registered,⁶⁷ 'comparable' to domestic organisations,⁶⁸ prove entitlement,⁶⁹ or meet certain conditions.⁷⁰ In Austria, donations to EU/EEA resident foundations are deductible except in certain areas such as research and education, and are more widely available in relation to disaster relief.⁷¹ In Slovakia and Sweden, there is no local incentive for giving, so there is no discrimination.

⁶¹ Ibid 202.

⁶² Ibid 267–268.

⁶³ Ibid 272.

⁶⁴ Ibid 272–273.

⁶⁵ The countries that do not include: Cyprus, Hungary, Lithuania, Malta, Portugal, Romania, Spain, Switzerland, Turkey, Ukraine. Lithuania however allows deductions for subsidiaries and in a prescribed list: Heidenbauer, *Charity Crossing Borders*, above n 19, 88. In relation to Malta, this is the consequence of donations only being allowed to specifically named entities, which are all domestic, but other domestic entities are not entitled to such relief: Ibid 88.

⁶⁶ Ireland extends its deductibility to Switzerland as well. The Netherlands allows donations also to Dutch overseas and territories, an other country exchanging information with the Netherlands or elsewhere where the entity has been endorsed by the competent Minister: Heidenbauer, *Charity Crossing Borders*, above n 6, 90.

⁶⁷ The Czech Republic; Denmark; Finland; Ireland; the Netherlands; the United Kingdom.

⁶⁸ Belgium; Estonia; the United Kingdom.

⁶⁹ Bulgaria; Germany; Luxembourg; Poland; Slovenia.

⁷⁰ Austria; Germany; the Netherlands.

⁷¹ Heidenbauer, *Charity Crossing Borders*, above n 6, 89.