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"Deregistered charities"
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Clarifying the tax consequences for deregistered charities

The Law Society appreciates the opportunity to comment on the Officials' Issues Paper, *Clarifying the tax consequences for deregistered charities, July 2013* (Issues Paper).

General comments

As a general comment, the Law Society shares the concern of the Inland Revenue Department (IRD) that the current law does not adequately deal with the full range of tax consequences facing deregistered charities. The policy intention of the proposed changes is to clarify through legislation how the tax rules should apply to deregistered charities including the practical implications of establishing values of depreciable property or consideration for financial arrangements held by a deregistered charity. We agree that this is a logical starting point.

This submission focuses on IRD's suggested solutions to clarify the tax laws, but also, where the suggested solutions may not result in the appropriate outcome for deregistered charities, suggests alternatives.

Overview of the Issues Paper

The Issues Paper seeks submissions on proposals to deal with the complexity and range of the potential tax consequences that could face deregistered charities. Those proposals are both legislative and operational and required co-operation between IRD and Charities Services (CS).

Tax concessions

The Issues Paper identifies that charities are entitled to charities-related tax concessions for:

(a) Income tax: an entity is tax exempt under sections CW 41 and CW 42 of the Income Tax Act 2007 (ITA). Those sections require that an entity must be either a charitable trust or an entity established and maintained exclusively for charitable purposes, and it must also be a "tax charity". To be a tax charity, the entity or trust must be registered under the Charities Act 2005 (CA).

(b) Fringe benefit tax: to receive FBT concessions, an entity must meet the definition of "charitable organisation", which in short means an entity not carried on for private pecuniary profit and whose funds are applied wholly or mainly to charitable, benevolent, philanthropic or cultural purposes in New Zealand. It does not rely on registration under the CA to obtain the FBT concession.

(c) Recognition as a "donee organisation" for the purposes of the donation tax relief provision (where donors to a registered charity are eligible to receive certain tax credits on their donations). A donee organisation must meet the same definition of "charitable organisation" as for the FBT concessions.

Deregistration

The Issues Paper identifies the scenarios under which a charity can be deregistered:

(a) It no longer qualifies for registration under the CA because it fails to meet any one of the requirements of registration;

(b) There has been a significant or persistent failure to comply with its obligations under the CA, such as failing to notify changes to the Charities Unit, provide annual returns, or to assist CS when it asks for information;

(c) There has been a significant or persistent failure by one or more of the entity's officers to meet their obligations under the CA, such as those identified in (b);

(d) It has engaged in serious wrongdoing, such as an unlawful or corrupt use of the entity's funds or resources; and

(e) It has requested to be deregistered.

Timing

The Issues Paper also identifies an issue with the timing of deregistration. CS is unable to deregister a charity retrospectively. However, there are situations in which an entity that was treated as charitable for tax purposes has subsequently been revealed to have never been charitable, or to have lost its charitable purpose prior to deregistration. In that event, IRD is, in some instances, able to retrospectively assess an entity for tax.

The Law Society considers that the Issues Paper correctly identifies and describes these matters and issues.

Current position

Currently, if a charitable entity is deregistered, the resulting tax consequences are unclear. Section HC 31 of the ITA provides transitional tax rules for charitable trusts that cease to be registered. That section includes rules for establishing the opening values for depreciable property and financial arrangements. However, those rules do not cover charitable entities other than trusts, and do not apply when a charity is deregistered and treated retrospectively as never having been exempt from income tax.

There are also no rules or guidelines for entities that can no longer rely on FBT or donee organisation concessions when they are no longer able to meet the definition of "charitable organisation".

The Issues Paper proposes a mixture of responses to deal with the tax consequences of deregistration depending on the reason for and timing of deregistration. The next part of this submission outlines IRD's proposals and comments accordingly.

Income tax

The Issues Paper proposes in the first instance to enact a new section similar to HC 31 that outlines the transitional tax rules for entities that are not trusts and have been deregistered as a charity. The Law Society considers that to be an appropriate response.

However, section HC 31 does not deal with the situation where a trust is deregistered, but is also found to have never in fact had a charitable purpose. In that instance, section HC 31 would not apply. That raises practical difficulties for establishing the opening values for depreciable property and financial arrangements, but also fairness issues in situations where the entity relied on official advice from IRD or CS.

The Law Society agrees in principle that where a charity was found not to have a charitable purpose, it should be assessed retrospectively. However, we consider that IRD should draft guidelines as to the tax treatment of entities that are found never to have had a charitable purpose. Those guidelines should apply where an entity is deregistered, whether through an investigation by CS, the Courts, or voluntarily.

Those guidelines should cover how and if the Commissioner will exercise her discretion not to reassess entities where:

(a) The entity misinterpreted its purpose as charitable when it in fact was not;

(b) The entity misled IRD and CS as to its charitable purpose; and

(c) The entity received incorrect advice from IRD or CS as to its charitable status. In that situation we consider that the Commissioner should not normally assess an entity retrospectively, although we accept that it depends on the circumstances.

In relation to (c), the Law Society considers that section HC 31 and any new sections for other entities that are deregistered should apply in situations where IRD decides not to assess an entity retrospectively where it has relied upon incorrect advice from IRD or CS as to its charitable status.

Fringe benefit tax

An entity does not have to be a registered tax charity for it to claim FBT concessions. Therefore deregistration is not an issue. Rather the issue is whether the charity ever actually met the requirements for the FBT concessions, or has ceased to do so at some prior time. The Issues Paper does not discuss retrospectively removing the concessions.

The Issues Paper does discuss the implications for FBT where a charity has been deregistered because it has engaged in "serious wrongdoing" as defined in the Charities Act. That might be through the unlawful or corrupt use of funds, or causing serious risk to public interest. The Issues Paper suggests that in such a case the law could be changed to allow IRD to revoke the FBT concessions under the FBT regime and apply the penalties regime under the TAA.

The Law Society broadly accepts that approach, however, considers that there should be clear parameters around IRD's ability to revoke concessions. IRD is only able to revoke FBT concessions if the entity no longer meets the requirements of the concessions in section CX 25. A charity may have been engaged in serious wrongdoing, however that will not automatically preclude it from being defined as a charitable organisation. On that basis, it would still be entitled to FBT concessions. The suggestion that concessions could be revoked, as referred to above, needs to be made clearer if that is intended and specific amendments to the penalty regime are likely to be required.

Donee organisations

Similarly, an entity does not have to be a registered charity to be a donee organisation. The Issues Paper states that IRD should continue to have discretion over whether to reverse donation claims upon deregistration. The Law Society considers that it is appropriate for IRD to continue its role of approving donee status and deciding whether it will reverse claims. However, there should be clear guidelines for the exercise of those powers by IRD, including about how that approval is made where the organisation is deregistered

because of incorrect advice given to the entity by IRD or CS. That is important in this instance because the impact of reversing claims is not on the organisation, but rather on the taxpayer making the donation.

To ensure that a bona fide donor is not penalised by having its donation credits reversed due to the charity receiving incorrect advice from IRD or CS, or through poor administration by the charitable entity, there should be a general "good faith" exemption whereby that bona fide donor is exempt from a tax liability arising from reversed donation claims. Clearly the question of good faith will be one of fact and degree and will depend upon a consideration of the conditions surrounding the donation; however the Law Society considers that such an exemption is appropriate. Tax liabilities arising from accumulated good faith donations when a charity is de-registered ought to be dealt with at the charity level, not through reversing donation claims. This point is covered further below under "Accumulated income".

Periods of non-registration

The Issues Paper raises the issue of entities that have been deregistered but subsequently re-registered. Under current tax law the deregistered entity is required to file tax returns for the periods of non-registration. The Issues Paper rightly says that this requirement gives rise to compliance costs for deregistered charities and IRD.

The Law Society considers that entities that have been deregistered but continue to carry on their charitable activity, and are then subsequently re-registered, should, in most cases be deemed never to have been de-registered.

We accept that there are situations where that treatment is inappropriate, for example, where an entity was deregistered for engaging in activity amounting to serious wrongdoing. However, where de-registration is for a more minor matter of non-compliance, is addressed within a reasonable time, the entity meets the criteria to be re-registered, and continuity of genuinely charitable activity can be established, the registration ought to be back-dated to cover any period of de-registration. The Law Society suggests that a correction addressed within say 6 months of de-registration should preserve the organisation's charitable continuity.

Accumulated income

The Issues Paper identifies an issue relating to the application of an entity's accumulated assets once it has been deregistered. Under the current law, there is no requirement for a deregistered charity to apply its accumulated income and assets to a charitable purpose. It can distribute tax free. Whether it must do so to another charity will depend on the terms of its constitutional document(s) and the preparedness of the charity's officers to abide by them. Most charitable trust deeds provide for the way that assets and income must be distributed when the charity is wound up but that does not cover the position where the entity has been deregistered but continues. Conceivably in that case the objects of the entity could be changed (once the constraints of registration have gone) and distributions made to non charitable objects or beneficiaries.

This involves difficult issues including the extent to which the tax law should reflect and take account of the ability of the Charities Division to police such distributions and the ultimate role of the Attorney-General in protecting the interests of charity. The Issues Paper requests submissions on what the appropriate treatment should be.

Some countries have dealt with this issue by requiring deregistered charities to apply their accumulated "charitable income and assets" to charitable purposes or be subject to income tax on them, or require the deregistered charity to transfer the assets to another charity.

The Law Society does not consider that it is appropriate to subject deregistered charities to a tax impost on funds already distributed. That is because in many cases the entity may not have available resources to meet such tax liabilities and its assets may not be in cash form. On that basis, we consider it is more appropriate

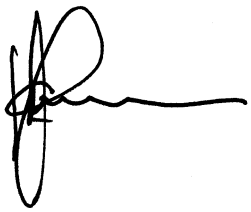
that a deregistered entity be required to apply its accumulated charitable funds to another charity or be taxed on the accumulated revenue. Where the constitutional document of the entity does not stipulate this or such treatment is not followed, the law should provide an "override" that requires one of these two outcomes. Taxation at this stage would provide an adequate "claw-back" against past donor rebates/deductions without adversely affecting the good faith donor. A time limit would be needed within which the charity should distribute the funds, or be subject to tax. That limit would need to be set having regard to instances where an entity that has been deregistered is able to work towards re-registration. In that case it should be able to hold its accumulated funds in anticipation of regaining charitable status.

Conclusion

This submission was prepared with assistance from the Law Society's Tax Law Committee.

If you wish to discuss this further please do not hesitate to contact the committee convenor Casey Plunket, through the committee secretary Rhyn Visser (04 463 2962, rhyn.visser@lawsociety.org.nz).

Yours sincerely



Chris Moore
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