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# Charities Alert

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## The Hunger Project – the most significant case ever on what is a PBI?

The Federal Court decision in *The Hunger Project Australia v* FC of T 2013 ATC 20-399 is probably the most significant decision ever in the context of determining what is a "public benevolent institution" (**PBI**). It was decided in favour of the taxpayer, is currently on appeal to the Full Federal Court and will probably make its way to the High Court. If the Commissioner of Taxation is ultimately unsuccessful, the government will most likely change the law.

### Introduction

The key issue that the court (Perram J) had to consider was whether an institution must provide services directly to those in need to be a PBI, or whether an institution that supports other institutions that provide the services can itself be a PBI. The Commissioner's view has been clear for a long time. Except in one limited circumstance (discussed below), the Commissioner has considered that a PBI must provide direct relief to persons in need (the "directness test"). See, for example, Taxation Ruling TR 2003/5 paragraphs 7, 61-62. The court in the Hunger Project determined that this was incorrect.

The importance of the case can be appreciated by considering the tax benefits that apply to PBIs. Very broadly, PBIs are deductible gift recipients (ie generally gifts to PBIs are tax deductible) and they are exempt from FBT (subject to relevant caps). Neither of these concessions generally applies to charitable institutions that are not PBIs (unless another specific concession applies).

So, the Treasury and/or the Australian Taxation Office will be carefully considering the potential financial cost of this decision.

### The Facts

Very broadly, the facts in Hunger Project were as follows.

- The taxpayer was a company limited by guarantee incorporated in NSW.
- Its constitution provided that its exclusive object included the relief of poverty etc with an emphasis on directly aiding persons suffering from chronic and persistent hunger.
- Other objects that existed solely for carrying out the exclusive object included soliciting donations and raising funds.
- It was part of a worldwide collaboration of organisations under the name "The Hunger Project".
- The taxpayer's role was essentially to raise funds to provide to other organisations that provided aid directly to those in need in developing countries.
- To a lesser extent it provided strategic guidance to other organisations.
- Its direct charitable activities were negligible.

### The decision

Perram J held that it was not a requirement that a PBI engage directly in the activities making up the object of its benevolence. Accordingly, as the taxpayer's benevolent objects were not merely abstract and its principal object of relieving hunger was achieved through its close relationships with the Hunger Project entities in other countries, it was a PBI.

There are two key aspects of the decision that are important to appreciate. These are:

- Why didn't Perram J consider that he was bound to follow cases that indicated that a PBI had to provide relief directly to those in need?
- Considering himself not so bound, why did he decide that the taxpayer was a PBI?

## Why wasn't the court bound by earlier decisions?

Very broadly, Perram J's reasoning was as follows:

- The expression "public benevolent institution" was first considered by the High Court in *Perpetual Trustee Co v* FC of T (1931) 45 CLR 224 (**Perpetual Trustee**):
  - the issue was whether an institution known as the Royal Naval House was a PBI.
  - The Royal Naval House was used to provide accommodation and recreational facilities to Navy personnel.
  - The High Court held that the Royal Naval House was not a PBI, because its activities were not benevolent (eg it did not provide relief to those in need); the issue of directness did not arise.
  - Only McTiernan J suggested that direct relief must be provided.
- In *Australian Council of Social Service Inc v Commissioner of Pay-roll Tax (NSW)* 82 ATC 4385 (**ACOSS**):
  - Rath J interpreted the decision in Perpetual Trustee to mean that an institution claiming the character of a PBI must itself dispense relief to the needy, and that it is the organisation of aid in a direct and immediate sense that is contemplated.
  - As the taxpayer in ACOSS did not provide direct relief, but rather its activities involved indirect aid such as providing advice, information, research and advocacy, Rath J held that it was not a PBI.
  - On appeal in *Australian Council of Social Services Inc v Commissioner of Pay-roll Tax* 85 ATC *4235*, Priestley JA (Mahoney JA agreeing) found against the taxpayer, so confirming the decision. However, Priestly JA did not base his decision on the directness aspect. In fact he said that there might be some force in the argument that a PBI did not have to provide services directly to those in need. However, a PBI would not include an institution, which although concerned, in an abstract sense, with the relief of poverty and distress, manifests that concern by promotion of social welfare in the community generally. So, he held that the taxpayer was not a PBI.
  - Street CJ was the other judge in the appeal in ACOSS. He considered that a PBI must provide its aid directly to those in need. Perram J criticised his reasoning.
- In the AAT decision of *Re Melbourne Western Region Commission Incorporated v Commissioner of Taxation* [1991] AATA 49 the AAT noted the potential differences between the approaches of Street CJ and Priestly JA in ACOSS, but did apply the directness test. Perram J considered that this case assisted the Commissioner.
- Perram J referred to other cases, but in those cases the decisions did not depend upon the directness test being applied.

So, Perram J's conclusion was that only Street CJ and Rath J in ACOSS directly decided that the directness test applied, and the AAT had applied the approach of Street CJ. However, he considered that Rath J's approach in ACOSS was not applied by the majority on appeal, and the majority on appeal in ACOSS avoided the issue and doubted the existence of the directness test. He considered other judges had avoided the issue factually by concluding that in the case before them the directness test was satisfied. In view of this he considered that he was not bound in any particular direction.

## Why did the court decide that the taxpayer in Hunger Project was a PBI?

Very broadly, Perram J's reasoning was as follows:

- The taxpayer's objects were not abstract and were sufficiently concrete. So it complied with the reasoning of the majority in the appeal in ACOSS.
- The High Court in *FC of T v Word Investments Ltd* 2008 ATC 20-072 held that an institution could be charitable even if it were a fundraising entity.
- The court in Word Investments observed that a consequence of the Commissioner's argument was that a charitable institution that had two divisions, one engaged in charitable activities and the other in fundraising, would be exempt, but if it were split into two organisations then the fundraising entity would

lose its exempt status. The court said that this distinction was not sound.

- Perram J considered that this logic applied equally if a PBI lost exempt status for its fundraising activities by doing the same thing.

## Australian Council of Overseas Aid case

Perram J did not refer to *Australian Council for Overseas Aid v FC of T* 80 ATC 4575 (**ACOA**), even though this case seems to provide strong support for his view.

In ACOA the taxpayer was set up as a co-ordinating and educating agency by other institutions. The other institutions were members of the taxpayer. The members were predominantly givers of aid to poor persons overseas and so were PBIs. Where some members were not PBIs, it was accepted that the taxpayer serviced them only in respect of their activities which were involved in aid for poor people overseas. The taxpayer did not provide services to the poor directly.

Connor ACJ determined in ACOA that the taxpayer was a PBI. He referred to the comments of Dixon J and Starke J in Perpetual Trustee and concluded that a PBI did not have to provide direct services. He considered that the taxpayer only served its members, and that "the taxpayer and its members should be looked at as a whole enterprise which is predominantly benevolent and of which the taxpayer is an integral part"; providing one of a number of steps in the benevolent process was sufficient for it to be a PBI.

The court considered ACOA in ACOSS. In ACOSS, Priestly JA (Mahoney JA agreeing) held that, even if the proposition in ACOA was correct, the taxpayer in ACOSS would still fail that test because the activities of the taxpayer in ACOSS were too general.

Street CJ in ACOSS doubted the correctness of the decision in ACOA. However, as discussed above, Perram J in Hunger Project criticised Street CJ's reasoning in ACOA.

The Commissioner in TR 2003/5 referred to ACOA and noted that doubt had been cast on the correctness of the decision (paragraph 64). While he accepted the case, he indicated that he would only apply it in very similar circumstances; it would be essential that the taxpayer's members be predominantly PBIs (paragraph 65). In our view, there is nothing that indicates that this was an essential part of the decision in ACOA.

The effect of the Commissioner's view is that if a PBI establishes a subsidiary company and that company only provides essential services to the PBI, then the subsidiary will be a PBI. However, if a subsidiary company is established that provides benefits directly to those in need, the subsidiary would be a PBI but the holding company would not , even if it only provides essential services to its subsidiary. We consider that such a result is contrary to the decisions in ACOA and Hunger Project.

## Possible arguments against Perram J's decision

It is clear that the Commissioner has for a long time considered that, except in the limited circumstances of the ACOA decision, a PBI must provide services directly to those in need. Indeed, in the Hunger Project one of the arguments for the Commissioner was that the explanatory memorandum to an FBT amendment stated that generally, a PBI gives aid directly to those in need. Perram J stated that the explanatory memorandum was wrong to the extent that it suggested that a PBI must provide services directly to those in need. However, the explanatory memorandum clearly represented the Commissioner's view.

The Commissioner has appealed the decision in Hunger Project. With respect, our view on the potential arguments that the Commissioner may raise are as follows:

- It seems to us that there is nothing in the decided cases that would indicate that the Federal Court is bound to determine that a PBI must provide aid directly to those in need. We consider that the cases overall show that this is not a necessary condition.
- Word Investments was determined in a very different context (ie it considered what is a "charitable institution", not what is a "PBI"). Perram J referred to the affront the law would cause if a charitable institution might lose its exempt status for its fundraising activities if they were devolved into a separate entity, and he could not "see why it would be less affronted if a PBI lost exempt status for its fundraising activities by doing the same thing". However, the taxpayer in Hunger Project would not have lost its income tax exempt status, and it seems from that passage that is the exemption being referred to (though it could have been referring to FBT exempt status).
- If an entity does not need to provide aid directly, where would be the dividing line? What would be the outer limits on what could be a PBI? For example if a law firm were established as a company limited by guarantee and had as its object the provision of funds to PBIs, would the law firm be a PBI and so it could be funded with tax deductible gifts and it could provide

FBT exempt benefits to employees (subject to the caps)?

## Consequences of Perram J's decision

Perram J's decision has potentially wide-ranging consequences, possibly expanding significantly the meaning of PBI (at least from what the Commissioner considered to be the meaning).

It seems to us that in the context of PBIs established as groups of companies limited by guarantee, the result is clearly appropriate.

Under the Commissioner's view, if one company provides health care services and also owns property to use in its activities and raises funds, it would be a PBI.

However, if that company restructured so that there were a holding company, separate operating companies for each facility, a separate land owning company and a separate fundraising company, the Commissioner's view would be that none of the holding, land owning or fundraising companies could be PBIs. The effect would be, for example, that the FBT exemption for staff employed by these companies would not apply, and the group could not seek donations to extend an existing health care facility as it would be owned by the land owning company.

We consider that such a view would be incorrect in law and both the ACOA and the Hunger Project decisions confirm this.

We also consider that if the Commissioner eventually loses on appeal, the government should not amend the law to provide that a PBI must provide aid directly to those in need. At the very least, it should cater for entities that work together, even if some of the entities do not provide aid directly, and even if they are not part of a formal corporate group.

Of course, the government's proposed changes to the law in relation to the taxation of certain commercial activities of charities needs to be taken into account by PBIs (including any institutions that now may wish to rely on the apparent expansion of what is a PBI).

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# The Cancer and Bowel Research Trust case - important implications for DGRs and their trustees

In *Cancer and Bowel Research Association Incorporated as trustee for Cancer and Bowel Research Trust v FC of T* 2013 ATC 10-316 (**the Cancer and Bowel Research Trust case**), the Administrative Appeals Tribunal (**AAT**) held that a deductible gift recipient (**DGR**)'s endorsement should be revoked on the basis that its trust deed did not comply with the legislative requirement to provide that at the first occurrence of the winding up of the entity or the revocation of the entity's DGR endorsement, the entity is required to transfer its surplus assets to a fund, authority or institution which is endorsed as a DGR.

## The Facts

Very broadly, the facts in the Cancer and Bowel Research Trust case were:

- By a deed dated 20 February 1998, the Cancer and Bowel Research Trust (**Trust**) was established with the Cancer and Bowel Research Association Incorporated as trustee (**Applicant**).
- The Trust was treated as a DGR from 20 February 1998 to 30 June 2000 under s 78(5) of the *Income Tax Assessment Act 1936* (**ITAA 1936**).
- On 19 May 2000, the Applicant applied for an exemption from income tax, and was granted that exemption.
- The Commissioner later issued formal endorsements effective from 1 July 2000. The DGR endorsement referred to item 2 of the table in s 30-15 of the *Income Tax Assessment Act 1997* (**ITAA 1997**). The income tax exempt charity status endorsement referred to item 1.1 (charitable institution) in s 50-5 of ITAA 1997 (as Item 1.1 stood at the relevant time).
- By a letter dated 1 April 2005 from the Commissioner to the Applicant, the Applicant had been endorsed to access charity tax concessions in its own right, from 1 December 2002. These concessions included an exemption from income tax as a charitable institution under s 50-5 of ITAA 1997 and, from 1 July 2005, GST concessions and an FBT exemption.
- On 8 February 2011, the trust deed was amended via an amending deed between the settlor and the

Applicant. It amended the trust deed in several material ways, including in relation to how any surplus should be distributed on any winding-up or loss of DGR status.

- By a letter dated 16 February 2012, the Commissioner revoked the endorsements of the Applicant as a DGR and as a charitable institution, and as exempt from income tax, FBT and GST. The revocation was effective retrospectively from 1 July 2000.
- The Applicant objected to the revocation, but the Commissioner disallowed the objection.

## The issues

The relevant issues included:

- whether the Applicant was entitled to be endorsed as a DGR as at 16 February 2012, being the date of the Commissioner's decision to revoke its endorsement as a DGR, and
- should any revocation of the endorsements granted to the Applicant take effect from 1 July 2000, or some other and what date.

## Legislative requirements

Subsection 30-125(1) of ITAA 1997 sets out the conditions for an entity to be entitled to be endorsed as a DGR.

One of these conditions is that the entity must comply with s 30-125(6):

> ***Transfer of assets from fund, authority or institution***
>
> ***S 30-125(6)*** *A law (outside this Subdivision), a document constituting the entity or rules governing the entity's activities must require the entity, at the first occurrence of an event described in subsection (7), to transfer to a fund, authority or institution gifts to which can be deducted under this Division:*
>
> *(a) any surplus assets of the gift fund (see section 30-130); or*
>
> *(b) if the entity is not required by this section to meet the requirements of section 30-130 – any surplus:*
>
> *(i) gifts of money or property for the principal purpose of the fund, authority or institution; and*
>
> *(ii) contributions described in item 7 or 8 of the table in section 30-15 in relation to a *fund-raising event held for that purpose; and*
>
> *(iii) money received by the entity because of such gifts or contributions.*
>
> ***S 30-125(7)*** *The events are:*
>
> *(a) the winding up of the fund, authority or institution; and*
>
> *(b) if the entity is endorsed because of a fund, authority or institution – the revocation of the entity's endorsement under this Subdivision relating to the fund, authority or institution.*

## Decision

The AAT affirmed the Commissioner's objection decision on revocation of the endorsement of the Applicant as a DGR.

The AAT considered that the trust deed did not satisfy the requirements for endorsement, ie it did not comply with the requirements in s 30-125(6).

Clause 6.1 of the amended trust deed did not require any surplus assets to be transferred to another fund, authority or institution endorsed as a DGR, in the event that the Trust's endorsement as a DGR was revoked.

Accordingly, the AAT found that the amended trust deed did not satisfy the requirements in s 30-125(6). Also, the AAT found that the winding up clause in the original trust deed had a similar omission. On this basis, the AAT considered that the revocation of DGR endorsement should take effect on and from 1 July 2000.

The AAT remitted the objection decision to the Commissioner to further consider whether the Applicant was entitled to be endorsed as an entity exempt from income tax, and as a charitable institution for GST and FBT purposes, and whether the Applicant was entitled to endorsement as a health promotion charity.

The Commissioner has appealed to the Federal Court against the AAT decision.

## Compliance with legislative requirements

The AAT held that it was appropriate for the Commissioner to revoke the DGR status of the Trust with retrospective effect from 1 July 2000, because its trust deed did not comply with s30-125(6).

This shows that for any entity wishing to be endorsed as a DGR or wishing to maintain its DGR endorsement, it would be important for its legal constituent documents (eg the constitution of a company, and trust deed of a trust) to comply with s 30-125(6). That is, the document must require the entity, at the first occurrence of the winding up of the entity or the revocation of the entity's DGR endorsement, to transfer its surplus assets to a fund, authority or institution which is endorsed as a DGR.

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## Retrospective amendments to the trust deed

The AAT also commented that the amending deed could not retrospectively vary the terms of the trusts created by the original trust deed, and that by virtue of the general trust law, the amending deed could only operate from the date when it was made. However, the AAT did not discuss relevant cases.

For example, the AAT did not refer to the decision of the Supreme Court of Western Australia in *Gra-ham Australia Pty Ltd v Perpetual Trustees WA Limited and Others* (1989) 1 WAR 65 (**Gra-ham Australia**). This case is relevant to the issue of whether retrospective amendments to trust deeds could be valid, because the court held that whether a retrospective amendment of a trust deed was within power and lawful was a matter of construction of the relevant instrument.

In *Gra-ham Australia*, the trust deed of a unit trust provided that unitholders may redeem their units by requesting the manager to repurchase all or any of their units. The price was calculated by the current realisation value method. That is, the calculation was based on the value of the unit as at the date at least seven days before the request was made.

Due to the collapse of the stock market in October 1987, the value of the investments comprised in the fund fell dramatically. The manager of the fund was requested by unitholders to repurchase the units held by them.

Unitholders then passed amendments to the trust deed to effectively substitute the current realisation value of units required to be repurchased under the deed. Instead of using the current realisation value method to calculate the price, the units were to be repurchased at their value on the day the request was received by the manager. The amendments were given effect by a supplemental deed.

The Supreme Court held that the supplemental deed was valid and that whether a retrospective amendment was within power and lawful was a matter of construction of the relevant instrument. This was notwithstanding the fact that the clause in the trust deed which conferred the power of amendment did not expressly deal with retrospective amendments.

The principle in *Gra-Ham Australia* that whether a retrospective amendment of a trust deed is within power and lawful is a matter of construction of the relevant instrument was also referred to in Young CJ's decision in *Global Custodians Ltd v Mesh* [2002] NSWSC 47.

Young CJ qualified the principle by stating that if a trust deed is drafted in a sufficiently wide way, a retrospective amendment will be valid, but this is subject to the principle that the exercise of a power of amendment cannot affect any vesting which has already taken place. The reason given by Young CJ was that the power to amend the trusts is itself an interest in the trust, and its exercise cannot affect an already vested interest.

Accordingly, it seems to us that it cannot be simply accepted, without an appropriate analysis of the deed and relevant circumstances, that an amendment cannot be retrospective.

## Retrospective revocation of endorsements

The AAT also considered the power of the Commissioner to revoke an endorsement previously granted.

For DGR endorsements granted under s 30-120 of ITAA 1997 and income tax exemption endorsements granted under s 50-110 of ITAA 1997, the Commissioner has the power to revoke these endorsements under s 426-55 of Sch 1 of the *Taxation Administration Act 1953* (**TAA 1953**).

Section 426-55 of Sch 1 of TAA 1953 provides that:

> ***426-55 Revoking endorsement***
>
> *(1) The Commissioner may revoke the endorsement of an entity if:*
>
> *(a) the entity is not entitled to be endorsed; or*
>
> ....
>
> *(2) The revocation has effect from a day specified by the Commissioner (which* **may** *be a day before the Commissioner decided to revoke the endorsement).*
>
> *(3) However, if the Commissioner revokes the endorsement because the entity is not entitled to it, the Commissioner must not specify a day before the day on which the entity first ceased to be entitled.*

(emphasis added)

A relevant issue arising from this section is whether the Commissioner is **obliged** to revoke the endorsement if an entity is not entitled to be endorsed, or if there is a discretion.

The word "may" in the legislation on its face confers an express discretion.

Under s33(2A) of the *Acts Interpretation Act 1901* (Cth), the word 'may' when used in legislation is to be construed in its natural sense:

> Where an Act assented to after the commencement of this subsection provides that a person, court or body may do a particular act or thing, and the word ***may*** is used, the act or thing may be done at the discretion of the person, court or body.

This subsection commenced on 18 December 1987.

However, the application of this subsection to an Act or a provision of an Act is subject to a contrary intention (s2(2) of the *Acts Interpretation Act 1901*).

There are also cases where the courts have not construed the word "may" in its natural sense but as imposing a duty (eg, *WH Soul Pattinson & Co Ltd v Secretary, Department of Health & Family Services and Others* (1997) 155 ALR 419).

These issues were not analysed by the AAT in the Cancer and Bowel Research Trust case. It seems to us that it cannot simply be assumed that the Commissioner must revoke the endorsement retrospectively. This is particularly so if there is an error in the deed which has not actually caused a problem and can be readily fixed. It seems to us that there is significant merit in interpreting "may" as meaning "may", such that the Commissioner has a discretion as to whether the endorsement should be revoked and, if so, from when it should be revoked.

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# Key deadline of 2 December 2013 to comply with the ACNC requirements

Just a reminder that 2 December 2013 is the deadline for the following entities:

- Religious organisations that have self-assessed themselves as religious institutions and received income tax exemption, wishing to register (opt-in) with the Australian Charities Not-for-profits Commission (**ACNC**), must do so before 3 December 2013. This will be necessary for those organisations to maintain their eligibility for tax concessions associated with their status as a religious institution (including income tax exemption and fringe benefits tax rebate).

  Click here for more information on how these organisations can opt-in with the ACNC.

- Some deductible gift recipients (**DGRs**) that were not endorsed as charities by the ATO before 3 December 2013 must register with the ACNC by this date. This will be necessary for those DGRs to continue to receive tax deductible donations. DGRs should review whether they are required to register with the ACNC.

  Click here to view the DGR factsheet.

- Registered charities that have the purpose of advancing religion must notify the ACNC of their subtype by 2 December 2013 to continue to receive additional tax benefits as a religious institution.

Click here to view the ACNC timeline of what charities need to do.

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For further information, please click here to contact our national Charities team