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Charities Alert

Tax concession entities – important changes to essential conditions

May 2012

On 17 April 2012, the Treasury issued a revised exposure draft of the *Tax Laws Amendment (2012 Measures No.4) Bill 2012:* tax exempt body 'in Australia' requirements, and associated explanatory materials and fact sheet. This follows a round of public consultations on an earlier version of the exposure draft and explanatory materials.

Below are some important points from the revised exposure draft.

Income tax exempt entities – 'in Australia' special condition

The revised exposure draft restates the 'in Australia' special condition that applies to income tax exempt entities, ie the condition that these entities generally must operate and pursue their objectives principally in Australia, and for the broad benefit of the Australian community.

The reason for restating this special condition is that the High Court of Australia in *Federal Commissioner of Taxation v Word Investments Limited* (2008) 236 CLR 204 (**Word**), decided that a charity is considered to be pursuing its objectives principally 'in Australia', if it merely operates to pass funds within Australia to another charity that conducts its activities overseas.

This finding was inconsistent with the Government's policy underlying this special condition.

Proposed change to 'in Australia' special condition

The current law essentially contains an 'expenditure' based test to determine whether an entity meets the 'in Australia' special condition. This will be replaced with an 'operates' and 'pursues its purposes' based test, so a wider range of circumstances will be relevant.

Under the new test, relevant factors will include where the entity incurs its expenditure, where it undertakes its activities, where its property is located, where it is managed from and who directly and indirectly benefit from its activities.

If an entity gives money or property to another entity that is not exempt, the use of the money and property by that other entity is taken into account in determining whether the first entity is operating principally in Australia and pursuing its purposes principally in Australia. This in particular is aimed at overcoming the effect of the Word decision.

Income tax exempt entities – making distributions overseas

The revised exposure draft tightens the exception for distributions that an income tax exempt entity may make overseas which are disregarded when considering whether the entity meets the 'in Australia' special condition. These distributions must be distributions

received by the entity by way of government grant or gift (money or property) that is **not** tax deductible. The entity must also ensure that requirements in the regulations are met.

According to the explanatory materials, it is expected that the regulations will include the following requirements:

- The entity must demonstrate that any activities undertaken by the entity outside Australia and the use of any money or property outside Australia is effective in achieving the entity's purpose.
- The entity must comply with all Australian and foreign laws, Australia's international treaty obligations, and uphold the high reputation of Australia and its not-for-profit sector when sending money overseas.
- The entity has in place current and appropriate governance arrangements for the proper monitoring of any overseas activities undertaken by both it and any in-country partners, to ensure that any money and property is being used in a proper and effective manner.

Under the current law, distributions received by the entity by way of government grant or gift (money or property), **whether tax deductible or not**, may be distributed overseas, **without** additional requirements in the regulations. Accordingly, the proposed change will be significant to those income tax exempt entities that currently make distributions overseas.

Deductible gift recipients (DGRs) – 'in Australia' special condition

The revised exposure draft codifies the 'in Australia' special condition that applies to deductible gift recipients (**DGRs**), including the requirement that these entities must generally operate **solely** in Australia, and pursue their purposes **solely** in Australia. For international affairs DGRs (eg overseas aid funds), they are not required to meet the condition of operating solely, and pursuing purposes solely, in Australia.

A DGR will not breach the 'solely in Australia' test if its activities outside Australia are merely incidental to its activities in Australia or its activities outside Australia are minor in extent and importance when considered with reference to its activities in Australia.

Complying with its governing rules and purposes

An entity must comply with **all** the substantive requirements in its governing rules (eg constitution for a company and trust deed for a trust) and use its income and assets **solely** for the purposes for which it is established and operated and for which it is entitled to be exempt from tax. If it breaches this requirement it will not be exempt from tax.

Definition of 'not-for-profit'

The revised exposure draft standardises the definition of 'not-for-profit', which will be applied consistently across the tax laws.

The proposed new definition of 'not-for-profit' (**NFP**) allows a NFP to gift surpluses and assets to other NFPs, even if those entities are owners or members, if the purpose of those entities is similar.

The proposed change will be a significant concession for groups of income tax exempt entities, as one entity may be able to distribute to its member (eg the controlling entity) in circumstances where this is not currently permitted.

Timing

The Government is seeking consultation on the revised exposure draft. Submissions on the revised exposure draft are due on 11 May 2012.

Click here for the revised exposure draft, explanatory materials and fact sheet.

If you would like Thomsons Lawyers to assist you in preparing a submission, please contact the writers.

The proposed new law will apply to determine whether an entity is entitled to be or remain income tax exempt/ DGR for income years following Royal Assent. It is expected that the draft legislation will be introduced into Parliament in mid-2012.

Suggested action

While this is an exposure draft, and there is still the consultation process, because this is a revised exposure draft prepared after the previous consultation process, it is reasonably likely that the final legislation will be substantially the same as this exposure draft.

If it becomes law and receives Royal Assent by 30 June 2013 (which seems to us to be reasonably likely), then it will generally apply from 1 July 2013.

Entities that are currently income tax exempt entities and DGRs should review their operations, objectives, constituent documents and governance arrangements for compliance with the proposed new law.

In particular, we consider the following should be done:

- The entity should review its activities and the governing rules. Are all the substantive requirements of these rules being complied with? Do the rules need to be varied? Do the activities need to be varied?
- The entity should review its activities and the reason the entity is entitled to be exempt from tax. Do the activities need to change in any way? Should the tax endorsement be varied?
- If the entity is a DGR, is it operated **solely** in Australia and pursuing its purposes **solely** in Australia? Consider all relevant activities. For example, a hospital may consider it obviously satisfies this test. But what does it do outside Australia? Does it have medical staff on secondment to overseas hospitals? Does it conduct overseas conferences? Does it support overseas healthcare activities? Does it bring in patients from overseas? Are the overseas activities merely incidental to its Australian activities or minor in extent and importance when considering its Australian activities?
- If the entity is relying on the current concession that effectively excludes overseas distributions received as gifts in applying the 'in Australia' test, what will be the effect of the new, much tougher, law?
- Charities that are established as a group of entities that would like to be able to transfer assets between the entities should consider whether all the entities have similar purposes. Should there be changes to the governing rules or activities of any entities?
- Charities that are set up by overseas charities should consider how the new 'in Australia' condition will apply to them, and what changes should be made. If the Australian activities are not separately incorporated, would this be necessary in their particular circumstances?
- Charities that make distributions to non tax exempt bodies will need to be able to trace where those distributions go. What systems will they need to put in place to comply with the new rules?

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