Chapter #
Restating and standardising the special conditions for tax concession entities (including the 'in Australia' conditions)

Outline of chapter

1.1 Schedule # to this exposure draft restates and standardises the special conditions for tax concession entities.

1.2 In particular, the exposure draft restates the 'in Australia' special conditions by ensuring that:

- income tax exempt entities generally must be operated principally in Australia and for the broad benefit of the Australian community; and
- deductible gift recipients generally must be operated solely in Australia and for the broad benefit of the Australian community.

1.3 The exposure draft also standardises the definition of 'not-for-profit' across the tax laws and implements Recommendation 1 of the 2001 *Report of the Inquiry into the Definition of Charities and Related Organisations* by adopting the term 'not-for-profit' in place of 'non-profit'

Context of amendments

1.4 Traditionally, entities cannot be income tax exempt unless they are operated principally in Australia, are prescribed as exempt in the *Income Tax Assessment Regulations 1997* or are a deductible gift recipient.

1.5 While both income tax exempt entities and deductible gift recipients are subject to 'in Australia' special conditions, they are subject to different thresholds (with the 'in Australia' conditions for deductible gift recipients applying a stricter test).

1.6 Recent court decisions have raised doubts about the proper application of both of these tests.

Income tax exempt entities

1.7 The purpose of the introduction of 'in Australia' special conditions for income tax exempt entities, which took effect from 1 July 1997, was to address tax avoidance arrangements which could use charitable trusts and certain other not-for-profit organisations to shift untaxed funds overseas.

1.8 Subsequently, the 'in Australia' special conditions have also operated to minimise the risk of income tax exempt entities being used for terrorist financing and money laundering, and to ensure the proper operation of not-for-profit entities and their use of public donations and funds.

1.9 The key principle used by the Australian Taxation Office (Tax Office) in determining whether a charity was eligible for endorsement included that a charity, its expenditure and the purpose of its activities be defined in terms of their location in Australia.

1.10 Recently, the High Court of Australia, in *Federal Commissioner of Taxation of the Commonwealth of Australia v Word Investments Limited* (2008) 236 CLR 204 (*Word Investments*) found that charities are considered to be pursuing their objectives principally 'in Australia' if they merely operate to pass funds within Australia to another charity that conducts its activities overseas.

1.11 This finding was inconsistent with the Commissioner of Taxation's (the Commissioner's) interpretation and with the clear policy intent underlying the special conditions. Prior to the High Court's decision a charitable institution needed to meet two requirements to be exempt from income tax: first, it must have a physical presence in Australia and, second, to the extent it has a physical presence in Australia, it must incur its expenditure and pursue its objectives principally in Australia.

1.12 A broad interpretation of 'physical presence' had been adopted – all that was required was for an organisation to operate through a division, sub-division or the like in Australia. The structure of the institution was immaterial as was whether it had its central management and control or principal place of residence in Australia. 'Physical presence' did not apply where an institution merely operated through an agent based in Australia.

1.13 An institution had, however, to the extent of its physical presence in Australia, only to incur its expenditure and pursue its objectives 'principally' in Australia. Therefore, it may incur its expenditure and pursue its objectives outside Australia to a lesser extent. Where there was some doubt whether the 'in Australia' special conditions

were satisfied it became necessary to examine each institution's individual circumstances.[1]

1.14 In *Word Investments*, once the Court had accepted that Word Investment's charitable purposes could be fulfilled by it making payments to other charitable institutions, the High Court's conclusion was that Word pursued its objectives principally in Australia by making payments to those institutions in Australia; even if the other institutions ultimately expend those funds outside Australia.

1.15 Ignoring minor overseas activities, the intent of the original law was only to allow a charity to be able to pass funds to an overseas charity that was endorsed as a deductible gift recipient (operating a developing or developed country relief fund), or an entity specifically prescribed in the regulations. The High Court's decision on *Word Investments* highlighted that the law is not achieving those objectives.

1.16 Consequently, charities can now be found to be pursuing their objectives principally 'in Australia' if they merely pass funds in Australia to another charitable entity that conducts its activities overseas.

1.17 Similar rules apply to other tax concession entities, however, stricter rules apply to charitable funds. Charitable funds can only claim income tax exemptions where they provide money, property and benefits solely to charities based in Australia.

Deductible gift recipients

1.18 The deductibility of gifts to public charitable institutions 'in Australia' was first introduced in section 18 of the *Income Tax Assessment Act 1915*.

1.19 The phrase 'in Australia' occurred in three separate contexts in the original section: income from all 'sources in Australia'; expenses 'actually incurred in Australia' and institutions 'in Australia'.

1.20 In *The Alliance Assurance Co Ltd v Federal Commissioner of Taxation* (1921) 29 CLR 424, the High Court held that the limitation 'actually incurred in Australia' in section 18 as a matter grammatical construction, did not apply to the phrase 'all losses and outgoings' and probably only applied to the concept of expenses.

1.21 As a result of the Alliance Assurance decision, the deduction provision was slightly reworded and included as section 23 in the *Income Tax Assessment Act 1922*, allowing 'gifts …to public charitable

[1] Explanatory Memorandums to the Taxation Laws Amendment Bill (No. 4) 1997 and Taxation Laws Amendment Bill (No. 7) 1997.

institutions in Australia if the gifts are verifiable to the satisfaction of the Commissioner'.

1.22 The Explanatory Memorandum to the Bill that became the *Income Tax Assessment Act 1922* notes that the amendment was for the purpose of limiting deductions to those actually incurred in Australia which is interpreted as meaning 'decided upon in Australia by the controlling authority, although the actual expenditure might be made outside Australia' and also included expenditure actually made in Australia.

1.23 The 1932-34 Ferguson Royal Commission on Taxation considered deductibility of gifts and donations to charitable institutions. The Royal Commission recommended in its third report that a deduction be allowed for gifts of one pound and upwards made during the year of income to charitable institutions which carry on their functions within the jurisdiction of the taxing authority.[2] In this event, the Commonwealth would allow deductions to a charitable institution in Australia, and each State would allow donations to similar institutions within the State. A provision was drafted by the Royal Commission to give effect to the recommendation, containing the requirement that there be an allowable deduction for gifts to certain funds, authorities or institutions *in Australia.*

1.24 The Conference of Commonwealth and State Commissioners of Taxation to discuss the recommendations of the 1934 Royal Commission on Taxation[3] considered the recommendations concerning gifts, and the draft provision.

1.25 The Report of Proceedings for the Melbourne Conference in 1935 questioned whether it was intended that deductions to a public fund would include contributions to funds raised in other countries, as in the case of an earthquake in Japan. The Victorian Commissioner of Taxation indicated that contributions to World Funds should not be allowed.

1.26 The New South Wales Commissioner of Taxation drew attention to the fact that the NSW equivalent provision included a requirement that a public fund must be established for the relief of persons 'in the State' who were in necessitous circumstances. The Commonwealth Commissioner of Taxation noted that the Federal law covered only charitable institutions in Australia, and drew attention to the words 'in Australia' in the Commonwealth draft. However, the Conference resolved to adopt the NSW drafting.

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[2] See paragraph 617 and 618 of the *Report of the Royal Commission 1934*.

[3] Report of the Conference of Commonwealth and State Commissioners of Taxation to discuss the recommendations of the 1934 Royal Commission on Taxation held in Melbourne on 8th, 12th and 23rd August 1935.

1.27 In 1935, the gift deductibility provisions were moved to a separate provision in section 78 of the *Income Tax Assessment Act 1936*.

1.28 This provision allowed gifts of the value of one pound and upwards paid to certain "funds, authorities or institutions in Australia" to be deductible.

1.29 The Explanatory Memorandum to the Income Tax Assessment Bill 1935 notes that the words 'in Australia' were added in order to make the intention of the law clear (as a result of the resolution of the State and Commonwealth Commissioners of Taxation noted above).

1.30 The gift deduction provisions remained in section 78 and were extensively amended over the years (the majority of the amendments were technical, to include, replace or remove named institutions or funds to the lists of deductible gift recipient, such as the addition of the United Nations Appeal for Children in 1948), before finally being rewritten in 1993.

1.31 An amendment was included in the Income Tax Law Amendment Bill 1981 to allow a deduction for gifts to certain overseas aid organisations, with the explanatory memorandum stating 'one extension will introduce a scheme to authorise deductions for gifts to certain public funds maintained for the relief of persons in developing countries'.

1.32 The current gift deductibility provisions are located in Division 30 of the *Income Tax Assessment Act 1997*.

1.33 The Commissioner has advised the Government that while the policy is clear, there is considerable doubt as to whether the law is achieving the objectives of "in Australia".

1.34 The changes to income tax exempt entities were announced in the then Assistant Treasurer's 2009-10 Budget Media Release No. 043. The release stated "that the Government will amend the 'in Australia' requirements in Division 50 of the *Income Tax Assessment Act 1997* to ensure that Parliament retains the ability to fully scrutinise those organisations seeking to pass money to overseas charities and other entities."

Summary of new law

1.35 Income tax exempt entities must operate and pursue objectives principally in Australia unless they are deductible gift recipients (which are subject to separate requirements) or are prescribed in the regulations as exempt from these special conditions.

1.36 The new law reverses the effect of the decision that charities and other income tax exempt entities can direct funds to overseas projects

outside the current policy intent and reinstates the principles underlying the current integrity rules.

1.37 The new law replaces the existing special conditions that are linked to the various exempt entity categories with a new consolidated and standardised provision clearly articulating the 'in Australia' special conditions.

1.38 If an entity pursues its purposes by conducting activities that directly advance those purposes – the entity is *not* entitled to be income tax exempt unless it operates principally in Australia.

1.39 Where an entity gives money or property (to further its purpose) to other entities that are not entitled to be income tax exempt, the use of those funds by those other entities should be taken into account when determining whether or not the entity giving the money has met the 'in Australia' special conditions. This addresses the recent court decision and ensures that tax exempt entities cannot avoid the special conditions by having other entities use its funds to undertake activities it itself cannot undertake.

1.40 This will require an income tax exempt entity to satisfy itself about how the entity it has given money or property to is using these funds, and ensures that the use of these funds is included when determining that the entity is pursuing purposes that are principally in Australia.

1.41 If an entity gives money to another income tax exempt entity to further its purpose, the money does not need to be traced, as the receiving entity will itself have met the in Australia special conditions (including being expressly exempt).

1.42 This ensures that any tax concessional money stays within the exempt entity framework and gets used principally in Australia for the broad benefit of Australians, and is not being passed on through entities and then spent overseas outside of the authorised categories.

1.43 Entities prescribed in the regulations are exempt from the 'in Australia' special conditions and are considered on a case-by-case basis. To be eligible to be considered for prescription, these entities must be either overseas not-for-profit entities exempt from foreign tax in their resident country, or be resident in Australia and operate and pursue their objectives principally outside Australia.

1.44 Entities prescribed in the regulations in the current law will be grandfathered.

1.45 The new law also codifies the 'in Australia' special conditions for deductible gift recipients so that the core principle for income tax exempt entities is applied similarly to deductible gift recipients but with a differing (stricter) threshold test, ensuring that deductible gift recipients

need to operate solely in Australia (unless expressly exempt). This will remove doubt about the operation of the current law that has been the subject of recent litigation.

1.46 If a deductible gift recipient gives property or benefits to a non-deductible gift recipient entity to further its purpose, the spending of the entity's funds should be taken into account when determining whether or not that entity meets the 'in Australia' special conditions for deductible gift recipients.

1.47 Restating the 'in Australia' special conditions will provide support to the anti-avoidance measures in the tax law which limit income tax exempt entities expending money offshore and ensure tax supported funds remain in Australia.

1.48 As a member of the Financial Action Task Force (FATF) (an inter governmental body dedicated to combating money laundering and terrorist financing), Australia has agreed to comply with FATF recommendations. FATF Special Recommendation VIII (SR VIII) requires FATF members to 'combat the misuse of NPOs (nonprofit organisations, that is, not-for-profit organisations) for the purpose of terrorism financing'. In FATF's last review of Australia's progress, it found that Australia was only partially compliant with SR VIII.

1.49 The 'in Australia' special conditions provide additional measures to address possible abuse of not-for-profit entities for the purposes of money laundering and terrorist financing, and ensure the proper operation of not-for-profit entities, their use of public donations and funds, and the protection of their assets. By limiting the use of monies to specified areas, in conjunction with greater regulatory requirements, ensures those monies are expended appropriately and in a manner consistent with the eligibility for tax concession status.

Comparison of key features of new law and current law

New law	***Current law***
The 'in Australia' special conditions are standardised and apply consistently across different categories of income tax exempt entities. The new law uses 'operates' and 'pursues its purposes' based tests rather than the existing 'expenditure' based test in order for a wider range of circumstances to be considered. If an entity pursues its purposes by	The 'in Australia' special conditions are contained in various sections throughout Division 50 of the *Income Tax Assessment Act 1997*. Each of the special conditions applies to different classes/categories of income tax exempt entity in a similar way but with some minor differences. The differences mostly reflect differences in entities eligible under particular categories.

New law	*Current law*
conducting activities that directly advance those purposes – the entity is not entitled to be income tax exempt unless it operates principally in Australia. The spending of the monies given to other entities to further an entity's purpose must be included when considering whether the donating entity 'operates' and 'pursues its purposes' in Australia.	Government policy on determining whether a charity is eligible for endorsement includes that an entity, its expenditure and the purpose of its activities is defined in terms of the entity's location in Australia and the extent to which it incurs its expenditure and pursues its objectives principally in Australia. Following recent judicial decisions, charities are considered to be pursuing their objectives principally 'in Australia' if they merely operate to pass funds within Australia to another charity that conducts its activities overseas.
The deductible gift recipient 'in Australia' special conditions are restated in similar terms to the new income tax exempt entity special conditions, but with the existing stricter threshold. In order to become a deductible gift recipient, an organisation will usually need to operate solely in Australia.	In order to become a deductible gift recipient, an organisation must generally operate solely in Australia (unless exempted from the condition).

Detailed explanation of new law

1.50 The new law:

- re-states the 'in Australia' special conditions for income tax exempt entities, ensuring that they generally must be operated principally in Australia and for the broad benefit of the Australian community with some exceptions – see paragraphs 1.51 to 1.102.
- standardises the other special conditions entities must meet to be income tax exempt, such as being a 'not-for-profit' entity, with some exceptions.
- standardises the term 'not-for-profit', replacing the defined and undefined uses of 'non-profit' throughout the tax laws – see paragraphs 1.88 to 1.98.
- codifies the 'in Australia' special conditions for deductible gift recipients so that the core principle for income tax exempt entities is applied similarly to deductible gift

recipients, but with the existing stricter threshold – see paragraphs 1.103 to 1.120.

Income tax exempt entities

1.51 In order to become income tax exempt, an entity must usually:

- operate principally in Australia ;
- pursue its purposes principally in Australia;
- comply with all the substantive requirements in its governing rules (paragraphs 1.83 to 1.87);
- use income and assets solely to pursue the purposes for which it was established; and
- be a not-for-profit entity (paragraphs 1.88 to 1.98);

1.52 Entities that do not meet the first two dot points ('in Australia' special conditions) can instead be either prescribed in the *Income Tax Assessment Act Regulations 1997* (see paragraphs 1.99 to 1.102) or be endorsed as a deductible gift recipient (subject to separate requirements, see paragraphs 1.103 to 1.120). A prescription in the regulations is a policy not administrative decision.

Principally in Australia

Activity based entities

1.53 If an entity pursues its purposes by undertaking activities, it must operate principally in Australia and pursue those purposes principally in Australia to qualify as income tax exempt (the 'in Australia' special conditions).

1.54 While no one factor is conclusive, in determining whether an entity is 'operating in Australia' and 'pursing its purposes principally in Australia' the Commissioner is expected to consider all surrounding circumstances including factors such as where the entity incurs its expenditure; where it undertakes its activities; where the entity's property is located; where the entity is managed from; where the entity is resident or located, where its employees are located; and who is directly and indirectly benefiting from its activities.

1.55 'Principally' means mainly or chiefly. Less than 50 per cent is not considered principally.

1.56 By substituting the existing 'expenditure' based test with an 'operates' and 'pursues its purposes' based test, a wider range of circumstances can be considered.

1.57 This will enhance the integrity of the rules, better reflect the policy intent and bring the test into better alignment with the test applied to deductible gift recipients.

Example 1.1: Expenditure versus operates test

An organisation is established as a Bible college in Australia, and runs weekly lessons for children in Australia.

The organisation fundraises in Australia, but purchases much of the supplies and equipment (such as religious books) from overseas. Whilst this may not have met the expenditure test in the previous law, depending on the other facts and circumstances of the organisation (such as possible assets and employees in Australia, and management control in Australia), the entity may now meet the 'in Australia' special conditions.

1.58 To be operating principally in Australia, an entity will be expected to be an Australian resident or have a sufficient connection and presence in Australia (a comparison can be draw with the test for determining the existence of a permanent establishment).

1.59 The test for residency will be the location of the entity's central management and control.

Example 1.2: Operating principally 'in Australia'

A sporting program designed to foster team building skills is established by a husband and wife team in Australia.

The program holds various sporting clinics at schools throughout Victoria during school holidays. The clinics are funded through the fundraising initiatives organised by the husband and wife. After a few years the pair decides to expand the reach of the program and so they set up a Brazilian division. The overseas division is run by locals who are employed by the Australian division. They receive managerial oversight from the Melbourne branch. Local sporting premises are rented by the Australian division and it also supplies all the equipment from Australia.

There is no fundraising activity in Brazil, and thus the Brazilian division is wholly dependent on the income it receives from the Australian division. At the end of the most recent financial year, 60 per cent of income was directed towards Australian based activities, with the remaining 40 per cent directed towards Brazilian activities.

On balance, the program meets the 'in Australia' special conditions. Even though 40 per cent of all monies are sent overseas, significant expenditure is incurred in Australia. Further factors considered include that Australian students are still benefiting from the activities of the program and thus there are direct and indirect benefits to the Australian community.

Example 1.3: Operating principally 'in Australia'

A literary society is set up in Australia to promote indigenous writing, both in Australia and abroad. The entity operates out of and is managed from Melbourne. Most of its expenditure is directed towards donating books to local schools and libraries. Occasionally it incurs

expenditure purchasing books from other indigenous culture organisations overseas.

The society will meet the 'in Australia' conditions. The occasional overseas expenditure will not prevent this criteria being met. While no one factor is determinative, the society is overall principally pursuing its purposes in Australia and is principally operating in Australia because it is managed in Australia, most of the expenditure is benefiting Australians and any assets and employees are in Australia.

Example 1.4: Global organisation funding overseas divisions

A Chinese religious society is set up in Beijing and establishes branches worldwide. Five such branches are set up in Australia. The branches are run by Australians and employ Australian religious instructors. The centres fundraise and collect donations for local events and activities as well as the international centres.

Head management in Beijing describes how the divisions are to be run, in a financial and administrative sense.

The religious society operates for the benefit of those that attend the religious seminars. It is estimated that approximately 500 people attend the seminars held by each branch. Each year, approximately 40 per cent of all income derived is sent back to Beijing, with 60 per cent used in Australia.

On balance, the Australian branches will not meet the 'in Australia' conditions. Whilst more than half of all income is kept in Australia, the head office exercises such a high degree of control over the Australian branches that the entity can not be said to be operating principally in Australia. Moreover, relatively few Australians are benefiting from the activities of the Australian branch and there is a lack of flow on indirect benefit to the wider community.

Example 1.5: Overseas control

An entity which manages assets to provide educational scholarships to disadvantaged young people around the world, based in Canada, wishes to start providing scholarships to Australian citizens, to study both in Australia and abroad.

The scholarships will pay a weekly amount to the recipients to go to an Australian university or an overseas university.

The organisation sets up a local Australian division (as a separate entity) with two employees who vet applications and choose recipients. However, central management and control of the whole organisation remains located overseas.

Although most of the money from the scholarships will be going overseas (by being paid weekly to Australian citizens studying overseas), the scholarships are benefiting Australians, and the organisation has a subsidiary located in Australia, with Australian employees.

It is likely that on balance the Australian branch of the organisation will meet the 'in Australia' special conditions. Although central management and control remains overseas, the amount of expenditure, operations and beneficiaries located in Australia could satisfy the special conditions.

1.60 An organisation does not have a sufficient connection with Australia if it is present in Australia only through an agent, or it merely owns investment property in Australia.

1.61 However, what assets the organisation has in Australia are a consideration for the special conditions.

1.62 A further factor to consider is what employees the organisation has in Australia.

1.63 The pursuit of purposes in Australia can include things done offshore if they are only a means of pursuing those purposes.

Example 1.6: Pursuing purposes by offshore means

QUU Charity, which is a resident of Australia, and operates 60 per cent in Australia, had decided to send some employees to an offshore conference to aid their efficiency for the Australian purposes.

This would be considered 'pursuing purposes in Australia' and will not result in QUU failing the 'principally in Australia' test.

1.64 The extent of the entity operating and pursuing its purposes principally in Australia will depend on the amount of relative monies and activities that are in Australia relative to the whole organisation.

1.65 All the factors relevant to the special conditions need to be considered to whether overall, on balance, an entity could be considered to be operating 'in Australia' and thus meet the special conditions.

Example 1.7: Overseas control

An overseas aid agency is established in France and has a division in Australia. French staffers are sent over to Australia to manage the Australian office. The French agency purchases a building within the city and organises the Australian fundraising activities from there. The Australian branch conducts fundraising activities in Australia and uses the funds to support Australian aid initiatives within Australia. Ten per cent of all monies are sent back to the head office in France each year, to go towards the costs of international administration.

The Australian branch will *not* meet the in Australia test. This is because it is a branch and has not been set up as a separate Australian entity and therefore given the entities overall activities, it is not operating principally or pursuing its purposes principally 'in Australia'.

If however, an entity is established or incorporated in Australia to undertake the branch's activities then the entity would meet the 'in Australia' special conditions as, on balance, the fact that the

organisation owns assets, conducts fundraising, employs Australian individuals and spends money in Australia would likely lead to it meeting the 'in Australia' special conditions.

1.66 However, certain distributions may be made overseas and disregarded when considering whether an entity meets the 'in Australia' special conditions.

1.67 These are distributions received by way of government grant and distributions received as a gift (money or property) that is not tax deductible.

1.68 In order for such gifts to be disregarded, the entity must ensure that they meet the requirements set out in the regulations.

1.69 These requirements are expected to include such things as:

- the entity must demonstrate that any activities undertaken 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 it's not-for-profit sector when sending money overseas; and
- the entity must show it 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 an proper and effective manner.

Conduit not-for-profit entities

1.70 If an entity gives money or property to another entity that is not an income tax exempt entity, the use of the money or property by the recipient (or any other entity) must be taken into account when determining whether the entity satisfies the 'in Australia' special conditions.

1.71 As such, if an income tax exempt entity wishes to give money to another entity to further its purpose, if the entity is not income tax exempt, the income tax exempt entity must satisfy itself about how the entity it has donated money or property to uses this property, and take account of the use of this money and property for the purposes of determining whether it is operating principally in Australia.

1.72 If an income tax exempt entity gives money to another income tax exempt entity, the receiving entity will itself have met the 'in Australia' special conditions and be operating principally in Australia, or be expressly exempt. An entity therefore does not need to take account of the eventual use of these funds by the donee entity.

1.73 This ensures that entities cannot be considered to be pursuing their objectives principally 'in Australia' if they merely operate to pass funds within Australia to another charity that conducts its activities overseas. This addresses the recent court decision and ensures that tax exempt entities cannot avoid the special conditions by having other entities use its funds on activities it itself cannot undertake.

1.74 This test works to ensure that the core test (as described in paragraph 1.51 above), that requires an entity to operate and pursue its purposes principally in Australia, takes account of all relevant circumstances and cannot be avoided by having another entity conduct activities that the primary entity cannot do itself.

1.75 For example, an entity that advances its charitable purposes by undertaking commercial activities with the purpose of generating surpluses that are donated to another entity with similar charitable purposes must consider the charitable spending of the donated funds when determining if it meet's the 'in Australia' special conditions.

1.76 For a charity to make a gift, it would need to ensure that the entity receiving the donation had similar or identical purposes. If it did otherwise, the entity making the donation could no longer itself be considered exempt.

1.77 Similar purposes would include a charity giving to another charity, regardless of their individual charitable purposes. However, a charity gifting money to an entity established for the encouragement of sport, for example, or an entity established for the encouragement of sport gifting money to an entity established for the promotion of agriculture, would not be considered similar purposes.

Example 1.8: Unrelated commercial activities for charitable purposes

Putter Ltd runs a commercial bread business, with the objective of helping the poor (and donating all profits to SWS, a charitable company who run homeless shelters around Australia and Asia).

SWS do not operate principally in Australia, as around 75 per cent of any funding goes to aiding shelters in the Asian region.

Putter Ltd would not be considered to be income tax exempt if it distributes all surplus funds to SWS, as Putter Ltd would not be considered to be operating principally in Australia, given that SWS expend about 75 per cent of all funds overseas

While Putter Ltd operates in Australia, and has staff in Australia, the spending of the money for charitable purposes occurs primarily overseas, even though SWS operates in Australia.

For Putter Ltd to be income tax exempt, they would only be able to give a portion of their income to SWS, so that overall, they are considered to be operating principally in Australia. The rest of the

money would need to be donated and spent within Australia, to further their charitable purpose of helping the poor.

Example 1.9: Passive investment activities for charitable purposes

SmithJones operates a passive investment income fund in Australia, with Australian staff, with the objective of helping abandoned animals.

SmithJones donates all of their returns to BlackBrown, who also have a purpose of helping abandoned animals. BlackBrown in established and set up in Australia.

However, BlackBrown donates all money they receive in a particular year to an entity overseas, for spending on abandoned animals. This entity was not listed in the regulations as income tax exempt in Australia. The donation includes the money gifted from SmithJones.

SmithJones do not meet the 'in Australia' special conditions. Although they donated all surplus funds to an organisation located and operating in Australia, the gifted funds were ultimately spent overseas.

SmithJones would be expected to know what the final charitable spending of the funds they donated to BlackBrown is, and include the spending when considering whether they meet the 'in Australia' special conditions.

Example 1.10: Commercial activities for charitable purposes

The Lowline Trading Company is a commercial not-for-profit business controlled and operated in Australia, with employees in Australia, producing clothing with the purpose of helping disadvantaged children.

Lowline does this by donating the majority of its profits to ChildAid, an income tax exempt entity, operating principally in Australia. The remainder of the profits are retained by Lowline to expand the business.

Lowline purchases supplies such as material and thread for making the clothing from another (non-exempt) commercial business.

Lowline Trading Company meets the 'in Australia' special conditions.

Example 1.11: Commercial activities for charitable purposes

Pass-it-on Ltd is a commercial not-for-profit business controlled and operated in Australia, with employees in Australia, for the purpose of using profits to help fund religious education overseas. This is done by donating profits to WYV Ltd.

WYV is listed in the income tax regulations as an income tax exempt entity.

Pass-it-on Ltd can meet the 'in Australia' special conditions by donating all profits to WYV, because WYV is an income tax exempt entity.

1.78 If an entity pursues its purposes through a combination of direct activities and donations to other similar entities, one or both elements of

the test respectively need to be applied to the respective 'activities' of the entity.

1.79 Restating this element of the test overcomes the High Court's decision in *Word Investments* by applying an adjusted test to entities that pursue their purposes by merely passing funds to other entities.

Exceptions from the 'in Australia' special conditions

1.80 Entities categorised as primary and secondary resources, and tourism are exempt from the 'in Australia' special conditions. In order to be income tax exempt they must be not-for-profit entities (see paragraphs 1.88 to 1.98 below).

1.81 Government and most Government related entities are also exempt from the 'in Australia' special conditions, but must meet the other special conditions attached to exempt entities.

1.82 Entities that would otherwise fail the 'in Australia' special conditions can be income tax exempt by being listed in the regulations, provided they meet the other special conditions required to be an income tax exempt entity and the qualifying conditions for prescription – see paragraphs 1.99 to 1.102. A decision to prescribe an entity in the regulations is a policy decision that would be made only in exceptional circumstances.

Governing rules and established purposes

1.83 Endorsement of entities as exempt from income tax under a general category is decided firstly by reference to the entities stated purposes and objectives. For established entities, some reference can be had to the entities actual activities to determine whether those activities demonstrate the pursuit of alternative or inconsistent purposes and objectives. However, this can create some difficulty for the Tax Office because 'inappropriate conduct' may not always manifest pursuit of an alternate purpose but nonetheless should result in entity no longer being entitled to endorsement.

1.84 For this reason, a special condition generally imposed on exempt entities is that they operate only in a manner consistent with their substantive governing rules and purpose. Therefore, while an entity's governing rules and purposes may initially determine their eligibility for endorsement/eligibility for an income tax exemption, they are expected to operate in a manner consistent with those rules and purposes to remain eligible.

1.85 Requiring an exempt entity to comply only with their substantive governing rules and purposes allows an entity to keep its income tax exempt status for minor procedural irregularities, such as an absence of quorum at a meeting or missing a required lodgement date.

Breaches of procedure irregularities will not, of themselves, affect an entity's continued entitlement to income tax exempt status.

1.86 Substantive governing rules are those rules of core importance to the operation of the entity and would include those related to an entity's object and purpose and those relating an entity's not-for-profit status.

1.87 This requirement applies equally to the income tax exempt categories that are not the subject of the endorsement rules. However, because the entity is not endorsed, the Commissioner will consider the same issues if he decides to issue an assessment for income tax payable because the entity is not considered to be income tax exempt.

Not-for-profit

1.88 A not-for-profit entity is generally an entity with a community or social purpose. It is an entity that is not operating for the profit or gain of its individual members, whether these gains be direct or indirect. This applies both while the entity is operating and when the entity winds up.

1.89 Additionally, a not-for-profit entity is one that does not provide any private benefit, directly or indirectly, to a related party such as a trustee, member, director, employee, agent or officer of a trustee, donor, founder, or to an associate of any of these entities (other than reasonable remuneration for services provided or re-imbursement of related costs).

1.90 The Commissioner has generally accepted an entity as being not-for-profit where its constituent or governing documents or the operation of law (for example, a statute governing the organisation) prevent it from distributing profits or assets for the benefit of particular people – both while it is operating and when it winds up. Any surplus made by an entity must be directed towards carrying out the entity's purposes.

1.91 However, the fact that a not-for-profit entity may make a profit does not negate its not-for-profit status so long as any surplus is applied to the not-for-profit purposes of the entity and the profit does not accrue to the benefit of identifiable members either directly or indirectly.

1.92 Despite the general prohibition, a not-for-profit entity can gift surpluses and assets to other not-for-profit entities (even if those entities are owners or members) if the purpose of those entities is similar and the distribution is intended to help the not-for-profit achieve its purpose.

1.93 Income tax exempt entities are generally required to be not-for-profit as the tax concession is intended to support activities that have a broad public benefit.

1.94 Trade union and employee associations are exempt from being not-for-profit entities, but must still meet the other special conditions required of exempt entities.

1.95 The current law uses the term 'non-profit' in both a defined and undefined sense throughout the tax law.

1.96 The new law standardises the definition of not-for-profit, replacing the various definitions of 'non-profit' currently used throughout the tax laws, and applies it consistently across the tax laws.

1.97 Recommendation 1 of the 2001 *Report of the Inquiry into the Definition of Charities and Related Organisations* suggested changing the term 'non-profit' to 'not-for-profit' for the reasons set out in the report.

1.98 The new law adopts this recommendation.

Regulation-making power

1.99 Overseas entities, or entities which are resident in Australia but operate and pursue their objectives principally outside Australia, which do not meet the 'in Australia' special conditions, but do meet the other special conditions to become income tax exempt (they are not-for-profit entities, and comply with all their governing rules, and use income and assets solely to pursue the purposes for which they are established) may be prescribed in the regulations as income tax exempt entities in special circumstances.

1.100 This power is intended to be applied only in exceptional circumstances, at the discretion of the Governor-General in Council. The Governor-General is expected to consider matters such as whether the entity will be providing a broad benefit to the Australian community, the national interest, tax system integrity, the risk of the entity being utilised for money laundering or terrorist financing and any other relevant considerations. This power is subject to Parliamentary scrutiny, by way of disallowance.

1.101 However, an entity may not be prescribed if the entity is a foreign resident and it is not exempt from foreign income tax in the country in which it is resident. This ensures that Australia does not extend a concession to an entity that does not receive such a concession in its home jurisdiction. If the entity was not required to be exempt from income tax in the country which it is resident, the outcome would be that Australia gives up its taxing rights over the entity's Australian sourced income to a foreign jurisdiction.

1.102 In prescribing an entity, the Governor-General may set conditions for the exemption to order to ensure the exemption is not misused.

Deductible gift recipients

1.103 Deductible gift recipients are exempt from the 'in Australia' special conditions for income tax exempt entities in Division 50 of the

ITAA 1997 because deductible gift recipients are subject to a separate test.

1.104 The new law codifies the 'in Australia' special conditions for deductible gift recipients so that the core principle for income tax exempt entities is applied similarly to deductible gift recipients but with a differing (stricter) threshold test. Standardising the core elements of the special conditions will minimise compliance costs on deductible gift recipients and simplify the tax framework applying to not-for-profit entities.

1.105 The 'in Australia' special conditions for deductible gift recipients are set out in Division 30 of the *Income Tax Assessment Act 1997*.

1.106 Deductible gift recipients must:

- operate solely in Australia; and
- pursue their purposes solely in Australia.

1.107 'Solely in Australia' is to be interpreted as requiring deductible gift recipients to be established and operated only in Australia (including control, activities and assets) and must have their purpose and beneficiaries only in Australia.

Example 1.12: Overseas operations

A public museum is incorporated in New Zealand and has a branch in Australia.

It is not 'in Australia'. It cannot be endorsed as a deducible gift recipient.

Example 1.13: Overseas operations

A fund is set up and operates in Australia. It makes its donations for the construction of schools run by a religious institution in Europe.

The fund is not 'in Australia'. It cannot be endorsed as a deductible gift recipient unless covered by an exempt category.

Example 1.14: Overseas operations

An organisation fundraises in Australia for saving an endangered animal in Africa.

Since the money is being transferred overseas, for helping an overseas cause, the fund is not 'in Australia'. It cannot be endorsed as a deductible gift recipient unless covered by an exempt category.

1.108 A deductible gift recipient does not fail the 'operating solely in Australia' and 'pursuing purposes solely in Australia' if the overseas activities are merely incidental to the Australian activities of the entity, and the overseas activities are minor in extent and importance when considered with reference to the Australian activities.

Example 1.15: Incidental activities

A large public museum operating in Australia has made an arrangement to send temporarily, a collection of artwork overseas, along with an individual who is an expert in the collection era, in return for receiving a temporary exhibition of artwork from overseas.

This would be considered to be minor in extent and importance of the Australian activities, and the museum would not lose its deducible gift recipient status.

Example 1.16: Incidental activities

A public benevolent institution is set up in Australia to help Australians suffering from cancer. Part of the treatment it provides involves travel to Canada.

The institution will be 'in Australia' if the Canadian travel is merely incidental to its treatment of Australians in Australia.

Example 1.17: Incidental activities

A public benevolent institution provides medical assistance to children in Australia with a particular disability but, to a minor extent, it also brings children from other countries to receive treatment in Australia.

The institution will still meets the 'in Australia' special conditions.

Example 1.18: Incidental activities

An orchestra which has a deductible gift recipient fund tours around Australia, and wishes to purchase an instrument.

The orchestra receives an opportunity to do a tour overseas for one week, and they choose to take the instrument on the tour.

Deductible gift recipient funds could be used to purchase the instrument, as the instrument will be used mainly in Australia, and its use overseas is incidental to this.

However, deductible gift recipient funds will not be able to be used to cover the flights of the orchestra members, and other tour costs incurred while the orchestra is touring overseas, as these costs are not considered incidental to the orchestra's activities in Australia.

1.109 Entities that are deductible gift recipients under the category of 'international affairs' are exempt from the deducible gift recipient 'in Australia' special conditions.

1.110 These deductible gift recipients include overseas aid funds, developed country relief funds and similar deductible gift recipients where their activities are clearly intended to be undertaken overseas. This is in recognition that although some organisations are not operating in Australia, it is considered that they nonetheless further Australia's overseas aid objectives and therefore contribute to Australia's broad public benefit.

1.111 Entities in this category are granted assistance through the Overseas Aid Gift Deductibility Scheme (OAGDS). Consistent with Australia's broader overseas aid program, the OAGDS is aimed at development initiatives which aim to improve the wellbeing of whole communities.

1.112 The OAGDS has appropriate integrity requirements in place to ensure that this taxpayer funded concession is directed to the causes that it was donated for, and not at risk of being misdirected to inappropriate and unauthorised operations. These integrity requirements are supported by special administrative arrangements because of the difficulties associated with monitoring activities undertaken outside of Australia.

1.113 In addition, entities on the Register of Environmental Organisations, which the Secretary to the Environment Department authorises as being exempt from the 'in Australia' special conditions, may also undertake overseas activities. This reflects the need for a number of environmental organisations to operate more broadly in order to affect change that will be benefit to the Australian public. However, in order to ensure the integrity of the deductible gift recipient regime, an exemption from the 'in Australia' conditions will be limited to certain entities listed on the register.

1.114 The Secretary to the Environment Department must make his or her decision about granting an exemption based on the requirements detailed in the regulations.

1.115 These requirements are expected to include such things as:

- the entity must demonstrate a genuine need to conduct activities overseas in order to further its purpose;
- the entity must demonstrate that those activities undertaken outside Australia are effective in achieving its purpose;
- if the entity has an in-country partner, the entity must demonstrate that it effectively interacts and coordinates activities with its in-country partner;
- the entity must 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
- the entity must show it 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 an proper and effective manner.

1.116 This ensures appropriate integrity requirements are in place to ensure that the deductible gift recipient concession is directed to the

causes that it was donated for, and not at risk of being misdirected to inappropriate and unauthorised operations.

1.117 Deductible gift recipient includes both entities that are themselves deductible gift recipients and entities that are deductible gift recipients because they operate a public fund.

1.118 However, these conditions only apply to the portion of the entity or public fund that is endorsed as a deductible gift recipient. Similarly, the part of the entity that is a deductible gift recipient is disregarded when applying the income tax exemption special conditions.

Example 1.19: Solely 'in Australia'

An entity is endorsed as a charitable institution in Australia. It operates a public fund which is as a deductible gift recipient under the Register of Cultural Organisations.

Only the funds relating to the public fund are required to meet the deductible gift recipient 'in Australia' special conditions, not the entire entity.

The charitable entity is required to operate principally 'in Australia' in order to be income tax exempt. This consideration does not include funds related to the deductible gift recipient portion of the organisation.

1.119 If a deductible gift recipient gives money to another entity to further its purposes, the deductible gift recipient must look through the entity it has given money to and consider the final use of this money when considering whether it meets the 'in Australia' special conditions.

1.120 This ensures that entities cannot be considered to be pursuing their objectives solely 'in Australia' if they merely operate to pass funds within Australia to another charity that conducts its activities overseas.

Application and transitional provisions

1.121 The measure commences from Royal Assent, and applies to determine whether an entity is entitled to be income tax exempt or remain income tax exempt for income years following Royal Assent.

1.122 Any regulations made under the existing legislation will remain in force as if made under the new law until they can be re-made. Entities listed in the regulations prior to commencement of this measure will be grandfathered, and hence unaffected by the changes.

1.123 The measure applies to determine whether an entity is entitled to a deductible gift recipient or remain a deductible gift recipient for income years following Royal Assent.

1.124 In regard to the standardisation of the definition of 'not-for-profit' entity, if the Commissioner currently treats an entity as a

not-for-profit entity but that entity no longer qualifies as being a not-for-profit entity due to the changes, that entity will continue to be treated as a not-for-profit entity for 12 months from Royal Assent to allow the entity sufficient time to amend its governing rules.

Consequential amendments

1.125 The new law replicates the arrangements allowing the Commissioner to check the status of specifically listed deductible gift recipients, and extends it to entities prescribed in the regulations as income tax exempt even though they fail the 'in Australia' special conditions.

1.126 This will allow the Commissioner to review whether a prescribed entity continues to be eligible to be income tax exempt, reflecting the Commissioner's current power to review the eligibility of specifically listed entities.

1.127 The Commissioner is to review and advise the Minister if the entity is or is not operating consistently with the obligations imposed on its listing.

1.128 The conditions for eligibility for a refund of franking credits to certain not-for-profit entities currently mirror the existing 'in Australia' special conditions in Division 50 of the ITAA 1997. The new law replicates the Division 50 changes for the refund of franking credit rules for not-for-profit entities by cross referencing the newly restated special conditions.

1.129 The definition of 'overseas charitable institution' the *Income Tax Assessment Act 1936* references a section now brought within the standardised new special conditions, and the reference is updated accordingly. The section refers to the previous 'in Australia' special conditions, referring to a foreign resident institution, the income of which would be exempt from section 50-5 if the institution had a physical presence in Australia and incurred its expenditure and pursued its purposes principally in Australia. This will now reference the new 'in Australia' special conditions.

1.130 Section 65J of the *Fringe Benefits Tax Assessment Act 1986* sets out the categories of employers that are able to access a fringe benefits tax rebate. These employers include religious institutions, public education institutions and charitable institutions.

1.131 To ensure consistency and simplify the tax laws, these provisions are being re-written to explicitly cross-reference back to the income tax exempt entity provisions in the income tax laws. Therefore, for an entity to receive a fringe benefits tax rebate, it must meet the 'in Australia' special conditions.

1.132 Currently there is an implicit assumption that an employer listed in the *Fringe Benefits Tax Assessment Act 1986* will need to meet the entity description under the income tax laws.