

Better targeting of not-for-profit tax concessions

Consultation Paper
27 May 2011

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ISBN 978-0-642-74707-5

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CONSULTATION PROCESS

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Closing date for submissions: 8 July 2011

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FOREWORD



I am very pleased to release this consultation paper on better targeting of not-for-profit (NFP) tax concessions.

In the 2011-12 Budget, the Minister for Social Inclusion and I announced a package of NFP reforms which will make it easier for the NFP sector to deliver vital assistance to Australia's most vulnerable people.

Too long has the sector waited for a Government to embark on this important reform process.

One of the announced NFP measures is to reform the use of tax concessions by businesses run by NFP entities.

This reform will ensure that valuable government assistance is directed to support NFPs' altruistic purposes, whilst delivering a level playing field between small, large and NFP businesses. The Government is also seeking to protect community assets from unnecessary commercial risks.

The Government provides significant support to the NFP sector to provide altruistic services to Australians. This measure is not about reducing that support, taxing the sector, or preventing the sector from running commercial businesses to support their activities. This measure is about making sure that the valuable support that the Government provides to the sector is targeted at supporting the altruistic activities of the sector, and not diverted to supporting unrelated commercial activities.

We understand that many NFPs face challenges in raising funds to maintain their services. Every cent counts when you are at the coal face.

As our record shows, this Government has actively encouraged NFPs to be innovative and to diversify and grow their revenue streams. It is for this reason that we are not seeking to prevent NFPs from undertaking commercial activities as a means to supplement their income.

However, we do consider that government support by way of taxpayer concessions to NFPs is best utilised in furtherance of the altruistic purposes of the NFP entity.

This consultation paper provides the NFP sector, the business sector and state and territory governments with the opportunity to comment on these important reforms. In particular, we are seeking information from the sector on the best way to implement these reforms, and to identify whether there are any unintended consequences.

The Hon Bill Shorten MP
Assistant Treasurer and Minister for Financial Services and Superannuation

SUMMARY

1. This consultation paper seeks public views on possible approaches to implement the Government's Budget announcement to better target NFP tax concessions to the altruistic activities of NFPs.
2. The Government announced in the 2011-12 Budget that it will reform the tax concessions provided to NFP entities to ensure they are targeted only at those activities that directly further an NFP's altruistic purposes.¹
3. Income tax concessions will only apply to profits generated by the unrelated commercial activities of NFPs, if they are directed to the NFP's altruistic purpose. This means an NFP entity will pay income tax on those profits that are not directed back to its altruistic purpose (that is, the earnings it retains in its commercial undertaking).
4. An NFP entity will also not have access to a fringe benefits tax (FBT) exemption or rebate, goods and services tax (GST) concessions or deductible gift recipient (DGR) support in relation to their unrelated commercial activities.
5. Small-scale and low-risk unrelated commercial activities will not be affected by the reforms. The reforms will not disturb the taxing arrangements associated with mutual income and the principles of mutuality. The reforms will not affect the passive income of NFPs.
6. The Government announced that the new arrangements will commence on 1 July 2011. Initially only new unrelated commercial activities that commence after 7:30 pm (AEST) on 10 May 2011 will be subject to the new arrangements.
7. The Government also announced that NFP entities with existing unrelated commercial activities will initially be able to continue to use their tax concessions to support these activities, with the intention of phasing these out over time. Further, NFP entities that have entered into government service delivery contracts as at 7:30pm (AEST) on 10 May 2011 will be allowed to use their tax concessions in support of that contract. Likewise, the 50,000 National Rental Affordability Scheme allocations will be unaffected by the tax changes.
8. The Government's reforms will ensure valuable government assistance is directed to supporting the altruistic activities of NFPs, the community assets of NFPs are protected from unnecessary commercial risks, and there is a level playing field for all small, large and NFP businesses in Australia.
9. The Government remains committed to consulting widely on the NFP reform process and is interested in the views of the NFP sector, the business sector and state and territory governments. The Australian Government is committed to harmonising NFP arrangements with the states and territories where possible in order to minimise compliance costs for the NFP sector. However, all decisions relating to access to state and territory tax concessions are decisions for state and territory governments. Further, if there were any changes to the GST base it would require the unanimous support of state and territory governments.

1 Assistant Treasurer's Media Release No.077, 10 May 2011.

10. The consultation paper is set out as follows:

- Section 1 of the paper provides background information on Commonwealth tax concessions for the NFP sector.
- Section 2 of the paper outlines the Government's policy intent and discusses options for implementing the reforms.
- Section 3 of the paper seeks views from stakeholders on how the Government should go about phasing out concessions for existing unrelated commercial activities, and whether support to adjust to the new arrangements should be provided.

1. BACKGROUND

11. Australia's NFP sector consists of approximately 600,000 entities, ranging from large, high-profile and well-resourced charitable entities to community-based societies run by volunteers.² It can be broadly defined as encompassing those in the economy who are not households, government, or businesses that operate for-profit.³
12. These entities have long played a valuable role in Australian society, providing numerous goods and services to the disadvantaged and needy, managing a range of resources in various industries, and delivering important social, spiritual, health, education and community services.
13. The Australian Government, and state and territory governments, provide the sector with a generous range of tax concessions to assist these organisations to meet their charitable and altruistic purposes.
14. Australian Government incentives include: exemptions from the payment of income tax; the ability to supply goods and services without the imposition of the GST with a capacity to re-claim tax credits on corresponding expenses;⁴ significant FBT exemptions and rebates; and DGR status.
15. In 2010-11, total quantifiable Commonwealth taxation expenditures provided to the sector is estimated at \$3.3 billion.⁵ Unquantifiable tax expenditures to the sector are likely of similar magnitude, consisting primarily of income tax exemptions.
16. Tax concessions for NFPs vary between states and territories and are also generous. Typically, there are exemptions from stamp duty, payroll tax, land tax and rates available.
17. Tax concessions are provided by governments in recognition of the significant contribution the NFP sector makes to Australian society. These concessions are taxpayer funded, and so there is an expectation from the community that taxpayer monies directly support altruistic purposes.
18. The reforms announced by the Australian Government on 10 May 2011 will seek to ensure that where NFPs engage in commercial activities unrelated to their altruistic purpose, income tax concessions will only be available where it is clearly seen that profits have been directed to advance that purpose.

2 Productivity Commission Research Report, Contribution of the Not-for-Profit Sector, January 2010, p xxvi.

3 Ibid p 3.

4 Subdivision 38-G of the *A New Tax System (Goods and Services Tax) Act 1999*.

5 Commonwealth of Australia, 2010 Tax Expenditures Statement, January 2011.

1.1 COMMONWEALTH TAX CONCESSIONS PROVIDED TO NFPs TO SUPPORT ALTRUISTIC ACTIVITIES

19. Tax concessions are generally afforded only to those NFPs providing welfare, education, worship, sport, art and other community services. For example, Subdivision 50-A of the *Income Tax Assessment Act 1997* (ITAA 1997) provides an exemption from income tax for the income of a number of altruistic entity types. These include:
- charitable institutions, religious institutions, scientific institutions, public educational institutions and charitable funds;⁶
 - community service organisations;⁷
 - societies and associations established for the purpose of promoting the development of certain primary and secondary resources, including aviation and tourism;⁸ and
 - clubs, societies and associations established for the encouragement of animal racing, art, a game or sport, literature, music or for musical purposes.⁹
20. NFPs may undertake commercial activities in carrying out their purposes, but any profit must be used to carry out the entity's purposes and not distributed to its owners, members or other private people (that is, they operate for a broad public benefit and not to benefit certain individuals).
21. FBT and GST legislation also provide for tax incentives for certain types of NFPs.¹⁰ A more defined group of NFPs can receive tax deductible gifts.¹¹
22. Appendix 2 lists altruistic entities that are exempt from income tax under Subdivision 50-A of the ITAA 1997, and entities entitled to FBT concessions under sections 57A and 65J of the *Fringe Benefits Tax Assessment Act 1986*.

1.2 INCOME TAX EXEMPT NFPs AND COMMERCIAL TRADING — HISTORY

23. The issue of charitable entities using altruistic tax concessions for engaging in commercial activities has always been contentious in Australia.
24. Prior to the High Court's decision in *Commissioner of Taxation v Word Investments Ltd* (2008)¹² (*Word Investments* decision), the Australian Taxation Office (ATO) considered that if the purpose of an NFP entity is carrying on a commercial enterprise to generate surpluses, the purpose was not charitable.¹³ However, NFPs were able to carry out activities to make profits where:
- the commercial activity was being carried out in a way that was charitable;

6 Items 1.1 to 1.5B in the table in subsection 50-5 of the ITAA 1997.

7 Item 2.1 in the table in subsection 50-1 of the ITAA.

8 Items 8.1 and 8.2 in the table in subsection 50-40 of the ITAA 1997.

9 Items 9.1 and 9.2 in the table in subsection 50-45 of the ITAA 1997.

10 For example, sections 65J and 57A of the *Fringe Benefits Tax Assessment Act 1986*.

11 Division 30 of the ITAA 1997.

12 (2008) 236 CLR 204.

13 Australian Taxation Office, TR 2005/21.

- the commercial operations were merely incidental to the carrying out of the charitable purpose; or
 - it did so by charging fees for charitable services.
25. The ATO has recently issued a draft ruling which updates its previous ruling following the *Word Investments Ltd* decision. The draft ruling provides the following view on the commercial activities of charitable institutions.¹⁴

An institution undertaking commercial or business-like activities can still be charitable if:

the sole purpose of the institution is charitable and it carries on a commercial enterprise to generate surpluses in order to further that charitable purpose. For example, in Word Investments¹⁵ the High Court accepted that a company had the charitable purpose of advancing religion even though it carried on an investment business and a funeral business. The High Court concluded that the company carried out its business activities to further its charitable purpose, rather than as an end in itself. The fact that the activities undertaken by the institution were not intrinsically charitable did not affect the characterisation of the institution as charitable;

the commercial operations are merely incidental to the carrying out of the charitable purpose. Examples from the cases are a home for neglected boys that also provided training through its farm and the promotion of temperance through the running of a canteen;

the activities undertaken by the institution are themselves intrinsically charitable but are being carried on in a way that is commercial. Examples from the cases are the preparation and sale of law reports, the manufacture and sale of animal vaccines, and providing cremation services; or

the institution holds passive investments to receive a market return to further its charitable purposes.

26. Appendix 3 provides examples from the ATO's website of ways in which charities may raise funds to carry out their charitable purposes, and carry out their purposes using business-like opportunities and methods. These examples indicate the approach taken by the ATO prior to the decision in *Word Investments* and reflect the last three paragraphs from the draft ruling above.
27. Entities covered by the tables in sections 50-10 (community service organisations), 50-40 (resource development) and 50-45 (sport and culture) may however have commercial purposes unrelated to their main altruistic purpose.
28. Justice Lockhart in *Cronulla Sutherland Leagues Club Limited v. FC of T*¹⁶ in relation to sub-paragraph 23(g)(iii) of the Income Tax Assessment Act 1936 (ITAA 1936)(later replaced by subsection 50-45) said: 'It [the club] may have other objects or purposes which are merely

14 Draft Taxation Ruling TR 2011/D2 Income tax and fringe benefits tax: charities, paragraph 254. This draft ruling is a publication released for public comment and seeks to replace Taxation Ruling Income tax and fringe benefits tax: charities TR 2005/21. TR 2011/D2 represents the Commissioner of Taxation's preliminary views.

15 *Commissioner of Taxation v Word Investments Ltd* (2008) 236 CLR 204.

16 90 ATC 4215 at 4225; (1990) 21 ATR 300 at 312.

incidental or ancillary thereto or which are secondary and even unrelated to the main object or purpose without disqualifying the body from the exemption.’ Whilst in that case, it was found that the main object or purpose of the club was the provision of social amenities to its members and not the encouragement of sport, a number of court and tribunal decisions have accepted clubs with significant entertainment facilities as having a main purpose of the encouragement of sport.¹⁷

29. In the *Word Investments* decision, the High Court considered commercial trading by charities and held that the relevant question was whether these activities were ‘carried on in furtherance of a charitable purpose’, not whether they were ‘intrinsically charitable’.
30. *Word Investments* had objects in its memorandum of association which advanced religious purposes, and other objects which aided those purposes, such as carrying on any business or activity. In the years relevant to the decision, *Word Investments* operated a business of conducting funerals the profits of which were paid to another charity. The High Court found that *Word Investments* was a charitable institution as its objects were confined to advancing religious charitable purposes. Although the commercial fundraising activities of *Word Investments* were not intrinsically charitable, they were charitable in character because they were carried out in furtherance of a charitable purpose.
31. The principles considered by the High Court in relation to the charitable institution in the *Word Investments* decision have possible application to the characterisation of other exempt entity types. Interest in altruistic entities operating unrelated commercial activities has increased as a result of the decision.

¹⁷ *Tweed Heads Bowls Club v. FC of T* 92 ATC 2087; AAT Case 8267; (1992) 24 ATR 1068; *St Marys Rugby League Club Limited v. FC of T* 97 ATC 4528; (1997) 36 ATR 281; *Terranora Lakes Country Club Limited v. FC of T* 93 ATC 4078; (1993) 25 ATR 294; Case W114 (*Grand United Port Macquarie West Bowling Club v. FC of T*) 89 ATC 891; AAT Case 5452 (*Grand United Port Macquarie West Bowling Club v. FC of T*) (1989) 20 ATR 4125

2. BETTER TARGETING OF NFP TAX CONCESSIONS

2.1 THE POLICY INTENT

32. The Government provides valuable tax concessions to NFPs to support their altruistic activities. But the Government believes that it is important that these tax concessions are only used to further the altruistic purposes of NFPs, and not their unrelated commercial activities. Such an approach is consistent with that followed by comparable overseas jurisdictions.
33. The Government recognises that NFPs undertake unrelated commercial activities either as an integral part of their activities or as a means to raise the funds necessary to carry out their charitable work. The Government is not acting to prevent NFPs from carrying on unrelated commercial activities.
34. The reforms are intended to encourage altruistic entities to direct profits generated by unrelated commercial activities back to their altruistic purposes. The reforms will also ensure a level playing field between small, large and NFP commercial activities.
35. The reforms will not affect the use of tax concessions to directly further an NFP entity's altruistic purpose, even where the activity is done in a commercial way, such as tax concessions supporting NFP hospitals, op-shops that sell second hand household items and clothing at discounted prices to disadvantaged members of the public, NFP child care centres, and charities whose purpose is to provide meaningful employment to disabled persons.
36. The reforms will also not affect NFP entities carrying on small-scale and low-risk activities such as lamington drive fundraisers, school fetes and leasing out of church halls. Other examples of 'related' commercial activity which the ATO has found to be acceptable are provided in Appendix 3.
37. The reforms will also not affect the passive investment activities of NFP entities.
38. Income tax exempt entities will begin to pay income tax on profits from unrelated commercial activities that are not directed back to their altruistic purpose. The intent is to ensure that the focus of the entity remains the altruistic purpose, promoting efficient use of resources for altruistic purposes and lessening business risk to altruistic assets from unprofitable commercial activities.
39. The Government is seeking sector views on how best to achieve this policy outcome. The models used by the United Kingdom (UK), Canada, the United States (US), Ireland and South Africa to target tax concessions to altruistic or charitable purposes are at Appendix 1.
40. These reforms will be implemented using a principles-based approach to tax law design, in accordance with the Government's commitment to improve tax system governance.¹⁸

18 Treasurer's Media Release No. 048 of 2011, 'Making Australia's tax system simpler and fairer', 10 May 2011.

2.2 ISSUES FOR CONSULTATION

What activities are related (or primary purpose) activities of an NFP?

41. The Government provides valuable tax concessions to support the altruistic activities of NFP entities. The reforms are intended to encourage altruistic entities to direct profits generated by unrelated commercial activities back to their altruistic purposes.
42. The Government announced that the reforms will not affect the use of tax concessions to directly further an NFP entity's altruistic purpose (that is, its primary purpose), even where the activity is done in a commercial way.
43. The altruistic purposes of an NFP are the purposes for which the Government provides the tax concessions. For example, in the case of charities, these would be the purposes for which the entity is endorsed as a charity (that is, its charitable objects/purpose).
44. Various common law countries direct their tax concessions to the altruistic activities of their charities or NFPs using various mechanisms.
 - 44.1. The UK describes 'primary purpose activities' as activities exercised in the course of the actual carrying out of a primary purpose of the entity.
 - 44.2. The Canada Revenue Agency explains its view of 'related business' based on common law principles to include businesses linked to a charity's purpose and subordinate to that purpose. The four forms of linkage identified are: business activities that supplement or are necessary for the effective operation of charitable programs; off-shoot or sale of by-product; use of excess capacity (assets or staff); and sale of items that promote the charity or its objects. Four factors indicating 'subordinate to the charitable purpose' are also identified. These cover the size of the business relative to the charity's operations, the integration of the business into the charity's operations, whether the charitable goals continue to dominate the entity's decision-making, and that the organisation operates for an exclusively charitable purpose.¹⁹
 - 44.3. While the US does not define 'related activity', the US defines 'unrelated trade or business' as:

any trade or business the conduct of which is not substantially related (aside from the need of such organisation for income or funds or the use it makes of the profits derived) to the exercise or performance by such organisation of its charitable, educational, or other purpose or function constituting the basis for its exemption ...
 - 44.4. In Ireland, the legislation refers to 'trades which are exercised in the course of the actual carrying out of a primary purpose of the charity'.
 - 44.5. In South Africa, 'related activity' is described as being 'integral and directly related to the sole or principal object of that public benevolent organisation, carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost, and does not result in unfair competition in relation to taxable entities'.
45. Consistent with the Government's policy intent, each of the above definitions would result in commercial activities which directly further an NFP entity's altruistic purpose, even where the

¹⁹ CPS-019.

activity is done in a commercial way, being ‘primary purpose’ (UK and Ireland), a ‘related activity’ (South Africa and Canada) or not an ‘unrelated trade or business’ (US).

46. Several countries explicitly define ‘trading carried out by beneficiaries’ as being income tax exempt. However, in Australia, commercial activity carried out through the employment of, say, individuals with a disability, is considered to be intrinsically charitable. Hence, if an NFP ran a pizza franchise for the purpose of employing persons with a disability, this would also be considered primary purpose activities.
47. In Australia a purpose is ‘incidental or ancillary to a charitable purpose if it tends to assist, or naturally goes with, the achievement of the charitable purpose.’²⁰ Ancillary activity would be considered as part of an NFP’s primary purpose commercial activities and remain income tax exempt. The level of annual turnover in commercial activities will have a bearing on the question whether the commercial activity really is ancillary. Commercial activity would not be regarded as ancillary to the carrying out of a primary purpose of the charity simply because its purpose is to raise funds or income for the charity.

Consultation questions

1. What should be the scope of a related business, unrelated business, primary purpose or non-primary purpose test?

Small-scale or low-risk commercial activity

48. The Government announced that the reforms will not affect NFP entities carrying on small-scale or low-risk activities such as lamington drive fundraisers and school fetes.
49. The small commercial activity exemptions provided in two comparable jurisdictions are outlined below.
 - 49.1. UK tax law provides a small-scale exemption from corporation tax (or income tax in the case of charitable trusts) on the profits from small-scale non-primary purpose trading, plus certain other income categorised as ‘incoming resources from miscellaneous activities’, subject to certain turnover thresholds. Small-scale trading is trading where the annual total turnover does not exceed £5,000, or 25 per cent of the charity’s total incoming resources subject to a limit of £50,000. The small-scale exemption applies only where all the relevant profits or income are applied for a charity’s purposes, not where the trading profits or other income are exempt from tax on some other basis.
 - 49.2. South African law contains a small activity exemption where do not exceed the greater of 5 per cent of the total receipts and accruals of that public benevolent organisation during the relevant year of assessment; or R150 000.
50. The UK charity law prevents charities from engage in non-primary purpose trading where there is a significant risk of loss to the assets of the charity. The significant risk to be avoided here is

20 Draft Taxation Ruling Income tax and fringe benefits tax: charities TR 2011/D2 paragraphs 27-28. This draft ruling is a publication released for public comment to replace Taxation Ruling Income tax and fringe benefits tax: charities TR 2005/21. TR 2011/D2 represents the Commissioner of Taxation’s preliminary views and affords specified protections if it is relied on.

that the turnover is insufficient to meet the costs of carrying on the trade, and the difference has to be financed out of the assets of the charity.

Consultation questions:

2. Should there be a small-scale threshold, and if so, what would be the appropriate threshold?
3. Is there an alternative principle that could be used to provide a small-scale or low-risk activity exemption?

Entity structure

51. The Government recognises that NFPs undertake unrelated commercial activities either as an integral part of their activities or in order to raise the funds necessary to carry out their charitable work. The Government is not acting to prevent NFPs from carrying on unrelated commercial activities. However, income tax exempt entities will begin to pay income tax on profits from unrelated commercial activities that are not directed back to the altruistic activity. The reforms are also intended to ensure a level playing field between for-profit and NFP commercial activities.
52. There are various methods by which the Government could implement this reform:
 - 52.1. Option 1 — Unrelated commercial activities could be undertaken through a separate entity which would be taxed equivalently to other commercial entities in Australia;
 - 52.2. Option 2 — Unrelated commercial activities could be undertaken in a separate entity, and profits retained in the entity at the end of the year would be taxed; or
 - 52.3. Option 3 — NFP entities could undertake unrelated activities within the NFP entity.
53. These options are outlined below.

Option 1 — Unrelated commercial activities could be undertaken through a separate entity which would be taxed equivalently to other commercial entities in Australia

54. Under this option, unrelated commercial activities could be undertaken through a separate entity. The separate entity could be taxed equivalently to all other commercial entities in Australia. However, where profits were provided to the *charity* for altruistic purposes they would be effectively income tax exempt. Existing mechanisms which allow an entity to pay its profits to a *charity* for charitable purposes are outlined below.
 - 54.1. Where the charity operates the unrelated commercial activity in a separate entity, the subsidiary may pay a franked dividend to the parent charity which, subject to entitlement as a charity or a DGR, applies for a refund of franking credits.
 - 54.2. If the parent is a DGR, the subsidiary may make tax deductible donations to the parent DGR where there are no commercial benefits flowing from the donation and the donation meets the other requirements to be considered a genuine gift.
 - 54.3. If the commercial activity is operated through a trust, the income of the trust may be distributed to the charity. If the income is applied to altruistic purposes, neither the

charity nor the trustee is likely to be subject to income tax. However, if the monies are not applied to altruistic purposes, either the charity or trustee may be subject to income tax. Proposed reforms to provide certainty for trusts may affect the taxation of trust income.

55. The categories of DGR cover a range of subsets of altruistic purposes including health, education, research, welfare and rights, environment, overseas aid funds and cultural organisations. Many charities also operate or partner with associated DGR funds or institutions.
56. The policy objective of ensuring that profits of a *non-charitable* exempt entity that are applied to altruistic purposes are income tax exempt can be achieved under the following concepts of the ITAA 1997.
 - 56.1. Where the entity donates the profits to another entity that is a DGR.
 - 56.2. If the commercial activity is operated through a trust, the income of the trust may be distributed to the NFP. If the income is applied to altruistic purposes, neither the NFP nor the trustee is likely to be subject to income tax. However, if the monies are not applied to altruistic purposes, either the NFP or trustee may be subject to income tax. Proposed reforms to provide certainty for trusts may affect the taxation of trust income.
57. Non-charitable income tax exempt entities (such as sports clubs and resource development organisations) are not generally eligible for franking credit refunds currently. Hence, franked dividends paid to a parent non-charitable exempt entity are not refundable. Community service organisations however commonly have a close association with one or more charities that are DGRs and may choose to establish a separate entity and pay franked dividends to these charities.
 - 57.1. Further consideration could be given to widening refundable franking credit rules to achieve the policy intent.
58. There are several benefits of separating unrelated commercial activities into a separate entity.
 - It would provide greater transparency as to what activities taxpayer money is supporting.
 - It would ensure that unrelated commercial activities are treated consistently with for-profit commercial activities.
 - It would be simple to administer, including where the unrelated commercial activity is not 100 per cent owned by the NFP, or where ownership changes partway through a year.
 - A subsidiary is not subjected to limits that may apply to an NFP if it chooses to conduct the activity itself. It will be free to operate on a purely commercial basis, using appropriate business models.
 - As unrelated commercial activities would be undertaken by a separate entity, the day-to-day operations of an unrelated commercial activity would not divert the time or effort of the NFP from its altruistic purposes.

- The risks associated with commercial activity would not place the assets of the charity or NFP at risk. In the UK, charity law allows charities to engage in non-primary purpose trading where no significant risk of loss is involved to the assets of the charity. The risk to be avoided here is that the turnover is insufficient to meet the costs of carrying on the trade, and the difference has to be financed out of the assets of the charity.

59. However, implementation of this option would need to take account of limitations imposed by other laws, such as state licensing and gambling laws, which may make it impossible to operate a separate entity and existing complex legal structures, that may need to be unwound.

60. The UK and Ireland both implement models similar to this option.

Option 2 — Unrelated commercial activities could be undertaken in a separate entity, and profits retained in the entity at the end of the year would be taxed

61. Under this option, unrelated commercial activity could be undertaken in a separate entity, and only those profits retained in the entity at the end of the year would be taxed.

62. This option would have the same benefits as Option 1, with respect to protecting the charitable assets and not diverting NFP time and effort away from its altruistic purposes.

63. This option would also provide NFP entities with a cash flow advantage over Option 1, as the NFP commercial activity would not be required to pay tax until the end of the year. This comes about because ordinary commercial entities would be subject to pay-as-you-go instalments and therefore would be paying income tax during the year.

64. However, this Option would be complex to implement and administer as it would require development of new taxation rules. It would also be necessary to address issues such as dealing with entities which are not 100 per cent owned, or where ownership changes partway through the year would.

64.1. Further, introducing a whole new corporate tax system for a small segment of the market introduces significant complexities for taxpayers, advisers and administrators.

Option 3 — NFP entities could undertake unrelated activities within the NFP entity

65. Under this Option NFP entities could undertake unrelated commercial activities within the NFP entity. However, the unrelated commercial activities would need to be accounted for separately and, if not directed to altruistic purposes within the year, be subject to taxation.

66. This Option may minimise the costs of restructuring for NFP entities that are already operating in this manner.

67. This Option would also allow an NFP to commence a new commercial activity without setting up a new entity.

68. However, there are several disadvantages of this Option.

- It would place higher compliance costs on the NFP, as separating activities between those which are related and those which are not related would be difficult.
- It would be complex to administer.

- It would not protect the assets of the NFP entity from risks associated with commercial activities.
 - It would not provide transparency as to how taxpayer money was being utilised.
 - The NFP focus would be divided between both the NFP activities and the unrelated commercial activities.
 - It would require input taxes to be applied on an activity basis rather than the entity basis that they are currently based upon.
69. The US does not require unrelated commercial activities to be undertaken through a separate entity. However, the complexities of the system for administering this policy have resulted in most entities choosing nonetheless to set up separate entities to avoid high compliance costs.

Consultation questions

4. Would there be any unintended consequences resulting from any of these options?
5. Which option do you prefer and why?
6. Would we need to proceed with more than one option?

3. TRANSITIONING TO THE NEW RULES

3.1 NEW UNRELATED COMMERCIAL ACTIVITIES COMMENCING AFTER 7:30 PM (AEST) ON 10 MAY 2011

70. The Government announced that the new arrangements commence on 1 July 2011 and will apply initially to unrelated commercial activities commenced after 7:30pm (AEST) on 10 May 2011.
71. If an income tax exempt entity commences a new unrelated activity after this date, that activity will be taxable. Depending on the model adopted for the reforms and the scale of the activity, in many cases the activity may need to be operated in a separate entity.
72. If an income tax exempt entity has commenced an unrelated commercial activity after 7:30 pm (AEST) 10 May 2011, the activity will be taxable from 1 July 2011.

3.2 UNRELATED COMMERCIAL ACTIVITIES EXISTING AS AT 7:30 PM (AEST) ON 10 MAY 2011

73. NFP entities with existing unrelated commercial activities will initially be able to continue to use their tax concessions to support these activities. An important role of this consultation paper is to seek views on transitional arrangements for these existing activities with, as stated in the press release, the intention of phasing them out over time.
74. Going forward, NFP entities with existing unrelated commercial activities will not be able to apply their tax concessions to new unrelated activities.
75. The purpose of the reforms is to provide a level playing field for small, large and NFP commercial activities. If NFPs are allowed to continue operating existing or undertake new unrelated business activities, these entities would be advantaged over entities that commence new unrelated business activities post 7:30 pm (AEST) on 10 May 2011. This advantage compounds where an existing activity expands over time without any change and so retains its income tax exempt status.
76. Providing a transition period will allow NFP entities the opportunity to re-structure their activities. It is therefore necessary to determine the appropriate transition of existing exempt unrelated business activities to taxable activities.
77. At the end of the transition period an entity operating an existing unrelated business activity will, depending on the model selected, need either to transfer the activity to a new taxable entity or pay tax on income from the activity if profits are retained. For some entities this may happen before the end of the period.

Consultation questions

7. Would assistance be required to transition to the new arrangements?
8. What costs will need to be borne by the entity?
9. What are the implications of longer versus shorter transitional periods?

Identifying an existing unrelated commercial activity

78. All altruistic income tax exempt entities will need to determine whether one or more of their activities may be regarded as unrelated commercial activity. The examples of 'related' activities provided in the press release and in Appendix 2 are provided as a guide. Ultimately, the characterisation of an activity will depend on the model that is adopted.
79. What may be regarded as an 'activity' is important in determining whether a particular post 10 May 2011 operation is regarded as a new activity or merely part of the operations of an existing activity. It is reasonable to expect that the decision will vary depending on the scale of the entity and the scale and type of commercial operation.
80. The 'same business test' that applies to carry forward corporate losses provides a model on how an assessment of existing business activities can be made on an ongoing basis.

Consultation questions

10. Would identification of the existing activity be by reference to the overall business or to particular activities? Provide examples including an explanation of the nature of the activity/activities.
11. Should activities intended to be carried on or contracted to enter into before 7:30 pm (AEST) on 10 May 2011 be included? How would these be evidenced?

Identifying a new activity

81. Should an entity with an existing income tax exempt commercial activity expand or change its operations during the transition period, these may affect their tax treatment. Commencing other activities in addition to the goods or services provided as at 10 May 2011 may result in a new activity, which would not be income tax exempt. The determination of what is a new activity would also need to consider the following:²¹
 - changes in the goods or services. Improving existing goods or services may not be a new activity, but a significant change in the goods or services provided may constitute a new activity;
 - an increase in the goods or services provided. An increase of sales of the same goods or services may not be a change in activity, but an increase of sales due to another factor may constitute a new activity;
 - a change in the market for goods or services — business considerations for the change in market would be relevant;
 - changes in the mix of customers of the taxpayer;
 - changes in the method of selling the goods or services;

²¹ This list is an adaptation of factors in Taxation Ruling TR 1999/9 'same business test'.

- changes in the location or locations — adding a new location would be a new activity, but merely moving to the same activity to a new location might not be;
- changes in the trade names, trade-marks, patents, royalty arrangements or other intellectual property rights;
- changes in the number of employees or contractors and in the nature of services performed by them;
- periods of dormancy — a new activity commences after dormancy;
- taking over another entity — any activity of the old entity will be a new activity of the continuing entity; and
- amalgamating with another entity — where the amalgamation results in a new entity, all activities of the new entity are new activities.

82. For some entities the administration involved in monitoring whether a new activity has commenced and if so the allocation of income and expenses across existing and new activities to arrive at a taxable income may outweigh the cost of merely transferring all unrelated commercial activities to a new entity.

Consultation questions:

12. What should be the test for identifying new activities?

Government service delivery contracts

83. Where NFP entities have already entered into government service delivery contracts, allowing these entities to complete the terms of these contracts will ensure they continue to access the commensurate tax concessions. These contracts will not be able to be extended nor materially varied or altered without losing the benefit of the transitional arrangement.

Consultation questions

13. What is an acceptable time limit for allowing tax concessions for existing government service delivery? Why?

National Rental Affordability Scheme

84. NFP entities who participate in the 50,000 National Rental Affordability Scheme allocations will be allowed to use their tax concessions in support of that activity.

The tax treatment of entities moving from exempt to taxable

85. Divisions 57 in Schedule 2D of the *Income Tax Assessment Act 1936* (ITAA 1936) and Division 58 of the ITAA 1997 currently provides for tax consequences which arise when an entity the income of which is exempt becomes, for any reason, subject to tax on any part of its income under the provisions of the Act.

86. The Division does not cover the situation where an exempt entity transfers its taxable business activities to a new entity. It does however provide for the situation where responsibility for 'particular functions' or 'particular activities' previously operated by an exempt government entity are transferred, either directly or to a new entity. A similar approach could be taken for exempt entities transferring functions and activities to a new entity.
87. The explanatory memorandum to the Bill²² inserting Divisions 57 in Schedule 2D into the ITAA 1936 explained that there were several models for dealing with the tax consequences of a change from exempt to taxable status investigated at the time. The explanatory memorandum explains three of these models as follows:

New taxpayer

Under this model, an entity becoming taxable is treated as if it comes into existence at the moment it becomes taxable. Such a new taxpayer has assets and liabilities and a variety of rights and obligations. Unless costs of its assets and consideration for its liabilities are imputed to it, it will have extreme tax consequences of any realisation of assets or satisfaction of liabilities; the most obvious way of dealing with this is to impute to the new taxpayer costs and consideration based on value at the moment the entity becomes taxable. Depreciation would have to be based on an imputed cost of depreciable assets, as otherwise all depreciation for existing assets would be denied; again, the market value at the moment the entity becomes taxable is an obvious possible starting point. Income and outgoings, if treated on the basis that the entity is a new taxpayer, could fall capriciously: that is, income could be fortuitously derived before or after the moment the entity becomes taxable and comes into existence as a taxpayer, and outgoings could arise similarly. A 'new taxpayer' model suggests that only what is derived or incurred by the new taxpayer is and is wholly relevant to the new taxpayer's tax position.

Continuing taxpayer without modification

This model involves the application of the existing law without modification. It results in the transition to taxable status having both positive and adverse income tax consequences. For instance, an assessable profit realised after transition will form part of assessable income, even if its value did not increase after transition. Many transitions to the Commonwealth tax net have so far occurred by this 'seamless transition' approach, or have relied on it with only minor modifications.

Continuing taxpayer, apportionment to taxable period

This model is colloquially referred to as the 'rule the books' approach. It involves ensuring that, to the extent that is practical, only income and deductions, gains and losses and tax effects that relate to the taxable period are included in that period, while those relating to the exempt period are excluded. In many cases, the simplest way to do this in relation to later gains and losses is by reference to the market value of assets and liabilities, when the entity becomes taxable, and so on these issues this will produce the same solutions as the most likely imputed costs and consideration under the 'new taxpayer' model.

88. The latter model or 'rule of books' approach was adopted in Division 57.

22 Taxation Laws Amendment Bill (No. 3) 1996

Consultation question

14. Will the continuation of the 'rule of books' model in Division 57 in Schedule 2f of the ITAA 1936 achieve an appropriate transition from exemption to taxable status?
15. Are there any other factors to consider in transferring a taxable function or activity of an exempt entity to a separate entity?

APPENDIX 1

89. The United Kingdom, Canada, the United States, Ireland and South Africa have adopted different models for targeting tax concessions to altruistic activities. This appendix sets out the models used in these countries.

THE UK MODEL

90. Charitable organisations based in England and Wales must register with the independent regulator of charities, the Charity Commission, if their income is over £5,000 a year.

91. To be a charity an organisation must be established for 'charitable purposes' only.²³ A charitable purpose must be for the public benefit, and falls within a number of named descriptions of purposes including (but not limited to) the prevention or relief of poverty, and the advancement of education, amateur sport, and environmental protection or improvement.²⁴

92. Once a charity is registered it can apply to Her Majesty's Revenue and Customs (HMRC) for recognition as a charity for tax purposes.²⁵

93. Tax exemption or tax relief is available on most of the income and gains received by charities provided the money is only used for charitable purposes, for example on:

- income received from individuals through 'Gift Aid' donations;
- most types of investment income;
- certain types of regular sources of income including bank or building society interest, royalties and stocks;
- income received from renting out land or property (whether in the UK or overseas) that the charity holds for charitable purposes; and
- capital gains on the proceeds of a disposal.

94. The basic rule is that profits a charity makes from trading activities are taxable, but this is subject to some exemptions.

95. Tax concessions may also extend to entities which are not charitable but altruistic in their purpose, for example amateur sports clubs. Once a sports club is registered with HMRC tax is payable on trading profits but only if its turnover is more than £30,000 per year.

Trading activities and taxation

96. In England and Wales, while charities may trade more or less freely in pursuit of their charitable objectives, there are restrictions on engaging in commercial activities the objective of which is to generate funds for the charity.²⁶

23 Section 1(a) *Charities Act 2006* (UK)

24 Section 2 *Charities Act 2006* (UK)

25 Some organisations are excepted or exempt from registration with the Charity Commission, however may still be recognised as a charity for tax purposes.

97. A charity is exempt from tax on the profits of any trade carried on in the UK or elsewhere provided its income is applied solely to charitable purposes and:
- the trade is exercised in the course of the actual carrying out of a primary purpose of the charity;²⁷
 - the work connected to the trade is mainly carried out by beneficiaries of the charity;²⁸
 - the trade is a non-primary purpose trade, the turnover of which falls below certain limits;²⁹ or
 - its profits have arisen from certain lotteries.
98. Charities are therefore allowed to undertake commercial activities provided these activities are either primary purpose trading, undertaken mainly by its beneficiaries or low-risk/small-scale non-primary purpose trading.

Primary purpose trading

99. Primary purpose trading contributes directly to one or more of the objects of a charity as set out in its governing document. Examples include an educational institution that provides educational services or courses on a fee payment basis, and a residential care charity which charges for residential accommodation. This form of trading is income tax exempt.
100. Primary purpose trading also includes ancillary trading, that is, trading that contributes indirectly to the successful furtherance of the purposes of the charity. For example, the sale of food and drink in a restaurant or bar by a theatre charity to members of an audience. The level of annual turnover in trading has a bearing on the question whether the trading really is ancillary, but there is no specific level. However, trading is not regarded as ancillary to the carrying out of a primary purpose of the charity simply because its purpose is to raise funds/income for the charity.
101. While all trading exercised in the course of carrying out a primary purpose of the charity is income tax exempt,³⁰ if a trade is exercised partly in the course of carrying out a primary purpose of the charity and partly not, each part is treated as a separate trade for taxation purposes.³¹ The primary purpose portion of the trade is income tax exempt.³²

Trading carried out by beneficiaries

102. Trading which is non-primary purpose but carried out mainly by beneficiaries (for example, the manufacture and sale of items by disabled people) is income tax exempt.³³
103. Where the work in connection with a charity's trade is carried out partly but not mainly by beneficiaries, the part carried out by beneficiaries is deemed to be part of the charity's exempt beneficiary trade and is income tax exempt.³⁴

26 <http://www.charity-commission.gov.uk/Publications/cc35.aspx> 'CC35 - Trustees, trading and tax' Version April 2007.

27 Section 478 of the *Corporations Tax Act 2010* (UK) and subsection 524 of the *Income Tax Act 2007* (UK).

28 Section 478 of the *Corporations Tax Act 2010* (UK) and subsection 524 of the *Income Tax Act 2007* (UK).

29 Section 480 of the *Corporation Tax Act 2010* (UK) and section 526 of the *Income Tax Act 2007* (UK).

30 Section 478 of the *Corporations Tax Act 2010* (UK) and subsection 524 of the *Income Tax Act 2007* (UK).

31 Subsection 479(2) of the *Corporations Tax Act 2010* (UK) and subsection 525(2) of the *Income Tax Act 2007* (UK).

32 Section 478 of the *Corporations Tax Act 2010* (UK) and subsection 524 of the *Income Tax Act 2007* (UK).

33 Section 478 of the *Corporations Tax Act 2010* (UK) and subsection 524 of the *Income Tax Act 2007* (UK).

104. The part not carried out by beneficiaries is deemed to be a separate trade. Assuming it is for a non-primary purpose, this will be taxable (unless the small trading exemption applies).³⁵

Non-primary purpose trading

105. Non-primary purpose trading involves trading with a main purpose of raising funds for the charity. It is distinct from trading which in itself furthers the charity's objects. Non-primary purpose trading generally includes the conduct of lotteries (the profits of which can be exempt from tax under certain conditions).

Trading activities and charity law

106. Charity law allows charities to engage in non-primary purpose trading where no significant risk of loss is involved to the assets of the charity.³⁶

107. The significant risk to be avoided here is that the turnover is insufficient to meet the costs of carrying on the trade, and the difference has to be financed out of the assets of the charity. Whether or not the risk associated with non-primary purpose trading is 'significant' is based on an assessment of a number of factors, including:

- the size of the charity;
- the nature of the business;
- the expected outgoings;
- turnover projections; and
- the sensitivity of the business' profitability to the rise and fall of the market.

108. Non-primary purpose trading is not subject to income tax exemptions — apart from the small-scale trading exemption (which should not involve significant risk).

109. The small-scale exemption is a statutory exemption³⁷ from corporation tax (or income tax in the case of charitable trusts) on the profits from small-scale non-primary purpose trading, plus certain other income categorised as 'incoming resources from miscellaneous activities', subject to certain turnover thresholds. Small-scale trading is trading where the annual total turnover does not exceed £5,000, or 25 per cent of the charity's total incoming resources subject to a limit of £50,000. There are further limitations on access to an exemption for trading activities to ensure the integrity of the tax system and ring fence charitable assets.

110. The small-scale exemption applies only where all the relevant profits or income are applied for a charity's purposes, not where the trading profits or other income are exempt from tax on some other basis.

111. The effect of non-primary purpose trading and the application of the small-scale exemption is that profits from a trading activity which have nothing to do with a charity's primary purpose and do not involve any beneficiaries, can still be exempt from tax.

34 Subsection 479(3) of the *Corporations Tax Act 2010* (UK) and subsection 525(3) of the *Income Tax Act 2007* (UK).

35 Subsection 479(3) of the *Corporations Tax Act 2010* (UK) and subsection 525(3) of the *Income Tax Act 2007* (UK).

36 Charity Commission 'CC35 - Trustees, trading and tax: How charities may lawfully trade'.

37 Section 480 of the *Corporation Tax Act 2010*(UK) and section 526 of the *Income Tax Act 2007*(UK).

112. Where a charity trades partly in the course of carrying out its primary purpose and partly for non-primary purposes each part is a separate trade for tax purposes.³⁸ The charity's non-primary purpose trade is not exempt from tax, unless the work is carried out mainly or partly by beneficiaries or the small trading exemption applies.
113. Where trading (other than trading in pursuit of charitable objects) involves significant risk to a charity's assets, it must be undertaken by a trading subsidiary.³⁹

Trading subsidiary

114. A trading subsidiary is a company, owned and controlled by one or more charities, set up in order to trade. The purpose of a trading subsidiary is usually to generate income for its parent charity. A trading subsidiary must be used for non-primary purpose trades involving significant risk to the assets of the charity, and is itself not a charity.
115. In the UK, where a charity itself trades and receives tax exemption, that exemption can be placed at risk if a loss is incurred. Charities are therefore encouraged to consider this consequence when deciding whether or not trading should be carried on by a trading subsidiary.
116. The income and retained trading profits from a trade which is carried on by a trading subsidiary are not income tax exempt but profits can be transferred back to the parent entities effectively tax free through the use of 'Gift Aid'.

The Canadian model

117. NFPs exempt from income tax under the Canadian income tax law include registered charities, agricultural organisations, boards of trade or chambers of commerce, benevolent or fraternal benefit societies and clubs, societies or associations organised and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit.⁴⁰
118. The Canadian income tax law describes two categories of charity that may be registered:
- charitable organisations — organisations 'all the resources of which are devoted to charitable activities carried on by the organisation itself';⁴¹ and
 - charitable foundations — corporations or trusts constituted and operated exclusively for charitable purposes that are not charitable organisations. Charitable foundations cannot carry on any business.⁴²
119. Registered charities are liable to a penalty of 5 per cent of gross revenue from a business that is not a 'related business'.⁴³ In the case of a charitable foundation the penalty applies if the foundation carries on any business. The penalty is increased to 100 per cent if the charity re-offends within 5 years.

38 Subsection 479(2) of the *Corporations Tax Act 2010* (UK) and subsection 525(2) of the *Income Tax Act 2007* (UK).

39 Charity Commission 'CC35 - Trustees, trading and tax: How charities may lawfully trade'.

40 Subsection 149(1) of the *Income Tax Act* (Canada).

41 Subsection 149.1(1) of the *Income Tax Act* (Canada).

42 Subsection 149.1(1) of the *Income Tax Act* (Canada).

43 Subsections 188.1(1) and (2) of the *Income Tax Act* (Canada).

120. 'Related business' is not defined except to include a business staffed substantially with volunteers.⁴⁴ The Canadian Federal Court of Appeal in *Earth Fund v. Canada (MNR)*⁴⁵ rejected the argument that any business is a 'related business' of a charitable foundation if all of the profits of the business are dedicated to the foundation's charitable objects.
121. Registration as a charity may also be revoked or refused where a charitable organisation carries on a business that is not a 'related business'; or where a charitable foundation carries on any kind of business — related or unrelated .
122. The Canada Revenue Agency explains its view of 'related business' based on common law principles in CPS-019 to include businesses linked to a charity's purpose and subordinate to that purpose.
123. Four forms of linkage are identified. These cover activities that supplement or are necessary for the effective operation of charitable programs; off-shoot or sale of by-product; use of excess capacity (assets or staff); and sale of items that promote the charity or its objects. CPS-019 provides the following examples:
- Business activities that supplement charitable programs.
 - A hospital's parking lots, cafeterias, and gift shops for the use of patients, visitors, and staff.
 - Gift shops and food outlets in art galleries or museums for visitors.
 - Book stores, student residences, and dining halls at universities for the use of students and faculty.
 - Off-shoot or sale of by-product.
 - A heritage village plants various grain crops in the fields surrounding the village. It does this so it can show visitors 19th century farm implements and how these implements were actually used. The grain is taken by cart to the village's mill, where visitors can watch it being ground into flour. This flour is then sold in a store within the heritage village and in a for-profit grocery store in a nearby community.
 - A church records its regular Sunday services for the benefit of members of the congregation who may have missed the service and others who wish to listen to it again. The church charges a small fee to cover the recording cost.
 - The same church has a famous choir, and each year its special Christmas services attract an overflowing attendance and a large audience for the recording of these services. The church sells the Christmas recordings, charging as high a price as it can obtain for them. This is a business activity. However, the business is related to the charity's purpose because the church first has to carry out part of its charitable program—holding the Christmas services—before it has anything to market.

44 Subsection 149.1(1) of the Income Tax Act (Canada).

45 2002 FCA 498.

- Use of excess capacity.
 - A charity’s program is a two-week arts festival held outdoors in July. The charity must have tents to protect performers and exhibits from the weather. No suitable tents are available in the community for rent, so the charity decides to buy its own tents. During the rest of the year, the charity can rent out the tents as a related business.
 - During the academic year, a university needs classrooms and student residences to operate. However, during the summer months, they sit empty. The university can rent out its facilities to conferences or visitors as a related business.
 - A church has a parking lot of a size determined by municipal by-laws or by the needs of its Sunday-morning congregation. It can rent out its parking spaces during the week as a related business.
- Sale of items that promote the charity or its objects.
 - Pens and cookies clearly displaying the charity’s name or logo, and t-shirts or posters depicting the work of the charity.

124. Four factors indicating ‘subordinate to the charitable purpose’ are also identified in the statement. These cover the size of the business relative to the charity’s operations, the integration of the business into the charity’s operations, whether the charitable goals continue to dominate the entity’s decision-making, and that the organisation operates for an exclusively charitable purpose.
125. CPS-019 notes that activities such as soliciting donations and selling donated goods to merely convert them to cash would not be considered businesses. Indicators provided that a charitable program involving a fee is not a business include: fee structures designed to defray costs rather than generate a profit; programs not otherwise available in the marketplace; and fees set according to a charitable objective as opposed to a market objective.
126. CPS-019 explains that a charity is normally invited to wind-up the unrelated business or to place it in a separate taxable corporation within a reasonable timeframe. If it does not do so, and there are no extenuating circumstances, its registration is revoked.
127. Charities in Canada can invest in a trading subsidiary on the same basis that it can invest in any other for-profit business. The charity’s directors/trustees would need to satisfy themselves that the investment represents a prudent use of the charity’s assets. They also need to be alert to ensure no benefit of a private nature is conferred on the corporation.
128. A charitable organisation can retain control over its trading subsidiary through share holdings or a power to nominate the board of directors. However, the Act does not allow charitable foundations to acquire more than half of the voting shares of a taxable company, unless the shares in the company were donated to the foundation.
129. Generally, donors can claim a tax credit up to 75 per cent of gross income for the year based on the eligible amount of the gift given to a qualified donee. However, this limit may be increased where capital property is donated. The eligible amount of gifts may be carried forward and claimed once, on any return for the next five years.

The US model

130. The US Internal Revenue Code provides for exemption from income tax under a number of categories including charities, educational bodies, private foundations, social welfare organisations, business leagues and social and recreational clubs.⁴⁶
131. Where an organisation qualifies under an exempt category, income tax may be imposed on an unrelated trade or business that the organisation carries on.⁴⁷
132. Section 513 of the Code defines ‘unrelated trade or business’ as
- any trade or business the conduct of which is not substantially related (aside from the need of such organisation for income or funds or the use it makes of the profits derived) to the exercise or performance by such organisation of its charitable, educational, or other purpose or function constituting the basis for its exemption ...*
133. Activities such as trade or business undertaken by volunteers, non-contingent sponsorship and advertising, selling donated merchandise, bingo, distribution of low cost articles such as badges and ribbons to solicit donations, and activities undertaken as part of trade fairs, and conventions are specifically excluded.⁴⁸
134. A business activity is not substantially related to an organisation’s exempt purpose if it does not contribute importantly to accomplishing that purpose.⁴⁹ Examples provided in the Inland Revenue Service Publication 598 indicate a narrower approach than in Canada or the UK.⁵⁰ For example the publication describes a ‘use of excess capacity’ scenario considered to be an unrelated trade or business which would be accepted as a related business in Canada.
135. Tax is imposed on the organisation’s unrelated business taxable income — that is, gross income derived from any unrelated trade or business regularly carried on by the exempt organisation, less deductions directly connected with carrying on the trade or business. Several types of income are excluded from this calculation, but not for all exemption categories including recreational clubs. Examples of excluded income are dividends, interest, annuities and other investment income, royalties, rent, and gains on sale of property other than trading stock.⁵¹
136. As donors can only claim charitable contributions of up to 50 per cent of their adjusted gross income in the US, if a subsidiary provided all its profits to a charity, they may not be completely transfer their profits tax exempt. The US has a classical system of corporate taxation so there is no franking credit system to adjust this outcome.

The Republic of Ireland model

137. Subsection 2(1) of the Charities Act 2009 (Ireland) defines a charitable organisation in Ireland. Section 3 provides statutory guidance on charitable purpose, that is, those which fall under the categories for the relief of poverty or economic hardship, for the advancement of education, for the advancement of religion, and for other purposes beneficial to the community.⁵²

46 Subsection 501(a) of the Internal Revenue Code (US).

47 Subsection 501(b) and section 511 of the Internal Revenue Code (US).

48 Section 513 of the Internal Revenue Code (US).

49 US Treasury Regulation 1.513-1.

50 IRS Publication 598 *Tax on Unrelated Business Income of Exempt Organisations*.

51 Sections 511 and 512 of the Internal Revenue Code (US).

52 *Commissioner for Special Purposes of Income Tax v Pemsel* [1891] AC 531.

138. Subsection 7(1) provides the Act's provisions do not preclude the determination of eligibility for exemption from liability to pay any tax.
139. In Ireland where an entity seeks income tax exemption, it must apply to the Office of the Revenue Commissioners (that is, Irish Tax and Customs), following which it receives a reference number.
140. Tax exemption will not be granted to entities with a mix of charitable and non-charitable purposes and may be withdrawn (retrospectively if necessary) if the entity does not comply with its charitable objects or to the conditions associated with the exemption.
141. Section 207 of the *Taxes Consolidation Act 1997* provides that certain income of certain charities is exempt from income tax where it is applied solely for charitable purposes. Tax exemption is also available to athletic or amateur game or sports bodies under section 235 of the *Taxes Consolidation Act 1997*.
142. Section 208 of the Act provides for a separate exemption on the trading profits derived by a charity in pursuit of its objects.
143. Trading by charities can take a number of different forms but must fall into one of two broad categories:⁵³
- trades which are exercised in the course of the actual carrying out of a primary purpose of the charity:
 - an example of this type of arrangement would be a religious organisation selling religious publications that is, the main object of the organisation is promoting religion and selling publications is merely a facility to achieve that object; or
 - trades mainly carried on by the beneficiaries of the charity:
 - an example would be the sale of goods produced by disabled people through a shop or mail order catalogue.
144. In either case the profit of the trade must be applied solely for the purpose of the charity except with respect to the profits of a trade of farming carried on by a charity.
145. Trading exemption is not granted automatically with charitable exemption and must be applied for specifically if the entity is either currently or may, in the future, be engaged in trading.⁵⁴ Each application is considered on a case by case basis.
146. A charity may still qualify for the trading exemption if the activities are ancillary to pursuing its primary purpose.

The Republic of South Africa model

147. The South African Income Tax Act exempts the income of a range of altruistic NFPs including public benefit organisations, scientific and industrial bodies and social clubs.⁵⁵

53 Tax & Duty Manuals - Section 16 [7.1.6] and Sections 207 and 208 of the *Taxes Consolidation Act 1997* (Ireland).

54 'Applying for Relief from Tax on the Income and Property of Charities CHY 1 April 2009' Irish Tax and Customs.

55 Subsection 10(1) of the Income Tax Act (South Africa).

148. Public benevolent organisation (PBO) is a defined term in the Act.⁵⁶ It covers organisations whose 'sole or principal' object is the carrying on of one or more public benefit activities (PBAs) in a non-profit manner and with an altruistic or philanthropic intent. PBAs are listed charitable and altruistic activities covering areas such as welfare, health care, education, religion, environment, research and amateur sport.⁵⁷
149. Paragraph 10(1)(cN) of the Income Tax Act exempts the receipts and accruals of an approved PBO — to the extent that the receipts and accruals are derived:
- (i) otherwise than from any business undertaking or trading activity; or*
 - (ii) from any business undertaking or trading activity:*
 - (aa) if the undertaking or activity:*
 - (A) is integral and directly related to the sole or principal object of that PBO ...;*
 - (B) is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost; and*
 - (C) does not result in unfair competition in relation to taxable entities;*
 - (bb) if the undertaking or activity is of an occasional nature and undertaken substantially with assistance on a voluntary basis without compensation;*
 - (cc) if the undertaking or activity is approved by the Minister ... having regard to:*
 - (A) the scope and benevolent nature of the undertaking or activity;*
 - (B) the direct connection and interrelationship of the undertaking or activity with the sole or principal object of the PBO;*
 - (C) the profitability of the undertaking or activity; and*
 - (D) the level of economic distortion that may be caused by the tax exempt status of the PBO carrying out the undertaking or activity; or*
 - (dd) other than an undertaking or activity in respect of which item (aa), (bb) or (cc) applies and do not exceed the greater of — (i) 5 per cent of the total receipts and accruals of that PBO during the relevant year of assessment; or (ii) R150 000.⁵⁸*
150. A PBO may conduct a business for fundraising purposes, but the receipts and accruals from its business or trading activities that fall outside the parameters in section 10(1)(cN) are not exempt.
151. If a PBO receives a distribution of income as beneficiary of a trust that conducted trading activities such as rental income or profit on a commercial bookshop, the distribution is not exempt. However the amount may be taken into account in the basic exemption calculation in subparagraph 10(1)(cN)(dd).

⁵⁶ Section 30 of the Income Tax Act (South Africa).

⁵⁷ Part I of the Ninth Schedule to the Income Tax Act (South Africa).

⁵⁸ See South African Revenue Service Interpretation Note: 24 (Issue 2) for a comprehensive explanation.

152. Gains or losses from the disposal of non-trading assets or assets substantially used for PBA purposes (90 per cent PBA and 10 per cent trade) or for a permissible business or trade are disregarded for CGT purposes. Other assets attract CGT.
153. Tax is imposed at a flat rate of 28 per cent on the taxable income after allowance for related deductions.
154. The 'sole or principal' object of a PBO must remain the carrying on of one or more public benefit activities (PBAs) in an NFP manner and with an altruistic or philanthropic intent. If the taxable business or trading activities of an approved PBO become its principal object, its status as an approved PBO is withdrawn.
155. A similar approach is taken to the receipts and accruals of recreational clubs — approved companies, societies and associations with a sole or principal object to provide social and recreational amenities or facilities for members.⁵⁹ Recreational clubs are exempt to the extent that the receipts and accruals are derived:⁶⁰
- in the form of membership fees of subscriptions paid by its members;
 - from any business undertaking or trading activity that:
 - is integral and directly related to the provision of social and recreational amenities or facilities for the members of that club;
 - is conducted substantially on a cost recovery basis; and
 - does not result in unfair competition in relation to taxable entities;
 - from any fundraising activities of an occasional nature and undertaken substantially with assistance on a voluntary basis without compensation; and
 - from any other source and do not exceed the greater of 5 per cent of the total annual membership fees and subscriptions or R100 000.⁶¹
156. Capital gains or losses on the disposal of a recreational club's assets are taken into account for CGT purposes. Clubs may elect for roll-over relief on disposal of assets other than shares where the proceeds are used to acquire replacement assets.

59 Section 30A of the Income Tax Act (South Africa).

60 Paragraph 10(1)(cO) of the Income Tax Act (South Africa).

61 See South African Revenue Service Tax Guide for Recreational Clubs, 2 July 2010, for more information.

APPENDIX 2

157. Subdivision 50-A of the *Income Tax Assessment Act 1997* lists various income tax exempt entities. Section 50-1 provides:

The total ordinary income and statutory income of the entities covered by the following tables is exempt from income tax. In some cases, the exemption is subject to special conditions.

158. The tables from subdivision 50-A which provide for income tax exemption of altruistic exempt entities are reproduced below.

50-5 Charity, education, science and religion

Item	Exempt entity	Special conditions
1.1	Charitable institution	See sections 50-50 and 50-52
1.2	Religious institution	See section 50-50
1.3	Scientific institution	See section 50-55
1.4	Public educational institution	See section 50-55
1.5	Fund established for public charitable purposes by will before 1 July 1997	See sections 50-52 and 50-57
1.5A	Trust covered by paragraph 50-80(1)(c)	See sections 50-52 and 50-60
1.5B	Fund established in Australia for public charitable purposes by will or instrument of trust (and not covered by item 1.5 or 1.5A)	See sections 50-52 and 50-60
1.6	Fund established to enable scientific research to be conducted by or in conjunction with a public university or public hospital	See section 50-65
1.7	Society, association or club established for the encouragement of science	See section 50-70

50-10 Community service

Item	Exempt entity	Special conditions
2.1	Society, association or club established for community service purposes (except political or lobbying purposes)	See sections 50-70

50-15 Employees and employers

50-20 Funds contributing to other funds

Item	Exempt entity	Special conditions
4.1	Fund established by will or instrument of trust solely for a purpose referred to in paragraph (a) or (b) of the column headed 'Recipient' in item 2 of the table in section 30-15 (and not covered by item 1.5, 1.5A or 1.5B of the table in section 50-5)	See sections 50-52 and 50-72

50-25 Government

50-30 Health

Item	Exempt entity	Special conditions
6.1	Public hospital	See section 50-55
6.2	Hospital carried on by a society or association	Not carried on for the profit or gain of its individual members, see also section 50-55
6.3	Private health insurer within the meaning of the Private Health Insurance Act 2007	Not carried on for the profit or gain of its individual members

50-35 Mining

50-40 Primary and secondary resources, and tourism

Item	Exempt entity	Special conditions
8.1	a society or association established for the purpose of promoting the development of: (a) aviation; or (b) tourism	Not carried on for the profit or gain of its individual members
8.2	a society or association established for the purpose of promoting the development of any of the following Australian resources: (a) agricultural resources; (b) horticultural resources; (c) industrial resources; (d) manufacturing resources; (e) pastoral resources; (f) viticultural resources; (g) aquacultural resources; (h) fishing resources	not carried on for the profit or gain of its individual members
8.3	A society or association established for the purpose of promoting the development of Australian information and communications technology resources	Not carried on for the profit or gain of its individual members

50-45 Sports, culture, film and recreation

Item	Exempt entity	Special conditions
9.1	a society, association or club established for the encouragement of: (a) animal racing; or (b) art; or (c) a game or sport; or (d) literature; or (e) music	See section 50-70
9.2	a society, association or club established for musical purposes	See section 50-70

FBT concessions

159. Sections 57A and 65J of the *Fringe Benefits Assessment Act 1986* provide for FBT concessions for certain NFPs. The sections are reproduced below. There are several other minor FBT concessions available only in relation to NFPs.

57A Exempt benefits—public benevolent institutions, health promotion charities, some hospitals and public ambulance services

(1) Where the employer of an employee is a public benevolent institution endorsed under subsection 123C(1) or (5), a benefit provided in respect of the employment of the employee is an exempt benefit.

(2) Where:

(a) the employer of an employee is a government body; and

(b) the duties of the employment of the employee are exclusively performed in, or in connection with:

(i) a public hospital; or

(iii) a hospital carried on by a society that is a non-profit society for the purposes of section 65J or by an association that is a non-profit association for the purposes of section 65J;

a benefit provided in respect of the employment of the employee is an exempt benefit.

(3) A benefit provided in respect of the employment of an employee is an exempt benefit if:

(a) the employer of the employee is a public hospital; or

(b) the employer provides public ambulance services or services that support those services and the employee is predominantly involved in connection with the provision of those services.

(4) A benefit provided in respect of the employment of an employee is an exempt benefit if the employer of the employee is a hospital carried on by:

(a) a society that is a non-profit society for the purposes of section 65J; or

(b) an association that is a non-profit association for the purposes of section 65J.

Note: Subsection 65J(5) explains:

(a) which societies are non-profit societies for the purposes of section 65J; and

(b) which associations are non-profit associations for the purposes of section 65J.

(5) A benefit provided in respect of the employment of an employee is an exempt benefit if:

(a) the employer of the employee is a health promotion charity; and

(b) the health promotion charity is endorsed under subsection 123D(1).

65J Rebate for certain non-profit employers etc.

(1) For the purposes of this section, an employer is a rebatable employer for a year of tax if the employer is not a public benevolent institution, is not a health promotion charity, and is covered by any of the following paragraphs at any time during the year of tax:

(a) a religious institution;

(aa) a non-profit scientific institution that:

(i) is engaged solely in research into the causes, prevention or cure of diseases in humans; and

(ii) is established by a law of the Commonwealth, a State or a Territory; and

(iii) is not conducted by or on behalf of the Commonwealth, a State or a Territory;

(b) a scientific or public educational institution (other than an institution of the Commonwealth, a State or a Territory);

(baa) a charitable institution (other than an institution of the Commonwealth, a State or a Territory) that is endorsed under subsection 123E(1);

(ba) a school (including a pre-school but not including a tertiary institution) that:

(i) although established by or under a law of the Commonwealth, a State or a Territory, is not conducted for or on behalf of the Commonwealth, a State or a Territory; and

(ii) is not conducted for the purpose of profit or gain to the persons or body of persons conducting it;

(e) a trade union;

(f) an association of employers or employees registered or recognised under the Fair Work (Registered Organisations) Act 2009 or a law of the Commonwealth, a State or a Territory relating to the settlement of industrial disputes;

(g) a non-profit society, non-profit association, or non-profit club, established for musical purposes, or for the encouragement of music, art, science or literature;

(h) a non-profit society, non-profit association, or non-profit club, established for the encouragement or promotion of a game or sport;

(i) a non-profit society, non-profit association, or non-profit club, established for the encouragement or promotion of animal races;

(j) a non-profit society, non-profit association, or non-profit club, established for community service purposes (not being political purposes or lobbying purposes);

(k) a non-profit society, or non-profit association, established for the purpose of promoting the development of aviation or tourism;

(ka) a non-profit society, or non-profit association, established for the purpose of promoting the development of Australian information and communications technology resources;

(l) a non-profit society, or non-profit association, established for the purpose of promoting the development of the agricultural, pastoral, horticultural, viticultural, aquacultural, fishing, manufacturing or industrial resources of Australia.

APPENDIX 3

CHARITIES — BUSINESS-LIKE ACTIVITIES

Introduction

160. Charities can carry out commercial and business-like activities where they are only carried out for the sake of, or in aid of, or in furtherance of the charitable purposes.
161. The ATO web page (extracted below) provides examples of these incidental ways in which charities raise funds to carry out their charitable purposes, and carry out their purposes using business-like opportunities and methods. It is not an exhaustive list. There will also be many other instances.

Integrated business-like activities

Charities often utilise the opportunities that their particular charitable character provides — volunteers, assets, donations, and so on — in raising funds. Examples of such integrated business-like activities — in ways we accept as consistent with carrying out the charitable purposes — include:

A youth development organisation regularly runs biscuit and chocolate sale drives. The biscuits and chocolates are purchased in bulk, and packets are allocated to the children's families for sale to the public.

A school, using its hall and volunteers, runs bingo two afternoons per week to raise money for the school.

A welfare organisation runs a weekly raffle of items donated by local businesses.

A family-crisis organisation operates a store selling second-hand goods that have been donated to it. Its volunteers and employees collect and process the donated goods.

An art gallery operates a gift shop within the gallery building. The shop sells prints of the gallery's art works, and clothes and other goods bearing the gallery's logo.

A religious institution operates a bookshop selling religious books and devotional items.

A drama society runs a snack bar at its hall when it presents its plays.

A school operates a tuck-shop, including the sale of uniforms and text-books, new and second-hand.

The student union of a tertiary college operates the refectory on campus.

These examples illustrate business-like activities that are only for the sake of, or in aid of, or in furtherance of the charitable purposes of the organisations.

It is assumed that the organisations meet all the other requirements to be charities.

By-products

In carrying out their charitable operations, many charities receive or produce things that they are then able to sell profitably to help fund their charitable works. Examples of making a profitable use of their 'by-products' — in ways we accept as consistent with carrying out the charitable purposes — include:

A trade school sells the items of furniture made by its trainees as part of their courses.

A college's hospitality students prepare and serve meals, while being assessed as part of their course, at the college's campus restaurant.

A musical society records some of its public performances and sells CDs of them.

A welfare organisation receives donated clothing which it distributes to the needy and sells in its shop. The remainder is sold as 'rags' to re-processors.

These examples illustrate business-like activities that are only for the sake of, or in aid of, or in furtherance of the charitable purposes of the organisations.

It is assumed that the organisations meet all the other requirements to be charities.

Fees charged for charitable services

Different charities are funded in different ways. While some rely on government funding or grants and endowments, many charities charge fees for the services they provide. Examples of charities charging for their services — in ways we accept as consistent with carrying out the charitable purposes — include:

A health clinic charges fees at the same rate as charged by comparable for-profit clinics.

A secondary school only enrolls pupils whose parents or guardians are able to pay its tuition fees.

An aged persons home sets its fees on the basis of — after factoring in government grants — meeting current costs, making reserves for maintenance and expansion, fees charged by comparable homes, and the economic profile of its residents and potential residents.

An agricultural charity, which has developed a new vaccine to protect livestock, manufactures and sells the vaccine. The prices are set to cover costs and fund future research and expansion.

An educational foundation, which hosts high-profile speakers, sets the entrance charge for its seminars in terms of market fees for similar speakers.

A charitable publisher of law reports sells its reports at market rates.

These examples illustrate business-like activities that are only for the sake of, or in aid of, or in furtherance of the charitable purposes of the organisations.

It is assumed that the organisations meet all the other requirements to be charities.

Commercial methods for charitable operations

Charities operate in many different ways. Examples of business-like methods adopted by some charities — in ways we accept as consistent with carrying out the charitable purposes — include:

A counselling organisation provides its counselling services solely through its employee counsellors. The counsellors are professionally accredited and are remunerated at professional rates.

A welfare organisation adopts 'total quality management' and achieves quality assurance certification.

A library uses a commercial supplier to provide its books, journals and magazines, and puts the contract to public tender every four years.

A family assistance organisation commits itself and all its operations to being 'professional, efficient, accountable, transparent, well-planned and strategic', applying 'good governance', and operating on 'sound economic principles'.

A homeless hostel has all meals provided by a professional catering service. It does not use volunteers for the preparation and serving of meals.

These examples illustrate business-like methods that are only for the sake of, or in aid of, or in furtherance of the charitable purposes of the organisations.

It is assumed that the organisations meet all the other requirements to be charities.

Passive investments

Charities commonly hold passive investments to raise funds to further their charitable purposes. Examples include:

A choral society has a cheque account for its day-to-day needs, and holds the funds that it does not need for day-to-day operations in term deposits as a reserve.

A respite service owns shares in publicly-listed companies. It holds the shares as a reserve and for the dividends.

A scholarship fund invests in cash management trusts to generate an income stream so that it can pay its scholarships.

A youth citizenship club conducts its youth activities in its multi-function building, whose facilities include a kitchen. When the building is not being used for the youth activities, it is let for dances, meetings and other functions.

A welfare agency uses the profit on sale of one of its camps to buy several rental properties which it then lets, so as to receive current income and for capital appreciation to fund later expansion.

These examples illustrate investment activities that are only for the sake of, or in aid of, or in furtherance of the charitable purposes of the organisations.

It is assumed that the organisations meet all the other requirements to be charities.

Exempt entities — companies controlled by exempt entities

Introduction

162. The fact that a company is controlled by an exempt entity does not mean the company is exempt from income tax. Nor does it mean that the company is taxable. The exemption status of the company will depend on its particular circumstances in light of the legal requirements.

163. The ATO web page (extracted below) gives examples where we accept a company, which is controlled by an exempt entity, is itself exempt from income tax. It is not an exhaustive list. There will also be many other instances.

Charities

Exempt charities sometimes set up and control non-profit companies. Some examples where we accept that such companies — which are set up and controlled by exempt charities — are themselves charitable institutions include:

The company's purpose is to operate a shop located in the controlling charity's museum. The shop is to sell souvenirs and collectibles of the museum. Surpluses from its operations are to be distributed to advance charitable purposes.

The company's objects and activities are to produce audio-visual resources, as directed and paid for by the controlling charity, to be used in the charity's teaching programs.

The company's purpose is to provide catering for patients at the controlling charity's hospitals.

The company's objects and activities are to provide administrative and managerial services for the running of the controlling charity's primary and secondary schools.

These examples only address the issue of whether the company is a charitable institution. They do not address the other requirements for exemption.

Sports clubs

Exempt sports clubs sometimes set up and control non-profit companies. Some examples where we accept that such companies — which are set up and controlled by exempt sports clubs — are established for the encouragement of a game or sport include:

The company's purpose is to run all aspects of the controlling club's sport, in so far as they apply to junior participants in the sport.

The company operates solely to bring spectators, from more distant parts of the metropolis, to games played by the controlling club's teams at the home ground. Using funding from the club, it arranges transport and pick-up points, coordinates seating, and advertises games, and so on.

The company's purpose is to carry out research, as directed and paid for by the controlling club, into ways that new technologies can help in the preparation of the club's playing fields.

The company's object and operation is to provide food and drinks to patrons while they are attending the controlling club's home games. Surpluses are distributed to support the club's development programs for disabled participants in the sport.

These examples only address the issue of whether the company is established for the encouragement of a game or sport. They do not address the other requirements for exemption.

Community service organisations

Exempt community service organisations sometimes set up and control non-profit companies. Some examples where we accept that such companies — which are set up and controlled by exempt community service organisations — are established for community service purposes (except political or lobbying purposes) include:

The company's purpose is to organise the controlling organisation's quarterly conferences. The conferences are mainly for the organisation's community service activities, but are also to provide benefits to members.

The company has the same objects as the controlling organisation. Its sole function is to hold passive investments to generate a return, and to make distributions from the surplus for community service purposes.

The company's objects and activities are to produce a magazine. The magazine is mainly to publicise the community programs of the controlling organisation, and also the member-focused programs. Surpluses, generated by advertising in the magazine, are distributed to support the range of the controlling organisation's programs.

These examples only address the issue of whether the company is established for community service purposes. They do not address the other requirements for exemption.