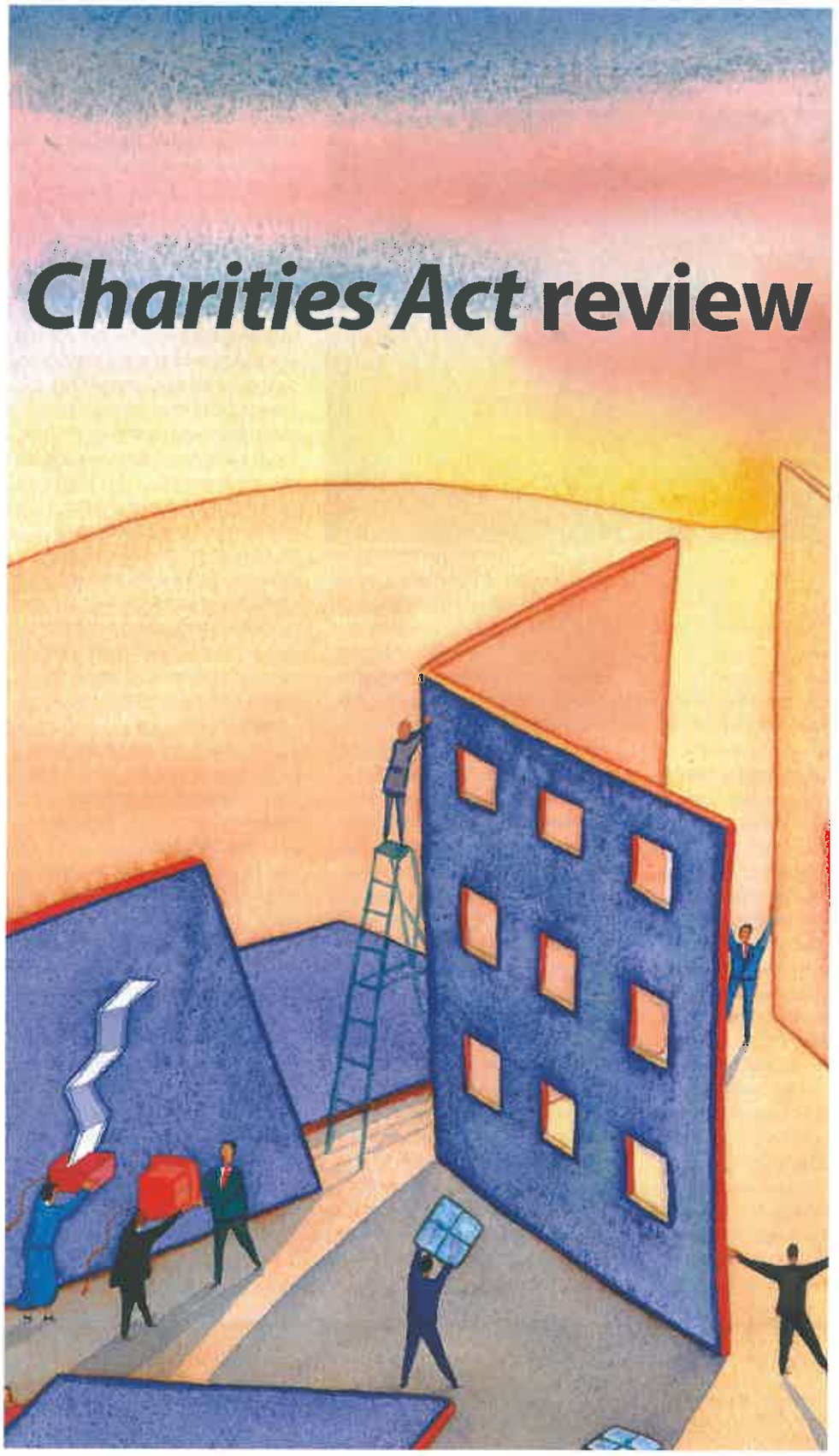
Charities Act review



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Since 1 July 2008, charities have been required to be registered with the Charities Commission (Commission) in order to be eligible for the charitable income tax exemptions in sections CW 41 and CW 42 of the *Income Tax Act* 2007. Since the Charities register opened on 1 February 2007, the Commission has registered over 25,500 charities. It has also, often controversially, declined to register over 100 charities and deregistered more than 20 organisations.

In its 2004 report on the Charities Bill, the Social Services Select Committee (Select Committee) acknowledged the concerns of many submitters that the definition of "charitable purpose" was too narrow, "excluding sporting groups and groups that undertake advocacy work", in particular. In response to these concerns, the Select Committee suggested a review of the definition, "to consider carefully whether the definition should be changed", once all initial registrations had been completed.

The Minister for the Community and Voluntary Sector, the Honourable Tariana Turia, announced a first principles review of the *Charities Act* 2005 in her speech to the Charities Commission Annual General Meeting in November 2010. The Department of Internal Affairs is expected to start the scoping work for this review next year, although the review itself is not expected to be completed until 2015. The Law Commission is also currently reviewing the *Charitable Trusts Act* 1957 in the context of its review of trusts.

Accumulation of funds

The question of whether, or to what extent, the accumulation of funds by charitable trading organisations is consistent with the public support afforded to these entities through the charitable income tax exemptions needs to be reconsidered, particularly if the accumulations are being used in an anticompetitive way. Is it in the public interest for a charitable trading entity to use the benefit of the charitable income tax exemptions to accumulate large reserves, from pre-tax funds, to reach a dominant position in a market, and then to take advantage of that market power to deter or eliminate competitors from that market? In the current economic climate, particularly as the Government searches for funds that can be 'freed up' to rebuild Canterbury, the question arises as to whether our hard-earned taxpayer dollars are best 'spent' on supporting such entities through the charitable income tax exemptions, or whether the funds would be better utilised elsewhere.

The 2001 Government discussion document *Tax and Charities* considered that trading charities' competitive advantage arises "only from the ability to grow a business faster by accumulating pre-tax funds" (chapter 9). The discussion document proposed that trading operations owned by charities should be subject to tax in the same way as other businesses, but with an unlimited deduction for distributions made to the relevant charitable purposes. The discussion document went on to suggest that "the accumulation of funds could lead to questions from the monitoring authority as to why this is happening". In the decade that has followed, trading operations owned by charities have not been made subject to income tax, although an amendment was made to section DB 41 of the *Income Tax Act* in 2007, allowing companies an unlimited deduction for donations made to charitable entities (capped at the level of their taxable income). In terms of accumulations of funds, there is no evidence that "questions from the monitoring authority" have had any chilling effect on anticompetitive use of accumulated funds by charitable trading organisations. The appropriate "monitoring authority" in this regard is likely to be the Commission, although the Commerce Commission also has an interest, given its role in promoting competition in markets for the long-term benefit of consumers within New Zealand. The Inland Revenue

Department (IRD) also has an interest through its responsibility for administering the charitable income tax exemptions.

The fact that various aspects of this issue fall within the jurisdiction of more than one agency is problematic, and it seems the issue has fallen through the cracks. It is important that the full, combined impact is properly considered, and with some degree of urgency if competition in affected markets is to survive.

Dual administration

Issues of dual administration between the IRD and the Commission need to be further considered. The charitable income tax exemptions reside in the *Income Tax Act*, with *Charities Act* registration being a necessary, but not sufficient, condition of eligibility for the exemption. The IRD is responsible for administering the charitable income tax exemptions, and must make an independent decision under its own legislation as to whether a particular entity is charitable. The IRD is also *required* by section 91E(1) of the *Tax Administration Act* 1994 to issue binding rulings in that regard, unless one of the statutory exceptions applies. A binding ruling that an amount of income is derived in trust for charitable purposes, or that a society or institution is established and maintained exclusively for charitable purposes, for the purposes of section CW 41 of the *Income Tax Act* is legally binding on the Commission (see section 13(2)(a) and (3) of the *Charities Act*).

Derogation by the IRD from its responsibility to administer its own legislation out of extra-statutory deference to the Commission raises administrative law issues. The dual process needs to be clarified.

'Blue-pencil' provision

The 'blue-pencil' provision of the *Charitable Trusts Act* (section 61B) should be further considered in light of dicta in *Canterbury Development Corporation v Charities Commission* [2010] 2 NZLR 707. In *Canterbury Development Corporation*, it was stated that there is "no logic to explain" why section 61B of the *Charitable Trusts Act* (which potentially allows deletion of certain provisions in a trust deed) applies to trusts and not to other entities. While nothing turned on the point in the case itself, it should be noted that there is logic to the distinction: if a charitable company or incorporated society is found to have some non-charitable purposes, it simply defaults to being an ordinary company or incorporated society. However, if a charitable trust is found to have some non-charitable purpose, it fails altogether, for reasons such as want of beneficiaries. Section 61B allows such a trust to be saved by striking out the non-charitable purposes, thereby enabling the intention of the settlor to be carried out to the remaining extent. Such a power is simply not required in the case of charitable entities that are not trusts.

The finding in *Canterbury Development Corporation* that Parliament used 'trust' in a general sense of being a charitable entity in section 61B is not as obvious as it's made out and needs to be considered further.

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Purposes and activities

The distinction between charitable purposes and the means by which these purposes are carried out needs to be revisited.

The position at common law has been that an entity's purposes are to be determined from an analysis of its constituting documents (see *IRC v Oldham Training and Enterprise Council* (1996) 69 TC 231 cited in *Canterbury Development Corporation* at [48]). It might be necessary to have regard to evidence to discover the consequences of pursuing a purpose or object but, ultimately, whether a purpose is charitable is determined 'on the papers'.

However, the Commission appears to be reaching decisions that entities are not charitable on the basis of an analysis of their *activities*. Similarly, the High Court in *Canterbury Development Corporation* appears to have decided that Canterbury Development Corporation was not charitable on the basis of an analysis of its activities (see, for example, [29], [30], [66], and [67]). The focus on activities in the High Court judgment has ostensibly derived from section 18(3)(a) of the *Charities Act*, which states that in considering an application for registration by an entity, the Commission must "have regard" to the entity's activities.

If the High Court decision in *Canterbury Development Corporation* is authority for the proposition that in assessing whether an entity's purposes are charitable, the terms of the entity's constituting documents and its activities are to be given equal weight, or indeed, that an entity's activities can effectively 'trump' the wording of its constituting documents, the High Court has changed the law. However, the judgment does not acknowledge any intention to change the law on the definition of charitable purposes.

The Government made it clear during the passage of the Charities Bill that the law on the definition of charitable purpose was not intended to be changed (*Report of the Social Services Select Committee considering the Charities Bill* (Report)). The Government specifically sought to retain the status quo in the sense of importing the common law into the charities legislation. It was also concerned that there should be consistency with other legislation (most notably the definition of charitable purpose in the income tax legislation).

Section 18 is clear in its terms. However, section 18 needs to be seen in context. An additional key policy rationale behind the *Charities Act* was that charities should be monitored (identified as a key deficiency of the former regime); to that end, the Commission was given the ability to deregister entities found not to be complying with their charitable purposes. The Commission was also given the ability to make that assessment at the point of registration, as the alternative – to register then deregister – would not make administrative sense. Hence, section 18(3)(a) was inserted.

However, section 18(3)(a) was never intended to be elevated to an amendment to the common law definition of charitable purposes. If an entity's activities are not consistent with its purposes, the entity is acting beyond its powers, and the Commission is not obliged to register such an entity, even if its purposes are charitable within the legal definition. However, the activities do not determine whether the purposes are charitable in the first place.

Section 18 applies to the Commission, but it does not apply to the IRD. The IRD, in administering the charitable income tax exemptions, and in issuing binding rulings in that context to which the Commission must have regard, is not subject to section 18 of the *Charities Act*, nor to the apparent change in law based on section 18 brought about by the High Court decision in *Canterbury Development Corporation*. In assessing whether an entity's purposes are charitable under the income tax legislation, the weight to be given by the IRD to an entity's activities is unchanged by section 18 or the High Court decision.

The definitions of charitable purpose in the *Charities Act* and the income tax legislation are therefore inconsistent, and contrary to the intention of the Government in passing the charities legislation. This lack of consistency is problematic.

If an entity's activities are not consistent with its charitable purposes, the entity is not eligible for

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registration under the *Charities Act*, but this should not disturb the question of whether it is legally charitable. Consideration of an entity's activities should be directed to the process of monitoring charities, but should not be elevated to an amendment to 410 years of charitable jurisprudence. If the law in this regard is to be changed, that should be made explicit.

The 'public/private' dichotomy

Clarification of the treatment of the 'public/private' dichotomy and the presumption of charitability is also required. A key element of the definition of charitable purpose is the oft-mentioned 'public benefit' test: a purpose, even if expressed in charitable form, cannot be charitable unless it is directed towards the benefit of the public, or a sufficiently important section of the public – it must not be made for the benefit of a particular individual (*Oppenheim v Tobacco Securities Trust Co Ltd* [1951] AC 297 (HL)). In this regard, it is well-established that the existence of incidental private benefits to individuals does not deprive an entity of its charitable nature.

Public and private benefits are opposite sides of a coin, often turning on an assessment of which is 'primary': an entity's overall objective, or the means by which that overall objective is pursued. Such assessments too often have a flavour of being 'all in the way you hold your mouth'. If an entity's public benefit is seen as 'primary', and any private benefits merely the means to that end, an entity's purposes can be charitable. However, if the private benefits to individuals are seen as primary, a conclusion that the entity is not charitable can be reached, with (no doubt) significant practical consequences for the entity concerned. The approach that is being taken by the Commission in this area seems inconsistent with the legal *presumption* of charitability: purposes that are beneficial to the public are *presumed* to be charitable in the absence of any ground for holding otherwise (see *CIR v Medical Council of New Zealand* [1997] 2 NZLR 297, and Lord Justice Russell in *Incorporated Council of Law Reporting for England and Wales v Attorney-General* [1972] 1 Ch 73 at 88). It is not clear why apparently incidental private benefits are 'trumping' the application of this presumption.

Assuaging need

Clarification of the issue of 'assuaging need' is also required. The High Court in *Canterbury Development Corporation* appears to hold that a purpose of economic development can only be charitable where it is directed to 'assuaging need'. However, the legal test for charitable purpose turns on whether there is a public benefit to the community. It is not necessary, as a matter of law, to show that a community, or a section of the community, is deprived in order to show that such community may benefit. This situation also requires clarification.

The definition of 'charitable purpose'

One of the key areas causing difficulty at the moment is the definition of 'charitable purpose' itself, or rather the way the definition is being interpreted. Much controversy has been caused by the Commission's interpretation of 'political purposes' or advocacy, which has resulted in entities such as the National Council of Women (NCW) being deregistered. The Commission's interpretation of economic development as a charitable purpose is also the source of debate (see "*Canterbury Development* case" [2010] NZLJ 248, "Charity and economic development" [2011] NZLJ 63, and "Charity is a general public use" [2011] NZLJ 60).

What constitutes a charitable purpose is notoriously elusive. For example, of the nine judges that considered the issue of charitable purpose in the Crown Forestry Rental Trust case, five considered the income in question was derived in trust for charitable purposes, but four did not, for two very different reasons: see *Latimer v Commissioner of Inland Revenue* [2004] 3 NZLR (PC), [2002] 3 NZLR 195 (CA), [2002] 1 NZLR 535 (HC).

The Courts have established a two-step inquiry in determining whether an entity's purpose is charitable (*Latimer v CIR* [2002] 3 NZLR 195 (CA) at [32] and *DV Bryant Trust Board v Hamilton City Council* [1997] 3 NZLR 342 at 348):

- Is the purpose for the public benefit?
- If so, is it charitable in the sense of coming within the spirit and intendment of the preamble to the *Statute of Charitable Uses Act* 1601 (the *Statute of Elizabeth*)?

The preamble to the *Statute of Elizabeth* contained a non-exhaustive list of purposes which had been regarded as charitable by Elizabethan Courts up to that time; the few lines as to what the then English Parliament considered to be charitable have since then formed the judicial starting point for a consideration of charity. Charitable purposes were distilled into four 'heads' of charity by Lord Macnaghten in *Commissioners for Special Purposes of Income Tax v Pemsel* [1891] AC 531 at 583: the relief of poverty; the advancement of education; the advancement of religion; or "any other matter beneficial to the community". The statutory definition of 'charitable purpose', contained in section YA 1 of the *Income Tax Act* and section 5 of the *Charities Act*, includes the four principal 'heads' of charity, and imports into the legislation the common law definition of charities.

In considering the Charities Bill in 2004, the Select Committee was careful not to recommend amending the definition of charitable purpose. The Select Committee was concerned that amending the definition would be "interpreted by the Courts as an attempt to widen or narrow the scope of charitable purposes, or change the law in this area, which was not the intent of the bill". The Select Committee was also concerned that amending the definition would result in inconsistencies with other legislation that contain definitions of charitable purpose (the income tax definition was a particular case in point).

However, the Select Committee did recommend two changes in response to the particular concerns that had been raised by submitters in relation to sport and advocacy:

- After noting that a significant level of funding for sporting, arts, and cultural organisations is provided from gaming trusts, and in order to "create certainty and ensure the flow of funds to both charities and sporting bodies", the Select Committee recommended that the tax status of gaming trusts be clarified by legislation. As a result, in 2006, gaming trusts gained their own specific income tax exemption (section CW 48 of the *Income Tax Act*). This meant that they did not need to register with the Commission to be exempt from income tax.
- Section 5(3) and (4) was inserted into the *Charities Act* to codify the common law as it relates to secondary purposes, and to clarify that an entity with non-charitable secondary purposes, including advocacy, undertaken in support of a main charitable purpose, will be allowed to register with the Commission.

Interestingly, given the Select Committee's expressed desire for consistency with other legislation, a corresponding amendment to codify the law regarding secondary purposes was not made to the definition of charitable purpose in the income tax legislation.

Similarly, clause 7 of the Statutes Amendment Bill (No 2), introduced on 22 February 2011, proposes to amend the definition of 'charitable purpose' in the *Charities Act* only. The proposed amendment will specifically include as a charitable purpose the purpose of an entity that promotes sport, if the purpose is "expressed to be, and is in fact, the means by which a charitable purpose (such as the promotion of health or education) will be achieved". As with the above amendment relating to advocacy, this proposed amendment appears to be merely a codification of the common law. However, even so, if

it is necessary to amend the *Charities Act* definition, it is not clear why is it not also necessary to amend the income tax definition, given that the two definitions are expressly referring to the same concept ('charitable purpose').

More fundamentally, it is not clear why the proposed amendment is being made at all. The case of *Re Nottage* [1895] 2 Ch 649, a nineteenth-century, British case concerning rich, white men yachting, has often been raised by the IRD as authority for the proposition that "sport is not charitable". However, since 1895, a reasonable body of authority has developed (such as the Canadian case of *Re Laidlaw Foundation* (1984) 13 DLR (4th) 491 and section 61A of the *Charitable Trusts Act*) suggesting that, in certain cases, the promotion of sport can be charitable.

It is axiomatic that the definition of charitable purpose is not static. Concepts relating to charitable purposes generally, or to any particular kind, are constantly changing with changes in social and community attitudes and needs (*Centreport Community Growth Trust v Commissioner of Inland Revenue* [1985] 1 NZLR 673 at 679, citing *Inland Revenue Commissioners v McMullen* [1980] 1 All ER 884 at 890).

The Commission clearly considered, in light of authority post-*Nottage* and the circumstances of contemporary New Zealand, including an obesity epidemic, that *Re Nottage* was not determinative. Therefore, the Commission differed from the IRD in reaching the view that, in certain cases, sport "can be charitable" (see the Commission's fact sheet, *Charitable purpose and sport and recreation organisations*, February 2010).

As this position was open to the Commission on the authorities available, it is not clear why the proposed amendment is considered necessary. If it is intended to ensure that entities considered charitable by the Commission, but not by the IRD, will nevertheless be able to avail themselves of the charitable income tax exemptions (for which *Charities Act* registration is necessary, but not sufficient, as previously discussed), then it is not clear why the amendment was made to the *Charities Act*, but not also to the definition of charitable purpose in the income tax legislation.

More broadly, it is also unclear why a similar approach to precedent has not been taken by the Commission in other areas, for example, with respect to advocacy. In July 2010, the Commission made the controversial decision to deregister the NCW essentially on the basis of *Bowman v Secular Society* [1917] AC 406 (HL). *Bowman* held that a trust for the attainment of political objects could not be a valid charitable trust, not because it was illegal, but because the Court had no means of judging whether a proposed change in the law would be for the public benefit. However, more recent authority has been critical of this view, and suggests that *seeking to secure peaceful and orderly change can be in the public interest*, and as such not precluded from charitable status (see Bogert, the *Law of Trusts* (Fifth edition) 1973, cited in "Moving the charitable goal posts", Mark von Dadelszen, *NZLawyer*, issue 155, 11 March 2011). The controversy that has accompanied the Commission's decision to deregister NCW illustrates that the relevance of *Bowman* to the interpretation of the definition of charitable purpose in New Zealand in 2011 needs to be re-evaluated.

The statutory definition of 'charitable purpose' does not prohibit development of the law. However, the Commission has been inflexible in its application of precedents in this area, seemingly without consideration of whether precedents such as *Bowman* remain relevant to our society. The Commission does not appear to undertake the analysis, arguably required of it under the fourth head of charity, to determine whether the work of NCW or other entities declined registration on the basis of *Bowman*, are in fact benefiting the New Zealand community. This cannot be the correct approach – the law of charities must be permitted to develop.

The Commission may consider that it is required by law to follow case law precedent, even where those cases no longer reflect our changing society. If this is the case, then the right of appeal to the High Court in section 59 of the *Charities Act* assumes particular importance.

The province of the definition of charitable purpose is the common law. The Charities Bill as introduced provided that the right of appeal against a decision of the Commission was to be to the District Court, whose decision was to be final. The Select Committee amended this, stating that, given its experience in considering matters relating to charitable entities, the most appropriate forum for hearing appeals should be the High Court (Report, 13), with recourse ultimately to the highest Court in the land. An appeal under section 59 proceeds by way of a rehearing, allowing a charity to have its position considered afresh by the Court. However, despite the Courts' role as the source of the law on the definition of charitable purpose, the High Court appears reluctant to disturb decisions of the Commission. Of the eight appeals that have been brought so far by charities challenging a decision of the Commission under section 59, every single one has been decided in favour of the Commission.

If the Commission will not develop the law on the definition of charitable purpose out of deference to precedent, and if the Courts defer to the Commission, then the development of the law will be stymied.

The definition of charitable purpose is the gateway to public support, through the charitable income tax exemptions, of organisations that are considered to be working for the public good and that the public wishes to support. It seems the public does support the work of NCW and many other organisations that have been deregistered or declined registration by the Commission.

The key cause of difficulty may not be the definition of charitable purpose itself, but rather the way the definition is being interpreted. In this regard, it is interesting to note that the Charity Commission in the United Kingdom has the same powers as a court when determining whether an organisation has charitable status and the same powers to take into account changing social and economic circumstances – whether to recognise a purpose as charitable for the first time or to recognise that a purpose has ceased to be charitable. It states that: "Faced with conflicting approaches by the courts, we take a constructive approach in adapting the concept of charity to meeting the constantly evolving needs of society. The Register of Charities is therefore a reflection of the decisions made by the courts and our decisions following the example of the courts" (http://www.charity-commission.gov.uk/Publications/RR1a.aspx).

Whether such an approach should be followed in New Zealand may be usefully considered as part of the review. In any event, it is time to start afresh and comprehensively consider what kind of organisations we, as a community, wish to support through the charitable income tax exemptions.

One cannot help feeling a sense of frustration that entities, such as NCW and the Canterbury Development Corporation, doing important work in the community, are being denied *Charities Act* registration, only to have that status likely conferred at a subsequent time once the review of the *Charities Act* has been completed. One might have been forgiven for hoping the Commission would consider not only what *is* charitable according to the law of New Zealand, but also what *should be*. It is disappointing that both the Commission and the Courts appear not to have 'grasped the nettle', and that statutory relief is still some years away. One can only hope that the affected charities manage to continue to do their good work, without the benefit of the income tax exemption, until statutory (and hopefully retrospective) relief becomes available. Many will restructure, as suggested by the Commission itself, even if, fundamentally, they should not have to.