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Our ref KPMGsubNFPIssuespaper

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Dear David

Taxation and the not-for-profit sector

KPMG is pleased to make a submission on the issues paper. We provide our responses to the specific questions below. Please note that we have attempted to answer most, but not all, of the questions asked.

We note that there are a diverse range of entities operating in the charitable and not-for-profit ("NFP") sector that perform important social functions. Therefore, care needs to be taken that any changes to tax settings do not unduly impact on the effective operation of these organisations.

As a general comment, we are concerned that key matters the issues paper is seeking to address are not specifically tax-driven – for example, the accumulation of business income. Even the tax abuse/avoidance concerns with certain donor-controlled charities raises the broader question whether these serve genuine charitable purposes and should be registered charities to begin with.

Therefore, we question whether changes to tax policy settings for the NFP sector, which will have broad impact including potentially significant compliance costs, are the best approach compared more specific interventions, such as greater enforcement of existing rules and compliance with the Charities Act 2005.

Q1. What are the most compelling reasons to tax, or not to tax, charity business income? Do the factors described in 2.13 and 2.14 warrant taxing charity business income?

The key problem definition(s) and how the suggested reforms are intended to address these is unclear. We elaborate below.

Paragraphs 2.14 states a potential problem with the current tax settings is the accumulation of business profits (allowing for re-investment at faster rates than for non-charitable competitors due to their tax-free nature). However, it goes on to state that this is true of any income earned by a charity (e.g. passive income), not just unrelated business income. Therefore, if accumulation of income is a wider policy concern it is not clear to us that removing the unrelated business income tax exemption fully addresses that issue.

Paragraph 2.15 notes there is a current fiscal cost from not taxing unrelated business income. However, there is no quantification of what that fiscal cost is and its distribution across the NFP sector. We further note that a de minimis for small-scale trading activities and/or relief mechanisms for distributed business income may result in little or no revenue actually being collected from affected charities, even if the unrelated business income tax exemption is removed. We therefore question the issues paper's rationale of potential revenue loss being a driver of the need for change, given some of these design considerations canvassed.

Paragraph 2.5 notes that the tax exemption framework for registered charities takes a 'destination of income' approach. To the best of our understanding, the validity of this overall framework is not in question. Therefore, we question to what extent key problem areas (such as accumulation or tax avoidance using donor-controlled charities) could be better achieved by greater enforcement of existing rules, rather than changes to tax settings that are likely to have both additional compliance costs and inevitably unintended consequences.

Q2. If the tax exemption is removed for charity business income that is unrelated to charitable purposes, what would be the most significant practical implications?

A key impact will be additional compliance costs. Not just from having to file income tax returns, but also monitor compliance with any related requirements. This will include:

- Determining whether any de minimis criteria apply.
- Determining whether there is a "business" and whether this is related/unrelated.
- Apportionment of business and non-business income. (We note this will become more important if the former becomes taxable.)
- Apportionment of expenditure between tax and non-taxable income sources.
- Application of relief mechanisms, including deductibility for distributions and/or maintenance of a memorandum account for tax paid.

These will require new income tax processes to be implemented, even if no income tax is ultimately payable, and additional resources, such as hiring new staff or upskilling existing staff.

The compliance impact for affected charities could well exceed the additional revenue that is collected.

If this change proceeds, to help mitigate some of the compliance cost impact, and provide certainty, we recommend legislatively codifying when a "business" arises for the purposes of the business income exemption. We note that the Commissioner has concluded in *IS 24/08: Charities – Business Income Exemption* that:

> *A charity might **not be carrying on a business** because the nature of its activities is not sufficient to result in those activities being a business and/or the activities are not carried on with a profit-making intention. **For example, activities carried out on a deliberately loss-making or breakeven basis.***

We expect that a number of charities may not be carrying on a business activity, as there will be no profit-making intention to that activity. These charities should not have to rely on meeting a de minimis or other arbitrary criteria to continue to operate under the status quo.

We recommend that the criteria identified by the Commissioner in IS 24/08 be included in a legislative definition of "business" for the purposes of determining whether there is unrelated business income.

Q3. If the tax exemption is removed for charity business income that is unrelated to charitable purposes, what criteria should be used to define an unrelated business?

If the proposal proceeds, then looking at international precedents seems reasonable. However, the context for why other countries have adopted such rules (and why New Zealand is an outlier) is important.

We understand that (at least) part of the need for more restrictive tax rules may be the comparative lack of transparency in those jurisdictions. In contrast, New Zealand has undertaken significant reform of our charities law and its operation, with more robust registration and disclosure rules in place for charities (including from a tax perspective).

Therefore, we would caution against a simple "lift and shift" approach for tax approaches adopted in other jurisdictions without reference to their "fit for New Zealand" and also consideration of whether changes to tax settings are the best approach to addressing wider concerns with how some in the NFP sector operate.

We make the following observations:

1. It is not clear from the issues paper whether the removal of the tax exemption for unrelated business income will be limited to where the relevant income earning activities are conducted by a subsidiary entity (or through an investment entity, such as a limited partnership) or the main charitable entity (the so-called "parent charity") as well. If the latter, then a number of design features, including relief mechanisms, will need to accommodate that wider scope.

2. We are aware of some charitable "groups" where a member entity(-ies) may perform a coordination, or act in a service entity, role for the group and receive income for providing specific services. The test for unrelated business income should be purely focussed on activities undertaken outside of the charitable group (i.e. with unrelated parties, such as members of the general public). Charities (and businesses owned by charities) providing services solely or predominantly to other charities should also be excluded from scope, as the concerns listed in paragraph 2.14 should not arise.

3. Based on our reading of the Canadian and UK precedents, the general principles appear to be that a "related business" must be linked to a charity's purpose (i.e. an usual or necessary concomitant, or offshoot, of a charitable programme) or otherwise subordinate to the charity's purpose (where the unrelated business activity is a minor part, is integrated into the charity's overall operations rather than stand-alone, and the charitable goals dominate the overall

decision making). It is important there is sufficient legislative clarity for affected charities to be able to determine their obligations with a high degree of confidence. We have recommended above legislatively codifying the criteria for when a "business" is carried on (based on the IS24/08 interpretation). Similar legislative guidance should be considered for when a business is "related".

4. We agree that income relating to the activities listed in paragraph 2.24 should remain exempt.

Q4. If the tax exemption is removed for charity business income that is unrelated to charitable purposes, what would be an appropriate threshold to continue to provide an exemption for small-scale business activities?

We have concerns about linking the de minimis exemption to the financial reporting rules (the Tier system) for charities, as it could result in counterintuitive outcomes. For example, it would appear that a charity that has significant business income but very little operating expenses (e.g. because it is effectively accumulating surpluses) would be unaffected by this change, whereas a charity that has consistently high operating expenditure because it is applying the income towards charitable purposes would become taxable.

There are also a number of practical issues with basing the de minimis solely on the financial reporting rules for charities.

- We understand Tier 3 and Tier 4 reporting charities can elect to report under the Tier 1 and Tier 2 requirements for financial reporting purposes. This choice may be made for a range of reasons to access the full suite of generally accepted accounting standards applicable for larger charitable entities. Choices around which accounting policies are adopted should not drive whether the de minimis exemption applied, or not.

- In our experience, there are significant judgments and diversity in practice for financial reporting and administrative purposes on the concepts of control and reporting entity boundaries for charities. This impacts the level of aggregation and disaggregation for reporting entities and these judgements flow through to filings with Charities Services (e.g. as individual or group registration). (A group entity will file a single annual return for all of the entities within the charitable group.) Again, decisions made around group or individual entity financial reporting should not drive tax outcomes.

We consider the de minimis criteria, if the unrelated business income tax exemption is removed, would be better based on a concept of income. We outline some of the design principles that would need to be considered.

- *Should the threshold be based on gross or net business income?* Having regard to the stated problem definitions in paragraphs 2.14 and 2.15 (i.e. accumulation and fiscal risk), charities, or enterprises that are owned by charities, that consistently run low surpluses should not be within scope – see below.

- *How should net income be calculated?* To minimise compliance costs, charities should be able to rely on accounting/financial reporting concepts to determine net income for de minimis purposes.

- *What should be the level of the threshold?* Again, to balance compliance costs and fiscal risk, we consider that the exemption threshold needs to be set at a reasonable level – for example, $1 million.

Q5. If the tax exemption is removed for charity business income that is unrelated to charitable purposes, do you agree that charity business income distributed for charitable purposes should remain tax exempt? If so, what is the most effective way to achieve this? If not, why not?

Deductible distributions

We agree that there should be a deduction, for tax purposes, if unrelated business income is distributed to the parent charity. However, there are a number of important design considerations, which are discussed below.

- As noted earlier, there will be complexity in how different charitable groups are organised. The concept of a "parent charity" therefore needs to be clarified in the context of distributions made within such charitable groups. Distributions made within the charitable group should be eligible for relief if it is made to any member of the charitable group that undertakes the group's charitable purpose(s).

- A deduction should be allowed if a distribution is made within the same tax year or within an appropriate period of time following year-end. (We note that deductions are already available for donations, under section DB 41 of the Income Tax Act, if the underlying income is subject to tax.) This is so that there is a reasonable period of time for business income to be distributed, without it being subject to tax. This additional period could be up to 6 months, to mirror the rules for distribution of beneficiary income for trusts. (The taxing mechanism for unrelated business income could be modelled on trust income.)

- To mirror the situation with distributions from subsidiaries, unrelated business income derived directly by a charity should also be exempt if the income is applied for its charitable purposes in the same tax year or within such additional period as allowed for distributions.

- It is not clear whether relief is intended to apply on distribution to the parent charity, or on application of the income by the parent charity (or other charity within a charitable group) to the charitable purpose(s). We consider that the compliance costs of tracking when distributed business income is applied to the charitable purpose(s), for deductibility purposes, is likely to outweigh any integrity benefit.

Refundability of tax paid

We support the availability of a refundable credit to be attached to future distributions. The design of such a mechanism needs to be carefully considered to minimise compliance costs for affected charities, including:

- Whether a memorandum account to record tax paid will be optional or mandatory for affected charities and charitable groups. There may be some charities that on compliance cost grounds may choose not to maintain such an account – e.g. if any unrelated business activities are regularly distributing net income.

- Whether a single memorandum account can be maintained to track tax paid on business income for charitable groups, rather than different accounts having to be maintained for different group entities.

- How and when "transactions" are required to be recorded to the memorandum account.

- How the refundability mechanism will work for charities that carry on the business activity directly. We assume that the proposed relief mechanisms will apply, albeit on use of any retained income as part of the charitable activities.

- The criteria for refundability of tax paid and the timing of refunds. For example, if the parent charity is not an income tax filer, how will it be able to access any refunds of tax paid by its subsidiaries on unrelated business income?

Q6. If the tax exemption is removed for charity business income that is unrelated to charitable purposes, what policy settings or issues not already mentioned in this paper do you think should be considered?

Paragraph 2.36 lists some of the complexities that will need to be addressed, which we agree with. We make some additional observations below.

Arguably, even under the current tax exemption settings the policy rationale for the "territorial restriction" for business activities carried on by a charitable entity is unclear, particularly when there are no such restrictions on sources of non-business (i.e. passive) income. There seems even less justification for such a restriction if unrelated business income will be subject to tax (albeit the interaction with any de minimis exemption would need to be considered).

Any change to the business income exemption, where a charity invests through a hybrid structure, such as a limited partnership, needs to be carefully considered. The issues paper, at paragraph 2.39, notes that new rules may be required to ensure that unrelated business income earned through a limited partnership is taxed. This raises an important policy question as to whether a charity can be said to carry on the underlying business activity as, technically, limited partners cannot be involved in the management or operations of a limited partnership. Therefore, when/should an investment in a limited partnership be more correctly treated as a "passive" investment with the underlying income treated as non-business income?

Q7. Should New Zealand make a distinction between donor-controlled charities and other charitable organisations for tax purposes? If so, what criteria should define a donor-controlled charity? If not, why not?

We consider the stated problem definition could be better addressed by greater enforcement of the existing rules by Inland Revenue and Charities Services. For example, if it is clear that the principal purpose or objective of setting up a donor-controlled charity (and/or entering into transactions with such a charity) is tax avoidance, there are existing mechanisms (section BG 1 of the Income Tax Act) to combat this. We would also assume if tax benefits are the key driver, then it is likely to bring into question whether there is a genuine charitable purpose(s) for establishment of the charity to begin with, which would be void against the requirements of the Charities Act 2005.

However, if a distinction is to be drawn, there needs to be a clear definition for a "donor-controlled charity". Based on the stated problem definition, it appears that the target is charities that are set up by private groups of individuals (generally, but not always, associated by blood or other familial relationships) who are acting together. The reference to "private foundations" is presumably instructive as to what is intended to be captured.

If a definition is introduced, it should not be so wide as to capture charities where there is a group of persons who may be considered "founders" but where there is no pecuniary benefit to those persons from establishment of the charity. We agree that similar criteria to that in Canda (outlined in paragraph 3.9 of the issues paper) are a useful starting point. It is also critical that the definition does not capture charitable entities within wider charitable groups (as by definition they could be "controlled" entities).

Q8. Should investment restrictions be introduced for donor-controlled charities for tax purposes, to address the risk of tax abuse? If so, what restrictions would be appropriate? If not, why not?

If the donor-controlled charities distinction proceeds, then there needs to be clarity on which transactions are of concern, from a tax avoidance or tax abuse perspective.

We do not favour blanket prohibitions on transactions involving donor-controlled charities, as we do not believe it should be the role of tax policy to police what transactions should, and should not, occur. We consider this raises a bigger policy question – are these genuine charities? If not, any counteraction should be via amendment to the Charities Act and/or enforcement by Charities Services.

We consider the better approach to targeting risk of tax abuse is via enforcement, including application of section BG 1 where tax avoidance is a concern, rather than targeted rules. However, if targeted tax rules are required, our preference would be for "arm's length" rules for transactions entered into by donor-controlled charities.

Q9. Should donor-controlled charities be required to make a minimum distribution each year? If so, what should the minimum distribution rate be and what exceptions, if any, should there be for the annual minimum distribution? If not, why not?

Paragraph 3.17 notes that the rationale for a minimum distribution rule is to mitigate risks around unrestricted accumulation and a significant timing mismatch between the tax benefit and ultimate public benefit.

We note the removal of the unrelated business income tax exemption is also aimed at (in part) addressing the issue of accumulation. It is not clear why a minimum distribution rule is also required for donor-controlled charities, if a donor-controlled charity's unrelated business income will become taxable. If the concern is accumulation by donor-controlled charities of non-business income, which does not appear to be the focus of the issues paper, that should be made explicit.

Further, if other integrity measures (i.e. restrictions on transactions / arm's length rules) are also implemented there would be a cascade of tax (and non-tax) measures that would apply specifically to donor-controlled charities. It is not clear to us, from the issues paper, that the risk of tax abuse for these NFP entities warrants this level of legislative attention (particularly given the enforcement tools already available to address tax avoidance and abuse).

If a minimum distribution rule is introduced:

- It seems sensible for the distribution rate to be set by reference to the charity's surplus income, rather than net assets. If based on net assets, this should exclude any assets that are used for carrying on of any charitable purposes (e.g. buildings).

- There should be exceptions where accumulation of surplus income is for a specific purpose, such as to fund capital projects that are related to the underlying charitable purpose.

Q10. What policy changes, if any, should be considered to reduce the impact of the Commissioner's updated view on NFPs, particularly smaller NFPs? For example:

- ***increasing and/or redesigning the current $1,000 deduction to remove small scale NFPs from the tax system***

- ***modifying the income tax return filing requirements for NFPs, and***

- ***modifying the resident withholding tax exemption rules for NFPs.***

We understand that Inland Revenue's updated view in the draft operational statement will be the subject of a separate consultation, so we make no comment on the change in interpretation.

However, we consider that it would be useful to consider whether the current tax policy framework for non-charity NFPs is fit-for-purpose, rather than focussing on specific issues, such as changing de minimis thresholds or modifying compliance obligations.

Q11. What are the implications of removing the current tax concessions for friendly societies and credit unions?

Again, we consider that any reform of the rules in this area need to be part of a wider review of the tax settings for the non-charitable NFP sector, rather than looking at the role of specific tax exemptions.

Q13. If the compliance costs are reduced following the current review of FBT settings, what are the likely implications of removing or reducing the exemption for charities?

The stated rationale for removing this exemption is potential labour market distortions and lack of coherence.

However, there is no evidence provided in the issues paper to suggest that the current FBT exemption for employees of charities is creating distortions in the labour market or that salary packaging to substitute cash remuneration for non-taxable benefits is indeed occurring in the charitable sector. We raise this as applying the FBT rules is likely to have a material adverse impact, both monetary and compliance costs, on charities.

While we acknowledge the "broad base" (coherence?) argument for aligning the FBT settings for charities with that of income tax payers, in our view, the scope of FBT has extended to taxing well beyond salary substitution (including where there is arguably no benefit being provided). These are known issues which are the subject of a separate FBT review. Application of the current rules, and their distortions, is likely to have a disproportionate impact on charities, their employees, and their ability to undertake charitable activities.

Q14. What are your views on extending the FENZ simplification as an option for all NFPs? Do you have any other suggestions on how to reduce tax compliance costs for volunteers?

We acknowledge the simplification benefits for volunteers. However, care needs to be taken that compliance costs are not simply shifted to charities, which may not be in a position to absorb these. We support optionality.

Further information

Please do not hesitate to contact us if you would like to discuss our submission in greater detail.

Yours sincerely

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