

TR 1999/D19 - Income tax: endorsement of income tax exempt charities

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Draft Taxation Ruling

Income tax: endorsement of income tax exempt charities

Contents	Para
What this Ruling is about	1
Ruling	6
Date of effect	43
Explanations	44
Examples	94
Detailed contents list	117
Your comments	118

Preamble

Draft Taxation Rulings (DTRs) present the preliminary, though considered, views of the Australian Taxation Office.

DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings which represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to entities endorsed or seeking to be endorsed as exempt from income tax under Subdivision 50-B of the *Income Tax Assessment Act 1997* ('the Act'). The Subdivision applies to charitable institutions and to funds established for public charitable purposes by will or instrument of trust (in this Ruling called 'charities').

2. Charitable institutions do not need to be endorsed if they are:

- prescribed institutions that are listed by name in the Income Tax Assessment Regulations 1997, located outside Australia and exempt from income tax in the country in which they are residents: paragraph 50-50(c); and
- prescribed institutions that are listed in regulation 50-50.01 of the Income Tax Assessment Regulations 1997, have a physical presence in Australia but incur their expenditure and pursue their objectives principally outside Australia: paragraph 50-50(d).

Overview

3. This Ruling provides guidance on a range of issues that affect the entitlement of charities to endorsement as income tax exempt. It considers:

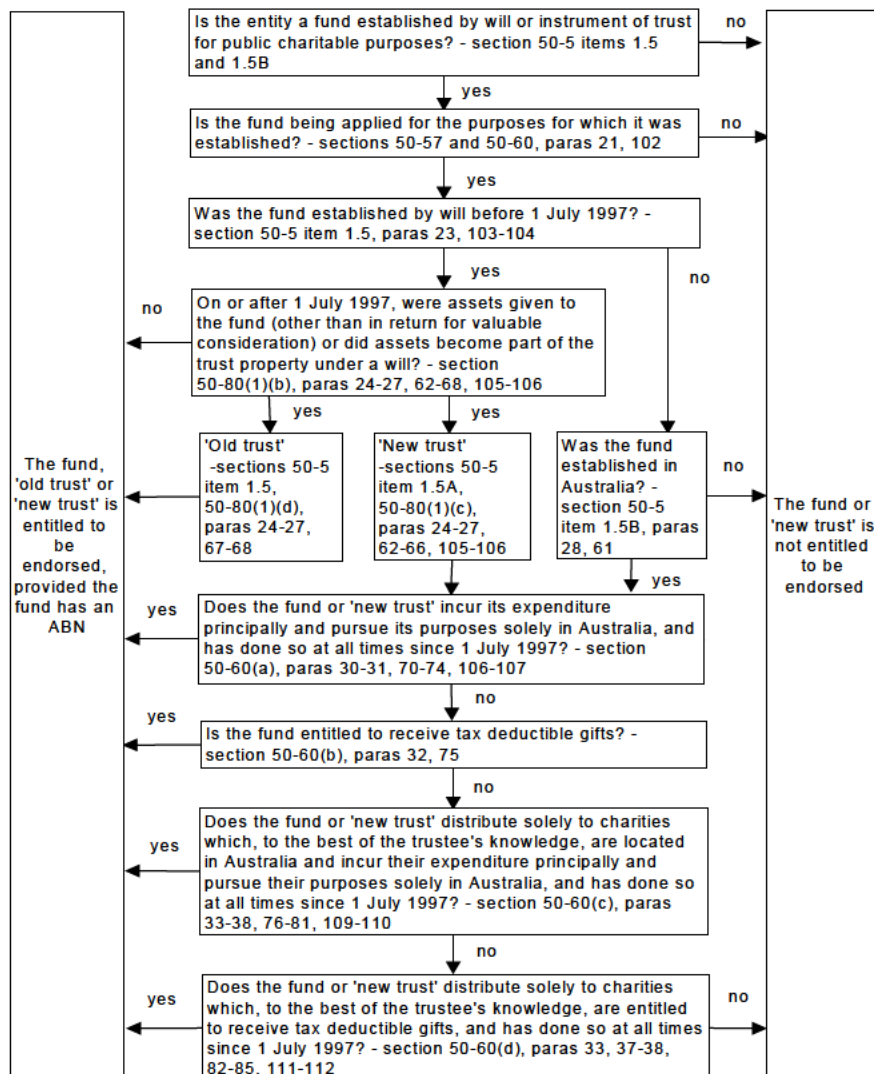
TR 1999/D19

- charitable institutions and special conditions for exemption; and
- funds established for public charitable purposes and special conditions for exemption.

4. We have summarised the issues in the following flowcharts for charitable institutions and charitable funds. These charts also provide references to provisions of the Act and to paragraphs in the Ruling.

Charitable institutions



Charitable funds**Definitions**

5. For the purposes of this Ruling the following key terms are used:

- ‘charity’** means an entity that is a charitable institution or a charitable fund;
- ‘charitable fund’** means an entity that is a fund established for public charitable purposes by will or instrument of trust;

TR 1999/D19

- ‘new trust’** means in relation to a charitable fund established by will before 1 July 1997, a trust deemed by the Act to exist comprising:
- assets given to the charitable fund after 30 June 1997 not in return for valuable consideration;
 - assets becoming part of the charitable fund under a will after 30 June 1997; and
 - any income derived from those assets;
- ‘old trust’** means in relation to a charitable fund established by will before 1 July 1997, a trust deemed by the Act to exist comprising the part of the charitable fund that is not the ‘new trust’;
- ‘special conditions’** mean conditions for entitlement to endorsement for charitable institutions in section 50-50 and for charitable funds in sections 50-57 and 50-60.

Ruling

6. From 1 July 2000, most charities seeking to claim income tax exemption must obtain an Australian Business Number (‘ABN’) and be endorsed by the Commissioner as exempt from income tax in accordance with Subdivision 50-B of the Act.

Which charities need to be endorsed

7. For a charity to be endorsed as exempt from income tax under Subdivision 50-B it must be:
- a charitable institution: item 1.1 in section 50-5;
 - a charitable fund established by will before 1 July 1997: item 1.5 in section 50-5;
 - the deemed ‘new trust’ of a charitable fund established by will before 1 July 1997: item 1.5A in section 50-5;
or

- a charitable fund established in Australia by will on or after 1 July 1997 or by instrument of trust: item 1.5B in section 50-5.

8. Accordingly, a charitable fund is not entitled to endorsement if:

- it is established by instrument of trust and not established in Australia; or
- it is established by will on or after 1 July 1997 and not established in Australia.

9. All charitable institutions must be endorsed unless they are prescribed institutions that meet the conditions set out in paragraph 2.

10. If a charity falling under one of the categories in paragraph 7 (apart from a prescribed institution) is covered by another provision in Division 50, it must be endorsed under Subdivision 50-B to be income tax exempt: subsection 50-52(3). For example, if an entity is both a charitable institution and a religious institution (item 1.2 in section 50-5), it must be endorsed as an income tax exempt charity. The fact that it is a religious institution does not confer exemption from income tax. It is immaterial whether it meets the conditions for exemption as a religious institution.

Charitable institutions

Charitable institutions – ‘special conditions’

11. To be entitled to endorsement a charitable institution must satisfy the ‘special conditions’ relevant to it: sections 50-1 and 50-5. Apart from the conditions for certain prescribed institutions (see paragraph 2), the charitable institution must satisfy the requirements of either paragraph 50-50(a) or (b).

‘Special condition’ - physical presence in Australia: paragraph 50-50(a)

12. Under paragraph 50-50(a) a charitable institution must meet two requirements: first, it must have a physical presence in Australia and, second, to the extent it has a physical presence in Australia, it must incur its expenditure and pursue its objectives principally in Australia (the **activity test**).

13. The term ‘physical presence’ is not defined and takes its ordinary meaning. It is sufficient that an institution operate through a division or the like in Australia. Operation merely through an agent in Australia, or the mere ownership of property in Australia does not indicate a physical presence.

TR 1999/D19

14. The **activity test** applies only to the extent that an institution has a physical presence in Australia. If an institution is wholly in Australia, the **activity test** applies to all the institution's expenditure and pursuit of objectives. If an institution's physical presence in Australia is a division, the **activity test** applies to the division's expenditure and pursuit of purposes.

15. The incurring of expenditure and pursuit of objectives must be principally in Australia. The term 'principally' is not defined but less than 50% would not meet this requirement. Any distribution by an institution of gifts or government grants it has received is disregarded: section 50-75 (see paragraphs 16 and 17). Expenditure, for these purposes, includes distributions for charitable purposes. Expenditure is incurred in Australia if money is paid or a liability is discharged in Australia and the material benefit of the expenditure is in Australia.

Distributions of gifts and government grants

16. Distributions of gifts or government grants that an entity has received in its own right or for a gift deductible fund, authority or institution it operates, are disregarded when determining whether it incurs its expenditure or pursues its purposes or objectives in Australia: section 50-75. The gifts do not need to be tax deductible. For the purposes of this provision the word 'gifts' is taken broadly to include receipts from fund raising by means of raffles, dinners, auctions, jumble sales and the like. However, receipts from commercial activities or under contract for services are not 'gifts'. The term 'government grant' does not extend to payments made by government for services provided under contract to government.

17. If a government grant is, in fact, applied offshore it does not affect exemption. A strict tracing of money received as gifts is not required. We assume that gifts are distributed in the ways most conducive to exemption, unless the circumstances indicate otherwise. For tax deductible gifts, we do not assume they are distributed offshore (see the 'in Australia' requirement in special condition (a) in item 1 in the table in section 30-15), except for overseas aid funds under item 9.1.1 in section 30-80. For the **activity test** the assumption means non-deductible gifts are the first monies distributed offshore. Accordingly, a charitable institution meets the **activity test** in relation to expenditure if, after excluding the government grants it distributes offshore and non-deductible gifts, more of its expenditure is applied in Australia than offshore.

'Special condition' - gift deductible institution: paragraph 50-50(b)

18. For a charitable institution to meet the 'special condition' in paragraph 50-50(b) it must meet the description and requirements in

item 1 of the table in section 30-15. The item refers to funds, authorities and institutions covered by Subdivision 30-B, which are named there or for which there is an endorsed deductible gift recipient. There are two types of endorsement. If the entity itself is such an institution, it is endorsed in its own right. If the fund, authority or institution is part of an entity, the entity is endorsed only for the operation of that fund, authority or institution.

19. To satisfy paragraph 50-50(b), it is not sufficient that the charitable institution operates a gift deductible fund or institution. The charitable institution must be a deductible gift recipient in its own right. If a charitable institution that needs to be endorsed as a deductible gift recipient ceases to be entitled to such endorsement, it no longer meets the 'special condition' under paragraph 50-50(b) for income tax exemption. Unless it meets one of the alternative 'special conditions' it ceases to be entitled to endorsement as exempt from income tax.

20. Endorsement as a deductible gift recipient under the gift provisions of the Act does not remove the need for a charity to be endorsed as income tax exempt.

Charitable funds

Charitable funds - applied for its purposes

21. For a charitable fund to be entitled to endorsement it must be applied for the purposes for which it was established: sections 50-57 and 50-60. Investment in a manner to benefit private entities or excessive accumulation of investment income are not the applying of a fund for its purposes. We regard distribution of a substantial part of the income (but not necessarily capital gains) as essential. However, we accept that a charitable fund may use some of its income to acquire assets which, in future, will produce more income for charitable purposes, and may accumulate some of its income for later distribution. Distributions for non-charitable purposes also indicate that a fund is not being applied for its purposes.

Charitable funds - establishment and 'new trusts'

22. The time and place at which a charitable fund is established, and the assets it has received, can affect the conditions it must meet to be entitled to endorsement.

Charitable funds - when established by will

23. Whether a fund established by will was established before 1 July 1997 is a question of fact that depends on the circumstances.

TR 1999/D19

Clearly, a testamentary fund is not established before 1 July 1997 if the testator died after that date. A trust is normally established at the time the executor or executrix vests title in trust property in the trustee for the purpose of establishing the fund in fulfilment of the charitable purposes set out in the will or codicils.

Charitable funds - established by will before 1 July 1997

24. A charitable fund established by will before 1 July 1997 may be treated as two parts: an 'old trust' and a 'new trust'. This applies if, on or after 1 July 1997, one or more assets are given to the charitable fund (other than in return for valuable consideration) or become part of the trust property under a will: section 50-80. The 'new trust' comprises those assets and any income derived from them. To be endorsed, the 'new trust' needs to meet the 'special conditions'. The 'old trust' need only be applied for the purposes for which the fund was established.

25. For working out the assets of the 'new trust', 'valuable consideration' means consideration that has a real and substantial value, though it need not be of equal value to what is received. It does not include consideration that is merely nominal, trivial or colourable.

26. If an asset is received by a charitable fund in substitution for an asset that comprised part of the 'new trust', the substituted asset forms part of the 'new trust': subsection 50-80(2).

27. The 'new trust' is reduced by expenses directly related to it and by a portion of expenses common to it and to the assets of the 'old trust'. We accept that a charitable fund can stream assets from the 'old trust' or the 'new trust', provided they are properly and separately accounted for.

Charitable funds - established in Australia

28. For a charitable fund established under an inter vivos trust to be established in Australia, under item 1.5B in section 50-5, the settlement of the trust must be made in Australia. In the case of a fund established by will, the fund must be vested in possession in Australia with the fund's trustee. In either case, it would be expected that the settled trust property and objects (for example, the instrument of trust) are subject to Australian law and that any State or Territory requirements such as stamping are complied with.

Charitable funds – 'special conditions' in section 50-60

29. To be entitled to endorsement, at least one of the four 'special conditions' in section 50-60 must be met by:

- a deemed ‘new trust’: item 1.5A in section 50-5; and
- a charitable fund established in Australia by will on or after 1 July 1997 or by instrument of trust: item 1.5B in section 50-5.

‘Special condition’ - purposes and expenditure in Australia: paragraph 50-60(a)

30. A charitable fund or ‘new trust’ satisfies the ‘special condition’ of paragraph 50-60(a) if it incurs its expenditure principally, and pursues its purposes solely, in Australia and has done so at all times since 1 July 1997. Distributions of any amounts received as gifts or government grants are disregarded: subsection 50-75(3) (see paragraphs 16 and 17).

31. While the charitable purposes must be pursued solely in Australia, activities that are merely incidental to the Australian purposes can be carried on outside Australia. The requirement for expenditure to be incurred principally in Australia has substantially the same meaning as set out in paragraph 50-50(a) and is discussed at paragraph 15.

‘Special condition’ - gift deductible: paragraph 50-60(b)

32. A charitable fund that is endorsed as a deductible gift recipient in its own right satisfies the ‘special condition’ in paragraph 50-60(b) while it is entitled to such endorsement.

‘Special condition’ - distributions: paragraphs 50-60(c) and (d)

33. A charitable fund or ‘new trust’ satisfies the ‘special conditions’ of paragraphs 50-60(c) and (d) where it distributes solely, and has at all times since 1 July 1997 distributed solely, to specified types of recipients. For this purpose, distributions do not include disbursements made as reasonable payment for goods and services. Distributions of amounts received as gifts or government grants are to be disregarded (see paragraphs 16 and 17). Because the test operates ‘at all times since 1 July 1997’, if a fund or ‘new trust’ fails once, it cannot meet the condition at any time in the future. It might, however, satisfy an alternative ‘special condition’.

34. Paragraph 50-60(c) requires the recipients to meet specified criteria ‘to the best of the trustee’s knowledge’. If the recipients in fact meet the specified criteria, no issue arises. However, if a recipient does not meet the criteria, the trustee’s actions and procedures are relevant. It is sufficient if the trustee exercises reasonable care in ensuring that the recipient satisfies the relevant

TR 1999/D19

requirements and could not reasonably know if a recipient does not meet them. We are satisfied if the trustee receives written confirmation from the recipient, and the trustee does not have reasonable grounds for doubt.

35. The charitable funds, foundations or institutions that are recipients pursuant to paragraph 50-60(c) must be located in Australia, to the best of the trustee's knowledge. The term 'located' is not defined and takes its ordinary or everyday meaning. The recipient need not be located exclusively in Australia. However, the location would be of an enduring nature. A mere physical presence is not sufficient. It is not necessary for the recipient to be a resident for income tax purposes. The recipients do not need to be endorsed as income tax exempt charities.

36. Recipients under paragraph 50-60(c) must incur their expenditure principally and pursue their purposes solely in Australia, to the best of the trustee's knowledge. Written confirmation on these points is sufficient, if the trustee does not have reasonable grounds for doubt.

37. The charitable funds, foundations or institutions that are recipients under paragraph 50-60(d) must be entitled to receive tax deductible gifts, to the best of the trustee's knowledge. From 1 July 2000 the gift deductible status of charities is recorded on the Australian Business Register (unless the entity does not have an Australian Business Number and is a prescribed private fund or is listed by name in Subdivision 30-B). From that date, if distributions are made to entities lacking the required status and the Register was not checked, we do not accept that the paragraph has been satisfied.

38. If a fund makes distributions to recipients only some of whom would meet the criteria in paragraph 50-60(c) and only some the criteria of paragraph 50-60(d), neither paragraph is satisfied.

Date of effect of endorsement

39. Endorsement as an income tax exempt charity has effect from a date specified by the Commissioner: subsection 50-130(1). This date may be earlier than the time the endorsement is made. The endorsement is not effective before 1 July 2000 as this is when the need for endorsement begins.

40. A charity may be endorsed prior to commencing any activity as a charity: paragraph 50-110(5)(b). This can enable endorsement from the time a charity is set up. The prerequisite is that there are reasonable grounds for believing that the charity meets the 'special conditions' applying to it: subparagraph 50-110(5)(b)(ii).

Informing the ATO

41. If an entity ceases to be entitled to endorsement, other than because it ceases to have an ABN, it must give written notice to the ATO: section 50-145. The notice is to be given before or as soon as practicable after the cessation. It should include the date of cessation.

Revoking endorsement

42. If endorsement is revoked retrospectively, the ordinary income and statutory income of the entity is not exempt from the date of effect of the revocation.

Date of effect

43. This Ruling applies from the commencement of Schedule 8 of the *A New Tax System (Tax Administration) Act 1999*, which inserts Subdivision 50-B, on Royal Assent.

Explanations

Which charities need to be endorsed***Charities under other exemption provisions***

44. Division 50 exempts the income of entities covered by various items in the Division. Those items include charitable institutions (item 1.1), religious institutions (item 1.2), public educational institutions (item 1.4) and non-profit hospitals (item 6.2). It is possible that an entity is covered by more than one item: *Chesterman v. FC of T* (1925) 37 CLR 317 at 320.

45. Where a charity (except a prescribed institution mentioned in paragraph 2) that could be entitled to endorsement is covered by more than one exemption item, it must be endorsed for its income to be exempt: subsection 50-52(3). If it is not endorsed it is not exempt.

Charitable funds

46. The charities that need to be endorsed are set out in subsection 50-52(1). Besides charitable institutions, they are the bodies set out in section 50-5:

- charitable funds established by will before 1 July 1997: item 1.5;

TR 1999/D19

- the ‘new trust’ part of charitable funds established by will before 1 July 1997: item 1.5A; and
- charitable funds established in Australia by will on or after 1 July 1997 or by instrument of trust: item 1.5B.

47. By implication, any other types of charitable funds are not required to be endorsed. Whether such a fund is exempt depends on whether it is covered by and meets the requirements of another item in Division 50.

Charitable institutions

Charitable institutions – ‘special conditions’

48. To be entitled to endorsement, a charity must satisfy the ‘special conditions’ relevant to it: sections 50-1 and 50-5. A charitable institution must meet at least one of the conditions of section 50-50. There are four alternative conditions; the first two are considered by this Ruling:

- the charitable institution has a physical presence in Australia: paragraph 50-50(a);
- the charitable institution is gift deductible: paragraph 50-50(b);
- the charitable institution is a prescribed institution located outside Australia (see paragraph 2); and
- the charitable institution is a prescribed institution that has a physical presence in Australia (see paragraph 2).

‘Special condition’ - physical presence in Australia: paragraph 50-50(a)

49. There are two tests in paragraph 50-50(a). First, a charitable institution must have a physical presence in Australia and, secondly, to the extent it has a physical presence in Australia, it must incur its expenditure and pursue its objectives in Australia (the **activity test**).

50. The term ‘physical presence’ is not defined and so takes its ordinary or everyday meaning. The explanatory memorandum relating to the Bill that introduced the provision says:

‘3.12 In the case of “physical presence” a broad interpretation has been adopted - all that is required is for an organisation to operate through a division, sub-division or the like in Australia. The structure of the organisation is immaterial as is whether it has its central management and control or principal place of residence in Australia. On the

other hand, the term does not apply where an organisation merely operates through an agent based in Australia.’

(Explanatory memorandum to the Taxation Laws Amendment Bill (No 7) 1997.)

51. The **activity test** applies only to the extent the institution has a physical presence in Australia. If the institution has a physical presence elsewhere than in Australia, it is necessary to consider the institution only insofar as it is physically present in Australia. For example, consider a charitable institution with its headquarters in Mexico and missions in 20 countries including Australia. Say that the vast majority of the institution’s activity and expenditure is outside Australia. On its own this is not enough to fail the **activity test**. It is necessary to consider the institution’s physical presence in Australia. Say that the Australian mission, with 26 permanent members, primarily carried out religious services, education and welfare in Australia, and spent most of its money doing so. It would be appropriate to conclude that, to the extent the institution has a physical presence in Australia, its expenditure and pursuit of objectives are principally in Australia. The institution would satisfy the **activity test**.

52. The expenditure and objectives need not be solely, but must be principally, in Australia. The explanatory memorandum comments on ‘principally’:

‘This term is also not defined in the legislation. The dictionary meaning of the word “principally” is mainly or chiefly. Accordingly, it is not possible to specify a particular percentage but less than 50% would not be considered to meet the “principally” requirement. Where there is some doubt whether this requirement is satisfied it will be necessary to examine each institution’s individual circumstances.’
(Paragraph 3.14 of the explanatory memorandum to the Taxation Laws Amendment Bill (No 7) 1997.)

Distributions of gifts and government grants

53. In considering where an institution principally incurs its expenditure and pursues its objectives, distributions of gifts and government grants are to be disregarded: subsection 50-75(1). If a government grant is applied offshore it does not affect exemption. A strict tracing of money received as gifts is not be required. We assume that gifts are distributed in the ways most conducive to exemption, unless the circumstances indicate otherwise (see **Example 4** at paragraphs 100 and 101). The explanatory memorandum to the Taxation Laws Amendment Bill (No 4) 1997 (which, when enacted, amended the *Income Tax Assessment Act 1936* to insert equivalent provisions) says:

TR 1999/D19

‘5.70 The legislation is silent about whether an institution has to monitor the source of the funds that it applies overseas – ie. whether they are obtained from income or from gifts. While it would be expected that an institution would have strict procedures in place to account separately for government grants and/or approved fund moneys under section 78, money is fungible and it loses its particular identity when combined with other money.

5.71 In these circumstances it would be reasonable to assume, that with the exception of government grants and section 78 fund moneys, money applied overseas would be applied firstly from “gifts” and that the “activity test” would only need to be applied if the total funds applied overseas exceeded the sum of the gifts and donations received.’

54. For the avoidance of doubt, subsection 50-75(2) confirms that the disregarding of gifts extends to gifts made to a gift deductible fund that the institution operates. This situation can arise where the institution is not gift deductible in its own right but it operates a fund that is. For example, a charitable institution, to which gifts are not tax deductible, might operate a necessitous circumstances fund for which gifts are deductible (item 4.1.3 of section 30-45).

55. The term ‘gifts’ in section 50-75 has a wide meaning:

‘... receipts from fund raising by means of raffles, dinners, auctions, jumble sales and the like by non-commercial or non-business organisations will be treated as amounts “in the nature of gifts”. However, where a donor is likely to obtain a tax deduction (eg, for advertising) the material advantage obtained would disqualify the donation as a gift in the hands of the recipient.’ (Paragraph 3.18 of the explanatory memorandum to the Taxation Laws Amendment Bill (No 7) 1997.)

(This wide reading does not, of course, extend the meaning of ‘gift’ for gift deduction purposes.)

‘Special condition’ - gift deductible entity: paragraph 50-50(b)

56. If gifts to a charitable institution are income tax deductible, the institution meets the ‘special condition’: paragraph 50-50(b).

Examples of charitable institutions referred to in the tables in Subdivision 30-B are a public benevolent institution (item 4.1.1 in section 30-45) and a public museum (item 12.1.3 in section 30-100).

57. However, there are two ways in which a charitable institution might be gift deductible. It might be gift deductible in itself, or it might be gift deductible only for gifts made to a fund, authority or institution that it operates. For example, say that the charity is a

public benevolent institution. The charity would be gift deductible in its own right. Contrast this with a school that operates a school building fund. Only gifts for the school building fund are deductible. The school is not gift deductible in its own right; it is only gift deductible in relation to the school building fund that it operates.

58. If a charitable institution is gift deductible only for a fund, authority or institution it operates, it does not meet the 'special condition' in paragraph 50-50(b).

Charitable funds

Charitable funds - establishment

59. The only charitable funds that can be entitled to endorsement are covered by items 1.5, 1.5A and 1.5B in the table in section 50-5 (see paragraph 7). The bodies covered by items 1.5A and 1.5B must meet at least one of the 'special conditions' in section 50-60. They are:

- item 1.5A: the 'new trust' part of charitable funds established by will before 1 July 1997; and
- item 1.5B: charitable funds established in Australia:
 - ◆ by instrument of trust; or
 - ◆ by will on or after 1 July 1997.

60. Accordingly, it may be necessary to know whether a fund was established by will before 1 July 1997 and, if so, what part of it, if any, is the 'new trust', and was the fund established in Australia.

61. For a charitable fund established under an inter vivos trust to be established in Australia, under item 1.5B in section 50-5, the settlement of the trust must be made in Australia. In the case of a fund established by will, the fund must be vested in possession in Australia with the fund's trustee. In either case, it would be expected that the settled trust property and objects (for example, the instrument of trust) are subject to Australian law and that any State or Territory requirements such as stamping is complied with.

Charitable funds - established by will before 1 July 1997

62. For charitable funds established by will before 1 July 1997 the 'special conditions' in section 50-60 only apply if certain assets become part of the trust property on or after that date. If the only assets given to a fund on or after 1 July 1997 are given to it in return for valuable consideration, the 'special conditions' in section 50-60 do not apply. Valuable consideration means consideration that has a real and substantial value (*Barton v. Official Receiver* (1986) 161 CLR

TR 1999/D19

75), though it need not be of equal value to what is received (*Official Trustee in Bankruptcy v. Mitchell and anor* (1992) 110 ALR 484). It does not include consideration that is merely nominal, trivial or colourable.

63. Accordingly, if the charitable fund is given no assets, or only receives income from the investment of its assets, or is only given assets for which it pays, it only needs to apply the fund for its purpose to be entitled to endorsement. Also, where an asset is received in substitution for another asset, the substitution is disregarded for these purposes; the new asset is taken to be the old asset: subsection 50-80(2). For an asset to be treated as a substituted asset, it must be of substantially the same nature and value.

64. However, if the fund receives any other assets, the Act deems it to be two trusts, an 'old trust' and a 'new trust': section 50-80. The 'special conditions' in section 50-60 apply to the 'new trust' but not to the 'old trust'.

65. The 'new trust' comprises the assets given to the fund (other than in return for valuable consideration) or that become part of the trust property under a will, on or after 1 July 1997. Examples include gifts, settlements and trust distributions. Income derived from these assets is also included. If an asset is received in substitution for an asset held before 1 July 1997 the asset, and the income from it, do not form part of the 'new trust': subsection 50-80(2).

66. The 'new trust' is taken to be a trust created after the start of 1 July 1997: paragraph 50-80(1)(c). Accordingly, item 1.5 - which covers funds established under a will before 1 July 1997 - cannot apply. It is covered by item 1.5A. The 'new trust' must satisfy at least one of the four 'special conditions' in section 50-60.

67. The remainder of the fund (that is, the part that is not the 'new trust') is deemed to be the 'old trust'. In effect, this is all the fund as at 30 June 1997, and property acquired from that date that:

- is received in substitution for assets held before 1 July 1997; or
- was given in return for valuable consideration; or
- is income derived from that property.

68. The 'old trust' is taken to be a trust created before 1 July 1997. Accordingly, the 'old trust' is covered by item 1.5. That is, it is entitled to endorsement when the charitable fund is being applied for the purposes for which it was established. The 'old trust' is not subject to the 'special conditions' in section 50-60. There is no need for the old trust to be applied for purposes in Australia, and offshore distributions from the 'old trust' do not affect entitlement.

Charitable funds – ‘special conditions’: section 50-60

69. There are four alternative ‘special conditions’ for charitable funds. They apply where, generally:

- the fund has its purposes and expenditure in Australia: paragraph 50-60(a);
- the fund is gift deductible: paragraph 50-60(b);
- the fund distributes solely to charities in Australia: paragraph 50-60(c); or
- the fund distributes solely to gift deductible bodies: paragraph 50-60(d).

‘Special condition’ - purposes and expenditure in Australia: paragraph 50-60(a)

70. To satisfy this ‘special condition’ the fund must incur its expenditure principally in Australia, pursue its charitable purposes solely in Australia, and have done so at all times since 1 July 1997.

71. In considering where the fund incurs its expenditure and pursues its purposes, distributions of gifts and government grants are to be disregarded: subsection 50-75(3). See paragraphs 53 to 55.

72. The fund’s expenditure need not be solely, but must be principally, incurred in Australia. The word ‘principally’ is explained in paragraph 52.

73. The fund’s charitable purposes must be pursued solely in Australia. Activities or pursuits incidental to the Australian purposes can be carried on outside Australia: paragraph 3.14 of the explanatory memorandum to the Taxation Laws Amendment Bill (No 7) 1997.

74. If the fund has failed this ‘special condition’ at any time since 1 July 1997 it cannot satisfy the condition at any time in the future. This means that, if the fund was established after 30 June 1997, the condition must be satisfied at all times that the fund has existed.

‘Special condition’ - gift deductible: paragraph 50-60(b)

75. Unlike the other three conditions, there is no legislative requirement that the fund has been a gift deductible fund at all times since 1 July 1997.

TR 1999/D19

'Special condition' – distributions to Australian charities: paragraph 50-60(c)

76. To satisfy this condition, the charitable fund must distribute solely, and have at all times since 1 July 1997, distributed solely:

- to charitable funds, foundations or institutions; and
- to the best of the trustee's knowledge:
 - ◆ they are located in Australia; and
 - ◆ they incur their expenditure principally in Australia and pursue their charitable purposes solely in Australia.

77. Distributions do not include disbursements made as reasonable payment for goods and services. Examples include the purchase and insurance of income producing assets, accountancy and administration services and the like.

78. The recipient organisation's location, expenditure and purpose must be 'to the best of the trustee's knowledge'. That is, it could happen that the recipient might not meet the statutory requirements. What is determinative is the trustee's actual and constructive knowledge about the recipients. If the recipients are to meet the requirements 'to the best of the trustee's knowledge', the trustee has put its mind to the criteria and the purposes of the recipients. Suitably worded questions in its application for funding forms would enable the trustee to make the relevant judgment.

79. The recipient charities must be located in Australia. The term 'located' is not defined and takes its ordinary or everyday meaning. The recipient fund, foundation or institution need not be located exclusively in Australia. However, the location would be of an enduring nature. A mere physical presence is not sufficient to satisfy this requirement, although it is not necessary for an organisation to be a resident for income tax purposes: paragraph 3.13 of the explanatory memorandum relating to the Taxation Laws Amendment Bill (No 7) 1997.

80. The requirement that the recipient pursues its purposes solely and incurs its expenditure principally in Australia is substantially the same as for the paragraph 50-60(a) 'special condition': see paragraphs 70 to 74. However, there is no requirement that the recipient must satisfy the conditions at all times since 1 July 1997.

81. Distributions of amounts that the charitable fund received as gifts or government grants are disregarded. Consequently, these monies may be distributed to charities operating offshore without jeopardising the fund's exemption. However, ignoring distributions of gifts and grants applies only to the fund making the distribution and not for determining the purpose of the recipient.

*'Special condition' – distributions to gift deductible charities:
paragraph 50-60(d)*

82. To satisfy this condition the fund must distribute solely to entities that, to the best of the trustee's knowledge, are gift deductible, and must have done so at all times since 1 July 1997.

83. The entities to which the fund distributes must be listed by name in the gift provisions, or be prescribed private funds, or be endorsed by the ATO as deductible gift recipients ('DGRs').

84. Distributions by the charitable fund are disregarded if they are of amounts received by it as gifts or by way of government grants: subsection 50-75(3). See paragraphs 53 to 55. Consequently, these moneys may be distributed to charities that are not DGRs without jeopardising the fund's exemption.

85. If the fund fails at any time from 1 July 1997 to distribute solely to the required entities, it cannot satisfy this 'special condition' at any time in the future.

Date of effect of endorsement

86. The ATO can give a retrospective date of effect to endorsement. This enables a charity that had not previously applied for endorsement retrospectively to gain income tax exemption. However, endorsement cannot be for a period when the charity was not entitled to endorsement.

87. The ATO does not place an arbitrary limit on the period of retrospectivity, but a charity needs sufficient evidence of its entitlement to endorsement.

Informing the ATO

88. The Act places the onus for checking that an entity is entitled to endorsement on the entity itself. Section 50-145 requires the entity to give written notice to the ATO that it has ceased to be entitled. The ATO can then revoke the endorsement: section 50-155.

89. If an entity makes changes in its governing documents or operations, it should routinely check whether it continues to be entitled. Entities do not need to notify the ATO merely because such changes have occurred. It is only if an entity ceases to be entitled to endorsement that the ATO needs to be informed.

90. The notice is to be given before or as soon as practicable after cessation. It should give the date of cessation. The ATO can then

TR 1999/D19

make the revocation from that day. The ATO cannot revoke from a date earlier than when the entity ceased to be entitled.

91. The requirement to give notice does not apply if the reason for cessation is that the entity ceases to have an ABN: subsection 50-145(3). In these cases the ATO revokes endorsement.

Revoking endorsement

92. The ATO can revoke the endorsement of an entity that is not entitled. We may do this following notification by an entity or on our own initiative. The ATO can also revoke endorsement if we have requested information on entitlement (under section 50-140) and the entity has not provided it in the required time.

93. The ATO communicates revocation by written or electronic notice. The notice specifies the date of revocation. The exemption ceases from that day. If endorsement is revoked because the charity has ceased to be entitled to endorsement, the date of revocation cannot be before the entity first ceased to be entitled.

Examples

Which charities need to be endorsed

Example 1

94. The Esk¹ Society is an association set up to advance charitable musical purposes. It is both a charitable institution and an association established for the encouragement of music.

95. Item 9.1(e) of section 50-45 provides for the income tax exemption of associations established for the encouragement of music. However, because the Esk Society is also a charitable institution it is only income tax exempt if it is endorsed by the ATO. It is immaterial that the Society meets the special conditions, in section 50-70, for item 9.1(e) in section 50-45.

Charitable institutions

Example 2

96. The Midland Foundation is a charitable institution that conducts scientific research into farm animals through its laboratories. It has two laboratories, one in Tasmania and one in the Philippines. Government grants and investment income are used to fund the

¹ The names in the **Examples** are taken from Australian highways.

Tasmanian laboratory. A minor part of the Australian investment income is used to help run the Philippines laboratory.

97. The Midland Foundation has a physical presence in Australia - the Tasmanian laboratory. The purposes of the Foundation's Australian operations, the Tasmanian laboratory, are pursued in Australia and the expenditure is incurred principally in Australia. Accordingly, the Midland Foundation meets the conditions in paragraph 50-50(a). If it has an ABN it is entitled to endorsement.

Example 3

98. Kennedy Inc is a charitable institution set up to provide travelling workshops in Asia on aspects of accounting. Its headquarters, members and property are in Australia.

99. Kennedy Inc has a physical presence in Australia but it does not pursue its objectives principally in Australia. It mainly pursues them in Asia. Accordingly, Kennedy Inc does not meet the 'special condition' in paragraph 50-50(a).

Example 4

100. The Palmerston Association is a charitable institution established to advance a particular sort of education. Its members and property are in Australia and it runs courses in Australia. It also uses money offshore to help its sister organisations in the Pacific region in the running of their courses. Its receipts are from investments of \$10,000, fees of \$20,000, and donations of \$30,000. The donations are not tax deductible to the donors. It uses \$35,000 offshore in obtaining equipment and services for its sister organisations. Of the remaining receipts, \$2,000 is held in reserve and the other \$23,000 is spent delivering courses in Australia.

101. The Association is physically present only in Australia and the distribution of \$30,000 received in gifts is to be disregarded (see paragraphs 16, 17 and 53 to 55). This leaves the running of the classes in Australia and the use of only \$5,000 offshore. In these circumstances, the Association incurs its expenditure and pursues its objectives principally in Australia. Accordingly, the Palmerston Association meets the 'special condition' in paragraph 50-50(a). If it has an ABN it is entitled to endorsement. Alternatively, if the donations were tax deductible (for example, all gifts went to the Association's Australian school building fund) it could not be assumed they were the first distributions offshore. The Association's expenditure would not be incurred principally in Australia.

Charitable funds - applied for its purposes***Example 5***

102. Guidance may be obtained from the following brief summary of some cases examined by the ATO:

- *Example 5A:* The HV 'M' Charitable Trust capitalised 29% of its income over an eleven year period (which included the depression years of the 1930s). It was conceded the fund was being applied for its purposes.
- *Example 5B:* The 'N' Trust was permitted to accumulate all income for a two year period. The trustees were advised that, if they desired to accumulate income for a longer period, the position would be reconsidered according to the relevant circumstances at the time.
- *Example 5C:* The 'W' Fund where, after distributing all income over a number of years, the major part of the income of a three year period was invested for the purpose of providing additional future income. It was conceded the fund was being applied for its purposes.
- *Example 5D:* The 'K' Foundation retained 10% of its annual income as a means of preventing erosion of its capital in times of inflation. It was conceded the fund was being applied for its purposes.
- *Example 5E:* 'V' Foundation argued that it was necessary to accumulate funds, rather than distribute, in order that it could derive a larger income in the future, commensurate with inflationary trends. The Foundation was advised that 'it must apply all or substantially all of its annual income for public charitable purposes and avoid excessive accumulation and investment if it is to continue to be regarded as being exempt from income tax'.

Charitable funds - establishment***Example 6 - when established by will***

103. Bruce Landsborough died in 1995. Under his will an annuity of \$30,000 per year was to be paid to a relative from income of the residue of the estate (with power to resort to capital if necessary). Upon cessation of the annuity, the remainder of the estate was to be held on charitable trust in Australia (to be called the Landsborough Foundation) for the advancement of education in Australia. On 1 July 1997 the annuity continued to be paid.

104. Although Bruce Landsborough died before 1 July 1997, the proposed Landsborough Foundation had not been established before 1 July 1997. Once it is established it needs to be applied for its purposes and satisfy the 'special conditions' in section 50-60, to be entitled to endorsement.

Example 7 - established by will before 1 July 1997

105. At 30 June 1997 the Bonang Fund, which was established by will, comprised shares in a company and \$10,000 cash at bank. On 1 January 1998, the fund received a bequest of \$50,000 cash. In March 1998, \$20,000 was distributed. All cash was held in one bank account.

106. The Bonang Fund is deemed to be two trusts for exemption purposes: an 'old trust' and a 'new trust'. The 'new trust' comprises the \$50,000 and any income from its investment. The bank fees are apportioned between the 'new trust' and the 'old trust'. The \$20,000 distribution can be accepted as reducing the 'new trust' (see paragraphs 24 to 27 and 62 to 68), provided this is consistent with the trust deed and the factual circumstances. As well as the requirement that it be applied for the Bonang Fund's purposes, the 'new trust' would need to satisfy the 'special conditions' in section 50-60.

Charitable funds – 'special conditions' in section 50-60

Example 8 - paragraph 50-60(a)

107. The Sturt Charity is a charitable fund established in Australia to promote the study of a particular African country's literature. Its sole activity is to provide scholarships to academics to undertake such study in that country. Of the 25 academics who have received grants, 15 have been Australian. The Charity's receipts are \$12,000 from investments, \$93,000 in grants from a fund in that country and donations of \$2,000.

108. While the gifts of \$95,000 would be disregarded, the objects and activities of the Charity indicate that the charitable purposes are not solely pursued in Australia, and it is doubtful whether the expenditure is principally incurred in Australia. Accordingly, the 'special condition' in paragraph 50-60(a) is not satisfied.

Example 9 - paragraph 50-60(c)

109. The Newell Fund is a charitable fund established to promote the spread of the Gospel in Oceania. Each financial year the Fund trustees consider requests for assistance from various charities linked to a particular denomination. In previous years the Fund concentrated

on charities in New South Wales. For the 2000 year the trustees decided to focus on Fiji. Total distributions were \$130,000 with \$50,000 going to Fiji-based charities and \$80,000 to NSW charities. The Fund's receipts were \$25,000 from investments and \$125,000 from donations.

110. The distribution of gifts received by the fund is disregarded. Given the approach of assuming money applied to non-Australian charities comes firstly from gifts (see paragraph 71), this would mean the distribution of \$50,000 to Fiji charities could be disregarded. This would leave distributions solely to charities located in Australia. If those NSW charities had purposes wholly and expenditure principally in Australia, the Newell Fund would satisfy the 'special condition' in paragraph 50-60(c).

Example 10 - paragraph 50-60(d)

111. The Eyre Trust is a privately controlled charitable fund established to relieve poverty. It does this solely by making distributions to public benevolent institutions. The trustee checks the Australian Business Register ('ABR') to ensure the recipients are gift deductible. The Trust makes a distribution in November 2000 to the Princes Association which the ABR shows as gift deductible. In the following February, the ATO revokes the endorsement of the Princes Association with effect from August 2000 and its gift status is removed from the ABR.

112. Despite the Princes Association not being gift deductible at the time of the distribution (due to the retrospective revocation) it was gift deductible to the best of the trustee's knowledge. The distribution would not cause the Eyre Trust to fail the 'special condition' in paragraph 50-60(d).

Date of effect of endorsement

Example 11

113. The Barkly Institute is incorporated on 1 August 2000. Its object is to operate a caring service in the Northern Territory. No activities are undertaken until September when it begins actively planning to commence the service. The service opens in October. Its ABN is effective from 1 August. It applies for endorsement in that month seeking an endorsement date of 1 August.

114. The Barkly Institute's endorsement as income tax exempt would apply from 1 August 2000.

Revoking endorsement***Example 12***

115. The Calder Bureau trains young people in office skills. With a change of control its governing documents are changed, removing the non-profit clause and providing for dividends to members. It begins to operate on a for-profit basis from 1 September 2000. It does not inform the ATO of the change. The ATO subsequently revokes its endorsement with effect from 1 September 2000.

116. The Calder Bureau is not exempt from income tax on its ordinary income and statutory income from 1 September 2000. It must lodge income tax returns for amounts earned from that date.

Detailed contents list

117. Below is a detailed contents list for this draft Taxation Ruling:

	Paragraph
What this Ruling is about	1
Class of person/arrangement	1
Overview	3
<i>Charitable institutions (flowchart)</i>	4
<i>Charitable funds (flowchart)</i>	4
Definitions	5
Ruling	6
Which charities need to be endorsed	7
Charitable institutions	11
<i>Charitable institutions – ‘special conditions’</i>	11
<i>‘Special condition’ – physical presence in Australia: paragraph 50-50(a)</i>	12
<i>Distributions of gifts and government grants</i>	16
<i>‘Special condition’ – gift deductible institution: paragraph 50-50(b)</i>	18
Charitable funds	21
<i>Charitable funds – applied for its purposes</i>	21
<i>Charitable funds – establishment and ‘new trusts’</i>	22
<i>Charitable funds – when established by will</i>	23
<i>Charitable funds – when established by will before 1 July 1997</i>	24
<i>Charitable funds – established in Australia</i>	28
<i>Charitable funds – ‘special conditions’ in section 50-60</i>	29

TR 1999/D19

<i>'Special condition' – purposes and expenditure in Australia: paragraph 50-60(a)</i>	30
<i>'Special condition' – gift deductible: paragraph 50-60(b)</i>	32
<i>'Special condition' – distributions: paragraphs 50-60(c) and (d)</i>	33
Date of effect of endorsement	39
Informing the ATO	41
Revoking endorsement	42
Date of effect	43
Explanations	44
Which charities need to be endorsed	44
<i>Charities under other exemption provisions</i>	44
<i>Charitable funds</i>	46
Charitable institutions	48
<i>Charitable institutions – 'special conditions'</i>	48
<i>'Special condition' – physical presence in Australia: paragraph 50-5(a)</i>	49
<i>Distributions of gifts and government grants</i>	53
<i>'Special condition' – gift deductible entity: paragraph 50-50(b)</i>	56
Charitable funds	59
<i>Charitable funds – establishment</i>	59
<i>Charitable funds – established by will before 1 July 1997</i>	62
<i>Charitable funds – 'special conditions': section 50-60</i>	69
<i>'Special condition' – purposes and expenditure in Australia: paragraph 50-60(a)</i>	70
<i>'Special condition' – gift deductible: paragraph 50-60(b)</i>	75
<i>'Special condition' – distributions to Australian charities: paragraph 50-60(c)</i>	76
<i>'Special condition' – distributions to gift deductible charities: paragraph 50-60(d)</i>	82
Date of effect of endorsement	86
Informing the ATO	88
Revoking endorsement	92
Examples	94
Which charities need to be endorsed	94
<i>Example 1</i>	94
Charitable institutions	96

<i>Example 2</i>	96
<i>Example 3</i>	98
<i>Example 4</i>	100
Charitable funds – applied for its purposes	102
<i>Example 5</i>	102
Charitable funds – establishment	103
<i>Example 6 – when established by will</i>	103
<i>Example 7 – established by will before 1 July 1997</i>	105
Charitable funds – ‘special conditions’ in section 50-60	107
<i>Example 8 – paragraph 50-60(a)</i>	107
<i>Example 9 – paragraph 50-60(c)</i>	109
<i>Example 10 – paragraph 50-60(d)</i>	111
Date of effect of endorsement	113
<i>Example 11</i>	113
Revoking endorsement	115
<i>Example 12</i>	115
Your comments	118

Your comments

118. We invite you to comment on this draft Taxation Ruling.

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Related Rulings/Determinations:

Subject references:

- charitable organisations

TR 1999/D19

- charitable trusts
- charities
- gifts and donations

Legislative references:

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