

TR 2015/1 - Income tax: special conditions for various entities whose ordinary and statutory income is exempt

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Taxation Ruling

Income tax: special conditions for various entities whose ordinary and statutory income is exempt

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1 This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner’s opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling applies to entities defined in paragraph 5 of this Ruling.
2. These entities fall under certain items in the tables in Division 50 of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ and meet the description of the type of ‘exempt entity’ in column 2 of the relevant table. These entities must satisfy the special conditions applicable to the relevant item in order for their ordinary and statutory income to be exempt from income tax.
3. This Ruling considers two of the special conditions that an entity must satisfy:
 - the entity must comply with all the substantive requirements in its governing rules (governing rules condition), and
 - the entity must apply its income and assets solely for the purpose for which the entity is established (income and assets condition).

¹ All legislative references are to the ITAA 1997 unless otherwise indicated.

4. This Ruling does not consider other special conditions in Division 50.

Definitions

5. In this Ruling, the following terms bear these meanings:
- **'ACNC'** means Australian Charities and Not-for-profits Commission.
 - **'Commissioner'** means Commissioner of Taxation.
 - **'entity'** means an entity (as defined in section 995-1) covered by items 1.1, 1.3, 1.4, 1.6, 1.7, 2.1, 3.1, 3.2, 4.1, 6.1, 6.2, 9.1 and 9.2 in the tables in Division 50.² Appendix 2 of this Ruling describes in more detail each of these different items.
 - **'governing rules condition'** means the requirement that an entity must 'comply with all the substantive requirements in its governing rules' in section 50-15 and paragraphs 50-50(2)(a), 50-55(2)(a), 50-65(2)(a), 50-70(2)(a) and 50-72(1)(c)³.
 - **'income and assets condition'** means the requirement that an entity must 'apply its income and assets solely for the purpose for which the entity is established' in section 50-15 and paragraphs 50-50(2)(b), 50-55(2)(b), 50-65(2)(b), 50-70(2)(b) and 50-72(1)(d)⁴.

Ruling

6. An entity must satisfy a number of special conditions in order for its ordinary and statutory income to be exempt from income tax under Division 50. These special conditions include the governing rules condition and the income and assets condition.

Governing rules condition

7. The governing rules condition requires an entity to 'comply with all the substantive requirements in its governing rules'.

² Item 4.1 (funds contributing to other funds) existed at the time the governing rules condition and income and assets conditions were introduced. This item was repealed by the *Charities (Consequential Amendments and Transitional Provisions) Act 2013*, effective 1 January 2014.

³ For funds covered by item 4.1.

⁴ For funds covered by item 4.1.

8. Three questions must be considered to determine whether an entity satisfies the governing rules condition:

- What are the 'governing rules' of the entity?
- What are the 'substantive' requirements in the entity's governing rules?
- At what time must the entity comply with all of the substantive requirements in its governing rules?

What are the 'governing rules' of the entity?

9. The 'governing rules' of an entity are those rules that authorise the policy, actions and affairs of the entity. That is, governing rules of an entity consist of the rules that direct:

- what the entity is required and permitted to do, and
- what those, who control the entity, are required and permitted to do in respect of the entity.

10. An entity may have governing rules from more than one source. To determine what constitutes the governing rules of an entity, consider all the various sources in which governing rules may be found.

11. The written documents under which an entity was formed will usually be the main source of its governing rules.⁵ There may also be other sources that comprise or supplement an entity's governing rules. The governing rules of some entities may be unwritten, although such circumstances are likely to be rare.

12. A centralised source may provide some or all of the governing rules for a group of entities or to a particular type of entity. For example, the religious law of a church may be the only source of governing rules for a group of church entities where there is no separate written document containing each entity's governing rules. Other centralised sources (such as relevant legislation) may provide some or all of the governing rules for a particular type of entity. For example, some parts of trust law (under the general law and statute) and the *Corporations Act 2001*, as they apply to trusts and corporations respectively, form some or all of an entity's governing rules.

13. However, not all rules that apply to an entity will form part of the entity's governing rules. Broad regulatory regimes which are not targeted to a particular entity or type of entity are not a source of governing rules. For example, the relevant criminal law and the *Privacy Act 1988* are not sources of an entity's governing rules.

⁵ These written documents are commonly referred to as 'constituent documents'.

14. Where an entity enters into obligations with third parties (including government) in accordance with its governing rules, the agreements entered into that give rise to those obligations generally do not form an additional source of governing rules. That is, the mere fact that an entity enters into an agreement such as a contract, lease, or licence does not mean that such an agreement forms part of the entity's governing rules.

15. However, broad regulatory regimes and agreements entered into with third parties may be expressly incorporated into an entity's governing rules.

16. An entity must identify all of its governing rules in order to then consider what the 'substantive' requirements are in those rules.

What are the 'substantive' requirements in the entity's governing rules?

17. For the purpose of the governing rules condition, an entity's governing rules are divided into two categories: those that are 'substantive' requirements and those that are not (referred to in this Ruling as 'procedural' requirements).

Substantive requirements

18. The 'substantive' requirements in an entity's governing rules are those rules that define the rights and duties of the entity.

19. The substantive requirements in an entity's governing rules include rules such as those that:

- give effect to the object or purpose of the entity
- relate to the non-profit status of the entity
- set out the powers and duties of directors and officers of the entity
- require financial statements to be prepared and retained
- set out the criteria for admission as a member of an entity
- require an entity to maintain a register of members, and
- relate to the winding-up of the entity.

Procedural requirements

20. Procedural requirements are those rules which prescribe the method or manner in which the rights and duties of the entity are carried into effect, and where applicable, enforced. Administrative processes are typically procedural requirements. For example the following are procedural requirements:

- rules regarding the process for granting membership of the entity
- the format in which a register of members is maintained
- how a particular meeting is to be conducted (including requirements for a quorum), and
- rules setting out how a member may vote at a meeting by proxy.

At what time must the entity comply with all of the substantive requirements in its governing rules?

Applies at all times during an income year

21. The governing rules condition is applied on a continuous basis throughout an income year. The entity must consider whether, at all times throughout the income year, it has complied with all of the substantive requirements in its governing rules. In order for an entity to be exempt from income tax for all of an income year, it must (among other things) satisfy the governing rules condition at all times during that income year.⁶ While an entity is in breach of the governing rules condition, its ordinary and statutory income will not be exempt from income tax.⁷

Income and assets condition

22. The income and assets condition requires an entity to 'apply its income and assets solely for the purpose for which the entity is established'.

23. Two questions must be considered to determine whether an entity satisfies the income and assets condition:

- what is the 'purpose for which the entity is established', and
- has the entity applied its income and assets solely for the purpose for which the entity is established?

⁶ Appendix 3 of this Ruling sets out the Commissioner's administrative treatment that may be relevant where there has been a breach of the governing rules condition.

⁷ An entity that is not entitled to income tax exemption as a result of such a breach will need to consider the application of Schedule 2D (Tax exempt entities that become taxable) of the *Income Tax Assessment Act 1936* (ITAA 1936).

What is the 'purpose for which the entity is established'?

24. The 'purpose for which the entity is established' is determined by a consideration of all of the features of the entity. The main factors to be considered are the objects in the entity's constituent documents, and the activities of the entity after its formation, up to the time at which the income and assets condition is applied. Other factors to consider include policies and plans, administration, finances, history and control, and any legislation governing the operation of the entity.⁸

References to 'purpose' include the plural

25. Many of the entities defined in paragraph 5 of this Ruling are established for more than one purpose. The word 'purpose' in the income and assets condition includes the plural. The income and assets condition tests whether the income and assets of an entity have been applied solely for the purpose or purposes for which the entity is established.

Incidental or ancillary purpose

26. The purpose for which the entity is established can include an incidental or ancillary purpose.⁹ A purpose is incidental or ancillary to the purpose for which the entity is established if it tends to assist, or naturally goes with, the achievement of that purpose. It does not mean a purpose that is minor in quantitative terms.¹⁰

27. An incidental or ancillary purpose is to be contrasted with a purpose that is an end in itself, of substance in its own right or is not intended to further the purpose for which the entity is established.

28. Incidental or ancillary purposes are merely aspects of the purpose for which the entity is established. Thus, the income and assets condition will not be breached merely due to an entity having an incidental or ancillary purpose.

⁸ See *Cronulla Sutherland Leagues Club Limited v. Commissioner of Taxation* (1990) 23 FCR 82; 90 ATC 4215; (1990) 21 ATR 300 at FCR 95 to 96; ATC 4225; ATR 312, *Brookton Co-operative Society Ltd v. Federal Commissioner of Taxation* (1981) 147 CLR 441; 81 ATC 4346; (1981) 11 ATR 880 at CLR 450 to 451; ATC 4351 to 4352; ATR 886.

⁹ The term 'concomitant' is sometimes used in place of 'incidental or ancillary' – see, for example, *Congregational Union of New South Wales v. Thistlethwayte* (1952) 87 CLR 375 at 442 and *Royal Australasian College of Surgeons v. Federal Commissioner of Taxation* (1943) 68 CLR 436 at 447.

¹⁰ *Navy Health Limited v. Federal Commissioner of Taxation* (2007) 163 FCR 1; [2007] FCA 931; 2007 ATC 4568; (2007) 68 ATR 215 at paragraph 65.

Change of purpose

29. The income and assets condition is applied on a continuous basis throughout an income year. In order for an entity to be exempt from income tax for all of an income year, it must (among other things) satisfy the income and assets condition at all times during that year. If an entity changes its purpose, and is still eligible for income tax exemption, the entity must consider from that point in time whether it is applying its income and assets solely for its new purpose.

Has the entity applied its income and assets solely for the purpose for which the entity is established?*Meaning of 'apply'*

30. The requirement that an entity must 'apply' its income and assets means that an entity must make use of all of its income and assets, solely for the purpose for which the entity is established. The word 'apply' does not mean 'substantially apply' or 'apply, on the whole'.¹¹

Accumulation

31. The income of an entity may still be 'applied' for the purpose for which the entity is established if some of the entity's income (whether it be gross income or net income) is accumulated, provided the accumulation is consistent with the purpose for which the entity is established. An entity may use some of its income to acquire assets which, in future, will produce income for its purpose or purposes, and may accumulate some of its income for later distribution.

32. To satisfy the income and assets condition, an entity that accumulates most of its income over a number of years will need to show on a year by year basis that the accumulation is consistent with the purpose for which the entity is established.

Meaning of 'solely'

33. The income and assets condition requires an entity to apply its income and assets 'solely' for the purpose for which the entity is established. This means that the entity must exclusively or only apply its income and assets for that purpose.

34. A strict standard of compliance is required under the 'solely' test. Nevertheless, the Commissioner accepts that misapplications of an entity's income and assets of an insignificant nature will not result in a breach of the condition. Relevant considerations include the amount of the misapplication and how often the misapplication occurs.

¹¹ See *Federal Commissioner of Taxation v. Bargwanna* (2012) 244 CLR 655; [2012] HCA 11 at CLR 670; HCA paragraph 44.

35. The income and assets condition will still be satisfied where:
- the misapplication or misapplications are immaterial in amount, and
 - there is a one-off misapplication or occasional, unrelated misapplications of part of the income or assets of an entity for a purpose other than the purpose for which the entity is established.

Applies at all times during an income year

36. The income and assets condition is applied continuously throughout the income year. In order for an entity to be exempt from income tax for all of an income year, it must (among other things) satisfy the income and assets condition at all times during that year. While an entity is in breach of the income and assets condition, its ordinary and statutory income will not be exempt from income tax.

Relationship between the governing rules condition and the income and assets condition

37. The governing rules condition and the income and assets condition are independent special conditions that must be satisfied by an entity (in addition to other special conditions for some entities) in order for its ordinary and statutory income to be exempt from income tax under Division 50.

38. While an entity is in breach of either or both of the special conditions, its ordinary and statutory income will not be exempt from income tax.¹²

Examples

Governing rules condition

Example 1 – rules not part of the entity’s governing rules – not a breach of the governing rules condition

39. The Beachside Table Tennis Club (Beachside) is an unincorporated entity that meets the description of exempt entity in item 9.1 of the table in section 50-45. It is a society, association or club established for the encouragement of a game or sport.

40. Beachside’s main purpose is the encouragement of table tennis. It fields numerous teams in local table tennis competitions.

¹² An entity that is not entitled to income tax exemption as a result of such a breach will need to consider the application of Schedule 2D of the ITAA 1936. See also Appendix 3 of this Ruling.

41. Beachside holds a trivia night for members and their family and friends at a local community centre in order to raise much needed funds for the club to field teams in local competitions. Alcohol is served during the event but Beachside did not arrange for a temporary liquor licence for the evening, which it was required to obtain under the applicable liquor licencing laws.

42. The liquor licencing laws do not form part of Beachside's governing rules because they are a broad regulatory regime that is not targeted to a particular entity or type of entity. The liquor licensing laws do not authorise the policy, actions and affairs of the entity. The breach of the liquor licensing laws does not result in Beachside failing to satisfy the governing rules condition.

Example 2 – requirement for audited financial statements – substantive requirement in the entity's governing rules

43. The Health Society (the Society) is a company limited by guarantee. It is an entity that meets the description of exempt entity in item 1.7 of the table in section 50-5 (a society, association or club established for the encouragement of science).

44. The Society's constitution at clause 8 requires it to prepare, keep and retain audited financial statements:

8. The Society must prepare, keep and retain audited financial statements to correctly record and explain the financial transactions and financial position of the Society.

45. The requirement in clause 8 is a substantive requirement in the Society's governing rules because it defines a duty of the entity; it is not merely a procedural requirement.

Example 3 – requirement to obtain approval for large item of expenditure – not a breach of the governing rules condition – not a substantive requirement

46. The QWE Society (QWE) is an incorporated association that meets the description of exempt entity in item 2.1 of the table in section 50-10. It is a society, association or club established for community service purposes (except political or lobbying purposes).

47. QWE's constitution requires that items of expenditure over \$25,000 be approved by the National Committee. In the year ended 30 June 2014, a single item of expenditure of \$27,000 is made by an employee without approval by the National Committee. The \$27,000 is applied in accordance with the community service objects in QWE's constituent documents.

48. The requirement for Committee approval of expenditure is not a substantive requirement in QWE's governing rules. It is not a requirement that defines a right or duty of the entity. This requirement is a procedural requirement because it relates to the method or manner in which a duty of the entity is carried into effect (that is, the duty of applying funds solely to its objects). QWE has not breached the governing rules condition as a result of the expenditure not being approved by the National Committee.

Example 4 – requirement to provide notice – not a breach of the governing rules condition – procedural requirement

49. The XYZ Union (XYZ) is a trade union which is an employee association and meets the description of exempt entity in item 3.2 of the table in section 50-15.

50. XYZ's constitution requires that 28 'clear' days' notice in writing be given to members before an annual general meeting (AGM) is held (that is, 28 days excluding the date the notice is issued and the date the AGM is held). There is a separate requirement in the constitution that an AGM is held each year.

51. In the year ended 30 June 2014, as a result of an inadvertent error, notices sent to all members advising of the AGM did not allow the required amount of notice as required under the XYZ's constitution. Only 26 'clear' days' notice was given to members, as the relevant officer of XYZ incorrectly included the day the notice was sent and the day of the AGM in their calculation of the requisite notice period. Nevertheless, the AGM still goes ahead in accordance with all of the other relevant rules in XYZ's constitution.

52. The requirement to provide 28 'clear' days' notice to members before an AGM is held, is not a substantive requirement in the entity's governing rules. It is a procedural requirement dealing with the method of notifying members about the AGM, rather than a rule regarding the duty to hold an AGM. The failure to meet this requirement does not result in XYZ breaching the governing rules condition.

Example 5 – private benefit – breach of the governing rules condition

53. The Help Charitable Trust (HC Trust) meets the definition of a registered charity in item 1.1 of the table in section 50-5. Mr Z is the trustee of the HC Trust.

54. The HC Trust's purpose is set out in clause 2 of the trust deed, which is to provide food for the homeless. Clause 3 states that the trustee must only apply the income and capital of the trust for this purpose.

55. In the year ended 30 June 2014, Mr Z transferred all of the funds from the HC Trust's bank account into his personal home loan 'offset' account. This resulted in Mr Z being charged less interest on his home loan.

56. The requirements in clause 2 and clause 3 of the trust deed are substantive requirements in the entity's governing rules as they define duties of the HC Trust, and are not merely procedural requirements.

57. As a result of the actions of the trustee, the HC Trust has not complied with all of the substantive requirements in its governing rules. The HC Trust has failed the governing rules condition under paragraph 50-50(2)(a) at this particular point in time.¹³

Example 6 – change of purpose in an income year – not a breach of the governing rules condition

58. Homeless not Helpless (HnH) is an incorporated association that meets the description of a registered charity in item 1.1 of the table in section 50-5.

59. HnH was originally established to provide assistance to homeless women. Its constitution limited its activities to the pursuit of this purpose. The constitution is the only source of governing rules of HnH.

60. During the year ended 30 June 2014, in response to an overwhelming need for its services, HnH began providing assistance to homeless women, men and children. On 1 July 2013, prior to commencing these new activities, HnH updated the objects clause in its constitution to reflect this change of purpose.¹⁴

61. The requirement in HnH's constitution which sets out the association's purpose is a substantive requirement in its governing rules as it defines a duty of HnH and is not merely procedural.

62. HnH has satisfied the governing rules condition during the year ended 30 June 2014. HnH has complied with its objects clause for the entire income year, as it changed its objects clause before commencing activities in pursuit of its new purpose.

Income and assets condition

Example 7 – private benefits – breach of the income and assets condition

63. The Medici Madrigal Society (Medici) is an incorporated entity that meets the description of exempt entity in item 9.1 of the table in section 50-45 (a society, association or club established for the encouragement of music).

¹³ Note that due to the actions of the trustee, the HC Trust has not satisfied the income and assets condition under paragraph 50-50(2)(b).

¹⁴ Refer to Appendix 3 of this Ruling for a discussion on a scenario where HnH does not update its constitution prior to the change in purpose.

64. The constitution provides that the objects for which Medici is established are to promote, foster, develop and assist the study of madrigal (a secular vocal music composition of the Renaissance and early Baroque eras), provide a forum for madrigal presentations, and to assist and arrange for musicians to travel abroad to participate in madrigal musical forums. Members of Medici are prohibited from benefiting from the operation or winding-up of the entity.

65. During the year ended 30 June 2014, Medici receives a bequest of \$100,000. \$60,000 of the bequest is applied towards a two-week overseas trip in that year for Medici's board of directors and their families. Five days of the tour relates to madrigal forums and study, and the remaining nine days overseas was spent on an organised tour visiting popular tourist destinations.

66. Medici does not satisfy the income and assets condition under paragraph 50-70(2)(b) at the time the \$60,000 is spent on the two-week trip for directors' and their families. Medici has not applied its income and assets solely for the purpose for which it is established; some of Medici's funds have been applied for private purposes.

Example 8 – profits from commercial activities used to further entity's purpose – not a breach of the income and assets condition

67. The Soul Worship Group (the SW Group) is a religious entity that meets the description of a registered charity in item 1.1 of the table in section 50-5.

68. The objects of the SW Group include the following:

To do all things necessary for the purpose of advancing the Soul Worship Group's religious views.

69. The SW Group's activities include the provision of Sunday school classes for children, Bible classes, community gatherings to discuss its religious views, and the distribution of religious books and articles.

70. In the year ended 30 June 2014, the SW Group establishes an 'opportunity shop' in an inner-city location to sell second-hand goods that have been donated to the organisation. It is envisaged that the profits from the shop will provide a regular income stream that will enable the organisation to increase the scale of its religious activities.

71. To set up the opportunity shop, the SW Group enters into a commercial property lease, purchases some fittings and fixtures, employs a part-time manager and driver for collection of goods, and arranges volunteers to operate the shop during business hours. This requires some funds from the SW Group's bank account to be drawn down.

72. The opportunity shop venture is a success. At the end of the year ended 30 June 2014, the SW Group retains an amount of the profits to cover contingencies (to cover operating costs and any unexpected events, etcetera) in the running of the shop for the following year. Apart from this, the entity's profits were applied to the SW Group's objects. The establishment and operation of the opportunity shop is consistent with the entity applying its income and assets solely for the purpose for which it is established.

Example 9 – entity with two purposes (sporting club) – not a breach of the income and assets condition

73. The United Central Districts Soccer Club (the Club) is an incorporated association that meets the description of exempt entity in item 9.1 of the table in section 50-45. It is a society, association or club established for the encouragement of a game or sport.

74. The objects in the Club's constitution state that its main purpose is the promotion and encouragement of soccer in the local area. A secondary purpose is to provide social and recreational facilities for members.

75. The Club conducts extensive sporting activities, including coaching and entering teams into soccer competitions and tournaments at the local and state levels, and providing referees and other officials at these events. The Club owns sporting stadiums and ovals from which matches are played. There is a high level of participation by members (either directly or indirectly) in the entity's sporting activities.

76. The Club provides facilities for its members and visitors from which it generates considerable income. During the year ended 30 June 2014, the majority of profits from these activities were used for the promotion of the Club's sporting activities. The remainder was used to improve the social, non-sporting facilities of the Club. No funds were applied for any other purpose.

77. The Club has satisfied the income and assets condition for the year ended 30 June 2014 because it has applied its income and assets solely for the two purposes for which it is established.

Example 10 – accumulation of income – not a breach of the income and assets condition

78. The Papillon Society (Papillon) is an incorporated entity that meets the description of exempt entity in item 1.7 of the table in section 50-5. It is a society, association or club established for the encouragement of science.

79. The constitution of Papillon provides the objects for which the entity is established are to promote, foster, develop and assist the study of butterflies, provide a forum for presentations and to assist and arrange for butterfly researchers to travel abroad to participate in scientific forums.

80. Papillon derives income from a number of sources, including bequests and a share portfolio. For the year ended 30 June 2014, Papillon received \$310,000 in income. Of this amount, \$210,000 is applied towards meeting the entity's objects, and the balance of \$100,000 is retained. Papillon has a plan to accumulate enough money to upgrade its research facilities and to employ another research scientist.

81. Papillon's accumulation of income in the year ended 30 June 2014 does not breach the income and assets condition. Papillon has applied its income and assets in a manner consistent with its objects, while accumulating income to further its objects in the future.

Example 11 – accumulation of income – breach of the income and assets condition

82. Q Ltd is a company limited by guarantee that meets the description of a registered charity in item 1.1 of the table in section 50-5.

83. Q Ltd's constitution states that its object is the relief of poverty in Australia. The constitution also contains a power enabling the company to retain profits.

84. Q Ltd operates second-hand clothing stores so that any profit generated can be paid to other charitable institutions to fulfil its object. After several years of operation the stores have made substantial profits but no funds have been transferred to any charitable institution. All profits have been retained.

85. Minutes of the most recent AGM indicate that profits are to be retained for expansion of the stores in 'the future'. There are no plans to transfer any funds to charitable institutions.

86. In these circumstances the accumulation of profits is not consistent with the entity applying its income and assets solely for the purpose for which it is established. For the year ended 30 June 2014, Q Ltd has breached paragraph 50-50(2)(b).

Example 12 – insignificant misapplication of income or assets – not a breach of the income and assets condition

87. The Oz Society (Oz) is an unincorporated entity that meets the description of exempt entity in item 2.1 of the table in section 50-10. It is a society, association or club established for community service purposes (except political or lobbying purposes).

88. During the year ended 30 June 2014, Robert, the treasurer of Oz, makes an error when using the online banking facility. Robert accidentally pays an invoice of \$60 for cleaning his private residence using Oz's funds. The same cleaning company services both Robert's house and Oz's office. Also during the same income year, Robert resigns from his position at Oz. The transaction was discovered by the new treasurer. There were no other misapplications of funds in the income year.

89. The payment of \$60 is an insignificant misapplication of Oz's income because the amount paid is immaterial and the misapplication is an isolated incident when viewed in the overall context of how the entity's income and assets are applied. Oz does not breach the income and assets condition for the year ended 30 June 2014.

Example 13 – misapplication of income or assets – breach of the income and assets condition

90. The Da Vinci Society (Da Vinci) is established to promote anatomical research. It is an incorporated entity that meets the description in item 1.7 of the table in section 50-5 (a society, association or club established for the encouragement of science).

91. During the year ended 30 June 2014, Da Vinci entered into a joint venture agreement with a number of 'for-profit' medical research organisations. The three directors of Da Vinci distribute the funds received from the joint venture equally amongst themselves. Each of the three directors of Da Vinci personally received \$50,000 for their private benefit for the year ended 30 June 2014.

92. Da Vinci has not applied its income and assets solely for the purpose for which it is established. When viewed in the overall context of how Da Vinci's income and assets are applied, the funds distributed for the directors' personal benefit were a material amount for a private purpose. It is not an insignificant misapplication.

93. Da Vinci has breached the income and assets condition in accordance with paragraph 50-70(2)(b) for the year ended 30 June 2014.

Date of effect

94. This Ruling applies to years of income commencing both before and after its date of issue. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

25 February 2015

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Background

95. Division 50 exempts from income tax the total ordinary and statutory income of an entity that is covered by one of the various items in the tables listed in the Division. The tables in Division 50 apply to a range of specified categories of entity. Many of the items in the tables require that certain special conditions be satisfied before the income of an entity can be exempt from income tax. These special conditions vary depending on the nature of the entity.

96. Schedule 11 of Part 5 to the *Tax Laws Amendment (2013 Measures No. 2) Act 2013* inserted two additional special conditions in sections 50-15, 50-50, 50-55, 50-65, 50-70 and 50-72¹⁵. These special conditions are:

- an entity must comply with all the substantive requirements in its governing rules, and
- an entity must apply its income and assets solely for the purpose for which the entity is established.

97. These two additional special conditions apply to an entity from the entity's income year that commences on or after 1 July 2013.

Governing rules condition

98. The first of the two special conditions for income tax exemption inserted into Division 50 by the *Tax Laws Amendment (2013 Measures No. 2) Act 2013* was the governing rules condition. This is the requirement that an entity must 'comply with all the substantive requirements in its governing rules'.

99. Three questions must be considered to determine whether an entity satisfies the governing rules condition:

- What are the 'governing rules' of the entity?
- What are the 'substantive' requirements in the entity's governing rules?
- At what time must the entity comply with all of the substantive requirements in its governing rules?

¹⁵ Item 4.1 (funds contributing to other funds) existed at the time the governing rules condition and income and assets conditions were introduced. Repealed as of 1 January 2014 by the *Charities (Consequential Amendments and Transitional Provisions) Act 2013*.

What are the 'governing rules' of the entity?

100. The first step in applying the governing rules condition is to ascertain the 'governing rules' of the entity.

101. The words 'governing' and 'rules', and the composite phrase 'governing rules' are not defined in the ITAA 1997. It is therefore necessary to consider the ordinary meaning of the phrase in the context in which it appears.¹⁶ This context is determined by considering the specific provisions in Division 50, as well as statements in the Revised Explanatory Memorandum to the Tax Laws Amendment (2013 Measures No. 2) Bill 2013 (Revised Explanatory Memorandum).

102. The Revised Explanatory Memorandum states that the governing rules condition was introduced to ensure that an entity is not entitled to income tax exemption if it engages in certain 'inappropriate conduct' that is insufficient to manifest in a separate purpose, but is, nevertheless, inconsistent with the substantive requirements in its governing rules.¹⁷

103. *The Australian Oxford Dictionary* defines the word 'rule' as 'a principle to which an action conforms or is required to conform'.¹⁸ The word 'govern' is defined to mean 'rule or control (a nation, subject, etc.) with authority; conduct the policy and affairs of (an organisation etc.)'.¹⁹

104. For the purpose of Division 50, 'governing rules' are those rules that authorise the policy, actions and affairs of the entity. That is, the rules that direct what the entity, and those who control it, are required and permitted to do in relation to the entity.

105. An entity may have governing rules from more than one source.

106. In most instances, an entity's governing rules are set out in writing. There may be some circumstances, however, where an entity's governing rules are unwritten, although such circumstances are likely to be rare.

107. Where an entity's governing rules are put in writing, a document or documents setting out matters such as the establishment, operation and winding up of the entity are a key source of those governing rules. Such documents are commonly referred to as the 'constituent documents' of the entity. Depending on the nature of the entity, governing rules may be contained in constituent documents such as constitutions, memoranda and articles of association, association rules, co-operative rules, trust deeds, enacting legislation and church laws.

¹⁶ *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408.

¹⁷ See paragraphs 9.57 to 9.60 of the Revised Explanatory Memorandum.

¹⁸ *The Australian Oxford Dictionary*, 2004, rev. 2nd edn, Oxford University Press, Melbourne.

¹⁹ *The Australian Oxford Dictionary*, 2004, rev. 2nd edn, Oxford University Press, Melbourne.

108. These various documents containing the governing rules of an entity contain rules in relation to matters such as:

- The entity's objects or purposes (what the entity is set up to do).
- The entity's powers (how the entity will do those things).
- Membership of the entity, including applying for or ceasing membership, providing a register of members, disciplining members, and settling disputes involving members.
- Management of the entity, including the composition of committees, and the roles of various officers of the entity.
- Financial matters of the entity, including establishing funds, accounts, borrowing, and audit requirements.
- The winding up of the entity.

109. Other rules that apply to an entity may come from a variety of sources, and may or may not form part of the entity's governing rules for the purpose of the governing rules condition. Examples of such rules that may or may not form part of an entity's governing rules include:

- mandatory codes of conduct
- regulatory State or Commonwealth laws
- laws applying to a particular type of entity, and
- other rules relating to the sector in which the entity operates.

110. It is necessary to consider whether, apart from the constituent documents of the entity (if any), any of these other rules are included in the entity's governing rules.

111. A centralised set of rules which specifically applies to a group of entities or to a particular type of entity will form part of an entity's governing rules. For example:

- the governing rules of an entity that is a trust established by a deed would include the trust deed, as well as the trust law that applies to the trust (under the general law and statute)
- the governing rules of an entity that is a corporation limited by guarantee or a corporation limited by shares would include its constitution, and the *Corporations Act 2001*, to the extent that the statute was applicable to the company, and
- the governing rules of an entity that is an incorporated association would include the relevant state or territory legislation applicable to associations.

112. The governing rules of some entities may come from a centralised source. For example, the religious law of a particular church may form all or part of the governing rules that apply to a group of entities controlled by a central administrative body. Each entity in the group may not have separate governing rules.

113. Not all rules that apply to an entity will form part of the entity's governing rules. For a rule to come within the scope of the governing rules of an entity, it must come from a source whose function is to authorise the policy, actions and affairs of the entity. Broad regulatory regimes which are not targeted to a particular entity or type of entity are not a source of its governing rules. For example, the relevant criminal law and the *Privacy Act 1988*.

114. Where an entity enters into obligations with third parties (including government) in accordance with its constituent documents or other governing rules, the agreements entered into that give rise to those obligations generally do not constitute an additional source of governing rules. Rules regulating leases, licences and contracts of service or for government concessions (such as fundraising exemptions or deductible gift status) are not governing rules of an entity because they do not authorise the policy, actions and affairs of the entity. The source of authority that permits the entity to enter into the agreement would be the entity's constituent documents or other governing rules, rather than the agreement itself.

115. Nevertheless, in some circumstances an entity may choose to expressly incorporate into its constituent documents provisions from broad regulatory regimes or agreements entered into with third parties. That is, the entity's constituent documents or other governing rules state that the broad regulatory regime or agreement entered into with a third party forms part of the entity's governing rules.

What are the 'substantive' requirements in the entity's governing rules?

116. The next step in applying the governing rules condition is to determine the 'substantive' requirements in the entity's governing rules. It is necessary to determine which of the entity's governing rules are substantive requirements and which are not.

117. Ascertaining the substantive requirements in an entity's governing rules requires a consideration of all of its governing rules. It is necessary to take into account all of the entity's facts and circumstances in order to make this determination.

118. The ITAA 1997 does not define the word 'substantive'. It is therefore necessary to consider whether the word takes its ordinary meaning in the context in which it appears.²⁰

²⁰ *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408.

119. The context is determined by considering the specific provisions in Division 50, as well as statements in the Revised Explanatory Memorandum.

120. The word 'substantive' narrows the enquiry of the governing rules condition. That is, the governing rules condition focuses on whether an entity has complied with all of the 'substantive' requirements in its governing rules, as opposed to whether it has complied with all of its governing rules.

121. The Revised Explanatory Memorandum explains that by limiting the loss of income tax exemption to breaches of substantive requirements in an entity's governing rules, procedural irregularities would not result in an entity losing its tax exempt status.²¹ For the purpose of this Ruling, any governing rules that are not substantive requirements are referred to as procedural requirements.

122. In *The Oxford Dictionary of English*, one of the definitions of the word 'substantive' is '(of law) defining rights and duties, as opposed to giving the procedural requirements by which those rights and duties are enforced'.²² This is consistent with the technical legal meaning of the word 'substantive'. In *John Pfeiffer Pty Ltd v Rogerson* (2000) 203 CLR 503, regarding the distinction between legislative provisions that are 'substantive' and those that are 'procedural', Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ said at paragraph 99:

... matters that affect the existence, extent or enforceability of the rights or duties of the parties to an action are matters that, on their face, appear to be concerned with issues of substance, not with issues of procedure. Or to adopt the formulation put forward by Mason CJ in *McKain*, 'rules which are directed to governing or regulating the mode or conduct of court proceedings' are procedural and all other provisions or rules are to be classified as substantive.

123. The 'substantive' requirements in an entity's governing rules are those rules that define the rights and duties of the entity. The remainder of an entity's governing rules are merely procedural requirements. Administrative processes are generally procedural.

124. Some examples of substantive requirements are:

Objects/purposes

- Rules that give effect to the object(s) or purpose(s) of an entity are substantive requirements. They set out what the entity is established to do. That is, such rules define the rights and duties of the entity.

Non-profit status

- Rules relating to the non-profit status of an entity are substantive requirements. These rules define the rights and duties of the entity.

²¹ See paragraph 9.61 to the Revised Explanatory Memorandum.

²² *The Oxford Dictionary of English*, 2010, 3rd edn, Oxford University Press.

Powers and duties of directors/officers

- Rules setting out the powers and duties of directors or officers of an entity are substantive requirements; they define the rights and duties of the entity.

Audit and accounts

- Rules requiring that annual financial reports be prepared, audited and retained are substantive requirements as they define duties of the entity.

Winding up

- Rules relating to the winding up of an entity are substantive requirements; they define the rights and duties of the entity.

125. In an entity's governing rules, some of the rules covering a particular subject matter will be substantive requirements, whereas other rules in relation to that topic will be procedural requirements. For example:

Membership

- Rules regarding the criteria for admission as a member of an entity are substantive requirements, as they define the right of individuals to membership of the entity.
- Rules requiring an entity to maintain a register of members are substantive requirements, as they define a duty of the entity.
- Rules regarding the process for applying for membership of an entity are procedural requirements, as they set out the method or manner in which a substantive requirement (the right to membership) is carried into effect. The requirement to maintain a register of members in a particular format is also a procedural requirement.

Meetings

- Rules requiring an entity to hold particular meetings of members and/or directors (for example, an AGM) are substantive requirements; they define a duty of the entity.
- Rules regarding how a particular meeting is conducted are procedural requirements. Such rules do not define rights or duties of an entity, but deal with the means by which the duty to hold a meeting is carried into effect.
- For example, the need for a quorum at an AGM is a procedural requirement, because it relates to the method by which the meeting is to be conducted, and does not affect the duty of the entity to hold the AGM.

Votes of members

- Rules setting out the right of a member of an entity to vote at an AGM are substantive requirements; these rules define the voting rights of members.
- Rules setting out how a member may vote at an AGM by proxy, the required documents to appoint a proxy, and the lodgement of proxy forms are procedural requirements. These rules do not define the rights or duties of an entity but deal with the method by which the right of members to vote are carried into effect or enforced.

126. The circumstances that give rise to a breach of a procedural requirement may also result in a breach of a substantive requirement. For example, although the need for a quorum at a meeting of members of an entity is a procedural requirement, the failure to have a quorum at an AGM may also invalidate that AGM. This may result in a breach of a substantive requirement to hold the AGM within a particular time period.

127. An entity's governing rules may include rules from sources other than its constituent documents. In this circumstance it is necessary to consider whether such rules are substantive requirements in an entity's governing rules.

128. Both the general law and statute may contain governing rules that define the rights and duties of a particular entity. For example, in relation to an entity that is a trust, the following general law duties of a trustee are substantive requirements (not an exhaustive list): the duty to carry out the trust in accordance with its terms; the duty to keep proper accounts; and the duty to avoid conflict and unauthorised profit. For corporations, certain provisions in Part 2D.1 of the *Corporations Act 2001* contain substantive requirements. These provisions set out some of the most significant duties of directors, secretaries, and other officers and employees.

At what time must the entity comply with all of the substantive requirements in its governing rules?

129. The final step in applying the governing rules condition is to consider whether the entity has complied with all of the substantive requirements in its governing rules during an income year.

Applies at all times during an income year

130. The governing rules condition is applied on a continuous basis throughout an income year. Therefore, in order for an entity to be exempt from income tax for all of an income year, it must (among other things) satisfy the governing rules condition at all times during that income year.

Commissioner's practical administration of the governing rules condition where corrective action is taken by the entity

131. Appendix 3 sets out the Commissioner's approach to compliance action for breaches of the governing rules condition where the entity has taken prompt corrective action.

Income and assets condition

132. The second of the two special conditions for income tax exemption inserted into Division 50 by the *Tax Laws Amendment (2013 Measures No. 2) Act 2013* was the income and assets condition. This is the requirement that an entity must 'apply its income and assets solely for the purpose for which the entity is established'.

133. The two questions that must be considered in determining whether an entity has satisfied the income and assets condition are:

- What is the 'purpose for which the entity is established'?
- Has the entity applied its income and assets solely for the purpose for which the entity is established?

What is the 'purpose for which the entity is established'?

134. The first step in applying the income and assets condition is to ascertain the 'purpose for which the entity is established'. It is only once this is determined can it then be considered whether the entity has applied its income and assets solely for this purpose.

135. Ascertaining the purpose for which the entity is established involves a consideration of all of the features of the entity. These features can include the entity's constituent or governing documents, its activities, policies and plans, administration, finances, history and control, and any legislation governing its operation.²³ The objects or objectives in the constituent documents of an entity, and the activities by which those objects or objectives are achieved, are the main factors to be considered in determining the purpose of the entity. These enquiries are directed towards a determination of the substance and reality of the entity's purpose.

136. The determination of the purpose for which the entity is established requires the consideration of the entity's circumstances during the income year in which the income and assets condition is applied. This is supported by a number of factors: the periodic operation of the provisions in Division 50; the use of the present tense in the income and assets condition; and the interpretation of the term 'established'.

²³ See *Cronulla Sutherland Leagues Club Limited v. FC of T* (1990) 23 FCR 82; 90 ATC 4215; (1990) 21 ATR 300 at FCR 95-96; ATC 4225; ATR 312 and *Brookton Co-operative Society Ltd v. Federal Commissioner of Taxation* (1981) 147 CLR 441; 81 ATC 4346; (1981) 11 ATR 880 at CLR 450 to 451; ATC 4351 to 4352; ATR 886.

Periodic operation of the provisions of Division 50

137. Division 50 operates on a periodic basis. That is, an entity must consider whether Division 50 applies to it in relation to each income year. The enquiry as to the purpose for which the entity is established considers not only the purpose for which the entity was established at its formation but also the purpose for which it is currently conducted. This requires consideration of the entity's circumstances at the point in time at which the income and assets condition is applied.

138. In *Cronulla Sutherland Leagues Club Limited v. Commissioner of Taxation* (1990) 23 FCR 82ALR; 90 ATC 4215; 21 ATR 300 at FCR 95 to 96; ATR 312 (*Cronulla Sutherland Leagues*), the Full Federal Court was required to determine whether the Cronulla Sutherland Leagues Club Ltd was exempt from income tax under former subparagraph 23(g)(iii) of the ITAA 1936, the predecessor to current section 50-45, as 'a society, association or club established for the encouragement or promotion of an athletic game or athletic sport in which human beings are the sole participants'. The Court held that the 'periodic operation' of the income tax exemption provisions meant that it was necessary to look at the purpose for which the club was conducted in the year the test was applied, not just at the time of formation.

139. In *Federal Commissioner of Taxation v. Word Investments Limited* (2008) 236 CLR 204; [2008] HCA 55; 2008 ATC 20-072; (2008) 70 ATR 225 (*Word Investments*), the High Court said, in obiter, at paragraph 34 that, being 'provisions in the legislation exempting tax on annual income', former paragraph 23(e) of the ITAA 1936 and item 1.1 in the table in section 50-5 have a 'periodic operation'. This meant that (in the context of determining whether an entity is a charitable institution) the entity's current purpose in a particular year of income must also be considered in addition to its purpose at formation.

140. The Commissioner considers that the reasoning of the High Court in *Word Investments* and the Full Federal Court in *Cronulla Sutherland Leagues Club*, that those relevant former exempting provisions had a 'periodic operation', also applies in the context of the income and assets condition (and the governing rules condition).

Use of the present tense

141. The requirement that an entity must 'apply its income and assets solely for the purpose for which the entity *is* established' (emphasis added) is written in the present tense. This supports the view that regard must be given to the current circumstances of the entity.

142. The particular use of a tense in a legislative provision should be considered in interpreting that provision.²⁴ In *Ervestra Ltd v. Federal Commissioner of Taxation* (2008) 169 FCR 300; [2008] FCA 249; 70 ATR 115, the Federal Court held that ‘tense may be a significant indicator to the proper construction of a taxation statute’.²⁵ In *Brookton Co-operative Society Limited v. Federal Commissioner of Taxation* 81 ATC 4346; (1981) 55 ALJR 479; (1981) 35 ALR 295, the High Court considered that the use of the present tense in the phrase ‘is established’ in determining whether a company ‘is established for the purpose of carrying on any business’ meant that it was necessary to consider the relevant purpose in the income year in which the test was applied.

Meaning of ‘established’

143. The interpretation of the term ‘established’ by the courts further supports the view that subsequent activities of an entity are an important consideration for determining purpose.

144. In *Cronulla Sutherland Leagues Club*, the Full Federal Court considered that the use of the word ‘established’ in former subsection 23(g) of the ITAA 1936 meant that it was necessary to look at the circumstances of the club in the relevant years of income in which the test was applied, as well as the circumstances surrounding the club’s formation.²⁶

References to ‘purpose’ include the plural

145. The term ‘purpose’ (in the singular) in the income and assets condition can be read as ‘purposes’ (in the plural).²⁷ The phrase ‘purpose for which the entity is established’ in the income and assets condition refers to all of the applicable purposes of the entity, not just the entity’s main purpose.

146. Division 50 allows income tax exemption for certain entities with more than one purpose. For example, a registered charity may have more than one charitable purpose, or it may have a charitable purpose and purposes incidental or ancillary to its charitable purpose.

²⁴ Pearce, DC, Geddes, RS 2014, *Statutory Interpretation in Australia*, 8th edn, Lexis Nexis Butterworths, Australia, pp. 208-209.

²⁵ The Federal Court cited the following cases in support of this proposition: *Brookton Co-operative Society Ltd v. Federal Commissioner of Taxation* (1981) 147 CLR 441; 81 ATC 4346; (1981) 11 ATR 880 and *Cronulla Sutherland Leagues Club Ltd v. Federal Commissioner of Taxation* (1990) 23 FCR 82; 90 ATC 4215; (1990) 21 ATR 300.

²⁶ See 90 ATC 4215 at 4220 to 4221.

²⁷ Section 23 of the *Acts Interpretation Act 1901* deals with rules as to gender and number and states: ‘In any Act: ... (b) words in the singular number include the plural and words in the plural number include the singular.’

Registered charities

147. A registered charity is an entity that is registered by the ACNC as a charity.²⁸ A registered charity may have more than one purpose, as long as all of its purposes are either:

- charitable purposes for the public benefit, or
- purposes that are incidental or ancillary to, and in furtherance or in aid of, its charitable purposes.²⁹

148. When applying the income and assets condition to a registered charity, the phrase 'purpose for which the entity is established' refers to:

- the charitable purposes of the entity, and
- any purposes incidental or ancillary to, and in furtherance or in aid of, the charitable purposes of the entity.

Other entities

149. An entity other than a registered charity that is covered by an item in the tables in Division 50 may also have more than one purpose. Whether an entity meets the description under a particular item in the tables in Division 50 is determined by reference to the purpose for which the entity is established. It is therefore necessary to consider how the income and assets condition applies to such an entity.

150. When applying the income and assets condition to an entity other than a registered charity, the phrase 'purpose for which the entity is established' refers to:

- the main purpose of the entity
- any purposes incidental or ancillary to the main purpose of the entity, and
- other unrelated purposes that are secondary to the main purpose of the entity.

Incidental or ancillary purpose

151. An entity may have purposes which, when viewed in isolation, would not be a purpose that would attract income tax exemption, but which are incidental or ancillary to its charitable purpose or main purpose.

²⁸ See subsection 995-1(1) of the *Income Tax Assessment Act 1997* and subsection 25-5(5) of the *Australian Charities and Not-for-profits Commission Act 2012*.

²⁹ See section 5 of the *Charities Act 2013*.

152. In the decision of the Federal Court in *Navy Health Ltd v. Federal Commissioner of Taxation* (2007) 163 FCR 1; [2007] FCA 931 Jessup J said at paragraph 65:

When the courts have described objects of an institution as ancillary, incidental or concomitant to a main object, they have not meant that the lesser object was merely a minor one in quantitative terms. Rather, they have required that object not be of substance in its own right, but only to be something which tends to assist, or which naturally goes with, the achievement of the main object.

153. For the purpose of this Ruling, a purpose is incidental or ancillary to the purpose for which the entity is established if it tends to assist, or naturally goes with, the achievement of that purpose. It does not mean a purpose that is minor in quantitative terms.³⁰

154. The courts have held that a charitable institution may have purposes which, when viewed in isolation would be non-charitable, but which are incidental or ancillary to its charitable purpose.³¹ This reasoning also applies to the income and assets condition. As long as these other purposes are wholly incidental or ancillary to fulfilling or furthering the purpose for which the entity is established (so that they are, in reality, only aspects of that purpose), they will not affect the income tax exempt status of the entity.

155. Determining whether a purpose is incidental or ancillary involves questions of degree, judgment, proportion, impression and weight.³² The incidental or ancillary purpose must be genuinely for the sake of, in aid of, or in furtherance of, the purpose for which the entity is established. An entity's incidental or ancillary purposes need not be set out in writing in its constituent documents.

156. As well as the phrase 'incidental or ancillary', other expressions used in the cases (relating to charitable purpose) are 'subsidiary' and 'concomitant'. These words all express the idea that the objects or purposes are not ends in themselves but tend to assist, or naturally go with, the achievement of the purpose for which the entity is established.

³⁰ *Navy Health Limited v. Federal Commissioner of Taxation* (2007) 163 FCR 1; [2007] FCA 931 at paragraph 65.

³¹ See *Congregational Union of New South Wales v. Thistlethwayte and Ors* (1952) 87 CLR 375 at 442; *Navy Health Limited v. Federal Commissioner of Taxation* (2007) 163 FCR 1 at paragraph 65; [2007] FCA 931; *Commissioner of Taxation v. The Triton Foundation* (2005) 147 FCR 362; [2005] FCA 1319 at paragraph 20.

³² This is consistent with the Commissioner's view in paragraph 183 of Taxation Ruling TR 2011/4 *Income tax and fringe benefits tax: charities*, as it applied to where a charitable institution had purposes which were incidental or ancillary to its charitable purpose.

Change of purpose

157. The income and assets condition is applied continuously throughout an income year. The relevant purpose (or purposes) to which an entity must solely apply its income and assets, are those that exist at the point in time the test is being considered. If an entity changes its purpose, and is still eligible for income tax exemption, the entity must consider from that point in time whether it is applying its income and assets to the new purpose.

Has the entity applied its income and assets solely for the purpose for which the entity is established?

158. The final step in applying the income and assets condition is to determine whether the entity has 'applied' its income and assets 'solely' for the purpose for which the entity is established.

Meaning of 'apply'

159. The word 'apply' is not defined in the ITAA 1997 and hence takes its ordinary meaning in the context in which it appears.³³ One of several meanings of 'apply' in *The Australian Oxford Dictionary* is 'make use of as relevant or suitable; employ'.³⁴

160. In the context of the income and assets condition, 'apply' means that an entity must make use of all of its income and assets solely for its purpose or purposes. Consequently, income received by an entity must be put to use within a reasonable period of receipt.

161. The requirement in former section 50-60 that, to be entitled to be endorsed as exempt, a charitable fund must have been 'applied for the purposes for which it was established' was examined by the High Court in *Federal Commissioner of Taxation v. Bargwanna* (2012) 244 CLR 655; [2012] HCA 11; 2012 ATC 20-312; (2012) 82 ATR 273 (*Bargwanna*) in the context of a misapplication of fund moneys by the trustees.

162. The High Court held that the fund was not entitled to endorsement as a tax exempt entity because it did not satisfy the requirement in former section 50-60 that the fund be 'applied' for the public charitable purposes for which it was established. The various acts of misapplications of the fund 'were not referable to the carrying out of the charitable purposes for which the Deed provided'. The High Court said that the term 'applied' is used in the sense of 'so administered as to give effect to the trusts established by the relevant instrument', rejecting an argument that 'applied' means 'substantially applied' or 'on the whole, applied'.³⁵

³³ *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408.

³⁴ *The Australian Oxford Dictionary*, 2004, rev. 2nd edn, Oxford University Press, Melbourne.

³⁵ *Federal Commissioner of Taxation v. Bargwanna* (2012) 244 CLR 255; [2012] HCA 11 at paragraph 44.

163. The Commissioner's view is that the word 'apply' in the income and assets condition takes the same meaning as considered by the High Court in *Bargwana*.

Meaning of 'income'

164. The word 'income' in the income and assets condition is not defined in the ITAA 1997 and therefore takes its ordinary meaning in the context in which it appears.³⁶ 'Income' is defined in *The Australian Oxford Dictionary* to mean 'the money or other assets received, especially periodically or in a year, from one's business, lands, work, investments, etc.'³⁷ In the income and assets condition, 'income' refers to both 'net' income and 'gross' income. That is, the requirement that an entity must apply its income solely for the purpose for which it is established relates to both the income received during a financial year, as well any surplus left over at the end of that year.

Accumulation

165. An entity can accumulate income provided the accumulation is consistent with the purpose or purposes for which the entity is established. An entity may use some of its income to acquire assets which, in future, will produce income for its purpose, and may accumulate some of its income for later distribution.

166. The High Court in *Bargwana* discussed whether, for the purpose of former section 50-60, accumulation of moneys was consistent with a fund being 'applied' for the requisite purpose. The High Court said at paragraph 30 that the Commissioner 'accepts that a fund may be 'applied' for charitable purposes without immediate expenditure of income as it is derived'.

167. The income and assets condition tests whether an entity's *income and assets* are 'applied' for the purpose for which the entity is established. The Commissioner's view is that accumulation of some of the income of an entity will not breach the income and assets condition, provided the accumulation is consistent with the purpose for which the entity is established. The Commissioner considers that this is consistent with the common law concerning former section 50-60³⁸ which considered the separate issue of when is a *fund* 'applied' for the purposes for which it was established.

³⁶ *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408.

³⁷ *The Australian Oxford Dictionary*, 2004, rev. 2nd edn, Oxford University Press, Melbourne.

³⁸ See also *Mahoney v. Federal Commissioner of Taxation* (1965) 9 AITR 513; (1965) 13 ATD 519; *Compton v. C of T* (1966) 116 CLR 233; [1966] HCA 1; (1966) 10 AITR 282; (1966) 14 ATD 157; *Mahony v. Federal Commissioner of Taxation* (1967) 10 AITR 463; (1967) 41 ALJR 232; and *Gorton v. Commissioner of Taxation* [2008] AATA 280; 2008 ATC 10-018; (2008) 72 ATR 201.

168. In *Word Investments* the High Court said at paragraph 22, in relation to whether a company was income tax exempt as a charitable institution:

a power to retain profits conferred on directors of a company which has charitable purposes cannot negate its character as a charitable institution. Its exercise, while it may delay the moment when assets are applied to charitable purposes, also increases the chance that more assets will eventually be so applied.

169. This does not mean that excessive or indefinite accumulation is permissible under the income and assets condition. An entity's entitlement to income tax exemption is a year by year assessment. An entity that accumulates most of its income over a number of years will need to show that this accumulation is consistent with its purpose.³⁹

170. Relevant factors to be considered include whether the entity has identified when and how its income is to be applied to its purpose and, if accumulation is to continue for an extended period, the reasons for this.⁴⁰

Meaning of 'solely'

171. The income and assets condition requires that an entity must apply its income and assets 'solely' for the purpose for which the entity is established. Although the income and assets condition is a strict test requiring exclusivity of purpose, certain misapplications of an entity's income and assets of an insignificant nature will not result in a breach of the condition.

172. The word 'solely' is not defined for the purposes of the ITAA 1997 and hence takes its ordinary meaning in the context in which it appears.⁴¹ *The Australian Oxford Dictionary* defines the word 'solely' as a derivative of 'sole', which is defined to mean 'one and only; single, exclusive'.⁴² For the purpose of Division 50, it is considered that 'solely' also takes this meaning.

173. An entity must apply its income and assets exclusively or only for the purpose for which the entity is established. The income and assets condition requires that none of the income and assets of the entity be applied for purposes that are not in accordance with, or incidental or ancillary to, the purpose for which the entity is established. An entity will not comply with the income and assets condition if it applies any of its income or assets for a private purpose.

³⁹ This is consistent with the Commissioner's position on accumulation in paragraph 40 of TR 2011/4, as it related to the accumulation of profits of a charitable institution.

⁴⁰ See paragraph 223 of TR 2011/4.

⁴¹ *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408.

⁴² *The Australian Oxford Dictionary*, 2004, rev. 2nd edn, Oxford University Press, Melbourne.

174. A strict standard of compliance is required under the 'solely' test. The test requires exclusivity of purpose. This test is similar to the requirement in section 62 of the *Superannuation Industry (Supervision) Act 1993* that each trustee of a regulated superannuation fund must ensure the fund is maintained solely for at least one of the legislated core purposes, which can be in conjunction with any approved ancillary purposes.⁴³

175. The courts have found that activities conducted by the trustee of a regulated superannuation fund can satisfy the sole purpose test, even though incidental, remote or insignificant benefits that are not stipulated in the Act are provided to a member or some other entity.⁴⁴

176. The Commissioner considers that, in some circumstances, a misapplication of an entity's income and assets of an insignificant nature will not result in a breach of the income and assets condition. That is, when viewed in the context of the overall application of the entity's income and assets, the misapplication is so insignificant it cannot be regarded as constituting a breach of the 'solely' test. This must be ascertained from a consideration of all of the relevant facts and circumstances. Relevant considerations include the amount of the misapplication and whether the misapplication is an isolated incident unrelated to other misapplications. Such instances are considered to be rare.

177. Therefore, the income and assets condition will still be satisfied where:

- the misapplication or misapplications are immaterial in amount, and
- there is a one-off misapplication or occasional, unrelated misapplications of part of the income or assets of an entity for a purpose other than the purpose for which the entity is established during an income year.

Applies at all times during an income year

178. The income and assets condition is applied continuously throughout the income year. In order for an entity to be exempt from income tax for all of an income year, it must (among other things) satisfy the income and assets condition at all times during that year.⁴⁵

⁴³ See section 62 of the *Superannuation Industry (Supervision) Act 1993*.

⁴⁴ See *Case X60 90* ATC 438; (1990) 21 ATR 3477 at ATC 446; ATR 3485; *Case 43/95 95* ATC 374; (1995) 31 ATR 1067 at ATC 382; ATR 1076. See also *Self Managed Superannuation Funds Ruling SMSFR 2008/2 Self Managed Superannuation Funds: the application of the sole purpose test in section 62 of the Superannuation Industry (Supervision) Act 1993 to the provision of benefits other than retirement, employment termination or death benefits*.

⁴⁵ Appendix 3 of this Ruling sets out the Commissioner's administrative treatment that may be relevant where there has been a breach of the income and assets condition.

Commissioner's practical administration of the income and assets condition where corrective action is taken by the entity

179. Appendix 3 sets out the Commissioner's approach to compliance action for breaches of the income and assets condition where the entity has taken prompt corrective action.

Breaches of the governing rules condition and income and assets condition – where no breach or misapplication is taken to have occurred

180. In some rare situations, a breach of a substantive requirement in an entity's governing rules may be rectified after the breach occurs, with the effect that the breach is treated as never having happened. A misapplication of part of the income or assets of an entity to a purpose other than the purpose for which it is established may similarly be rectified after the misapplication occurs.

181. Where the breach or misapplication is rectified with effect from the time the breach occurred, for example pursuant either to the entity's governing rules or the jurisdiction of a court, the breach or misapplication is taken to have never occurred at all. In these situations, there is no breach or misapplication which would give rise to a failure of the governing rules condition or the income and assets condition. Certain church laws, for example, provide for such a remedy for applicable controlled entities. Another situation where this may occur is where a court orders that the constituent documents of an entity be rectified.

182. Rectification is to be distinguished from the more common situation where the effects of a breach or misapplication are remedied or corrected⁴⁶ after the event. In those circumstances, the breach or misapplication is still taken to have occurred. Accordingly, one or both of the governing rules condition and the income and assets condition may not be satisfied.

Relationship between the governing rules condition and the income and assets condition

183. The governing rules condition and the income and assets condition are independent requirements that an entity must satisfy, along with other requirements in Division 50, in order for its ordinary and statutory income to be exempt from income tax. Some circumstances may give rise to a failure to satisfy either or both of these special conditions.

⁴⁶ See Appendix 3 of this Ruling.

184. While an entity is in breach of either or both of the special conditions, its ordinary and statutory income will not be exempt from income tax.⁴⁷

Potential overlap with ACNC governance standards for registered charities

185. Appendix 3 sets out the Commissioner's approach to applying the income and assets condition to registered charities that have satisfied the ACNC's governance standards.

⁴⁷ An entity that is not entitled to income tax exemption as a result of such a breach will need to consider the application of the Schedule 2D of the ITAA 1936. See also Appendix 3 of this Ruling.

Appendix 2 – Entities to which the Ruling applies

ⓘ *This Appendix lists the entities to which the Ruling applies. It does not form part of the binding public ruling.*

186. This Ruling applies to an entity covered by the following items in the tables in Division 50:⁴⁸

- item 1.1 of the table in section 50-5 dealing with registered charities
- item 1.3 of the table in section 50-5 dealing with scientific institutions
- item 1.4 of the table in section 50-5 dealing with public educational institutions
- item 1.6 of the table in section 50-5 dealing with funds established to enable scientific research to be conducted by or in conjunction with a public university or public hospital
- item 1.7 of the table in section 50-5 dealing with societies, associations or clubs established for the encouragement of science
- item 2.1 of the table in section 50-10 dealing with societies, associations or clubs established for community service purposes (except political or lobbying purposes)
- item 3.1 of the table in section 50-15 dealing with employee associations or employer associations
- item 3.2 of the table in section 50-15 dealing with trade unions
- item 4.1 of the table in section 50-20 dealing with funds contributing to other funds⁴⁹
- item 6.1 of the table in section 50-30 dealing with public hospitals
- item 6.2 of the table in section 50-30 dealing with hospitals carried on by a society or association
- item 9.1 of the table in section 50-45 dealing with societies, associations or clubs established for the encouragement of: animal racing; art; a game or sport; literature; or music, and
- item 9.2 of the table in section 50-45 dealing with societies, associations or clubs established for musical purposes.

⁴⁸ Provided that the entity meets any applicable special conditions set out in column 2 of the table.

⁴⁹ Until the repeal of this item effective 1 January 2014.

Appendix 3 – Administrative treatment

❶ *This Appendix is provided as information to help you understand the Commissioner’s proposed administrative treatment in respect of the governing rules condition and the income and assets condition. It does not form part of the binding public ruling.*

Breaches of the governing rules condition and income and assets condition – Commissioner’s practical administration where corrective action is taken by the entity

187. In some circumstances, an entity may take subsequent action to correct:

- a breach of a substantive requirement in an entity’s governing rules, or
- the application of part of its income or assets to a purpose other than the purpose for which it is established (‘misapplication’).

188. For the purpose of the Commissioner’s administration of the governing rules condition and the income and assets condition, this is referred to as ‘corrective action’ having taken place in relation to the relevant breach or misapplication.

189. Corrective action has the overall effect of putting the entity back to the same position it was before the breach or misapplication occurred. Nevertheless, in such circumstances, a breach or misapplication is still taken to have occurred, although the effects of the breach have been reversed.

190. The Commissioner may consider whether or not to allocate resources to take compliance action in respect of an entity which has become taxable for a period of time due to a breach of the governing rules condition or the income and assets condition. The Commissioner considers that it is not appropriate to allocate resources where all of the following criteria are satisfied:

- (1) Either:
 - (a) as a result of a breach of a substantive requirement in the entity’s governing rules, the entity does not satisfy the governing rules condition at a particular point in time, or
 - (b) as a result of a misapplication of part of the entity’s income or assets, the entity does not satisfy the income and assets condition at a particular point in time, and
- (2) corrective action has been taken in relation to the breach or misapplication within a reasonable time

- (3) the corrective action has resulted in, or will result in, the entity being placed in the position (or substantially the same position) it would have been in had the breach or misapplication not occurred, and
- (4) the entity notifies the Commissioner of all of the above matters.

191. In certain circumstances, the Commissioner may advise the entity to undertake additional steps to correct the breach or misapplication.

192. Notwithstanding the approach set out in paragraphs 190 and 191 of this Ruling, the Commissioner will take appropriate compliance action if there is evidence of fraud, evasion or tax avoidance, or if the Commissioner is concerned about ongoing breaches of the governing rules condition or the income and assets condition.

Example – Application of the Administrative Treatment

193. In Example 6 of the Ruling, HnH changed its objects clause before it commenced the new activities of providing assistance to homeless men and children (in addition to homeless women). Assume, however, that HnH did not change its objects clause before commencing the new activities. In this situation, its support of homeless men and children would be inconsistent with its stated objects. HnH would therefore be in breach of the governing rules condition, as it did not comply with a substantive requirement in its governing rules.

194. Assume further that, after it commenced the new activities, HnH initiated the process to update its governing rules to allow it to provide services to homeless women, men and children. The process to amend the rules took many months, but ultimately the purpose of HnH was amended to allow it to pursue these broadened activities. In these circumstances, the Commissioner would consider that it was appropriate not to allocate compliance resources to consider HnH's entitlement to income tax exemption.

Potential overlap with ACNC governance standards for registered charities

195. Where a registered charity does not meet the income and assets condition, it will not be entitled to income tax exemption under Division 50. The circumstances that gave rise to the failure to meet this special condition may also have consequences under the governance standards of the ACNC. That is, the requirements of the income and assets condition may overlap with the requirements of the ACNC governance standards.

196. Division 45 of the *Australian Charities and Not-for-profits Commission Act 2012* provides a framework for a set of principle-based minimum governance standards that apply to most registered entities. An entity must comply with these governance standards (among other requirements) in order to be entitled to be registered under that Act.⁵⁰

197. There are five governance standards set out in the *Australian Charities and Not-for-profits Commission Regulation 2013*. In particular, governance standard 1 deals with a similar subject matter to that of the income and assets condition. Governance standard 1 requires that a registered entity must:

- (a) be able to demonstrate, by reference to the governing rules of the entity or by other means, its purposes and its character as a not-for-profit entity, and
- (b) make information about its purposes available to the public, including members, donors, employees, volunteers and benefit recipients, and
- (c) comply with its purposes and its character as a not-for-profit entity.⁵¹

198. The Commissioner recognises that there is a significant overlap between the income and assets condition and the ACNC governance standards as they apply to registered charities.

199. Therefore, in the event that the ACNC has requested that an entity provide evidence of meeting the governance standards and has determined that an entity has satisfied the five governance standards at a particular point in time, the Commissioner will, subject to paragraph 200 of this Ruling, accept that the income and assets condition has been met at that time.

200. If the ACNC has not requested that the entity provide evidence of meeting the governance standards, or at the time of applying the income and assets condition there are additional or changed circumstances from the time of consideration by the ACNC, the Commissioner must consider these additional or changed circumstances in determining entitlement to income tax exemption in accordance with Division 50.

⁵⁰ See paragraph 25-5(3)(b) of the *Australian Charities and Not-for-profits Commission Act 2012*.

⁵¹ See subsection 45.5(2) of the *Australian Charities and Not-for-profits Commission Regulation 2013*.

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