

TR 2014/D5 - Income tax: special conditions for various entities whose ordinary and statutory income is exempt

 This cover sheet is provided for information only. It does not form part of *TR 2014/D5 - Income tax: special conditions for various entities whose ordinary and statutory income is exempt*

This document has been finalised by TR 2015/1.

 There is a Compendium for this document: **TR 2015/1EC** .



Draft Taxation Ruling

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

Contents	Para
PROPOSED LEGALLY BINDING SECTION:	
What this Ruling is about	1
Ruling	6
Date of effect	78
Appendix 1	
Entities to which the Ruling applies	79
NOT LEGALLY BINDING SECTION:	
Appendix 2	
<i>Explanation</i>	80
Appendix 3	
<i>Administrative treatment</i>	157
Appendix 4	
<i>Your comments</i>	171
Appendix 5	
<i>Detailed contents list</i>	173

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

This publication is a draft for public comment. It represents the Commissioner’s preliminary view about the way in which a relevant taxation 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.

You can rely on this publication (excluding Appendices 2 to 5) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don’t have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

What this Ruling is about

1. This Ruling applies to entities listed in Appendix 1.
2. These entities fall under certain items in the tables in Division 50 of Part 2-15 of the *Income Tax Assessment Act 1997* (ITAA 1997), 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 entities listed in Appendix 1 must satisfy:
 - the entity must comply with all of 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).
4. The Ruling does not consider other special conditions in Division 50 of the ITAA 1997.

Definitions

5. In this Ruling, the following terms bear these meanings:
- **'ACNC'** means the Australian Charities and Not-for-profits Commission.
 - **'Commissioner'** means the Commissioner of Taxation.
 - **'entity'** means entity (as defined in section 995-1 of the ITAA 1997) 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 of the ITAA 1997.¹
 - **'governing rules condition'** means the requirement that an entity must 'comply with all the substantive requirements in its governing rules' in sections 50-15, 50-50(2)(a), 50-55(2)(a), 50-65(2)(a), 50-70(2)(a) and 50-72(1)(c)² of the ITAA 1997.
 - **'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 sections 50-15, 50-50(2)(b), 50-55(2)(b), 50-65(2)(b), 50-70(2)(b) and 50-72(1)(d)³ of the ITAA 1997.

Ruling

6. An entity listed in Appendix 1 must satisfy a number of special conditions in order for its ordinary and statutory income to be exempt from income tax under Division 50 of the ITAA 1997. 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'.
8. Three questions must be considered to determine whether an entity satisfies the governing rules condition:
- What are the 'governing rules' of the entity?

¹ Item 4.1 (funds contributing to other funds) was included 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.

² For funds covered by item 4.1.

³ For funds covered by item 4.1.

- What are the ‘substantive requirements’ in the entity’s governing rules?, and
- Has the entity complied 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 a coherent set of enforceable rules relating to the establishment, operation and winding up of the entity. They are rules that authorise the policy, actions and affairs of the entity.

10. The process of determining what constitutes the governing rules of an entity requires a consideration of all of the various sources in which governing rules may be found. The written documents under which an entity was formed will usually be the main source of the entity’s governing rules.⁴ There may also be other sources (such as relevant legislation) that comprise or supplements an entity’s governing rules.

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

What are the ‘substantive requirements’ in the entity’s governing rules?

12. The phrase ‘substantive requirements’ takes its technical legal meaning in the governing rules condition. The substantive requirements in an entity’s governing rules are those that define the rights and duties of the entity. These requirements can be contrasted with the procedural rules by which those rights and duties are applied and enforced.

13. The substantive requirements in an entity’s governing rules include the rights and duties of the entity such as those that give effect to the object or purpose of the entity, relate to the non-profit status of the entity, relate to the winding-up of the entity, and require financial records to be kept.

⁴ These written documents are commonly referred to as ‘constituent documents’.

Has the entity complied with all of the substantive requirements in its governing rules?

Applies at all times during an income year

14. 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.⁵

Income and assets condition

15. The income and assets condition requires an entity to ‘apply its income and assets solely for the purpose for which the entity is established’.

16. 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?

What is the ‘purpose for which the entity is established’?

References to ‘purpose’ include the plural

17. Many of the entities listed in Appendix 1 are established for more than one purpose. The word ‘purpose’ in the phrase ‘purpose for which the entity is established’ includes the plural. The income and assets condition tests whether the income and assets of an entity have been applied solely for the purposes for which the entity is established.

Ascertaining the ‘purpose for which the entity is established’

18. The enquiry as to the purpose for which the entity is established involves determining the substance and reality of the relevant facts and circumstances relating to the entity.

19. The process of ascertaining the purpose for which the entity is established is different for a fund than for the other types of entity to which the income and assets condition applies.

⁵ Appendix 3 sets out the Commissioner’s administrative treatment that may be relevant where there has been a breach of the governing rules condition.

20. The purpose for which a fund is established is ascertained by considering the constituent documents of the fund (primarily the instrument of trust or the will) and any relevant legislation.

21. For entities other than funds, the relevant purpose is determined primarily by reference to the entity's constituent documents, but also by consideration of the activities of the entity after its formation, up to the time at which the income and assets condition is applied.

Changing purpose

22. The income and assets 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 income and assets condition at all times during that year. If an entity (other than a fund) changes its purpose, 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'

23. The requirement that an entity must 'apply' its income and assets solely for the purpose for which the entity is established means that an entity must put to use its income and assets solely for the relevant purpose.

Ability to accumulate

24. The income of an entity may be 'applied' for the purpose for which the entity is established if the entity's profits are accumulated, provided that any accumulation is consistent with the purpose for which the entity is established.

25. An entity that accumulates most of its profits over a number of years will need to be able to show that this accumulation is consistent with its purpose.

Meaning of 'solely'

26. The income and assets condition requires an entity to apply all of its income and assets 'solely' or only for the purpose for which the entity is established and not for any other purpose.

27. The income and assets condition will still be satisfied despite a one-off application of part of the income or assets of an entity, other than for the purpose for which the entity is established, that is insignificant in amount.

Applies at all times during an income year

28. The income and assets condition is applied continuously throughout the 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 income and assets condition at all times during that year.⁶

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

29. The governing rules condition and the income and assets condition are independent special conditions that must be satisfied by an entity listed in Appendix 1 (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 of the ITAA 1997.

30. 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.⁷

Examples

Governing rules condition

Example 1 – requirement to record financial transactions and prepare annual financial statements – substantive requirements in the entity’s governing rules

31. 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 of the ITAA 1997 (a society, association or club established for the encouragement of science).

32. The Society’s constitution at clause 8 requires it to record all financial transactions and to prepare annual financial statements.

33. The requirement in clause 8 is the primary mechanism by which the Society demonstrates that its purposes and objectives are being met. This requirement is a substantive requirement in the entity’s governing rules because it defines duties of the entity; it is not merely a procedural rule.

⁶ Appendix 3 sets out the Commissioner’s administrative treatment that may be relevant where there has been a breach of the income and assets 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 to the *Income Tax Assessment Act 1936* – Tax exempt entities that become taxable. See also Appendix 3.

Example 2 – rules not part of the entity’s ‘governing rules’ – not a breach of the governing rules condition

34. 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 of the ITAA 1997. It is a society, association or club established for the encouragement of a game or sport.

35. Beachside is a table tennis club. Its main purpose is for the encouragement of table tennis. It fields numerous teams in local table tennis competitions. Beachside does not own or rent its own premises and does not provide social facilities for its members.

36. 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. Alcohol is served during the event but Beachside did not arrange for a liquor licence for the evening.

37. The liquor licencing laws do not form part of Beachside’s governing rules. They are regulatory laws that apply to a large number of organisations; they are not part of a coherent set of enforceable rules relating to the establishment, operation and winding up of the entity. The breach of the liquor licensing laws does not result in Beachside failing to satisfy the governing rules condition.

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

38. The QWE Society (QWE) is an unincorporated entity that meets the description of exempt entity in item 2.1 of the table in section 50-10 of the ITAA 1997. It is a society, association or club established for community service purposes (except political or lobbying purposes).

39. 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 purposes in QWE’s constituent documents.

40. This requirement for Committee approval of expenditure is not a substantive requirement in the QWE’s governing rules. The requirement is not a right or duty of QWE, it is a procedural requirement. 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 governing rules condition – procedural

41. 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 of the ITAA 1997.

42. XYZ's constitution requires 28 'clear' days of 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.

43. 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 of 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.

44. The requirement to provide 28 'clear' days' notice to members before an AGM is not considered to be a substantive requirement in the entity's governing rules as it is merely procedural. Therefore, the failure to meet this requirement does not result in XYZ breaching the governing rules condition.

Example 5 – private benefit – breach of governing rules condition

45. The Help Charitable Trust (the HC Trust) meets the definition of a registered charity in item 1.1 of the table in section 50-5 of the ITAA 1997. Mr Z is the trustee of the HC Trust.

46. 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. The trust deed is the only source of governing rules of the HC Trust.

47. In the year ended 30 June 2014, Mr Z transfers 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.

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

49. As a result of Mr Z's actions, the HC Trust has not complied with all of the substantive requirements in its governing rules. The HC Trust has therefore failed to satisfy the governing rules condition under paragraph 50-50(2)(a) of the ITAA 1997 at this particular point in time.

50. Note that it is also considered that, due to Mr Z's actions, the HC Trust has not satisfied the income and assets condition under paragraph 50-50(2)(b) of the ITAA1997.

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

51. 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 of the ITAA 1997

52. HnH was originally established to improve the lives of homeless women. Its constitution limits its activities to the pursuit of this purpose. The constitution is the only source of governing rules of HnH.

53. 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 updates the objects clause in its constitution to reflect this change in purpose.

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

55. 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 before commencing activities in pursuit of its new purpose.

Income and assets condition

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

56. The Medici Madrigal Society (Medici) is an entity that meets the description of exempt entity in item 9.1 of the table in section 50-45 of the ITAA 1997 (a society, association or club established for the encouragement of music).

57. 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.

58. During the year ended 30 June 2014, Medici receives a bequest of \$300,000. \$200,000 of the bequest is applied towards a six-week trip to Italy and France in that year for Medici's board of directors and their families. Only one week of the tour relates to madrigal forums and study, the remaining five weeks overseas were spent on an organised tour visiting popular tourist destinations.

59. Medici does not satisfy the income and assets condition under paragraph 50-70(2)(b) of the ITAA 1997 at the time the \$200,000 is spent on the directors' families. Medici has not applied its income and assets solely for the purpose for which it is established; a portion 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

60. The Soul Worship Group (the SW Group) is a religious entity that meets the description of an exempt entity in item 1.1 of the table in section 50-5 of the ITAA 1997. The SW Group satisfies the definition of a 'registered charity' under section 995-1 of the ITAA 1997.

61. 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.

62. 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.

63. In the year ended 30 June 2014, the SW Group establishes an 'opportunity shop' in an inner-city location, which sells 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.

64. In setting up the shop, the SW Group enters into a lease, purchases some fittings and fixtures, and arranges for volunteers to operate the shop during business hours. This requires some funds from the SW Group's bank account to be drawn down.

65. The opportunity shop venture is a success, and all of the profits are applied only for the purpose of the SW Group. 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

66. The United Central Districts Soccer Club (the Club) is an unincorporated association that meets the description of exempt entity in item 9.1 of the table in section 50-45 of the ITAA 1997. It is a society, association or club established for the encouragement of a game or sport.

67. 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 and minor purpose is to provide social and recreational facilities for members. The majority of members of the Club participate (either directly or indirectly) in the entity's sporting activities.

68. The Club conducts extensive sporting activities, including coaching and entering teams in 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.

69. The Club also provides facilities for its members and visitors from which it generates considerable income. The majority of profits from these activities are used for the promotion of the Club's sporting activities. The remainder is used to improve the social, non-sporting facilities of the Club. No funds are applied for any other purpose.

70. 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

71. The Papillon Society (Papillon) is an entity that meets the description of exempt entity in item 1.7 of the table in section 50-5 of the ITAA 1997. It is a society, association or club established for the encouragement of science.

72. 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.

73. 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 5-year plan to accumulate enough money to upgrade its research facilities and to employ another research scientist.

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

Example 11 – insignificant misapplication of income or assets – not a breach of the income and assets condition

75. The Oz Employee Association (OEA) is an entity that meets the description of exempt entity in item 3.1 of the table in section 50-15 of the ITAA 1997. It is an employee association.

76. During the year ended 30 June 2014, the treasurer of OEA makes an error when using the online banking facility. The treasurer accidentally pays an invoice for a one-off cleaning of his private residence using OEA's funds. The same cleaning company services both the treasurer's house and OEA's office. There were no other misapplications of funds in the income year.

77. In these circumstances, the overpayment is an insignificant misapplication of OEA's assets. On this basis, OEA does not breach the income and assets condition for the year ended 30 June 2014.

Date of effect

78. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

13 August 2014

Appendix 1 – Entities to which the Ruling applies

ⓘ *This Appendix lists the entities to which the Ruling applies. It forms part of the proposed binding public ruling.*

79. This Ruling applies to entities that meet the description in column 2 of the following items in the tables in Division 50 of the ITAA 1997:

- 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 funds⁸
- 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.

⁸ Until the repeal of this item effective 1 January 2014.

Appendix 2 – Explanation

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

Background

80. Division 50 of the ITAA 1997 exempts from income tax the total ordinary and statutory income of entities that are covered by 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 must 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.

81. Schedule 11, Part 5 of 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 50-72⁹ of the ITAA 1997. 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.

82. 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

83. The first of the two special conditions for income tax exemption inserted into Division 50 of the ITAA 1997 by the *Tax Laws Amendment (2013 Measures No. 2) Act 2013* is the governing rules condition. This is the requirement that an entity must ‘comply with all the substantive requirements in its governing rules’.

84. 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?
- Has the entity complied with all of the substantive requirements in its governing rules?

⁹ Item 4.1 (funds contributing to other funds) was included at the time the governing rules condition and income and assets conditions were introduced. This item was repealed by *Charities (Consequential Amendments and Transitional Provisions) Act 2013*, effective 1 January 2014.

What are the ‘governing rules’ of the entity?

85. The first step in applying the governing rules condition is to ascertain the ‘governing rules’ of the entity.

86. 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.¹⁰ This context is determined by considering the specific provisions in Division 50 of the ITAA 1997, as well as statements in the Revised Explanatory Memorandum to the Tax Laws Amendment (2013 Measures No. 2) Bill 2013 (Revised Explanatory Memorandum).

87. The *Oxford Dictionary of English* defines the term ‘govern’ to mean ‘conduct the policy, actions, and affairs of (a state, organization, or people) with authority’.¹¹ One of several meanings of ‘rule’ in the *Macquarie Dictionary* is ‘a principle or regulation governing conduct, action, procedure, arrangement, etc’.¹²

88. 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.¹³

89. For the purposes of Division 50 of the ITAA 1997, it is considered that ‘governing rules’ are a coherent set of enforceable rules relating to establishment, operation and winding up of the entity. They are the rules that authorise the policy, actions and affairs of the entity.

90. 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.

91. 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.

¹⁰ *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408; [1997] HCA 2.

¹¹ 3rd edn.

¹² 5th edn.

¹³ Revised Explanatory Memorandum to the Tax Laws Amendment (2013 Measures No. 2) Bill 2013, paragraphs 9.57 – 9.60.

92. 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.

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

94. Rules that apply to an entity may be from a variety of sources, and may or may not form part of the entity's governing rules. Examples of such rules applicable to an entity include:

- contracts entered into with government;
- codes of conduct (which may be voluntary or mandatory)
- 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.

95. Not all of the rules that apply to an entity will form part of the entity's 'governing rules'. For a rule to come within the governing rules of an entity, it must come from a source whose function is to 'govern' the entity. That is, the rule must be one that authorises the policy, actions or affairs of the entity.

96. It is therefore necessary to consider whether, apart from the constituent documents of the entity (if any), any other rules are included in the 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* (Cth), 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.

97. The governing rules of some entities come from a centralised source. For example, the canon law of a particular church may constitute the governing rules that apply to a number of entities controlled by a central administrative body.

98. Rules which apply because of a choice made by the entity to enter into leases, licences, contracts of service or for government concessions such as fundraising exemptions or deductible gift status, do not form part of the entity's governing rules.

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

99. The next step in applying the governing rules condition is to determine the 'substantive requirements' in the entity's governing rules.

100. The ITAA 1997 does not define the words 'substantive' and 'requirements', or the composite phrase 'substantive requirements'. It is therefore necessary to consider whether the phrase takes its ordinary meaning in the context in which it appears,¹⁴ or whether it has a technical legal meaning.

101. The context is determined by considering the specific provisions in Division 50 of the ITAA 1997, as well as statements in the Revised Explanatory Memorandum.

102. The phrase 'substantive requirements' 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.

103. 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, breaches of procedural irregularities would not result in an entity losing its tax exempt status.¹⁵

¹⁴ *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408; [1997] HCA 2.

¹⁵ Revised Explanatory Memorandum to the Tax Laws Amendment (2013 Measures No. 2) Bill 2013, paragraph 9.61.

104. The phrase ‘substantive’ in the income and assets condition takes its technical legal meaning.¹⁶ In the *Oxford Dictionary*, one of the definitions of ‘substantive’ is ‘(of law) defining rights and duties, as opposed to giving the procedural rules by which those rights and duties are enforced’.¹⁷ The *Macquarie Dictionary* defines ‘requirement’ as ‘that which is required; a thing demanded or obligatory’.¹⁸

105. The ‘substantive requirements’ of an entity’s governing rules in the context of Division 50 of the ITAA 1997 are the rules that define the rights and duties of the entity.

106. The procedural rules by which the rights and duties are applied or enforced are not part of the ‘substantive requirements’ in an entity’s governing rules.

107. The substantive requirements in an entity’s governing rules include the rights and duties of the entity such as those:

- that give effect to the object or purpose of the entity
- relating to the non-profit status of the entity
- relating to the winding-up of the entity, and
- that require financial records to be kept.

108. 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.

109. Examples of procedural rules that generally would not be substantive requirements include the requirement for a quorum or providing sufficient notice of a meeting.

Has the entity complied with all of the substantive requirements in its governing rules?

110. 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.

Applies at all times during an income year

111. 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.

¹⁶ *Attorney-General (NSW) v. Brewery Employees’ Union (NSW)* (1908) 6 CLR 469 at 531.

¹⁷ 3rd edn.

¹⁸ 5th edn.

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

112. 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

113. The second of the two special conditions for income tax exemption inserted into Division 50 of the ITAA 1997 by the *Tax Laws Amendment (2013 Measures No. 2) Act 2013* is 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'.

114. 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'?

Ascertaining the 'purpose for which the entity is established'

115. 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 that it can then be considered whether the entity has applied its income and assets solely for this purpose.

116. The income and assets condition applies to a range of exempt entities described in the tables in Division 50 of the ITAA 1997. For the purposes of Division 50, the process of ascertaining the 'purpose for which the entity is established' is different for entities that are funds than for the other types of entity to which the condition applies.

Funds

117. The income and assets condition (and the governing rules condition) applies to entities that are funds that meet the description of exempt entity in item 1.6 of the table in section 50-5 of the ITAA 1997. An entity that meets the description of exempt entity in item 1.1 of the table in section 50-5 of the ITAA 1997 (because it is a 'registered charity') may also be a fund.

118. When the income and assets condition is applied to an entity that is a fund, the relevant purpose is determined only from the constituent documents of the entity, usually a trust deed, and any relevant legislation.

119. In *Federal Commissioner of Taxation v. Word Investments Limited (Word Investments)* [2008] HCA 55 (2008) 236 CLR 204; 2008 ATC 20-072; (2008) 70 ATR 225; at paragraph 70, the High Court considered the differences between former provisions of the ITAA 1997 providing for income tax exemption for charitable institutions and charitable funds. The Court stated that trusts covered by section 50-60 of the ITAA 1997 and funds covered by sections 50-57, 50-60 and 50-65 of the ITAA 1997 continue to have their status as a trust or a fund 'even if the trustees are acting in breach of trust and not applying the assets to the relevant trust or fund purposes'. This was the reason that the former provisions exempting charitable funds from income tax required the fund to be 'applied for the purposes for which it was established', whereas it was not necessary for charitable institutions to be subject to a similar condition.

120. The Commissioner considers that this reasoning applies to all funds subject to the income and assets condition. For these entities, the enquiry as to the 'purpose for which the entity is established' is limited to a consideration of the constituent documents of the fund (primarily the instrument of trust or the will) and any relevant legislation establishing the fund.

Other entities

121. For entities other than funds, the process of 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.¹⁹ 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.

¹⁹ See *Federal Commissioner of Taxation v. Word Investments Limited (Word Investments)* [2008] HCA 55; (2008) 236 CLR 204; (2008) 70 ATR 225; 2008 ATC 20-072 and *Cronulla Sutherland Leagues Club Limited v. FC of T* (1990) 23 FCR 82; 90 ATC 4215 at 4225; (1990) 21 ATR 300.

122. For entities other than funds, 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 of the ITAA 1997; the use of the present tense in the income and assets condition; and the interpretation of the term ‘established’.

Periodic operation of the provisions of Division 50

123. Division 50 of the ITAA 1997 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 (other than a fund) 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.

124. In *Cronulla Sutherland Leagues Club Limited v. FC of T* (1990) 23 FCR 82; (1990) 21 ATR 300; (1990) 90 ATC 4215 (*Cronulla Sutherland Leagues Club*), 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 *Income Tax Assessment Act 1936* (ITAA 1936) (the predecessor to current section 50-45 of the ITAA 1997) 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.

125. In *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 of the ITAA 1997 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.

126. The Commissioner considers that the reasoning of the High Court in *Word Investments* and the Full Federal Court in *Cronulla Sutherland Leagues Club* that item 1.1 has a ‘periodic operation’ also applies to the other items in the tables in Division 50 of the ITAA 1997.

Use of the present tense

127. 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.

128. The particular use of a tense in a legislative provision should be considered in interpreting that provision.²⁰ In *Envestra Ltd v. Federal Commissioner of Taxation* [2008] FCA 249; 70 ATR 115; 169 FCR 300, the Federal Court held that ‘tense may be a significant indicator to the proper construction of a taxation statute’.²¹ 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’

129. The interpretation of the term ‘established’ by the courts further supports the view that the subsequent activities of an entity (other than a fund) are an important consideration for determining purpose.

130. 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.²²

²⁰ Pearce DC, Geddes RS 2011, *Statutory Interpretation in Australia*, 7th edn, Lexis Nexis Butterworths, Australia, p 166.

²¹ The Federal Court cited the following cases in support of this proposition: *Brookton Co-operative Society Ltd v. Federal Commissioner of Taxation* 81 ATC 4346; (1981) 35 ALR 295; (1981) 147 CLR 441; *Cronulla Sutherland Leagues Club Ltd v. Federal Commissioner of Taxation* (1990) 23 FCR 82 (1990) 21 ATR 300; (1990) 90 ATC 4215.

²² See 90 ATC 4220 and 90 ATC 4221.

References to ‘purpose’ include the plural

131. The reference to the term ‘purpose’ (in the singular) in the income and assets condition can be read as ‘purposes’ (in the plural).²³ 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.

132. Division 50 of the ITAA 1997 allows income tax exemption for certain entities with more than one purpose. For example, a ‘registered charity’ is entitled to income tax exemption if it meets all of the relevant criteria in item 1.1 in the table in section 50-5 of the ITAA 1997. A registered charity may have more than one charitable purpose, or it may have a charitable purpose and purposes ancillary and incidental to its charitable purpose.

133. A registered charity is an entity that is registered by the ACNC as a charity.²⁴ 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.²⁵

134. 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.

135. Entities other than registered charities that are covered by items in the tables in Division 50 of the ITAA 1997 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 entities.

136. When applying the income and assets condition to entities other than registered charities, the phrase ‘purpose for which the entity is established’ refers to:

- the main purpose of the entity
- any purposes ancillary or incidental to the main purpose of the entity, and/or

²³ Section 23 of the *Acts Interpretation Act 1901* (Cth) 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.’

²⁴ ITAA 1997 subsection 995-1(1) and *Australian Charities and Not-for-profits Commission Act 2012* subsection 25-5(5).

²⁵ *Charities Act 2013* section 5.

- other unrelated purposes that are secondary to the main purpose of the entity.

Changing purpose

137. 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 (other than a fund) changes its purpose, 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?

138. 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’

139. The word ‘apply’ is not defined for the purposes of the ITAA 1997 and hence takes its ordinary meaning in the context in which it appears.²⁶ One of several meanings of ‘apply’ in the *Macquarie Dictionary* is ‘to put to use; employ’.²⁷

140. For the purposes of Division 50 of the ITAA 1997, it is considered that ‘apply’ in the context of the income and assets condition means an entity must put to use its income and assets solely for its purpose.

Ability to accumulate

141. An entity may accumulate income without breaching the income and assets condition provided that the accumulation is consistent with the purpose or purposes for which the entity is established.

142. The accumulation of income by an entity in certain situations has been viewed as being consistent with income tax exemption under an item of the tables in Division 50 of the ITAA 1997. For example, the Commissioner’s view in paragraphs 39 and 40 of Taxation Ruling TR 2011/4 is that the accumulation of income by a charitable institution may be consistent with income tax exemption under former section 50-5 of the ITAA 1997. This is supported by the High Court in *Word Investments*, which said at paragraph 22 (in

²⁶ *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408; [1997] HCA 2.

²⁷ 5th edn.

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.

143. Despite the general proposition above, an entity that accumulates most of its income over a number of years may not satisfy the income and assets condition where the accumulation of income was to such a degree that the income of the entity was not applied for the ‘purpose for which the entity is established’. An entity that accumulates most of its profits over a number of years will need to be able to show that this accumulation is consistent with its purpose. Whether an entity satisfies the income and assets condition in this regard must be considered on a case by case basis, taking into account all of the relevant facts and circumstances.

Meaning of ‘solely’

144. The income and assets condition requires that an entity must apply its income and assets solely for its purpose. Although the income and assets condition is a strict test, certain misapplications of an entity’s income and assets of an insignificant amount will not result in a breach of the condition.

145. 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.²⁸ One of the definitions of ‘solely’ in the *Macquarie Dictionary*, is ‘exclusively or only’.²⁹ For the purposes of Division 50 of the ITAA 1997, it is considered that ‘solely’ also takes this meaning.

146. An entity must therefore only or exclusively apply its income and assets for its purpose. That is, 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 ancillary or incidental to the purpose for which the entity is established. Subject to the exception below, an entity will not comply with the income and assets condition if it applies any of its income or assets for a private purpose.

147. The use of the word ‘solely’ means that the income and assets condition is a strict test requiring exclusivity of application. This is similar to the requirement that a regulated superannuation fund be maintained only for its core and ancillary purposes.³⁰

²⁸ *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408; [1997] HCA 2.

²⁹ 5th edn.

³⁰ *Superannuation Industry (Supervision) Act 1993* section 62.

148. In the context of section 62 of the *Superannuation Industry (Supervision) Act 1993*, case law supports the proposition that activities conducted by a regulated superannuation fund can satisfy the relevant 'sole purpose test', even though incidental, remote or insignificant benefits are provided to a member or some other entity.³¹

149. Similarly, although the income and assets condition is a strict test, insignificant misapplications of an entity's income and assets will not result in its contravention. The Commissioner considers that the income and assets condition is not contravened in the event of an insignificant misapplication of part of the entity's income or assets for a purpose other than 'the purpose for which the entity is established'.

150. Whether a misapplication of an entity's income and assets is insignificant will vary depending on the situation, and must be ascertained from a consideration of all of the relevant facts and circumstances, including for instance the number and regularity of occurrences.

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

151. 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

152. 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.

153. 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.

³¹ Case X60 90 ATC 438 at 446; (1990) 21 ATR 3477 at 3485, Case 43/95 95 ATC 374 at 382; (1995) 31 ATR 1067 at 1076. See also Self Managed Superannuation Funds Ruling SMSFR 2008/2.

154. Rectification is to be distinguished from the more common situation where the effects of a breach or misapplication are remedied or corrected 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

155. 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 of the ITAA 1997, in order for its ordinary and statutory income to be exempt from income tax. Some circumstances may give rise to the failure to satisfy either or both of these special conditions.

Potential overlap with ACNC governance standards for registered charities

156. 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.

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 proposed 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

157. 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’).

158. For the purposes 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.

159. 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.

160. 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.

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

162. Notwithstanding the approach set out in paragraphs 160 and 161, 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

163. 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.

164. Assume further that, after it commenced the new activities, HnH initiated the process to update its governing rules to allow HnH 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

165. Where a registered charity does not meet the income and assets condition, it will not be entitled to income tax exemption under Division 50 of the ITAA 1997. 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.

166. 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.³²

167. 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.³³

168. 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.

169. 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 167, accept that the income and assets condition has been met at that time.

170. 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 of the ITAA 1997.

³² *Australian Charities and Not-for-profits Commission Act 2012* paragraph 25-5(3)(b).

³³ *Australian Charities and Not-for-profits Commission Regulation 2013* subsection 45.5(2).

Appendix 4 – Your comments

171. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

172. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments, and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	26 September 2014
Contact officer:	Jeremy Khaw
Email address:	Jeremy.Khaw@ato.gov.au
Telephone:	(03) 9275 2035
Facsimile:	(03) 9275 2827
Address:	Australian Taxation Office PO Box 9977 Box Hill VIC 3128

Appendix 5 – Detailed contents list

173. The following is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	1
Definitions	5
Ruling	6
Governing rules condition	7
<i>What are the ‘governing rules’ of the entity?</i>	9
<i>What are the ‘substantive requirements’ in the entity’s governing rules?</i>	12
<i>Has the entity complied with all of the substantive requirements in its governing rules?</i>	14
<i>Applies at all times during an income year?</i>	14
Income and assets condition	15
<i>What is the ‘purpose for which the entity is established’?</i>	17
<i>References to ‘purpose’ include the plural</i>	17
<i>Ascertaining the ‘purpose for which the entity is established’</i>	18
<i>Changing purpose</i>	22
<i>Has the entity applied its income and assets solely for the purpose for which the entity is established?</i>	23
<i>Meaning of ‘apply’</i>	23
<i>Ability to accumulate</i>	24
<i>Meaning of ‘solely’</i>	26
<i>Applies at all times during an income year</i>	28
Relationship between the governing rules condition and the income and assets condition	29
Examples	31
Governing rules condition	31
<i>Example 1 – requirement to record financial transactions and prepare annual financial statements – substantive requirements in the entity’s governing rules</i>	31
<i>Example 2 – rules not part of the entity’s ‘governing rules’ – not a breach of the governing rules condition</i>	34
<i>Example 3 – requirement to obtain approval for large item of expenditure – not a breach of governing rules condition – not substantive</i>	38

<i>Example 4 – requirement to provide notice – not a breach of governing rules condition – procedural</i>	41
<i>Example 5 – private benefit – breach of governing rules condition</i>	45
<i>Example 6 – changing purpose in an income year – not a breach of governing rules condition</i>	51
Income and assets condition	56
<i>Example 7 – private benefits breach of the income and assets condition</i>	56
<i>Example 8 – profits from commercial activities used to further entity’s purpose – not a breach of the income and assets condition</i>	60
<i>Example 9 – entity with two purposes (sporting club) – not a breach of the income and assets condition</i>	66
<i>Example 10 – accumulation of income – not a breach of the income and assets condition</i>	71
<i>Example 11 – insignificant misapplication of income or assets – not a breach of the income and assets condition</i>	75
Date of effect	78
Appendix 1 – Entities to which the Ruling applies	79
Appendix 2 – Explanation	80
Background	80
Governing rules condition	83
<i>What are the ‘governing rules’ of the entity?</i>	85
<i>What are the ‘substantive requirements’ in the entity’s governing rules?</i>	99
<i>Has the entity complied with all of the substantive requirements in its governing rules?</i>	110
<i>Applies at all times during an income year</i>	111
<i>Commissioner’s practical administration of the governing rules condition where corrective action is taken by the entity</i>	112
Income and assets condition	113
<i>What is the ‘purpose for which the entity is established’?</i>	115
<i>Ascertaining the ‘purpose for which the entity is established’</i>	115
<i>Funds</i>	117
<i>Other entities</i>	121
<u>Periodic operation of the provisions of Division 50</u>	123
<u>Use of the present tense</u>	127

<u>Meaning of ‘established’</u>	129
<i>References to ‘purpose’ include the plural</i>	131
<i>Changing purpose</i>	137
<i>Has the entity applied its income and assets solely for the purpose for which the entity is established?</i>	138
<i>Meaning of ‘apply’</i>	139
<i>Ability to accumulate</i>	141
<i>Meaning of ‘solely’</i>	144
<i>Commissioner’s practical administration of the income and assets condition where corrective action is taken by the entity</i>	151
Breaches of the governing rules condition and income and assets condition – where no breach or misapplication is taken to have occurred	152
Relationship between the governing rules condition and the income and assets condition	155
Potential overlap with ACNC governance standards for registered charities	156
Appendix 3 – Administrative treatment	157
Breaches of the governing rules condition and income and assets condition – Commissioner’s practical administration where corrective action is taken by the entity	157
<i>Example – Application of the Administrative Treatment</i>	163
Potential overlap with ACNC governance standards for registered charities	165
Appendix 4 – Your comments	171
Appendix 5 – Detailed contents list	173

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2011/4; TR 2006/10;
SMSFR 2008/2

Previous Rulings/Determinations:

Subject references:

- charities
- governing rules condition
- income and assets condition
- income tax
- income tax exempt
- special conditions
- registered charities
- non profit entities

Legislative references:

- ITAA 1936 23(e)
- ITAA 1936 23(g)
- ITAA 1936 Sch 2D
- ITAA 1997 Div 50
- ITAA 1997 50-5
- ITAA 1997 50-5 item 1.1
- ITAA 1997 50-5 item 1.3
- ITAA 1997 50-5 item 1.4
- ITAA 1997 50-5 item 1.6
- ITAA 1997 50-5 item 1.7
- ITAA 1997 50-10
- ITAA 1997 50-10 item 2.1
- ITAA 1997 50-15
- ITAA 1997 50-15 item 3.1
- ITAA 1997 50-15 item 3.2
- ITAA 1997 50-20
- ITAA 1997 50-20 item 4.1
- ITAA 1997 50-30
- ITAA 1997 50-30 item 6.1
- ITAA 1997 50-30 item 6.2
- ITAA 1997 50-45
- ITAA 1997 50-45 item 9.1
- ITAA 1997 50-45 item 9.2
- ITAA 1997 50-50(2)(a)
- ITAA 1997 50-50(2)(b)
- ITAA 1997 50-55(2)(a)
- ITAA 1997 50-55(2)(b)
- ITAA 1997 50-57
- ITAA 1997 50-60
- ITAA 1997 50-65(2)(a)
- ITAA 1997 50-65(2)(b)
- ITAA 1997 50-70(2)(a)

- ITAA 1997 50-70(2)(b)
- ITAA 1997 50-72
- ITAA 1997 50-72(1)(c)
- ITAA 1997 50-72(1)(d)
- ITAA 1997 995-1
- Acts Interpretation Act 1901 23
- Australian Charities and Not-for-profits Commission Act 2012 25-5(3)(b)
- Australian Charities and Not-for-profits Commission Act 2012 25-5(5)
- Australian Charities and Not-for-profits Commission Act 2012 Div 45
- Charities Act 2013 5
- Charities (Consequential Amendments and Transitional Provisions) Act 2013 3
- Corporations Act 2001
- Tax Laws Amendment (2013 Measures No. 2) Act 2013 Sch 11
- Superannuation Industry (Supervision) Act 1993 62
- Australian Charities and Not-for-profits Commission Regulation 2013 45.5(2)

Case references:

- Attorney-General (NSW) v. Brewery Employees' Union (NSW) (1908) 6 CLR 469; (1908) 14 ALR 565
- Case 43/95 (1995) 31 ATR 1067; 95 ATC 374
- Case X60 (1990) 21 ATR 3477; 90 ATC 438
- CIC Insurance Ltd v. Bankstown Football Club Ltd (1997) 187 CLR 384; (1997) 141 ALR 618; [1997] HCA 2
- Brookton Co-operative Society Ltd v. Federal Commissioner of Taxation (1981) 147 CLR 441; (1981) 35 ALR 295; (1981) 11 ATR 880; 81 ATC 4346
- Cronulla Sutherland Leagues Club Limited v. FC of T (1990) 23 FCR 82; 90 ATC 4215; (1990) 21 ATR 300

- *Envestra Ltd v. Federal Commissioner of Taxation* [2008] FCA 249; 70 ATR 115; 169 FCR 300
 - *Federal Commissioner of Taxation v. Word Investments Ltd* [2008] HCA 55; (2008) 236 CLR 204; (2008) 70 ATR 225; 2008 ATC 20-072
 - *Amendment (2013 Measures No. 2) Bill 2013*
 - *The Macquarie Dictionary*, 2009, rev. 5th edn, The Macquarie Library Pty Ltd, NSW
 - *Oxford Dictionary of English*, 2010 3rd edn, Oxford University Press,
 - Pearce DC, Geddes RS 2011, *Statutory Interpretation in Australia*, 7th edn, Lexis Nexis Butterworths, Australia, p 166.
- Other references:*
- Revised Explanatory Memorandum to the Tax Laws

ATO references

NO:	1-58GNXWG
ISSN:	1039-0731
ATOlaw topic:	Income tax ~~ Exempt entities ~~ charity, education, science and religion Income tax ~~ Exempt entities ~~ Community service Income tax ~~ Exempt entities ~~ General requirements Income tax ~~ Exempt entities ~~ Not for profit and mutual organisations

© AUSTRALIAN TAXATION OFFICE FOR THE COMMONWEALTH OF AUSTRALIA

You are free to copy, adapt, modify, transmit and distribute this material as you wish (but not in any way that suggests the ATO or the Commonwealth endorses you or any of your services or products).