Regulatory Impact Statement

New tax rules for deregistered charities

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question addressed in this statement is whether the current tax rules adequately deal with the tax consequences facing deregistered charities and their donors and, if not, how these rules should be changed.

A "deregistered charity" refers to an entity that has been removed from the Charities Register by the Department of Internal Affairs – Charities Services and, consequently, is no longer eligible for the charities-related tax concessions in the Income Tax Act 2007.

The key objectives of the proposed reform are to clarify the tax law so that deregistered charities and their donors have a greater level of certainty as to their tax obligations, and to protect the integrity of the revenue base by ensuring the tax concessions that apply to charities are well-targeted and policy intentions are met.

Inland Revenue and the Treasury consulted on the proposed reform in an officials' issues paper, *Clarifying the tax consequences for deregistered charities*, which was released in July 2013. Discussions were also had with a number of key submitter groups from the charitable sector. Two major policy changes arose from consultation, which led to the issues paper's suggested solution being modified.

- The first change is to relieve any retrospective tax costs for deregistered charities and their donors who have acted in good faith and have been compliant with their constitutions.

- The second change is to impose an additional tax cost on the net assets of deregistered charities that have not divested themselves of their assets or income that they had accumulated as a charity, within 12 months of the deregistration date.

The proposals are expected to give rise to a net fiscal cost of up to $28 million, due to relieving the retrospective tax liabilities of charities which are potentially at risk of deregistration in the coming months. This cost is expected to arise across the next two financial years.

Based on recent deregistrations, the fiscal gain from imposing a tax on net assets retained could be as much as $30 million in any one year if no assets are distributed. However, we note that the number of deregistrations is declining, and that a scenario in which no charities distribute is highly unlikely. We consider the fiscal gain is likely to be much lower, reflecting the notion that if this change is successful, deregistered charities would distribute most, if not all of their assets and income to charitable purposes within the 12-month period. As a result, we expect only a very small fiscal gain.

There are caveats on the estimates provided above. Our analysis of this data indicates that deregistrations are decreasing in number since the Charities Register opened and so using historical data to quantify the potential fiscal implications may not be reliable. Furthermore, the available data is not tax data so it is, at best, a proxy. For example, income measures reported in the charities' annual returns could include non-taxable income such as grants, which would tend to overstate the implied tax (or fiscal gain) and understate the implied forgone tax (or fiscal cost). We also do not know how many deregistered charities, when faced with the imposition of a tax, would divest themselves of all their assets and income within the 12-month period to avoid the tax. For these reasons, quantifying the net effect of option 1 has been problematic.

On balance, we believe the net fiscal effect of the combined policy changes is likely to be a fiscal cost of up to $28 million.

There are no other significant constraints, caveats or uncertainties concerning the regulatory analysis undertaken. None of the policy options considered impair private property rights, restrict market competition, or override fundamental common law principles.

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STATUS QUO AND PROBLEM DEFINITION

Charities registration and related tax concessions

1. In New Zealand, the registration of charities began on 1 February 2007. The Department of Internal Affairs – Charities Services is responsible for determining whether an entity can be registered as a "charitable entity" under the Charities Act 2005. Although registration is voluntary, one of the benefits of registration is that a registered charity may be entitled to charities-related tax concessions under the Income Tax Act 2007.

2. The charities-related tax concessions are:

- an income tax exemption.[1] Registered charities are exempt from income tax on their non-business income (e.g. donations and passive investment income such as interest and dividends). Registered charities may also be exempt from income tax on their business income derived directly or indirectly, as long as that income is applied to charitable purposes in New Zealand and no person with some control over the business activities of the charity can direct or divert income derived from the business to their benefit or advantage;

- a fringe benefit tax (FBT) exemption. Registered charities may also be entitled to an exemption from FBT on non-cash benefits paid to their employees who are employed in the non-commercial operations of the charity; and

- recognition as a "donee organisation" for the purposes of the donations tax relief provisions. This means that donors to a registered charity are eligible to receive certain tax benefits on their donations. In the case of individuals, this relief is in the form of a tax credit; in the case of corporate or Māori authority donors, in the form of a tax deduction.

Deregistered charities

3. In July 2008 the tax law was amended to link eligibility to the charities-related income tax exemption to registration with Charities Services. However, there were no consequential amendments made to specifically deal with circumstances when the registration requirement is no longer met. In short, the current tax rules do not deal with the full range of circumstances involving deregistration of charities.

4. A "deregistered charity" is an entity that has been removed from the Charities Register by Charities Services, but which continues in existence. These entities can face a range of complex tax consequences that can be retrospective, transitional or prospective in nature. This is because deregistration means the deregistered charity is no longer eligible for the charities-related income tax exemption – its tax status changes from tax-exempt to taxable. It may also mean the deregistered entity is no longer eligible for the fringe benefit tax exemption and donee organisation status.

[1] Since 1 July 2008, an entity must be registered with Charities Services to be eligible for the income tax exemption for charities. Before this date, a practice developed where an entity would seek Inland Revenue's confirmation that it met the requirements of charitable status and therefore was eligible for the associated exemption.

5. The nature and extent of the potential tax consequences ultimately depends on the underlying reason why the entity was deregistered. These consequences may be more onerous (and may involve retrospective tax liabilities) if the deregistered charity is found never to have had a "charitable purpose" or ceased being charitable in purpose at some time in the past, compared with the situation when a deregistered charity has simply failed to file the required return with Charities Services.

6. Since the Charities Register opened, 4,126 charities have been deregistered. The most common reason for deregistration is a failure to file the required annual return (60%). However, we expect there to be fewer instances of these types of deregistrations in the future. Until recently, Charities Services automatically deregistered charities if they had failed to file one annual return. Under a new approach, registered charities are given more opportunity to file their annual returns. Although not apparent from the data, 24 former charities have been deregistered because they were found not to have a "charitable purpose". This small group is spread across "voluntary deregistrations" and "no longer qualified to be registered".

7. The table below provides statistics on Charities Services' deregistration decisions, as at September 2013.

Deregistration decisions (as at September 2013)	**Number**
Failure to file annual return	2,496
Voluntary deregistrations - 450 entities voluntarily deregistered because they were in the process of winding up or merging with another charity	1,617
No longer qualified to be registered	12
Serious wrong-doing	1

Problem definition

8. There are a number of problems with the current law (status quo). These relate to:

Income Tax

- The current income tax rules provide for the tax consequences for deregistered charities that are trusts but not corporate entities. Therefore, it is unclear how deregistered charities that are corporate entities should transition to the tax base. Furthermore, the tax rules do not take into account the circumstances when a deregistered charity has acted in good faith and in accordance with its constitution since registration in order to limit the potential for retrospective tax liabilities.

FBT

- Similarly, there may be tax consequences for deregistered charities that have previously relied on the FBT exemption. The tax law is unclear as to how and when Inland Revenue would deal with these entities for FBT purposes.

Donors

- Donors who have made cash donations to deregistered charities after the point at which those entities no longer qualify to be a donee organisation should not be eligible for donations tax relief. Although Inland Revenue has the ability to reverse previous donations tax relief that have been claimed incorrectly, the tax law is unclear as to how and when this power would be exercised in relation to deregistered charities and their donors.

Accumulated assets and income

- Although there is a requirement for a deregistered and disestablished charity to distribute its assets and income to charitable purposes, there is no such requirement when a deregistered charity continues its operations. This result is inconsistent with the intended policy that accumulated charitable income and assets should always be destined for a charitable purpose, regardless of whether the entity ceases to exist or not.

9. The officials' issues paper, *Clarifying the tax consequences for deregistered charities,* which was released in July 2013, was written to address the question of whether the current tax law is clear, consistent and coherent in relation to circumstances involving deregistered charities. The paper noted that the current tax law is neither comprehensive nor robust – that is, current tax law does not adequately deal with the full range of tax consequences involving deregistered charities and, in some cases, does not achieve the desired policy outcome.

10. As noted above, the issues with the current law are more minor with deregistrations caused by a failure to file the required annual return, as such entities are likely to face only prospective tax liabilities. However, as this group lost its registration through administrative non-compliance with the Charities Act 2005, they are likely to be even more under-resourced and unsophisticated than the norm. Thus, officials' view is that requiring such a group to comply with complex and unclear tax law is unsustainable. This seems particularly unreasonable as it is likely that this group could still be undertaking charitable activities.

11. For entities that were deregistered because they were never charitable or were involved in serious wrongdoing, although the number of these entities is much smaller (than other deregistered entities), the implications are much larger, as these deregistrations could involve retrospective as well as prospective tax liabilities. This would include any social housing providers that have characteristics similar to the Queenstown Lakes Community Housing Trust, which was the subject of a High Court decision that found that the Trust was not charitable in purpose *[2011] 3 NCLR 50.*

12. For these reasons, and given the significance of the charitable sector in providing social services in New Zealand, and the importance of ensuring that the associated tax concessions are targeted correctly, we do not consider the status quo to be sustainable.

OBJECTIVES

13. The objectives of changing the current rules are to:

- clarify the tax law so that deregistered charities and donors have a greater level of certainty as to their tax obligations after deregistration; and
- protect the integrity of the revenue base by ensuring the tax concessions that apply to charities and their donors are well-targeted and meet policy intentions. This includes, for example, ensuring that if an entity has claimed tax exemption as a charity and has accumulated assets and income, these assets and income should always be destined for a charitable purpose.

REGULATORY IMPACT ANALYSIS

14. Three options have been considered for addressing the current problems and achieving the stated objectives.

Option 1 (preferred solution)

15. A specific set of rules (in legislation) would apply to deregistered charities to:

Income tax

- clarify how the general tax rules apply to all deregistered charities, regardless of their legal form;
- establish the opening values of any depreciable assets and other assets, or consideration for any financial arrangements held by a deregistered charity when it enters the tax base;
- prescribe tax commencement rules for when the general tax rules should apply to deregistered charities. These rules would be linked to whether an entity has complied with its constitution and other supporting information since it registered with Charities Services (or Inland Revenue);

FBT

- clarify the circumstances in which the FBT exemption no longer applies to deregistered charities;

Donors

- clarify the circumstances in which donors who have made cash donations to deregistered charities may be affected; and

Accumulated income and assets

- impose tax on the value of the net assets (with certain adjustments) of the deregistered charity at the expiry of a 12-month period. Adjustments would be made to the net assets calculation to exclude donated assets and any assets or income applied to charitable purposes within the 12-month period.

16. The proposed tax rules for deregistered charities would also apply to entities that have relied on or are relying on the income tax exemption in section CW 42(5)(b) of the Income Tax Act 2007. See further discussion on this matter under "Consultation".

17. The proposed tax rules would also be supported by two amendments to the Charities Act 2005. These changes would provide that a decision to register or deregister a charity can be backdated and, where an entity fails to file an annual return, this would be a separate ground for deregistration.

Option 2 (solution in the officials' issues paper)

18. The solution suggested in the issues paper, which was largely based on current practice, would:

Income Tax

- clarify how the general tax rules apply to all deregistered charities, regardless of their legal form. This involves extending the current tax rules applying to deregistered charities that are trusts to all deregistered charities, regardless of their legal form;

- establish the opening values of any depreciable assets and other assets, or consideration for any financial arrangements held by a deregistered charity when it entered the tax base;

- prescribe detailed timing rules for when the general tax rules should have applied in five distinct deregistration circumstances. In four of the five circumstances, retrospective tax consequences could potentially occur.

19. The issues paper also noted that:

FBT/Donors

- deregistered charities would also require clarification as to their eligibility for the FBT exemption and donee organisation status, after deregistration. There was concern that operational guidance based on the current tax law on these matters might not have been sufficient to achieve the desired policy outcomes.

Accumulated assets and income

- there is no obligation for deregistered charities that continue in existence to apply their income and assets to charitable purposes following deregistration. The issues paper called for submissions on the appropriate treatment to apply to deregistered entities.

Option 3 (status quo)

20. The status quo is set out under "Status quo and problem definition". As noted earlier, officials' view is that the status quo is not sustainable.

Analysis of options

21. Officials' analysis of the two options is summarised in the table below. Each option is assessed according to its additional costs and benefits relative to the status quo.

Options	Costs	Benefits	Net impact
Option 1 provides a comprehensive set of tax rules in legislation to clarify: • what tax rules apply to deregistered charities • when the tax rules apply to deregistered charities • the tax consequences for deregistered charities for FBT purposes where the entity is compliant with its constitution • the tax consequences for donors who believed the deregistered charity was a donee organisation Option 1 also imposes a tax on the net assets of a deregistered charity that continues to operate beyond 12-months, after deregistration	*Taxpayers* New tax cost and additional compliance costs relating to the imposition of tax on the net assets of deregistered charities that remain in operation, 12 months from the date of deregistration *Tax system* Additional administrative costs associated with assessing the imposition of tax on net assets	*Taxpayers* No retrospective tax cost for deregistered charities that have been compliant with their constitutions No retrospective tax cost for donors who have claimed donations tax relief, where they assumed the entity was a bona fide donee organisation Increased fairness overall, as deregistered charities are treated in the same way as charities who cease to exist *Tax system* Improved compliance due to clear, consistent and coherent tax rules for deregistered charities and their donors A fiscal cost of up to $28 million over two years – due to relieving retrospective tax liabilities A fiscal gain of between $0 - $30 million – tax on net assets	Preferred option Overall improvement on option 2 and the status quo in terms of compliance, taxpayer certainty, fairness, and the coherency of the tax system On balance, the net fiscal effect of the proposed changes is likely to be a fiscal cost of up to $28 million.

Option 2 provides a set of income tax rules in legislation to clarify what and when the income tax provisions apply to deregistered charities, with some operational guidance provided on: • when the FBT exemption no longer applies • when donors may be affected	*Taxpayers* Same as status quo *Tax system* Inconsistent treatment of deregistered charities that continue in operation and charities that are wound up	*Taxpayers* Slight improvement in taxpayer compliance associated with clearer income tax rules *Tax system* Fiscally neutral Slight improvement in tax administration associated with clearer income tax rules	An overall improvement on the status quo As the proposed solution was largely based on the current rules and practice, the fiscal cost of this option would be fiscally neutral

22. Option 1 is favoured because it would provide clear, consistent and coherent tax rules for deregistered charities and their donors. It addresses a greater range of tax consequences and gives rise to fairer outcomes for the affected groups, compared with option 2 and the status quo. Additionally, option 1 achieves the desired policy intentions by ensuring that the charities-related tax concessions are properly targeted to bona fide charities, and that deregistered charities are held to account for the assets and income they built up while they enjoyed the benefit of the tax concessions.

23. Option 1 is expected to lead to improved compliance overall, as deregistered charities and donors should benefit from having clear and robust tax rules. Even so, we acknowledge that deregistered charities may face additional tax costs and compliance costs relating to the new tax on net assets. On the other hand, there will be no retrospective tax costs for deregistered charities and their donors that have acted in good faith and have been compliant with their constitutions.

24. Inland Revenue would need to assess the new tax on net assets so there may be a small increase in administrative costs, but this would be offset by the savings resulting from the removal of the need to assess retrospective tax consequences for compliant, deregistered charities and donors.

25. Option 1 is expected to give rise to a net fiscal cost of up to $28 million, due to relieving the retrospective tax liabilities of charities which have been identified as potentially being at risk of deregistration in the coming months. This cost is expected to arise across the next two financial years.

26. There could be a fiscal gain associated with imposing tax on the value of the net assets of deregistered charities that continue to operate beyond the 12-month period, following deregistration. Based on recent deregistrations, the fiscal gain could be as much as $30 million in any one year if no assets are distributed. However, I note that the number of deregistrations is trending downwards, and that a scenario in which no charities distribute is highly unlikely. Officials have advised that the fiscal gain is likely to be much lower, reflecting the notion that if this policy change is successful, deregistered charities would distribute most, if not all of their assets and income to charitable purposes within the 12-month period. As a result, I expect only a small fiscal gain.

27. There are caveats on the fiscal estimates provided above. Analysis of the underlying data indicates that deregistrations are decreasing in number since the Charities Register opened and so using historical data to quantify the potential fiscal implications may not be reliable. Furthermore, the available data is not tax data so it is, at best, a proxy. For example, income measures reported in the charities' annual returns could include non-taxable income such as grants, which would tend to overstate the implied tax (or fiscal gain) and understate the implied forgone tax (or fiscal cost). It is also not known how many deregistered charities, when faced with the imposition of a tax, would divest themselves of all their assets and income within the 12-month period to avoid the tax. For these reasons, quantifying the net effect of the proposal is problematic.

28. On balance, therefore we believe the net fiscal effect of the combined policy changes in option 1 is likely to be a fiscal cost of up to $28 million.

29. Option 2 is not supported because it does not deal with the full range of tax consequences facing deregistered charities and their donors. It also would give rise to unfair outcomes for deregistered charities and their donors who have acted in good faith and had been compliant with their constitutions. Option 2 effectively mirrors current practice, and so is expected to be broadly fiscally neutral and to lead to a slight improvement in both compliance and administration, as deregistered charities and Inland Revenue would benefit from having clearer and more robust income tax rules. However, option 2 did not go far enough.

30. There are no economic, social, environmental or cultural impacts associated with the options considered above.

Application date

31. The application date proposed in the issues paper was 1 April 2014. Officials now recommend that the changes to the Tax Acts should generally apply from 14 April 2014 – that is, deregistered charities whose date of final decision is on or after 14 April 2014 would have to apply the new rules. 14 April 2014 is the date that most of the proposals in the Social Housing Reform Bill are expected to be enacted.

32. With respect to the tax on net assets, however, officials recommend a split application date. It would apply from 1 April 2015 to entities which are deregistered by Charities Services, or which lose their tax charity status. It would, however, apply from 14 April 2014 to entities which choose to voluntarily deregister.

33. The reason for the 1 April 2015 date is to give current and prospective charities and their advisors more time to become familiar with the proposal to impose tax on net assets for deregistered charities that continue to operate beyond the 12-month period after deregistration. Applying the proposal to entities which choose to voluntarily deregister, however, between 14 April 2014 and 1 April 2015 will act as an anti-avoidance measure to ensure that there is not a sudden deluge of entities deregistering during that period in order to avoid the new tax on net assets.

34. The changes to the Charities Act 2005 will apply from 14 April 2014.

CONSULTATION

35. Inland Revenue and the Treasury consulted on the proposed reform in an officials' issues paper, *Clarifying the tax consequences for deregistered charities*, released in July 2013. A total of 15 submissions were received on the issues paper from a range of people including tax specialists, academics and specialist advisors to the charities sector. The submissions confirmed that current tax law does not deal adequately with the full range of tax consequences facing deregistered charities. Submissions also agreed that the suggested solution was a good starting point.

36. Officials also had discussions with a number of key submitter groups. These groups included the Association of Non-Governmental Organisations of Aotearoa, the Fundraising Institute of New Zealand, Volunteering New Zealand, Greenpeace, Social Development Partners, and the New Zealand Institute of Chartered Accountants.

37. Officials also discussed preliminary proposals with officials from the Treasury, the Department of Internal Affairs and the Ministry of Business, Innovation and Employment.

38. The feedback in submissions and discussions with these groups helped to formulate officials' preferred option.

39. The key issues raised in submissions related to:

- the "tax commencement rules" and the potential for retrospective tax liabilities to arise;
- the tax treatment for accumulated assets and income of deregistered charities; and
- donor consequences.

Tax commencement rules

40. Submitters were concerned about income tax applying retrospectively when a deregistered charity had acted in good faith and in accordance with its constitution since registration. Submitters considered that deregistered charities should be able to rely on previous decisions made by Charities Services (or Inland Revenue) to recognise these entities as meeting the legal tests of a charity. In addition, submitters suggested that a time bar apply to deregistered charities that enter the tax base, to limit the potential for retrospective tax liabilities and provide greater certainty. The time bar would limit Inland Revenue's ability to go back more than four years to reassess past tax years, except in cases of fraud, wilful wrongdoing or omission of income.

41. In response to these submissions, we greatly simplified the approach to determining when the general tax rules should apply. If a deregistered entity has acted in good faith and has complied with its constitution since it was registered by Charities Services (or Inland Revenue), income tax obligations should commence from the date of final determination of an entity's charitable status, either through the Charities Services disputes process or through the Courts. This means that an entity would start paying tax only after exhausting all dispute procedures for determining its charitable status. However, if an entity has been found to be non-compliant, the tax rules would apply from the date of non-compliance.

42. Consequently, we have revised the rules to determine the application of the tax rules to reflect the changed approach. The revised rules are:

Deregistration situation	**Tax commencement date of tax rules**
The deregistered charity has complied with its constitution, rules and any other information supplied to Charities Services (or Inland Revenue before 1 July 2008)	The deregistered charity would be subject to tax on income from the "date of final decision"
The deregistered charity has not complied with its constitution, rules and any other information supplied to Charities Services (or Inland Revenue before 1 July 2008)	The deregistered charity would be subject to tax on income from the "date of non-compliance"

43. We do not support a time bar on the basis that its need is reduced – that is, the revised tax commencement rules should reduce the incidence of retrospective tax liabilities for deregistered charities that have acted in good faith and have been compliant with their constitutions.

44. The tax commencement rules would also apply to determine the continued application of the FBT exemption. This means that compliant entities would lose their FBT exemption from the date of final decision, and non-compliant entities from the date of non-compliance if they no longer meet the requirements of the FBT exemption.

Donor consequences

45. Submitters agreed that Inland Revenue should be able to reverse donations tax relief in certain circumstances. However, they expressed concern about Inland Revenue's ability to reverse donations tax relief when donors have claimed the relief in good faith, assuming that the organisation was a bona fide donee organisation.

46. We share the same concerns as submitters, and consider that Inland Revenue should reverse donations tax relief only if a donor had knowledge, at the time of claiming the tax relief, that the entity did not satisfy any of the requirements to be a donee organisation, or when the donor was involved in fraudulent activities.

Accumulated assets and income

47. Submitters put forward a range of views on the tax treatment of accumulated charitable assets and income, including:

- requiring deregistered charities to distribute their accumulated income and assets to a charitable purpose or to a registered charity (the Australian model);
- requiring deregistered charities to distribute their accumulated income and assets to a charitable purpose or to a registered charity within a specified period, or risk the income and assets being subject to tax (the Canadian model);
- imposing tax on the accumulated assets (i.e. not accumulated income) that have been purchased from untaxed income, and accumulated income that has not been distributed or paid to another charity within a prescribed period (say 12 months); or

- ring-fencing accumulated income, so that it must be applied to a charitable purpose after deregistration. This treatment has been adopted in the Treaty of Waitangi settlements process by some treaty settlement entities that have chosen to receive their treaty redress and manage it under a non-charitable entity structure.

48. Officials' view is that, where an entity has accumulated assets and income as a charitable entity with tax-exempt status, its assets and income should always be destined for a charitable destination, regardless of whether the entity ceases to exist or not. However, if a deregistered charity continues in existence, we consider that the value of its net assets (i.e. assets *minus* liabilities) should be subject to income tax. The imposition of tax in this instance is intended to be a proxy for taxing the deregistered charity as if it had always been a tax-paying entity. This outcome is consistent with the current policy intentions underlying the charities-related tax concessions – that is, the tax concessions should only be available to bona fide charities and deregistered charities should be held to account for the assets and income they have built up while they enjoyed the benefit of the tax concessions.

49. For reasons of fairness, we also consider that deregistered charities should be given time to apply any assets or income to charitable purposes before the imposition of any tax, and an adjustment should be permitted for any donated assets as these assets were not funded by non-taxed income.

50. We believe that the best approach is to tax the deregistered charity on the value of its net assets (with certain adjustments) remaining at the end of a 12-month period from the day the entity became subject to tax. Adjustments should be made to the net assets calculation to exclude donated assets and any assets or income distributed for charitable purposes within the 12-month period. This approach is a simple, low compliance costs option but we acknowledge that it may result in a tax impost for some deregistered charities that is higher than what they would have paid had they always been subject to tax.

51. The example below illustrates how the new tax would operate.

Example

Charity A's date of final decision is 1 June 2015. The balance sheet for Charity A as at 31 May 2016 (12 months after the date of final decision) is shown below.

Assets		**Liabilities**	
Cash	$50	Loan	$200
Inventory	$300	**Equity**	
Land (donated)	$3,000	Shareholder's equity	$3,150

The net asset calculation would be $3,150; *less* the value of the donated land; *less* any assets and income distributed within 12 months of the date of deregistration. The net assets value would be $150 ($3,150 less $3,000). The tax rate would be the rate applicable to the entity. If the deregistered entity were a trust it would be taxed at the trustee rate of 33%.

Other matters raised in submissions

52. A number of other issues were raised in submissions but were not specifically covered in the officials' issues paper. In particular, three further matters have been included in the recommended option as outlined below:

- The proposed tax rules for deregistered charities should also apply to entities that have relied on or are relying on section CW 42 (5)(b) of the Income Tax Act 2007 of the "tax charity" definition. That provision confers the charities-related tax exemption on entities that had started, before 1 July 2008, the process of registering with the former Charities Commission and that intend to complete the process of registration. The provision is a transitional measure intended to give more time for entities that were struggling to meet the 1 July 2008 deadline for registration and continued tax-exempt status. For reasons of certainty and fairness, these entities should be able to take advantage of the tax exemption afforded by the transitional provision, provided they have complied with the requirements of that provision. Officials recommend that entities that rely on section CW 42 (5)(b) of the Income Tax Act 2007 should be able to rely on the proposed new rules for deregistered charities. We are aware of at least one high-profile entity that would benefit from this change.

- To support the proposed tax changes, we propose a consequential amendment to the Charities Act 2005 to give Charities Services more flexibility around the process for determining the date of registration and deregistration. This change would help to support the tax commencement rules for determining the application of the general tax rules. Charities Services advise this flexibility would avoid potentially serious consequences for smaller and less robust charities deregistered for administrative non-compliance, and which may incur a tax liability as a result. This includes charities who may fail to file the required annual return.

- To complement this change, and create a less onerous compliance framework, we also propose a second consequential amendment to the Charities Act to clarify that failure to file an annual return is a separate ground for deregistration. Currently, such administrative non-compliance is considered under the general heads of serious wrongdoing, or a significant and persistent failure of the organisation to meet its obligations under the Charities Act.

CONCLUSIONS AND RECOMMENDATIONS

53. The preferred option (option 1) is to enact specific rules in the Income Tax Act 2007 and the Tax Administration Act 1994 to cater for the full range of tax consequences for circumstances involving deregistered charities. To support the proposed new tax rules, two minor amendments to the Charities Act 2005 are also recommended.

54. The preferred option is the result of consideration of feedback on submissions on the issues paper and further analysis by officials.

IMPLEMENTATION

55. The changes to the Tax Acts will generally apply from 14 April 2014 – that is, deregistered charities whose date of final decision is on or after 14 April 2014 would have to apply the new rules. With respect to the tax on net assets, however, we recommend a split application date. It would apply from 1 April 2015 to entities which are deregistered by Charities Services, or which lose their tax charity status and would apply from 14 April 2014 to entities which choose to voluntarily deregister. The changes to the Charities Act 2005 will apply from 14 April 2014.

56. There are no significant implementation risks arising from the proposed new rules for deregistered charities. Transitional arrangements and enforcement of the proposed changes will be managed by Inland Revenue as business as usual. Current Inland Revenue operational guidelines relevant to charities would be updated to explain the proposed new rules to deregistered charities and their donors. Inland Revenue will also work with Charities Services to help communicate these changes to existing and prospective charities.

57. Overall, we expect there to be an improvement in compliance through having clear, consistent and coherent tax rules for deregistered charities.

MONITORING, EVALUATION AND REVIEW

58. There are no specific plans to monitor, evaluate and review the proposed new rules for deregistered charities. If any detailed concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

59. In general, Inland Revenue monitoring, evaluation and review of new legislation takes placed under the GTPP. The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves a post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, changes identified as necessary for the new legislation to have its intended effect would generally be added to the tax policy work programme, and proposals would go through the GTPP.