Robin Oliver Tax Policy Scholarships

2017 Tax Competition

Proposal:

To encourage timely application of funds to charitable purposes, remove business income tax exemption for charities; allow tax deduction at the time funds are applied.

Shift focus from 'proposed purpose' to 'amounts distributed'.

Submitter:

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Proposal

Remove charities' income tax exemption and instead allow a deduction against income when funds are applied to charitable purposes. This will assist the government's objective of increasing support to disadvantaged members of society.

Benefits:

- Prevents tax free retained earnings being held in profit-making 'charitable' entities**.**
- Encourages tax exempt income to be distributed where it is needed, earlier.
- Allows anyone to start a charitable activity and receive donations, income and assets to support that activity.
- Allows anyone to choose where their donations are spent.

Topical issues

Wealth Creation and reason for removing business income exemption

Government support of charities (via income tax exemptions) allows charities to spend on charitable purposes out of untaxed income and is intended to increase support to disadvantaged members of society.

Commercial companies registered as charities are given tax exemption if profits are derived with an intention to distribute to a charity. The timing of distributions from these taxfree profits is not considered in the legislation.

Currently certain charities are "stockpiling" profits by making minimal or no annual distributions. Cash flows arising from undistributed profits are in some instances accumulated in the charity, others are applying funds to further invest in business activities. Both situations decrease the amount of taxfree profits that are reaching disadvantaged members of society and frustrate the intention of the income tax exemption.

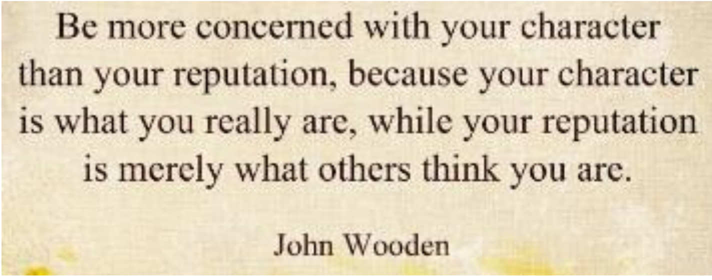
A search on the charities register showed that the top 5 charities' combined surpluses that were not distributed to a charitable purpose, totalled $200m for one year[1]. That is $56m of forgone income tax and $200m that did not reach disadvantaged members of society.

This is equivalent amount of funds that a recent government initiative undertook to provide in social housing to help ease the housing problem in New Zealand – taxpayer assistance that may not have been needed if charities were required to distribute a greater portion of tax free profits.

Some of the larger profit-making charities distributed (as donations) 1% and even as little as .2% of their annual tax free profits. In contrast, "for-profit" companies are paying 28% of profits to society via income tax.

Despite nil or low actual distribution to charitable causes, society perceives "charities" as providers of "community" benefit.

[1] 2014 Financial Statements data.



The situation is exacerbated when charities are operating businesses in competition with competitors who are subject to income tax. Competitors perceive that the absence of income tax liability enables charities to undercut them at rates they cannot match as they pay 28% income tax. This impacts competitors' cash flows and ability to invest.

Advantages of charitable status

	For profit company "Charity"	For profit company
Tax Benefits	Exempt from income tax	No tax benefits
Capital introduced	High wealth individuals introduce funds	Shareholders
Contribution to society	As little as .2%	From 28%

I have compared a charity[2] with a "for profit" entity to illustrate the current tax advantages. The example entity does not perform charitable activities, rather it derives profits which are then available to distribute to charities that undertake charitable activities[3].

5 years: 2012-2016	Charity	For Profit Company
Income	$163m	$163m
Surplus	$23m	$23m
Donated to charities	$2m	$2m
Tax credit/advantage	$5.8m	$600k
Tax paid	*0*	*$5.8m*
Retained earnings	$21m	$15.2m

Both entities' retain profits to acquire business assets. When these surpluses are retained and not distributed charities are advantaged, as illustrated below.

2 This information was taken from financial statements filed with the charities register for the 2012 to 2016 years.
3 I have simplified the details for this example and have compared it to a hypothetical for-profit company making the same distribution to charities.

	Tax Advantage by current charities tax regime	Contribution to charities	Funds available for future business acquisition
Charities	$5.8m	$2m	$21m
For-profit	$600k	$2m	$15.2m
Advantage for charities	**$5.2m**	**$ -**	**$5.8m**

Advantages to charities:

- Additional $5.8m for business asset acquisition
- Decreased pressure on operating margins (due to exemption to the 28% tax rate)
- No pressure to return retained earnings to shareholders
- Decreased need for borrowings to fund asset acquisitions, therefore lower interest expense

Replacing the charities' exemption with deductions for distributions would enable all organisations to pay nil income tax where distributions (deductible) equal income, regardless of whether they hold charitable status.

Income tax deductions for donations to organisations with donee status are already available and could be extended to allow deductions for donations made to any qualifying charitable activity or asset.

Donee activities and assets will need to be registered with the charities register.

Emerging future challenges

Social enterprise movement

The current tax regime creates barriers for equity owned companies set up to help those in need. –Social Entrepreneurs operating social enterprises (SEs).

SE's cannot be recognised as charitable entities where private equity is often required for activities with high start-up costs (i.e. app development). Private investment requires a return to investors and therefore falls outside the definition of a charity. Without this private investment these entities wouldn't exist.

Although these companies can claim deductions against their income for amounts paid to registered charities, they receive no such deductions for funds applied internally on assets acquired or developed for charitable purposes, nor can they access donations to fund these activities and assets.

A 2012 Department of Internal Affairs survey published in June 2013[4], found that:

1. Unincorporated SEs were interested in growth but are limited in their ability to raise capital as they cannot pay returns to investors.
2. Tax exemptions and payment of return to investors cannot co-exist.
3. SEs using the company structure see no advantage of a new legal structure, **unless tax exemptions were part of the picture** (and without the regulatory requirements associated with tax-exempt charities).

[4] Legal Structures for Social Enterprises -Published by the Department of Internal Affairs, June 2013.

SE’s aim is to help those in need without the same tax benefits as charities.

Digital movement

Use of technology is increasing, so too are apps developed to enable disadvantaged members of society to access help, including apps that connect:

1. volunteers to charities
2. people with other people (to combat loneliness and depression)
3. homeless (including working homeless) to nearby short-term accommodation
4. people with mental health issues to service providers in the area.

Large investments are often required. An app can take two full time staff 5 years to develop and market, costing upwards of $500k[5]. This is often met by capital investment due to lack of grants/donations.

SEs provide an asset which serves to help a social purpose. SEs are required to pay tax on any profits they generate. This reduces the amount of cash flow that is available to invest in developing or acquiring assets to serve their social purpose.

Below is the illustration used earlier, with the inclusion of a social purpose company.

	For profit company "Charity"	Social purpose company	For profit company
Tax Benefits	Exempt from income tax	No tax benefits	No tax benefits
Capital introduced	High wealth individuals introduce funds	Difficulty to attract shareholders	Shareholders
Contribution to society	As little as .2%	28% of surpluses, as well as assets used for social purpose	From 28%

The proposed extension to the provision allowing deductions (for donations made to any qualifying charitable activity or asset) will allow companies with private investors to also undertake charitable activities and hold assets for community benefit, operating as a hybrid entity for income tax purposes.

An illustration of how this works is shown below.

Total Contributions	**$514,200**
Total Equity	$326,700
Total Donations	$187,500
Tax paid on donations	$52,500

[5] On a modest salary of $50k per annum.

	Year One	Year Two	Year three	Year Four	Year Five	Total
Equity						
Marketer	$ 10,000.00	$ 5,000.00	$ 5,000.00	$ 5,000.00	$ 8,350.00	$ 33,350.00
Developer	$ 10,000.00	$ 5,000.00	$ 5,000.00	$ 5,000.00	$ 8,350.00	$ 33,350.00
Other Investors	$ 80,000.00	$ 50,000.00	$ 30,000.00	$ 50,000.00	$ 50,000.00	$ 260,000.00
Donations						
Doner	$ 500.00	$ 2,000.00	$ 3,500.00	$ 5,000.00	$ 6,500.00	$ 17,500.00
Doner	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 5,000.00
Doner	$ 1,000.00	$ 2,000.00	$ 3,000.00	$ 4,000.00	$ 5,000.00	$ 15,000.00
Doner Company			$ 20,000.00	$ 20,000.00	$ 20,000.00	$ 60,000.00
Doner Company			$ 30,000.00	$ 30,000.00	$ 30,000.00	$ 90,000.00
Total Contributions	**$102,500**	**$65,000**	**$97,500**	**$120,000**	**$129,200**	**$514,200**

Benefit:

- Ability to attract donations, allowing donors a tax credit (in this example a total credit of $52,500)
- Allows private investors to support a social purpose
- Attracts sophisticated and socially minded investors/donors/mentors
- More likely to achieve social purpose with private investors making up only 63% of total contributions by year 5[6], decreasing the pressure to return equity.

Administration requirements:

1. Tax credits permitted on funds applied to charitable purpose. The recent increase in reporting requirements of charities[7] mean minimal reporting requirement changes to administer this proposal, as application of funds has become more transparent.

2. Charitable **activities** to be registered with the Charities Register.

3. To encourage distribution, tax to be paid on retained earnings not been applied after 3 years.

4. Tax to be paid on any assets purchased for charitable purposes, with deduction permitted, if change of use occurs[8].

5. Apportionments will need to be calculated for amounts applied to mixed used assets (business and charitable). Several apportionment calculations are required by charities under the current regime to assess (separately) FBT, GST and donee status[9].

Inland Revenue's Business Transformation will enable streamlining of these processes.

[6] Initially (year 1) 80% of investors would have required a return.

7 https://www.charities.govt.nz/new-reporting-standards/about/

[8] Tax will be required to be made on assets that leave the charity or are no longer used for charitable purposes. Donations to hybrids will be treated as equity belonging to the entity, to restrict hybrids from increasing their share value with donation income.

[9] These are, or have been recently, the topic of tax policy makers – in QWBA, Issues reports and public consultation documents.

Impact on business

The proposal will only have a negative impact on profit earning charities that do not distribute funds for charitable purposes, requiring tax to be paid on those amounts.

Gaining political acceptance

The proposal would be favoured by both National Party and Labour party voters. The proposal seeks to level the competition for those in business and increases funds being distributed to our disadvantaged members of society.

Economic impact for New Zealand

1. A tax environment that:
    - Creates a level playing field for all entities; undertaking charitable and/or business related activities
    - Encourages distribution of funds derived for charitable purposes.

2. Increase availability and application of:
    - Tax revenue
    - Funding (donations)
    - Charitable activity (support)
    - Assets
    - Social Entities (support).

3. Encourage a community that grows for the purpose of supporting each other rather than accumulating profit.