

A Word to the wise

By **Claire Russell**, Solicitor, Makinson & d'Apice

In the current economic climate it is important for charities to know exactly what they are permitted to do in order to raise funds, without the risk of losing their charitable status and the benefits associated with that status. Fortunately, on 3 December 2008, the High Court handed down a judgment which unequivocally removed the uncertainty as to whether a charitable institution can engage in commercial activities as part of its charitable purposes.

The case was *Commissioner of Taxation of the Commonwealth of Australia v Word Investments Limited* [2008] HCA 55 (*Word*) and the charitable sector, from charities and churches to school fête groups, all breathed a sigh of relief upon receiving the news that their commercial fundraising activities would not 'contaminate' them and result in a loss of their tax exempt status.

Before considering the implications of *Word*, it is worth recapping the salient parts of the judgment.

The facts

Wycliffe Bible Translators (Wycliffe) was an income tax exempt charity that undertook evangelical missionary work predominantly in developing countries. Part of Wycliffe's work involved spreading the Christian religion by translating the Bible into indigenous languages and then teaching the local people to read the Bible.

In 1975 Wycliffe established Word Investments Limited (WIL) as a financial and fundraising arm of Wycliffe. Initially, WIL raised funds through housing development and passed surplus profits onto Wycliffe. In the late 1980s, WIL took over Wycliffe's fundraising activities which involved borrowing money from supporters on low- or no-interest terms, investing that money at commercial rates, and passing the surplus onto Wycliffe. WIL also offered a fee-based financial planning service at this time, again passing all surplus profits onto Wycliffe. In 1996, WIL established a funeral business for both supporters and the public. In 2002, WIL created a separate

trust to operate the funeral business.

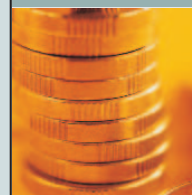
In March 2005, the Australian Taxation Office (ATO) refused to endorse WIL as a tax exempt charity on the basis that it was not an organisation instituted to advance or promote charitable purposes. WIL commenced proceedings, which ultimately ended up in the High Court.

The issues

The Commissioner for Taxation claimed that there were four obstacles to WIL receiving a tax exemption.

1. WIL's objects were not confined to charitable purposes.
2. WIL was an entity that engaged in solely commercial activities for profit and therefore could not be a charitable institution, despite it redirecting the profit to a bona fide charitable institution.
3. The recipients of WIL's profits were not confined in the use to which the funds could be put.
4. WIL did not have a physical presence in Australia, did not incur its expenditure in Australia and did not pursue its objectives principally in Australia.

- *High Court rejects ATO argument that earning profit is an end in itself for charitable organisation*
- *Activities of taxpayer were found to be commercial in nature, but charitable in character*
- *Charities can be involved in profit-making activities without endangering tax-exempt status*



The decision

The High Court, by a 4–1 majority, rejected the ATO’s arguments that WIL had a commercial object of making a profit. It held that WIL’s commercial efforts to make a profit were solely in pursuance of its charitable purposes and rejected the contention that WIL had as an *object* the engagement of commercial activities. Engaging in commercial activities was an exercise of its powers to fulfil its charitable purposes. The court said that to point to the goal of profit and isolate it as the relevant purpose was to create a false dichotomy between characterisation of an institution as commercial and characterisation of it as charitable. In other words, it is important to consider the natural and probable consequences of WIL’s purposes and activities, and in this case the result was that the profit would be spent in achieving religious purposes.

In the Federal Court proceedings, Sundberg J encapsulated how it is the *object* of the fundraising activities that must be assessed rather than the scale of the commercial activity undertaken.

There may appear to be a vast difference between selling lamingtons at a church fete and selling funeral services, but where the object of raising the funds is the same, I can see no reason to draw a legal distinction between the two.

The High Court ultimately supported Sundberg J’s reasoning by rejecting the ATO’s submission that WIL had a commercial object of profit which was an ‘end in itself’. WIL’s ‘end goal’ was not the creation of profit but the furtherance of religious purposes.

The ATO had also submitted that the recipients of the funds were at liberty to spend the money on non-charitable objects. A majority of the High Court noted that the funds paid by WIL were paid to bodies that had an obligation to fulfil their object, and that all recipients of WIL funds were charitable institutions with charitable

objects. WIL was, therefore, entitled to assume that the funds would be used as it intended for charitable purposes. Further, WIL’s activities, although commercial in nature, were charitable in character because they were paid to charitable institutions to assist in the furtherance of their charitable purposes. The court relied on a case decided in the English Court of Appeal (*Inland Revenue Commissioners v Helen Slater Charitable Trust Ltd* [1981] STC 471) in which Oliver LJ stated:

I entertain no doubt whatever that, as a general proposition, funds which are donated by charity ‘A’, pursuant to its trust deed or constitution, to charity ‘B’ are funds which are ‘applied’ by charity ‘A’ for charitable purposes.

It was also held that the requirements that WIL have a physical presence in Australia, incur its expenditure in Australia and pursue its objectives in Australia, pursuant to s 50-50(a) of the *Income Tax Assessment Act 1997*, were all met. WIL did have a physical presence in Australia; it did incur its expenditure in Australia; and it did pursue its objectives in Australia. The decisions to pay were made in Australia; the payments were made in Australia; the recipients were Australian organisations; and the objects of WIL included giving financial assistance to those organisations.

The court made the following observations in respect of s 50-50(a):

Section 50-50(a) does not impose a prohibition on distributing to other charitable institutions. Nor does it require the money, when ultimately expended by [the recipient], to be expended in Australia...It only imposed a requirement that [WIL] incur its expenditure and pursue its objectives principally in Australia — not that [the recipient] do so.

Any organisation can conduct any commercial activities and still be entitled to be endorsed as a charity provided the profits are applied towards charitable purposes. Charities will, in light of this judgment, be able to set up subsidiary entities that can raise funds through commercial enterprises and retain their charitable status. This also provides opportunities to pursue asset protection strategies through the use of these subsidiary entities.

No private benefit

The ‘charitable institution’ is the instrument that carries the charitable (or public benefit) purpose into effect. An essential aspect of a charity is that it is not concerned with bringing about private benefit. To determine whether a private benefit is being conferred, one must look to where the profits and capital of the charitable institution are being distributed. Distribution to private individuals or to non-charitable entities is a

private benefit distribution and will result in the nullification of the charitable status. It is this, quite simple, tenet of charity law that the High Court applied in *Word*.

The court upheld the basic principle that a charity is not to be concerned with private benefit. In examining the activities, objects and purposes of WIL, it was evident to the Court that the distribution of profits was being made to charitable institutions for charitable purposes. The activities of WIL could not, of themselves, negate WIL's charitable status, so long as no entity other than one with charitable purposes could ever become entitled to receive any of WIL's profits. The goal of making a profit was not an end in itself but was incidental to WIL's charitable purposes. It is, therefore, not the commercial activity that is at issue; it is what becomes of the fruit of those activities.

The constituent documents

Having said all that, however, it would be naïve to suggest that the notion of charitable status starts and finishes with an absence of private benefit. It is also essential that the charitable institution that engages in commercial activities meets the legal test of charity. This means that it must have clearly stated charitable purposes contained in its trust deed or constitution.

WIL was set up with the purpose of advancing religion. It achieves this by generating income. The vehicle by which that income is generated is investment schemes and a funeral business. It is clear that WIL was not established to engage in investments and a funeral business with the ultimate goal of making a profit that could be distributed to its owners. Its purpose was to make a profit and distribute that profit to charitable institutions that had obligations — under their own constituent documents — to apply those funds to their charitable purposes.

It is important to establish the charitable purpose of the institution. Consequently, the constituent documents must be clearly drafted to ensure that the purpose and object clauses reflect the charitable purpose to which the activities of the charity are directed.

Opportunities

In short, the implications of the judgment are that any organisation can conduct any commercial activities and still be entitled to be endorsed as a charity provided the profits are applied towards charitable purposes. The High Court recognised that this area of law required modernisation, and the decision in *Word* has brought it right up to date. As government funding dries up and a push to privatisation and self-funding is advanced, many charities will rely

on entrepreneurial activities to remain viable. The court has, then, recognised that charities can be legitimately involved in commercial ventures as part of their charitable purposes without having to give up the advantages of tax exemptions in the process. It could even be said that the court is, in effect, encouraging entrepreneurial activity by charitable institutions.

Charities will, in light of this judgment, be able to set up subsidiary entities that can raise funds through commercial enterprises and retain their charitable status. This also provides opportunities for charities to pursue asset protection strategies through the use of these subsidiary entities. These entities can charge fees for services and, so long as the purpose is selfless, in the sense that it is not intended to make a profit for private benefit, the institution is charitable. Sundberg J observed that the use of separate entities already occurs and states that:

[t]he [ATO's] argument is inconsistent with the corporate structure of many contemporary charities which are complex and involve the use of separate legal entities to perform separate functions. Where they are all working together to pursue a common charitable purpose, it is artificial to consider the purpose of each entity separately.

The law, as it exists today, due to the decision in *Word*, accords greater scope for charitable institutions to accumulate capital and income for future use. Charitable institutions that have previously been denied tax-exempt status may wish to consider reapplying to the ATO for endorsement. It is reasonable to expect that the ATO will scrutinise such applications.

It is therefore imperative for any charitable institution considering an application for tax exempt status — for an entity that engages in commercial activities for charitable purposes — to ensure that the objects clauses of the constituent document for the entity are clearly drafted to reflect the charitable purposes of that entity.

The last Word

The ATO has not yet responded to the High Court's decision and it is possible, perhaps likely, that it will seek to amend the law in such a way as to negate the *Word* decision and to revert to extinguishing tax exemptions for charitable institutions engaging in commercial activities. However, until the law changes, charitable institutions with clear charitable objects and purposes may raise funds by engaging in commercial activities, without the risk of losing their charitable status.

Claire Russell can be contacted on (02) 9233 7788 or via email at crussell@makdap.com.au. ●