Charity Accumulation: Interrogating the Conventional View on Tax Restraints

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Abstract

Charities have the potential to obtain income tax exemption by becoming endorsed by the Commissioner of Taxation. The view traditionally adopted by the Commissioner, and accepted by many advisers, is that the endorsement conditions require the relatively direct and active use of funds. Such a test can constrain accumulation of income and assets by charities. This article interrogates the conventional view and finds that there is a stronger legal basis for construing the conditions as focusing on whether a charity's funds have been administered by the charity controllers in accordance with the charity's rules and the law. This alternative construction raises a number of questions about regulatory duplication, the potential lack of regulation of the time of benefit provision and the way this timing issue might be addressed.

I Introduction

A key perceived benefit from being a charity is the potential to obtain an exemption from income tax. However, to obtain the benefit there are several requirements (in addition to being a charity) that must be satisfied and these include endorsement conditions set out in the income tax legislation.[1] The conventional view in Australia, as recently reflected in the Australian Taxation Office's ('ATO') Taxation Ruling ('TR') 2015/1,[2] is that these endorsement conditions require the relatively direct and active use of funds, which limits charities' ability to accumulate income and assets. This article proposes a new view as to the relevant endorsement conditions for the income tax exemption. In order to make this argument, the article questions the conventional view. There are two bases for doing so. First, at a policy level, the conventional view's partial inconsistency with the dominant rationales for charity tax exemption and the inherent uncertainty of the concepts underlying the conventional view. Second, doctrinal legal analysis supports an alternative 'maladministration' test based on

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1 Hereafter 'the income tax endorsement conditions' or 'endorsement conditions'. See Part IIC.

2 Australian Taxation Office, *Income Tax: Special Conditions for Various Entities Whose Ordinary and Statutory Income is Exempt*, TR 2015/1, 25 February 2015 ('TR 2015/1').

whether, in accumulating income and assets, a charity has complied with its governing rules and the law. The article also identifies the implications for the overall system of regulation of accumulation by charities and for whether society should impose timing constraints on charitable accumulation at all.

For many charities, being able to accumulate income and assets is an important matter. Accumulation can enable flexibility, certainty and longevity[3] and, possibly, increase the level of benefits,[4] as well as promoting independence[5] and a more pluralist charity sector.[6] However, accumulation can also raise concerns. For example, governance fears that accumulated funds may be lost or improperly applied[7] or that it may promote 'mission drift'.[8] In addition, there is the timing issue that accumulation results in the enjoyment of income being deferred to future generations, as well as potentially enabling the perpetuation of the charity creator's control over charity property.[9] As a result of these concerns, there are various legal limits that potentially apply, to a greater or lesser degree, to charity accumulation. Tax rules constitute one of these constraints, with other restraints provided by perpetuities rules, governance duties and general charity supervisory regulatory controls.[10]

As outlined in Part IIA, there is significant debate over the rationale for the charity income tax exemption. However, the dominant theories suggest that charities should produce some goods for the benefit of the community rather than

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3 As to flexibility, certainty and longevity, see, eg, W I Scales, R G Mauldon and M M McGovern, 'Charitable Organisations in Australia' (Report No 45, Industry Commission, 16 June 1995) 251; Hubert Picarda, *The Law and Practice Relating to Charities* (Bloomsbury Professional, 4th ed, 2010) 623; L A Sheridan, *Keeton & Sheridan's The Modern Law of Charities* (Barry Rose, 4th ed, 1992) 400; Paul E Sackett, 'Charitable Trusts — Validity of Provisions for Accumulations' (1930) 16(4) *Virginia Law Review* 370, 374; *Ballard v A-G* (Vic) (2010) 30 VR 413, 424 [64]–[65] (Kyrou J).

4 Sackett, above n 3, 374; Alexander M Wolf, 'The Problems with Payouts: Assessing the Proposal for a Mandatory Distribution Requirement for University Endowments' (2011) 48(2) *Harvard Journal on Legislation* 591, 619. For countervailing considerations see, eg, Kerry O'Halloran, *Charity Law and Social Inclusion: An International Study* (Routledge, 2007) 50; Daniel Halperin, 'Is Income Tax Exemption for Charities a Subsidy?' (2011) 64(3) *Tax Law Review* 283, 286; *Federal Commissioner of Taxation v Word Investments Ltd* (2008) 236 CLR 204, 219 [22] (Gummow, Hayne, Heydon and Crennan JJ) ('*Word Investments*').

5 In the context of reserves, see, eg, Picarda, above n 3, 623.

6 In the context of indirect funding of not-for-profit organisations through tax concessions, see, eg, Scales, Mauldon and McGovern, above n 3, 271. See also Richard Krever, 'Tax Deductions for Charitable Donations: A Tax Expenditure Analysis' in Richard Krever and Gretchen Kewley (eds), *Charities and Philanthropic Organisations: Reforming the Tax Subsidy and Regulatory Regimes* (Australian Tax Research Foundation, 1991) 1, 11–13.

7 Joel H Feld, 'Unreasonable Accumulation of Income by Foundations' (1967) 16(2) *Cleveland-Marshall Law Review* 362, 366–7, 368–9. See also Scales, Mauldon and McGovern, above n 3, 250.

8 Mission drift entails actions taken for reasons other than the charity's purpose. In the context of accumulation, this could include accumulating funds out of a desire to maintain their own legacy on the part of the donor, or to enhance social status on the part of controllers: Halperin, 'Is Income Tax Exemption for Charities a Subsidy?', above n 4, 286.

9 John A Borron Jr, Westlaw, *Simes and Smith, The Law of Future Interests* (3rd ed, at July 2013) § 1463; American Law Institute, *Restatement (Second) of Property: Donative Transfers* (1983) § 2.2 cmt (e); D E Allan, 'The Rule Against Perpetuities Restated' (1963) 6(1) *University of Western Australia Law Review* 27, 71; Law Commission (UK), *The Rules Against Perpetuities and Excessive Accumulations*, Report No LC251 (1998) 129–30 [10.19].

10 For a general discussion of the applicable restraints, see, eg, Ian Murray, 'Accumulation in Charitable Trusts: Australian Statutory Perpetuities Rules' (2014) 8(2) *Journal of Equity* 163, 167–76.

hoarding resources indefinitely, but that independence from government in determining what and when those goods are produced is also important. This has two implications. First, while restraints on charitable accumulation can be viewed as consistent with the dominant theories, those theories do not provide clear guidance as to when accumulation is acceptable or unacceptable. Instead, in formulating or critiquing restraints, it is necessary to consider the specific benefits and detriments raised by the practice of accumulation. For instance, theories of intergenerational justice,[11] may be more helpful in addressing accumulation's deferral of the enjoyment of income and assets to future generations. Second, the theories about freedom from taxation for charities do not require that accumulation restraints be housed in the tax legislation. Indeed, some militate against it. Thus, to the extent it is appropriate to regulate charitable accumulation, behavioural controls imposed outside the tax system also need to be considered.

Accordingly, determining the nature of the accumulation restraints under the income tax endorsement conditions is relevant to a range of questions about the manner in which charity accumulation is regulated. For instance, what is the scope of the conventional view and how does it address the specific benefits and detriments raised by the practice of accumulation? If the conventional view is wrong and income tax exemption rules do not impact on the timing of provision of benefits, then are there any other restraints that might compel charities to benefit the current generation, rather than saving for the future? For instance, governance duties could be relevant, as might the public pressure from disclosure of financial information to the Australian Charities and Not-for-profits Commission ('ACNC') and its subsequent public dissemination. If the conventional view is correct, it is worth questioning whether a test that relies on a government regulator's view about the appropriateness of accumulation is consistent with the tax exemption rationales and with theories about accumulation advantages and disadvantages. Further, it might be more consistent with the tax exemption rationales and accumulation theories for governance rules to focus on processes but leave decision-making largely independent, or for disclosure rules that rely on self-regulation due to public pressure.

In light of these broader considerations, this article interrogates the conventional view of the income tax endorsement conditions by asking whether the conventional view is correct as a matter of law and whether there might be other alternative constructions of the test. This is a useful goal in its own right because it is vital to guiding the direction of further research into the regulation of accumulation under the tax regime. After all, the conventional view of the endorsement conditions involves distinguishing between 'excessive' and 'non-excessive' accumulation of income and assets, and between accumulation for 'general' versus 'specific' purposes. If correct, this raises the question of how to determine when accumulation is 'excessive'? What is a 'specific', as opposed to a 'general', reason for accumulation?

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[11] While the content and concept of 'intergenerational justice' remain in debate, it is a term that groups a range of philosophical, social, economic and political theories that attempt to articulate what obligations, if any, are owed by the present generation in relation to past and future people.

Fundamentally, understanding the reach of the conventional view is also relevant to charities themselves, as, if correct, it may have a material impact on the activities that they can undertake. The key practical impact is that accumulation for general and non-time limited purposes is likely to fail the test. For example, retaining income and assets until the charity's funds reach a target amount was asserted to be an 'arbitrary decision' by the Commissioner in the *Federal Commissioner of Taxation v Bargwanna* ('*Bargwanna*')[12] litigation.[13] Such an approach would be unlikely to meet the need for a specific purpose,[14] unless, perhaps, detailed specific reasons exist for the target amount, such as the purchase of a particular asset. Further, what of a charity that decides to retain a set proportion of income and assets received each year — say 49%? Even if the decision is grounded in the notion of intergenerational justice,[15] which can be interpreted as requiring some saving for future generations,[16] one must ask whether this is a sufficiently 'specific' reason or whether it is in any event too 'excessive'.

These questions can be rendered somewhat less abstract by imagining Harvard University as being located in Australia. Harvard's 2014 annual report discusses the goal of continued growth for Harvard's $36.4 billion endowment in fairly broad intergenerational terms:

> [W]e are pleased with the overall growth of $4.6 billion in Harvard's net assets, much of which is attributable to net growth in the market value of the endowment. At $36.4 billion, the endowment is within 2% of its 2008 peak — but with a significantly improved risk and liquidity profile. Harvard's endowment, like those of our peers, still must recapture its lost purchasing power so that future generations of students and scholars will receive the same important support that has been available to past generations.[17]

Finally, the scope of the conventional view, the matter of whether it is correct in law and the uncertainty attending both of these issues is particularly relevant to persons such as directors and other charity controllers who may be required to make operational decisions based on assumptions about a charity's income tax endorsement status. Further, such responsible persons[18] for medium or large registered charities must also sign a solvency declaration and a declaration that the financial statements provide a true and fair view of the charity's financial position.[19] Auditors and reviewers are also required to make declarations in relation to whether the relevant financial statements provide a true and fair view of

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12 (2012) 244 CLR 655.

13 *Re TACT and Federal Commissioner of Taxation* (2008) 71 ATR 827, 839 [42] (Senior Member Taylor) ('*TACT*'), citing the Commissioner's submissions. The Commissioner did not make this argument before the High Court: see below n 44 and accompanying text.

14 See below nn 54–61 and accompanying text.

15 See above n 11.

16 For instance, Rawls used his liberal philosophical social contract theory of justice to ground a principle of 'just savings': John Rawls, *A Theory of Justice* (Clarendon Press, 1972) 285 (albeit conceived as a limit on the 'difference principle' that supports distributive justice).

17 Harvard University, *Financial Report Fiscal Year 2014* (2014) <http://finance.harvard.edu/files/fad/files/har_fy14_financialreport.pdf> 3.

18 The legislation uses the term 'responsible entity': *Australian Charities and Not-for-profits Commission Act 2012* (Cth) s 205-30 ('*ACNC Act*').

19 Ibid s 60-15(1); *Australian Charities and Not-for-profits Commission Regulation 2013* (Cth) regs 60.10, 60.15 ('*ACNC Regulations*').

the charity's financial position.[20] Loss of income tax exemption as a result of accumulation practices that breach the endorsement conditions could have a significant — even retrospective — impact on a charity's financial position and, hence, a material impact on its operations and financial statements.

Part II of this article defines what is meant by 'accumulation' in this article and outlines the income tax exemption conditions of relevance to accumulation. Part III articulates the parameters of the conventional view. As the recent changes to the income tax exemption special conditions and TR 2015/1 appear to have created some confusion about the extent to which the Commissioner adheres to the conventional view, this Part also explores the Commissioner's stance. The conventional view is then questioned in Part IV, which details its conceptual difficulties and proposes an alternative 'maladministration' interpretation of the 'application-for-purposes' test. Finally, the conclusion discusses the research questions that are unlocked by the finding in Part IV that the maladministration interpretation is to be preferred.

II Context

This article focuses on the tax restraints on accumulation, as it is necessary to understand their scope and impact before examining their interaction with the other accumulation limits. Part IIA below very briefly sketches some key considerations for the theoretical basis for the charitable tax exemption, as these are relevant to the context in which the accumulation tax constraints operate. Part IIB identifies the meaning of 'accumulation' as used in this article. Part IIC then outlines the income tax exemption conditions that apply to accumulation.

A *The Rationale for Income Tax Exemption*

The non-taxation of charities is a highly contested area, with disagreement even on the issue of whether it is correctly classified as a concession, as opposed to being the inherent starting position.[21] Clearly, a starting assumption of freedom from taxation would suggest a lesser role for tax rules in regulating charity behaviour. However, arguments for excluding charity income from the tax base or that are couched in notions of 'sovereignty',[22] may have limited relevance to the application of non-tax constraints, albeit a 'sovereignty' understanding both

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20 *ACNC Act* ss 60-30, 60-45, 60-50.

21 In large part this is due to differing views on how to define the tax base and as to the sovereign status of charities. See, eg, Evelyn Brody, 'Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption' (1998) 23(4) *Journal of Corporation Law* 585; Krever, above n 6, 1, 3–5; Rob Atkinson, 'Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses' (1997) 27(2) *Stetson Law Review* 395; Myles McGregor-Lowndes, Matthew Turnour and Elizabeth Turnour, 'Not for profit Income Tax Exemption: Is there a Hole in the Bucket, Dear Henry?' (2011) 26(4) *Australian Tax Forum* 601, 602–9. Halperin has specifically examined accumulation and theorised that an exemption for investment income is a concession in the United States context: Halperin, 'Is Income Tax Exemption for Charities a Subsidy?', above n 4, 285–7.

22 See above n 21.

supports rules that bolster the autonomy of charities and provides a rationale for constraints on charities' power.[23]

Further, to the extent that non-taxation is viewed as a concession, there is a range of competing rationales. The dominant explanation is that the concessions are subsidies, to finance the production of public and quasi-public goods in place of government production.[24] A variation of the subsidy rationale is that charity concessions make up for the potential difficulties faced by charities in raising capital.[25] Accordingly, the dominant theories have two implications of relevance to this article. First, rather than squirrelling resources away indefinitely, charities should produce some goods for the benefit of society. Second, a degree of independence from government in deciding precisely what and when those goods are produced is also significant.

B *Meaning of 'Accumulation'*

'Accumulation' possesses both a narrow and a broad meaning.[26] In a narrow sense, it denotes the identification of a portion of income from a capital sum, adding that income to the capital and investing it (and keeping it invested until the end of the accumulation period), rather than applying it in some other way.[27] In a broader sense, accumulation 'signifies [nothing] more than a simple aggregation of instalments of income to create a single fund'.[28] That is, the retention of income and assets representing prior years' income without any 'capitalisation' of that income.

The narrow meaning is relevant to the application of perpetuities rules. For the purposes of the tax provisions and this article, however, it is the broad meaning that is relevant. This is consistent with the interpretation of 'accumulation' that appears to be adopted by the ATO.[29]

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23 See, eg, Brody above n 21, 586–9. The rationale for constraints being that charities should not become too powerful a rival to government.

24 See, eg, Estelle James and Susan Rose-Ackerman, *The Nonprofit Enterprise in Market Economics* (Harwood Academic, 1986) 20, 29–31, 84–9; Australia's Future Tax System Review Panel, *Australia's Future Tax System: Report to the Treasurer*, Final Report (2010) pt 2 vol 1, 206; Note, 'Developments in the Law: Nonprofit Corporations' (1992) 105(7) *Harvard Law Review* 1578, 1620–5.

25 Henry Hansmann, 'The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation' (1981) 91(1) *Yale Law Journal* 54, 71–5.

26 See, eg, Geraint Thomas, *Thomas on Powers* (Oxford University Press, 2nd ed, 2012) 239–40, citing *Re Rochford's Settlement Trusts* [1965] Ch 111 and *Re Berkeley* [1968] Ch 744, 780 (Widgery LJ).

27 See, eg, D W M Waters, M R Gillen and L D Smith (eds), *Waters' Law of Trusts in Canada* (Carswell, 4th ed, 2012) 699; Law Commission (UK), above n 9, 110 [9.2]; *Re Berkeley* [1968] Ch 744, 772 (Harman LJ).

28 *Re Berkeley* [1968] Ch 744, 780 (Widgery LJ). See also the broad approach adopted in *Re Rochford's Settlement Trusts* [1965] Ch 111, 122–3, 125 (Cross J).

29 TR 2015/1, above n 2, 13–14 [79]–[80], 14 [82]–[86], 28 [160], 30 [169]–[170]. See also Australian Taxation Office, *Income Tax: Endorsement of Income Tax Exempt Charities*, TR 2000/11, 28 June 2000, 7 [21] ('TR 2000/11'). TR 2000/11 was withdrawn on 19 August 2015 on the bases that it referred to endorsement provisions that have since been amended and that it did not adequately address *Word Investments*. As the discussion in Part IIC demonstrates, while the second reason is relevant to accumulation, the application-for-purposes wording discussed in

C *Income Tax Exemption Conditions*

The income tax exemption renders all ordinary and statutory income of an endorsed charity exempt from income tax and is a benefit that is accordingly directly applicable to accumulated income itself. It is potentially relevant to all charities.

To be eligible for the concession, a charity must be registered as such by the ACNC[30] and meet several special conditions.[31] The present incarnation of the special conditions includes a requirement that every charity must 'comply with all the substantive requirements in its governing rules' and 'apply its income and assets solely for the purpose for which the entity is established'.[32] Note that the requirement applies to both income and assets, so, in addition to income, it extends to capital contributions and to previously retained assets. Similar 'compliance-with-rules' and 'application-for-purposes' requirements also exist for the income tax exemptions for most non-charitable not-for-profits.[33] The requirements are intended to permit a greater focus on an entity's ongoing activities, as opposed to the purposes stated in its constituent documents.[34] Therefore, despite a short legislative hiatus, the second of the two special conditions seems intended to serve a similar purpose to the former s 50-60 of the *ITAA97* requirement that a charitable fund be 'applied for the purposes for which it was established'. The questions are: just what does the application-for-purposes test require? And how does it apply to accumulation?

III The Conventional View

The conventional view is that former s 50-60 of the *ITAA97* and, by analogy, the new application-for-purposes constraint, require the relatively direct and active use of funds. As outlined below, such a test involves distinguishing between 'excessive' and 'non-excessive' accumulation, and between accumulation for 'general' versus 'specific' purposes. This is the view adopted by the Commissioner of Taxation and that appears to be adopted by commentators, to the extent that comment exists.[35]

TR 2000/11 is very similar to that currently employed in the income tax endorsement conditions. References in this article to TR 2000/11 are to the ruling as it existed immediately prior to its withdrawal.

30 *Income Tax Assessment Act 1997* (Cth) ss 50-5 ('registered charity' requirement), 995-1(1) (definition of 'registered charity') ('*ITAA97*').

31 Ibid s 50-1.

32 Ibid s 50-50(2).

33 Ibid div 50.

34 See, eg, Explanatory Memorandum, Tax Laws Amendment (2013 Measures No 2) Bill 2013 (Cth) 224 [11.56]–[11.60].

35 See, eg, Scales, Mauldon and McGovern, above n 3, 250–1; Lisa Strelein, 'Taxation of Native Title Agreements' (Native Title Research Monograph No 1/2008, Australian Institute of Aboriginal and Torres Strait Islander Studies, 2008) 33–4; David Ward, *Trustee Handbook: Roles and Duties of Trustees of Charitable Trusts and Foundations in Australia* (Philanthropy Australia, 2nd ed, 2012) 17; Minerals Council of Australia and National Native Title Council, Joint Submission to The Treasury (Cth), *Native Title, Indigenous Economic Development and Tax* and to the Attorney-General (Cth) and Department of Families, Housing, Community Services and Indigenous Affairs (Cth), *Leading Practice Agreements: Maximising Outcomes from Native Title Benefits*,

The Commissioner of Taxation interpreted former s 50-60 of the *ITAA97* as limiting the ability to accumulate income (including the administrative retention of income) within a charitable trust.[36] As s 50-60 applied to 'charitable funds', it was primarily relevant to charitable trusts, rather than incorporated charities.[37] In terms of scope, various public rulings and guidelines purported to allow charitable trusts, including ancillary funds,[38] to accumulate some income on a continuous basis.[39] The examples contained in the rulings[40] suggest that the ATO has, historically, in exceptional circumstances, permitted significant accumulation by charitable trusts for around 10 years,[41] with ongoing accumulation potentially permitted provided it is around 20% of income or an inflation-based amount.[42]

Nevertheless, the rulings and the Commissioner's contentions in the recent *Bargwanna* litigation demonstrate that the Commissioner requires funds to be relatively directly or actively used to achieve a charitable trust's purposes in order to be 'applied'. The rulings and contentions show this through their focus on the specific reason for, extent of and duration of, accumulation. In other words, accumulation must either be relatively insubstantial, or else linked to a specific project and of finite duration, rendering it sufficiently directly linked to an outcome. For instance:

> Investment in a manner to benefit private entities or excessive accumulation of investment income are not the applying of a fund for its purposes. We regard distribution of a substantial part of the income (but not necessarily capital gains) as essential. However, we accept that a charitable fund may use some of its income to acquire assets which, in future, will produce more income for charitable purposes, and may accumulate some of its income for later distribution.[43]

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30 November 2010, 12. *Contra* Matthew Turnour and Myles McGregor-Lowndes, 'Taxing Charities: Reform Without Reason?' (2012) 47(2) *Taxation in Australia* 74, 75–6 (qualified support); Australian Association of Philanthropy, Submission to the Industry Commission, *Charitable Organisations in Australia*.

36 See, eg, the Commissioner's contentions in the *Bargwanna* litigation: *TACT* (2008) 71 ATR 827, 839 [42], 840–1 [45] (Senior Member Taylor). See also TR 2000/11, above n 29, 7 [21]; Australian Taxation Office, *Income Tax and Fringe Benefits Tax: Charities*, TR 2011/4, 12 October 2011, 55 [230] ('TR 2011/4').

37 As to the distinction between a charitable institution and a charitable fund, see below n 130 and accompanying text.

38 References to ancillary funds include prescribed private funds.

39 TR 2000/11, above n 29, 7 [21]; TR 2011/4, above n 36, 55 [230]; Australian Taxation Office, *Accumulation of Income by Charitable Funds*, IT 340, 23 June 1982 ('IT 340'); Commonwealth of Australia, *Guidelines for Prescribed Private Funds Version 3*, May 2004, 4–5 [26]–[32].

40 TR 2000/11, above n 29, 22 [102]; IT 340, above n 39, 1 [2]–[6].

41 See, eg, Strelein, above n 35, 34; Minerals Council of Australia and National Native Title Council, above n 35, 12. An approach by the ATO of permitting significant accumulation in exception circumstances, for up to 10 years, is also supported by several discussions between the author and ATO officers.

42 As to a practice of permitting inflation-based accumulation for ancillary funds, see, eg, Treasury (Cth), 'Improving the Integrity of Public Ancillary Funds' (Discussion Paper, Australian Government, November 2010) 5. Note that the guidelines for ancillary funds that applied before the minimum distribution requirement was introduced were more restrictive of accumulation than the rules applying generally to charitable funds.

43 TR 2000/11, above n 29, 7 [21]. See also TR 2011/4, above n 36, 55 [230].

The approach was expressed even more clearly in the Commissioner's submissions in the *Bargwanna* litigation, as enunciated in the High Court of Australia:

> In *Trustees, Executors and Agency Co Ltd v Acting Federal Commissioner of Taxation* the Commissioner submitted the fund was not so applied if the income was being accumulated rather than *expended* for charitable purposes. … A submission along these lines was unsuccessfully put to the AAT by the Commissioner, but was not renewed in this Court.[44]

And the approach is also described by the Administrative Appeals Tribunal:

> The Commissioner contends the combined effect of the observations of Isaacs J in *Trustees, Executors and Agency Co Ltd v Acting FCT* (1917) 23 CLR 576; [1918] VLR 1; 24 ALR 17 and Taylor J in *Compton v FCT* (1966) 116 CLR 233; 39 ALJR 400 is to require the conclusion that a fund is not 'applied for the purposes for which it was established' if the trustees merely accumulate its income. The accumulation must occur for some specific and objectively justifiable good reason. In particular, the Commissioner contends that a mere desire to accumulate income until the trust fund reaches a specified amount, is essentially an arbitrary decision. The Commissioner says that in the present case the trustees' general intention to accumulate TACT's income, until it has net assets of $1,000,000, is inadequate and that the accumulation of income has been excessive. The trustees' intention is not directed to any particular purpose and is not supported by any analysis of either the appropriateness of the $1,000,000 target or the period of time that may be required for it to be achieved. The Commissioner contends that the lack of any definite timeframe, purpose or management plan, together with the extent of accumulation that has occurred, requires the conclusion that the fund does not satisfy the requirement that it 'is applied for the purposes for which it was established'.[45]

A draft taxation ruling, released in 2014, indicated that the Commissioner was also likely to use the restated provision as a restraint, albeit perhaps with a little greater elasticity.[46] Nevertheless, when the final ruling was issued (in the form of TR 2015/1), the portion of the ruling dealing with accumulation had been revised, with the Commissioner explicitly stating that the constraints on accumulation under the new provision are consistent with the Commissioner's interpretation of the requirements of the old s 50-60.[47] It is debatable whether the ruling does, in fact, adopt an equivalent approach to that under s 50-60, not least because the Commissioner expressly adopts the High Court's reasoning in *Bargwanna* as to the

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44 *Bargwanna* (2012) 244 CLR 655, 666 [29]–[30] (French CJ, Gummow, Hayne and Crennan JJ) (emphasis in original).

45 *TACT* (2008) 71 ATR 827, 839 [42] (Senior Member Taylor).

46 Australian Taxation Office, *Income Tax: Special Conditions for Various Entities Whose Ordinary and Statutory Income is Exempt*, TR 2014/D5, 13 August 2014, 5 [24]–[25], 24–5 [141]–[143].

47 TR 2015/1, above n 2, 29 [167]–[170] (and the text in the accompanying footnotes in TR 2015/1). See also Australian Taxation Office, *Ruling Compendium*, TR 2015/1EC, 25 February 2015, items 2.5, 2.15 ('TR 2015/1EC'). Note that the Commissioner cites *Re Gorton and Federal Commissioner of Taxation* (2008) 72 ATR 201 ('*Gorton*') as forming part of the body of law explaining the s 50-60 requirement. However, *Gorton* related to the assessability of a lump sum insurance settlement payment and the deductibility of payment of part of this sum into a superannuation fund. It did not deal with the issue of accumulation in any form.

meaning of 'applied'.[48] What is clear is that the final ruling expresses caution about the extent to which accumulation is permissible and appears particularly restrictive of accumulation for the general purposes of a charity.

The final ruling, like the draft ruling, defines 'apply' by reference to whether an entity 'make[s] use of' its income and assets,[49] and includes a temporal constraint that 'income received by an entity must be put to use within a reasonable period of receipt'.[50] Rather than being based on any purported governance duty to distribute income within a reasonable period of receipt,[51] this appears based on the definition of 'apply' as meaning to 'make use of'.

Nevertheless, TR 2015/1 accepts that accumulation can amount to the 'making use of' income provided it is 'consistent with the purpose for which the entity is established'.[52] However, the new guidance on when accumulation might be 'consistent with the purpose for which an entity is established' clearly reflects the cautious approach of the earlier s 50-60 guidance:

> 169. This does not mean that *excessive or indefinite* accumulation is permissible under the income and assets condition. An entity's entitlement to income tax exemption is a year by year assessment. An entity that accumulates most of its income over a number of years will need to show that this accumulation is consistent with its purpose.
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> 170. Relevant factors to be considered include whether the entity has identified when and how its income is to be applied to its purpose and, if accumulation is to continue for an extended period, the reasons for this.[53]

Turning to accumulation for the general purposes of an entity, the final ruling indicates that accumulation is likely to be treated as consistent with an entity's purpose where it is for a specific reason (that falls within the entity's

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48 TR 2015/1, above n 2, 28–9 [162]–[163].

49 Ibid 7 [30], with the change from the draft ruling being the need to 'make use', rather than 'put to use'.

50 Ibid 28 [160].

51 In the context of the exercise of a power to retain, rather than accumulate, income, cf Charity Commission, UK Government, *Charities and Reserves*, Guidance CC19, 1 June 2010, 14 <https://www.gov.uk/government/publications/charities-and-reserves-cc19>; Charity Commission, UK Government, *Operational Guidance: Charity Income Reserves*, OG 43 P1, 15 May 2009 [1]–[3] <http://ogs.charitycommission.gov.uk/g043a001.aspx#tab2>, citing *A-G v Alford* (1855) 4 De G M & G 843, 852 (Cranworth LC) (charitable trust — no express finding that income and assets had to be distributed within a reasonable period of receipt, albeit a failure to communicate with the other persons jointly responsible for determining distribution recipients was described as misconduct); *Re Locker's Settlement* [1977] 1 WLR 1323, 1325–6 (Goulding J) (private discretionary trust to distribute between charities and private individuals). However, whether trustees are required to (a) consider whether to exercise a distribution power within a reasonable time of receiving income or (b) distribute that income within a reasonable time of receiving the income, depends on whether the relevant power is a mere power or a trust power: *Breadner v Granville-Grossman* [2001] Ch 523, 540–1 (Park J); Lynton Tucker et al, *Lewin on Trusts* (Thomson Reuters, 19th ed, 2015) 1339–40. Moreover, where the trustee is provided with a separate power to accumulate or retain income, this may result in any obligation to distribute income applying only to such amounts that the trustee has not determined to accumulate or retain: see, eg, *BRK (Bris) Pty Ltd v Federal Commissioner of Taxation* (2001) 46 ATR 347, 355–6 [32]–[36] (Cooper J) (power to accumulate income in a private discretionary trust).

52 TR 2015/1, above n 2, 7 [31].

53 Ibid 30 [169]–[170] (emphasis added) (citations omitted).

charitable purposes),[54] and where it is not too extensive in scope or time.[55] In fact, though it does not appear in the final ruling, the Commissioner's response to issues raised during consultation adopts the very language used by the Commissioner before the Administrative Appeals Tribunal in *TACT*: 'accumulation must occur for some specific and objectively justifiable good reason'.[56]

While the above approach would not preclude accumulation for the general purposes of a charity, it does raise some significant impediments. More problematic is Example 11 contained in the final ruling:

> 82. Q Ltd is a company limited by guarantee that meets the description of a registered charity in item 1.1 of the table in section 50-5.
>
> 83. Q Ltd's constitution states that its object is the relief of poverty in Australia. The constitution also contains a power enabling the company to retain profits.
>
> 84. Q Ltd operates second-hand clothing stores so that any profit generated can be paid to other charitable institutions to fulfil its object. After several years of operation the stores have made substantial profits but no funds have been transferred to any charitable institution. All profits have been retained.
>
> 85. Minutes of the most recent AGM indicate that profits are to be retained for expansion of the stores in 'the future'. There are no plans to transfer any funds to charitable institutions.
>
> 86. In these circumstances the accumulation of profits is not consistent with the entity applying its income and assets solely for the purpose for which it is established. For the year ended 30 June 2014, Q Ltd has breached paragraph 50-50(2)(b).[57]

It is not clear from the example precisely why the accumulation is inconsistent with Q Ltd's charitable purpose. After all, it appears the funds are intended to be invested so that the assets held for charitable purposes would not simply be reduced by inflation. Indeed, depending on the profitability of the proposed new stores, the value of the funds available for the charitable purposes might even increase in real terms over time. It seems to be implied by the fact that there are 'no plans to transfer any funds to charitable institutions' that the directors have improperly exercised their power to accumulate — perhaps by failing to take account of relevant matters. The general thrust of the example certainly appears to be that a decision to accumulate for a general reason that is not time limited, and that applies to an extensive portion of income, will readily be treated by the Commissioner as not amounting to an 'application' of the relevant income.

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54 Ibid 13–14 [79]–[80] (Example 10).

55 Ibid 14 [82]–[86] (Example 11), 30 [170].

56 TR 2015/1EC, above n 47, item 2.12; *TACT* (2008) 71 ATR 827, 839 [42] (Senior Member Taylor).

57 TR 2015/1, above n 2, 14 [82]–[86] (Example 11).

IV Interrogating the Conventional View

The Commissioner's interpretation[58] that the application-for-purposes test involves looking at whether accumulation is 'excessive' or for a 'general', rather than a specific and time-limited, purpose is open to question, as there have always been at least two interpretations of these words or their precursors. The first is that the trust funds must be administered by the trustees in accordance with the trust deed (including furthering the trust's charitable purposes) and the law.[59] That is, the funds must not be applied in breach of trust except, perhaps, in a minor way, or in a way not detrimental to the charitable purposes.[60] The second interpretation requires relatively direct or active use, which would not be satisfied by accumulation for the general purposes of a trust. The latter would justify the Commissioner's stance that accumulation must either be insubstantial, or else linked to a specific project and of finite duration, rendering it sufficiently directly linked to an outcome.[61]

This Part commences by detailing several conceptual difficulties with the conventional view of the application-for-purposes test and then follows with doctrinal analysis of the test.

A *Conceptual Difficulties*

As discussed in Parts I and IIA, the charity tax exemption rationales[62] suggest that there should be a balance between ensuring the production of public goods and the autonomy of charities. However, an application-for-purposes test based on notions of 'excessive' or overly 'general-purpose' accumulation essentially involves a government regulator substituting its decision about the appropriate level of accumulation for that of the charity. This gives rise to some inconsistency with the tax exemption rationales and it may be more consistent to address such intergenerational timing issues by leaving decision-making with the charity, but

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58 Even as expanded by TR 2015/1.

59 The High Court in *Bargwanna* appeared to treat maladministration as involving a failure to comply with or give effect to the trust deed or the general law of trusts: (2012) 244 CLR 655, 669–70 [43]–[44] (French CJ, Gummow, Hayne and Crennan JJ). Compare the slightly broader language used in *Mahony v Federal Commissioner of Taxation* (1967) 41 ALJR 232, 235 (Taylor J), 238 (Windeyer J) ('*Mahony*').

60 *Mahony* (1967) 41 ALJR 232, 235 (Taylor J), 238 (Windeyer J); *Compton v Commissioner of Taxation* (1966) 116 CLR 233, 239 (Taylor J) ('*Compton*'). *Compton* was affirmed on appeal to the Full Court on another ground. Cf Turnour and McGregor-Lowndes, above n 35, 76.

61 *Trustees, Executors and Agency Co Ltd v Acting Federal Commissioner of Taxation* (1917) 23 CLR 576, 586–7 (cf Isaacs J – the two examples provided by his Honour potentially support both characterisations), 588 (Gavan Duffy and Rich JJ: 'in point of fact applied to, used for, or expended on, such purposes') ('*Trustees, Executors*'); *Compton* (1966) 116 CLR 233, 239–40 (Taylor J).

62 In addition to the relevance of independence to the provision of public and quasi-public goods, theories on the role of charities (and broader civil society organisations) in facilitating political action and in facilitating self-determination emphasise characteristics such as independence and plurality (for a recent discussion see, eg, Jonathan Garton, *The Regulation of Organised Civil Society* (Hart Publishing, 2009) 70–83) and in relation to which accumulation may also provide benefits: see above nn 5–6 and accompanying text.

imposing process and integrity requirements by way of governance duties, or by generating public pressure through disclosure of accumulation levels.[63]

In addition, there are some real difficulties with the notions of 'excessive' or overly 'general-purpose' accumulation. While there might be some hope of distinguishing general from specific purposes,[64] the two concepts are likely to lie at either end of a continuum, which could cause characterisation problems for purposes falling between the extremes. More fundamentally, allocation to specific purposes does not *necessitate* any greater or more immediate use of funds, albeit the identification of a specific purpose may mean that the allocated funds are one step closer to being expended.[65]

Further, the ATO has not proposed any principled basis for determining what is 'excessive', with the only guidance provided being analogy to decided cases,[66] which themselves do not disclose any inherent principle. Other than at the extremes, there must be a real danger that 'excessiveness' will depend on the subjective perspective of the viewer, unless an underlying theoretical perspective, such as Rawls' 'just savings' rate,[67] is applied. Certainly, in the United States context, an initial federal tax law attempt to preclude 'unreasonable' accumulations of income by private charitable foundations was abandoned in 1969 in favour of a mandatory payout percentage.[68]

B *Australian Support for a 'Maladministration' Construction*

The maladministration interpretation of the application-for-purposes test is supported by obiter dicta of the High Court in *Bargwanna*.[69] The case concerned several breaches of trust relating to the administration of a charitable fund, with the issue being whether the breaches meant that the charitable fund had not been

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63 There are some gaps in the current Australian governance duties and disclosure obligations: see, eg, Ian Murray, 'Accumulation in Charitable Trusts: Australian Common Law Perpetuities Rules' (2015) 9(1) *Journal of Equity* 30, 34–5. However, examples exist in other jurisdictions. For instance, the mandatory list of matters to which directors must have regard under the *Companies Act 2006* (UK) c 46, s 172 could serve as a model for requiring regard to intergenerational justice. Further, most registered charities in England and Wales that prepare accruals-based accounts are required to include their level of reserves in the accounts: Charity Commission, *Charities and Reserves*, above n 51, 11.

64 For example, there is a body of cases on the distinction between a 'general' and a 'particular' charitable intent, as the distinction is relevant to whether cy-près principles are applicable to save a gift. The focus is on a donor's intent. See, eg, G E Dal Pont, *Law of Charity* (LexisNexis Butterworths, 2010) 405–18 [15.44]–[15.69]. Even in this alternative context, Dal Pont notes that the distinction is 'hardly exact or objective': at 406 [15.47].

65 On the basis that the charity controllers have identified what the funds will be used for.

66 See, eg, TR 2000/11, above n 29, 22 [102]; IT 340, above n 36, [2]–[6]. As to criticisms of this approach, see, eg, *TACT* (2008) 71 ATR 827, 839 [42] (Senior Member Taylor).

67 See above n 16.

68 Marion R Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation* (Harvard University Press, 2008) 264, 272–6.

69 See especially *Bargwanna* (2012) 244 CLR 655, 669–70 [43]–[44] (French CJ, Gummow, Hayne and Crennan JJ). Roots and Chen also appear to interpret the reasoning in *Bargwanna* in this way: Lachlan Roots and Lydia Chen, 'Charitable Trusts: Some Important Reminders' (2012) 23(4) *Journal of Banking and Finance Law and Practice* 302, 302. Cf Turnour and McGregor-Lowndes, above n 35, 76.

'applied for the purposes for which it was established'.[70] The key breaches of trust spanned a number of income years and constituted:

- mixing relatively significant amounts[71] of trust funds with non-trust funds, coupled with a failure to obtain interest on those trust funds.[72] An amount in compensation was apparently added to the trust fund in a later income year.[73]
- transferring an amount of $210 000, representing just under 50% of the trust funds at the relevant time, into a personal mortgage offset account of the trustees so as to reduce the interest payable by the trustees on their personal home loan.[74] The principal amount was subsequently largely refunded to the trust, along with an amount in respect of interest foregone.[75]

The High Court found that the breaches resulted in the trust being ineligible for endorsement in the relevant income years.

When the proceedings were initially before the Administrative Appeals Tribunal, the Commissioner of Taxation had asserted that accumulation of income by the trustees, rather than direct expenditure, was another ground for finding that the trust had not been applied in the requisite manner. The Commissioner abandoned the accumulation issue by the time the case reached the High Court,[76] but the Court still commented on it. The comments indicate that the former s 50-60 version of the application-for-purposes test was concerned with maladministration, rather than investment versus expenditure. There are two key ways in which the comments demonstrate this.

First, the joint judgment stated that the term 'applied' 'is used in the sense of so administered as to give effect to the trusts established by the relevant instrument'[77] and noted that:

> The relevant provisions of the Act direct attention to the terms of the instrument of trust by which a fund is established in Australia for public charitable purposes. It would appear that too little attention to the terms of the Deed was paid in submissions to the AAT, and to Edmonds J and then to the Full Court. It is by reference to those terms and to the general provisions of the law of trusts that it will be determined whether in a period under consideration by the Commissioner the fund the subject to the charitable trusts of the deed has been duly administered.[78]

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70 *Bargwanna* (2012) 244 CLR 655, 660 [4] (French CJ, Gummow, Hayne and Crennan JJ).

71 Minor amounts in the income years ending in 2002 to 2005. Thereafter, 10%, 20% and 25% respectively of the trust's total funds: *Bargwanna v Federal Commissioner of Taxation* (2010) 191 FCR 184, 196 [35].

72 *Bargwanna* (2012) 244 CLR 655, 661–2 [10], 670 [45] (French CJ, Gummow, Hayne and Crennan JJ).

73 *Federal Commissioner of Taxation v Bargwanna* (2009) 72 ATR 963, 973 [33] (Edmonds J).

74 *Bargwanna* (2012) 244 CLR 655, 661–2 [10], 670 [45] (French CJ, Gummow, Hayne and Crennan JJ).

75 Ibid 663–4 [18] (French CJ, Gummow, Hayne and Crennan JJ).

76 Ibid 666 [30] (French CJ, Gummow, Hayne and Crennan JJ).

77 Ibid 669–70 [44] (French CJ, Gummow, Hayne and Crennan JJ).

78 Ibid 669 [43] (French CJ, Gummow, Hayne and Crennan JJ).

In other words, determining maladministration is the starting point to determining whether funds held under a charitable trust have been appropriately applied. Indeed, the judgment referred favourably to Windeyer J's statement, some 45 years earlier, in relation to a similar 'application' requirement for superannuation funds, which focused on maladministration:

> The statutory requirement that the fund 'is being applied' for the purposes for which it was established was the subject of some discussion during the course of the argument. It does not cause me any great difficulty in this case. If a fund answering the statutory description was not being administered according to the trusts thereof, the statutory requirement of due application would not be met.[79]

Second, the joint judgment clearly acknowledged that the accumulation of income, at least in the sense of administrative retention, can amount to an 'application' of that income. It referred to an example of accumulation discussed in *Trustees, Executors*[80] as meeting a precursor exemption requirement.[81] The example involved accumulation of 100% of trust income over four years for the specific purpose of purchasing, with the accumulated sum, radium to be used for health purposes. The endorsement of this example suggests that, of itself, a decision to accumulate income should not breach the special condition, since it has the potential to amount to the requisite 'application', albeit the bounds of acceptable accumulation are left unstated.

What of the bounds? While the joint judgment in *Bargwanna* referred to wills and trusts cases on the effect of a term requiring 'application' of money to a particular purpose specified in the will or trust as mandating that 'the moneys be devoted to or employed for that special purpose', their Honours did not equate 'devotion' or 'employment' with direct expenditure.[82] Nor would the example referred to above require immediate expenditure. Indeed, the judgment emphasised that it is the charitable fund, not just the income, that must be 'applied' and that the pursuit of a charitable purpose would not typically involve the 'expenditure or consumption of corpus'.[83] This is a clear acknowledgment that the property of a charitable trust can be 'applied' to furthering its charitable purposes without ever expending, at a minimum, the initial trust capital. This, in turn, suggests that indirect use of trust funds can also amount to an 'application'.

Again, if funds can be applied when employed in a deferred and/or indirect way, what are the limits? It is submitted that the joint judgment already provides the answer with its statement that 'applied' means 'so administered as to give effect to the trusts established by the relevant instrument'.[84] That is, has the

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79 Ibid 667 [33] (French CJ, Gummow, Hayne and Crennan JJ), quoting *Mahony* (1967) 41 ALJR 232, 238 (Windeyer J). See also the reference at 667 [34] to a similar sentiment in *Compton* (1966) 116 CLR 233, 246–7 (Kitto J).

80 (1917) 23 CLR 576, 586–7 (Isaacs J).

81 *Bargwanna* (2012) 244 CLR 655, 666–7 [31] (French CJ, Gummow, Hayne and Crennan JJ).

82 Ibid 666 [28] (French CJ, Gummow, Hayne and Crennan JJ), citing *Williams v Papworth* [1900] AC 563, 567; *Davies v Perpetual Trustees Executors and Agency Co of Tasmania Ltd* (1935) 52 CLR 604, 608.

83 *Bargwanna* (2012) 244 CLR 655, 666 [30]–[31] (French CJ, Gummow, Hayne and Crennan JJ).

84 Ibid 669–70 [44] (French CJ, Gummow, Hayne and Crennan JJ).

decision to accumulate been made in accordance with the trust deed (including the trust deed's object of pursuing the trust's charitable purposes) and the law? As noted by Turnour and McGregor-Lowndes, the High Court's sanctioning of the *Trustees, Executors* example, and its reference to Isaacs J's notion of 'elasticity' in the phrase 'fund is being applied', suggests that charity trustees have some flexibility in determining how to administer their trusts.[85] This seems a fairly uncontroversial explanation of the effect of a charity trustee's duties in exercising their powers. Trustees have a circumscribed discretion in exercising a power. For instance, they must exercise a power in accordance with the purposes for which it was given; take account of relevant considerations, but not irrelevant ones; act in good faith and in the 'best interests' of the trust; and not act 'irrationally or capriciously'.[86]

Nevertheless, Turnour and McGregor-Lowndes appear to retain some reservations about accumulation of income and assets. The authors have stated that the *Bargwanna* reasoning would mean that charity trustees cannot 'accumulate surpluses (perhaps to apply them to business, rather than charitable purposes) without regard to the obligation to apply charitable assets to charitable purposes'.[87] What does it mean to apply assets or income to a business, rather than a charitable, purpose? If business and charity are intended to be a dichotomy, *Word Investments* has already demonstrated it to be a phoney one.[88]

Based on *Word Investments*, there is no automatic reason why the carrying on of a business, or investment activities, cannot be the pursuit of charitable purposes. Indeed, Turnour and McGregor-Lowndes have previously noted that commercial activities do not prevent an entity having a charitable purpose.[89] After all, in *Word Investments* the majority noted that in examining the relevance of activities, the focus must be on whether they 'are carried on in furtherance of a charitable purpose', rather than being 'intrinsically charitable'.[90] Activities of accepting deposits from the public to be invested at market rates with nil or nominal interest paid in return, operating a funeral business, and distributing surpluses to other entities to support evangelical religious activities, were held indirectly to achieve a purpose of the advancement of religion.[91] Perhaps, ultimately, Turnour and McGregor-Lowndes' discussion of *Bargwanna* is merely intended to highlight the fact that a charity trustee cannot misapply charity assets

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85 Turnour and McGregor-Lowndes, above n 35, 76; ibid 666–7 [31] (French CJ, Gummow, Hayne and Crennan JJ).

86 See, eg, Thomson Reuters, *Ford and Lee: The Law of Trusts* (at 20 February 2014) [12.14510], [12.14610], [12.14630], citing *Karger v Paul* [1984] VR 161, 163–4 (McGarvie J); Thomas, above n 26, ch 9, 474–5.

87 Turnour and McGregor-Lowndes, above n 35, 76.

88 (2008) 236 CLR 204, 219 [24] (Gummow, Hayne, Heydon and Crennan JJ).

89 McGregor-Lowndes, Turnour and Turnour, above n 21, 602.

90 *Word Investments* (2008) 236 CLR 204, 221 [26] (Gummow, Hayne, Heydon and Crennan JJ). As to the difficulties in determining the nature of an activity (and its import) separately from the motivation or purpose behind it, see also Ian Murray, 'Charitable Fundraising Through Commercial Activities: The Final Word or a Pyrrhic Victory?' (2008) 11(2) *Journal of Australian Taxation* 138, 159–62; Maurice C Cullity, 'The Myth of Charitable Activities' (1990) 10(1) *Estates & Trusts Journal* 7, 7; Dal Pont, above n 64, 322.

91 *Word Investments* (2008) 236 CLR 204, 225–6 [37]–[38] (Gummow, Hayne, Heydon and Crennan JJ).

by applying them to a non-charitable purpose. This interpretation is consistent with the maladministration construction set out above.

In *Word Investments*, when considering the impact on an entity's charitable status of its activities, the High Court referred to case law[92] on whether income has been 'applied for charitable purposes' to make the point that activities can indirectly achieve a charitable purpose. The Court stated:

> One submission advanced by Mr Andrew Park QC for the successful taxpayer in that case [*IRC v Helen Slater Charitable Trust* [1982] Ch 49] may be noted:
>
> > 'The Crown's wide submission that money subject to charitable trusts is not 'applied for charitable purposes' unless actually expended in the field, is revolutionary, unworkable and unacceptable in practice. There are innumerable charities, both large and small, in this country which operate on the basis of raising funds and choosing other suitable charitable bodies to donate those funds to … If the Crown's wide argument is correct, many charitable bodies would be losing a recognised entitlement to tax relief and may, moreover, cease to be regarded as charitable.'[93]
>
> It is likely that the position in Australia is similar.

In doing so, the High Court majority did not address Jessup J's suggestion in the Full Federal Court that a charitable institution's commercial activities must be 'in harmony' with its stated charitable purpose.[94] Indeed, the majority did not propose any nexus test requiring some sort of 'commonality' between activities and objects.[95] Their Honours did, however, refer to what this author considers to be a limit on the scope of activities (or purposes) that might be considered in furtherance of an overarching charitable purpose:

> the charitable purposes of a company can be found in a purpose of bringing about the natural and probable consequence of its immediate and expressed purposes, and its charitable activities can be found in the natural and probable consequence of its immediate activities.[96]

Dal Pont has referred to this reference as 'somewhat Delphic'.[97] However, it is suggested that the reference can be imbued with meaning by treating it as setting the bounds for activities that promote the charitable purpose, as opposed to evidencing a separate non-charitable purpose, since that was the issue to which the comments related.[98] Further, it is submitted that the reference might also provide guidance about the range of permissible activities that a trustee could pursue without being in breach of trust. That is, guidance on the scope of the trustee's powers.

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92 *Inland Revenue Commissioners v Helen Slater Charitable Trust Ltd* [1982] Ch 49 ('*IRC v Helen Slater Charitable Trust*').

93 *Word Investments* (2008) 236 CLR 204, 225–6 [37] (Gummow, Hayne, Heydon and Crennan JJ).

94 *Federal Commissioner of Taxation v Word Investments Ltd* (2007) 164 FCR 194, 221 [97] (Jessup J).

95 See, eg, Ian Murray, 'Charity Means Business — *Commissioner of Taxation v Word Investments Ltd*' (2009) 31(2) *Sydney Law Review* 309, 318; Dal Pont, above n 64, 62–3 [3.26].

96 *Word Investments* (2008) 236 CLR 204, 226 [38] (Gummow, Hayne, Heydon and Crennan JJ).

97 Dal Pont, above n 64, 63 [3.26].

98 As to the relevance of accumulation provisions to the existence of a separate non-charitable purpose, see, eg, Murray, 'Australian Common Law Perpetuities Rules', above n 63, 38–9.

Accordingly, if trustees act within the bounds of their powers, as described above, it should be possible to characterise a decision to retain assets or accumulate income to invest in a business or in passive investments as being in furtherance of charitable purposes and an application of the relevant assets or income. Turnour and McGregor-Lowndes refer to *Bargwanna* as precluding accumulation 'in a manner inconsistent with the charitable purpose', but this arguably only has meaning if viewed through the lens of the trust law constraints on the exercise of trustee powers, or alternatively from the perspective, where relevant, of determining whether the trust or entity has a charitable purpose.

Moreover, if one substituted a direction to accumulate for an accumulation power in the trust deed, the Commissioner's interpretation of the requirement appears very difficult to maintain. After all, complying with a valid trust deed requirement must surely amount to 'administer[ing the trust so] as to give effect to the trusts established by the relevant instrument' in the words of the majority judgment in *Bargwanna*.

C *United Kingdom Precedent*

The maladministration interpretation also appears consistent with commentary and cases in the United Kingdom ('UK'). The UK tax legislation contains no blanket income tax exemption for charities. Instead, specific categories of income and gains are rendered exempt, with the exemptions applying to most types of income and gains.[99] Other than minor exceptions,[100] and some minor changes in wording, each of the exemptions only applies to income or gains so far as the income or gain is 'applied to charitable purposes only' or 'applied for charitable purposes'.[101]

In the UK there is a second set of conditions that is also relevant to charities. These are the 'charitable expenditure rules', which, in broad terms, reduce the income tax exemptions to the extent that a charity has a 'non-exempt amount' for a tax year.[102] The aim is to address the fact that, unlike the Australian provisions, the UK primary exemption provisions focus only on a charity's income or gains, not misapplication of its other assets.[103] To have a 'non-exempt amount' a charity must have, among other things, 'non-charitable expenditure' for the relevant tax year.[104] The definition of this phrase includes a range of listed items.[105]

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99 See generally, HM Revenue & Customs, UK Government, *Charities: Detailed Guidance Notes*, Annex i: Tax Exemptions for Charities, 6 November 2015 <https://www.gov.uk/government/publications/charities-detailed-guidance-notes/annex-i-tax-exemptions-for-charities>.

100 For a discussion of the minor exceptions, see, eg, James Kessler and Oliver Marre, *Taxation of Charities and Non-profit Organisations* (Key Haven Publications, 9th ed, 2013) 114–15.

101 *Corporation Tax Act 2010* (UK) c 4, pt 11 chs 2–3; *Income Tax Act 2007* (UK) c 3, pt 10; *Taxation of Chargeable Gains Act 1992* (UK) c 12, s 256(1).

102 *Corporation Tax Act 2010* (UK) c 4, s 492; *Income Tax Act 2007* (UK) c 3, s 539; *Taxation of Chargeable Gains Act 1992* (UK) c 12, ss 256(3), (3A).

103 See, eg, Kessler and Marre, above n 100, 155.

104 *Corporation Tax Act 2010* (UK) c 4, s 493; *Income Tax Act 2007* (UK) c 3, s 540; *Taxation of Chargeable Gains Act 1992* (UK) c 12, ss 256(3), (3A).

105 *Corporation Tax Act 2010* (UK) c 4, s 496; *Income Tax Act 2007* (UK) c 3, s 543.

Most would not be relevant to accumulation of income or retention of assets.[106] However, two categories are relevant: amounts 'invested' in an 'investment which is not an approved charitable investment'; and 'expenditure' that is 'not incurred for charitable purposes only' — as a potential sweep-up of accumulated income or retained assets not deemed to be 'invested'.[107] It is unnecessary for the purposes of this paper to define 'investment'[108] or 'expenditure', but simply to note two things. First, the approved investment rules merely require investment in certain classes of investment assets, such as certain *Trustee Investment Act 1961*[109] investments, or shares or securities issued by a company that are listed on a recognised stock exchange.[110] Clearly, this would not necessarily preclude retention of assets or accumulation.[111] Second, even if retention or accumulation involves 'expenditure', whether an amount has been 'incurred for charitable purposes only' is likely to turn on the same issue of compliance with the charity rules as the question of 'applied to charitable purposes only'.[112]

Unsurprisingly, the UK provisions have been described as constituting 'a legislative background, similar to *ITAA97* s 50-60'.[113] Yet, the cases and commentary on these provisions and their precursors, and even Her Majesty's Revenue & Customs ('HMRC'), clearly accept that a decision to reinvest and accumulate income or gains can amount to the income or gains being applied to or for charitable purposes.[114]

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106 In particular, the categories of non-charitable expenditure include trading losses of a non-primary purpose trade or property business, transaction losses from transactions entered into other than in the course of carrying out a charitable purpose, substantial donor payments or transactions and certain non-commercial loans.

107 *Corporation Tax Act 2010* (UK) c 4, ss 496(1)(d), (g); *Income Tax Act 2007* (UK) c 3, ss 543(1)(f), (i).

108 In any event, an 'investment' is likely to be characterised by reference to its ordinary commercial meaning as 'property held by trustees for the purpose of generating money, whether from income or capital growth, with which to further the work of the [charity]': *Harries v Church Commissioners* [1992] 1 WLR 1241, 1246 (Sir Donald Nicholls V-C). See also Charity Commission, UK Government, *Charities and Investment Matters: A Guide for Trustees*, CC14, 1 October 2011, 2. In some circumstances, broader definitions have also been adopted, countenancing a wider range of returns, potentially including expenditure on assets that provide some financial return and that assist in achieving a charity's purposes: *Culverden Retirement Village v Registrar of Companies* [1997] 1 NZLR 257, 261–2.

109 9 & 10 Eliz 2, c 62.

110 *Income Tax Act 2007* (UK) c 3, s 558; *Corporation Tax Act 2010* (UK) c 4, s 511.

111 The 'Type 12' general category of investments requires that the investment be one that 'is made for the benefit of the [charity] and not for the avoidance of tax': *Income Tax Act 2007* (UK) c 3, s 558; *Corporation Tax Act 2010* (UK) c 4, s 511. If made in pursuit of charitable purposes by way of administering a charity in accordance with its rules, it is difficult to see how the investment would not be 'for the benefit of' the charity, such that this requirement would not appear to require anything different to the applied to charitable purposes test.

112 See, eg, Con Alexander et al, *Charity Governance* (Jordan Publishing, 2nd ed, 2014) 273. It is also implicit in the HMRC guidance, which uses the two tests interchangeably in some circumstances. See especially, HM Revenue & Customs, UK Government, *Charities: Detailed Guidance Notes*, Annex ii: Non-charitable Expenditure, 6 November 2015, [1]–[2], [8] <https://www.gov.uk/government/publications>.

113 *TACT* (2008) 71 ATR 827, 840–1 [45] (Senior Member Taylor) (referring to the precursor UK provisions).

114 *IRC v Helen Slater Charitable Trust* [1982] Ch 49, 55 (Oliver LJ, Fox and Waller LJJ agreeing) (*Income and Corporation Taxes Act 1970* (UK) c 10, ss 360(1), (2)); HM Revenue & Customs, 'Non-charitable Expenditure', above n 112, [8]; *General Nursing Council for Scotland v Commissioners of Inland Revenue* (1929) SC 664, 671 (Lord Sands), 673–4 (cf Lord Blackburn, who

For instance, *IRC v Helen Slater Charitable Trust*[115] involved two charities created by a husband and wife and controlled by common directors. Over a three-year period, the first charity distributed all or nearly all of its income to the second charity each year — with the second charity accumulating nearly all of these amounts as part of its general funds. The ground for the English Court of Appeal's decision related to whether the payment to the second charity constituted an 'application'.[116] Their Lordships nonetheless commented on the issue of accumulation, as the Crown had argued that to be applied, funds must be 'actually expended … "in the field"; that is to say, on the expenses of managing the charity and distributions for the attainment of particular charitable objects'.[117] As noted by Oliver LJ:

> Manifestly the legislature, in enacting them in the form in which they are, intended to impose some additional qualification for the exemption of income beyond that of merely being applicable for charitable purposes. On the narrow view of the matter that additional qualification could be no more than this, that the income be not actually applied for non-charitable purposes, as, for instance, occurred in *Inland Revenue Commissioners v Educational Grants Association Ltd* [1967] Ch 993: but I agree with Slade J that it imports more than that—some affirmative requirement that the income should have been dealt with in some way or other. Speaking for myself I am, however, disposed to favour the view expressed by Lord Sands in *General Nursing Council for Scotland v Inland Revenue Commissioners* (1929) SC 664, 671, that the limitation is of small application. Charitable trustees who simply leave surplus income uninvested cannot, I think, be said to have 'applied' it at all and, indeed, would be in breach of trust. But if the income is reinvested by them and held, as invested, as part of the funds of the charity, I would be disposed to say that it is no less being applied for charitable purposes than it is if it is paid out in wages to the secretary. I share Slade J's difficulty in seeing why an accumulation for a specific charitable purpose resolved on by the trustees as being a desirable way of carrying out their charitable objects should be, as it is conceded it is, an 'application', whereas an accumulation for the general purposes of the charity is not.[118]

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expressed the view that retained income must be 'appropriated to expenditure on charity in the immediate future': *Income Tax Act 1918*, 8 & 9 Geo 5, c 40, s 37(1)(b)). The General Nursing Council accumulated and invested surplus income from its operations, with the issue being whether the investment income subsequently received and reinvested was 'applied' to charitable purposes and so exempt. Reasoning on the meaning of 'applied' was not necessary to the decision as the Council was found not to be a charity. *Contra Inland Revenue Commissioners v Educational Grants Association Ltd* [1967] Ch 123, 139 (Pennycuick J). Justice Pennycuick, in obiter dicta, seems to contemplate two breaches of the applied to purposes requirement, accumulation of income and maladministration: 'so long as the income is expended at all (in contradistinction to being accumulated), the [application to purposes] requirement must equally be satisfied if the application is within the powers of the corporation'. The case did not concern accumulation. See also Jean Warburton, Debra Morris and N F Riddle, *Tudor on Charities* (Sweet & Maxwell, 9th ed, 2003) 306.

115 [1982] Ch 49.

116 The tax provisions were subsequently amended to restrict incentives to pass income on to another charity in this fashion, by rendering the payment taxable in the hands of the recipient charity unless certain exemptions applied: Warburton, Morris and Riddle, above n 114, 308.

117 *IRC v Helen Slater Charitable Trust* [1982] 1 Ch 49, 55 (Oliver LJ, Fox and Waller LJJ agreeing).

118 Ibid 59 (Oliver LJ, Fox and Waller LJJ agreeing).

Subsequent decisions such as *Sheppard v Inland Revenue Commissioners (No 2)*[119] have followed this approach. In addition, a number of commentators have stated that the UK applied-for-charitable-purposes test is focused on a class of failures to comply with the charity's rules.[120] Kessler and Marre have explicitly stated that income that has been accumulated (including by way of building up reserves) in accordance with the charity's rules and the law is 'applied for charitable purposes'.[121] Of course, this is different to a situation where the charity simply does not deal with the income at all, say, by leaving it uninvested. Such activity would likely breach various duties, such as the duty to consider whether to exercise a power, duties relating to the exercise of a power to retain income (for example, for a proper purpose and in the best interests of the charity) and, potentially, prudent person duties relating to the investment of funds.[122]

> This appears to be the approach adopted to accumulation by the HMRC:
>
> HMRC will challenge accumulations of income on the grounds that the income hasn't been applied to charitable purposes, for example if:
>
> - income isn't invested at all but kept in cash or in a current account
> - it becomes apparent that investment decisions aren't made exclusively for the benefit of the charity, for example, where accumulated income is being invested in a project in which there's a potential conflict between the interest of the charity and the interest of the trustee or provider of the charity funds.[123]

D *Does the Additional Compliance-with-Rules Condition Affect the Interpretation of the Application-for-Purposes Rule?*

Looking to the immediate context, one question may be whether the second special condition focused on compliance with governing rules should affect the interpretation of the application-for-purposes condition. That is, might the compliance-with-rules condition be focused on maladministration, with the application-for-purposes condition centred on something else, such as a test of 'consistency' with charitable purpose or of degree of closeness to effectuation of the charitable purpose? It is submitted that the context does not require this interpretation as it is entirely possible to view both the compliance-with-rules and application-for-purposes conditions as concerned with maladministration, but with different types of maladministration. The first concerns maladministration

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[119] (1993) 65 TC 724, 731–2 (Commissioner Widdows) (dividend of £140 000 treated as wholly applied for charitable purposes by the trustees of a charitable trust where £134 000 was loaned shortly after receipt of the dividend by way of two investments for the relevant tax period). This finding was not the subject of appeal.

[120] Kessler and Marre, above n 100, 120–1; Alexander et al, above n 112, 271–2.

[121] Kessler and Marre, above n 100, 126–7.

[122] As to trustee duties, see generally, Thomson Reuters, *Ford and Lee: The Law of Trusts* (at 12 August 2015) [9.010]–[9.22010]. The prudent person investment duties apply to the trustees of a charitable trust and may apply in a broadly similar way to incorporated charities either through the application of analogous duties, or through the duty of care, skill and diligence owed by controllers.

[123] HM Revenue & Customs, 'Non-charitable Expenditure', above n 112, [8].

involving a breach of a rule considered substantive[124] in its own right, regardless of the effect of the breach. An example is the requirement to prepare and retain audited financial statements.[125] Financial statement rules are important because they ensure the existence of information that can help determine whether an entity is being administered in accordance with its charitable nature, although breach does not necessarily mean that income and assets are being applied for something other than the entity's purpose.

The application-for-purposes requirement can be characterised as concerned with a different class of breaches: breaches of trust that are detrimental to achieving the trust's charitable purposes. Failure to prepare and retain audited financial statements would not, of itself, fall within this class of breaches. In contrast, breach of a procedural rule relating to the level of remuneration of an employee or agent might not amount to breach of a substantive requirement, but would amount to maladministration that would reduce the funds available to pursue the charity's purposes.

Further, treating the special conditions as each concerned with separate classes of maladministration better accords with the interpretation of s 50-60 in *Bargwanna*. The newly introduced application-for-purposes requirement mirrors the wording of former s 50-60 and was intended to encapsulate the interpretation of s 50-60 adopted in *Bargwanna*.[126] This renders relevant the understanding of the text of s 50-60 set out above.[127] In this regard, it may also be pertinent that *Bargwanna* was a case clearly decided on the basis of several instances of maladministration by the trustees that could not be justified as being 'referable' to achieving the trust's charitable purposes.[128]

E *Charitable Institutions*

Much of the above reasoning relates to charitable funds. Should the same approach apply to charitable institutions, now that the same special condition applies to all registered charities? Previously, separate special conditions existed for charitable funds and charitable institutions, rather than one rule for all charities.[129] The distinction between charitable funds and institutions was a simplistic one,

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[124] There is likely to be some debate over the meaning of 'substantive' in this context. The Commissioner of Taxation defines the 'substantive' requirements of an entity's governing rules as those that 'define the rights and duties of the entity': TR 2015/1, above n 2, 4 [18].

[125] Ibid 9 [43]–[45] (Example 2).

[126] Explanatory Memorandum, Tax Laws Amendment (2013 Measures No 2) Bill 2013 (Cth) 225 [11.64].

[127] As to the relevance of precursor statutory provisions and parliamentary approval of previous judicial construction to legislative interpretation, see, eg, D C Pearce and R S Geddes, *Statutory Interpretation in Australia* (LexisNexis Butterworths, 8th ed, 2014) 121–2 [3.31], 136–44 [3.43]–[3.49]. In addition, given that the plurality in *Bargwanna* rejected a 'substantially applied' interpretation of s 50-60, the addition of the reference to 'solely' applied in the new provision should not make a difference.

[128] *Bargwanna* (2012) 244 CLR 655, 661–2 [10], 670 [45] (French CJ, Gummow, Hayne and Crennan JJ).

[129] The classes of charitable funds and charitable institutions were merged for income tax exemption purposes by the *Australian Charities and Not-for-profits Commission (Consequential and Transitional) Act 2012* (Cth) (the special condition reforms were introduced by later legislation).

essentially being between 'funders' and 'doers'. The key question about whether a charity was an institution, rather than simply a pool of assets, was whether it could be described as '"an undertaking formed to promote some defined purpose …" or "the body (so to speak) called into existence to translate the purpose as conceived in the mind of the founders into a living and active principle"'.[130]

The s 50-60 condition, discussed above, applied to most charitable funds.[131] The special conditions for charitable institutions did not previously include a similar requirement. As apparently accepted by the High Court in *Word Investments*, the reason for this difference was that a charitable institution's status as a charity needed to be tested from time to time by reference to a range of matters, including its constituent documents and ongoing activities.[132] In contrast, a charitable fund's status as a charity was typically tested by reference to the terms of the trust,[133] so that a trustee might be acting in breach of the trust terms and hence 'not applying the assets to the relevant trust or fund purposes', but this would not prevent the trust from continuing to be for charitable purposes.[134] Although the implications are not explored in the joint judgment, this reasoning is supportive of the maladministration interpretation of s 50-60 discussed above.

The Explanatory Memorandum to the amending Bill acknowledged that an entity's activities can be relevant to a determination of its purpose,[135] which aligns with the approach adopted in the case law to determine whether an entity continues to be a 'charitable institution'.[136] However, as noted by this author previously, other than helping to determine the relative weight of an entity's stated objects, or its purpose where it does not have a written constitution, the practical effect of examining an entity's activities may be relatively limited.[137] Accordingly, there is

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130 *Stratton v Simpson* (1970) 125 CLR 138, 158 (Gibbs J, Barwick CJ and Menzies J agreeing), quoting Lord Macnaghten in *Mayor of Manchester v McAdam (Surveyor of Taxes)* [1896] AC 500, 511; cf 145–6 (Windeyer J), 154 (Walsh J).

131 Testamentary charitable trusts established before 1 July 1997 were subject to separate special conditions under former s 50-57 of the *ITAA97*, a provision which was not as demanding as s 50-60, but which still required that the relevant 'fund is applied for the purpose for which it was established'.

132 *Word Investments* (2008) 236 CLR 204, 236–7 [70] (Gummow, Hayne, Heydon and Crennan JJ).

133 Ibid. It is not true that activities are always ignored in characterising a charitable trust. For circumstances in which activities may be relevant, see, eg, Murray, 'Charitable Fundraising' above n 90, 157; Jonathan Garton, 'Charitable Purposes and Activities' (2014) 67(1) *Current Legal Problems* 373, 389–97 (trusts and companies).

134 *Word Investments* (2008) 236 CLR 204, 236–7 [70] (Gummow, Hayne, Heydon and Crennan JJ). See also *Bargwanna* (2012) 244 CLR 655, 668 [36] (French CJ, Gummow, Hayne and Crennan JJ).

135 Explanatory Memorandum, Tax Laws Amendment (2013 Measures No 2) Bill 2013 (Cth) 224 [11.58].

136 *Word Investments* (2008) 236 CLR 204, 236–7 [70] (Gummow, Hayne, Heydon and Crennan JJ); *Bargwanna* (2012) 244 CLR 655, 668 [36] (French CJ, Gummow, Hayne and Crennan JJ). See also *Royal Australasian College of Surgeons v Federal Commissioner of Taxation* (1943) 68 CLR 436, 444 (Latham CJ), 446 (Rich J), 448 (Starke J), 450–1 (McTiernan J), 452 (Williams J) (the case focused on whether the College was a scientific institution rather than a charitable institution); *Inland Revenue Commissioners v City of Glasgow Police Athletic Association* [1953] AC 380, 396 (Lord Normand), 399 (Lord Morton), cf 398 (Lord Oaksey); *Tasmanian Electronic Commerce Centre Pty Ltd v Federal Commissioner of Taxation* (2005) 142 FCR 371, 385 (Heerey J).

137 Murray, 'Charitable Fundraising', above n 90, 156–62. For a discussion of the breadth of circumstances in which activities may be relevant to determining purpose or charitable status, see, eg, Robert Meakin, *The Law of Charitable Status: Maintenance and Removal* (Cambridge

likely to be a range of activities that do not assist in furthering an entity's purposes, but that do not preclude the entity from being a charity. For instance, applying a portion of an entity's assets towards private benefits for the controllers, in breach of the entity's constitution,[138] or, possibly, excessive entertainment expenditure.[139] As acknowledged in the Explanatory Memorandum, the current special condition aims to address this gap,[140] although it is not intended to apply to 'minor procedural irregularities'.[141]

The Commissioner of Taxation's past practice was to use charitable status as the basis for questioning accumulation by charitable institutions, given the absence of a special condition focused on application of assets and income. That approach was based on treating accumulation as an activity that shed light on the purpose of the relevant entity,[142] with 'excessive' or 'indefinite' accumulation raising risks for charitable status.[143] However, as discussed above, relying on activities in this way leaves significant gaps. Indeed, in *Word Investments*, the joint judgment expressly accepted that a general power, in an institution's constitution, to retain profits (permitting accumulation in the broader sense) would not prevent that institution from being charitable.[144] Their Honours noted that '[i]ts 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'.[145]

Accordingly, it seems likely that the special condition that now applies to charitable institutions results in a stricter test. The focus shifts from whether an entity continues to be charitable to whether income and assets have been applied solely for the entity's charitable purpose. As discussed for charitable funds, it is submitted that this should be construed as requiring that the entity's income and assets be dealt with in accordance with the entity's constituent or governing rules, as derived from its constitution and other applicable sources, such as the *Corporations Act 2001* (Cth) or state and territory associations incorporation legislation.[146] As all charitable institutions must, like charitable funds, have a charitable purpose, it

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University Press, 2008) 27–32; Garton, above n 133, 389–97. For instance, in addition to the circumstances listed in the body of this article, activities may also be relevant: where the wording of an entity's objects is ambiguous; in order to determine whether the entity's purpose is charitable in the case of a purpose that has not previously been determined to be charitable; in order to determine whether objects are for public or private benefit; or in order to determine if the entity is a sham charity.

138 See, eg, TR 2015/1, above n 2, 11–12 [63]–[66] (Example 7).

139 See, eg, *Cancer and Bowel Research Association Inc as trustee for Cancer and Bowel Research Trust and Commissioner of Taxation* [2013] AATA 336 (24 May 2013) [98] (Jarvis DP) (the entertainment expenditure was not considered sufficient to transform the Research Association from a charitable to a non-charitable institution).

140 Explanatory Memorandum, Tax Laws Amendment (2013 Measures No 2) Bill 2013 (Cth) 224–5 [11.59]–[11.62]. The Explanatory Memorandum indicates that both the compliance-with-rules and application-for-purposes conditions are intended to address this mischief.

141 Ibid 224 [11.61]. The examples provided are of failing to meet a lodgement deadline or lack of quorum at a meeting.

142 TR 2011/4, above n 36, 11 [39]–[40].

143 Ibid 52 [222].

144 *Word Investments* (2008) 236 CLR 204, 219 [21]–[22] (Gummow, Hayne, Heydon and Crennan JJ).

145 Ibid 219 [22] (Gummow, Hayne, Heydon and Crennan JJ).

146 For a discussion of 'governing rules', see, eg, TR 2015/1, above n 2, 3–4 [9]–[16]. Note also that a charitable trust may be a charitable institution.

should be equally possible to identify breaches that are not detrimental to the charitable purposes. There seems no good reason to adopt a different approach for charitable institutions. After all, the fact that activities may be relevant to showing a change in purpose over time for charitable institutions but not charitable funds, as discussed above, is a separate matter to whether assets and income are being applied toward those current purposes. Indeed, that was the 'mischief' to be addressed by broadening the application-for-purposes requirement to charitable institutions.[147] Further, as the application-for-purposes special condition is now expressed as a single condition applying to all charitable funds and charitable institutions (as charities), textual considerations likewise suggest that the requirement is the same for both charitable funds and charitable institutions.

F *Conclusion on the Construction of the Application-for-Purposes Test*

It seems likely that the Commissioner of Taxation will interpret the new endorsement wording as constraining accumulations of income in a broadly similar fashion to the way that the Commissioner applied the former s 50-60 of the *ITAA97* to charitable funds. The difference, of course, is that the new application-for-purposes test applies to charitable institutions as well as charitable funds, thus broadening the range of affected charities. This approach would likely restrict accumulation for the general purposes of a charity and accumulation of substantial portions of income and assets.

Nevertheless, as examined above, Australian and UK precedent suggests that the application-for-purposes test is focused on maladministration that affects whether funds are used to promote a charity's purpose. Of course, 'excessive' or general purpose accumulation might amount to maladministration where it involves an exercise of power by trustees or controllers in a way that breaches their duties. However, the starting point is to identify a breach of duty, not to identify 'excessive' or 'general purpose' accumulation. The central role of governance duties and the potentially narrower scope of the maladministration interpretation raise a number of research questions, as discussed in the conclusion below.

Finally, even if a maladministration interpretation reflects the better view of the endorsement conditions, as noted in Part I, what are charity controllers and auditors to do if the Commissioner adopts a more restrictive construction? The difficulty is compounded by the fact that failure to comply with the endorsement conditions automatically results in loss of entitlement to income tax exempt status,[148] with the Commissioner's only real ability to ameliorate this outcome being not to undertake compliance action.[149] Risk-averse charity controllers may

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147 As to the relevance of and limitations upon context (including the mischief to be addressed) in interpreting legislation and the ability to refer to explanatory materials to determine context, see, eg, Pearce and Geddes, above n 127, 92–4 [3.7].

148 *Taxation Administration Act 1953* (Cth) sch 1 s 426-55; Ian Murray, 'Fierce Extremes: Will Tax Endorsement Stymie More Nuanced Enforcement by the Australian Charities and Not-for-profits Commission?' (2013) 15(2) *Journal of Australian Taxation* 233, 252–4.

149 The Commissioner has indicated that this administrative practice may be adopted where the charity has taken corrective action: TR 2015/1, above n 2, 35–6 [187]–[192].

therefore seek to avoid accumulating income or assets outside the Commissioner's view of the permitted bounds, or may accept the time and expense of applying for a private binding ruling. To the extent that charity controllers, auditors or reviewers are required to declare that the financial statements provide a true and fair view of a charity's financial position, this also raises the potential need to highlight risk in the notes to the financial statements. Of course, one wonders whether the inclusion of such a note would invite investigation by the ATO.

V Conclusion

The finding in Part IVF that the income tax exemption application-for-purposes requirement is a maladministration test unlocks a number of research questions. First, if the restraint seeks to encourage compliance with governance duties relevant to achievement of charitable purpose, is there a good reason to have a tax rule and regulation by the Commissioner of Taxation in addition to the ACNC governance standards[150] and ACNC regulation of registered charities?[151] Indeed, except in the case of ancillary funds, the information base available to the Commissioner of Taxation would typically be low in respect of accumulation, except to the extent that the Commissioner accesses information obtained or published by the ACNC, or obtains information through the Commissioner's investigatory powers. That is because, typically, charities that are exempt from income tax are not required to lodge an annual tax return unless specifically requested to do so by the Commissioner.[152] It should be noted that as the ACNC presently only regulates registered charities, there may well be very good reasons for retaining an income tax exemption maladministration condition that applies to non-charities.

Second, if the scope of the tax restraint is limited to maladministration, the tax and other accumulation restraints are likely to leave substantial gaps in the boundaries for the timing of provision of benefits and the perpetuation of the charity creator's control over charity property.[153] How large are the lacunae? Should society be sufficiently worried to impose a restraint? To illustrate some of the potential issues, it is worth returning to the Harvard University example referred to in Part I above. One may ask whether a desire to maintain 'support' for future students and researchers is a good reason to continue growing endowment investments. There may be reason to probe deeper if one assumes that Harvard will

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[150] *ACNC Regulations* sub-div 45-B. Of particular relevance to accumulation, governance standard 1 requires a registered charity to 'comply with its [charitable] purposes and its character as a not-for-profit entity' on an on-going basis.

[151] For a discussion of the degree of overlap between governance standard 1 and the income tax endorsement conditions, see, eg, Murray, 'Fierce Extremes', above n 148.

[152] Many charities and other income tax exempt not-for-profits, particularly larger ones, would nevertheless need to lodge returns or activity statements, in respect of goods and services tax, fringe benefits tax and pay-as-you-go reporting: Australian Taxation Office, *Tax Statements and Returns* (20 July 2015) <https://www.ato.gov.au/Non-profit/Tax-statements-and-returns/>. These would reveal some financial information, albeit not typically in a way that would directly elucidate accumulation levels.

[153] See, eg, Murray, 'Australian Common Law Perpetuities Rules', above n 63, 33–9.

be able to seek further contributions in the future to provide that future support[154] and also that future generations of students and scholars will likely be better off than current generations.[155] Nor is Harvard's endowment fund the only source of revenue for Harvard University.

The endowment contributed $11.6 billion to Harvard's operating budget over the five years to 30 June 2014. It also increased in size by $10.3 billion.[156] As a proportion, 47% of new income and assets was retained. Alternatively, viewed in relation to annual operating expenses of $4.4 billion,[157] the endowment fund alone could finance Harvard's operations for over eight more years. Should Australian comparators of Harvard University be compelled to spend more for the benefit of current generations in these circumstances? There are likely to be differing perspectives on whether that would be a good or bad thing. Further, a divergence of views may arise on whether tax rules and regulation by the Commissioner represent the correct regulatory response to the issue. After all, such a response would involve a government regulator substituting its decision about the appropriate level of accumulation for that of the charity. As discussed in Part IVA of this article, it is potentially more consistent with the balance between ensuring the production of public goods and the autonomy of charities inherent in many charity tax exemption rationales to address such intergenerational timing issues by leaving decision-making with the charity, but imposing process and integrity requirements through governance duties or public disclosure of accumulation levels.

Third, if it is proposed to use the tax regime to constrain accumulation by charities, an Australian blueprint for mandatory payout rules already exists for ancillary funds.[158] These rules do not directly target the accumulation of funds, but focus on the spending side of the ledger, which ensures at least a minimum level of current benefits. Ancillary funds can qualify as deductible gift recipients under the *ITAA97*,[159] so that donors can potentially claim an income tax deduction for gifts or contributions to an ancillary fund.[160] To meet the description of a public or private ancillary fund, the trustees must have agreed to comply with the public or private ancillary fund guidelines,[161] which are sets of regulations that impose a range of conditions, including several directly relevant to accumulation:

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154 See, eg, Harvard University, above n 17, 2–3 (in relation to fundraising campaigns); Daniel Halperin, 'Tax Policy and Endowments — Is Excessive Accumulation Subsidized?' (2011) 67(1) *The Exempt Organization Tax Review* 17, 21.

155 See, eg, Michael Klausner, 'When Time Isn't Money: Foundation Payout Rates and the Time Value of Money' (2003) 1(1) *Stanford Social Innovation Review* 51, 57–8.

156 Harvard University, above n 17, 8. The majority of the increase was due to investment returns, rather than new contributions.

157 Ibid 6.

158 A substantial minority of charities are in the form of public or private ancillary funds. There were approximately 1,795 public and 1,115 private ancillary funds at 31 October 2013: Australian Taxation Office, *Taxation Statistics 2011-12* (20 June 2014) <https://www.ato.gov.au>.

159 *ITAA97* s 30-15(1) item 2.

160 Ibid s 30-15(1) items 2, 7, 8.

161 *Taxation Administration Act 1953* (Cth) sch 1 ss 426-102(1), 426-105(1). Failure to comply with the guidelines may also cause an ancillary fund to lose its entitlement to endorsement as a deductible gift recipient: ibid s 30-125(1)(d).

- The ancillary fund must meet a minimum annual distribution requirement of 5% (4% for public ancillary funds) of the market value of the fund's net assets as at the end of the preceding financial year.[162]
- The fund's investment strategy must have particular regard to the fund's cash flow requirements, including the minimum distribution requirements.[163]

Pertinently, the relevant minimum distribution rates identified above were described, in the context of private ancillary funds ('PAFs'), as 'strik[ing] the right balance between ensuring resources flow to the charitable sector now, whilst also allowing PAFs to grow for the benefit of the sector in the future'.[164]

Having characterised the true nature of the application-for-purposes test as a maladministration test, consideration of these questions is a key next step.

[162] *Private Ancillary Fund Guidelines 2009* (Cth) guideline 19; *Public Ancillary Fund Guidelines 2011* (Cth) guideline 19. Where the fund meets its expenses from its own assets or income, the minimum distribution is $11 000 or 5% ($8800 or 4% for a public ancillary fund), whichever is the greater.

[163] *Private Ancillary Fund Guidelines 2009* (Cth) guideline 30.2; *Public Ancillary Fund Guidelines 2011* (Cth) guideline 30.2.

[164] Nick Sherry, 'Important Philanthropic Reforms and Further Sector Consultation' (Media Release of the Assistant Treasurer (Cth), No 6, 25 June 2009).