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Jayne Beggs
Kaiwhakahaere Kaupapahere
Policy Manager | Policy Group
Te Tari Taiwhenua Internal Affairs
PO Box 805
Wellington 6140

By email: charitiesact@dia.govt.nz / Jayne.Beggs@dia.govt.nz
Copy to: Louise.Cooney@dia.govt.nz

Dear Jayne

Review of the Charities Act 2005

1. Further to your email dated 13 May 2021, we write to respond to the request for input from targeted stakeholders on initial options in connection with the review of the Charities Act 2005. We appreciate the opportunity for consultation.

Charities with business activities

2. The first paper ("**the paper**") is entitled "We want your views on charities with business activities" and puts forward 3 options for crystallising the current approach taken by the Department of Internal Affairs – Charities Services Ngā Ratonga Kaupapa Atawhai ("**Charities Services**") and Charities Registration Board Te Rātā Atawhai ("**the Board**").
3. The paper notes submitters' concerns that Charities Services' current approach is arbitrary and without legal basis (page 1). The paper also acknowledges that the approach is not easy to find on Charities Services' website. The paper puts forward options for addressing these specific concerns.
4. However, the paper does not acknowledge that the current approach is unhelpful, inconsistent with principle, and inconsistent with government policy.

Social enterprise

5. A charity carrying on business activities to raise funds for their charitable purposes is, by definition, a "social enterprise" (being an organisation that trades goods and services to achieve social, environmental, economic, and cultural (ie charitable) goals).¹ In a recent report, the Minister for the Community and Voluntary Sector, Hon Priyanca Radhakrishnan, acknowledged that "Given the economic challenges posed by the Covid-19 pandemic, it is now even more vital to increase social enterprise activity".²
6. The paper acknowledges that charities are able to carry out business activities "if the

¹ <https://www.socialenterpriseauckland.org.nz/what-is-social-enterprise/>

² A roadmap for impact, April 2021, p6: <https://www.theimpactinitiative.org.nz/publications/roadmap-for-impact>

business income is ultimately applied” to charitable purposes³ (page 1). However, it does not consider how best to support and enable charities’ business (ie social enterprise) activities.

Destination of funds test

7. The principle that charities are able to carry out business activities if the business income is ultimately applied to charitable purposes is known as the “**destination of funds test**”. The destination of funds test provides that, in principle, it does not matter how a charity raises its funds, provided they are always destined for charitable purposes. In order for an entity to be a charity, all of its funds must, by definition, always be destined for charitable purposes: an entity that did not limit the application of its funds to charitable purposes, both during its lifetime and on winding up, would not be eligible for charitable registration. Charities Services vets all charities’ governing documents when applying for registration to ensure their rules do not allow them to apply funds other than in furtherance of their charitable purposes.⁴ A charity that amended its rules so as to circumvent these requirements would no longer be qualified for registration.⁵
8. It is also inherent in the destination of funds test that no person may be able to make a private pecuniary profit from the charity, as by definition this would divert resources away from charitable purposes. Charities Services vets all charities’ governing documents when applying for registration to ensure their rules do not allow for private pecuniary profit. Charities Services also imposes strict requirements regarding conflicts of interest⁶ and the financial reporting rules for registered charities require disclosure of related party transactions.
9. On that basis, there is no need for the additional requirement imposed by Charities Services that “the charity will not provide resources to the business at below market rates”. The requirement may in fact be counterproductive: subject always to the destination of funds principle, there may be good reasons why a charity might provide resources to the business at below market rates, such as to help the business get started and get to the point where it might be able to raise funds for charitable purposes. All decisions made by the charity must, by definition, be made in the best interests of the charitable purposes of the charity.
10. Similarly, the additional requirement imposed by Charities Services that the charity must demonstrate that the business is “capable of making a profit to go to charitable purposes” is unnecessary. It can also be very a difficult threshold for a start-up social enterprise to meet.
11. Why place such barriers in the way of social enterprises just because they happen to be structured as charities? What is the rationale for making doing good so difficult?

Need for judicial review

12. The additional requirements imposed by Charities Services in the area of business activities do not derive from the case mentioned in the paper (*Auckland Medical Aid Trust v Commissioner of Inland Revenue* [1979] 1 NZLR 382 (SC)). There is in fact

³ The paper articulates the principle as “provided the business income is ultimately applied to the charity”, however, this reference was presumably intended to refer to “the charitable purposes” rather than to “the charity”.

⁴ See: <https://www.charities.govt.nz/ready-to-register/need-to-know-to-register/charitable-purpose-and-your-rules/>, last accessed 13 May 2021.

⁵ Charities Act 2005, section 32(1)(a).

⁶ <https://www.charities.govt.nz/news-and-events/blog/conflicts-of-interest-and-registering-as-a-charity/>.

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no legal basis for these requirements, and it is concerning and disappointing that charities that meet all the legal requirements for registration are being denied registration.

13. If a charity had managed to challenge Charities Services' interpretation, a Court may have well found Charities Services' approach to be ultra vires and therefore unlawful. However, as is well known, most charities are unable to access the appeal right under the Charities Act as it is currently structured. A start up social enterprise that has just been denied registration, and therefore most likely funding, is unlikely to have the resources to be able to mount a challenge to the High Court under section 59. We are concerned that Charities Services may be looking to use the review of the Charities Act to codify its practice in this area in advance of proper consideration as to its legality.
14. Although Charities Services and the Board repeatedly assert that they are complying with the law as set down by Parliament and the Courts, in fact they are often applying an *interpretation* of the law that is not accepted. It is not uncommon for the interpretation taken by Charities Services and the Board to be found legally incorrect; their approach has in fact been found wanting on many occasions by the Courts, see for example: *Re The Foundation for Anti-Aging Research and The Foundation for Reversal of Solid State Hypothermia* (2016) 23 PRNZ 726; *Greenpeace of New Zealand Incorporated v Charities Registration Board* [2020] NZHC 1999 (10 August 2020); *Family First New Zealand v Attorney-General* [2020] NZCA 366 (27 August 2020) Clifford and Stevens JJ; *Greenpeace of New Zealand Incorporated v Charities Registration Board* [2020] NZHC 2993 (12 November 2020); *Better Public Media Trust v Attorney-General* [2020] NZCA 290 (15 July 2020); *National Council of Women of New Zealand Inc v Charities Registration Board* (2014) 26 NZTC 21075 (HC); and *The Plumbers, Gasfitters and Drainlayers Board v Charities Registration Board* [2013] NZHC 1986.
15. The fact that charities were able to obtain these rulings despite the difficulties raised by the appeal right as it is currently structured speaks to the depth of concern and even anger about the approach being taken by Charities Services and the Board under the Charities Act. Many are looking to the review of the Charities Act to try to find a better balance, particularly one that is more enabling of charitable work.

Purpose-based governance

16. In addition to being unhelpful and most likely unlawful, the additional requirements imposed by Charities Services and the Board on the business activities of charities are also unprincipled.
17. Eligibility for registration under the Charities Act is determined by an entity's *purposes*:⁷ as noted by the Supreme Court of Canada in *Vancouver Society of Immigrant and Visible Minority Women v Minister of National Revenue* [1999] 1 SCR 10 (**Vancouver**) at [144], the common-law definition of "charity" developed in the context of trust law, where a charitable purpose trust is an exception to the general rule that a purpose trust is invalid. Therefore, the trust law question focuses on charitable purposes, not activities.
18. While there is no dispute that s18(3) of the Charities Act requires regard to be had to activities as part of the process of considering whether an entity qualifies for registration, difficulty arises because s18(3) does not specify what activities are

⁷ Charities Act 2005, section 13.

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required to be considered *for*.

19. At common law, the issue with respect to activities is not the character of the activity itself, but the *purpose in furtherance of which it is carried out* (*Vancouver* at [152]-[152]). Aside from the limited ability to look to activities in construing an entity's purposes under the extrinsic evidence rule (see the discussion in *Unresolved issues in New Zealand charities law* New Zealand Law Journal March 2021 at 49), the key issue with respect to activities is that they must be carried out in furtherance of the charity's *stated* charitable purposes (see *Re The Foundation for Anti-Aging Research and The Foundation for Reversal of Solid State Hypothermia* (2016) 23 PRNZ 726 at [88]).
20. The various reports that preceded the Charities Act in New Zealand make numerous reference to the need to find a way to ensure that charities were not falling into "mission drift", and were continuing to act in furtherance of their *stated* charitable purposes over time (Property Law Reform and Equity Committee Report on the Charitable Trusts Act 1957 (February 1979), 2; Report by the Working Party on Registration, Reporting and Monitoring of Charities (28 February 2002), 21-2; Report to the Minister of Finance and the Minister of Social Welfare by the Working Party on Charities and Sporting Bodies (November 1989), iv-v, 10, 21, 63, 67; *Tax and Charities - a government discussion document*, Inland Revenue Department, June 2001, para 8.7. See also Myles McGregor-Lowndes & Bob Wyatt (eds) *Regulating Charities: The Inside Story* (New York: Routledge, 2017), ch10).
21. Charities are private organisations, albeit for public purposes (Matthew Harding "Independence and Accountability in the Charity Sector" in John Picton and Jennifer Sigaloos (eds) *Debates in Charity Law* (Hart, Oxford, 2020) 13, at 13-14). Reflecting the principle of **settlor autonomy**, the law makes it clear that people involved with charities have a duty to comply with the rules they have signed up to (Trusts Act 2019, ss24 and 26; Companies Act 1993, s134; Incorporated Societies' Bill 15-1, cl51). For a for-purpose entity such as a charity, those rules must, by definition, include the entity's stated purposes, which must, by definition be charitable in order to qualify for registration.
22. By imposing these additional requirements on the *activities* of entities with clearly charitable purposes, Charities Services and the Board are confusing the distinction between purposes and activities, and are straying into the territory of exercising operational control over charities' day to day activities. Just as it is not for the Inland Revenue Department to tell taxpayers how to run their businesses, similarly it is not for Charities Services or the Board to tell charities how best to further their charitable purposes. Through the financial reporting rules imposed on registered charities, registered charities in New Zealand are already subject to the most comprehensive transparency and accountability regime for charities anywhere in the world. There needs to be a strong case for the creation of further rules, yet the case for further rules in this area not been made out.
23. It would be a better use of Charities Services' resources to simply ask charities to demonstrate how any particular activity or transfer of resources is in the best interests of its charitable purposes. This was the approach originally suggested by the Inland Revenue Departments "Tax and Charities" discussion document in 2001 (which preceded the accountability regime introduced by the Charities Act). If the charity cannot demonstrate how a particular activity is in the best interests of its stated charitable purposes, it is using funds unlawfully, which constitutes "serious wrongdoing" under section 4 of the Charities Act. Serious wrongdoing is grounds for

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deregistration under section 32(1)(e) of the Charities Act. Providing the monitoring authority with the information necessary to ask and answer such a question was a key issue the Charities Act regime was intended to address.⁸ Rather than imposing new “rules”, the comprehensive mechanisms already available should be utilised.

24. Many charities are struggling: costs are increasing, demand for services is increasing, yet sources of revenue are diminishing. We should be encouraging and enabling charities to raise funds and become self-sufficient and self-sustaining, not making it more difficult. Any attempt to introduce further regulation should be carefully scrutinised for duplication, necessity and potential overreach.

Feedback on 3 initial policy options

25. We are concerned that the proposition that Charities Services’ approach may not be helpful or appropriate has not even been considered in the paper. As you will be aware, many submitters have raised concerns about the nature of the review of the Charities Act and the closeness of the Department of Internal Affairs’ Policy Team to Charities Services. We would be very concerned if the review of the Charities Act were to be used as a vehicle for Charities Services to create the legal basis for an unhelpful and unprincipled approach that has so far been lacking.
26. We **strongly oppose** all 3 of the initial policy options put forward in the paper.
27. In particular, we strongly oppose giving the current settings an imprimatur (options 1 and 3). With respect to the second option (asking the Board to approve or reject the current arbitrary approach), we note that while Board was established to provide an independent check on Charities Services’ decision-making, lack of resourcing, a framework whereby Charities Services provides secretarial and administrative support to the Board (Charities Act, s8(6)), and an oracular mindset on the part of Charities Services, have effectively neutralised the Board’s ability to carry out this role. In practice, the Board is not sufficiently independent of Charities Services and we do not have confidence that this option will deliver any improvement on options 1 or 3 other than window-dressing.
28. Instead, we recommend a 4th option: that the Charities Act be amended to clarify the legal duty imposed on all charities that all decisions must be made in the best interests of the charity’s stated charitable purposes. This would reflect a principled approach that is easy for charities (which are often run by volunteers) to understand and comply with. It would also remove the need to create complex, artificial rules that merely increase the compliance burden on charities (and cost to government and taxpayers) and would do nothing to assist charitable work. Provided the charity can demonstrate that its business activities meet this test, there should be no difficulty.
29. The current approach being applied by Charities Services is not lawful and should be discontinued.

Other topics raised in the business paper

Private profit in charities with business activities

30. As discussed above, a registered charity applying funds to private pecuniary profit will by definition be in breach of its constituting document. This would constitute a breach of their legal duty to comply with their constituting document (however the

⁸ See the discussion in *Charity regulation in New Zealand: history and where to now*, *Third Sector Review*, Vol 26 issue 2, 2020, p28.

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charity is structured). As such, such a use of funds would be unlawful, which constitutes serious wrongdoing, and is grounds for deregistration.

31. The key issue with respect to business activities, as with any activities, is that the activity is carried out in the best interests of the charity's stated charitable purposes.⁹ Applying funds to private pecuniary profit is inherently inconsistent with charitable purpose and cannot be demonstrated to be in the best interests of charitable purpose. Fiduciary duties are meaningful only if they are enforced. It is not clear why Charities Services seeks to create new and complex rules rather than using the rules that are already available.
32. In terms of how charities manage risks of private pecuniary profit, the key mechanism is by ensuring all decisions are made in the best interests of the charity's charitable purposes. Charities should know that they may have to demonstrate how any particular action or activity meets this standard.
33. In terms of our experience of finding information on what is required to register a charity when the charity is involved in carrying on business activities, our principal concern is that much of the material on Charities Services' website is legally incorrect. There does not appear to be any mechanism for the charitable sector to have meaningful input into Charities Services' interpretations before they are posted onto Charities Services' website. In a democratic society such as New Zealand, laws should be made by Parliament following a democratic process. They should not be made by Charities Services simply posting "guidance" on its website.

Consolidated financial reporting

34. At page 3, the paper makes the point that in consolidated accounts, movements of funds between the charity and entities it controls may not be visible.
35. In our view, the Australian model provides an elegant answer to this concern.
36. Subdivision 60-E of the Australian Charities and Not-for-profits Commission Act 2012 gives the Australian Charities and Not-for-profits Commissioner (broadly the Australian equivalent of Charities Services) the power to require a registered charity to provide an additional report. If there was concern about opaqueness about a particular charitable business, a similar power would allow Charities Services (or whatever agency is ultimately responsible for administering the Charities Act) to request the information it needs. Such a targeted approach would be preferable to imposing a blanket additional requirement to prepare separate financial statements which would only increase compliance costs unduly.
37. We do not support the idea of requiring controlled charities to require provide separate financial statements on a blanket basis. Instead, we recommend that the Charities Act be amended to provide the agency ultimately responsible for administering the Charities Act with a power to require a registered charity to provide a separate report of specified information, similar to the approach taken in Australia.

Business decisions that put charitable funds at risk

38. Business involves risk. The path towards finding (and funding) innovative solutions to intractable problems will never be linear. We must not paralyse charities. Provided all decisions can be shown to have been made in the best interests of the stated charitable purposes, charities must be allowed to fail. The Charities Act regime is

⁹ See *Re The Foundation for Anti-Aging Research and The Foundation for Reversal of Solid State Hypothermia* (2016) 23 PRNZ 726.

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about accountability, through disclosure of comprehensive information on the charities register; it is not about "regulating" the day to day activities of charities.

39. As discussed above, charities are private organisations albeit for public purposes. If the charity cannot show that the business decision which led to loss of charitable funds was not made in the best interests of the charity's stated charitable purposes, then there is a breach of legal duty, which constitutes serious wrongdoing as discussed above. There are also legal duties about trading while insolvent which may be triggered.
40. Otherwise, however, in principle, government should not interfere in the day to day running of charities, just as it does not interfere in the day to day running of for-profit businesses.

Conclusion

41. We would appreciate the opportunity to discuss the above issues with you before final proposals are formulated.

Yours sincerely

SUE BARKER CHARITIES LAW

Susan Barker

Director

+64 (0) 21 790 953

susan.barker@charitieslaw.co

PO Box 3065 Wellington 6140