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Dear Sir

Submission in Relation to Prescribed Private Funds

We endorse the government's objective of tightening the integrity of the PPF regime and of simplifying the rules applying to PPFs. However, as a general comment, we note that the purpose of the PPF regime was to create a new vehicle and new opportunities for private philanthropy,¹ therefore the rules should not be too restrictive or discouraging of this objective.

PPFs were introduced to encourage private philanthropy by filling a gap that was not satisfied by funds which sought contributions from the public (PAFs).² Accordingly, a greater level of control was permitted to private donors.³ The main incentives for donors in contributing to a PPF have therefore been:

- (a) a tax deduction (which they could already obtain by making a donation to a PAF or a non-ancillary fund DGR);
- (b) no requirement to seek funds from the general public (not available under the PAF model);
- (c) greater control over the final destination of the funds in the PPF (not available under the PAF model); and
- (d) a degree of accumulation of funds in the PAF (up to a target capital amount) before distribution to a non-ancillary fund DGR (limited accumulation permitted for PAFs, depending on the formation of an accumulation plan).

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¹ The Hon John Howard PM, 'Community-Business Partnership Develops New Tax Initiatives to Promote Philanthropy' (Press Release, 30 March 2001).

² Explanatory Memorandum, *Taxation Laws Amendment Bill (No 8) 1999* (Cth) [5.28].

³ The current PPF Guidelines provided that the controlling body of a PPF must include at least one person who is a 'responsible person'. By contrast, the requirement for a public fund is that a majority of the members of the controlling body must be 'responsible persons': Taxation Ruling TR 95/27, [9].

PPFs, like PAFs, do, however, have a public function in that they were intended to help address social issues.⁴ Accordingly, the first principle set out in the Discussion Paper, that PPFs are philanthropic, must balance the incentives for acts of philanthropy by private donors (set out above) against the public benefit to be provided by PPFs.

One way of measuring the public benefit to be provided by PPFs is to look to the revenue foregone due to tax deductions on donations. According to this measure, the distributions from a PPF should be at least equivalent to and roughly proximate in time with the revenue foregone. This approach suggests that PPFs need not be long-lasting, unless they receive on-going donations. We agree that this is a relevant measure, but suggest that the government also consider the benefits from longer term (although not necessarily perpetual) PPFs. There is a significant cost, both in time and expenses, in establishing a PPF. Operating a PPF also requires a substantial time and expertise commitment. However, once established and operating, PPFs provide a mechanism for efficiently allocating resources to non-ancillary fund DGRs, particularly if greater donor involvement (with associated expertise) is encouraged. This provides a direct cost saving to government and, ideally, permits a better allocation of resources. A longer lifespan for PPFs is also likely to encourage greater levels of donation and intergenerational involvement – thus resulting in the allocation of more funds to the benefit of the community. In addition, sustainable PPFs should provide 'doing' DGRs with greater funding certainty, hence assisting them in carrying out their core purposes rather than searching for alternative funding sources.

In our view, the integrity of PPFs should be achieved by fewer, simpler rules which are effectively monitored and enforced by an adequately resourced body. There should be an increased focus on education, given the government's recognition that 'compliance issues... are mainly due to mistakes or lack of knowledge'. In addition, matters going to the efficient administration of PPFs, such as the valuation of illiquid assets, should be left to donors and trustees and supported by targeted integrity measures to prevent leakage of administrative costs to related parties.

Principle 1 – PPFs are philanthropic

Consultation Questions

1.2 What is an appropriate distribution rate? Why?

As a general comment, we are supportive of greater simplicity in the rules applying to PPFs, but consider there should be a degree of flexibility for PPFs in the manner in which they make their distributions. We consider that there can be flexibility while maintaining the integrity of the PPF regime.

More specifically, the government needs to clarify the role it sees for PPFs. Are they to include endowed foundations that provide significant and regular funding for other DGRs but do not engage in active on-going fundraising? We suggest that the private nature of PPFs, as opposed to PAFs, indicates that PPFs should not have an obligation to seek on-going funding in order to continue in existence, at least for a reasonable length of time to justify the costs of their establishment and to permit the PPF to build and use its expertise in selecting DGR recipients. Setting a minimum distribution rate that is too high will not allow the PPF regime to achieve this advantage and may also discourage individuals from establishing or donating to PPFs.⁵ It is also likely to have a negative impact on DGRs which may rely on a PPF for on-going funding to carry out their activities. However, paragraph 20 of the Discussion Paper suggests that the minimum distribution rate should

⁴ The Hon John Howard PM, 'Community-Business Partnership Develops New Tax Initiatives to Promote Philanthropy' (Press Release, 30 March 2001).

⁵ Philanthropy Australia Inc, *Response to the Treasury Discussion Paper 'Improving the Integrity of Prescribed Private Funds'* (2009), 7.

be set at a level such that PPFs which do not receive on-going donations should eventually be wound-down.

The Prime Minister's press release relating to the original PPF provisions noted that the PPF was intended to be 'a new vehicle for private philanthropy similar to that existing in the United States'. Accordingly, the US experience with philanthropic vehicles should be taken into account in determining whether a minimum distribution rate is appropriate. In the US, many private foundations have been in existence for substantial periods of time. For example the Rockefeller Foundation was established in 1899 and is still active today. Further, it appears, at a high level, that US private foundations are required to distribute an adjusted amount based on 5% of the following net amount: market value of the foundation's assets less liabilities and less assets used for 'exempt purposes'.⁶ This 5% level roughly mirrors that proposed by Philanthropy Australia in its submission.⁷

A 5% rate may be considered relatively low on a measure of the revenue foregone in a particular income year. However, this must be weighed against the funds irrevocably committed to the public benefit to be distributed in the future and against the 'soft benefits' provided by PPFs. In our view, the distribution rate should be set at a level that permits PPFs to continue in existence for a substantial length of time, although not necessarily indefinitely. This should also ensure a significant application of PPF funds to philanthropic purposes for the benefit of the current community.

In terms of building flexibility into the regime, we note that a PPF may want to grow so that it can carry out a specific project. If the minimum distribution rate is too high, it will be difficult for it to reach its target. In this regard, we note that the US also appears to provide concessions where a philanthropic fund seeks to accumulate amounts for a specific project.⁸ Accordingly, we suggest that the concept of an optional accumulation plan (to be approved by the ATO) be retained for PPFs that wish to accumulate funds at a greater level than permitted by a compulsory distribution rate. Failure to actually apply the accumulated funds to the specified project could result in a higher distribution rate for that PPF in subsequent years.

Further, whatever the minimum distribution rate adopted, we also suggest that:

- (a) PPFs be provided credit for exceeding the minimum distribution level in a given year. This could be achieved by adopting a rolling average mechanism. For instance, averaging over rolling 3 year periods in a similar manner to that for non-concessional contributions to superannuation funds.⁹
- (b) The possibility of retrospectively 'fixing' inadvertent failures to meet minimum distribution requirements. For instance, akin to the offset against the superannuation guarantee charge provided for late contributions.¹⁰

⁶ US Department of the Treasury Inland Revenue Service, *Minimum Investment Return* <<http://www.irs.gov/charities/foundations/article/0,,id=137646,00.html>> accessed 12 January 2009; US Department of the Treasury Inland Revenue Service, *Distributable Amount* <<http://www.irs.gov/charities/foundations/article/0,,id=160532,00.html>> accessed 12 January 2009.

⁷ Philanthropy Australia Inc, *Response to the Treasury Discussion Paper 'Improving the Integrity of Prescribed Private Funds'* (2009), 5.

⁸ US Department of the Treasury Inland Revenue Service, *Taxes on Failure to Distribute Income* <<http://www.irs.gov/charities/foundations/article/0,,id=137632,00.html>> accessed 12 January 2009; US Department of the Treasury Inland Revenue Service, *Set-asides* <<http://www.irs.gov/charities/foundations/article/0,,id=137659,00.html>> accessed 12 January 2009.

⁹ See s 292-85 *Income Tax Assessment Act 1997* (Cth).

¹⁰ Section 23A *Superannuation Guarantee (Administration) Act 1992* (Cth).

- (c) The consequences of failing to meet the required distribution rate be clarified. For initial, lower level breaches, rather than a total loss of tax exemption, it may be more appropriate for the PPF to be subject to tax on the amount that it failed to distribute. A sliding scale could be adopted for more significant breaches.

1.3 Should the Commissioner have the ability to modify the minimum amount according to market conditions (for example, based on average fund earnings)?

We consider that the Commissioner should have the ability to modify the minimum distribution amount according to market conditions as not doing so could restrict the future viability of PPFs by forcing them to give away capital such that the fund will not be sustainable for the future.

1.4 Should a lower distribution rate apply for a period to allow newly established PPFs to build their corpus?

In our view, a reduced distribution rate should apply to permit newly established PPFs to build their corpus in the first three to five years. The reduced distribution rate could potentially be applied by means of a stepped scale over each of the initial years.

1.5 Are there any issues that the Government needs to consider in implementing the requirement to ensure PPFs regularly value their assets at market rates?

Consideration should be given to the cost of obtaining valuations and required standard of valuations, particularly where those valuations relate to illiquid assets.

1.6 Is setting a minimum PPF size appropriate? What should the minimum PPF size be in dollar terms? Should a fund have to distribute all its capital when its total value falls below this minimum amount?

We support the sentiment that operating efficiencies should be encouraged for PPFs so that their capital base is not excessively reduced by operating expenses. However, in our experience donors are very aware of this issue. In addition, PPFs are formed in a broad range of circumstances. Some donors may prefer (or may need) to establish the corpus of a PPF by means of a series of donations over time, rather than one up-front lump sum. Setting a minimum size may prevent some potential donors from irrevocably committing funds for philanthropic purposes.

If a minimum size (or a minimum distribution, as Philanthropy Australia has suggested)¹¹ is adopted, consideration will need to be given to:

- (a) The impact of market fluctuations on PPF size if PPFs are required to revalue their assets annually at market rates. For instance, the ASX All Ords Price Index fell more than 44% from the end of November 2007 to November 2008.¹² An averaging mechanism could address this issue. For instance, as suggested earlier, averaging over rolling 3 year periods in a similar manner to that for non-concessional contributions to superannuation funds.¹³
- (b) A ramp-up period for newly established PPFs.

¹¹ Philanthropy Australia Inc, *Response to the Treasury Discussion Paper 'Improving the Integrity of Prescribed Private Funds'* (2009), 8.

¹² Australian Securities Exchange, *Historical Market Statistics* <http://www.asx.com.au/research/market_info/historical_equity_data.htm#End_of_month_values> accessed 12 January 2009.

¹³ See s 292-85 *Income Tax Assessment Act 1997* (Cth).

- (c) The possibility of retrospectively 'fixing' inadvertent failures to meet minimum size or distribution requirements. For instance, as suggested earlier, akin to the offset against the superannuation guarantee charge provided for late contributions.¹⁴
- (d) The consequences if an established PPF fails to meet the minimum size or distribution requirements. A compulsory distribution of capital may, in some circumstances, be inconsistent with the terms of a PPF trust deed and the requirements of applicable State legislation.¹⁵ It may also frustrate contractual obligations that trustees have entered into where they have committed to on-going funding for DGRs. Accordingly, it will be necessary to determine the extent to which compulsory distribution requirements are intended to render State legislation inoperative and to override the PPF trust deed.

The extent of the Commonwealth Parliament's power to address the above issues (even if the trustees of PPFs are required to be constitutional corporations as suggested in paragraph 29 of the Discussion Paper) needs to be considered.

In addition, the level of compulsory distributions discussed in paragraphs 16 to 20 of the Discussion Paper is likely to increase the significance of a minimum size requirement if the level is set at a rate that will cause the capital of a PPF to be eroded from year to year unless further donations are received. If a minimum size requirement is introduced, then we recommend that those fewer PPFs be permitted to exist for a longer period of time (by setting a lower distribution rate), in order to maximise the efficiency savings.

If a minimum size requirement is introduced, then we suggest that it should be accompanied by measures dealing with the issues identified above.

1.7 Are there any relevant issues that need to be considered in improving and standardising the public accountability of PPFs?

We have no objection to a requirement that all PPFs be required to have an ABN and to be recorded on the Australian Business Register with the indication that they are a PPF.

1.8 Are there any concerns with the proposal to require that the contact details of PPFs be provided to the public? What information should be provided publicly?

We do not consider it appropriate to provide contact details for PPFs to be provided to the public. There is already a list of all PPFs in the Income Tax Assessment Regulations 1997. The question of where the funds are to be donated is a matter for the trustee of the PPF to freely decide without constant representations from possible recipients. The receipt of unsolicited requests for donations may significantly add to the administration costs for PPFs.

However, to improve public accountability, it may be useful for PPFs to provide the following information for inclusion on the Australian Business Register website:

- (a) total assets held by the PPF at the end of the financial year;
- (b) donations received during the financial year;
- (c) amounts distributed during the financial year; and
- (d) the recipients of the distributions.

¹⁴ Section 23A *Superannuation Guarantee (Administration) Act 1992* (Cth).

¹⁵ See eg, s 7 *Charitable Trusts Act 1962* (WA).

2. Principle 2 – PPFs are trusts

Consultation Questions

2.1 Will two years be a long enough transitional period for existing PPFs to comply fully with the new Guidelines?

We are supportive of a transitional period for existing PPFs. As noted in several of our other comments, the transitional provisions should provide transitional mechanisms relating to the following potential impacts of the new rules on existing PPFs:

- (a) inconsistencies with State legislation applying to PPFs;
- (b) inconsistencies with a PPF's trust deed;
- (c) inconsistencies with a PPF's contractual obligations; and
- (d) PPFs which no longer meet any minimum requirements, such as a minimum size requirement.

In addition, we suggest that the focus of the transition should not be solely on having the appropriate legal mechanisms in place. To ensure compliance with the new regime, there should be a significant focus on education for trustees of PPFs in this period.

2.2 Are there any cost or other concerns relating to the corporate trustee proposal?

If a corporate trustee model is adopted, we note that consideration will need to be given to transition mechanisms for existing PPFs which do not have a corporate trustee. The transition mechanism should take account of PPF trust deeds that do not contemplate corporate trustees and should ensure that there are no adverse tax consequences from the change of trustee.

2.3 Are there any privacy concerns that the Government needs to consider?

We have no recommendations in respect of this question.

2.4 Are there any concerns over particular penalty types?

We agree that the penalty imposed should suit the breach, but we consider that penalties should be limited to administrative penalties, other than in cases of fraud or wilful or gross negligence. In the event of fraud, other regimes should apply to enable appropriate action to be taken, so no specific criminal penalties should be required in any new PPF regime. It will be important that any penalty imposed relating to an action or omission of the trustee does not alter the position of the original donor or the ultimate recipient. Financial penalties could have an adverse impact on the benefit that the PPF is able to have in relation to its stated objects. Where trustee action demonstrates an inability for the trustee to act appropriately, then removal or disqualification could be appropriate, but that should follow a sustained period, or numerous examples, of inappropriate activity and should enable replacement trustees to be appointed, or a period of grace to apply to enable an appropriate replacement trustee to be identified and appointed. Personal liability for trustees in cases of breach should be limited to cases of fraud or gross or wilful negligence, to avoid the possible effect of trustees not being willing to so act in that capacity for PPFs.

It may be appropriate for there to be a mechanism to ensure that funds ultimately go to deductible gift recipients (ie intended beneficiaries) rather than to the ATO.

2.5 If a fit and proper person test were introduced, what criteria should be imposed on trustees?

In setting the character and competence standards for trustees, it is important to note that:

- (a) As stated in the Prime Minister's press release at the time the PPF measures were introduced, the aim of the provisions is to 'provide businesses, families and individuals with greater flexibility to start their own trust funds for philanthropic purposes'.¹⁶ These comments were reiterated in the Assistant Treasurer's press release relating to the Discussion Paper.¹⁷
- (b) To encourage the founders of PPFs to develop long term relationships with PPFs and to enable the founders to impart their business and other skills and experience to PPFs,¹⁸ a role for the founders in controlling the PPF is relevant.

In keeping with the above concepts, it is appropriate that all trustees or all board members of the trustee meet minimum character standards. It is also appropriate that trustee/s of PPFs (and, for that matter, the controllers of all tax exempt entities) as a group have the capacity to ensure that PPFs meet their obligations, including tax law obligations. However, to encourage the establishment of and donations to PPFs, any requirements should ensure that the founders of or significant donors to a PPF can be involved in the control of the PPF even if, as individuals, they do not possess appropriate qualifications and experience to ensure the PPF meets its obligations.

The criteria for tax agents set out in Appendix C to the Discussion Paper apply to each individual tax agent. If applied to each trustee of a PPF or each board member of a corporate trustee, this would impose too onerous an obligation. The fit and proper person tests for registrable superannuation entities provide a better model in this regard, although we question whether the same level of detail would be necessary for all PPFs. Given the private nature of PPFs, the character and competence standards for self managed superannuation funds may provide a better model for many PPFs (as opposed to PAFs). Tiered criteria may more appropriately address the risk posed by PPFs of different sizes and complexity.¹⁹

To the extent that the government wishes to address the competence of all trustees or board members, we suggest compulsory on-going training for trustees or board members who do not meet the required minimum levels. The training should be provided at a relatively basic level with the aim of alerting trustees or board members to their duties, rather than comprehensively dealing with the content of those duties. The trustee declaration required for trustees of self managed superannuation funds provides an abbreviated example of such awareness building.

¹⁶ The Hon John Howard PM, 'Community-Business Partnership Develops New Tax Initiatives to Promote Philanthropy' (Press Release, 30 March 2001).

¹⁷ The Hon Chris Bowen MP, 'Improving the Integrity of Prescribed Private Funds – Consultation Paper Released' (Press Release, 26 November 2008).

¹⁸ See, eg Philanthropy Australia Inc, *Response to the Treasury Discussion Paper 'Improving the Integrity of Prescribed Private Funds'* (2009), 3-4.

¹⁹ Tiered regulation has been suggested in other contexts for not-for-profits. See, eg Senate Standing Committee on Economics, Parliament of Australia, *Disclosure Regimes for Charities and Not-for-Profit Organisations* (2008), [9.15], [10.24], [10.25].

2.6 Are there any other provisions presently in the Model Trust Deed that should be covered in the updated Guidelines?

Clause 6 of the Model Trust Deed, which is in relation to the establishment and operation of a gift fund, should be deleted. Section 30-130 of the *Income Tax Assessment Act 1997* no longer requires an entity that is endorsed as a DGR as a whole to maintain a gift fund.

2.7 Are there any provisions not in the Deed that should be in the updated Guidelines?

We have no recommendations in respect of this question.

3. Principle 3 – PPFs are private

Consultation Questions

3.1 Would there be any disadvantages if a cap were introduced on the number of donors to a PPF (for example, a maximum of 20 donors over the life of the fund)?

A lifetime cap to the number of donors is impractical and would impose an unnecessary administrative burden on PPFs. Relevant private groups may well exceed any arbitrary number imposed, such that families or other close groups may well exceed 20, or any other number over the life of the PPF.

The requirement that the fund be "private" could be implemented by introducing a cap of 20 individuals each year or no more than 50 over rolling 3 year periods. However, any such restriction on the number of donors would require PPFs to track donations and may result in breach of the rules, where donations are sent from different sources via different media. The government must recognise that any requirement to refuse to accept, or return a donation to donors, because the maximum number had been reached would impose costs and use of time that would otherwise be used on furthering the purposes of the PPF.

3.2 Is conversion from PPF to PAF an acceptable mechanism to deal with changing PPF circumstances?

This appears to be a good way to provide additional flexibility for PPFs and PAFs. However, as the funds held by the PPF or PAF will remain devoted to philanthropic purposes, the legislative mechanism should ensure that the conversion does not trigger any adverse tax consequences. In particular, capital gains tax and stamp duty.

Conversion from a PPF to a PAF should not be mandatorily required, but should be available as an option for PPFs that change their strategy and wish to become PAFs, or where PPFs receive interest from donors outside their private group and determine that they would be best served by expanding their scope and becoming PAFs.

3.3 What rules could be used to deal with the conversion from a PPF to a PAF?

A simple conversion process should be available, whereby relevant endorsements are fast-tracked and other transition issues are dealt with on a priority basis. Rules that ensure that tax attributes (such as tax exempt and gift deductible) continue without interruption between the time at which a PPF identifies that it should, or will choose to, convert to a PAF and the time at which that endorsement is received should be introduced.

4. Principle 4 – PPFs are ancillary funds

Consultation Questions

4.1 Would there be any disadvantages from introducing this limitation to the existing PPF investment rules?

In our view, a PPF should not be restricted from holding illiquid assets provided they have sufficient liquid assets to meet their philanthropic obligations. Preventing PPFs from holding illiquid assets will basically limit the classes of investments of a PPF to cash and liquid shares. In contrast, trustee legislation has been amended over the years to broaden the range of investments a trustee can make in respect of trust funds. It may be more appropriate for a PPF to be permitted to hold a mix of assets in order to maximise the amount of income generated from its investments. Requiring that illiquid assets that are donated to the PPF to be converted to liquid assets may also restrict the donation of such assets and could attract significant costs of conversion.

Concerns that PPFs may hold non-productive illiquid assets should also be met by the integrity measures preventing donors from obtaining any benefit from their donation (other than a tax deduction).

We would welcome the opportunity to be further involved in the process of amending the PPF regime, including in any working party addressing the matter.

Please contact Teresa Dyson on (07) 3259 7639 if you have any questions.

Yours faithfully

