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The Manager
Philanthropy and Exemptions Unit
Personal and Retirement Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: pafreforms@treasury.gov.au

Dear Sir/Madam

Improving the integrity of public ancillary funds discussion paper: submission

We welcome the opportunity to comment on the Discussion Paper *Improving the integrity of public ancillary funds* released November 2010 (“the Discussion Paper”).

Generally we think Treasury has adopted a lazy “copy and paste” approach to preparing the Discussion Paper and the Discussion Paper’s release for public consultation is ill timed. Despite our reservations, we commend Treasury for encouraging debate on means to improve trust and confidence in giving by the Australian public to deductible gift recipient (“DGR”) endorsed public ancillary funds (“PuAFs”).

Who we are

DF Mortimer and Associates is a law practice that specialises in the law relating to not-for-profit organisations and charities. Our clients include operators of PuAFs.

We prepared this submission mindful of our current and prospective clients’ need for:

- Maintaining trust and confidence in philanthropic giving by the public; and
- A proportionate administrative and regulatory burden on operators of PuAFs.

Summary of proposed changes to PuAFs

The ATO has identified common errors in its reviews of PuAFs including:

- distributions paid directly to entities located offshore;
- benefits provided to non-DGRs located in Australia; and
- distributions to other ancillary funds.¹

¹ ATO *Non-profit News service No 0262 – PuAFs breaching their trust obligations*, 12 January 2010.

The changes proposed in the Discussion Paper and associated documents to address these and other issues are:

1. PuAFs that cannot meet a minimum distribution threshold are not to be deemed “philanthropic” and will lose their DGR endorsement;
2. At a minimum, a mandatory distribution of 5% of a PuAF’s net assets per annum, or \$11,000 (whichever is the greater);
3. A range of administrative penalties on a strict liability basis, where a PuAF trustee is in breach of their duties;
4. Annual lodgement of an income tax return by PuAF trustees to help ensure assets are being distributed;
5. A “fit and proper person test” for PuAF trustees to replace the “Responsible Persons Test”; and
6. A PuAF corporate trustee to replace individual trustees.

Our submission: key points

The key points in our submission are:

1. The deeming of an ancillary fund to not be “philanthropic” where it cannot meet a minimum distribution requirement is absurd and offensive;
2. An \$11,000 annual minimum distribution threshold is no less arbitrary than the current ATO guidance about “excessive” accumulation;
3. Strict liability for breach of PuAF trustee obligations leaves no room for “gentle warning” educative measures;
4. Treasury should consult with the proposed Office of the Non Profit Sector regarding simple and uniform reporting requirements for PuAFs;
5. A fit and proper person test adds no additional accountability for PuAF trustees than is offered by the Responsible Person test;
6. Proposals in the Discussion Paper could logically apply to all DGR endorsed “public funds”, such as scholarship funds, necessitous circumstances funds, overseas aid funds and school building funds and as such, needs to be publicly discussed more widely than by way of the Discussion Paper; and
7. a corporate trustee has some benefits for the operators of PuAFs, despite the additional administration and duties of its directors.

Our submission: discussion²

1. The deeming of an ancillary fund to not be “philanthropic”³

It is worth noting the definition of philanthropy provided by Philanthropy Australia:⁴

The planned and structured giving of money, time, information, goods and services, voice and influence to improve the wellbeing of humanity and the community.

It is also pertinent to note the lesson on giving provided in Luke 21:1-4⁵

Jesus looked up and saw the rich putting their gifts into the offering box, and he saw a poor widow put in two small copper coins. And he said, "Truly, I tell you, this poor widow has put in more than all of them. For they all contributed out of their abundance, but she out of her poverty put in all she had to live on."

Neither statement suggests that “giving” should achieve a certain frequency or quantum. The Discussion Paper however takes a divergent view:

“Public ancillary funds are vehicles for acts of philanthropy by donors, and benefit from significant tax concessions on that basis. The distributions of public ancillary funds should therefore be of a *quantity and regularity* [our italics] such that the fund can be characterised as philanthropic.”⁶

In our opinion the statement that philanthropy is characterised by how “regular” and “how much” one gives is absurd and offensive.

It appears by making this statement Treasury is trying to eliminate small PuAFs in order to reduce the costs of regulation. If this is the case we encourage Treasury to better articulate what it is trying to achieve. We say (without intended irony) that presently it appears Treasury does not understand what “philanthropy” actually is.

2. Minimum annual distribution

The Discussion Paper anticipates the regulation of PuAFs through principle based “Guidelines” (“the Guidelines”). The Guidelines will take a similar form as the guidelines for private ancillary funds (“PAFs”)⁷. The PAF guidelines require a minimum of \$11,000 to be distributed each year by the PAF.

Effectively, a PuAF that annually distributes less than \$11,000 would be deemed to not be “philanthropic” and accordingly unable to be endorsed as DGR. Small PuAFs such as may be operated by church groups, ethnic groups and groups in regional and rural areas would not be able to avail themselves of DGR endorsement for their PuAF unless they raised the specified minimum amount per year.

² For convenience, the numerical references in this section correspond to the references under “Our submission: key points”. Our discussion does not correspond with Discussion Paper consultation questions.

³ Discussion Paper, paragraph 26.

⁴ < <http://www.philanthropy.org.au/>> at 10 December 2010.

⁵ *The Bible*, English Standard Version.

⁶ Discussion Paper, paragraph 22, principle 1.

⁷ Discussion Paper, paragraph 1.1.4.

We accept there is a case for better guidance on accumulation and distribution. For example, ATO Tax Ruling 2000/11 sets out the ATO's current view on accumulation of income by a charitable income tax exempt entity (such as a charitable PuAF). It states at paragraph 21 that:

"excessive accumulation of investment income [is] not the applying of a fund for its purposes. We regard distributions [to beneficiaries] of a substantial part of the income but not necessarily capital gains as essential.

The definitions "excessive" and "substantial" have been judicially criticised⁸ as essentially involving an "arbitrary distinction".

We think however that a minimum distribution proposed by the Discussion Paper is no less an "arbitrary distinction" than the guidance provided by the ATO in TR 2000/11. We suggest that Treasury needs to find a principle that on the one hand permits certainty of expectation, and on the other permits flexibility of a PuAF to manage its assets consistent with its purposes. We think the principle "must be applied for the purposes for which it is established" already articulated in the *Income Tax Assessment Act 1997* ("ITAA 97")⁹ is a useful starting point.

It may be the Guidelines need not be drafted with mandatory distribution and accumulation requirements. Instead better principle based guidance (see our point 3 below for the meaning of "guidance") than currently exists under TR 2000/11 may suffice.

However, if Treasury wishes to persist with minimum distribution requirements we think it should do so only with a principles based "if not then why not" option clause. That is, if a PuAF does not comply with any minimum distribution requirement it needs to explain why it has not done so and with reference to an agreed principle.

Case study

We provide with permission, a brief case study to assist Treasury to understand some of the people who may operate (or inspire to operate) a PuAF. Please first see the link: <http://www.starnewsgroup.com.au/news/berwick/170/story/67566.html>

Family and supporters of the child in this story, Nikolaous have created an income tax exempt charitable trust to hold and disburse income from charitable fundraising. Family and supporters are also considering establishment of a tax deductible PuAF to receive tax deductible donations.

However if the Guidelines are approved, their PuAF will need to raise at least \$11,000 in tax deductible donations and investment income annually to qualify as "philanthropic" and entitled to DGR endorsement. Such an annual target may not always be achievable for the small group of family and supporters.

⁸ *Re Tact and Commissioner of Taxation [2008] AATA 275, 45.*

⁹ See s 50-60 ITAA 97.

3. Strict liability for breach of trustee obligations leaves no room for “gentle warning” measures

The Discussion Paper has noted that the ATO accepts that not-for-profit organisations “have a strong desire to get it right” and that compliance issues when they arise “are mainly due to mistakes or lack of knowledge.”¹⁰ Accordingly, PuAF trustees may need some educative guidance to assist them to perform their duties.

The Guidelines in our opinion are no more a “guideline” than is the requirement not to exceed the speed limit under the *Road Safety Road Rules 2009* (Vic). The Guidelines are better characterised as being “rules”. For example the Guidelines list mandatory obligations for the trustees of PuAF. A strict liability penalty applies if those obligations are not met. We calculate the penalty for failing to make a distribution where the shortfall is more than \$1000 to be \$3,300.¹¹

The ATO may have discretion not to impose a penalty,¹² but the extent of this discretion is by no means clear or certain that it will be exercised.

The Guidelines are different in substance to for example, the UK Charity Commission “guidance” documents which set out the Commission’s interpretation of the *Charity Act 2006* (UK), the *ASX Corporate Governance Principles and Recommendations* and even the ATO’s Tax Rulings. The points raised in these latter documents serve as an educative tool to guide entities in best practice but do not impose a strict liability penalty for non-compliance.

We accept that as a last resort, a range of administrative penalties for PuAFs is needed. However we think Treasury ought to consider as a priority, the development of educative guidelines (in the sense we have described above) for PuAF trustees. As the Inspector-General of Taxation has noted:

*Penalties represent an escalation in sanction by the Tax Office and are an indication that less interventionist measures, such as help and education, have failed to produce compliance.*¹³

At the risk of labouring our point, we also provide a link to a brief discussion by Dr Simon Longstaff of the St James Ethics Centre, Sydney as to why a rules based approach is not always appropriate particularly as an educative tool:

<http://www.ethics.org.au/ethics-articles/corporate-governance-principles> .

¹⁰ Discussion Paper, paragraph 58.

¹¹ Based on the current base penalty rate of \$110 and a penalty of 30 penalty units for failing to make a distribution (per the PAF Guidelines).

¹² Section 298-20, Schedule 1 *Taxation Administration Act 1953* “(1) The Commissioner may remit all or a part of the penalty.”

¹³ Inspector -General of Taxation *Review in to the Tax Office’s Administration of Penalties and Interest Arising from Active Compliance Activities* May 2005, paragraph 3.6.

4. Treasury should consult with the proposed Office of the Non Profit Sector regarding reporting measures, rather than require PuAFs to submit an income tax return and undertake a compulsory audit.

It is worth briefly noting the variation in financial reporting and auditing that presently exists for not for profit organisations.

- Under the *Corporations Amendment (Corporate Reporting Reform) Act 2010* companies limited by guarantee with annual revenue less than \$250,000 and DGR endorsement are required to produce a financial report which can be “reviewed” instead of audited. A review does not need a company auditor.
- Under the *Associations Incorporation Amendment Act 2010 (Vic)* incorporated associations (with DGR endorsement or not) with annual revenue less than \$250,000 provide a signed annual statement to Consumer Affairs Victoria (CAV), but do not have to provide audited accounts.
- Other DGR endorsed “public funds” in the table on the table in subdivision 30-B of the ITAA 1997 are not required to submit annual income tax or other statements to the ATO.

As is evident from our brief review, there is a divergence of approach in financial reporting.

We accept that not for profit organisations, including DGR endorsed public funds need to disclose income and revenue to the public, the ATO and to other government agencies. Such disclosure will help build trust and alert regulatory authorities to issues. Consistent with the view expressed by the Productivity Commission¹⁴ we think such reporting should be:

- proportionate to the risk involved; and
- standardised across jurisdictions (to reduce administration).

We think this issue is best discussed with the Non-Profit Sector Reform Council which is being established to support the Office for the Non Profit Sector (‘the Non Profit Office’) to administer. The Non Profit Office will examine a “one stop reporting shop”.¹⁵

The last thing the not-for-profit sector needs now in our opinion, are two federal government agencies working separately to develop reporting regime’s.

If Treasury cannot wait until the Non Profit Office is established, we suggest in the interim that a simple “annual information statement” be submitted to the Commissioner in lieu of an income tax return. This annual statement should be a cash based statement of expenditure and revenue; a form familiar to community organisations. In our view this information would be sufficient for the Commissioner to alert them to any issues regarding accumulation and non distribution.

5. A fit and proper person test adds no more than the Responsible Persons Test

Treasury seems to want to persist in advancing a “fit and proper person test” for PuAFs. This is despite the same proposal not being adopted for PAFs.

¹⁴ See generally, Productivity Commission, *Contribution of the Not-for-Profit Sector*, 2010, section 6.5.

¹⁵ <http://www.dpmc.gov.au/nonprofit_reform_council.cfm>, at 10 December 2010.

It is worth reiterating Tax Ruling 95/27 which requires a PuAF a majority of its trustees or governing body to be "Responsible Persons". The Tax Ruling provides an indicative list of such persons which include school principals, clergy, solicitors, doctors and other professional persons, members of parliament and generally persons who are accepted as having a degree of responsibility to the community as a whole because they perform a public function or belong to a professional body.

In short, we think the current Responsible Person's requirements are sufficient. Bear in mind that the Responsible Person's requirements for PuAFs are more onerous than for PAFs. This is because a *majority* of PuAF trustees must be Responsible Persons.

6. Measures proposed in the Discussion Paper could logically apply to all "public funds"

Proposals in the Discussion Paper could logically apply to all "public funds", under subdivision 30-B ITAA 97 such as scholarship funds, necessitous circumstances funds, overseas aid funds and school building funds. As such, the proposals need to be publicly discussed more widely than by way of the Discussion Paper, rather than perhaps one day being presented to operators of these other public funds effectively as a *fait accompli*.

7. A corporate trustee has some benefits

In our view a corporate trustee has some benefits for the operators of PuAFs, despite the additional administration and duties of its directors. The major benefit is that a corporate trustee exists in perpetuity, unlike individual trustees. For this reason we do not resist the Discussion Paper's proposal that PuAFs have a corporate trustee.

8. Other minor matters

We note that the model deed for PAFs no longer includes power of trustees to fundraise. Such a power for PAF trustees was of no use. However PuAFs trustees are required to seek donations from the public. Accordingly they need to be given power to do so under the trust deed. Any PuAF "administration expenses" allowed by the ATO should also include expenses associated with that fundraising.

We support the Discussion Paper's proposal that the ABR website display a DGR endorsed entity is either an "Item 1 DGR" or "Item 2 DGR". This in itself we imagine, will help PuAF trustees avoid incorrect distributions.

Conclusion

Treasury has approached the Discussion Paper with the view that the Guidelines are to be similar to the PAF guidelines. We think this is a lazy "copy and paste" approach. Treasury seeks to apply a legislative regime designed especially for high net worth individuals and their families to establish their own privately run and operated DGR endorsed foundations. In doing so it has lost sight of the context in which PuAFs operate.

The release of the Discussion Paper and proposed enactment of the Guidelines in July 2011 has in our opinion been ill timed. This is because the Non-Profit Sector Reform Council is currently being established to oversee establishment of the Non Profit Office. The Discussion Paper does not tell us whether the Non Profit Office will be involved in any decision relating to PuAFs. We think the Non Profit Office ought to be involved.

Despite our qualifications about the Discussion Paper, we commend Treasury for encouraging debate on PuAFs. We encourage Treasury to now move that debate to the proposed Non Profit Office and to operators of other “public funds” before making any recommendations to the Assistant Treasurer for legislative change.

Yours faithfully

DF MORTIMER & ASSOCIATES

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