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

Dear Sir,

IMPROVING THE INTEGRITY OF PRESCRIBED PRIVATE FUNDS (PPFs)

I refer to The Treasury's Discussion Paper "Improving the Integrity of Prescribed Private Funds (PPFs)" (the Discussion Paper) and make the following comments as a private citizen and as an accountant and tax agent with a small number of clients who have established PPFs to further their philanthropic interests.

Generally I applaud the removal of the restrictive accumulation plans, the general simplification and greater certainty of the rules.

However, I am concerned that the new guidelines reflect an approach to PPFs that is short term. I believe there is a grave risk that this approach will greatly reduce the desire to establish PPFs and will put at risk the objectives of PPFs already established. Should these rules have a retrospective effect, then the basis and objective of many established PPFs may well be undermined. I have some concerns with what I believe is an excessive emphasis on market values rather than income as a basis for the distribution policy of PPFS.

I have addressed my concerns in answering your consultation questions.

CONSULTATION QUESTIONS

What is an appropriate minimum distribution rate? Why?

The minimum distribution rate should be 100% of investment income.

Why?

The discussion paper enunciates Principal 1 as "PPFs are philanthropic". However, it seems clear that the Government is anxious that PPFs are not of an enduring nature.

The discussion paper makes the point that the Government is anxious that the revenue forgone (up to 46.5% of contributions to PPFs) finds its way into philanthropic purposes within a relatively short period.

The Discussion Paper suggests the purpose of the PPF systems is to create a benefit to the charitable sector that is greater than that available had the Government not forgone the revenue forgone but collected it and directed it to the charitable sector.

This seems a reasonable purpose. However, in my opinion, the current proposals are too short term in vision. A longer term plan would not preclude an enduring nature for PPFs or a building of wealth within the PPF.

Indeed, it is my view that PPFs can sustain long term programs of support to the charitable sector at consistent or increasing real levels, if their income can grow to match inflation.

It is therefore my view that the minimum distribution rate should be set in reference to the income of the PPF. Further, income should not be defined so as to include realised or unrealized gains or losses.

There is no need for reinvestment of income as a safeguard against inflation. If the trustees want to retain the real purchasing power of the capital then they should be free to invest in appropriate growth assets and not be constrained by the need to realize some of those investments each year.

Finally, any variation to distribution policy should not be applicable to established PPFs. Many of these funds will have been established with an accumulation plan that may envisage contributions over a number of years. A change in distributions policy that lifts the minimum distribution level, could put the basis on which these accumulation plans were implemented at risk.

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

No.

I don't believe the Commissioner needs to have the ability to modify the minimum distribution amount nor do I believe he should have this ability.

I don't believe it is necessary for any adjustment to the minimum distribution amount whether by the Commissioner, Treasury or any other regulator. Markets fluctuate considerably, but over time growth assets (equities and real property) should maintain a real value.

The Commissioner should be restricted to administering the PPFs in accordance with the law and the Government (Treasury) Guidelines. The requirement for the Commissioner to set policy should be limited wherever possible. This enables the Commissioner to focus on his primary duty of collecting what is due and not setting the price list.

If, as I suggest should be the case, the minimum distribution amount is the income earned, market fluctuations are irrelevant. Income fluctuations follow market fluctuations but are much diluted in the they are not as responsive to the sensitivity of markets.

Further, as noted above, many PPFs have been established with a longer term program of philanthropic support to the charitable sector in mind. If the distribution criteria is uncertain, the longer term objectives could be at risk.

Should a lower distribution rate apply for a period (for example, 1-2 years) to allow newly established PPFs to build their corpus?

No.

However, the minimum distribution for any year should be based on the financial statements of the PPF for the immediate preceding year and thus there would be no minimum distribution required for the period from establishment to the first balancing date. The minimum distribution amount in the second "year" may be smaller than that of a year the follows a full year, if the first "year" or period. (ie from establishment to first balancing date) is only a short period.

NOTE:- This discussion paper makes the comment that "The failure of PPFs to value assets leads to reduced distributions as some PPFs do not determine the value of unrealized capital gains, which the Guidelines say must be distributed if they are in excess of the approved capital base over any two consecutive financial years". This is only true in times of rising market values. Where the markets are falling, even if income levels are maintained, a minimum distribution amount that is based on market values (there by including unrealized capital losses), will result in much reduced minimum distribution amounts.

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

Yes

Even if minimum distribution amounts are not based on asset values (as suggested by me above), the regular valuation of assets at market values is appropriate as it is only by looking at current realizable values that the trustees (and the Commissioner) can determine that assets are being properly managed.

The trustees of self managed superannuation funds have similar prudential obligations and are required by statute to implement and review annually an investment strategy This should be a requirement for the trustees of a PPF as well. To properly implement monitor and review that investment strategy, asset values must be relevant – ie market values.

However, in implementing any such requirement the Government needs to consider frequency and cost.

In terms of frequency, I would think the valuation of assets in the annual financial statements should be at market values.

In terms of cost, it is important to remember some assets, which may be appropriate assets for a PPF trustee to hold, do not have a regular market quotation (eg real property, unlisted equities). The obtaining of values for these assets may be a costly process and/or indeed an uncertain process. Some allowance for costly valuations to be obtained on a less frequent basis (every 3-5 years) or trustee valuations should be provided.

Is setting a minimum PPF size appropriate

No

The discussion paper quite validly notes a concern that the administration expenses could be disproportionate and erode capital.

It has been my experience that the founders of the PPF and their families have been very active in the investment of the capital and the identification of potential beneficiaries and the distributions there to. As a consequence, the administrative costs are low. This is more likely to be the case where the PPF is smaller and established by a family rather than private corporation.

Accordingly, a fund with say $200,000, producing $10,000 to $15,000 in distributable income may still be very beneficial to the community.

As PPFs reduce capital (especially if the minimum distribution amount is set based on fund value and not income) it will eventually fall below a minimum size, if set. In this case the whole of the capital would need to be distributed and this may not be consistent with the PPFs purpose or indeed the public interest.

In paragraph 4 of the discussion paper the point is made that "a PPF cannot distribute to another PPF or to a public ancillary fund". If a minimum PPF size is to be set, then transfer to another PPF or a public ancillary fund (PAF) should be permitted.

Indeed, transfer of the capital from one PPF to another PPF or PAF should be permitted at any time and at the discretion of the trustees. This may be desired for example where such a transfer is consistent with the purpose of the PPF and leads to administrative efficiencies.

What should the minimum PPF size be in dollar terms?

One Dollar.

Although I am of the view that there should be no minimum PPF size, if one is to be set, the amount should not discourage the formation of PPFs by philanthropic minded taxpayers with limited means. The criteria should be that there are sufficient funds for the PPF to be effective PPF and provide a real benefit to the community.

If the Government does set a minimum dollar it will create many issues that need to be allowed for. These might include (but would not be limited to):-

(i) Currently, accumulation plans are required and the funding can be over a number of years. Is the minimum size envisaged by the Government, the minimum at any time or at the culmination of the accumulation plan?

(ii) What are the circumstances when an existing PPF's funds fall below the minimum, particularly if further contributions are possible? Is there a timeframe to recover?

(iii) What is the consequence of a minimum PPF size in markets that have fallen by 54% (as is the current position with the Australian share market)?

(iv) How frequently must this be assessed?

(v) Could that fact that a PPF is close to the minimum size discourage the trustees from making distributions to charities so as to preserve the PPF?

Should a fund have to distribute all its capital when its total falls below this minimum amount?

No

I have made some comments above that are relevant to this question.

Generally, I think it should be left to the trustees to determine when the philanthropic purpose of the PPF can no longer be supported by the funds available. At that time and only at that time (and it could be an annual test the trustees need to apply), the trustee could have certain options:-

(i) distribute all the remaining capital and income to complying deductible gift recipients (DGRs)

(ii) Distribute all the remaining capital to one or more other PPFs and/or PAFs

(iii) a combination of (i) and (ii)

The annual test that the trustees could be required to apply to themselves could be in the form of a question the trustees need to answer each year in the PPFs annual return to the Commission. Such a question could be

> "Are the trustees satisfied that the assets held or expected to be contributed to the PPF during the next financial year sufficient for the trustees to meet the objectives of the PPF".

Are there any relevant issues that need to be considered in improving and standardizing accountability of PPFs?

Yes.

I think public accountability can best be improved, by ensuring all PPF trustees are conscious of, understand and actively adhere to their fiduciary obligations.

This could be done by requiring all trustees to sign annual returns where they acknowledge these fiduciary obligations and their compliance therewith.

Education of PPF trustees via seminars and publications will help.

To assist trustees focus on their obligations, the annual reporting could ask the trustees to report on the PPF's objective and how they have achieved that in the financial period covered by the report.

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

Yes.

I am not sure that all PPF's (some are fairly small and have fixed programs in place) would welcome the level of "requests" that might result from a public listing of all PPFs. However, a facility for PPFs to be listed (for a period or permanently) at their option may be beneficial.

There are already commercial operations that offer "screening" services that purport to screen trustees from requests. If all PPFs were listed and subject to extensive requests I think this may only lead to an abundance of commercially based "screening" services which could increase administrative cost substantially.

As an alternative, the Commissioner could also establish a website for trustees to access where DGRs could place a link to their own websites or give a brief outline of their charity. This would enable PPF trustees wanting to seek out worthy beneficiaries to do research without the risk of the pressure of requests. There are many philanthropic persons who do perhaps not want to receive unsolicited requests.

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

Yes.

Two years should be ample time if the new Guidelines and the changes needed are clear.

However, it would be helpful if a consultative process could be established where changes (e.g. to trust deeds needed to facilitate the adoption of new Guidelines) can be approved in principal by the ATO (as regulator) prior to formalisation.

Are there any costs or other concerns relating to the corporate trustee proposal.

Yes.

There are a number of benefits of corporate trustees but I have difficulty in agreeing with the proposal in the discussion paper that the cost of requiring corporate trustees would be "far outweighed by the ATO's enhanced ability to take action against PPFs that miss manage their money".

The costs of moving to a corporate trustee are in reality minimal.

It is not the cost side I have difficulty with. It is how the ATO's ability to take action is enhanced where there is a corporate trustee that I have difficulty with.

Firstly, if there has been some misuse of PPF funds and some punitive or corrective action is needed, that action to be taken will be against the trustee or trustees not the PPF itself. I think this is understood. It seems to me that the only benefit a corporate trustee provides here is that a corporate trustee may be more easily identified (e.g. because it is registered). Individuals may move offshore, change address within Australia, change name or otherwise be hard to contact.

However, this benefit is illusionary. If the corporate trustee is a $2 company, which is likely to be the case if the Company's activities are limited to acting as the trustee of the PPF (which is most likely), then being able to identify and take action against the corporate trustee may be easier, but ineffective.

To be effective further action is needed. For example the Commissioner or a liquidator of the corporate trustee will still need to pursue the directors for the funds to effect punitive action and, if possible, recover funds.

Thus a corporate trustee in effect places an additional hurdle between the regulator and the individuals ultimately responsible for any PPF mismanagement (and the ultimate source of any restitution of funds).

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

I am not aware of any privacy concerns here.

The trustees of a PPF have a fiduciary duty as trustee, to the beneficiaries. The beneficiaries are the population of DGR status charities. It is difficult for these charities to take the trustees to task when there is a breach of that fiduciary duty. It seems quite appropriate for the Commissioner to be charged with the responsibility of representing those beneficiaries for such purposes. As such, the Commissioner could bring to the attention of any regulator any concerns in the same way any beneficiary might do.

Are there any concerns over particular penalty types?

No.

Care should be taken to ensure the remaining PPF funds are not further reduced by penalties.

The penalty should be addressed only to the trustees. However, where breaches are repeated or serious the trustees should be removed and professional trustees appointed (for a period or permanently). Alternatively the PPF could be wound up and the funds transferred to another PPF or PAF (See comments above).

There is no doubt that one reason individuals or families establish PPF is to have control over which charities benefit from the funds they have set aside for philanthropic purposes. The loss of that control would be a severe penalty and whilst I have no concerns with any of the penalties foreshadowed, encourage the Government to maximize the use of removal/disqualification of trustees (with other penalties or fines if appropriate).

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

Firstly, I understand this test would apply to directors of corporate trustees as well as individual trustees. Further, is there to be two levels of tests, one for the responsible person trustees and one for the others?

It is my view that it will be difficult to have a "fit and proper persons" test that will apply in all cases. There may be some specific exclusions (e.g. persons disqualified to be public company directors).

It is important to remember that many PPFs are established by family groups. It is my experience that parents can want their children to be involved in the family PPF (the family having a longer term view). The types of characteristics listed in Appendix 'C' are difficult for family members to assess in each other. The responsible person should be subject to specific tests (as is currently the case) but to develop a test that can be effectively applied by a family to its own members may be difficult.

If a "fit and proper person" test for trustees other than the responsible person were to be introduced and it was so stringent as to exclude some or all of a family's members (because, for example, they had no business experience), then there is a risk the PPF will not be established.

If the Government is concerned with the whole concept of PPFs (i.e. family charitable funds) then they should abandon the whole concept. If the Government feels that PPFs enable philanthropy to be more widely expressed, and will provide an overall benefit to the community, then the "family" nature must be retained.

It is my view that the trustees (or directors of trustee companies) need to have ready access to material on their obligations and the responsible person's position needs to be reinforced. The ability to remove control from the family where the trustees fail to meet their obligations is, in my view, enough to encourage the family to familiarize themselves with and adhere to their obligations.

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

The Trust Deed needs to be a complete document in itself. As noted in the discussion paper, the trustees of PPFs are obligated to comply with other laws, specifically its state Trustee Act and Federal taxation laws.

Therefore, movement from the trust deed to the updated Guidelines may not be appropriate. It is, however, open for the guidelines to cover aspects that may be covered in some or all trust deeds as well as matters not generally address in the trust deed. There needs to be a mechanism to resolve conflicts between trust deeds and guidelines but this possibility will always exist and that mechanism is needed. [NOTE, once a trust deed is created it is a static document unless the deed itself is amended. Where as it is in the nature of Government to constantly change guidelines. This greatly increases the potential for conflict between the trust deed and the guidelines. This could create a need to constantly change trust deed and this will involve costs to the PPF]

It is important not to overlook the fact that the provisions of a trust deed are protected by the force of law. A trust deed creates rules that a trustee (and others) must adhere to and I don't see that the guidelines will have any greater support or recourse to the forces of the law. What I do see is that the guidelines can be more easily changed by the Government.

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

I think the best policing of the actions of the Trustees will be by the Trustees themselves. I think this can be done in two ways.

(i) By giving the responsible person trustee the ability to veto any decision and an obligation on the other trustees and to ensure the responsible person trustee is aware of all transactions before they are committed to. This will, of course, increase the burden on the responsible person trustee and there would need to be some "diminimus" provisions, however, I think the responsible person trustee (who must be independent) should have some level of veto.

(ii) By increasing the level of annual reporting. The financial data reported on each year is currently adequate. However, the trustees should be asked to comment on their overall performance in terms of the objectives of the PPF. The objective of PPFs is to provide philanthropic support to the community via DGR status charities. The trustees should report on how they see this overall objective and how they are achieving it. The auditor of the PPF may be asked to report on this statement by the Trustees. All trustees could be required sign this report.

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 a fund)?

Yes.

I base this answer on my premise that PPFs should be enduring and not a short term program as it seems to me the Government intends. However, even in a short term program some of the following comments apply.

I am not sure what life time the Government has in mind for PPS but note that PPFs (like superannuation funds) do not necessarily have a vesting date. This is a specific exemption provided by Government and is indicative of the longer term rather than the shorter term.

Accordingly, a PPF could endure several generations. The funding or gifting to the PPF could extend to a wide circle of family with associated family companies and trusts donating.

Clearly, there are considerable income tax concessions when donations are made to PPFs. These concessions are taken into account when families make donations. I am sure the Government intends this to be the case; otherwise the whole concept of PPFs is not viable. The Government must also appreciate that the family should be able to make those donations from whatever entity in the family group both

(a) has the funds to donate and

(b) can maximize the benefit of the income tax concessions.

This is not tax avoidance. The income tax concessions are not a benefit that arises without a substantial cost. The concessions merely reduce the cost to the taxpayer of optional philanthropy and leverage the benefit to the community of that philanthropy. The income tax concessions may direct revenue from the Government's own coffers to a fund with philanthropic purposes (as noted in the discussion paper) but at the same time an at least equal amount is diverted from the family's coffers to that fund.

It is quite sensible to allow the family flexibility as to who and what entities make the donations and receive the income tax concessions.

To limit the number to 20 may limit the ability of the family to maximize the income tax concessions (the result of which will be less funding of the PPF) and could also limit the life time of the fund.

A limit of a number of allowed donors, whether it is 20 or some other number, will be a greater constraint on some PPFs than on others (depending on fund size, size of family and the age of the fund).

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

I am not familiar enough with the distinction between a PPF and a PAF to fully comment here, and time has not allowed me to gain that familiarity. However, on the basic understanding that a PPF is privately controlled and a PAF is more of a public entity with a broader base of donors, I can see no reason why a PPF should not convert to a PAF (whatever that involves) if the PAF structure is more suited to the change in circumstances

It should not, however, be the only mechanism. Amalgamation with another PPF or winding up and dispersal of all funds may be better alternatives in some circumstances. There may be other alternative.

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

Again the lack of familiarity with the difference between a PPF and a PAF hinders my response to the question.

I would think the prudential requirements and fiduciary obligations of the trustees of both types of fund are much the same, if not identical.

The reporting obligations of a private fund (PPF) are likely to be less onerous than as for a public fund (PAF), but this should only be in terms of who can see the financial and other reports.

The qualification of the trustees of a PPF should be less onerous than might be prudent for a PAF. I would suggest the requirements of a PAF trustee be required to be met by the responsible person trustee of a PPF. So there will need to be rules as to who can be a continuing trustee (or director of a trustee company) by conversion from a PPF to a PAF.

Would there be any disadvantages from introducing this limitation (requiring conversion of illiquid assets to liquid assets) to the existing PPF investment rules?

Yes.

The Trustees should be free to invest the funds as they see best. The size of the fund and the level of income etc are all factors that trustees must consider (together with the philanthropic purposes) when setting the investment strategy.

This area is one of my real concerns with regard to the proposed changes.

I think that the Government needs to decide whether or not PPFs are in the interest of the community in general or not. I believe they are. If that is the Government's view then Government should put in place rules and guidelines that are predicated on the belief that founders and sponsors of a PPF (who are generally the trustees or associated with the trustee) and the trustees of that PPF will conduct themselves in a truly philanthropic manner. This is, without exception, my experience.

There will be a great range of skill sets amongst the PPF trustee population. Guidelines will assist Trustees to identify their obligations and how to meet them. However, the rules guidelines should not be predicated on the basis that Trustees, founders and sponsors will attempt to abuse the PPF or use the PPF for tax avoidance purposes.

Certainly such abuse and use for tax avoidance purposes may well occur, it is the nature of some taxpayers to entertain any advantage. I have discussed the reporting and penalty regimes above that should minimize these risks to the revenue. However, most founders, sponsors and trustees will, in my opinion, act in a prudential, fiduciary and truly philanthropic manner.

The Trustees need to be free to invest as they see fit to best achieve the philanthropic purposes of the PPF. If this calls for some investment in growth assets, so be it.

I have commented above that I do not believe the minimum distribution amount should be based on anything other than the income of the fund. This does not preclude the Trustees from distributing capital (far from it) it simply means the Trustees are not obliged to distribute capital and can build the fund into a resource that can and will support the DGR status charitable bodies of Australia long into the future. The substantial benefit to the community of such a resource is obvious and will reduce the demands on government.

I also have difficulty with the definition of liquid and illiquid assets. This is a relative team. Is a bank account liquid? Generally yes, but what if it is currently an account frozen to protect the financial institution it is placed with (as is the case with some institutions in the current economic climate).

Restrictions on PPF investments should be limited to the general restriction for trustee investments and should exclude any investments that are not at arms length with the trustee, founder or sponsors or their associates.

CONCLUSION

I think the PPF system has the potential to empower Australia to build a substantial and reliable resource of privately controlled funds dedicated to the support of charitable bodies. These funds will be in the control of private individuals with philanthropic intent and a wide skills base.

However, this resource must be built with a long term view. It must be built, maintained, governed and regulated on the predication that there are a substantial number of Australian taxpayer who have genuine philanthropic intent and that that philanthropic intent cans be used to build a valuable national resource. The system controlling this resource should be flexible and acknowledge the wide skills base and the potential for individuals with modest means to contribute.

The discussion paper seems to suggest that the Government is anxious to see its forgone revenue transferred from the PPFs to the charitable bodies in a short period of time. I think this is a narrow and short sighted view. The longer term view is, in my opinion, preferable. PPFs should be allowed to be enduring bodies with transfer of control between generations of the founder's family and even between controlling families.

The rules and regulations should be predicated on the premise that founders, sponsors and trustees have a philanthropic intent and a desire to meet their fiduciary and regulatory obligations. The discussion paper is looking to introduce penalties that match the crime (rather than the all or nothing approach). This is to be applauded, although penalties should not be imposed so as to dilute the overall resource. Penalties should be directed at reducing the involvement of founders, sponsors and particularly trustees who breach their fiduciary and or regulatory obligations and the recovery of funds misused.

Any rules concerning minimum distribution and investment should focus on the distinction between income and capital. Realised and unrealized gains should be on capital account with income being the earnings of capital (interest, dividends and rental).

The focus of minimum distribution amounts on capital (rather than income) is, in my view, fundamentally flawed. The current economic downturn highlights this. In the current economic climate, private giving is likely to fall putting stress on the vast number of charitable bodies who rely heavily on private donations for funding. At this time, when these bodies could well be most dependant on PPFs to sustain their funding needs, a minimum distribution amount based on market values of capital will be reduced by the decline in market values. A minimum distribution amount based on income levels, however, would not be impacted to the same extent.

The fundament flaw is the Government's view that PPF should not be enduring.

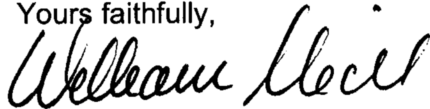
The Government rightly recognizes that up to 45% (46.5% in reality) of PPF funds are funded by Government revenues forgone. The Government is anxious to see this forgone revenue injected into philanthropic purposes in the short term. This is understandable.

However, no less than 53.5% of PPF funds are sourced from Australian taxpayers.

A long term view could see this leveraging of Government revenues forgone build a significant resource that could reliably contribute in a meaningful way to charitable bodies, at the same levels regardless of the economic climate, for generations.

Any changes to the environment in which existing PPFs operate should not be such as to put at risk the objectives or the basis of operation of those PPFS.

Yours faithfully,



William John Neill