Improving the integrity of public ancillary funds

Treasury Discussion Paper - November 2010

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Introduction

Thank you for the opportunity to provide comments and submissions in respect of Treasury's discussion paper for improving the integrity of public ancillary funds (**Discussion Paper**). We provide some background comments regarding certain aspects relating to the public ancillary fund regime more generally, that we believe merit further consideration by Treasury, and offer some specific comments on the consultation questions posed in the Discussion Paper.

We support the key principles informing the Discussion Paper as summarised at page 4. However, care needs to be given to the implementation of the principles to ensure that the practical operation of the proposed regime is not counterproductive to the overarching goal of promoting (and not discouraging) philanthropy in Australia. As donations and deductible contributions made to a public ancillary fund can only ever be applied to other deductible gift recipient (**DGR**) endorsed entities, that are not themselves a mere conduit fund, we submit that the pursuit of integrity must be approached from the perspective of enforcing public accountability and prudent management rather than of preventing revenue leakage. In our practical experience, founders who seek advice in regard to establishing a public ancillary fund are primarily motivated by philanthropy and are only incidentally motivated by any tax benefits that may flow from contributions to such funds.

We support greater transparency and accountability relating to the management of public ancillary funds but submit that this should not be achieved at the expense of efficiency which may be compromised by the requirements to comply with multiple laws and regulations at both a federal and state level that impact upon such funds. Therefore, we are concerned that the proposed legislative guidelines, though welcome in principle, will add another layer of complexity to existing compliance obligations for corporate trustees of public ancillary funds under the *Corporations Act 2001*, general trust law and fundraising legislation. This concern is to be balanced by a need for much greater clarity on the compliance obligations relating to the management of public ancillary funds.

Where public ancillary funds are structured as charitable trusts, this has the effect of limiting the range of potential DGR beneficiaries to those that are also endorsed by the Commissioner as charities. This is because of the differences in the categories of entities that are entitled to DGR status under Division 30 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) and the categories of entities that are entitled to exemption from income tax under Division 50 of the ITAA 1997 on the ground that they are charities. Not all DGR entities have income tax exemption status as charities and not all income tax exempt charities have DGR status. Consequently, public ancillary funds established as charitable trusts are precluded from making distributions to non-charitable DGRs, such as school library and building funds established by government schools. This result limits the potential benefits that may be provided by public ancillary funds and adds to the compliance difficulties in managing such funds.

Further, given the Commissioner's current approach in administering charitable trusts, it is unclear whether public ancillary funds that are not established to pursue charitable purposes do in fact qualify as valid trusts under general trust law principles where the class of discretionary DGR beneficiaries includes entities that are not themselves charitable. We submit that these issues need to be given further consideration by Treasury.

We submit that the current legislative requirement, which is unchallenged by the Discussion Paper, that public ancillary funds established *inter vivos* must be established as trusts, should be tested. We question whether it is necessary to structure public ancillary funds as a trust. For example, another option may be to incorporate public fund rules into the constitution of a company limited by guarantee. Having a single entity would reduce the compliance obligations in relation to the on-going management of such funds.

We submit that the government's current review of the public ancillary fund regime provides an opportunity to address issues that are common to all DGR entities that are currently administratively required to comply with the Commissioner's public fund rules in Taxation Ruling TR 95/27. Therefore, we support a general codification of the public fund rules in principle for all DGRs, subject to a careful scrutiny of the continuing relevance of the principles set out in TR 95/27 being carried out, and provided that any such codification does not create further complexity at the expense of efficiency in the administration of public ancillary funds.

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Responses to specific consultation questions

Consultation Question 1 – What is an appropriate minimum distribution rate for a public ancillary fund and why?

Given the public control over public ancillary funds, and subject to sufficient accountability in relation to their management, we do not consider that it is desirable to impose a minimum distribution rule. However, to the extent that a minimum distribution rule would be imposed, we submit that it should recognise the existence of any illiquid assets of a public ancillary fund that has the potential to generate distributable income and should not operate harshly to force a sale of such assets simply to satisfy the minimum distribution rule in a particular income year. If a public ancillary fund has experienced poor investment results in any one income year, the minimum distribution rule should provide the public ancillary fund with an opportunity to recover from its losses in the following income year, unless certain non-mitigating factors are present which would justify a stricter distribution rule from a deterrent perspective, such as investments having been made in bad faith. Further, we submit that the minimum distribution rule should provide the Commissioner with a discretion to be waived in particular circumstances, for example, in the context of the recent global financial crisis. There should also be a carve-out to allow for capital accumulation in certain situations, for example where a decision has been made to commit money to a specific project to be carried out by a DGR recipient entity, such as building an extension to a building used in carrying out the DGR purposes.

Consultation Question 2 – Are there any issues that the Government needs to consider in implementing the requirement to ensure public ancillary funds regularly value their assets at market value?

The requirement to regularly value assets at market value is prudent. However, the government should bear in mind that a requirement to regularly market value assets adds to the compliance costs of administering public ancillary funds more generally. Such costs reduce the value of distributions that may ultimately be available for distribution to DGR recipient entities.

Consultation Question 3 – Are the valuation rules that apply to private ancillary funds also appropriate for public ancillary funds? If not, why not?

We have no comments to make in this regard in addition to those made in response to question 2 above.

Consultation Question 4 – Are there any issues with requiring public ancillary funds to lodge a return?

The requirement to lodge an annual return is consistent with the goal of achieving greater public accountability and scrutiny of public ancillary funds. However, from the perspective of efficiency, we submit that an annual return for public ancillary funds should be simplified.

Consultation Question 5 – Are there any issues with imposing greater public disclosure requirements on public ancillary funds? What information should remain confidential and what information should be disclosed and why?

Public ancillary funds should be required to provide information about the amount of income earned, expenses incurred, the total amount of distributions made and a broad description of the types of DGR recipient entities to whom distributions are made (for example to a PBI). However, for privacy reasons, information that identifies any particular DGR recipient should not be disclosed to the wider public. Information should be provided to specific donors regarding the identity of ultimate beneficiaries.

Consultation Question 6 – Is the administrative penalty regime (including magnitude of penalties) that applies to private ancillary funds suitable for public ancillary funds?

An administrative penalty regime places the Commissioner into the defacto role of public regulator of public ancillary funds. Further consideration should be given to whether the *Corporations Act 2001* (in relation to a corporate trustee) and general trust law already provide the Australian Securities Investment Commission (**ASIC**) and the State and Territory Attorneys General with sufficient regulatory control over public ancillary funds. To the extent that there is a need to supplement existing regulatory regimes with a specific tax administration penalty regime, it would be preferable to develop such a regime for all DGR entities required to comply with the public ancillary fund guidelines.

Consultation Question 7 – Are there any difficulties in requiring public ancillary funds to have a corporate trustee?

We agree that it is preferable to have a corporate trustee compared to individual trustees because of the perpetual life of a corporation which means, among other things, that ownership of the public ancillary fund's assets does not change hands as it would in the event of a change in individual trustees (which can have stamp duty implications). However, the requirement for a corporate trustee increases the associated compliance costs in managing public ancillary funds. The corporate trustee would need to comply with both the obligations imposed in the *Corporations Act 2001* and general trust law obligations in its capacity as trustee. Consideration could be given to other forms of structuring public ancillary funds, as discussed in our introductory comments above, such as incorporating public fund rules into the constitution of a company limited by guarantee.

Consultation Question 8 – Are the rules for suspension or removal of trustees of private ancillary funds suitable for public ancillary funds?

We submit that the rules should explicitly set out the specific circumstances in which the Commissioner would be able to exercise administrative powers to suspend or remove a trustee. This power should only be exercised in exceptional circumstances that should be clearly set out in the legislation and the power should only be exercisable at a senior SES level within the Australian Taxation Office (for example, at Assistant Commissioner level).

Consultation Question 9 – What fit and proper person requirements should be imposed on trustees of public ancillary funds?

We submit that further clarification and guidance should be provided on the 'responsible person' requirement as defined in Taxation Ruling TR 95/27 and on who is or is not considered to be an 'associate' of a founder or major donor.

Consultation Question 10 – What transitional arrangements are required for existing public ancillary funds to conform to the new arrangements?

Existing public ancillary funds should be given sufficient time to comply with any new requirements and implement any necessary changes to their structure and investment strategies without the risk of being penalised for any prospective failures to comply with the new regime. Any structural changes or necessary transfer of assets as a result should not trigger any taxation implications at either a federal or state level (for example, there should be no stamp duty implications as a result of a required transfer of any assets).

Consultation Question 11 – Should the term 'public fund' be codified in the guidelines in accordance with the principles set out in ATO Taxation Ruling TR 95/27?

Codification of the public fund rules is desirable but only after a detailed analysis of Taxation Ruling TR 95/27 is carried out. In this regard, we refer to our introductory comments as set out above. In particular, it would be desirable to clarify the obligations that responsible persons have in relation to their management of the public ancillary fund in comparison to the role of a corporate trustee and its board of directors.

Consultation Question 12 – Can the investment and risk minimisation rules that apply to private ancillary funds be suitably applied to public ancillary funds?

The current investment rules in the private ancillary fund guidelines on permissible investment strategies (in clauses 30-32) are broadly drafted. Greater clarity could be provided in relation to permissible investment strategies. For example, to what extent is it intended that the proposed guidelines will supplement existing obligations of trustees under general trust law principles to not enter into speculative investments? Given existing laws and regulations that already impose significant duties of care upon companies and trustees in relation to

making prudent investment decisions, and other legislative prescriptions, we consider that it would be unduly burdensome and restrictive to require public ancillary funds to prepare and strictly follow a written investment strategy. Further, the concept of an 'uncommercial transaction' in clauses 41 and 42 in the current private ancillary find guidelines is undefined and therefore vague. Further clarity on the concept of what is considered to be an uncommercial transaction would be desirable. The guidelines should clearly set out a test or examples of situations that are considered to be uncommercial transactions.

Specific information

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