Submission to the Commonwealth Treasury

Improving the Integrity of Public Ancillary Funds

Discussion Paper November 2010

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Introduction

This submission addresses the release of the Commonwealth Treasury's discussion paper on *Improving the Integrity of Public Ancillary Funds* (November 2010). The University of Western Sydney (UWS) has a taxation law academic group within the School of Law. Members of this group wish to provide an informed contribution on this discussion paper. Some of the suggestions that have been provided in this submission are of a policy nature under which circumstances the Australian Taxation Office could use different penalties. In addition the proposals should be seen as part of the consensus that the sector as a whole requires a broad based reform.

If any of the responses require further explanation please contact Lecturer of Taxation and Financial Planning, Elen Seymour at the UWS School of Law at e.seymour@uws.edu.au

Staff involved in producing this response

The University of Western Sydney, School of Law, has a variety of staff from many different areas of the law. In respect of this submission, the substantive legal submissions have been prepared by Elen Seymour, Dr Elfriede Sangkuhl, and Marina Nehme.

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General Observations:

The discussion paper, *Improving the Integrity of Public Ancillary Funds*, is proposing reforms to improve the transparency and integrity in this area. The discussion paper proposes to do this by providing 'a framework that will provide trustees with greater certainty as to their obligations and provide donors and the charitable sector with greater confidence that donations are being used effectively.'[1]

This submission has not addressed all of the consultation questions raised in the discussion paper but confined itself to the following questions:

- What is an appropriate minimum distribution rate for a public ancillary fund and why?
- Is the administrative penalty regime (including magnitude of penalties) that applies to private ancillary funds suitable to public ancillary funds?
- Can the investment and risk minimisation rules that apply to private ancillary funds be suitably applied to public ancillary funds?

The observations of this submission are summarised as follows:

- Clarification of whether public ancillary funds are to be prohibited from carrying on business and whether such a prohibition is compatible with the High Court decision in *Word Investments.*
- The introduction of a 5% of net assets basis of determining a minimum distribution for public ancillary funds is not always appropriate and that the terms of the fund itself should be the reference point.
- Administrative sanctions are important and need to become part of the armoury of the Australian Tax Office in bringing integrity to public ancillary funds.
- There is a need for a broad based reform including the creation of a independent regulator separate and distinct from the Australian Tax Office. The creation of an independent regulator such as a Charities Commissioner would be in line with emerging international best practice.

[1] Australian Government, *Improving the Integrity of Public Ancillary Funds*, November 2010, v.

Consultation Question – 2.1.1 Required distributions

What is an appropriate minimum distribution rate for a public ancillary fund and why?

The setting of an appropriate minimum distribution rate is problematic for a number of reasons.

1. Contradiction of purpose of public ancillary funds

The discussion paper recommends a minimum distribution of 'at least 5 per cent of the market value of the fund's net assets in each financial year'[2]. This distribution rate has apparently been established on the understanding that public ancillary funds, in common with private ancillary funds[3], are to act as a conduit for raising funds from the public and distributing those funds to the charity or philanthropic organisation for which it was established. The minimum distribution rate was also established for the stated purposes of:

- Ensuring that 'donations made through public ancillary funds will be directed to the charitable sector in a relatively short period of time'[4], and
- Ensuring that 'public ancillary funds not continuing to receive donations are eventually wound down'[5] thus preventing 'the erosion of the fund through negative investments, management fees and the like'[6].

The underlying assumption of the above stated purposes is that public ancillary funds are to 'collect donations from the public' [7]with the purpose of transferring those monies from the 'donor to non-ancillary DGRs[8,9]. The contradiction in purpose is found in the *Private Ancillary Fund Guidelines 2009* where Private ancillary funds are not permitted to conduct a business[10], consistent with the above purposes, but yet are required to 'maintain a current investment strategy'[11]. A requirement to maintain an investment strategy appears to allow ancillary funds the opportunity to grow as

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[2] *Improving the Integrity of Public Ancillary Funds*, as above, November 2010, para 31, 5.

[3] *Private Ancillary Fund Guidelines 2009,* para 8 states that a private ancillary fund 'is philanthropic in character and it is a vehicle for private philanthropy.' This discussion paper is proposing to introduce a regulatory framework for public ancillary funds based on the private ancillary fund guidelines.

[4] *Improving the Integrity of Public Ancillary Funds*, as above, para33. 6.

[5] Ibid, para 35, 6.

[6] Ibid

[7] Ibid, para 22, 4

[8] Deductible gift recipients

[9] *Improving the Integrity of Public Ancillary Funds*, as above, para 22, 4

[10] *Private Ancillary Fund Guidelines 2009*, para 40

[11] Ibid, para 30

philanthropic organisations in the tradition of the great American Foundations[12] established for philanthropic purposes for the long term. Until this contradiction is resolved, setting a minimum distribution is inappropriate.

2. Failure to take account the various types of public ancillary funds

Public ancillary funds will have different sources of income and different overhead structures and also have different sizes ranging from small scale to large business-like funds. For example, a fund could consist of a simple managed investment providing an income stream with minimum overheads. We support the principle that public ancillary funds should not be 'sparse distributors of funds'[13].

However, we do not support the principle that public ancillary funds should not be prolonged accumulators of funds. We think it entirely appropriate that the investment strategy of a public ancillary fund should include scope for the establishment of long term growth funds, such as the Rockefeller Fund, where the investment income stream be distributed for the philanthropic purpose of the fund. In this way the public ancillary fund can become a long-term source of income for philanthropic purposes. The short term approach, implicit in the minimum distribution requirement as proposed, will not allow for long term income growth nor for the financial independence of funds.

Setting a minimum distribution amount of 5% of the market value of the funds net assets in each financial year is not appropriate because:

- Different sizes of funds
- Different types of investment strategies, some allowing for the distribution of the capital of the fund and others providing for long term growth and accumulation of the capital of the fund
- Different overhead structures of funds

The discussion paper is making an assumption that public ancillary funds not continuing to receive donations will be wound down[14]. This may not necessarily the case. Funds that are sufficiently large, well endowed and well managed could continue to grow even without donations. In addition, a well managed growing fund would be more likely to attract donations as opposed to funds with a shrinking capital base.

3. Funds prohibited from conducting a business

[12] Foundations as old as the Rockefeller Foundation, established in 1913 by John D. Rockefeller, Sr. to promote the well-being of humanity around the world to the comparatively recent Gates Foundation.

[13] *Improving the Integrity of Public Ancillary Funds*, as above, para 26, 4

[14] Ibid, para 34, 6

The *Private Ancillary Funds Guidelines 2009* prohibit private ancillary funds from carrying on a business[15]. It is not clear whether the Public Ancillary Fund Guidelines will contain a similar prohibition for public ancillary funds. We would recommend that public ancillary funds be allowed to conduct businesses and direct their profits towards their philanthropic purpose. This is because charities are permitted to conduct businesses and to divert their business surpluses to their charitable purpose[16]. It appears to us inconsistent to allow charities to conduct businesses and to prohibit public ancillary funds from conducting businesses.

For example in the *Word Investments Ltd* case the majority held the 'activities of Word in raising funds by commercial means are not intrinsically charitable, but they are charitable in character because they were carried out in furtherance of a charitable purpose.'[17] The facts were that from about 1986 Word accepted deposits from members of the public who received little or no interest on the funds, Word invested the deposits at commercial rates of interest. In 1996 Word commenced a funeral business for profit. The profits from the investment business and the funeral business were used to support an exempt charity, Wycliffe Bible Translators International. In our view the activities of a charitable organisation such as Word Investments could be equally carried out by a public ancillary fund.

If public ancillary funds were permitted to carry on a business then a minimum distribution rate of 'at least 5 per cent of the market value of the fund's net assets in each financial year'[18] would be inappropriate.

Proposal

In order to take account the different investment strategies, sizes and operations of public ancillary funds we propose that instead of establishing a minimum distribution rate funds be required to distribute in accordance with the trust deed of the fund. This would allow for the fund to set distribution rates appropriate to the particular circumstances of each fund. The appropriateness of the distribution rate could be assessed by the ATO when approving the establishment of the fund.

It is also proposed that such an approach could be supplemented by the regulator establishing a series of benchmark rates of distribution that they would consider to be appropriate taking into account the different risk profiles of different types of public ancillary funds. This would remove the need to have a pre-determined distribution rate set in the Guidelines. The ATO could publish this information and create administrative enforceability through the use of the ATO's public rulings program. This approach requires the ATO to have access to appropriate information By setting appropriate benchmark return rates in a public document will remove some of the ambiguity of our proposal and allow for future funds to determine a distribution rate that is considered best practice during the drafting stage. Funds that are below the

[15] *Private Ancillary Fund Guidelines 2009,* para 40

[16] *Commissioner of Taxation v Word Investments Ltd* [2008] HCA 55

[17] *Commissioner of Taxation v Word Investments Ltd* [2008] HCA 55, para 27

[18] *Improving the Integrity of Public Ancillary Funds*, as above, para 31, 5.

benchmark return rates will be on notice and will need to reasonably document why a return is appropriate to their circumstances notwithstanding they do not meet the benchmark.

Consultation Question – 2.2.2 Increasing regulatory powers

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

1. Appropriateness of an administrative penalty regime

Administrative sanctions are largely understood as being sanctions imposed by the regulator without the intervention of a court or tribunal.[19] They are a form of intermediary penalties which allow regulators to deal with minor breaches of the law. As the discussion paper noted, the current system allows the ATO to revoke a public ancillary fund's endorsement or to refer an alleged breach of the law to the State Attorney General. This regime is unsatisfactory as it does not take into account minor breaches of the law. It is an 'all or nothing approach'. If the breach is minor, it will be unreasonable for the ATO to revoke a fund's endorsement. Imposing such a penalty means that the ATO is treating all funds in the same way irrespective of whether a breach of the law is minor or not. It also means that the ATO views all public ancillary funds, irrespective of the gravity of the alleged breach of the law, as 'bad apples'. Such a move will create resentment in the mind of the regulated entities which will lead to less cooperation with the regulator.[20]

Similarly if the ATO ignores minor breaches of the law because it deems that it has no appropriate sanction to deal with the breach, it will be sending a message to the regulated entity that certain provisions in the legislation are not enforceable. As Bhattacharya and Daouk stated, a scenario where the regulator's enforcement powers are not adequate to enforce the law is worse than a scenario where there is no regulation at all.[21]

Accordingly, having administrative sanctions is essential as it will allow the regulator to impose the sanction that is most appropriate to deal with the breach. Braithwaite, for example, has observed that the more sanctions there are, the better, since if there are a multitude of sanctions dealing with one act, at least one of those sanctions may be able to be used to deal with the offending behaviour.[22] Further, the availability of

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[19] Australian Law Reform Commission (ALRC), *Principled Regulation: Federal Civil and Administrative Penalties in Australia* (Report No 95, 2002), at 78.

[20] Eugene Bardach and Robert Kagan, *Going by the Book: The Problem of Regulatory Unreasonableness* (Temple University Press, Philadelphia, 1982) at 92–3.

[21] Utpal Bhattacharya and Hazem Daouk, "When No Law is Better than a Good Law" (2004)

<http://www.istfin.eco.usi.ch/u_bhattacharya.pdf >.

[22] Brent Fisse and John Braithwaite, *Corporations, Crime and Accountability* (State University of New York Press, New York, 1993) at 91; John Braithwaite, "Convergence in Models of Regulatory Strategy" (1990–91) 2 CICJ 59, at 59; Helen Bird, "The Problematic Nature of Civil Penalties in the Corporations Law" (1996) 14 C&SLJ 405, 410; Chris Dellit and Brent Fisse, "Civil Liability under

multitude of sanctions allows the ATO to apply an enforcement pyramid. This approach is desired because compliance is most likely when agency displays an explicit enforcement pyramid.[23]

Braithwaite and Ian Ayres described such an enforcement pyramid in their *Responsive Regulation: Transcending the Deregulatory Debate*.[24] An example of the pyramid that may be available to the FMA is characterised in Diagram 1.

Australian Securities Regulation: The Possibility of Strategic Enforcement" in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia and New Zealand* (LBC Information Services, Australia, 1994) at 579.

[23] John Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (State University of New York Press, New York, 1985) at 115; Christine Parker, "Reinventing Regulation within the Corporation: Compliance Oriented Regulatory Innovation" (2000) 32 Admin & Soc'y 529 at 541.

[24] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University, New York, 1992) at 35-6.

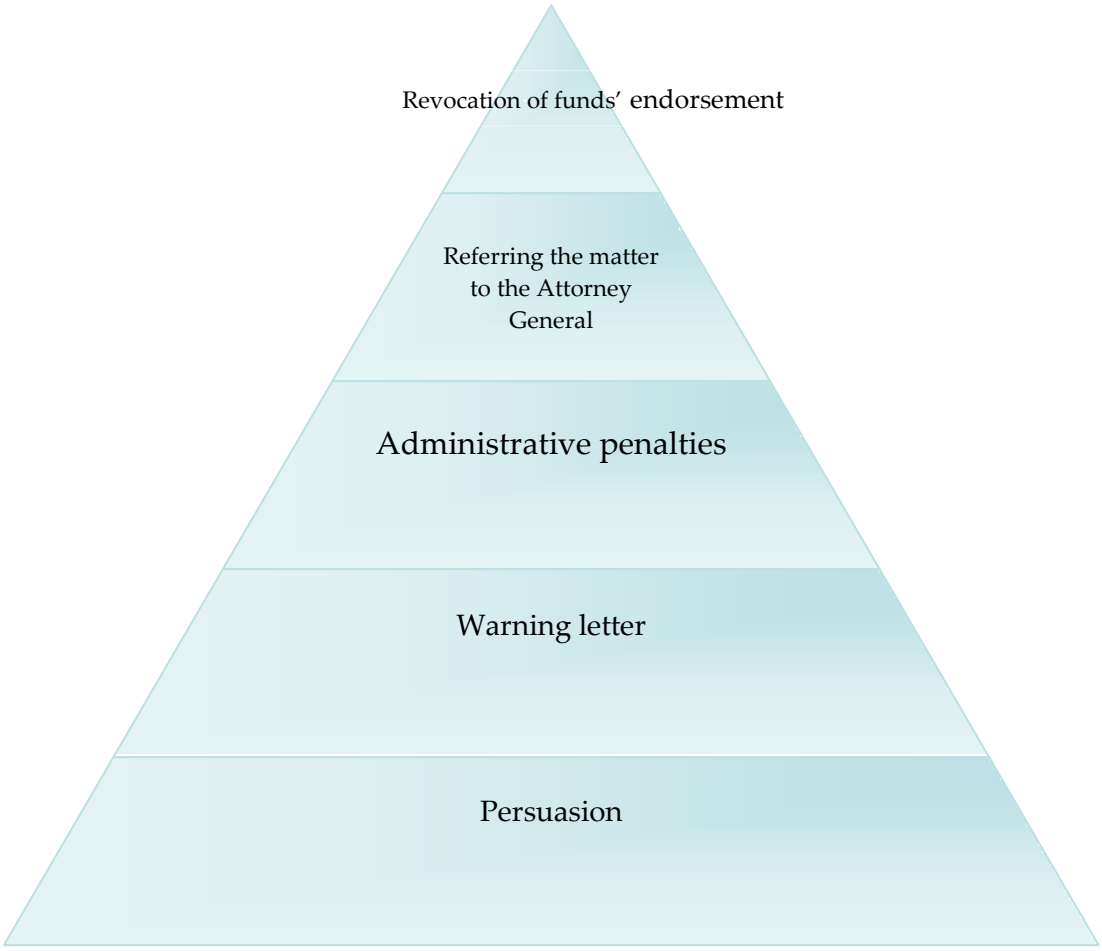

Diagram 1. enforcement pyramid[25]

As depicted in Diagram 1, the base of the pyramid represents attempts to coax compliance by persuasion. The next stage of enforcement is a warning that action may be taken if the violation continues. If this fails to secure compliance, administrative penalties may be relied upon to deal with the conduct. If these methods do not work to secure compliance, more drastic major can be taken.

The width of each layer in the pyramid represents the proportion of the total number of enforcement activities that occur at that level. The explanation for the varying size is simple. If the regulator can plausibly threaten to match any non-compliance by moving up successive levels of the pyramid, then most of the regulator's work will be

[25] The enforcement pyramid is based on Braithwaite's enforcement pyramid as illustrated in Ayres and Braithwaite, above n 9 at 35.

done effectively at the bottom levels of the pyramid. The lighter sanctions will dissuade the regulated entity from continuing its illegal activities because it will not want the regulator to use its strong sanctions. Put another way, when there is equilibrium between harsh and soft sanctions, the regulator attains the result it requires by speaking softly.[26]

In summary, the basic idea behind Braithwaite enforcement pyramid is that governments should respond to the conduct of those they seek to regulate in deciding whether a more or less interventionist approach is needed. It is better to begin with dialogue and then increase in severity.

Accordingly, we endorse the introduction of an administrative penalty regime. We also recommend the introduction of a variety of administrative sanctions such as enforceable undertakings in addition to monetary administrative sanctions.

An enforceable undertaking is a promise enforceable in court. It is akin to settlement as it is the result of a compromise. In the undertaking, the alleged offender (who can also be referred to as the promisor) promises to do or not to do certain action. One of the main characteristics of an enforceable undertaking is its enforceability in court in the case of non-compliance by the promisor with the terms of the undertaking. Consequently, this sanction may be a perfect fit in the regulatory landscape for it has two facets: one of persuasion and one of enforcement. On the one hand, the sanction is based on negotiation between the regulator and the alleged offender. Such negotiations may lead to settlement of the matter through the acceptance of an undertaking.

On the other hand, the sanction is also based on enforcement strategy. The enforceability of an undertaking in court means that when the persuasion strategy attempted in the use of an enforceable undertaking fails (because the promisor has not complied with the terms of the undertaking), the enforcement strategy embedded in the undertaking may take over since, in such instances, the regulator has the option of enforcing the undertaking in court. Rational people would be aware that non-compliance with the undertaking would lead to its enforcement. The option of enforcement gives an edge to the regulator because, in diminishing the likelihood that the promisor will not comply with the terms of the undertaking, it maximises the chances of compliance with the undertaking.[27]

Additionally, unlike monetary sanctions, an enforceable undertaking attempts to prevent the breach from reoccurring in the future by requiring trustees to revise their

[26] Ayres and Braithwaite, above n 9 at 35– 6; John Braithwaite, above n 7, at 63–4.

[27] Braithwaite, above n 7, at 118; Ministry of Consumer Affairs, *Summary on Submission on International Comparison Discussion Paper*, September 2006, <http://www.consumeraffairs.govt.nz/policylawresearch/enforcement-review/paper-two/submissions-summary/submissions-summary-01.html#P56_16558> .

compliance programs, put in place educational training and implement a monitoring system to guard against future breaches.

Further, an enforceable undertaking is restorative in nature.[28] For example, it can be used to provide compensation to victims of the alleged breach. The Australian and Securities Investments Commission has this sanction at its disposal and it has relied on it in such a way. For example, one prominent example can be found in the case of Multiplex Ltd, where Multiplex allegedly breached the continuous disclosure rules. It entered into an undertaking with ASIC, where it promised to compensate the investors for their loss and to engage an external consultant to reduce the possibility of a similar breach reoccurring.[29]

The availability of the intermediary sanctions such as an enforceable undertaking also allows the regulator to use persuasion when possible and punishment when appropriate.[30] Applying such a strategy will allow the regulator to enhance cooperation with the regulated community while limiting their resentment. After all, one will probably be inclined to listen to the concerns of a regulator if the consequences of not listening are drastic.[31]

2. The appropriateness of the ATO being the regulator

The appropriateness of the ATO continuing to be the regulator is an issue that ought to be considered in any decision regarding regulation of public ancillary funds. If the objective of the regulation is to 'improve the integrity of public ancillary funds'[32] then due consideration should be given to the need for substantial and broad based reform of the charitable sector as a whole. The approach of adding 'piecemeal' regulation to a sector that has been repeatedly described as confused and administratively overburdened is not an approach designed to enhance integrity or clarity. We ask that it be recognised that regulation of public ancillary funds by the introduction of a guideline forms only a small part of a sector in need of substantive reform.

It is proposed that the establishment of an independent national commission should be part of that broad reform process. This view is held not only by the authors but is held in the charitable sector, in the government sector and in academic circles[33]. An independent national commission has been a key recommendation of reviews of the

[28] Marina Nehme, "Enforceable Undertaking: A Restorative Sanction" (Forthcoming, 2010) *Mon ULR.*

[29] ASIC, Enforceable Undertaking: Multiplex Limited, Document No 017 029 205 (20 December 2006).

[30] Ayres and Braithwaite, above n 9 at 117–18.

[31] Ibid; John Braithwaite, "Convergence in Models of Regulatory Strategy" (1990–91) 2 CICJ 59 at 63. See also Matthew Zinn, "Policing Environmental Regulatory Enforcement: Cooperation, Capture and Citizen Suits" (2002) 21 Stan Envtl L J 81 at 104.

[32] *Improving the Integrity of Public Ancillary Funds*, as above, para 1, 1

[33] See for example Fiona Martin, 'Is it time for an independent regulator of the non profit sector in Australia?' Tax Specialist, 2009, 12,148.

charitable sector for the past two decades. This year alone the recommendation for such a regulator was endorsed by three key reviews of the not-for-profit sector: the Henry Review; [34] the Productivity Commission; [35] and the Senate Economics Legislation Committee.[36] The opinion held by each review was that the creation of an independent regulatory body would help address the issues pertaining to integrity including public confidence, transparency and accountability.

It is considered that the emerging international best practice in relation to regulation of the charitable sector involves the establishment of a suitably empowered charities commission. A regulator has been established of this kind in England and Wales, Scotland, New Zealand and Ireland to positive effect.[37]

It should be noted that an independent regulator would facilitate the collection of comprehensive data on the sector. The data collected could be used to target government support for the sector better, and would help individual donors make more informed choices about their giving. Such information could also be used by the ATO to determine benchmark return rates appropriate for funds of different kinds as indicated above.

[34] Australian Government, Australia's Future Tax System, 2010, Recommendation 41

[35] Australian Government, Productivity Commission Research Report 'Contributions of the not-for-profit Sector' 116-117

[36] Australian Parliament, Senate Economics Legislation Committee, 'Tax Laws Amendment (Public Benefit Test) Bill 2010' Recommendations 3-4, 42

[37] Ibid, 38

Consultation Question – 2.4.1 Public Ancillary Fund investment rules should ensure liquidity and low risk

- *Can the investment and risk minimisation rules that apply to private ancillary funds be suitably applied to public ancillary funds?*

If a normal public trust breaches any ATO regulations or fails to pay tax etc it is appropriate the TAA administers to penalties and that is what happens. If in a public trust the trustee breaches any other trust obligations then they may be breaching their obligation under the trust deed and other legislation such as the Trustee Acts in each State and Territory. In the case of public ancillary funds there appears to be an added burden placed on the ATO to manage the activities of the trustees beyond trustees' obligation to the tax acts. Such a dual role of the ATO is of concern because it may create duplication of the system and a number of people looking at the same conduct creating a burden to the public trusts. We recommend that a new regulator should be created to regulate the non profit sector in Australia.

Conclusion:

The discussion paper provided by Treasury is an important discussion point in the quest to bring about integrity, transparency and accountability to a sector that is increasing in importance in modern society as governments continue to utilise the sector to support its own activities. As with all amendments to the law, it is important to balance the enforcement aspects with appropriate levels of compliance burden. Part of an attempt to restore integrity should include a range of enforcement stratgeies available to the administrator and enforceable undertakings should form part of the spectrum.

Nonetheless reform of the part needs to be considered in the light of the sector as a whole. The sector as a whole is in urgent need of reform and the proposed regulations are likely to only bring about another piecemeal solution to an increasingly complicated puzzle. It is time international best practice is adopted and an independent regulator created and tasked with bringing accountability, integrity and transparency to the not-for-profit sector.

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17 December 2010