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XX May 2022

Not-for-profit Unit
Individuals and Indirect Tax Division
Treasury
Langton Cres
Parkes ACT 2600

Submitted by Email

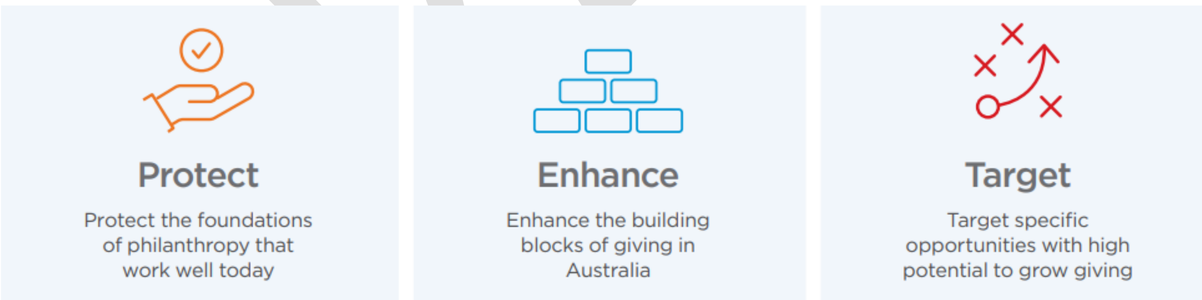
Dear Sir/Madam,

<u>Distribution Guidelines for Ancillary Funds</u>

Philanthropy Australia appreciates the opportunity to make this submission in response to the Treasury's consultation on possible reforms to the distribution guidelines for ancillary funds (AFs).

As the peak body for philanthropy in Australia, our vision is 'a generous and inclusive Australia' and our purpose is 'to inspire more and better philanthropy'.

Philanthropy Australia's *Blueprint to Grow Structured Giving*[1], and our *2022 Election Statement*[2] set out an objective to double giving by 2030. Achieving this objective, and seeing the benefits of more and better philanthropy in Australia, requires action in a range of areas that fall within the three strategic priorities shown below.



The second priority includes a focus on ensuring that existing structured giving vehicles are designed in a way that encourages philanthropy and enhances it impact, and this consultation process provides an opportunity to examine improvements to the AF regulatory framework that will assist with achieving this objective and thereby benefit the Australian community.

Philanthropy Australia is broadly supportive of the proposals canvassed in this consultation process. Our submission offers a number of comments about alternative implementation options, and also sets out additional aspects of the AF regulatory framework which we believe warrant attention.

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[1] See: https://www.philanthropy.org.au/tools-resources/a-blueprint-to-grow-structured-giving/
[2] See: https://www.philanthropy.org.au/tools-resources/2022-election-statement/

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Accumulating Funds to Support Large Projects

Philanthropy Australia is supportive of the proposal to expand the Commissioner of Taxation's discretion to reduce the minimum distribution for an AF to allow for the accumulation of funds to support large projects. This would involve amendments to Guidelines 15 (7)-(8) in each of the *Taxation Administration (Public Ancillary Fund) Guidelines 2022* (PuAF Guidelines) and *Taxation Administration (Private Ancillary Fund) Guidelines 2019* (PAF Guidelines). Our responses to the questions asked in the consultation paper are below, and we also propose an alternative approach that would achieve the same outcome as that considered in the consultation paper, but will be more simple to administer.

Response to Consultation Questions

1. Should both PAFs and PuAFs be able to accumulate funds?

Both PAFs and PuAFs should be allowed to accumulate funds for large projects, but only for a limited period of time and with appropriate controls in place to ensure that there is no overall reduction in the amount which is distributed over that period of time.

2. As public ancillary funds are not required to make a distribution in the year of establishment or the following four years, do they have the ability under the existing rules to accumulate capital for large projects?

Whilst this is true, the existing rules do not allow older PuAFs to accumulate funds for larger projects, which is a significant limitation.

3. Should a limit be imposed on the amount a fund may accumulate, either as an absolute asset value or a percentage of the value of the fund's assets? If so, what would be appropriate values?

In determining whether to grant an exemption from the minimum distribution and the conditions attached to the exemption, the Commissioner should have regard to the amount of accumulation that is planned relative to the size of the fund, and the ability of the fund to distribute the funds at the conclusion of the accumulation period given its investment strategy and possible variations in market conditions.

4. Are the matters for the Commissioner's consideration appropriate? Should the Commissioner consider other criteria?

The matters which the consultation paper proposes the Commissioner give consideration in deciding whether to grant an exemption from the minimum distribution are appropriate. However, as stated in the response to question 3, the Commissioner should also consider (1) The need to ensure that there is no overall reduction in the amount which is distributed over the accumulation period, based on an appropriate forecast of investment performance over this period and a comparison of distributions that would otherwise occur annually versus a distribution that would occur at the end of the accumulation period; (2) How possible variations in market conditions could impact the ability of the fund to make a planned distribution at the end of the accumulation period, which would involve taking into account the size of the fund relative to the amount that is proposed to be accumulated.

5. Is a five-year period for accumulation sufficient, too short, or too long?

A 5 year accumulation period is appropriate. A longer period would make it difficult to ensure that there is no overall reduction in the amount which is distributed, given the various uncertainties associated with market conditions and investment performance.

6. What should the consequences be if an ancillary fund does not proceed to support the project for which it accumulated funds?

The accumulated funds should be required to be distributed to other eligible entities, in the first financial year following the accumulation period, or within two financial years of a decision to not proceed with funding a project. An application seeking an exemption should set out a proposed approach to meeting this requirement if the funding of the project does not proceed. An AF should be required to notify the Commissioner, within 21 days, of a decision to not proceed with funding a project.

Allowing Limited 'Spreading' of Distributions

The approach above would provide additional flexibility for AFs, whilst ensuring that AFs retain their philanthropic purpose. However, it does introduce some administrative complexities in terms of the process for applying for and deciding upon applications for exemptions from the minimum distribution.

The resources used in this process, including within the Australian Taxation Office, may be relatively high and not commensurate with integrity risks that the process seeks to address. In addition, such a process inevitably involves making subjective judgements and may result in inconsistent outcomes.

An alternative approach to the process proposed in the discussion paper would involve allowing AFs to 'spread' distributions over a 5 year period. This would allow an AF to reduce their distribution below the amount otherwise required in a year, with a requirement to distribute the difference between these two amounts within 5 years.

For example, if a PAF had net assets of $10 million, it's minimum distribution for the following financial year would be $500,000. The AF could be permitted to distribute $400,000, with a requirement to distribute the remaining $100,000 within 5 years, over and above any minimum distribution that is required in any of those 5 years.

The ability to do this could be limited, for example to no lower than 4 per cent and 3 per cent in the case of a PAF and PuAF respectively. Any further reduction to an AF's minimum distribution would require approval from the Commissioner, as is currently required. This would ensure that a minimum proportion of an AF's assets is still distributed each year, and also addresses the risk that an AF may decide to make no distribution for 4 years and then be required to make a very large distribution in the 5th year.

This may lead to potentially 'lumpy' levels of support from AFs, but also possible variations in market conditions may impact the ability of the AF to make such a large distribution in a single year.

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There could be a requirement to specify any amount that is being 'spread' as part of an AF's annual return, and to report when such an amount is distributed. This would enable the Australian Taxation Office can monitor compliance with the requirement to distribute such an amount within the required timeframe.

The Guidelines could also still be amended to expand the Commissioner's discretion to reduce the minimum distribution for an AF to allow for the accumulation of funds to support large project, as discussed above. However, because an AF could decide to 'spread' its distributions within the permitted limits without the need for a specific reason, fewer AFs would need to avail themselves of the exemption in general.

Such additional flexibility would minimise the administrative complexity of the AF regulatory framework and reduce the resources used for applying for and deciding upon applications for exemptions, with appropriate safeguards in place to ensure that AFs retain their philanthropic purpose.

Flexibility in Transferring Assets Between Ancillary Funds

Philanthropy Australia has long advocated for increased flexibility that would allow AFs to make distributions to other AFs, and we strongly support action to address the current restriction preventing this.

The purpose of an AF is to provide property or benefits to Item 1 deductible gift recipients (DGRs). As part of furthering this purpose, many AFs and particularly PuAFs, have an important role as 'philanthropic infrastructure'. They are intermediaries that facilitate and promote more effective and responsive philanthropy, by using expertise, relationships and knowledge of community needs in order to pool funds and coordinate their distribution in a responsive manner.

Community Foundations are major users of PuAFs, and they have been hindered by existing restrictions that limit their ability to receive funds from PAFs in particular. Therefore, Philanthropy Australia welcomed the opportunity to work with the Treasury in order to secure the 2022-23 Budget announcement providing specific listings to 28 Community Foundations affiliated with Community Foundations Australia.

This announcement will have major benefits in terms of providing a flexible and supportive environment for enhancing the impact of Community Foundations across Australia. Our comments in this submission are predicated on the effective implementation of this commitment, noting that the specific listings have bipartisan support from both the Government and Opposition. We look forward to working with the Treasury in order to facilitate this process.

However, there is a range of entities other than Community Foundations which use a PuAF structure that are still impacted by the current restriction that prevents AFs making distributions to other AFs. For this reason, addressing this restriction is still necessary.

Philanthropy Australia recognises that the AF regulatory framework needs to ensure that there is a continued flow of funds towards 'Item 1' deductible gift recipients (DGRs).

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Therefore, certain safeguards are necessary as part of the addressing the current restriction. However, we would caution against an approach that involves addressing one source of red tape, and replacing it with a new source of red tape.

Any safeguards need to be proportionate to the level of risk, and not adopt a 'zero risk' approach, predicated on an assumption that removing the restriction will result in a large redirection of distributions towards other AFs in order to avoid making distributions to Item 1 DGRs.

Average distributions levels by AFs consistently exceed the minimum, which is evidence that AFs are established to undertake philanthropy and that their trustees take this responsibility seriously. This should be an operating assumption when designing any safeguards as part of addressing the current restriction.

AFs are the most highly regulated type of charitable entity in Australia, with extensive governance and reporting requirements that exceed those of other charitable entities. The presence of these requirements, including detailed reporting of donations and distributions, enables oversight by the Australian Taxation Office, and allows for the monitoring of behaviour changes that are a result of addressing the current restriction.

A Preferred Model for Addressing the Current Restriction

Philanthropy Australia's preferred model for addressing the current restriction involves:

- Amendments to the tax laws that allow an AF to make distributions to other AFs;
- Allowing the AF making the initial distribution (AF 1) to include this in its minimum distribution, but not the AF which receives the funds and subsequently distributes them (AF 2);
- AF 1 would not be able make a distribution to any sub-funds (or equivalent) in relation to which the directors of the AF 1 trustee have a substantive right to make distribution recommendations;
- AF 2 would be required to distribute the funds to Item 1 DGRs within 5 years of receipt;
- AF 2 would also be required to report on the amounts received from other AFs, as well as when these amounts are distributed to Item 1 DGRs, as part of its annual return;
- In order to facilitate this, and address the provisions within trust deeds requiring distributions from AFs to Item 1 DGRs, AF 1 would be 'deemed' to be an Item 1 DGR for the purposes of receiving distributions from AF 2 consistent with this model.

Response to Consultation Questions

1. Is there a concern if a PAF transfers assets to a PuAF given the latter has a lower minimum distribution rate?

   No. Average distributions levels by PuAFs consistently exceed the minimum, and therefore it is not apparent that the difference in distribution rates would raise any substantive issues.

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2. To address the risk of churning of funds between ancillary funds with different accounting periods, should the existing prohibition on transferring assets if any have been received from another ancillary fund with the two previous years apply to such transfers?

   No. The safeguards proposed in Philanthropy Australia preferred model already address these risks.

3. Should any ancillary fund be able to transfer assets to any other ancillary fund, or should transfers be limited, for example a PAF may transfer to a PuAF but not the other way around?

   Philanthropy Australia would support an approach which does not allow for PuAFs to make distributions to PAFs, other than as allowed for under existing portability provisions.

4. Should the existing prohibition on moving assets contributed, either directly or indirectly, by the public from a PuAF to a PAF apply to these transfers?

   Given this response to question 4, this issue would not arise.

5. Should a fund require the Commissioner's consent before transferring assets?

   No. Provided that distributions are made consistent with Philanthropy Australia's preferred model, this would be unnecessary. Under Philanthropy Australia's preferred model, the Australian Taxation Office would have oversight of the flow of funds as the amounts received from other AFs, as well as when these amounts are distributed to Item 1 DGRs, would be reported in an AF's annual return.

Other Matters Warranting Attention

Philanthropy Australia thanks the Treasury for the opportunity to raise the following additional aspects of the AF regulatory framework which warrant attention:

- **PuAF and PAF Guideline 22 (3) – inserting 'material' before benefit**
  - The absence of the term 'material' before 'benefit' arguably means actions such as providing directors of an AF with sandwiches during a board meeting would represent a benefit that is in breach of the Guidelines. Public recognition of a PuAF by a grantee, following a grant made by the trustee, may be considered a 'benefit', and therefore also result in a breach the Guidelines.
  - Taxation Ruling TR 2005/13, *Income tax: Tax deductible gifts - what is a gift*[3], focuses on 'material benefits', and it is submitted that the Guidelines should do the same. This approach makes sense in terms of the regulatory framework for PuAFs being risk-based and proportionate, and not concerned with benefits that are immaterial.

[3] See: https://www.ato.gov.au/law/view/document?DocID=TXR/TR200513/NAT/ATO/00001

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- **PuAF Guideline 27(1) (b) – including a reference to sub-funds**
  - Sub-funds should be required to recommend distributions that fulfil the minimum distribution requirement before they can apply to transfer, and the drafting of the Guideline should reflect this.
  - As currently drafted, the Guideline requires the entire PuAF to fulfil this requirement. This restriction has led to instances where transfers cannot be approved by the Australian Taxation Office until very late in the financial year, after a PuAF as a whole has fulfilled requirement.
  - This reduces the benefits of portability provisions, which are designed to provide flexibility and facilitate philanthropic assets to be held within the most appropriate structure.
- **Clarity and Certainty for Donations of Unlisted Shares – addressing current deficiencies in the valuation methods**
  - The current approach to valuing donations of unlisted shares over $5,000, for the purposes of determining the level of a tax deduction, lacks clarity and certainty.
  - A valuation can only be undertaken after a donation has been made, and there is no method setting out how such a valuation is to be undertaken. This can act as a disincentive for the donation of unlisted shares by startup founders in particular, restricting the growth of philanthropy amongst these and other cohorts. Issues also arise in relation to valuing assets already within an AF.
  - It is possible that this could be addressed by the Australian Taxation Office issuing a ruling which sets out the method for how such valuations are to be undertaken, and which use the last funding round for a startup as the reference point, provided it is within 3 years of the donation. However, amendments to the tax laws and/or the Guidelines may also be necessary.
- **Multi-year Grants – clarifying options for how these are treated under the Guidelines**
  - Multi-year year grants are recognised as a leading practice within philanthropy, providing a more consistent funding flow for grantees.
  - Currently, such grants can only be treated as a distribution when they are transferred to an Item 1 DGR. However, some AFs would prefer to include an entire grant commitment covered by a grant agreement, in the year the commitment is made.
  - Clarifying that this is permitted under the Guidelines would provide for additional flexibility and would assist with encouraging multi-year granting.
  - Appropriate safeguards, such as a requirement to distribute an amount to another Item 1 DGR in cases where a grant cannot be made to the originally intended grantee as well as reporting of such arrangements in an AF's annual return, would ensure that the integrity of the AF regulatory framework is maintained.

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Concluding Comments

Philanthropy Australia once again thanks the Treasury for the opportunity to make this submission. We would welcome the opportunity to discuss the matters in the submission further, and are very happy to assist with the more detailed aspects of addressing them.

In this regard, please do not hesitate to contact Philanthropy Australia's Director of Policy, Government Relations and Research, Sam Rosevear (sam@philanthropy.org.au, 1300 511 500).

Yours Sincerely,

Jack Heath
CEO
Philanthropy Australia