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13 May 2022

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

Submitted by Email

Dear Sir/Madam,

Distribution Guidelines for Ancillary Funds

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).

Philanthropy Australia is supportive of the reforms canvassed in the paper released as part of the consultation process. Our submission responds to the questions asked by the Treasury in the paper, offers comments about alternative implementation options, and sets out additional aspects of the AF regulatory framework which we believe warrant attention.

We believe that the package of reforms discussed in this submission would form a key part of a renewed effort to enhance the taxation and regulatory framework for philanthropy in Australia, in order to benefit the broader community. Philanthropy Australia would value the opportunity to work with the Treasury and the Australian Government to achieve these necessary and important policy outcomes.

About Philanthropy Australia

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.

[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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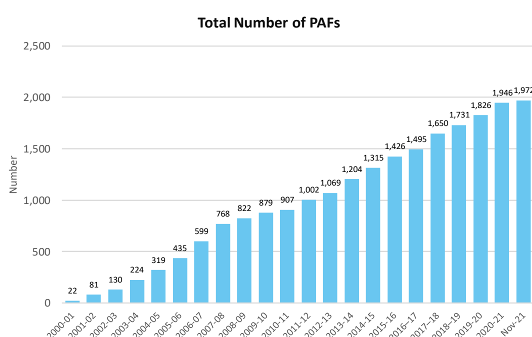
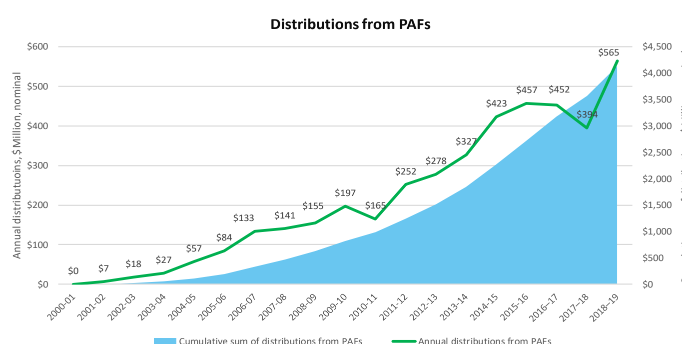
The second priority includes a focus on ensuring that existing structured giving vehicles are designed in a way that encourages philanthropy and enhances it impact.

Philanthropy Australia believes that a range of reforms are needed in this regard, as set out in both documents referred to above, including structural reform of the deductible gift recipient (DGR) framework in order to expand access to DGR endorsement and increase the range of entities that can receive distributions from AFs.

AFs are a critical component of Australia's 'philanthropic infrastructure', aiming to increase the assets that are directed towards philanthropic purposes. They are the most highly regulated type of charitable entity in Australia, and their regulatory framework includes safeguards to ensure that assets are used for community benefit in an appropriate manner.

Philanthropy Australia believes that in general, the regulatory framework for AFs is functioning well and is administered effectively. Over time, the number of private ancillary funds (PuAF) has grown to just under 2,000 and there has been strong growth in their annual and cumulative distributions.





There are now more than 1,400 PuAFs, with their cumulative distributions having exceeded $3.5 billion. Public ancillary funds (PuAFs) are used for a broader range of purposes than PAFs[3], and there has been consolidation in the total number of PuAFs in recent years.

Notably, sub-funds within PuAFs are an increasingly attractive structured giving vehicle, with the most recent data showing that there are approximately 2,000 sub-funds[4].

In order to build on these positive trends, Philanthropy Australia believes that a range of targeted improvements to the regulatory framework for AFs are needed to address sources of unnecessary red tape and ensure that the framework is fit for purpose. This consultation process provides an important opportunity to examine these improvements, and our comments and responses to the consultation questions are set out below.

[3] For a discussion of these roles, see: Williamson, A, Luke, B, & Furneaux, C. 2021. Perceptions and Conceptions of 'Place' in Australian Public Foundations. *Nonprofit and Voluntary Sector Quarterly*, 50(6), 1125–1149. https://eprints.qut.edu.au/208913/

[4] See: Seibert, K. 2019. Snapshot of Sub-funds in Australia. Swinburne University of Technology. https://researchbank.swinburne.edu.au/items/68f5d8fa-1441-42b6-b73d-939e70a2e354/1/

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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.

Responses 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 safeguards 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 to, when 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 the real value 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,

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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 by the end of the financial year following the accumulation period, or the end of the financial year following the year in which a decision to not proceed was made. 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.

6.1 Should an administrative penalty be applied to the fund's trustees?

A penalty consistent with those already provided for under Guideline 15 should apply, however it should not be imposed unless there is evidence of deliberate misconduct. Philanthropy Australia supports the approach set out in Practice Statement Law Administration 2014/1, *Administration of Penalties for Failure to Comply with Ancillary Fund Guidelines*[5], which includes an emphasis on facilitating compliance and a presumption that a trustee is honest and seeking to meet their obligations (unless there is information which suggests otherwise).

6.2 Should the fund be required to immediately distribute to type 1 DGRs an amount equivalent in value to the distributions it would have had to make if the lower distribution rate had not been agreed?

An immediate requirement would be impractical. However, as noted above, a requirement to distribute within a reasonable timeframe should apply.

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 of 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.

[5] See: https://www.ato.gov.au/law/view/document?docid=PSR/PS20141/NAT/ATO/00001

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

For example, if a PAF had net assets of $10 million, its 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. There could be a requirement to augment the $100,000 that is 'spread' with an additional amount, calculated using a simple approach that is set out in the Guidelines, to ensure that the real value of 'spread' distributions is maintained.

The ability to undertake such 'spreading' could be limited, by not allowing a reduction in the minimum distribution beyond 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.

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 to 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 projects, 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.

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.

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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. Our preferred model for achieving this is set out below, followed by our responses to the consultation questions.

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 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[6].

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[7]. For this reason, addressing this restriction is still necessary and important.

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).

Therefore, certain safeguards are necessary as part of the addressing the current restriction. Philanthropy Australia's preferred model, and our responses to the consultation questions, acknowledges this.

However, we would caution against an approach that involves removing one source of unnecessary red tape, and replacing it with a new source of such red tape. Consistent with a best practice approach to regulation, any safeguards that are imposed should be commensurate with integrity risks. Their imposition should not be based on a 'zero risk' approach, which is predicated on an assumption that removing the current restriction will result in a large redirection of distributions towards other AFs in order to deliberately avoid making distributions to Item 1 DGRs.

[6] For a discussion of this role, see: Williamson, A and Leat, D. 2021. Playing Piggy(bank) in the Middle: Philanthropic foundations' roles as intermediaries. *Australian Journal of Public Administration*, 80(4), pp. 965-976. https://eprints.qut.edu.au/208151/

[7] We refer to the submission by Arnold Bloch Leibler, which sets out detailed examples illustrating the issues that currently arise because of the existing restriction.

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Average distribution 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 the guiding assumption when designing any safeguards as part of addressing the current restriction.

As noted earlier in this submission, 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 any 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 (except from a PuAF to a PAF);
- 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 (the Commissioner would be able to provide approval for such distributions in extenuating circumstances);
- 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 to be from AFs to Item 1 DGRs, AF 2 would be 'deemed' to be an Item 1 DGR for the purposes of receiving distributions from AF 1.

Responses to Consultation Questions

7. 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.

8. 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's preferred model address these risks, and we believe that imposing additional requirements would not be proportionate to these risks.

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9. 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?

   We support a safeguard which precludes PuAFs from making distributions to PAFs, other than as provided for under existing portability provisions.

   9.1 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.

10. 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 our preferred model, the Australian Taxation Office would have oversight of the flow of funds. This is because 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.

11. Who should be required to ensure the receiving fund distributes an amount equivalent to the value of the transferred assets: the giving fund or the receiving fund?

    The receiving fund (AF 2), with such distributions reported in its annual return.

12. Would the benefits to receiving funds of receiving additional resources be outweighed by the costs of administering the transferred assets?

    No, provided that the any safeguards imposed are proportionate to integrity risks. Philanthropy Australia's preferred model seeks to achieve this balance.

13. What consequences should apply if the receiving fund does not distribute to type 1 DGRs an amount equivalent to the value of the transferred assets? For example, should an administrative penalty be imposed on the trustee of the fund?

    A penalty consistent with those already provided for under Guideline 15 should apply, however it should not be imposed unless there is evidence of deliberate misconduct. As noted in the response to question 6.1, Philanthropy Australia supports the approach set out in Practice Statement Law Administration 2014/1, *Administration of Penalties for Failure to Comply with Ancillary Fund Guidelines*.

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,

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  - 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*[8], 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.

- **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 Commissioner 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 and related issues**
  - 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 family businesses and startup founders in particular, restricting the growth of philanthropy amongst these cohorts.
  - It is possible that this could be addressed by the Commissioner issuing a ruling which sets out the method for how such valuations are to be undertaken. In the case of unlisted assets held in a startup, a valuation could use the last funding round for a startup as the reference point, provided it is within 3 years of the donation. An alternative reference point would be necessary in relation to donations of unlisted shares in family businesses. Amendments to the tax laws and/or the Guidelines may also be required.
  - There are related issues associated with selling down unlisted shares within a short timeframe, once they have been donated to an AF, in order to provide the necessary liquidity to meet distribution requirements.

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

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- There are benefits to providing flexibility regarding the timeframe available for such unlisted shares to be sold down, including varying the minimum distribution in the short-term, whilst ensuring that AFs retain their philanthropic purpose and that the level of distributions meets or exceeds the level that would otherwise be the case were the minimum distribution not varied.
- In the absence of such flexibility, there can be a disincentive to donate unlisted shares to an AF. This may result in lower amounts of assets being directed towards philanthropic purposes and less benefit to the community, compared with what would otherwise be the case.
- The Commissioner's existing discretion under Guidelines 15 (7)-(8) of the PuAF and PAF Guidelines likely provides the necessary scope to address these issues and remove any barriers to increasing the level of funds directed towards philanthropic purposes. There would be benefit to issuing a ruling that provides the necessary certainty and clarity and minimises the administrative complexity.

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 their implementation.

In this regard, please do not hesitate to contact Philanthropy Australia's Policy and Regulatory Specialist, Krystian Seibert (kseibert@philanthropy.org.au, 1300 511 500).

Yours Sincerely,

Jack Heath
CEO
Philanthropy Australia