philanthropy australia

Philanthropy Australia Inc.
Assn. No. A0014980 T
ABN 79 578 875 531

philanthropy.org.au

Adelaide
Suite 912, Level 9
147 Pirie Street
Adelaide SA 5000
T +61 (0)418 854 361
adelaide@philanthropy.org.au

Brisbane
Suite 7E, Level 7
344 Queen Street
Brisbane QLD 4000
T +61 (0)7 3103 2652
brisbane@philanthropy.org.au

Melbourne
Level 2 55 Collins Street
Melbourne VIC 3000
T +61 (0)3 9662 9299
info@philanthropy.org.au

Sydney
52 Victoria Street,
Paddington NSW 2021
T +61 (0)2 9326 9200
sydney@philanthropy.org.au

12 February 2016

General Manager
Law Design Practice
The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxlawdesign@treasury.gov.au

Dear Sir/Madam,

Exposure draft of amendments to the Private Ancillary Fund Guidelines 2009 and the Public Ancillary Fund Guidelines 2011

Please find attached Philanthropy Australia's submission in response to the exposure draft of amendments to the *Private Ancillary Fund Guidelines 2009* and the *Public Ancillary Fund Guidelines 2011* (the draft amendments).

Philanthropy Australia thanks the Treasury for the opportunity to make a submission in response to the draft amendments.

Philanthropy Australia would welcome the opportunity to discuss the matters raised in this submission further. In this regard, please do not hesitate to contact Krystian Seibert, Policy & Research Manager, on (03) 9662 9299.

Yours Sincerely

Sarah Davies
Chief Executive Officer

Philanthropy Australia Submission – Exposure draft of amendments to the *Private Ancillary Fund Guidelines 2009* and the *Public Ancillary Fund Guidelines 2011*

Introduction

Philanthropy Australia is the national peak body for philanthropy and is a not-for-profit membership organisation comprising more than 800 Members and Associates. These include trusts and foundations, businesses, families and individuals who want to make a difference through their own philanthropy and to encourage others with their giving. Our vision is for 'A More Giving Australia' and our mission is to 'Lead an innovative, growing, influential and high performing philanthropic sector in Australia.'

Philanthropy Australia shares the Australian Government's commitment to growing our culture of philanthropy. We therefore strongly support initiatives such as the re-established Prime Minister's Community Business Partnership. We appreciate and value the ongoing effort and dedication of its members, and recognise their support for updating the *Private Ancillary Fund Guidelines 2009* and the *Public Ancillary Fund Guidelines 2011*.

Ancillary funds (AF), be they private (PAF) or public ancillary funds (PuAF), are a critical part of Australia's philanthropic infrastructure, and make up a considerable part of Philanthropy Australia's membership. Therefore, we have a strong interest in ensuring that the regulatory framework for AFs is well-designed, in order to support the effective operation of AFs and thereby contribute to the wellbeing of the community, which is the ultimate reason any philanthropic structure is established.

We believe that this regulatory framework should be based around principles of simplicity, clarity, certainty and ensuring there are appropriate incentives to encourage philanthropy.

Philanthropy Australia believes that, by and large, the regulatory framework established by the *Private Ancillary Fund Guidelines 2009* and *Public Ancillary Fund Guidelines 2011* has functioned well. It is commendable that since their introduction, no amendments have been made to both sets of Guidelines. It is our view that given the long term nature of philanthropy, a consistent and stable regulatory framework is important. Regular and/or ad hoc changes to this framework can lead to uncertainty and unintended consequences, and impact upon donor confidence, leading to a reduction in the growth of philanthropy.

However, Philanthropy Australia has recognised the need for updating parts of the Guidelines, and has advocated for this to occur. Therefore, we welcome the opportunity to provide input into this process.

Philanthropy Australia's response to the draft amendments is divided into two parts. The first part provides some general comments on the draft amendments, followed by the second part which provides detailed comments on specific items in the amendments (with a separate discussion of the proposed change to the minimum annual distribution and the introduction of a Program Related Investments framework).

General Comments

Adoption of Proposals from Philanthropy Australia's 'Early Wins to Grow Philanthropy and its Impact' Submission

In November 2014, Philanthropy Australia made a submission to the newly established Prime Minister's Community Business Partnership. It focused on a number of inexpensive and simple changes which could be made to address a number of red tape burdens which are a barrier to giving, improve existing giving vehicles to make them more effective and flexible, and support impact investment.[1]

We are pleased that the draft amendments contain a number of changes proposed in this submission. These include the introduction of portability for PAFs (Schedule 1, Item 32), providing more clarity regarding impact investments by PAFs (Schedule 1, Item 10), and allowing AFs to provide guarantees to deductible gift recipients (DGRs) (Schedule 1, Item 27; Schedule 2, Item 20).

Although we welcome the inclusion of these changes, we are recommending certain modifications to ensure the changes reflect the policy intent which underpins them.

Recognition of the Role of the Australian Charities and Not-for-profits Commission

Philanthropy Australia welcomes the recognition of the role of the Australian Charities and Not-for-profits Commission (ACNC) as a 'co-regulator' of AFs together with the Australian Taxation Office (ATO).

[1] 'Early Wins to Grow Philanthropy and its Impact' is available here.

Philanthropy Australia supports the retention of the ACNC, and we interpret this recognition of the ACNC within the draft amendments as a sign that the Australian Government is planning to retain this important body.

We support the proposals to reduce duplication in reporting requirements for AFs, such as those contained in Schedule 1, Items 5 and 23, and Schedule 2, Items 5 and 16 of the draft amendments.

Changes to the Minimum Annual Distribution

Philanthropy Australia does not support the proposed changes to the minimum annual distribution requirements for AFs contained in Item 7 of Schedules 1 and 2.

The current minimum annual distribution of 5% of net assets for PAFs and 4% for PuAFs is a simple method for calculating the minimum annual distribution and is well understood within the philanthropic sector. The proposed new method for calculating the minimum annual distribution will likely lead to reduced and more volatile levels of philanthropic support, possibly jeopardise community confidence in philanthropy, and add complexity. At the same time, we believe that an investment strategy based around a balanced asset portfolio enables an AF to meet its minimum annual distribution, cover costs, as well as maintain the real value of its assets or grow them.

This view is consistent with a large majority of the feedback we have received from our Members who represent a broad cross-section of PAFs and PuAFs. It is also informed by feedback from philanthropic intermediaries whose role is to establish and manage AFs and to provide advice to existing and prospective philanthropists. However, we note that a small minority of feedback we have received from Members does support the proposed draft amendment.

Other Necessary Changes

Philanthropy Australia recommends that in addition to the changes in the draft amendments, two further changes to the regulatory framework for AFs should be implemented in order to support higher impact philanthropy and reduce red tape.

Firstly, a ‘Program Related Investments’ framework for AFs should be introduced, as outlined in a report by Philanthropy Australia commissioned by the Department of Social Services in order to inform the work of the

Prime Minister's Community Business Partnership.[2] This is discussed further in this submission.

Secondly, the AF regulatory framework should allow for distributions from AFs to PuAFs (for example from a PAF to a PuAF operated by a community foundation). This restriction is currently a source of red tape, and is a barrier to community foundations and other organisations attracting new donors. This change is discussed in more detail on page six of Philanthropy Australia's 'Early Wins to Grow Philanthropy and its Impact' submission to the Prime Minister's Community Business Partnership. However, it is not discussed further in this submission.

Although this change would require legislative change, we believe that it is necessary in order to deliver an AF regulatory framework which is truly fit for purpose.

Detailed Comments

Section 2 – Commencement

Philanthropy Australia recommends that the portability provision in Item 32 of Schedule 1 (new Guideline 51A) of the draft amendments commences at least six weeks prior to 1 July 2016. This would allow PAFs that want to wind up and transfer their net assets to another AF during this financial year to be able to do so.

As currently drafted, the commencement date of the draft amendments will mean that such PAFs will only be able to wind up and transfer their net assets to another AF in the next financial year, which will mean that they will incur additional audit and associated costs.

Commencement at least six weeks before 1 July 2016 would allow the relevant formalities to be completed to ensure this process can occur before 1 July 2016.

Schedule 1 – Amendments to the Private Ancillary Fund Guidelines 2009

Item 4 (Guideline 14)

Philanthropy Australia supports the insertion of Guideline 14.2 and the associated example.

However, in order to provide consistency with the PuAF Guidelines, we recommend that the numbering within Guideline 14 should be modified.

[2] 'Program Related Investments – An Opportunity for Australia' is available here.

The proposed new Guideline 14.2 should become Guideline 14.1, with the existing Guideline 14.1 becoming Guideline 14.2, following by the proposed new Guideline 14.3.

Item 5 (Guideline 17)

As noted above, Philanthropy Australia welcomes the recognition of the role of the ACNC as a ‘co-regulator’ of AFs together with the ATO, and we support the reduction in duplicated reporting requirements for PAFs which will be the result of this draft amendment.

However, Philanthropy Australia notes that Clause 14.1(b) of the model PAF trust deed published by the ATO[3] requires that certain changes to a PAF trust deed be approved by the ATO.

We recommend that this inconsistency between the PAF Guidelines and the model PAF trust deed be rectified. This could be achieved by requesting that the ATO amend the model PAF trust deed to only require notification for all changes to a PAF trust deed, or to seek approval for changes through the ACNC.

Item 10 (Guideline 19.3)

Philanthropy Australia welcomes the inclusion of an example in the PAF Guidelines that will provide more clarity regarding impact investments by PAFs.

The proposed example is consistent with that in Guideline 19.3 of the PuAF Guidelines. However we believe that it is unnecessarily complex and that simpler wording should be used in both examples.

Philanthropy Australia understands that the ATO interprets this Guideline as meaning that the difference between the amount of interest accrued under a loan issued by a PAF to a deductible gift recipient, and the interest which would accrue on a comparable loan sourced from a financial institution at 'arm's length', can form part of the PAF's annual distribution for the purposes of complying with the PAF Guidelines.

We therefore recommend modified wording to be used for this example, based on the ATO interpretation of this Guideline and the wording used in the existing Example 2 regarding the leasing of office space, such as:

> *If a private ancillary fund lends to an eligible deductible gift recipient at a discount to the interest rate which would be charged on a comparable loan sourced from a financial institution at ‘arm's length', the fund is providing a benefit whose market value is equal to the discount.*

[3] The model trust deed is available here.

Once this change is made, we would recommend that the ATO also consider providing further public guidance regarding this Guideline, as it is an area which has been characterised by some uncertainty.

Item 19 (Guideline 28.1)

Philanthropy Australia supports the substitution of Guideline 28.1 and the insertion of Guideline 28.1A.

However, given that very few PAFs will have assets of less than $500,000, we recommend that the threshold in Guideline 28.1A be set at $1,000,000. This will also be consistent with the threshold for PuAFs in Guideline 28.2 of the PuAF Guidelines.

Item 27 (Guideline 35.1)

Philanthropy Australia welcomes amendment to Guideline 35 to allow a PAF to provide a loan guarantee entered into for the sole benefit of one or more eligible DGRs.

The provision of such a loan guarantee will amount to the conferring of a benefit upon a DGR. For example, the DGR may consequently be able to obtain a loan from a financial institution which it otherwise would not have been able to obtain.

However, as currently drafted, the amendment makes no provision for the value of a loan guarantee to be included as part of a PAF's minimum annual distribution. This is inconsistent with existing Guideline 19.3, which states that 'a distribution includes the provision of money, property or benefits'. It also results in one type of benefit, such as providing a grant of money to an eligible DGR,[4] being treated more favourably than another type of benefit, namely a loan guarantee.

Therefore, Philanthropy Australia recommends that the PAF Guidelines include a simple mechanism which allows the provision of a loan guarantee to be included as part of a PAF's minimum annual distribution. This mechanism would provide that, where a loan guarantee is entered into for the sole benefit of an eligible DGR, 5% of the value of the guaranteed loan amount can be included as part of the PAF's minimum annual distribution.

For example, if a PAF provided a loan guarantee to an eligible DGR that borrowed $100,000 to be repaid over 5 years, then the PAF could include $5,000 per year as part of its minimum annual distribution.

[4] The term 'eligible DGR' is used here and elsewhere to reflect the fact that AFs can only provide funds or other benefits to certain types of DGRs.

If the DGR were to default and the guarantee was therefore called upon, the full amount payable by the PAF could be included as part of its minimum distribution less any amount associated with the loan guarantee already included in previous years.

The benefit of this will be two-fold. Firstly, it will provide some form of incentive to PAFs to provide loan guarantees to eligible DGRs and therefore enable them to leverage other sources of funding which they would normally be unable to access. Secondly, as 5% is equal to a PAF's minimum annual distribution, it will also help ensure that sufficient assets are set aside by the PAF in order to fulfil the loan guarantee should it ever be called upon.

Even if the minimum annual distribution is changed as proposed in the draft amendments, 5% would still represent a simple way of valuing the provision of a guarantee.

Philanthropy Australia also recommends that 'loan guarantee' be defined to include other forms of contingent liability, such as an indemnity, irrevocable standby letter of credit, bond or other similar instrument. This could be done through the inclusion of a note.

Item 32 (Guideline 51A)

Philanthropy Australia welcomes the proposed introduction of portability for PAFs.

However, we believe that as currently drafted the amendment is problematic as it restricts portability to being from one PAF to another PAF, rather than between AFs.

This is not consistent with the former Assistant Treasurer's and former Minister for Social Services' announcement of 28 May 2015, which stated that the change

> *... will provide PAFs, which are private funds set up to provide money or property to deductible gift recipients, with the flexibility to transfer their net assets to **other ancillary funds**.*[5]

It is also not consistent with the explanatory memorandum for the relevant enabling legislation for the Public Ancillary Fund Guidelines 2011 (the Tax Laws Amendment (2011 Measures No. 7) Act 2011), which stated that

> *Portability of funds **between ancillary fund types** will be permitted … to provide additional flexibility in the management of funds.*

[5] Assistant Treasurer and Minister for Social Services Joint Media Release, 'Measures to boost philanthropy in Australia', 28 May 2015. Available here.

Although this enabling legislation related to PuAFs, the explanatory memorandum appeared to be expressing a general view about the appropriateness of allowing portability between ancillary fund types, be they PAFs or PuAFs.

Therefore, Philanthropy Australia recommends that the wording of the draft amendments be modified to allow for a PAF to transfer assets to another ancillary fund rather than just a PAF.

In addition, Philanthropy Australia recommends that the draft amendments be modified to allow for a PAF's assets to be divided and separately transferred to another ancillary fund, with the agreement of its trustee.

This need may arise in a situation where a married couple establish a PAF, but then experience a marriage breakdown and as part of a divorce settlement would like to divide the assets of the PAF so they may both have their own PAFs (or direct a portion of the assets of the PAF to a sub-fund of a PuAF, as the case may be)

Based on these two recommendations, Philanthropy Australia believes that the wording of the draft amendments should be modified to read as follows

> 51A. With the agreement of the Commissioner, a *private ancillary fund may transfer assets to **another ancillary fund** if:
>
> - it transfers all or a portion of its net assets to that ancillary fund; and
> - it has already complied with guidelines 19 to 19.6 for that financial year (about minimum annual distributions); and
> - none of the assets of the transferring fund have been received from another ancillary fund during the 2 previous years
>
> *Note 2: With the agreement of the Commissioner, a *private ancillary fund's assets may effectively be divided and a portion of them transferred to a separate ancillary fund.*

Items 33 and 34 (Guidelines 52-58)

Philanthropy Australia queries why Guideline 52 should also not be repealed, given that this Guideline is also redundant.

Schedule 2 – Amendments to the Public Ancillary Fund Guidelines 2011

Item 20 (Guideline 35.1)

Philanthropy Australia welcomes the proposed amendment to Guideline 35 to allow a PuAF to provide a loan guarantee entered into for the sole benefit of one or more DGRs.

However, our concerns regarding the current drafting of this amendment are the same as those regarding the current drafting of the same amendment as it applies to PAFs, discussed in further detail above.

Consistent with our reasoning with regard to the PAF Guidelines, we recommend that a simple mechanism be included within the PuAF Guidelines, which allows the provision of a loan guarantee to be included as part of a PuAF's minimum annual distribution.

This mechanism would provide that where a loan guarantee is entered into for the sole benefit of a DGR, 4% of the value of the guaranteed loan amount can be included as part of the PuAF's minimum annual distribution.

If the minimum annual distribution is changed as proposed in the draft amendments, 5% of the value of the guaranteed loan amount could be used to calculate the amount which can be counted towards a PuAF's minimum annual distribution. In this regard, it would be beneficial to provide consistency with how loan guarantees are treated in the case of PAFs and PuAFs.

Philanthropy Australia also recommends that 'loan guarantee' be defined to include other forms of contingent liability, such as an indemnity, irrevocable standby letter of credit, bond or other similar instrument. This could be done through the inclusion of a note.

Item 22 (Guideline 44)

Philanthropy Australia welcomes the proposed addition of a note to Guideline 44, which will provide clarity regarding the appropriateness of trustees examining the non-binding preferences indicated by donors to a PuAF.

However, we recommend that different wording be used, because, depending on the particular PuAF and its relevant policies, it may on occasion not be good practice to review non-binding preference indicated by donors.

For example, a hospital foundation may be established as a PuAF, with its governing document providing that all funds are to be distributed towards the hospital based on the needs of the hospital. In such a situation, it may not be good practice to review non-binding preference indicated by donors.

We recommend more specific wording to address the more common situation where a PuAF has a number of sub-funds within it, and the donors to a sub-fund express preferences regarding how funds they have donated are distributed. In such a situation it is entirely appropriate that the trustee of the PuAF review the preferences of donors before making distributions. General wording can also be included to reflect other situations where it may be good practice for the trustee of the PuAF to review the preferences of donors before making distributions.

Therefore, we are of the view that the wording of the note should be modified to read

> *Note: Where a *public ancillary fund has sub-funds established by different donors, it is appropriate for the trustee to review the non-binding preferences of donors to those sub-funds before making distributions. Where a *public ancillary fund does not have sub-funds established by donors, it may still be good practice for trustees to review the non-binding preferences of donors before making distributions.*

Items 23 and 24 (Guideline 50)

Philanthropy Australia does not support these draft amendments and believes that they are very problematic. Therefore, we recommend that they are not proceeded with.

Currently, with the agreement of the ATO, and if certain criteria are met, a PuAF may transfer assets to another AF – be it a PAF or a PuAF.

This is an important provision, as a donor may 'start out small' and establish a sub-fund of a PuAF into which they donate more funds over time. At some point, when the balance of the sub-fund is large enough, they may wish to establish their own PAF, and may request that the trustee transfer the net assets of a sub-fund to that PAF. This provides flexibility and different options to a donor regarding how they structure their philanthropy.

The effect of Items 23 and 24 would be to prohibit such a transfer. This would increase red tape.

There does not appear to be any policy rationale for restricting portability to between the same type of AF, and the draft amendment also contradicts the policy intent underpinning the regulatory framework for PuAFs, as outlined in the explanatory memorandum for the enabling legislation for the PuAF Guidelines (the Tax Laws Amendment (2011 Measures No. 7) Act 2011), which states that

> *Portability of funds* ***between ancillary fund types*** *will be permitted … to provide additional flexibility in the management of funds.*

The explanatory memorandum makes it clear that the Parliament intended the portability of funds to be permitted between ancillary fund types, and the PuAF Guidelines need to reflect this.

Philanthropy Australia also does not support substituting the words 'the net assets' with 'any asset of the fund' in the last dot point of Guideline 50. The practical effect of this draft amendment would be to further restrict the ability to transfer assets from one AF to another AF. This would be entirely inappropriate because many PuAFs have multiple sub-funds, the assets of which may be transferred into or out of the PuAF relatively frequently.

As currently drafted, the amendment would mean that if a PuAF accepted the transfer of assets from another PAF or PuAF in the previous two years (for example, to set up a new sub-fund), it could not agree to transfer out any other unrelated sub-fund during that time. Once again, this would increase red tape.

Concessional Loans – Guideline 19.3

As stated above in the discussion of the proposed draft amendment to the PAF Guidelines in Item 10, Philanthropy Australia believes that the wording used for example 3 in the existing PuAF Guideline 19.3 is unnecessarily complex and that simpler wording should be used.

We recommend that the wording currently used for example 3 in Guideline 19.3 be amended, to reflect the ATO interpretation of this Guideline and the wording used in the existing Example 2 regarding the leasing of office space. This amendment would take the following form

> *If a public ancillary fund lends to an eligible deductible gift recipient at a discount to the interest rate which would be charged on a comparable loan sourced from a financial institution at 'arm's length', the fund is providing a benefit whose market value is equal to the discount.*

Proposed Changes to the Minimum Annual Distribution

General Comments

Philanthropy Australia does not support the proposed changes to the minimum annual distribution requirements for AFs contained in Item 7 of

Schedules 1 and 2, and we recommend the retention of the current minimum annual distribution requirements.

Although we appreciate that the motivation for these draft amendments is to provide ‘greater flexibility in unexpected economic conditions’, we believe that the current minimum annual distribution of 5% of net assets for a PAF and 4% of net assets for a PuAF is simple and well understood.

Although investment returns can fluctuate, we believe that a well-crafted investment strategy can ensure that, over time, an AF can meet its minimum annual distribution and cover costs, as well as maintain the real value of its assets or grow them.

The new method is also likely to lead to a considerable reduction in philanthropic support in a year that follows a year of negative investment returns.

This view has been informed by consultation and engagement with our Members, and is consistent with a large majority of feedback we have received from our Members who represent a broad cross-section of PAFs and PuAFs.

It is also informed by feedback from philanthropic intermediaries whose role is to establish and manage AFs and to provide advice to existing and prospective philanthropists.

However, we note that a small minority of feedback we have received from Members does support the proposed draft amendment.

The three main reasons for this are that, firstly, if there is a period of lower investment returns, a minimum annual distribution which is linked to either the Reserve Bank of Australia’s target for the cash rate or investment returns will ensure that the value of an AF’s assets will not be eroded in any one year. Secondly, a reduced minimum annual distribution does not preclude AFs from choosing to distribute a higher amount. Thirdly, it provides more scope to vary distributions if a sufficient quantity of appropriate projects cannot be identified for funding in any one year.

In some cases there is also a view that it should be a matter for the trustee to determine an appropriate minimum distribution rather than have such a requirement mandated through regulation.

Although Philanthropy Australia understands these views, we believe that because of the context within which philanthropy operates in Australia, the current minimum annual distribution requirements provide a simple and well understood method for appropriately balancing the expectation that AFs will provide regular and ongoing support for DGRs, with the ability to maintain the real value of an AF’s assets over time.

Philanthropy Australia sets out below a number of principles which outline our perspective on this context. These principles inform our view on the proposed changes to the minimum annual distribution requirements.

Principles Which Inform Philanthropy Australia's View

Ancillary Funds Have a Philanthropic Purpose

AFs are established to benefit the community, by providing support to DGRs so that they may further their purposes – be that addressing poverty, supporting the arts, protecting the environment or another purpose.

This philanthropic purpose is recognised and supported by government, through the provision of a full tax deduction for any amount contributed to an AF, an income tax exemption for assets within an AF and other concessions such as the availability of refundable franking credits.

In return, there is an understandable expectation from both the community and government that AFs will provide regular and ongoing support for DGRs, even during times of low investment returns. This is especially the case where an AF may have low investment returns in a particular year, but still has considerable assets.

Such giving is the ultimate source of philanthropy's legitimacy within the community, and it is the reason individuals, families or businesses establish an AF in the first place.

Philanthropy is a Long-term Activity

Philanthropy is a long-term activity in two senses.

Firstly, the investment horizon for philanthropic assets is long-term. Even though investment returns may fluctuate from year to year, it is important that over time the assets of an AF are able to retain their real value or grow. Although there may be negative returns over one or two years, they should not be viewed in isolation, as what is important is the value of assets over time. Negative returns over one or two years may be more than offset by positive returns in other years, enabling the value of assets to be preserved over the long-term.

Secondly, social change is a long-term process. The entrenched challenges which philanthropy seeks to address in partnership with the organisations it funds cannot be addressed in one or two years. This requires stable funding sources, because large fluctuations in funding can lead to uncertainty and an inability to commit to longer-term strategies to address particular challenges. During times of low investment returns, philanthropy may be even more important as a source of funding for social change if other funding sources are reduced.

Philanthropy is Diverse

Philanthropy involves different approaches, which depend on the views and approaches of donors and trustees. This is the case when it comes to the lifespan of AFs.

Some AFs will be established to operate in perpetuity, with a desire for them to continuing to exist on an ongoing basis, including after founding or other donors have passed away.

On the other hand, some AFs will be time limited, with founding or other donors seeking to distribute all an AF's funds within a given time period, such as during their lifetime.

The AF regulatory framework, and the minimum annual distribution, needs to suit both types of donor. This requires a minimum annual distribution which balances, on the one hand, an expectation that AFs will provide regular and ongoing support for DGRs, with the need to maintain the real value of an AF's assets over time.

Simplicity is Important

Like with any regulatory framework, simplicity is important. Complexity leads to uncertainty, and can stifle innovation. In the case of AFs, although simplicity may mean that particular requirements may not suit the individual circumstances of some AFs, there should be scope for these individual AFs to alter their approach to fit in with the requirements which suit the majority of AFs.

Detailed Comments

Philanthropy Australia's concerns with proposed changes to the minimum annual distribution for AFs can be divided into a number of specific issues. These are discussed below in no particular order of importance.

Managing Fluctuations in Investment Returns

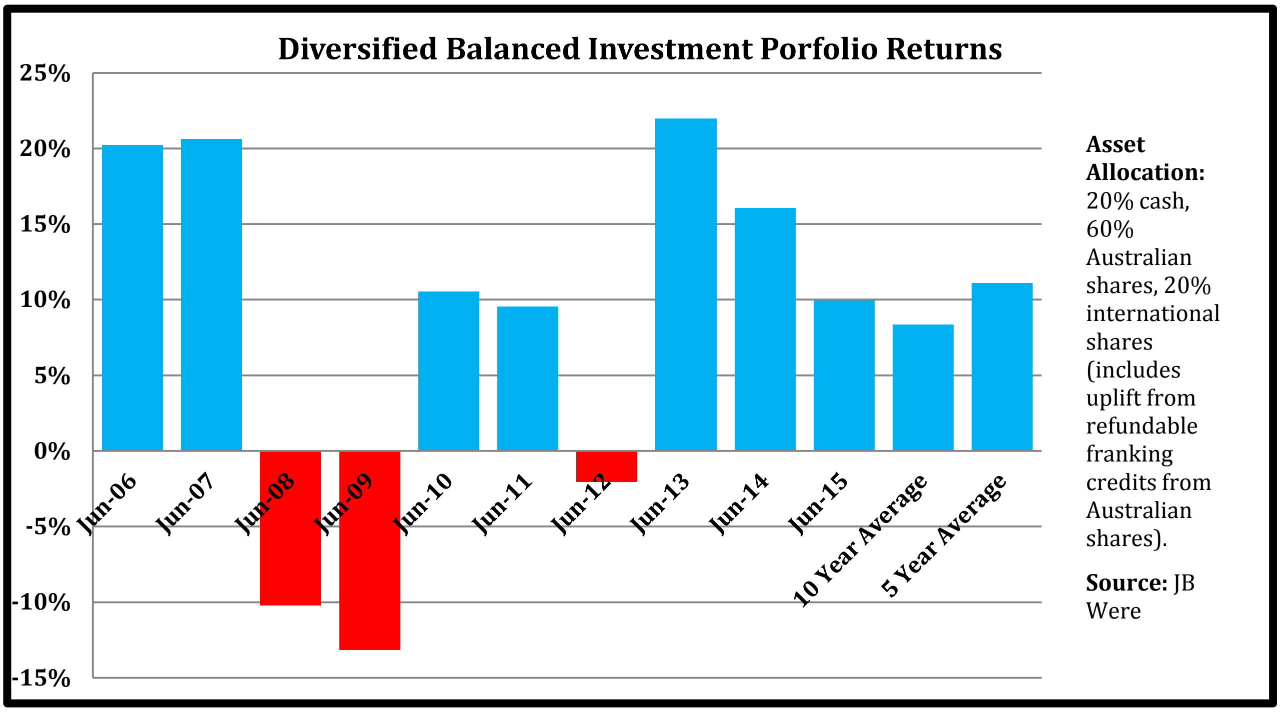
Although we appreciate that the motivation for these draft amendments is to provide 'greater flexibility in unexpected economic conditions', we believe that the current minimum annual distribution is set at an appropriate level.

In any event, although flexibility may be worthwhile, it must also be balanced against other considerations which are discussed in more detail below.

Although investment returns can fluctuate, the investment horizon is long-term. Philanthropy Australia believes that a well-crafted investment strategy, incorporating appropriate diversification, can ensure that, over time, an AF can meet its minimum annual distribution, cover costs, as well as maintain the real value of its assets or grow them.

For example, we have experienced highly uncertain economic conditions in recent years. There was the Global Financial Crisis, and more recently we've seen an end to the mining investment boom. However, as the graph on the following page illustrates, over both a 5 year and 10 year period, average returns from a balanced investment portfolio have been 8.3% and 11.1% per annum respectively.

Philanthropy Australia appreciates that not all AFs will necessarily have such an investment portfolio. However it does show that a balanced investment portfolio which is neither low nor high risk has been able to deliver the kinds of returns necessary for AFs to meet the minimum annual distribution, cover costs, as well as maintain the real value of its assets or grow them.



For example, even though losses for 2007-08 and 2008-09 were considerable, they were preceded by two very strong years, and followed by two reasonable years. The same applies for 2011-12, where a small loss was following by two very strong years.

Philanthropy Australia does appreciate that past performance is not an indicator of future performance. There may be a period of sustained low returns which may justify reviewing the minimum annual distribution at some point in the future, but at this stage there is no evidence that this will be the case. One forecast by an authoritative economist predicts medium term investment returns from a diversified investment portfolio to be 7.3% on average per annum, which would increase to over 8% once refundable franking credits are included.[6]

Reduced and More Volatile Levels of Philanthropy Support

Each of the alternative approaches proposed in the draft amendments is likely to lead to both reduced and more volatile levels of philanthropic support for DGRs. In the short-term this is almost a certainty.

In terms of reduced levels of philanthropic support, at this stage it appears that for the 2015-16 financial year, the average of the Reserve Bank of Australia's target for the cash rate will be at or close to 2%. Based on the first method proposed for calculating the minimum annual distribution, this will mean that in 2016-17, the minimum annual distribution will drop by half for PuAFs, and by more than half for PAFs.

Some AFs may have negative investment returns for the 2016-17 financial year, given the current performance of the share market. Based on the second alternative method proposed for calculating the minimum annual distribution, PuAFs and PAFs will only need to distribute $8,800 or $11,000 respectively, even if their assets are very large. Although many AFs currently give and will continue to give above the minimum required of them, some will not, resulting in a reduction in philanthropic support.

By linking the minimum annual distribution with the Reserve Bank of Australia's target for the cash rate and investment returns, philanthropic support will become more pro-cyclical than is currently the case. The minimum annual distribution will fluctuate in line with economic conditions – during times of weak performance, philanthropic support will be reduced and the opposite will be the case during times of strong performance. The current minimum annual distribution removes some of this cyclicality, by introducing a reasonable floor below which distributions cannot fall.

Philanthropy Australia represents funders, and does not purport to represent the interests of other charities/not-for-profit organisations which rely on philanthropic funds. However we are very mindful of their needs and the environment in which they operate. This is especially so because the interests of funders and charities/not-for-profit organisations are aligned in that effective philanthropy cannot achieve its objectives by acting alone, but rather through working in partnership with the organisations it funds.

[6] Shane Oliver, 'What Return Can You Expect in this Market?, July 2015, available here.

Social change is a long-term process, which requires more as opposed to less stable funding sources for charities and not-for-profit organisations which rely on philanthropic funds. Large fluctuations in funding can lead to uncertainty and an inability to commit to longer-term strategies to address particular challenges. This will impact upon the long-term viability of charities/not-for-profit organisations and their ability to partner with philanthropy.

Even in the short-term, sudden reductions in philanthropic funds can have a large impact on the capacity and capability of charities and not-for-profit organisations which rely on philanthropic funds, leading to reductions in programs, and a loss of staff with experience and expertise. This will have an impact upon the community.

Maintaining Community Respect and Confidence

Philanthropy in Australia enjoys widespread respect within the community. Every year, philanthropists are recognised as part of the Queen's Birthday and Australia Day Honours, and the contribution of philanthropists and philanthropy in general is celebrated in the community and the media.

This respect is combined with confidence, with a widespread view that philanthropy works to further the common good, particularly amongst those who've had contact with philanthropy either through their work, because of their particular situation or in some other way.

This respect and confidence is a precious asset, and one which Philanthropy Australia is very concerned to protect and preserve. One aspect of this is ensuring that we have an effectively regulatory framework which promotes respect and confidence, through appropriate rules and mechanisms to ensure high standards of conduct within the sector. These rules and mechanisms should not be too onerous, but strike a balance between ensuring high standards of conduct within the sector whilst providing flexibility.

In this regard, we are concerned that the proposed changes to the minimum annual distributions for AFs could jeopardise this respect and confidence.

If the Reserve Bank of Australia's target for the cash rate remains at a low level, then the minimum annual distribution for AFs will drop considerably if the proposed changes are adopted.

In years when investment returns are generally negative, many AFs will also have negative investment returns. In the following financial year, PuAFs and PAFs will only need to distribute $8,800 or $11,000 respectively, even if their assets are very large and even if their negative investment return was very small.

To put this into perspective, based on 2012-13 data from the ATO, the average net assets of a PAF are $2.6 million. A distribution of $11,000 would represent 0.42% of such a PAF's net assets.

Donors to an AF receive a full tax deduction for any amount contributed to an AF, an income tax exemption for assets within an AF and benefit from other concessions such as the availability of refundable franking credits. In return, there is an expectation from both the community and the government that AFs will provide regular and ongoing support for DGRs.

If the proposed changes to the minimum annual distribution are adopted, then it is understandable that there may be criticism from the broader community and attention from the media on the fact that despite these concessions, there will be times when AFs can distribute what amounts to an insignificant amount of funds and miniscule proportion of their assets. This criticism may be compounded by the fact that AFs will still be able to pay for expenses such as staff, advisers and office accommodation.

Even though Philanthropy Australia would expect that many AFs would still distribute a reasonable amount even if their investment returns are negative, rules and regulations do impact upon behaviour. The mere possibility that some AFs won't distribute anything above $8,800 or $11,000 will likely be sufficient to have a harmful impact upon the standing of philanthropy in the community.

As the peak body for philanthropy in Australia, whose objective is to encourage more and better philanthropy and to celebrate the role of philanthropy in our community, the fact that the proposed changes open up such a possibility is of great concern to us.

<u>The Introduction of Complexity</u>

We have received feedback from our Members stating that the proposed method will introduce more complexity into the AF regulatory framework.

When the current minimum annual distributions for PAFs and PuAFs were finalised in 2009 and 2011 respectively, they aimed to provide those establishing and running AFs clarity around what they must distribute from the very beginning of the financial year. That is why Philanthropy Australia supported those changes, and continues to support them.

The 5% or 4% of net assets requirement is simple and well understood. It doesn't change from year to year, and the actual dollar amount to be granted each year can be easily calculated from financial statements early in the financial year.

This will not be the case if the proposed changes to the minimum annual distributions for AFs are adopted.

Targeted Exemptions from the Minimum Annual Distribution

Although Philanthropy Australia does not support wholesale changes to the minimum annual distribution requirements for AFs, we do believe that there are two circumstances which warrant a narrowly targeted exemption from the minimum annual distribution requirements.

Firstly, there are a number of small PuAFs, most of them operated by community foundations. Community foundations are a type of philanthropic organisation working in a specific geographic area which, over time, seeks to build up an endowed fund from donors in the community. It uses these funds to grant to the charities/not-for-profit organisations within their own community, using a place-based strategy.

Such community foundations typically have a relatively small amount of assets. In such a situation, it can be too costly to use a fund manager to invest in an appropriately structured investment portfolio. Therefore, their assets often solely or principally comprise of term deposits and other such investments, making it hard for them to generate a return which is sufficient to meet the PuAF minimum annual distribution.

In such a situation, it can also be difficult to sustain the operation of a community foundation, given the need to undertake fundraising and administer grants.

Philanthropy Australia believes that there is merit in supporting the growth of community foundations in Australia, given the important role they play in empowering communities and supporting their resilience. Therefore, consideration should be given to a targeted exemption from the minimum annual distribution for small PuAFs, as proposed in the submission from Australian Community Philanthropy.

This exemption would only require them to distribute 2% of net assets, whilst their assets are less than $2 million, enabling them to accumulate a portion of their income in order to grow their assets. If they are above $2 million, the standard minimum annual distribution would apply.

$2 million is regarded as an appropriate threshold because above this level it becomes easier for community foundations to sustain their operations, and therefore a larger minimum annual distribution is appropriate.

Secondly, some Ancillary Funds, as a consequence of one or more specific gifts, may struggle to generate sufficient income to sustain a 5% minimum annual distribution and have an investment portfolio that is dominated by a relatively illiquid stock or other asset. This would typically cover situations where stock is owned by a PAF and is subsequently re-valued at many times its original value, or stock is bequeathed to a PAF (perhaps with a direction or request contained in the will that the stock be retained by the AF), and in both cases the stock is the largest asset of the PAF.

In order to encourage philanthropic gifts particularly by businesses and entrepreneurs, including at the start-up phase of their enterprises, consideration should be given to providing the Commissioner of Taxation with additional powers to approve a minimum annual distribution and investment strategy which differs from the AF Guidelines, even if only for a set period of time.

Such additional powers would only be used in exceptional circumstances, such as where the value of a stock cannot be promptly realised, cannot be promptly realised other than at a discount to its market value, or, having regard to other circumstances, should more appropriately be realised over time in order to obtain a better return for the asset.

A Program Related Investments Framework

In the second half of 2015, Philanthropy Australia was commissioned by the Department of Social Services to undertake a project (the project) examining Program Related Investments (PRIs) in order to inform the work of the Prime Minister's Community Business Partnership.

The project involved examining the PRI framework in the United States, developing a number of options for how such a framework could be implemented in Australia, seeking to ascertain demand for such a framework in Australia within the philanthropic sector, and recommending a model for introducing PRIs in Australia. The output of the project was a report, 'Program Related Investments – An Opportunity for Australia' (the report).[7]

PRIs involve investments made by foundations to further their charitable purposes, with the explicit understanding that those investments will earn below-market returns. Although a PRI is not a grant, it counts toward a foundation's minimum distribution requirement in the year a disbursement is made. Once repaid, the funds used for a PRI must be distributed again in the following year, in addition to the foundation's minimum annual distribution. In this sense, PRIs could be considered a form of 'repayable grant'.

PRIs have a number of benefits – they enable foundations to leverage their assets better, and provide a new source of investment for charities and social enteprises.

[7] The report is available here.

PRIs can also benefit the taxpayer – by enabling foundations to better leverage their assets to further their charitable purposes, PRIs effectively provide more ‘value’ to the taxpayer in return for the tax concession which has been provided to donors to a PAF/PuAF.

There are ways that concessionary investments made by PAF and PuAFs in DGRs can still be counted, at least in part, towards the minimum annual distribution. Item 10 of Schedule 1 of the draft amendments, which adds a new example to PAF Guideline 19.3, will provide more clarity in this regard (although as noted above, we are proposing alternative wording for the example in both the PAF and PuAF Guidelines).

However, a key finding from the project was that there was little interest in using the current options available to PAF and PuAFs in Australia to make concessionary investments in DGRs.

One reason for this appeared to be the fact that such a concessional investment involves allocating part of the investment to the foundation’s assets and part of the investment to the foundation’s granting.

There was a general view that this approach was somewhat confusing, with the very cautious approach taken by many trustees in relation to investments being made using the corpus also being relevant. Even with the draft amendment proposed in Item 10 of Schedule 1 (which is also proposed to be replicated in the PuAF Guidelines), it is unlikely that this reluctance will be overcome.

A key finding of the project’s consultation process was that there is very strong support from a broad range of stakeholders for the introduction of a PRI framework in Australia – PRIs may provide a new and innovative way to leverage limited philanthropic funds in Australia in order to increase their impact and effectiveness.

Philanthropy Australia recommends that a PRI framework be implemented as part of amending the PAF and PuAF Guidelines.

Although the report recommended allowing PRIs to be made in both DGRs, and certain organisations which are not DGRs, we realise that this would require legislative change. However, Philanthropy Australia is of the view that a PRI framework could be introduced which at this stage is limited to allowing PRIs to be made in DGRs, which would only require amendments to the PAF and PuAF Guidelines. These amendments could be drafted broadly enough to allow for PRIs to be extended to other eligible entities once appropriate legislative changes are made.

Philanthropy Australia would welcome the opportunity to assist the Treasury to develop these amendments. We have provided some suggested wording for amendments to the PAF Guidelines below, which involves the insertion of two new Guidelines following Guideline 19. These could be replicated in the PuAF Guidelines.

PROGRAM RELATED INVESTMENTS

19A. A Program Related Investment is a loan, the giving of a guarantee or indemnity, or any other investment which meets the following conditions:

19A.1. The primary purpose of the investment must be to further the charitable purposes or activities of a deductible gift recipient or other eligible entity

19A.2. The production of income or the appreciation of property may not be a significant purpose of the investment.

*Example 1: A *private ancillary fund provides a zero interest loan to an eligible deductible gift recipient which is used to further the deductible gift recipient's charitable purposes. The loan would be considered a program related investment.*

*Example 2: A *private ancillary fund provides a loan to an eligible deductible gift recipient which has been unable to secure a loan from a financial institution on terms acceptable to the deductible gift recipient. The loan is used to further the deductible gift recipient's charitable purposes. The interest rate on the loan is 2%, and if the *private ancillary fund had not made the loan it could have invested those funds in a term deposit with an interest rate of 3%. The loan would be considered a program related investment.*

19B. In the year in which a program related investment is made, the amount of the program related investment can be treated as if it were a distribution by *private ancillary fund

19B.1. The value of a program related investment of a *private ancillary fund is excluded from its net assets

19B.2. Upon repayment of the principal of a program related investment, the amount repaid must be distributed in the current or following financial year in addition to the *private ancillary fund's minimum annual distribution as required by Guideline 19

19B.3. Any income received from a program related investment forms part of the *private ancillary fund's net assets

19B.4. Guideline 19.3 does not apply to a Program Related Investment

*Example 1: In year 1, a *private ancillary fund provides a zero interest loan of $100,000 to a deductible gift recipient which is used to further the deductible gift recipient's charitable purposes. In year 1, $100,000, representing the value of the loan, is treated as a distribution by the*

**private ancillary fund. In year 4, the loan is repaid. Therefore, in year 4 or 5, the *private ancillary fund must distribute $100,000 in addition to its minimum annual distribution.*

*Example 2: In year 1, a *private ancillary fund provides a loan of $100,000 to a deductible gift recipient which is used to further the deductible gift recipient's charitable purposes. In year 1, $100,000, representing the value of the loan, is treated as a distribution by the *private ancillary fund. In year 2, $12,000 is repaid consisting of a repayment of $10,000 of the principal and $2,000 in interest. $2,000 is included in the *private ancillary fund's net assets as at the end of year 2, and in year 2 or 3, the *private ancillary fund must distribute $10,000 in addition to its minimum annual distribution.*