



# Submission

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## Commercial Law Section

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### Improving the Integrity of Prescribed Private Funds

To: Philanthropy and Exemptions Unit, Personal and Retirement Income Division

A submission from the Law Institute of Victoria (LIV)

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**Contents**

1 IMPROVING THE INTEGRITY OF PRESCRIBED PRIVATE FUNDS: SUBMISSION..... 3

1.1 Introduction ..... 3

1.2 Executive summary ..... 3

2 The Discussion Paper..... 3

2.1 PPFs: the regulatory framework ..... 4

2.1.1 Income Tax Assessment Act 1997 ..... 4

2.1.2 A New Tax System (Australian Business Number) Act 1999..... 5

2.1.3 Tax Rulings - overview..... 6

2.1.4 Tax Ruling 95/27..... 6

2.1.5 Tax Ruling 2000/11..... 7

2.1.6 State Trustee Acts ..... 9

2.1.7 Guidelines for Prescribed Private Funds version 3..... 10

3 Conclusion ..... 10

## 1 IMPROVING THE INTEGRITY OF PRESCRIBED PRIVATE FUNDS: SUBMISSION

### 1.1 Introduction

The Law Institute of Victoria (*LIV*) welcomes the opportunity to comment on the *Improving the integrity of Prescribed Private Funds ("PPFs")* Discussion Paper released November 2008 ("the Discussion Paper").

Our submission will review the existing regulatory framework for Prescribed Private Funds ("PPFs") and in doing so will answer some of the "consultation questions" raised in the Discussion Paper.

### 1.2 Executive summary

The LIV acknowledge the proposal in the Discussion Paper to transfer administration of PPFs away from the Treasurer to the Commissioner of Taxation ("the Commissioner"). This makes good sense as the Commissioner already has the responsibility and capability to administer other forms of tax deductible funds.

We accept that some amendments to the *Income Tax Assessment Act 1997* ("ITAA 97") will be needed to transfer administration of PPFs from the Treasurer to the Commissioner. In particular, ITAA 97 will need to be amended to give power to the Commissioner to endorse and revoke endorsement of PPFs.

We also welcome the flexibility that the Commissioner will consequently have to apply a range of penalty types where PPF trustees have not met their compliance obligations.

However we submit the Discussion Paper does not show why PPFs ought to be subject to different and more complex legislative requirements than a similar tax deductible fund known as the "Ancillary Fund". We submit if the proposals in the Discussion Paper to create a statutorily supported "PPF Guidelines" are implemented, PPFs will be less attractive to high net worth persons as a vehicle for giving.

We submit that Treasury and the Commissioner should review the existing range of regulation and quasi-regulation applicable to Ancillary Funds and PPFs before considering enactment of a statutorily supported PPF Guidelines.

## 2 The Discussion Paper

The Discussion Paper acknowledges that PPFs are a form of tax deductible "Ancillary Fund".<sup>1</sup> However the Discussion Paper proposes to regulate PPFs quite differently to Ancillary Funds by giving statutory force to certain "PPF Guidelines", presumably by amendments to the ITAA 97.

Amongst other things such PPF Guidelines may require:

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<sup>1</sup> At p 3.

- a fixed, minimum distribution of PPF assets to qualifying Deductible Gift Recipients (“DGRs”) each year (the “minimum” proposed will equal 15% of the closing value of PPF assets including unrealised capital gains);
- annual valuation of PPF assets by its trustees;
- a minimum size corpus for a PPF (proposed as \$500,000);
- PPF trustees to invest only in liquid assets;
- public display of PPF contact details on the “ABR” website; and
- a “fit and proper person test” for PPF trustees.

Ancillary Funds do not have any of these requirements.

## 2.1 PPFs: the regulatory framework

PPFs are subject to the following forms of regulation or quasi-regulation:

- Income Tax Assessment Act 1997;
- *A New Tax System (Australian Business Number) Act 1999*;
- Tax Ruling 95/27;
- Tax Ruling 2000/11 (where the PPF is also charitable);
- State trustee acts; and
- The Guidelines for Prescribed Private Funds version 3 and Model Deed (“the Guidelines”).

We will discuss each of these forms of regulation or quasi-regulation with reference issues raised in the Discussion Paper.

### 2.1.1 Income Tax Assessment Act 1997

The ITAA 97 provides for the creation and structure of a PPF.

It is worth noting the intentions of the then Government when it sought to introduce PPFs as expressed by the Treasurer in the *Explanatory Memorandum to Taxation Laws Amendment Bill (No. 8) 1999*.

In the Explanatory Memorandum, the Treasurer, the Hon Peter Costello MP stated:

“To be eligible to receive gift deductible donations, prescribed private funds will need to comply with most of the requirements of public funds ....”<sup>2</sup> The Explanatory Memorandum went on to note that PPFs, unlike other public funds, do not have to seek and receive contributions from the public.

Thus PPFs were clearly intended by Government to function like other “public funds”, albeit without the requirement that donations are to be solicited from the public.

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<sup>2</sup> At paragraph 5.25

*Taxation Laws Amendment Act (No. 2) 2000* subsequently amended the ITAA 97 to provide for PPFs. Amongst other things, Item 2 of the table in section 30-15 of the ITAA 97 was amended by inserting the words “or prescribed private funds, “.

The only other type of public fund that meets the requirements of Item 2 of the table in section 30-15 of the ITAA 97 is the "Ancillary Fund". The Ancillary Fund unlike the PPF, must solicit donations from the public and have a majority of its trustees as “Responsible Persons”.

For convenience we will refer to PPFs and Ancillary Funds collectively as being "Item 2 DGRs".

Item 2 DGRs are permitted to provide money, property or benefits only to funds, authorities or institutions endorsed as DGRs under item 1 of the table in section 30-15 of the ITAA97. For convenience we will refer to these beneficiaries as being "Item 1 DGRs".

In essence, PPFs under the ITAA 97 are similar to Ancillary Funds, with the exception that PPFs do not have to seek and receive contributions from the public or have a majority of Responsible Persons as trustees. Item 2 DGRs act as a conduit between a donor claiming a tax deduction, and the ultimate DGR beneficiary.

Under the ITAA 97, Item 2 DGRs that seek exemption from payment of income tax are subject to what we refer to as the “purposes test”.<sup>3</sup>

Essentially the purposes test means that an Item 2 DGR “must be applied for the purposes for which it is established”. It is worth noting that the ITAA 97 does not prevent Item 2 DGRs from investing donations where to do so will ultimately generate returns for Item 1 DGRs. We will discuss the purposes test further as a principle to guide accumulation of income within a PPF under the heading “Tax Ruling 2000/11” below.

### 2.1.2 *A New Tax System (Australian Business Number) Act 1999*

The *A New Tax System (Australian Business Number) Act 1999* created the Australian Business Register (“ABR”) and requires certain information to be publicly displayed on the ABR.

In the Discussion Paper, the contact details of PPF trustees are proposed to be displayed on the ABR website, ostensibly to facilitate contact by Item 1 DGRs seeking funding from PPFs. We note trustees of Ancillary Funds in particular are not under a similar requirement to display their contact details on the ABR.

We do not think PPF trustees should be required to display their contact details on the ABR when other DGR endorsed entities are not. If PPF trustees do wish to attract potential beneficiaries, PPF trustees are free to for example set up their own website or otherwise advertise their existence to the public.

All Item 2 DGRs are legally obliged to disburse their funds to Item 1 DGRs, regardless of whether they are approached by Item 1 DGRs or not. Accordingly, it could be expected that PPF trustees will be actively looking for Item 1 DGRs, if only to meet their obligations to disburse funds.

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<sup>3</sup> See s 50-72 ITAA 97; also see s 50-57 and 50-60 ITAA 97.

However, we do suggest that the ABR website display that a DGR endorsed entity is either an “Item 1 DGR” or “Item 2 DGR”. This will help assist PPF trustees (and Ancillary Fund trustees for that matter) in ensuring that entities to whom they wish to give are the eligible “Item 1 DGR” type.

### 2.1.3 Tax Rulings - overview

We note that tax rulings do not have the force of statute. If a person disagrees with the views of the Commissioner as expressed in a tax ruling the person may challenge them.

On the other hand, to the extent that they are “public rulings” a tax ruling is written binding advice on the way in which in the Commissioner's opinion or a provision of an act or regulation administered by the Commissioner, would apply. Tax rulings may deal with any matter involved in the application of a relevant act or regulation including ultimate conclusions of fact.

In our experience, tax rulings in relation to DGR entities and Item 2 DGRs in particular, are used and relied upon by legal practitioners and their clients. They thus in our opinion have a role in regulation of PPFs, even though they do not have the force of statute.

We note the Commissioner must have power to administer an act or regulation applicable to PPFs before he could create a tax ruling that gives his opinion on that act or regulation.

It is worth noting also that the Commissioner cannot directly provide tax rulings on trust law applicable to PPFs as these laws are not under his administration.<sup>4</sup>

If it came to pass that the opinion of the Commissioner as expressed in relevant tax rulings was regularly challenged by PPF trustees there may be a need for statutory intervention to give certainty. We do not think that time has yet come.

### 2.1.4 Tax Ruling 95/27

Tax Ruling 95/27 relevantly expresses the Commissioner's view on operation of public funds generally and Ancillary Funds in particular. This Tax Ruling was released by the Commissioner on 2 August 1995, some years prior to establishment of PPFs under the ITAA 97.

Tax Ruling 95/27 is potentially useful from the point of view of:

- PPF trustee qualifications; and
- PPF trustee powers of investment.

Amongst other things Tax Ruling 95/27 requires an Ancillary Fund to have a majority of its trustees or governing body to be "Responsible Persons"<sup>5</sup>. The Tax Ruling provides an indicative list of such persons which include School Principals, Clergymen, Solicitors, Doctors and other professional persons, Members of Parliament and generally persons who are accepted as having a degree of responsibility to the community as a whole because they perform a public function or belong to a professional body.

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<sup>4</sup> See generally TR 2006/10.

<sup>5</sup> at paragraph 21.

In our view the indicative list of “Responsible Persons“ provided in Tax Ruling 95/27 reasonably equates to the proposal in the Discussion Paper that PPF trustees be subject to a “fit and proper person test”. Accordingly we see no need to add a “fit and proper person test”.

A question arises on the *quantity* of qualified persons to act as PPF trustees. A PPF currently need only have one Responsible Person as trustee; an Ancillary Fund must have a majority of its trustees as Responsible Persons. We accept from the point of view of accountability and governance that PPF trustees may also need to be in the majority, Responsible Persons.

Family members who wish to become involved in their PPF, but do not qualify as Responsible Persons, could be appointed to relevant trustee advisory committees to provide recommendations on suitable Item 1 DGRs to receive assistance.

Tax Ruling 95/27 also requires Ancillary Fund trustees<sup>6</sup> to invest any unused funds accrued as a result of a gift, in securities which a trustee may do under Australian law. The essence of this restriction is that investments are confined to securities that are "trustee securities" under Australian trust law.

Unfortunately from the point of view of regulation of investment powers of PPFs (and Ancillary Funds for that matter) this aspect of Tax Ruling 95/27 is out of date. Certain amendments to state trustee acts across jurisdictions in the mid to late 1990's<sup>7</sup> effectively permit trustees to make any form of investment (ie not just “trustee securities”), subject to prudent consideration.

However there may be a role for Tax Ruling 95/27 in expressing the Commissioner’s view for example on what he sees as being a “prudent investment”, particularly in the context of the need for PPF trustees to provide for beneficiaries.

In our view Tax Ruling 95/27 should accordingly be “updated” to:

- explicitly recognise PPFs as a class of public fund alongside Ancillary Funds;
- require a majority of PPF trustees to be Responsible Persons;
- reflect amendments to state trustee acts regarding “prudent” investments; and
- express the Commissioner’s view on what may in fact be “prudent” investment by a public fund trustee.

We submit these amendments will guide and provide assurance to trustees of all item 2 DGRs, not just trustees of PPFs.

#### 2.1.5 Tax Ruling 2000/11

Depending on how its purposes are defined, a PPF may also be a "charitable fund". As a charitable fund a PPF may only distribute to Item 1 DGRs that are also charitable. Accordingly Tax Ruling 2000/11 would apply to those PPFs.

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<sup>6</sup> at paragraph 43.

<sup>7</sup> See for example Trustee and Trustee Companies (Amendment) Act 1995 (Vic); Trustee Amendment (Discretionary Investments) Act 1997 (NSW).

Tax Ruling 2000/11 is potentially useful for PPFs as it sets out the Commissioner's view on accumulation of income by a charitable income tax exempt entity.

Tax Ruling 2000/11 relevantly states at paragraph 21 that:

"excessive accumulation of investment income [is] not the applying of a fund for its purposes. We regard distributions [to beneficiaries] of a substantial part of the income but not necessarily capital gains as essential. However we accept that a charitable fund may use some of the income to acquire assets which, in the future, will produce more income for charitable purposes, and may accumulate some of its income for later distribution."

We note the definitions "excessive" and "substantial" have been criticised<sup>8</sup> as essentially involving an "arbitrary distinction". We agree that the definitions could be improved. What is needed however is a principle to guide definitions.

There is an underlying principle of charity law that a charity must apply its funds to its purposes. We submit that this principle is expressed in the ITAA 97 by the purpose test.<sup>9</sup> Paragraph 21 of Tax Ruling 2001/11 refers to the purpose test and appears to be based on that test.

The purpose test also applies specifically to Item 2 DGRs that are income tax exempt, whether they are charitable or not.<sup>10</sup>

The Discussion Paper proposes another principle to address accumulation of income by a PPF, namely: "a PPF should benefit the charitable sector more than if the government had taken the revenue foregone".<sup>11</sup> Essentially this principle is one based on a cost/benefit analysis. For convenience we will refer to this principle as the "cost/benefit test".

We do not think that the cost/benefit test is consistent with the common law of charity or the purposes test under the ITAA 97. The cost/benefit test does not appear to be applied to any other DGR endorsed fund. Accordingly we submit the purpose test, as a principle to guide accumulation of income within a PPF, is to be favoured.

We understand Treasury is concerned that funds within PPFs may not be actually distributed to beneficiaries. However we do not see why a PPF should be subject to the cost/benefit test when other not-for-profit funds that have obtained tax concessions and deductibility are not.

We note in passing a paper produced by the Queensland University of Technology<sup>12</sup> that \$1.2B has been donated to PPFs since 2002 whilst during the period 2002 - 2007, a total of \$301.3M has been distributed to Item 1 DGRs.

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<sup>8</sup> Re Tact and Commissioner of Taxation [2008] AATA 275, 45.

<sup>9</sup> s 50-57 and 50-60 ITAA 97.

<sup>10</sup> s 50-72 ITAA 97 in relation to item 2 DGRs that are not "charitable".

<sup>11</sup> At p 5.

<sup>12</sup> Queensland University of Technology, The Australian Centre for Philanthropy and Non Profit Studies CPNS Current Issues Sheet 2008/6 "Prescribed Private Funds".



It would be a mistake however to assume that these figures indicate PPFs are accumulating funds when they ought to be distributing them. Many PPFs are still in the "accumulation phase" during which time they are permitted under the current PPF *Guidelines* to retain up to 95% of donations received. At least some of the funds retained by PPFs would be invested into income producing assets such as real estate and shares which in return will produce additional income for the PPF to distribute.

Bear in mind that community foundations and some donor advised funds administered by trustee companies use the "Ancillary Fund" legal structure. In some cases these Ancillary Funds may accumulate substantial corpus from donations and investments without being subject to a requirement that a minimum rate of distribution to beneficiaries is required.

PPF trustees are subject to scrutiny of their accounts in a way the Ancillary Fund trustees are not. PPF trustees must submit audited accounts with an Annual Information Return to the Commissioner each February. The information disclosed includes income received from investments. The Annual information Return we submit, will help the Commissioner to form a prima facie view whether the PPF is complying with the purpose test.

Accordingly we recommend that:

- Tax Ruling 2000/11 be updated to address definitional problems with the terms "excessive" and "substantial", with reference to the purpose test in ITAA 97;
- The purpose test as a principle to guide accumulation within a PPF be favoured by Treasury over the cost/benefit test; and
- Treasury and the Commissioner rely on the Tax Ruling system as a means to regulate PPFs including accumulation and investment of income, unless statutory intervention to create certainty is necessary.

#### 2.1.6 State Trustee Acts

State trustee acts require trustees to invest trust funds with care, diligence and skill that a prudent person would exercise.<sup>13</sup>

Trustees under trustee acts are also required to have regard to certain matters in exercising their power of investments. For example they must consider the purposes of the Trust and the needs of its beneficiaries, the need to maintain the real value of the capital or income of the trust, potential for capital appreciation and likely income return and timing of income return amongst other things.<sup>14</sup>

We note that the PPF "Model Deed" in the current PPF *Guidelines* includes clauses requiring PPF trustees to abide by state trustee acts.

Thus investment decisions by PPF trustees could on the face of things, be regulated by trustee acts.

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<sup>13</sup> see for example Trustee Act 1958 (Vic), section 6.

<sup>14</sup> see for example Trustee Act 1958 (Vic), at section 8.

An issue arises as to standing under a trustee act to sue PPF trustees for breach of their duties. The Commissioner would appear not to have standing to sue. Trust beneficiaries usually have standing trustees. The class of PPF beneficiaries may extend as widely as all item 1 DGRs. It is also unlikely that potential beneficiaries of a PPF would even be aware of a particular PPF. All of this creates difficulties in using trustee acts to keep PPF trustees accountable for their investment decisions.

Accordingly we do not recommend Treasury and the Commissioner rely on trustee acts to regulate PPF trustee investment decisions.

#### 2.1.7 Guidelines for Prescribed Private Funds version 3

The *Guidelines* currently have no statutory force. We presume the *Guidelines* exist essentially at the discretion of the Treasurer who under ITAA 97, s995 (1) has discretion to declare that a fund is not a PPF.

The Treasurer currently “prescribes” that a PPF be listed in the tax regulations. Treasury proposes in the Discussion Paper to transfer administration of PPFs away from the Treasurer to the Commissioner. The Commissioner will then “endorse” PPFs (as the Commissioner currently does for Ancillary Funds).

We submit this proposal makes administrative sense given the Commissioner’s role endorsing other DGR entities.

We agree that the ITAA 97 be amended to give the Commissioner power to endorse, refuse to endorse, or revoke DGR endorsement of a PPF. We submit such power should be on similar terms to the Commissioner’s current powers in relation to Ancillary Funds.

Accordingly we do not think it follows that a new version of the *Guidelines* with a range of mandatory requirements for PPFs be given statutory force. As should be evident from our submission, we submit that wherever possible, PPFs should be subject to similar regulation and quasi-regulation as Ancillary Funds, with allowance for the fact that PPFs do not solicit funds from the public or currently have a majority of their trustees as Responsible Persons.

### 3 Conclusion

The LIV agrees with the need to transfer administration of PPFs away from the Treasurer to the Commissioner; this necessarily will require some legislative amendment to the ITAA 97.

We do not think that a form of statutory *Guidelines* with the range of proposals suggested in the Discussion Paper need follow as a consequence of the Commissioner being given power under the ITAA 97 to endorse or revoke endorsement of a PPF.

We submit by proposing a range of mandatory requirements for PPFs under a statutory *Guidelines* that the Discussion Paper has lost sight of the fact that PPFs are a similar legal entity to Ancillary Funds and an existing (albeit not perfect) body of relevant law and quasi-regulation already exists.

The LIV submit Treasury and the Commissioner should try to improve the existing regulatory regime for Item 2 DGRs. This will provide a consistent and coherent

body of law and tax ruling in relation to PPFs. It will give high net worth persons a real choice between donating to a community foundation or donor advised Ancillary Fund or, making a decision to set up their own PPF.

Giving statutory force to a new PPF Guidelines with the range of mandatory requirements suggested by the Discussion Paper, if implemented, would in our view, not make PPFs attractive at all.