

The new private ancillary fund regime



PRIVATE ANCILLARY FUNDS (PAFs) NOW REPLACE PRESCRIBED PRIVATE FUNDS (PPFs). IT IS NOT JUST THE NAME THAT HAS CHANGED. PRACTITIONERS MUST ENSURE THAT THEY ARE AWARE OF THE SIGNIFICANT CHANGES INTRODUCED TO IMPROVE INTEGRITY UNDER THE NEW REGIME.

INTRODUCTION

In recent times the use of prescribed private funds (PPFs) has become increasingly common.¹ This increase in popularity of PPFs can perhaps be attributed to the ability of families and small business to utilise PPFs for charitable purposes without the need to seek contributions from the public as compared to the conduct of a charity or general deductible gift recipient (DGR).

However, with the increase in popularity of PPFs has come concerns regarding the integrity of the PPF regime. In addition, the certainty and guidance provided by the PPF regime has also been questioned. To address these concerns, reforms to the PPF regime have been a recurring topic since the 2008 Budget, with the ultimate outcome being significant changes to the operation of what was previously known as PPFs through their replacement with Private Ancillary Funds pursuant to *Tax Laws Amendment (2009 Measures No. 4) Act 2009* and the introduction of the *Private Ancillary Fund Guidelines 2009*.

PRESCRIBED PRIVATE FUNDS (PPF)

A PPF is a fund listed by name in the *Income Tax Assessment Regulations 1997* subject to compliance with the conditions in item 2 in the table in s 30-15 of the *Income Tax Assessment Act 1997 (ITAA97)*. PPFs are private funds that were normally established by families and business for philanthropic purposes and which did not require public contributions to be sought.

There were three requirements that had to be satisfied in order for an entity to be endorsed as a PPF:²

1. Fund established for the requisite purpose
In order for a fund to be endorsed as a PPF, the fund must have been established under a will or instrument of trust solely for the purpose of providing money, property or benefits to DGRs or towards establishing DGRs.³
2. Fund must be a public fund
Save for the requirement to seek public contributions, the fund must have been a public fund. Guidance as to what constituted a public fund was provided by the Commissioner in taxation ruling TR 95/27.
3. Integrity assurance measures
The fund had to meet the integrity assurance measures, which overlapped to some degree with the public fund requirements (referred to at item 2 above).

Process of endorsement of a PPF prior to 1 October 2009

If a proposed fund fell within the definition of a PPF, an application had to be submitted to the Australian Taxation Office (ATO). The ATO then made a determination as to whether the requirements were satisfied and provided that the requirements were satisfied the application was then forwarded to Treasury for consideration and if appropriate endorsement.

IMPROVING THE INTEGRITY OF PPFs

In recent times PPFs have been the subject of scrutiny with questions arising regarding their integrity. As a result PPFs have been the subject of significant review and consequently reform.

2008 Budget

The Treasurer announced as part of the 2008 Budget that the Government proposed legislating new guidelines in order to improve the integrity of PPFs, such legislation to have effect from 1 July 2009⁴. The aim of including legislative provisions in the form of the guidelines was to provide certainty in respect of the obligations imposed on PPFs. The Treasurer noted as follows:

“The changes will, among other things, ensure regular valuation of assets at market rates, increase the size of compulsory distributions, and give the Australian Taxation Office greater regulatory powers.”⁵

Improving the integrity of PPFs – discussion paper

On 26 November 2008, consistent with the 2008 Budget commitment, the then Assistant Treasurer announced the release of the discussion paper titled “Improving the integrity of Prescribed Private Funds (PPFs)” (**Discussion Paper**). The Discussion Paper set out a number of proposed changes to the PPF regime all of which would form part of guidelines to be legislated. The proposed changes to the PPF regime included:

1. PPFs being subjected to a minimum size requirement. The example given was a minimum size of \$500,000.
2. A requirement that PPFs make a minimum distribution each year, such amount to be calculated on the basis of the value of the PPF's net assets at the close of the previous financial year. Reference was made in the Discussion Paper to the minimum distribution being

equal to 15% of the value of assets of the PPF.

3. The donors of a PPF being restricted to a maximum number of donors for the life of the PPF, with the example of a maximum of 50 donors provided.
4. Investments made by a PPF being restricted to liquid assets.
5. The qualification requirements in relation the trustees of a PPF be increased.

The Discussion Paper also evidenced the Government's intention to move the regulatory powers in relation to the both the establishment and regulation of PPFs from Treasury to the Commissioner.

One hundred and thirty eight submissions were received in relation to the terms of the Discussion Paper. Although there was support for the underlying purpose of the Discussion Paper, there was an overwhelming expression of concern regarding the impact of the increased regulation and restrictions on the ongoing use of PPFs. Of particular concern was the effect of the proposed legislative guidelines on the attractiveness of PPFs.

THE INTRODUCTION OF PRIVATE ANCILLARY FUNDS

Tax Laws Amendment (2009 Measures No. 4) Bill 2009

On 14 May 2009 the then Assistant Treasurer released for public consultation an exposure draft of *Tax Laws Amendment (2009 Measures No. 4) Bill 2009 (TLAMB4 2009)*, being the legislative instrument to give effect to the Government's 2008 Budget commitment to improve the integrity of PPFs. The proposed changes to the PPF regime, to have effect from 1 October 2009,⁶ include the change of name of PPFs to Private Ancillary Funds⁷ (PAF).

TLAMB4 2009 also included the following provisions as part of the proposed new PAF regime:

1. The definition of a PAF, which included a requirement that the trustee of the PAF be a corporation. In addition, provisions regarding the liability of directors were included, such provisions providing that the directors of the corporate trustee are jointly and severally liable to administrative penalties in relation to any of the directors falsely holding

out that the PAF is endorsed, entitled to be endorsed or to remain endorsed as a DGR.⁸

2. Granting the Commissioner the power to impose administrative penalties.⁹
3. Granting a Minister with the power to make guidelines regarding the establishment and maintenance of PAFs by legislative instrument.¹⁰
4. Granting the Commissioner with powers in respect of the establishment and conduct of PAFs, including the power to suspend or remove the trustee of a PAF.¹¹

Further, the imposition of unlimited personal liability was inconsistent with the concept of limited liability under the *Corporations Act 2001* and was therefore a greater level of liability than that imposed on the directors of public companies.¹⁴

- The continued lack of certainty in relation to the rules which will govern PAFs. It was identified that the ability for a Minister to make binding guidelines that may be substantially changed in the future without any review by Parliament, will likely be a deterrent for some potential donors.¹⁵

“ Although there was support for the underlying purpose of the Discussion Paper, there was an overwhelming expression of concern regarding the impact of the increased regulation and restrictions on the ongoing use of PPFs. ”

Submissions

Fourteen different bodies made submissions in relation to TLAMB4 2009, although a number of those submissions noted that the absence of the proposed guidelines meant that comprehensive comments as to the implications of TLAMB4 2009 were unable to be provided. Regardless, a number of issues were raised in relation to the new PAF regime, including:

- The proposed role and powers of the Commissioner including whether the Commissioner is the most appropriate body to be granted the new role in relation to PAFs. The independence of the Commissioner in undertaking this role was questioned in light of the Commissioner's role as the “single national regulator”.¹²
- The potentially damaging impact of imposing joint and several liability on directors of the corporate trustee of a PAF. The ground for this submission being that the imposition of such liability would discourage people from volunteering their time to such philanthropic organisations.¹³

Draft Guidelines

The Draft Guidelines were released for public consultation on 25 June 2009¹⁶ and include the requirements that must be met for trust or fund to be considered a PAF together with the rules governing the day to day conduct of a PAF (**Draft Guidelines**).

There have been a number of fundamental changes made to the new PAF regime as compared to the previous PPF regime. The following is a brief summary of some of the fundamental changes made pursuant to the Draft Guidelines.

1. Minimum distributions

A PAF will be required to make a minimum distribution of 5% of the market value of the assets of the PAF (as at the end of the previous financial year) each financial year.¹⁷

In the event 5% of the market value of the assets of the PAF is less than \$11,000 and expenses of the PAF have been paid from the PAF's assets or capital, the PAF must distribute \$11,000 in that year.¹⁸ In the event that the PAF holds less than \$11,000 in income and capital, the remainder of the PAF must be distributed.

2. Valuation

The market value of the PAF's assets (other than land) must be estimated at least annually.¹⁹ It was originally proposed in the Discussion Paper that valuation be undertaken annually.

However, a valuation must be obtained in relation to the value of land held by a PAF every three years (such valuation to be in writing).²⁰

In the event the Commissioner considers the estimate of market value of any asset to be unreasonable, the Commissioner has the power to request that a further valuation is undertaken.²¹

3. Accounts and financial statements of a PAF

The trustee must keep or cause to be kept proper accounts in relation to all receipts and payments of the PAF.²²

Further, financial statements showing the position of the PAF must be prepared at the end of each financial year.²³

4. Audit

An audit of the PAF must be undertaken each financial year, with an audit report to be submitted to the Commissioner with the PAF's income tax return for the relevant financial year.²⁴

5. Investment Strategy

The trustee of a PAF must prepare and maintain a current investment strategy for the PAF.²⁵ An investment strategy for a PAF must include the investment objectives of the PAF and detail the investment methods the trustee proposes adopting to achieve the objectives. Further, the investment strategy is required to reflect the purposes of the PAF including the risk involved in the investments, the composition of the PAF's investments as a whole, the liquidity of the investments having regard to the cash flow requirements of the PAF (including the distribution requirements) and the ability of the PAF to discharge existing and prospective liabilities.

6. Distribution Strategy

In addition to an investment strategy and regardless of the minimum distribution requirements, the trustee of a PAF is required to prepare

a distribution strategy in written form.²⁶ The distribution strategy is required to address and quantify donations expected to be received and expected recipients of distributions and the size of distributions.

7. Restrictions on investments

The Draft Guidelines include a number of limitations in relation to the investments able to be made by a PAF, including that the trustee of a PAF must not borrow money.²⁷

8. Restriction on the receipt of donations from certain persons

The Draft Guidelines prohibit a PAF receipting donations totalling more than 10% of the market value of the assets of the PAF from entities other than the founder, the associates of the founder or the employees of the founder.²⁸

9. Penalties

The Draft Guidelines detail the penalties that apply to a breach of provisions of the Draft Guidelines.

Submissions

A number of concerns arising from the Draft Guidelines were raised as part of the public consultation process. These concerns included:

- The additional compliance costs likely to be incurred by PAFs in obtaining the necessary valuations of any assets and/or land of the PAF.²⁹
- The requirement for a distribution plan being redundant as a result of the 5% minimum distribution requirement included in TLAMB 2009.³⁰
- The prohibition on borrowing by a PAF was queried, particularly in light of the model trust deed in relation to PPFs permitting borrowing.³¹
- The restrictions regarding transactions with specified entities, save for where the transaction is a gift, was queried with it being proposed that such a provision should apply only where the transaction is not on an arm's length basis.
- The cap on donations made by anyone other than the founder, the associates of the founder or the employees of the founder.

TLAMA4 2009 and the finalised Guidelines

On 10 September 2009 the Assistant Treasurer announced the passage of TLAMB4 2009 through the Senate without amendment.³² Royal assent was received on 18 September 2009 with the relevant provisions of *Tax Laws Amendment (2009 Measures No. 4) Act 2009 (TLAMA4 2009)* having effect from 1 October 2009.

The provisions included in TLAMA4 2009 remain largely unchanged as compared to the draft version of TLAMB4 2009 released for public consultation, with the majority of amendments made being minor drafting amendment only.

A number of amendments have been made to the *Private Ancillary Fund Guidelines 2009 (Guidelines)* at least in part as a result of the concerns raised as part of the public consultation process. The amendments to the Guidelines as compared to the Draft Guidelines include the following:

- The requirement to obtain a valuation of assets held by the PAF has not been removed, however more guidance has been included in relation to the procedure to be followed when estimating the market value of a PAF's assets (other than land).³³
- An additional requirement to retain the accounts of the PAF for a period of five years has been inserted into the Guidelines.³⁴
- The requirement to prepare and maintain a distribution strategy as set out in the Draft Guidelines has been removed.
- The general prohibition against a PAF borrowing money has been retained, however this is now subject to clauses 33.1 and 33.2. Clause 33.1 permits borrowing of money if:
 - (a) the purpose of the borrowing is to enable a distribution to be made to the DGR as required under the Guidelines and which, apart from the borrowing, the trustee of the PAF would have been unable to undertake; and
 - (b) the period of borrowing does not exceed 90 days; and

(c) the borrowing does not result in total borrowings of the PAF exceeding 10% of the market value of the assets of the PAF.

- The threshold of donations able to be accepted from entities other than the founder, the associates of the founder and the employees of the founder has been increased to an amount equal to 20% of the market value of the assets of the PAF.³⁵

Are the new integrity measures beneficial?

The question to be addressed in reviewing TLAMA4 2009 and the Guidelines is whether they have had the intended effect of improving the integrity of philanthropic funds of this kind or alternatively have resulted in the once attractive nature of PPFs diminishing such that the new PAFs have become a complicated and costly vehicle to use for philanthropic purposes.

Arguably the new measures have introduced a new level of complexity from a compliance point of view. However, more importantly the restrictions introduced in relation to minimum distribution levels, the costs of complying with the valuation and audit requirements and the restrictions introduced in relation to certain donors means that the utilisation of PAFs is likely to be out of reach of a number of families and small businesses that previously would have considered the use of a PAF to achieve their philanthropic intentions. This arises principally as a result of the significant increase in the costs to conduct a PAF.

The increase in costs arguably arises from the following:

- The minimum annual distribution level of 5% of the value of the assets of the PAF or \$11,000 (and if less than \$11,000 the balance of assets of the PAF), means that in order for the PAF to be continued on a long term basis the balance of funds held by a PAF should be at least \$220,000 in each year (5% of which is \$11,000).
- The ability to obtain donations from people other than the founder, associates of the founder and the employees of the founder has been restricted, the result of which is

that retaining the minimum balance necessary to keep a PAF in operation is further complicated.

- The costs incurred in order to ensure compliance by the PAF have increased, meaning that again retention of the minimum balance necessary to keep a PAF in operation is further compromised.

In contrast however, there are a number of beneficial changes arising from the new PAF regime, including the governance of PAFs by one body and the further guidance provided in relation to the investment strategies required to be prepared and maintained by a PAF. Ultimately these are measures that not only improve the integrity of PAFs but also should provide more certainty in relation to the conduct of a PAF.

Despite these observations, the overall impact of TLAMA4 2009 and the Guidelines is yet to be seen, particularly given that apart from an acknowledgement of the new PAF regime no publications or guidance has been provided by the ATO. From the point of view of ensuring the integrity of the PAFs is maintained, the new measures are a step in the right direction. The question is, at what cost have the measures been introduced? Arguably, this question will only be answered with time.

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Reference notes

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- 7 Sections 65 and 70 of Tax Laws Amendment (2009 Measures No. 4) Bill 2009.
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- 19 Section 20 of the Draft Guidelines.
- 20 Section 21 of the Draft Guidelines.
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