



Strategic Responsive Solutions

PUBLIC ANCILLARY FUNDS – A “NEW” VEHICLE FOR PUBLIC PHILANTHROPY

A paper to be presented on 8 May 2015

TEN Annual Charities & Not for Profits Conference, Melbourne

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1 BACKGROUND

- 1.1 Australians are a philanthropic nation - statistics indicate that in 2010-2011, approximately 4.8 million taxpayers claimed a deduction for gifts to Deductible Gift Recipients (DGRs), donating a total of approximately \$2.1 billion¹. The tax deduction benefit available to donors undoubtedly encourages at least some of this generosity, and allows Australians to maximize their philanthropic giving.
- 1.2 Public Ancillary Funds are a vehicle that can be used to harness the generosity of the Australian public on a tax-deductible basis. These funds may take the form of public or community foundations, or may be established by charities as a means to fund at least some of their own charitable activities. The Australian government has given considerable attention to the promotion and development of the regulatory framework for public ancillary funds in recent years, and despite having strict requirements for both their establishment and continued operation, these Funds are an effective vehicle for public philanthropy.
- 1.3 As a threshold question I query whether the availability of a tax deductible receipt increases giving by the extent that it might? That is, have people decided to give to a cause regardless of whether a tax deductible receipt is available or not? And if so, will they decide to give more if a tax deductible receipt is available to them?
- 1.4 This paper examines the changes in recent years that have altered the regulatory landscape for public ancillary funds (PAFs), and how these changes affect the use of PAF distributions in particular.

What are Ancillary Funds?

- 1.5 Ancillary funds are funds which are entitled to deductible gift recipient (DGR) endorsement, and are therefore entitled to receive donations which are tax deductible. These funds essentially operate as a tax deductible fundraising mechanism to distribute to other DGRs, and cannot engage in any other activities.
- 1.6 Ancillary funds fall within two categories:
 - Private ancillary funds – these allow businesses, families and individuals to establish and donate to a charitable trust of their own and issue a tax deductible receipt for that giving,

¹ *Australian Taxation Office, Taxation Statistics 2010-2011 (2013).*

without the seeking contributions from the public, for the purpose of disbursing funds to other Item 1 DGRs².

- Public ancillary funds (PAFs - the topic of this paper) – these funds are distinct from private ancillary funds in that they invite the public to contribute to the fund, and issue a tax deductible receipt for that giving, effectively for the purpose of both capital growth and distributing funds to other Item 1 DGRs.

1.7 Section 8 of the *Public Ancillary Fund Guidelines 2011* provides the following key principles

“A public ancillary fund must be established, maintained and wound up in accordance with the following principles:

- *it is an ancillary fund, it is philanthropic in character and it is a vehicle for philanthropy; and*
- *it is a trust that:*
 - *seeks to comply with all relevant laws and obligations; and*
 - *is open, transparent and accountable to the public (through the Commissioner)”.*

1.8 Additionally, the intention of the Government is that such Funds will grow to a point of becoming self-perpetuating (or endowed), with growth occurring each year over and above minimum distribution requirements, to provide long-term solutions for deficiencies in income streams for such organisations. This intention is made clear by the five year establishment distribution holiday, where funds are encouraged to build up capital in the first five years of operation without the need to comply with mandatory distribution requirements (discussed below at 4).

2 REGULATORY FRAMEWORK

2.1 The *Income Tax Assessment Acts* of 1997 and 1936 cover the taxation aspects of PAFs together with the *Public Ancillary Fund Guidelines 2011* - these constitute Schedule 8 of the *Taxation Administration Act 1953* as amended by *Tax Laws Amendment (2011 Measures No. 4) Act 2011*), and are therefore not just administrative guidelines, but have legislative effect.

² An Item 1 DGR is ‘a fund, authority or institution covered by an item in any of the tables in Subdivision 30-B’ of [the *Income Tax Assessment Act 1997* (Cth)]’ (extracted in full in Schedule 1 to this paper) as opposed to an Item 2 DGR (which is the type of DGR to which Private and Public Ancillary Funds belong to – discussed further below at 4.8-4.11).

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- 2.2 Given that PAFs are trusts, they and their trustees must comply with any requirements imposed by the relevant trust legislation and common law, and the common law principle of fiduciary responsibility will apply to trustees.
- 2.3 Regard must also be given to the relevant state charity or trust legislation. Legislation under Collections Acts (State and Territory based) must also be considered.³
- 2.4 Further, corporate trustees must continue to comply in all respects with the *Corporations Act 2001*, and funds which are endorsed as charities must also comply with ACNC requirements.
- 2.5 The introduction of the *Public Ancillary Fund Guidelines 2011* (“the Guidelines”) (which came into effect from 1 January 2012) left key features of PAFs unchanged, while introducing new requirements that were designed to increase accountability in the sector:

*“The purpose of the Guidelines is to set minimum standards for the governance and conduct of a public ancillary fund and its trustee. The Guidelines aim to ensure that public ancillary funds are properly accountable and act in the manner expected of an entity holding philanthropic funds for a broad public benefit”.*⁴

PAFs – one ‘Collections Act’ registration

- 2.6 The advantage of a PAF is that it acts as a centralized ‘hub’ for fundraising. This means that although an organisation may operate a number of DGR Funds, the PAF is the only body that is conducting fundraising activities, and is therefore the only body that requires Collections Act approval. It is not necessary to seek and maintain Collections Act approval for the various Funds to which the PAF distributes, if these Funds are not themselves making public appeals for support.
- 2.7 Conducting fundraising activities without approval by the relevant state body is an offence which can lead to significant penalties.⁵

³ QLD – *Collections Act 1996*, administered by Office of Fair Trading. NSW – *Charitable Fundraising Act 1991*, administered by Office of Liquor, Gaming and Racing. ACT – *Charitable Collections Act 2003*, administered by Office of Regulatory Services. VIC – *Fundraising Act 1998*, administered by Consumer Affairs Victoria. SA – *Collections for Charitable Purposes Act 1939*, administered by Office of Consumer and Business Services. WA – *Charitable Collections Act 1946*, administered by Department of Commerce. NT – *Gaming Control Act 1993*, administered by Department of Business. TAS – *Gaming Control Act 1993*, administered by Tasmanian Gaming Commission.

⁴ Explanatory Statement issued by Bill Shorten, Assistant Treasurer 2011.

⁵ QLD – 20 - 40 penalty units per breach or 3 – 6 months imprisonment, *Collections Act 1966* (Qld), s 11. NSW – 50 penalty units, *Charitable Fundraising Act 1991* (NSW) s 10. ACT – 200 units or two years imprisonment, *Charitable Collections Act 2003* (ACT) s 14. VIC – 240 penalty units, *Fundraising Act 1998* (Vic) s 17A. SA – \$4,000 or 1 year imprisonment, *Collections for Charitable Purposes Act 1939* (SA) s 6. WA – penalty not exceeding \$100, *Charitable Collections Act 1946* (WA) s 6. NT – 85 penalty units or 2 years imprisonment, *Gaming Control Act 1993* (NT) s 74. TAS – 50 penalty units, *Gaming Control Act 1993* (Tas) s 76ZZT.

- 2.8 Once approval is obtained for the PAF from the Office of Fair Trading or its equivalent in other States or Territories, the PAF must comply with annual reporting requirements regarding its fundraising activities, and inform the Office of Fair Trading of any amendments to constituent documents (such as the PAF trust deed or trustee company constitution).⁶

3 THE PUBLIC ANCILLARY FUND GUIDELINES 2011

- 3.1 The Guidelines provide extensive guidance in relation to the establishment, ongoing operation, and winding up of PAFs.

Establishment of a PAF

- 3.2 PAFs are established as trusts, by trust deed. Pursuant to the Guidelines, the Fund must be maintained as a valid trust under State legislation.⁷
- 3.3 The ATO has published a model trust deed for PAFs, which can be found on their website at www.ato.gov.au/forms/public-ancillary-fund-model-trust-deed. We expect that the introduction of this model Deed will largely preclude circumstances arising as did in the case of *Commissioner of Taxation v Cancer and Bowel Research Association Inc as trustee for the Cancer and Bowel Research Trust* [2013] FCAFC 140, in which it was decided that a PAF's trust deed did not meet the full requirements of the ATO for DGR funds, resulting in the revocation of endorsement for the fund, backdated approximately 13 years. However, the fact that the trust deed considered in this case had been through multiple amendments and provided to the ATO as required on each occasion with the breach not being brought to the attention of the trustees by the ATO, highlights the ultimate responsibility of a fund's trustees to ensure compliance. Care should therefore be taken to ensure that the model trust deed is appropriate for the specific anticipated purposes of any established PAF.
- 3.4 Being a trust, there must be a trustee for the PAF who is willing to submit to the strict requirements imposed by the ATO and other regulatory bodies for the operation of the Fund. Due to these requirements, it will often be necessary for organisations to establish a 'trustee company' separate to the organisation itself to act as the trustee of the PAF, depending on the activities, functions and corporate capabilities of the existing entity - in the case of many

⁶ QLD – *Collections Act 1966* (Qld), s 32. NSW – *Charitable Fundraising Act 1991* (NSW) s 23. ACT – *Charitable Collections Act 2003* (ACT) s 48. VIC – *Fundraising Act 1998* (Vic) Division 2A. SA – *Collections for Charitable Purposes Act 1939* (SA) s 15. WA – *Charitable Collections Act 1946* (WA) s 20. NT – *Gaming Control (Community Gaming) Regulations 1993* (NT) s44. TAS – *Gaming Control Act 1993* (Tas) s 143.

⁷ *Public Ancillary Fund Guidelines 2011*, 8.

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established companies, the objects of the company or makeup of the board (for example) will not be sufficient for the requirements of a trustee of a PAF.

- 3.5 The Rules of the Fund must stipulate that the Fund is public in nature⁸ – that is, the clear intention of the founders or promoters of the Fund is that the public will be invited to make contributions to the Fund.
- 3.6 The Rules of the Fund (usually the Trust Deed) must also clearly set out the Objects and purpose of the Fund, which must be the sole purpose of providing money property or benefits to eligible entities in accordance with the Guidelines (other DGRs who are not ancillary funds).⁹ The Rules must also stipulate that the Fund is established and must operate as a not-for-profit entity,¹⁰ and provide for the procedure on winding up of the Fund in accordance with the Guidelines.¹¹
- 3.7 The Guidelines require that the majority of individuals involved in the decision-making of the fund must be ‘individuals with a degree of responsibility to the Australian community as a whole’.¹² The majority of directors of the trustee company must therefore be ‘Responsible Persons’ as defined by the ATO.¹³ This is defined as an individual who:
1. performs a significant public function;
 2. is a member of a professional body having a code of ethics or rules of conduct;
 3. is officially charged with spiritual functions by a religious institution;
 4. is a director of a company whose shares are listed on the Australian Securities Exchange;
 5. has received formal recognition from government for services to the community;
 6. is an individual before whom a statutory declaration may be made; or
 7. is approved as a Responsible Person by the Commissioner of Taxation.
- 3.8 More information about who the ATO recognizes as ‘responsible persons’ can be found on the ATO website at www.ato.gov.au.

⁸ *Public Ancillary Fund Guidelines 2011*, 44.

⁹ *Public Ancillary Fund Guidelines 2011*, 10.1

¹⁰ *Public Ancillary Fund Guidelines 2011*, 11.

¹¹ *Public Ancillary Fund Guidelines 2011*, 10.2

¹² *Public Ancillary Fund Guidelines 2011*, 14.

¹³ *Public Ancillary Fund Guidelines 2011*, 15.

- 3.9 A trustee company established for the purpose of acting as trustee of the PAF can be utilised in many other ways by the organisation, including (for example) acting as the trustee for any other DGR Funds that the organisation may operate.
- 3.10 Can the trustee company be a “Pty Ltd” company as opposed to a company limited by guarantee – given that it is the trust and not the company that has the tax concessions? Technically yes, however problems with succession of control and ‘revenue consequences’ of moving ‘shares’ in that trustee company, combined with a significant PR challenge mean in our experience “perceived cost savings” of using a “Pty Ltd” corporate structure are not “real cost savings”.

Investment strategy

- 3.11 Given that the primary purpose of a PAF is to manage assets for the eventual benefit of DGR beneficiaries, investment of Fund assets is a principal responsibility of the Fund’s trustee. In addition to the requirements specifically set out in the Guidelines regarding a PAF’s investment strategy (discussed below), the trustee must comply with the duty of care imposed by the relevant state trust legislation. This requires the trustee to exercise “the care, diligence and skill that a prudent person would exercise in managing financial affairs of others”,¹⁴ or the standard of care of a ‘prudent person of business’,¹⁵ depending on the State in which the trustee is based. Where the trustee’s profession, business or employment includes acting as a trustee or investing funds for other purposes, the duty of care is raised - the trustee must “exercise the care, diligence and skill that a prudent person engaged in that profession, business or employment would exercise in managing financial affairs of others”.¹⁶
- 3.12 Pursuant to the Guidelines, a PAF’s trustee must prepare and maintain a current investment strategy for the fund.¹⁷ This should clearly set out the investment objectives of the PAF and the methods that the trustee will adopt to achieve those objectives.¹⁸ The Guidelines further provide that the investment strategy must have particular regard to (but not be limited to) the following:

¹⁴ *Trustee Act 1925* (ACT), s14A(2)(b); *Trustee Act 1925* (NSW), s14A(2)(b); *Trustee Act 1958* (Vic), s6(1)(b); *Trustees Act 1962* (WA), s 18(1)(b).

¹⁵ *Trusts Act 1893* (NT), s 6(1)(b); *Trusts Act 1973* (Qld) s22(1)(b); *Trustee Act 1936* (SA), s 7(1)(b); *Trustee Act 1898* (Tas), s 7(1)(b).

¹⁶ *Trustee Act 1925* (ACT), s14A(2)(a); *Trustee Act 1925* (NSW), s14(2)(a); *Trustee Act 1893* (NT), s 6(1)(a); *Trusts Act 1973* (Qld), s 22(1)(a); *Trustee Act 1936* (SA), s 7(1)(a); *Trustee Act 1898* (Tas), s 7(1)(a); *Trustee Act 1958* (Vic), s 6(1)(a); *Trustees Act 1962* (WA), s 18(1)(a).

¹⁷ *Public Ancillary Fund Guidelines 2011*, 30.

¹⁸ *Public Ancillary Fund Guidelines 2011*, 30.1

- the risk in making, holding and realising the investment versus likely returns, having regard to the fund's objects and expected cash flow requirements (including distribution requirements);
- the potential benefits of diversification of the fund's investments, and the risks of inadequate diversification;
- the liquidity of the fund's investments, having regard to its expected cash flow requirements (including distribution requirements);
- the ability of the fund to discharge its existing and prospective liabilities (if any); and
- the investment requirements imposed by State or Territory laws.

3.13 To fully comply with the Guidelines, there must be evidence that the trustee is actively implementing the investment strategy - that is, all investment decisions are made in accordance with the strategy.¹⁹ To this end, the investment strategy must be available in written form along with a record of associated decision-making processes), in order to allow the trustee, an auditor or the Commissioner to determine whether the trustees have complied with their obligations.²⁰ Importantly, the audit of a PAF requires the auditor to form an opinion about whether the trustee has complied with the Guidelines.²¹

3.14 Administrative penalties are imposed on trustees for failure to comply with each respective Guideline in relation to investment strategies. For example, 10 penalty units²² are applied for failure to prepare and maintain a current investment strategy,²³ failure to implement the investment strategy,²⁴ and failure to make the strategy available in written form.²⁵ A higher penalty of 30 penalty units are applied for breaches of Guidelines 33-38, which deal with investment limitations on trustees (discussed below).²⁶

¹⁹ *Public Ancillary Fund Guidelines 2011*, 31.

²⁰ *Public Ancillary Fund Guidelines 2011*, 32.

²¹ *Public Ancillary Fund Guidelines 2011*, 28.

²² 1 penalty unit = \$170. *Crimes Act 1914* (Cth), s 4AA and so 30 penalty units = \$5,100.

²³ *Public Ancillary Fund Guidelines 2011*, 30.

²⁴ *Public Ancillary Fund Guidelines 2011*, 31.

²⁵ *Public Ancillary Fund Guidelines 2011*, 32.

²⁶ *Public Ancillary Fund Guidelines 2011*, 39.

- 3.15 The Guidelines also provide limitations around the trustee’s discretion regarding investments, imposing restrictions on the investment activities that the Fund may engage in (*Public Ancillary Fund Guidelines 2011, 33-40*). For example, a trustee cannot borrow money or maintain a current borrowing of money, except in limited and short-term circumstances.²⁷ Collectables cannot be purchased by the Fund, and any collectables donated by way of gift to the Fund must be sold within 12 months.²⁸ Investments must be made and maintained on an arms-length basis,²⁹ and the trustee must keep Fund assets separate from all other assets it manages.³⁰
- 3.16 In particular, we note the limitation imposed by the Guidelines that a PAF must not carry on a business.³¹ This restriction is qualified by the direction that a fund may carry on investment activities with repetition, volume and regularity without contravening this restriction.³² Importantly, the Guidelines also specify that undertaking public fundraising appeals (and associated activities - lamington drives, raffles and charity balls, for example) will not contravene this Guideline.³³

4 DISTRIBUTIONS FROM PAFS

- 4.1 Distributing funds to eligible DGRs is the very purpose of the existence of PAFs. However, strict restrictions do apply as to the entities that are able to receive such distributions, and the way in which such distributions may be made.
- 4.2 Once a PAF is established by an organisation and is raising income through philanthropic donations and investments, there are a wide variety of DGRs that organisations can establish for PAF funds to be distributed to in accordance with the mandatory distribution requirements. Alternatively, PAFs can be established independently and distribute to already established DGRs operated by other entities, even related entities.
- 4.3 A major benefit to utilizing a PAF for raising income to later distribute to other DGRs is the level of control that the trustee of the PAF retains in deciding where to direct distributions. For example, in a school environment, the school may fundraise through a PAF for the purpose of

²⁷ *Public Ancillary Fund Guidelines 2011, 33.*

²⁸ *Public Ancillary Fund Guidelines 2011, 38.*

²⁹ *Public Ancillary Fund Guidelines 2011, 34.*

³⁰ *Public Ancillary Fund Guidelines 2011, 37.*

³¹ *Public Ancillary Fund Guidelines 2011, 40.*

³² *Public Ancillary Fund Guidelines 2011, 40.1*

³³ *Public Ancillary Fund Guidelines 2011, 40.2*

making distributions to any number of DGR funds - for example, a scholarship fund, building fund, library and necessitous circumstances fund. Depending on the particular needs of the school, and the terms under which the funds were raised, distribution from the PAF can be made in proportions that reflect the particular capital or recurrent funding needs of the school in any given year.

Distribution requirements

Five year establishment distribution holiday

- 4.4 Given the maintenance costs for operating a PAF and acknowledging that it can take some time to build a substantial Fund, PAFs are not required by the ATO to make distributions during the financial year in which the Fund was established or within the next 4 financial years.³⁴ Ideally, this allows trustees to accumulate funds in the trust to the point where the Fund is self-perpetuating. However, even during this 5-year period, the trustee can certainly consider making appropriate distribution from the Fund during each year in accordance with both the purpose of the Fund and the needs of the various DGRs that the fund supports.

Year six and following minimum 4% distribution

- 4.5 Following this 5-year grace period, each financial year PAFs are required to distribute 4% of their market value of the Fund's net assets as valued at the end of the previous financial year.³⁵ However, a minimum distribution amount of \$8,800 (or the remainder of the Fund) applies if the value of 4% of the fund is less than \$8,800.³⁶
- 4.6 Distributions by the Fund do not necessarily need to be made by cash gifts, but may also take the form of property or other benefits. If the fund is making any such distributions, the market value of the property or benefit provided is to be used in determining compliance with the distribution guidelines.³⁷ By way of example, the Guidelines provide that in circumstances where a PAF leases property to a DGR at a discount to the market price, the fund will be taken to be providing a benefit "whose market value is equal to the discount".³⁸
- 4.7 The penalty for a contravention of these minimum distribution guidelines is 30 penalty units if the shortfall is greater than \$1,000.³⁹ The Commissioner may also request the trustee to

³⁴ *Public Ancillary Fund Guidelines 2011*, 19.2

³⁵ *Public Ancillary Fund Guidelines 2011*, 19

³⁶ *Public Ancillary Fund Guidelines 2011*, 19.1

³⁷ *Public Ancillary Fund Guidelines 2011*, 19.3

³⁸ *Public Ancillary Fund Guidelines 2011*, 19.3

³⁹ *Public Ancillary Fund Guidelines 2011*, 19.4

rectify any shortfall in the minimum distribution for a financial year - if such a request is made, the trustee must comply within 60 days, or further penalties apply.⁴⁰

What charities can receive funding from PAFs? DGR status explained

- 4.8 The *Income Tax Assessment Act 1997* section 30-15 provides for two classifications of Deductible Gift Recipient - 'Item 1', and 'Item 2'.
- 4.9 Item 1 DGRs are defined as 'a fund, authority or institution covered by an item in any of the tables in Subdivision 30-B' of that Act'.⁴¹ The tables in subdivision 30-B set out over 50 specific types of DGR funds that can be established, and any special conditions for both the fund itself and the application of funds received on a tax-deductible bases by that DGR. Item 1 DGRs include most other funds, authorities or institutions with DGR endorsement, and include funds of categories such as health, education, research, cultural organizations and international affairs. Item 1 DGRs are set out in the Schedule to this paper.
- 4.10 Ancillary funds (whether public or private) are the only Item 2 DGR - the Act defines these as:
- “an ancillary fund established and maintained under a will or instrument of trust solely for:
- (a) the purpose of providing money, property or benefits to a fund, authority or institution to which gifts are deductible under Item 1 of this table, and for any purposes set out in the item of the table in Subdivision 30-B that covers the fund, authority or institution; or
- (b) the establishment of such a fund, authority or institution”.⁴²
- 4.11 Given their designation as Item 2 DGRs, a PAF can therefore not distribute funds to another ancillary fund (public or private), or for the purpose of the establishment of such a fund.⁴³

Recommendations of NFP Tax Concession working group

- 4.12 In May 2013, the *Not-For-Profit Sector Tax Concession Working Group* published a Report on reforms necessary for fairer, simpler and more effective tax concessions for the not-for-profit sector. This report considered the current system for granting DGR status and recommended reforms designed to “increase certainty, reduce red tape for eligible entitles and ... further

⁴⁰ Note – one penalty unit is \$170 (*Crimes Act 1914* (Cth), s 4AA) and so the total penalty is \$5,100.

⁴¹ *Income Tax Assessment Act 1997*, 30.15

⁴² *Income Tax Assessment Act 1997*, 30.15

⁴³ *Income Tax Assessment Act 1997*, 30.15

increase philanthropy”.⁴⁴ If adopted, these reforms could significantly widen the class of potential DGR beneficiaries of PAF distributions.

- 4.13 The Report recognizes that strict operational requirements/restrictions for entities with DGR status often results in the necessity for an entity to restrict the operations of particular entities in their control to fall within the strict endorsement guidelines for that particular DGR item. Alternatively, organisations may need to set up multiple funds, authorities and institutions to carry on activities that fall within a range of DGR categories.⁴⁵ For entities that have multiple purposes which satisfy a multitude of DGR categories, the establishment and ongoing administration of multiple DGR funds is complex and inefficient. For these reasons, the Report contends that the DGR framework is not sufficiently flexible to reflect the way that many community organisations currently operate.
- 4.14 The Report also observes that not all charities in Australia registered with the ACNC are able to be endorsed as a DGR - at the time of publication, approximately half of all registered Australian charities had DGR status.⁴⁶
- 4.15 Based on these considerations, the Report has recommended that DGR status is extended beyond the current scope of eligible entities to all charities that are registered with the ACNC (with some restrictions).⁴⁷
- 4.16 If imposed, this change may require action from many DGRs who are not currently registered as charities, as the Working Group specifically recommends that entities currently enforced under existing DGR categories be required to seek charity registration to retain their DGR status.⁴⁸
- 4.17 It is further recommended that charities whose purposes are principally for the advancement of religion, or the advancement of childcare through child care or primary and secondary education would be permitted to be endorsed as DGRs with the restriction that DGR funds are applied to activities which are for other charitable purposes.⁴⁹ For religious charities, the Working Group considers that additional support through deductible donations is not warranted given the pluralist nature of our society. For charities which principally advance education through childcare or primary and secondary education, the Working Group considers that the unlimited extension of DGR status will create integrity issues for such

⁴⁴ *The Australian Government the Treasury*, Not-For-Profit Sector Tax Concession Working Group, “Final Report” (May 2013), 21.

⁴⁵ *Ibid*, 23.

⁴⁶ Australian Taxation Office, *Taxation Statistics 2010-2011* (2013)

⁴⁷ *The Australian Government the Treasury*, Not-For-Profit Sector Tax Concession Working Group, “Final Report” (May 2013), 26.

⁴⁸ *Ibid*, 26

⁴⁹ *Ibid*, 24.

organizations due to the private benefits that they provide – it would be difficult for such entities to differentiate between the payment of fees and voluntary donations, for example.⁵⁰

- 4.18 The Working Group’s recommendations do not specifically address any distinction between Item 1 and Item 2 DGRs – this would indicate that the proposed reforms will also target ancillary funds, both public and private. ACNC registration would therefore be required for PAFs to maintain their DGR endorsement, creating a further regulatory scheme that each fund would be required to comply with. PAFs and their interaction with the ACNC is discussed further below.

Effect of proposed changes on schools

- 4.19 Currently, schools that wish to receive tax deductible donations must establish a DGR fund relevant to their particular capital or recurrent funding needs. Often, multiple funds will be established – typically a building fund, scholarship fund, library and necessitous circumstances fund. Each of these funds has specific ongoing requirements imposed by the ATO to retain endorsement, in addition to the separate establishment costs for each fund (which can be significant).
- 4.20 However, if a school was registered as a charity with the ACNC (as most independent or religious schools are), the proposed changes would technically have the effect of a school being able to apply for endorsement as a DGR without the need to establish multiple separate DGR funds. Administratively and practically, this option may be appealing due to the reduction in compliance steps that would otherwise need to be taken in respect of each separate fund. However, the school’s controlling entity would need to be aware of the proposed restrictions for charities that which principally advance education through childcare or primary and secondary education, and make the case that their particular activities allow DGR funds to be applied to activities which are for other charitable purposes. Whether funds donated on a tax deductible basis could then be applied to, for example, the construction of a school building or provision of scholarships (as with an endorsed building fund or scholarship fund), is unclear – but the hope would be that the existing DGR categories remain. Schools need to watch this space carefully, as abolition of individual funds may adversely affect their funding model.

5 PENALTY SCHEME & PRACTICE STATEMENT LAW ADMINISTRATION 2014/1

- 5.1 The Guidelines are enforced through a system of administrative penalties.⁵¹ Prior to the introduction of subdivision 426-D of the *Taxation Administration Act 1953* (“TAA”), there were

⁵⁰ Ibid, 24.

⁵¹ *Public Ancillary Fund Guidelines 2011*, 4

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no guidelines enforced through the imposition of administrative penalties for PAFs - the only option available to the Commissioner of Taxation to sanction breach of the previous provisions was the removal of the entity's endorsement for tax concessions.⁵² The Guidelines then introduced its administrative penalty regime, which aims to ensure accountability from trustees, and that in all respects a trustee acts in the manner expected of a trustee holding philanthropic funds for the public benefit.⁵³ Clear guidance now also exists with the publishing of Practice Statement Law Administration (“PS LA”) 2014/1, which allows the Commissioner to apply responses to breaches of the Guidelines in a consistent manner.

5.2 Penalties are imposed on a strict liability basis - however, there are some transitional rules to be taken into account for Funds in existence before the Guidelines came into force in 2012.

5.3 We note that these penalties can also apply to individual directors of a corporate trustee where the penalty cannot be reasonably recovered from the company.⁵⁴ Penalties applied cannot be reimbursed from the PAF's funds.⁵⁵

5.4 The Guidelines specify the amount of the penalty to be applied in respect of breaches of each Guideline – different penalty amounts apply depending on the specific Guideline breached, and the severity or consequence of the breach.⁵⁶ Examples of applicable penalties include:

- \$550 for failure to notify the ATO within 21 days of any change to the Fund's Governing Rules;
- \$1,100 for failure to keep proper accounts or make accounts available to the ATO;
- \$3,300 for failure to comply with minimum annual distribution;
- \$3,300 for breach of any investment guidelines.

Steps in the administration of subdivision 426-D penalties

5.5 PS LA 2014/1 sets out three main steps to be followed by the Commissioner in applying the administrative penalties:

⁵² *Australian Taxation Office, Practice Statement Law Administration 2014/1, 2.*

⁵³ *Ibid*, 12.

⁵⁴ *Ibid*, 17.

⁵⁵ *Ibid*, 20.

⁵⁶ *Ibid*, 15.

1. Determine if a penalty is imposed by law – this will involve establishing if there is a breach of Guidelines, if the Guidelines impose a penalty for the breach, and determining whether the liability should be imposed on the trustee or individual directors of the corporate trustee;
 2. Determine if the Commissioner should exercise the discretion to remit all or part of the penalty; and;
 3. Notify the trustee and/or each director of the corporate trustee liability to pay the penalty.
- 5.6 The Commissioner of Taxation also has the power to suspend or remove the corporate trustees of PAFs that consistently breach the guidelines or other relevant Australian laws.⁵⁷

Defences to subdivision 426-D penalties

- 5.7 There are statutory defences available to Directors who breach paragraph 426-120(1)(a) where:
- a) The Director was not aware of the breach, and cannot reasonably be expected to be aware of the breach,⁵⁸ or
 - b) The Director took all reasonable steps to ensure that a breach did not occur,⁵⁹ or
 - c) There were no such steps that the Director could have taken.⁶⁰
- 5.8 Taking ‘reasonable steps’ means acting with care and diligence in complying with the Guidelines, having regard to all the relevant circumstances.⁶¹ As to whether it would have been ‘reasonable to expect’ a Director to be aware of a breach, this is decided by the Commission by the application of an objective test.⁶² In the application of this test, the facts will be viewed as they would be by a ‘reasonable and prudent director of reasonable ability, who in the proper discharge of duties as a director had reasonable grounds for expecting the breach’ – a higher degree of responsibility will also apply to directors who are a ‘responsible person’ (it is noted that only a majority of directors are required to be ‘responsible persons’).⁶³

⁵⁷ *Public Ancillary Fund Guidelines 2011*, 47.

⁵⁸ *Taxation Administration Act 1953* (Cth), s 426-120(5)(a)

⁵⁹ *Taxation Administration Act 1953* (Cth), s 426-120(5)(b)

⁶⁰ *Taxation Administration Act 1953* (Cth), s 426-120(5)(c)

⁶¹ *Australian Taxation Office*, Practice Statement Law Administration 2014/1, 36.

⁶² *Ibid*, 35.

⁶³ *Ibid*, 35.

5.9 The Director will bear the onus of proving that the defence to the penalty applies.⁶⁴

Remission decisions

5.10 Pursuant to section 298-20 of the TAA, the Commissioner has unfettered discretion to remit all or part of the penalty imposed under section 426-120. In the case of each trustee or director liable to an administrative penalty, the Commissioner needs to consider whether to exercise this discretion.⁶⁵ This discretion must be exercised in a fair and reasonable way after an objective analysis of all relevant factors, which includes ensuring that the prescribed penalty does not cause unintended or unjust results.⁶⁶ However, the Practice Statement is clear that as a starting point, the quantum of penalties prescribed in the Guidelines is considered appropriate.⁶⁷

5.11 In approaching the issue of a remission of penalty, ATO personnel must have regard to the purpose of the provision in the Guidelines, and consider the following:

1. The high level of care, skill and diligence expected of trustees of philanthropic funds; and
2. The objective of the penalty regime – that is, to promote consistent treatment of breaches of the Guidelines, which would be compromised if penalties were remitted without just cause, arbitrarily, or as a matter of course.

5.12 It is acknowledged that in some circumstances, penalties imposed by the Guidelines may not provide a just result to the trustee/directors of the corporate trustee. If an unjust result could arise through the imposition of a penalty, the Commissioner is directed to have regard to the all relevant acts and omissions leading to the breach of the Guidelines.⁶⁸ In circumstances where multiple administrative penalties from various breaches of the Guidelines arise and create an unjust result, the Commissioner should consider whether the cumulative penalty applicable is defensible, just and proper in light of the overall circumstances.⁶⁹ Whether the penalties arise from connected circumstances, a single course of conduct, or a single error will

⁶⁴ *Taxation Administration Act 1953* (Cth), s 426-120(7)

⁶⁵ *Australian Taxation Office, Practice Statement Law Administration 2014/1*, 41.

⁶⁶ *Ibid*, 42.

⁶⁷ *Ibid*, 43.

⁶⁸ *Ibid*, 47.

⁶⁹ *Ibid*, 48.

be relevant in this regard – it would generally be unjust, for example, to apply multiple penalties if they arise from the same course of action.⁷⁰

- 5.13 The Practice Statement is also careful to note that Guidelines 34 to 37 and 41 to 42 are “significant integrity assurance measures”.⁷¹ These Guidelines cover appropriate practices and processes to safeguard funds received by a PAF and ensure tax deductible donations are used for an appropriate approved purpose. For this reason, it is made clear that remission of a penalty applied in respect of breach of these Guidelines would be exceptional.
- 5.14 Trustees who are dissatisfied with a decision of the Commissioner to refuse to remit a penalty may object in the manner set out in Part IVC of the TAA, which is via a request for review with the Commissioner in the first instance, or the Administrative Appeals Tribunal or Federal Court if the outcome of this review is unsatisfactory to the Trustee.⁷²
- 5.15 As at 27 April, the ATO had not published that it had made any penalty findings against directors of PAFs.

6 INTERACTION WITH ACNC

- 6.1 To be clear, not all PAFs are charities. To be registered as a charity with the ACNC, a PAF must meet the legal definition of a ‘charity’ under the Charities Act 2013 (Cth).
- 6.2 Pursuant to this legislation, ‘charity’ is defined as an entity that is:
- i. a not-for-profit entity; and
 - ii. all of the purposes of which are charitable purposes that are for the public benefit, or purposes that are incidental or ancillary to, and in furtherance or in aid of, purposes of the entity covered in (i).⁷³
- 6.3 Pursuant to this Act, “charitable purpose” is defined as any of the following:
- a) the purpose of advancing health;

⁷⁰ Ibid, 48.

⁷¹ Ibid, 49.

⁷² *Taxation Administration Act 1953* (Cth), s 14ZZ.

⁷³ *Charities Act 2013* (Cth), s 5.

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- b) the purpose of advancing education;
- c) the purpose of advancing social or public welfare;
- d) the purpose of advancing religion;
- e) the purpose of advancing culture;
- f) the purpose of promoting reconciliation, mutual respect and tolerance between groups of individuals that are in Australia;
- g) the purpose of promoting or protecting human rights;
- h) the purpose of advancing the security or safety of Australia or the Australian public;
- i) the purpose of preventing or relieving the suffering of animals;
- j) the purpose of advancing the natural environment; or
- k) any other purpose beneficial to the general public that may reasonably be regarded as analogous to, or within the spirit of, any of the purposes mentioned in paragraphs (a) to (j).

6.4 The purposes of the entity will be considered ‘for the public benefit’ if the achievement of the purpose would be of public benefit, and the purpose is directed to a benefit that is available to at least members of a sufficient section of the general public. Regard will be had to the entity’s governing rules, activities and any other relevant matters to determine the purposes of the entity.⁷⁴

6.5 In our view, PAFs at least satisfy the last limb of “charity”, that is, other purpose beneficial to the general public analogous to, or within the spirit of, another charitable purpose.

6.6 Registering as a charity with the ACNC is means that there are no tax issues with accumulated/capitalized income. Failure to register will technically see accumulated income in relation to which there was not a sufficient deductible gift to another DGR or taxable at the top marginal tax rate (plus penalty). For funds established prior to 31 December 2013, ancillary funds could be endorsed by the ATO as ‘income tax exempt funds’ (“ITEFs”), and thereby receive income tax exemptions. On 1 January 2014, all funds that were endorsed by the ATO as ITEFs were automatically registered with the ACNC in order to continue receiving this exemption (but can choose to ‘opt-out’), and must continue to meet the ATO conditions for

⁷⁴ *Charities Act 2013* (Cth), s 5.

being an ITEF to continue to be exempt from income tax.⁷⁵ It is however necessary for all newly established funds (established since 1 January 2014) to specifically seek registration with the ACNC in order to receive the benefit of income tax exemption.

- 6.7 PAFs which are registered with the ACNC have ongoing requirements under the ACNC Act, in addition to all other obligations under the regulatory framework discussed above. These include notifying the ACNC of certain changes, keeping records, reporting to the ACNC each year, and complying with the ACNC governance standards.

Withholding confidential information from ACNC register

- 6.8 If registered with the ACNC, the ACNC Register will generally display core information on the PAF including its name, contact details, governing documents (the trust deed), names and positions of Responsible Persons, and financial reports (depending on the size of the charity, based on annual income). Private ancillary funds are specifically permitted to request that the ACNC withhold or remove some of this information from the Register, due to the potential to identify individual donors. However, no such specific provision applies to PAFs.
- 6.9 Aside from this specific allowance for private ancillary funds, the circumstances under which the ACNC will withhold information from the Register are limited. Charities may apply to the ACNC for information to be withheld, and the Commissioner has discretion to withhold or remove this information based on whether the information:
- is commercially sensitive and publication could cause harm to the charity or a person;
 - is inaccurate, or likely to confuse or mislead;
 - is offensive;
 - could endanger public safety; or
 - is covered by ACNC regulations.
- 6.10 Identity and quantum of donor amounts to PAFs does not need to be disclosed on the ACNC register.

⁷⁵ *Charities (Consequential Amendments and Transitional Provisions) Act 2013* (Cth), Schedule 2, s 4(4).

Schedule 1

Extract from *Income Tax Assessment Act 1997 (Cth)* Subdivision 30-B

Tables of recipients for deductible gifts.