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**Response to the Treasury Discussion Paper
'Improving the Integrity of Prescribed Private Funds'**

The views expressed in this submission represent HSC & Company's professional perspective and are based on publically available research and consultation with key members of Australia's philanthropic and business community.

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Response to the Treasury Discussion Paper 'Improving the Integrity of Prescribed Private Funds'

Introduction

Prescribed Private Funds (PPFs) have played a significant role in promoting philanthropy in Australia.

Notwithstanding the tax incentives for donors that accompany these relatively simple vehicles, evidence suggests PPFs have delivered consistently toward the intent of promoting philanthropy and establishing long term, meaningful incomes for charities.

There are currently 769 PPFs with an estimated value in excess of \$1.5b. For the year ending 30 June 2007 a combined total of \$117m was distributed from PPFs to deductible gift recipient (DGR) charities. Furthermore since 30 June 2007, 170 new PPFs have been formed¹.

HSC & Company and our thinking

HSC & Company (HSC&Co) is a specialist strategy consulting firm. In working with industry leaders we address and solve key issues that limit more efficient flows of resources from people and businesses wanting to give to charitable organisations. A key focus at HSC&Co is that we present to business and government an appropriately skilled team that provides informed views on how to build a more robust third² sector.

In light of the achievements of PPFs noted above HSC&Co believes there is opportunity to improve the effectiveness of PPFs whilst also making these structures more attractive to existing and prospective trustees.

HSC&Co sees the need to present general comment on four key issues in the Treasury discussion paper 'Improving the Integrity of Prescribed Private Funds'. We have addressed specific consultation questions in the adjoining section.

The views expressed in this submission represent our professional perspective and are based on publically available research and consultation with key members of Australia's philanthropic and business community.

We look forward to working with the Treasurer, the Australian Taxation Office (ATO), Philanthropy Australia and other key stakeholders to achieve outcomes consistent with comments recently made by the Treasurer:

"As a partner, one of our roles is to provide a policy environment which makes it simple and rewarding for Australians to get involved in giving, and which helps philanthropic organisations grow and flourish."³

¹ http://www.bus.gut.edu.au/research/cpns/documents/2008_6_PPFs_Final_Web.pdf (accessed 14 December 2008)

² According to the Senate Standing Committee on Economics (December 2008), the 'Third Sector' includes 'Not-For-Profit, non-government, voluntary, and intermediary organisations'

³ Foreword, *Australian Philanthropy* issue 71, November 2008

1. Giving: not an event but a part of life

- 1.1 The cultural evolution of giving in Australia over the last 10 years has been significant. Our research suggests a broad departure has occurred from just providing money in the hope greater social impact will be created. This departure is being matched with a desire to participate in a more engaged style of philanthropy.
- 1.2 We understand that many donors who have established PPFs are business people. Typically these donors not only have a desire to give but to 'operationalise' their intent by introducing their acumen, effort and influence to increase the professionalism of the third sector. This 'engaged' philanthropy brings with it a focus toward the preconditions of effectiveness that does not assume good intentions alone will deliver meaningful social impact.
- 1.3 The mechanism broadly responsible for catalysing this longer-term engagement with the third sector is the PPF.
- 1.4 Building on the desire to become a more engaged philanthropist, some donors establish PPFs on account of the opportunity it affords their family or business to create a trans-generational legacy of giving. PPFs also play a vital role for donors wishing to give in a structured manner but over a more defined period.
- 1.5 PPFs have also provided professional advisers with an understandable construct that can be discussed with clients considering structured giving. This provides inroads to increase the flow of resources to the third sector from high net worth individuals – an important and largely untapped resource to date. Although positive, we understand a substantial proportion of professional advisers (with a desire to engage with their clients in discussion around structured giving) face difficulties in introducing clients to PPFs due to limited general, client focused information.

2. PPFs in focus

- 2.1 Examination of the integrity of PPFs to improve governance and administration to a consistent and proper standard is welcomed by HSC&Co.
- 2.2 HSC&Co is aware of the difficulties associated with providing central education and information for PPFs as well as identifying who 'owns' PPFs. We also understand a small number of PPFs may have acted 'improperly' in relation to adhering to existing legislation⁴. We are informed that improper conduct is likely to have occurred not in a deliberate attempt to misuse the PPF structure but as a result of inadequate knowledge or information about how to manage a PPF.
- 2.3 There are foreseeable advantages in efficiently centralising and streamlining the PPF establishment, education, governance and administration processes under one agency. HSC&Co is supportive of these functions being brought under the authority of the Commissioner of Taxation.
- 2.4 On preliminary inspection it appears the coverage of existing mechanisms including State Trustee Acts, independent auditors and an independent Responsible Person could be reinforced by:

⁴ http://www.bus.gut.edu.au/research/cpns/documents/2008_6_PPFs_Final_Web.pdf (accessed 28 December 2008)

- A useable and comprehensive Trustee Guide (similar to that provided to new trustee's of self managed superannuation funds)
- Compulsory mentoring programs for new PPFs administered by the ATO and delivered collaboratively by Philanthropy Australia and well established PPFs
- Expanding PPF legislation to allow experienced organisations (e.g. family offices) to be more involved in managing PPFs on behalf of PPF trustees

3. Determining a mandatory minimum distribution rate for PPFs

- 3.1 On account of the considerable impact made in promoting philanthropy, it is important that PPFs continue to be a key mechanism to encourage donors to share their wealth with the community. HSC&Co agrees that a number of benefits and administrative synergies can be realised in relation to setting a sensible mandatory minimum distribution rate for PPFs.
- 3.2 Determining the minimum distribution rate however requires careful consideration.
- 3.3 As such we note the following in relation to setting this rate (reasoning in support of this perspective can be found on page 4):
- 3.3.1. Where the historical average distribution from PPFs (of approximately 15%) is used as a benchmark, the components of this 'average' metric require separate investigation to ensure that:
- Corporate foundations and those that grant 100% of their capital each year do not unduly influence the setting of a mandatory minimum distribution rate
 - Extraordinary capital growth of the last 5 – 8 years does not unduly influence the setting of a mandatory minimum distribution rate
- 3.3.2 Preliminary calculations suggest that for well-established foundations adopting a 15% minimum distribution rate could result in resources becoming exhausted within 8 – 10 years. This appears inconsistent with the intent of PPFs to promote a lasting contribution to the community.
- 3.3.3 HSC&Co endorses a *minimum* distribution rate of between 5% - 7% on the basis that assets of the PPF are valued (in a consistent manner) at 30 June each year and 5% - 7% of total assets are distributed before 30 June of the following year.

HSC&Co Insight

- 3.4 Given the current examination of PPFs, HSC&Co offers an additional concept for consideration. We propose that *within* the PPF structure an *option* becomes available for donors to embark upon a more direct and aggressive distribution of income to the third sector. Such an option could include a:
- Higher minimum distribution rate of 15%

- Shorter agreed distribution period
 - The availability of specific, subsidised support to assist in the administration and management of the PPF
- 3.5 We consider this option would be well received by aged donors that have a preference to play an active and engaged role in giving toward the end of their lives but without the desire to create a trans-generational legacy. HSC&Co is pleased to provide further guidance on this important concept.

4. Social entrepreneurs will advance the third sector

- 4.1 Social entrepreneurs bring new thinking and innovative solutions to address and tackle social issues. Not surprisingly these people are ambitious and can bring with them significant 'real world' experience and expertise.
- 4.2 We believe social entrepreneurs will provide the third sector with the innovations necessary (in effect sector capability building) to take advantage of the growing culture of giving.
- 4.3 Although endorsed by Philanthropy Australia as a welcomed commodity, social entrepreneurs are unable to secure funding from PPFs due to current limitations on how funding can be distributed.



- 4.4 There is an opportunity to explore an innovation that would result in PPFs *selectively* yet meaningfully supporting social entrepreneurs. HSC&Co has investigated this in depth and is pleased to provide further insight on this important concept.

Consultation Questions

5. Principle 1 – PPFs are philanthropic

Q. What is an appropriate minimum distribution rate? Why?

- 5.1 HSC&Co endorses a *minimum* distribution rate of between 5% - 7% on the basis that assets of the PPF are valued (in a consistent manner) at 30 June each year and a minimum between 5% - 7% of total assets are distributed before 30 June of the following year. We believe a nominated rate within this range is suitable due to:
- 5.1.1 Over the longer term the growth of invested funds in a largely conservative environment is likely to be on average 5%⁵
 - 5.1.2 Such a rate reflects a sensible distribution rate that affords the PPF with flexibility to deliver a more sustainable source of income to the third sector

⁵ http://www.perpetual.com.au/pdf/152_PFP.pdf (accessed 7 January 2008)

- 5.1.3 PPFs are likely to distribute more than 5% - 7% per annum
- 5.2 The vital and relevant issue of balance underpins our perspective. A balance must be struck between what distribution rate will assist PPFs in delivering their philanthropic intent and obligations and the distribution rate that will essentially constrain and provide disincentive to existing and prospective PPF trustees.
- 5.3 The implications of creating disincentives are real. The depth of which can result in donors disengaging from the concept of being philanthropic and not channelling financial resource towards social effort. Financial contribution is only the beginning of what could be lost. Add to this the multiplier effect of donor effort, influence and reach that could benefit the community and the total cost is substantial.
- 5.4 The societal benefits linked to an engaged donor establishing a PPF are on the other hand significant. This *begins* with and is primarily due to the capital pool of the PPF being permanently held in trust and only allocated to charitable purposes.
- 5.5 We believe a minimum distribution rate of between 5% - 7% will provide a welcomed balance.
- 5.6 This balance will further ensure PPFs continue leveraging the inherent structural flexibility of the PPF vehicle to deliver a broad mix of funding to short and longer-term projects, desirable DGR's and ideally in the future social entrepreneurs.
- 5.7 An important supporting fact is that in many cases funding of this nature cannot be secured through government or business avenues but through PPFs.

Q. Should the Commissioner have the ability to modify the minimum amount according to market conditions (for example, based on average fund earnings)?

- 5.8 In the interest of sustainable and simpler management of PPF income and distribution, HSC&Co does not endorse the Commissioner being able to modify the minimum amount according to market conditions.

Q. Should a lower distribution rate apply for a period (for example, 1-2 years) to allow newly established PPFs to build their corpus?

- 5.9 No. HSC&Co believes a mandated minimum distribution rate (between 5% - 7%) could be applied across all PPFs regardless of age.

Q. Are there any issues that the Government needs to consider in implementing the requirement to ensure PPFs regularly value their assets at market rates?

- 5.10 HSC&Co supports the regular valuation of assets held within PPFs at market rates. The two issues to highlight with implementing such a requirement include:
- Minimising costs
Measures need to be taken to ensure the cost of valuation is kept to a minimum such that valuation does not become a burdensome 'cost of compliance'. Where this (total) cost can be demonstrated as minimal HSC&Co supports an annual valuation. Where this cannot be achieved we recommend the regular valuation period be every two years.

- Consistent valuations
Valuation of assets at market rates is likely to require some formal guidance to PPFs to ensure the valuation outcomes are consistent.

Q. Is setting a minimum PPF size appropriate?

Q. What should the minimum PPF size be in dollar terms?

Q. Should a fund have to distribute all its capital when its total value falls below this minimum amount?

5.11 HSC&Co does see merit in establishing a minimum amount on entry (to establish a PPF) but does not support maintaining a minimum size throughout the lifetime of the PPF.

5.12 HSC&Co does not consider appropriate the distribution of all capital when a PPFs total value falls below a minimum.

5.13 A proposed minimum distribution rate of between 5% - 7% per annum:

- Is consistent with previous comment on minimum distribution rates for PPFs.
- Reduces the need for PPFs (if their corpus falls below a set minimum) to close.
- Assists PPFs with managing real challenges related to market volatility and the impact this can have on increasing or decreasing the size of a PPF (with a minimum size) over a short period.

Q. Are there any relevant issues that need to be considered in improving and standardising the public accountability of PPFs?

5.14 HSC&Co endorses the proposal that PPFs maintain an ABN that is published on the Australian Business Register.

Q. Are there any concerns with the proposal to require that the contact details of PPFs be provided to the public? What information should be provided publicly?

5.15 The concerns with revealing the contact details of PPFs are well founded but not without solution.

5.16 We understand many PPFs have remained deliberately small to ensure overheads do not unnecessarily erode community-destined resources. Making public the details of PPFs would not only be intrusive but would almost certainly attract increased volumes of unsolicited funding applications. The implication of which extends to managing expectations of charities that may incorrectly assess a PPF as a new income source. This is likely to be an unwelcomed strain on PPFs and reduce the attractiveness of participating in private philanthropy – an additional disincentive to what we have already provided comment on above.

HSC&Co Insight

5.17 HSC&Co has invested considerable effort in learning how to address and solve this issue. Our thinking is based on the premise that more robust infrastructure

must be made available to:

- Maintain the privacy of PPFs.
- Minimise the cost and effort in the grant making process (on both the grant making and grant seeking sides).

5.18 Our design leverages existing social networking concepts and affords PPFs and grant seekers the chance to engage at more meaningful levels as a relationship deepens. Upon request HSC&Co is pleased to provide further guidance on this important concept.

6 Principle 2 – PPFs are trusts that: (1) abide by all relevant laws and obligations, and (2) are open, transparent and accountable

Q. Will two years be a long enough transitional period for existing PPFs to comply fully with the new Guidelines?

6.1 HSC&Co's preliminary assessment (that requires further investigation to understand the implications of trust deed compliance) is that with appropriate and focused change management – leadership, education, communication and process alignment – a two-year transition period is sufficient.

Q. Are there any cost or other concerns relating to the corporate trustee proposal?

6.2 In the time available HSC&Co have been unable to research this topic adequately and is unable to provide comment.

Q. Are there any privacy concerns that the Government needs to consider?

6.3 We seek clarification on this point. Is the Government wishing to understand privacy concerns relating to the corporate trustee proposal?

Q. Are there any concerns over particular penalty types?

6.4 HSC&Co is in favor of the ATO being granted the ability to more flexibly sanction PPFs. There is a need to establish a sensible suite of penalties (extending beyond the existing revocation of PPF tax status) and measures that ensure those PPFs in breach of regulation be addressed on an individual and proportionate basis.

6.5 Such penalties and measures might leverage those already available in the commercial sector whereby (and by way of example only) directors face fines or become prohibited from taking similar roles for a defined duration.

Q. If a fit and proper person test were introduced, what criteria should be imposed on trustees?

6.6 HSC&Co is concerned about the introduction of a 'fit and proper person test' to serve as a condition or measure of the integrity of a PPF. The measured introduction however of a sensible fit and proper person test may prove valuable in relation to mentoring (refer to comment in 6.9.2).

- 6.7 Our primary concern is based largely on how some family based PPFs may be restricted when wanting to introduce family members as trustees. A secondary concern relates to how such a test would be defined in order to take a family interest into account. Our perspective extends to the following:
- 6.8 Education**
- 6.8.2 Well designed, informative and consistently adopted education material that clearly outlines the accountabilities, practicalities and implications of becoming a trustee / responsible person will greatly assist in the selection or appointment to these roles.
- 6.8.3 In relation to professional advisors and their understanding of PPFs, there is also a need for more complete and consistent education. General standards of advice may also prove useful. Existing insight and infrastructure available from experienced organisations like Enrich Australia may be useful in further informing this position.
- 6.9 Mentoring**
- 6.9.2 Where younger and perhaps less experienced people are introduced to roles as trustees an overarching accountability framework should exist. This would involve a senior trustee / responsible person mentoring the newly appointed office bearer until such time as they demonstrate a 'fitness' for the role. In this instance, HSC&Co believes there is merit in the individual delivering the mentoring having satisfied the requirements of a fit and proper person test.
- 6.9.3 We also believe the mentoring program currently offered by Philanthropy Australia to be a key mechanism of two-way insight – both to inform PPFs and understand frustrations and gaps in understanding. Any development of training material or formalising of mentoring programs must consider the insight gained from this effort.
- 6.10 Education Design & Implementation**
- 6.10.2 Material to support the above points should be designed collaboratively between ATO, Treasury, Philanthropy Australia and other relevant key stakeholders. Specialist information designers should also be involved. This will ensure that correct adoption of standardised terminology will occur and a more united position can be delivered to existing and prospective industry participants. It also ensures such material will be generally useful, useable and desirable to its audience.
- 6.10.3 In terms of implementation, the program to deliver this education material could be managed by the ATO with the support of Philanthropy Australia and appropriately credentialed advisors.
- 6.11 We believe this approach is also more likely to help mitigate future issues relating to PPF breaches.
- 6.12 Although helpful, HSC&Co note that education must exist in tandem with refined legislative powers capable of improving PPF governance and administration. This includes the management of any PPF that inappropriately misuses their PPF structure.

- 6.13 Recognising this is an ongoing effort, effective guidelines must appropriately detail education and mentoring standards to complement administration and governance process.

7 Principle 3 – PPFs are private

Q. Would there be any disadvantages if a cap were introduced on the number of donors to a PPF (for example, a maximum of 20 donors over the life of the fund)?

- 7.1 HSC&Co is very supportive of PPFs remaining a vehicle for private philanthropy and that the primary source of funding to PPFs should be private and not public donation.
- 7.2 After considering Philanthropy Australia's⁶ perspective on this topic, HSC&Co concurs with the following reasons for not supporting the limiting of the number of donors that can contribute to a PPF.
- PPFs are a useful vehicle for workplace giving programs in small firms and partnerships.
 - Extended families involving more than three generations can easily involve more than 100 family members and friends making donations into the foundation.
 - PPF events may from time to time invoke high numbers of people including some donors who may wish to make contributions into the foundation.
 - Existing PPFs are approached by likeminded individuals who are willing to join them and increase their community commitment through donating to an existing PPF rather than establishing a new one. This is highly beneficial to the community as it increases both the dollars and the culture of giving without the duplication of additional administration.

Q. Is conversion from PPF to PAF an acceptable mechanism to deal with changing PPF circumstances?

Q. What rules could be used to deal with the conversion from a PPF to a PAF?

- 7.3 There are a number of important benefits associated with introducing a mechanism capable of efficiently converting PPFs to Public Ancillary Funds (PAF) and PAFs to PPFs.
- 7.4 The first key benefit is that such a move would introduce flexibility consistent with the superannuation industry – flexibility already familiar to Australians.
- 7.5 We understand that at present there is no way of rolling from one structure to another. This is likely to be having the unfortunate consequence of minimising new contributions to PAF's because with little flexibility this structure is unlikely to meet the longer-term needs of the donor.

⁶ Philanthropy Australia, Response to the Treasury Discussion Paper 'Improving the Integrity of Prescribed Private Funds' (accessed 8 January 2009)

- 7.6 In HSC&Co's view the recognition that comes with 'switching' (from the superannuation industry) would play a very positive role in encouraging medium tier donors⁷ to become more involved in a PAF and use this vehicle as an intermediate step before transitioning to a PPF.
- 7.7 In essence the ability to convert a PAF to PPF (and visa versa) opens an avenue of potential and substantial income for charities over the longer term.

8 Principle 4 – PPFs are ancillary funds

Q. Would there be any disadvantages from introducing this limitation to the existing PPF investment rules?

- 8.1 On preliminary inspection HSC&Co understands there is sufficient scope in existing state Trustee Acts (relating to investment guidance) to ensure PPFs can deliver against their philanthropic commitments.
- 8.2 In the time available HSC&Co have been unable to adequately research the implications of asset liquidity as noted in the Treasury discussion document and is unable to provide comment.

⁷ HSC&Co defines 'medium tier donors' as an important group of individual donors who usually donate in the tens of thousands of dollars per annum but who are not in a position to establish a PPF.

Conclusion

In the interest of promoting philanthropy and improving the robustness of the third sector HSC&Co welcomes this examination of the integrity of PPFs. We view this as another step forward – and one complementary to other concurrent efforts – to improving the general accountability and transparency of donation.

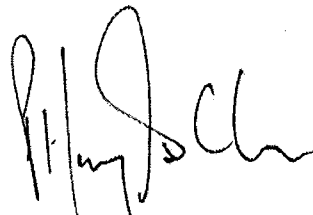
When reflecting on key issues:

- PPFs have promoted philanthropy in a tangible and meaningful since their inception.
- The private nature of PPFs must be preserved in such a way that real disincentives are minimised.
- A mandated minimum distribution rate between 5% and 7% affords PPFs the flexibility to deliver a more sustainable source of income to the third sector over the long term.
- Introducing sensible and value adding measures to improve accountability across the PPF community will prove beneficial.
- Easily accessible, consistent and insightful education for 1) existing and prospective PPFs and 2) professional advisers will deliver multifaceted benefit.

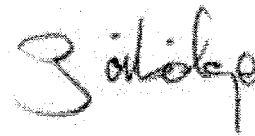
Throughout this submission we have noted a number of potential solutions that will contribute to advancing philanthropy in this country and in some cases help establish a best practice standard for the world to observe.

HSC&Co welcomes the opportunity to working closely with Treasury, the Australian Taxation Office, Philanthropy Australia and other key stakeholders to increase longer-term private investment to benefit communities and address social issues.

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