PITCHER PARTNERS
ADVISORS PROPRIETARY LIMITED

Level 19
15 William Street
Melbourne
Victoria 3000

Tel: 03 8610 5000
Fax: 03 8610 5999

ACN 052 920 206

Postal Address:
GPO Box 5193
Melbourne Vic 3001
Australia

www.pitcher.com.au
info@pitcher.com.au

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| Melbourne | Sydney | Brisbane | Perth | Adelaide

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13 January 2009

Manager
Philanthropy And Exemptions Unit
Personal And Retirement Income Division
C/ – The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam,

Discussion Paper – Improving the Integrity of Prescribed Private Funds ("the Discussion Paper")

Pitcher Partners welcomes the opportunity to provide comments on the Discussion Paper.

For the purposes of this submission Pitcher Partners comprises 4 independent firms operating in Adelaide, Melbourne, Perth and Sydney. Collectively we would be regarded as one of the largest accounting associations outside the (so called) 'Big Four'.

Our specialisation is servicing and advising smaller public companies, large family businesses, small to medium enterprises ("SMEs") and high wealth individuals.

Since the Prescribed Private Fund ("PPF") regime was introduced we have assisted approximately 12 clients in establishing such funds. Subsequent to that, we have advised our clients on various aspects of the administration of such funds. In some instances, partners from Pitcher Partners have acted as trustees of PPFs and also in the capacity of the responsible person of that PPF.

General Comments

We are fully supportive of any measures that are aimed at improving the integrity of PPFs. For example, the various breaches mentioned at para 27 of the Discussion Paper must be appropriately dealt with. Therefore, changes to the law to allow action to be taken against trustees and PPFs which have committed such breaches is fully supported.

We are concerned however that some of the proposals included in the Discussion Paper may be a disincentive against PPFs being established in the coming years. Through the PPFs that we have been associated with or advised on, we have witnessed significant philanthropic contributions made to date. Furthermore, we are aware of planned future philanthropic contributions to be made.

A major concern is that some of the proposed measure will have retrospective application. This may be inequitable where a PPF was established under the current rules and future contributions to that PPF were earmarked having regard to the current rules and approved accumulation policy.

It is with great regret that certain rogue trustees have caused Treasury to consider such wide-ranging changes to the administration of PPFs.

The following are some general observations founded upon our experience:

1. The capital of a PPF is permanently and irrevocably separate from that of its founder(s) and available for long term philanthropic purposes

2. PPFs have created a philanthropic focus for successful business persons that previously did not exist. As a generalisation, previous to the establishment of 'their' PPFs many of our clients did not have a philanthropic focus of substance;

3. The genesis for many PPFs has been a large one-off cash generating event. Absent the PPF structure, it is improbable that many founders

would have otherwise committed this amount to philanthropic endeavours;

4. Those clients that have established PPFs have usually introduced the next generation into the investment and gifting decision making processes associated with those PPFs with the intention of promoting a long term philanthropic focus within the family;

5. Those clients that have established PPFs have embraced the governance and integrity obligations associated therewith;

In our opinion PPFs have strongly contributed to high wealth families embracing a sustainable philanthropic culture that did not previously exist. This long term benefit should not be underrated.

In our opinion the PPF concept has been working very effectively, with limited compliance complexity and does not need any material reform.

We are concerned that the cost benefit of the proposals outlined is disproportionate to the issues of concern.

Specific Comments

<u>1. Principles Based Approach</u>

We are troubled to read that "the Government intends that the new PPF Guidelines will be drafted using a "principles based approach"[1]:

"Principles based" drafting is conceptually drafting legislation by reference to broad principles rather than strict rules. A significant difficulty for Trustees in this respect is the uncertainty that arises in trying to interpret "broad principles". Consequently the appropriateness of such an approach needs to be very carefully considered.

A recent example of an attempt of principles based drafting was in respect of the legislation regarding Taxation of Financial Arrangements. The first draft

[1] Page 1, paragraph 3.

of that legislation founded upon the concept of principles based drafting was approximately 26 pages. Among other things the uncertainty that arose resulted in more and more amendments to the first draft of the legislation as a consequence of which the legislation tabled in Parliament in December 2008 was well over 120 pages of legislation. This reflects the difficulties associated with principles based drafting.

Fundamentally, in our experience in interpreting legislation, which is considerable, principles based drafting will create uncertainty and consequently compliance costs for PPFs and the Government agencies involved in their administration and regulation.

2. Required Distributions

The proposed annual distributions principle is to be changed to:

> "...a system that would simply require PPFs to distribute a minimum amount in a given year which is calculated based upon the value of the PPF's net assets at the close of the previous financial year. PPF's would value their assets annually at 30 June, and this 'close in value' would be used to calculate a minimum amount that must be completely distributed over the following 12 months (to the end of the financial year). The calculated closing value would include all realised and unrealised capital gains..."[2]

The current economic environment clearly illustrates the difficulties in enforcing distributions by reference to "unrealised amounts".

The risks associated with this is where the market value of assets drop significantly after 30 June. PPFs may therefore be required to realise losses on assets in order to meet minimum distributions.

[2] Page 4, paragraph 19

Also, PPFs may be required to realise investments that they would otherwise have intended to hold long term to meet minimum distribution requirements. Therefore the prudent trustees' investment approach is directly impacted.

In prescribing a distribution rate for the PPF to apply to the closing value of its net assets, Treasury needs to be aware that many PPFs would want to build up their corpus with a view to making regular gifts to certain recipients. Some founders of PPFs want to experience the feeling associated with making a significant difference to a particular recipient and therefore would prefer to make more material gifts than one-off gifts. Having too high a distribution rate may therefore unintentionally disadvantage potential recipients of PPF distributions and thereby reduce the private sector support of philanthropic causes.

We note the implication in the Discussion Paper of a 15% minimum distribution rate. A prudent Trustee(s) will have a long term investment focus and historically (prior to the current economic circumstances) will typically have looked to a 4% to 8% cash yield. Where the distribution rate exceeds the average investment return of the PPF, the fund must eventually, and relatively quickly, be wound down to nil unless they are material contributions each year by the founders of the PPF. This would constitute a fundamental disincentive to the future establishment of PPFs. We would recommend modelling be performed and released on the impact an imposed distribution rate would have on fund balances over time.

3. Retrospective Application of the Measures

It seems that these proposals are to apply to existing PPFs and thus are retrospective in their operation.

The retrospectivity is exacerbated by the comments in the Discussion Paper[3] regarding the 'distribution rate' to be applied to the 'closing value'.

[3] Page 5, paragraph 20

Given the significant impact that some of the proposals in the Discussion Paper will have on existing PPFs, we strongly request that consideration be given to having the existing rules for PPFs grandfathered. In other words, existing PPFs should be able to continue under the existing rules, particularly where the ATO has approved an accumulation plan for the PPF.

An unintended consequence of moving towards a model requiring minimum annual distributions is that many PPFs will have to make changes to their existing trust deeds, where the accumulation plan was contained in a clause of the deed.

4. Regular Valuations of Assets at Market Rates/Restricting PPF Investments to Only Liquid Assets

By requiring PPFs to value assets at market rates, they would probably not be able to invest in unlisted assets as these may be too difficult to obtain valuations for. Therefore PPFs could only invest in assets that are both liquid and have a market. This effectively restricts it to listed shares, managed funds (who publish a daily unit price) and cash.

Although not totally against the requirement to have only liquid assets the Discussion Paper should clarify what it considers liquid assets to be.

A disadvantage from introducing the liquid asset investment proposal for existing PPFs, would be a requirement for them to realise certain assets in order to move the funds into the designated liquid assets. Consequently, transitional measures should be considered.

5. Minimum PPF size

Setting that minimum PPF size e.g. $500,000 may be appropriate. However, PPFs should be allowed a certain period to reach the minimum target.

Having an automatic requirement for a PPF to distribute all of its capital when its total value falls below a minimum amount seems a little arbitrary. There may be a reason why the capital value has fallen and also the fund may have an intention to boost its capital base in the coming years. Therefore, the Commissioner should be provided with some discretion as to when a PPF needs to be wound up.

6. Increased Public Accountability

There are serious concerns with the proposal to have the contact details of PPFs available to the public. If this was to occur, PPFs would become flooded with requests from various charities and eligible recipients. This would further increase the administration costs of the fund. The trustees of most PPFs today are knowledgeable people and they are able to best decide where the funds should be gifted.

7. Giving the ATO Greater Regulatory Powers

The Discussion Paper contains a proposal to require all PPFs to have a corporate trustee. We have a number of PPF clients operating very effectively where a number of individuals comprise the 'Trustee'. Indeed many 'family' trusts and superannuation funds do not have corporate trustees. It was not clear to us from the Discussion Paper how having a corporate trustee would give the ATO power to further regulate PPFs. This point should be elaborated in further consultation.

An increase in the potential penalties to presumably the trustees of the PPF's is raised in the Discussion Paper. The Discussion Paper does not make it clear whether it is believed that there have been a number of breaches by the trustees in the past. The other issue to consider is whether by having a number of penalties for potential trustees, whether that would discourage potential trustees from accepting a position as trustee of a PPF.

8. Introduction of a Fit and Proper Person Test for Trustees

The Discussion Paper fails to acknowledge the distinction that can be drawn between the non-profit sector and PPFs. PPFs are typically set up by more sophisticated parties than traditional non-profit entities. We would like to understand why the current "responsible person" test is not operating appropriately before moving to a new test for trustees.

9. Limiting the Number of PPF Donors

We fully recognise that PPFs have been established as a vehicle to encourage private philanthropy. However in our opinion, imposing a strict cap on the number of potential donors may not always be practical. Some founders of a PPF could have well in excess of 20 related entities. As such, the potential donors to the PPF may exceed 20 donors.

A possible test where PPFs can only receive donations from persons (including entities) who are associates of the founders of the PPF may be preferable. Associate in this context could take its meaning from Section 318, *Income Tax Assessment Act 1936.*

Notwithstanding, we understand that there are a number of PPFs which generate workplace donations. We would need to understand the impact of any 'capping' on these schemes.

10. Proposed Changes and Trust Deeds

Many of the changes in contemplation may require amendments to existing Trust Deeds. This would be a costly compliance obligation. More generally consideration will need to be given on a PPF by PPF basis as to whether these amendments are possible – again adding to cost.

Retrospective adjustments may in the worst case, require changes to Trust Deeds that lead to a resettlement of the Trust. This could lead to the cessation of the PPF, loss of income tax exemption (or a new PPF approval process) and possible stamp duty costs arising from the transfer of 100% of the assets. All of this additional administration and costs would ultimately be to the detriment of chartitable causes.

As can be seen, significant practical difficulties, if not impossibilities, arise with retrospective adjustment, legally and technically, leading to potential breaches of trust by the Trustees or actions by potential beneficiaries against the trustee/responsible persons.

We are of the firm belief that it is too late to change the rules for existing PPFs.

Further information

If you require further information about any of the issues raised in this submission please do not hesitate to contact me on 03 8610 5170.

Yours faithfully

Peter Riley
Executive Director
Pitcher Partners Advisors Proprietary Limited