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The Manager
Philanthropy & Exemptions Unit
Personal & Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: ppfreview2008@treasury.gov.au

Dear Sir

Prescribed Private Funds - Integrity Improvement Discussion Paper

Introduction:

De Groots is a boutique law firm practising exclusively in the fields of estate administration, estate litigation and estate planning. In the course of our practice we have advised many clients in relation to the establishment of prescribed private funds ("PPF"s) and have been involved in the formation of a significant number of those funds.

Given the alacrity with which our clientele has embraced the PPF, we feel it is appropriate to respond to the discussion paper. Before raising specific issues we make the following general points.

General Comments.

We have had the opportunity of perusing eight submissions relating to the discussion paper listed on your Department's website as well as a detailed submission prepared by Philanthropy Australia Inc ("PA") (copy attached) and apparently forwarded to you under cover of letter dated 8 January 2009 but not currently listed on your website.

We generally endorse the PA submission and the submissions lodged on behalf of the Patterson Foundation, the Andyinc Foundation, the Petre Foundation and the Sara Halvedene Foundation. All of these submissions are closely aligned with feedback from our PPF clients regarding the discussion paper and our general experience in this area.

The writer has been personally involved in philanthropic and community service endeavours for over 40 years. I have not, during that time, encountered any mechanism, policy or process which has enlivened philanthropy to the same degree as the PPF has. You are aware of the figures. They speak for themselves. It would be a shame (and much more costly for the Government) if steps taken as a consequence of this exercise cause the golden goose to cease laying its golden eggs.

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Some of the proposals put forward in the discussion paper are diametrically opposed to the fundamental principles upon which the current version of the PPF and its operation are based

I quote the following extracts from both the Prime Minister's press release of 30 March 2001 and the current guidelines and suggest that the highlighted portions of these extracts need to be kept in front of mind when considering the various issues which the discussion paper raises.

- "By creating opportunities for private philanthropy, *the government is building up the social coalition* in which government, business, community organisations and individuals work together on social issues."

- "Limits will apply to the accumulation of money within the fund, such *that investment income can only be accumulated at a rate equivalent to the CPI*, with the rest disbursed to public philanthropic funds."

- "*Tax deductibility* will only be given *where private charitable funds are used for the purpose for which they are intended ......*"

- Paragraph 4 of the Current Guidelines states:

  "...individuals and corporations are able to establish *privately controlled funds* for philanthropic purposes without seeking and receiving public contributions.

- In Paragraph 8 of the Guidelines, it is stated that "*the fund must,, not only at its establishment but throughout its existence, comply with the terms of the law* "

- In paragraph 20 of the Guidelines, there is provision that the controlling body of the fund must include "*at least one person who is a 'responsible person' as defined in clause 2.1 of the model trust deed.* That is, a person who has a general responsibility to the community."

Each of the items mentioned above has been a significant factor in attracting our clients to consider establishing PPFs.

In particular, the concept of the social coalition, the ability for funds to be accumulated at a rate equivalent to CPI, tax deductibility, private control and the promise of a legal framework with which PPFs must comply, are all essential ingredients of the success which PPFs have enjoyed to date.

One of the principal technical difficulties which we have encountered in this area of our practice is the dearth of black letter law surrounding PPFs. The want of certainty and continuity in an area where hundreds of millions of privately donated dollars is at stake principally in long term projects is a common concern amongst our clients and that concern is reflected in the submissions referred to above.

In those submissions, it is a common refrain that:

- there is no way we would have established a PPF under some rules suggested in the discussion paper;

- the new rules constitute a breach of faith with those who have established a PPF;

- existing PPFs should be grandfathered

These comments reflect our experience and client feedback. They need to be taken seriously if the golden goose is not to be slaughtered. They also point to the need (apparently embraced by the initial budget and subsequent announcements) for the PPF rules to be enshrined in legislation and not in guidelines as at present.

Accordingly we were initially delighted to read that the guidelines were to be legislated but have some concern as to indications in the discussion paper that the guidelines are to be retained but given the force of law. Does this mean that the guidelines will remain whatever some minister or bureaucrat says they are (being capable of variation according to his her digestion) but carrying with them the supreme authority of the parliament?

We are strongly of the view that the certainty which an industry of this potential demands can only be achieved by the minimum conditions being enshrined in the relevant legislation. The reverse situation where the legislation stipulates that the guidelines are whatever the minister says they are is untenable. My suggestion would be that the minimum conditions to apply to PPFs be incorporated into Division 30 of the Income Tax Assessment Act.

Initially, all PPFs were established as charitable trusts and had no requirement for a perpetuity period. Subsequent amendments to the legislation (permitting non-charitable deductible gift recipients to be beneficiaries of a PPF) now have the effect (at least in those states which have not adopted remedial legislation) of requiring PPFs wishing to benefit non-charitable DGRs to adopt a perpetuity period, although there is no such requirement in South Australia.

The fact remains that most PPFs are charitable trusts with no perpetuity period. Accordingly, for every $1.00 donated to a PPF the ATO foregoes tax of say 45c. The $1.00 donated is set aside permanently together with its income for community benefit.

Looked at in another way, the donor has irrevocably divested himself of $1.00 in exchange for the Australian government foregoing 45c of revenue to benefit the community. This is part of the "social coalition" to which I referred in my opening remarks.

Accordingly, there is a real cost to the donor in establishing a PPF which far exceeds the government's contribution. The discussion paper has regard only to cost to Government and does not give credit to the Australians who are putting up the lion's share of the funding.

To suggest the government should seek to effectively recover 100 % of its contribution within three years (which a 15% distribution rate would achieve) completely negates the concept of government participation in a social coalition. This approach also completely disregards the ongoing benefit which the community reaps as a consequence of the ongoing distribution of the income of the fund which, under the existing rules, can continue in perpetuity.

The second paragraph of the first principle listed in paragraph 13 of the paper is deficient in not acknowledging the contribution of both the donor to the fund and the government and needs revision to acknowledge the contribution by the donor to the fund as well as the long term benefit generated by the ongoing dispersal of income from the fund. The measure of the benefit to the community needs to have regard to the donor's contribution as well as the government's contribution.

To ignore the donor's contribution and the benefit it generates is not only contrary to the social coalition concept but deprives the contributor of any official acknowledgement of his philanthropic efforts

We see little point in regurgitating many of the carefully considered and relevant submissions already lodged. We will, however, refer to appropriate submissions in commenting on the paper.

Areas for Improvement.

Subject to our earlier comments concerning the form that legislation should take and the second paragraph of the first Principle, we have no difficulty in principle with paragraphs 9, 10, 11 and 12 of the discussion paper. Updating the guidelines, creating the relevant legislation, and giving the ATO appropriate regulatory powers are matters which call out for urgent action.

The ATO is to be complimented on the manner in which the non-profit centre team in Canberra has managed its PPF portfolio to date. In our experience the ATO has acted throughout in a most helpful, professional and appropriate manner in encouraging the use of PPFs, in providing general information and materials, and in providing extremely helpful practical advice in establishing and managing them.

Philanthropy and Required Distributions.

Again, the principle lying behind the statement in paragraph 20 of the paper that "...the Government expects that this revenue foregone will be directed to the charitable sector in a relatively short period of time..." overlooks or ignores that the donor has outlaid a greater contribution (of at least a 55c nett) against the government's contribution.

This approach suggests that the donor must not only forego a reasonable and continuing return for charity from his contribution but also that the fund which has established has to reimburse the government for its contribution . As pointed out above, this approach overlooks the donor's wishes as well as the cost to the donor and the ongoing benefit from the donor's contribution.

The comment in the 4th dot point of Para 20 of the paper also causes us concern. We have been instrumental in establishing funds the sole purpose of which was to create a fund which could continue to generate philanthropic donations when the founder retired from professional practice and no longer had the ability to contribute on a regular basis.

Rules requiring ongoing contributions throughout the life of the fund can only act as a disincentive to founders considering establishing a fund in similar circumstances, have a detrimental effect by reducing the life expectancy of such funds, and must limit the funds which are available for distribution in the long term.

We support the comments in the submissions from the Patterson Foundation, the Petre Foundation, the Andyinc Foundation, the Sara Halvedene Foundation and the detailed submission from PA to the effect that 15% is an inappropriate minimum distribution rate.

It is unsustainable over time and there is no need for me to repeat the arguments in those submissions. Whilst I do not query the distribution rate of 15% estimated by the ATO, it does not accord with the experience of our clients and I believe the answer to the conundrum lies in the explanation in the PA submission.

A 5% distribution rate is clearly realistic, sustainable and appropriate and it is a rate which should enable well managed funds to continue indefinitely and grow in line with inflation (if that is what the sponsors want).

Whilst the ATO figures indicate that many individuals have opted to distribute at higher rate, the short history of PPFs now available does not establish that that rate of distribution is sustainable in the longer term (particularly once the circumstances which have generated such unstainable rates are taken into account or change).

Neither does a 5% minimum rate mean that those so inclined will not distribute more as is apparently currently occurring.

A 5% minimum rate will not breach faith with the many hundreds of philanthropists who have established PPFs on the basis of the existing rules.

Several of our clients have taken the view that they would not have established a PPF had the rules now suggested been in place at the time their funds were established.

We support the view that the Commissioner should not have the ability to modify the minimum amount according to market conditions.

To establish a lower distribution rate in early years will only generate complexities and further differentiate between funds.

Regular Valuations of Assets to Market.

The various alternative accumulation plan models do not make for simple administration of PPFs. Accordingly, we concur with all of the abovementioned submissions supporting an across the board approach to annual distributions from a PPF based on a fixed percentage of an annual valuation of fund assets (with the exception of real estate assets) to market value.

I comment subsequently on the need to include investments other than liquid investments in PPF portfolios. I support the PA submission suggesting 5 yearly valuations of such investments (if necessary with the application of an appropriatly targeted CPI adjustment in the intervening years). The cost of annual valuations on such assets as real estate and private company shares (which are currently acceptable investments) would adversely impact on funds available for distribution.

In relation to annual valuations, both cost and standard of valuation needs to be considered. The valuation of market traded securities is a simple task whereas less regularly traded assets require a different approach.

Minimum PPF Size.

In relation to minimum PPF size, we believe that many individuals will be prevented from establishing a PPF if they are not given a period of time to build up an adequate fund of corpus.

Whilst many of our clients have established a PPF on the back of a major asset sale, just as many have proceeded on the basis that they will establish a fund over a period of years (quite often 10 years). Accordingly, if the fund was to contain, initially, less than the suggested $500,000.00 these funds would never come into existence.

We regularly encounter clients with medium sized estates lacking spare resources to establish a PPF inter vivos but who wish to make a large philanthropic bequest on death. Usually we would recommend a testamentary bequest to a PPF established with nominal capital inter vivos to achieve appropriate Capital Gains Tax relief. The proposed limit would prevent that course and reduce contributions from these sources.

Accordingly, we think it unwise to provide a minimum dollar size.

As with self managed superannuation funds, we consider that the market place will sort out this issue. The rollover suggestion in the Petre submission has merit in this context. Perhaps by starting small and building up a significant corpus in a sub trust in a community foundation, it would be possible for a budding philanthropist to roll his sub fund over into a PPF.

Similarly, we believe that a fund should not have to distribute all its capital if a minimum dollar size is stipulated and reached. The reason for this is that the capital will be spent and dissipated and will no longer be available to provide ongoing income for community purposes. There should be an alternative or an option permitting rollover into another PPF or similar fund.

Public Accountability.

We agree with your proposed public accountability proposal so far as it relates to having an ABN and being recorded on the Australian Business Register.

However, making contact details available publicly will create more problems than it solves for the reasons stipulated in the abovementioned submissions. Our clients, generally speaking, operate their PPFs on the smell of an oily rag and could not conceivably handle a massive paper flood from charities seeking donations.

Clearly ATO supervision, education of trustees and annual audits will cover any inappropriate or ineffective use of funds.

ATO Regulatory Powers.

In relation to your second principle, abiding by all relevant laws, it seems to us that a more preferable solution is to have one set of uniform trustee laws applying throughout the Commonwealth (as is the case with corporate law). The state to state differences already in existence create difficulties for the operation of PPFs, particularly when non-charitable DGRs are trust beneficiaries.

We are generally in favour of appropriately empowering the ATO to regulate all aspects of PPFs.

It is our understanding that the number of PPFs which have been found to breach guidelines is very, very few and indeed (as the Tax Office has indicated) breaches generally speaking arise through ignorance rather than any attempt to beat the system.

We think that appropriate education coupled with the other accountability rules is the appropriate solution.

Unfortunately, wherever there is a tax deduction there will always be persons seeking to take it without paying the price. However, the overriding benefit to the Australian community through the establishment of PPFs is clear. It does not serve the nation well to impose draconian regulations and compliance requirements on all PPFs when there is such a small percentage of defaulters. The accountability emphasis should be in empowering the ATO in this area.

We agree in principle that a PPF should have a corporate trustee. I cannot recall establishing one which did not have a corporate trustee.

However, consideration should be given to developing a standard set of trust laws to apply to PPFs (or perhaps not for profit trusts generally) so that we have a degree of uniformity across all states.

Over time the use of a corporate trustee will minimise administration costs such as will be incurred with the death of an individual trustee requiring the transfer of all assets into a new trustee's name. This cost is avoided with a corporate trustee.

In addition, proprietary companies which act exclusively as the trustee of a superannuation fund are classified by ASIC as sole purpose companies which attract lower establishment and annual fees. Such a benefit could easily be extended to PPF trustee companies.

There should not be a requirement for a sole corporate trustee for the reasons given in the PA submission.

I recommend that further consideration be given to:

- the extent to which it is reasonable to require established PPFs to comply with a new set of rules which conflict with the basic tenets and purpose of an existing fund;

- The extent to which it is necessary for established PPFs to change to satisfy the new rules as ultimately established;

- the extent to which current trust deeds permit changes of the nature proposed;

- a general grandfathering of existing PPFs which are not prepared or not able to opt into the new rules; and

- the desirability of a longer transition period in circumstances where the imposition of a shorter year period would prevent the fund complying with the new guidelines. Eg if a $500,000 minimum limit is to be imposed, in the circumstances of an existing fund which is being built up to a $500000 capital base over 10 years with currently only $200,000 contributed,

Fit and proper person test for trustees

The two examples given for the fit and proper person tests in appendix C, namely RSE licensees and tax agents, would rule out the great majority of existing PPF trustees. The standards here are unrealistically high.

For example, whilst I have been engaged in estate administration and trust administration for over 40 years, I would not qualify for either qualification, this notwithstanding the fact that I work in a specialist firm dealing specifically with trust issues. This is an inappropriate and unrealistic standard.

Such a high standard of qualification can only increase administration costs.

I agree with the PA submission that education rather than prescription is the answer.

Removing provisions from model trust deed into the guidelines.

I draw your attention to my earlier comments regarding guidelines being incorporated into legislation. The minimum conditions need to be legislated and the basic rules established as law not guidelines.

I have in my practice, been actively involved with the administration of self-managed superannuation funds for almost thirty years. There is a robust similarity between the development of these two vehicles and I believe there is much to be gained from studying the history of changes to the superannuation rules to see what controls will work and what will not.

Many of the issues which are currently causing difficulty with PPFs have been addressed in that field. Perhaps some of the prudential supervision requirements from that field could be adopted here, particularly those relating to investment rules, investment strategy and controls, borrowings, acquisition of members' assets, arms length investment, in-house asset rules, related party dealings etc.

Prohibition of benefit and auditing requirement clauses should clearly be incorporated into the legislation.

Similarly, we consider this to be an appropriate place to address a standard set of trust provisions to cover the whole of Australia in relation to PPFs.

PPFs are private

One matter which we strongly believe needs to be considered in this context is the element of private control which has been one of the main drivers of the success of PPFs. Tightening the rules to restrict founders and family members from acting as trustees will of necessity deter potential philanthropists from establishing PPFs.

The principles should specifically acknowledge the tenet of private control of PPFs.

The area which your queries address relates to a close connection between donors and founders. We believe that this needs to be extended to accepting the need to have a close relationship between those who establish, those who donate and those who manage the fund.

We agree with the PA submission that it would be unwise to limit numbers of donors and for the reasons set out in that submission.

We have already seen the involvement of large family numbers in the operation of a PPF and indeed whole workplaces involved in utilising PPF structures for donations from employees. We have also heard of professional firms considering the establishment of a PPF for clients who wish to make contributions.

Again, as suggested by PA, we think that there are existing rules which adequately cover this field.

***Conversion to* and from PPFs.**

Again we agree with the PA and Petre submissions on the need to establish flexible roll over mechanisms to enable PPFs to convert to Ancillary funds and vice versa.

We feel that it is important that the relevant fund should have the ability to change its structure without penalty or requiring it to be wound up to meet its evolving needs and to be able to continue as a productive and effective entity.

Principle 4 – PPFs are ancillary funds

We do not agree that PPF assets should be limited to liquid assets.

We have already mentioned testators who wish to make testamentary dispositions of core real estate and other illiquid assets to PPF's on death. This significant source of charitable funding would be lost if the proposed rule were adopted.

The trustees of a PPF would not be complying with the Queensland trustee law investment requirements if they did not have sufficient liquid assets to meet philanthropic obligations.

We think it is unwise to rule out investments in real estate, particularly where such assets are the result of testamentary gifts, part of a balanced portfolio or long term income producing or wealth generating assets.

We feel that this issue is best managed by the existing controls in the form of the relevant trust law, ATO supervision, auditor supervision, the responsible person, the uncommercial transaction rules and the like earlier discussed.

We consider that these existing mechanisms coupled with appropriate education and enhanced ATO enforcement powers will ensure the best outcome.

Yours faithfully
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