



Australian Government
The Treasury

TSY/AU

Distribution guidelines for ancillary funds

Consultation on possible policy changes

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Consultation Process

Request for feedback and comments

Interested parties are invited to lodge a written submission addressing the discussion questions which can be found through the paper.

Electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

If you would like part of your submission to remain in confidence, you should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Cth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 6 May 2022.

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The principles outlined in this paper have not received Government approval and are not yet law. As a consequence, this paper is merely a guide as to how the principles might operate.

Distribution rules for ancillary funds

Introduction

An ancillary fund is a trust set up and maintained solely for the purpose of providing money, property or benefits to deductible gift recipients (DGRs). Although an ancillary fund is also a deductible gift recipient, it does not undertake charitable work. Instead, it acts as an intermediary between donors and DGRs that do undertake such work.¹

Ancillary funds encourage philanthropy by allowing donors to receive an upfront tax deduction for gifts that are distributed over time to type 1 DGRs that undertake charitable work.

Two types of ancillary fund exist, private ancillary funds (PAFs) and public ancillary funds (PuAFs). PuAFs must ask for donations from the public. PAFs are restricted in their ability to receive donations from people other than their founders or relatives, associates and employees of the founders.

Ancillary fund rules

To ensure ancillary funds meet their philanthropic goal, guidelines made under the *Taxation Administration Act 1953* require funds to make a minimum distribution each financial year to type 1 DGRs.

For PuAFs the minimum distribution is \$8,800 or 4 per cent of the fund's net asset value at the end of the previous year, whichever is greater. For PAFs the minimum distribution is the greater of \$11,000 or 5 per cent of the fund's net asset value.²

The minimum distribution amounts of \$8,800 and \$11,000 encourage winding up of funds whose expenses are similar to or exceed investment returns. Were this not to occur, gifts for which tax concessions apply could end up funding administration costs. However, to ensure funds are permitted to accumulate capital following establishment, no ancillary fund need make a distribution in the financial year in which it is established; PuAFs need not make a distribution in the following four financial years.

The Commissioner of Taxation may approve, following a request from an ancillary fund, a lower minimum distribution rate in a particular year. However, the rate cannot be zero and the fund is still bound by the minimum distribution of \$8,800 and \$11,000 as applicable.

In deciding whether to reduce the minimum distribution rate, the Commissioner must have regard to:

- the purpose and object of the fund;
- the general market conditions in Australia;
- the past, current and expected levels of returns from the fund's investments;
- the long-term impact on the assets of the fund from not reducing the rate for a financial year;
- the level of distributions made by the fund in previous financial years;

¹ The latter DGRs are known as 'item 1' or 'type 1' DGRs as they are described in item 1 of the table at section 30-15 of the *Income Tax Assessment Act 1997*. Ancillary funds are also known as 'item 2' or 'type 2' DGRs as they are described in item 2 of the table at section 30-15.

² Note the minimum distribution amount of \$8,800 or \$11,000 applies only if the expenses of the fund are met from the assets or income of the fund.

- the investment strategy and distribution strategy of the fund;
- the size of the fund;
- the compliance history of the fund and the trustee;
- the fees and expenses of the fund; and
- the terms and other circumstances relating to any gift to the fund under a will.

The Commissioner may impose conditions in relation to a reduction in the distribution rate.

Restrictions apply to the ability of ancillary funds to transfer funds to entities that are not type 1 DGRs. Ancillary funds must not transfer funds to other ancillary funds except in limited circumstances:

- a PAF may convert to a PuAF and is then subject to the public fund rules;
- with consent of the Commissioner, an ancillary fund (or a sub-fund of PuAF) may transfer its net assets to another ancillary fund, provided it has already made its minimum distribution. Assets donated by the public must not be transferred to a PAF.
- otherwise, upon winding up, an ancillary fund must distribute its net assets to type 1 DGRs.

Further information on the rules governing ancillary funds is available on the ATO website at www.ato.gov.au/Non-profit/Getting-started/In-detail/Types-of-DGRs/Public-ancillary-funds/ and www.ato.gov.au/Non-profit/Getting-started/In-detail/Types-of-DGRs/Private-ancillary-funds/.

Limitations of existing rules

Both sets of ancillary fund guidelines have recently been remade and are fit for purpose in ensuring funds are philanthropic and funds flow through to type 1 DGRs.

However, the Australian Government acknowledges circumstances exist where a uniform approach to regulation may limit alternative approaches to supporting the charitable activities of type 1 DGRs. Specifically:

- the requirement for funds to make a minimum distribution each financial year might prevent ancillary funds working with type 1 DGRs to support large projects, particularly capital intensive projects such as health or research infrastructure;
- the limitation on moving assets between ancillary funds prevents private ancillary funds contributing to the work of public ancillary funds that are better placed to support particular types of DGR1s.

The Government seeks feedback on proposals addressing these limitations while preserving the philanthropic nature of ancillary funds.

Issues for discussion

Accumulating funds to support large projects

As ancillary funds are philanthropic funds, the Commissioner's discretion to reduce the minimum distribution rate is not intended to allow funds to preserve their capital in perpetuity. Rather, it addresses unusual circumstances where, for example, a fund receives a gift from a will subject to conditions that limits the fund's investment choices or where a fund has made a significant distribution above the minimum in previous years.

However, circumstances exist where it might be appropriate to approve a lower distribution rate for an ancillary fund to permit it to build funds to support a large project. An example is an ancillary fund established to support health services in a region that might wish to assist the construction of new buildings at a hospital or health clinic operated by an item 1 DGR. While the Commissioner may consider this purpose of the fund when deciding whether to approve a lower distribution rate, it is not a sufficient criterion for approving a lower distribution. The Commissioner may also only approve a lower rate for a particular year, while accumulation of funds for a specific project might take several years.

Alternative option for accessing a lower minimum distribution rate

Where an ancillary fund has identified a project for which it wishes to accumulate funds, it may request the Commissioner lower the minimum annual distribution rate, including to zero, for one or more years. If the Commissioner approves a zero distribution, the minimum distribution amount of \$8,800/\$11,000 would also not apply.

In considering whether to approve a lower distribution, the Commissioner would need to take into consideration the purpose and objects of the fund; maturity of project planning and the likelihood of it going ahead; the fund's investment strategy; the size, fees and expenses of the fund; the fund's compliance history; and, if applicable, whether the fund failed to fund projects for which it previously received approval for a lower minimum or zero distribution rate.

The maximum period for which the Commissioner may approve a lower or zero distribution rate is five years. The Commissioner may impose conditions on the fund when approving the lower distribution.

Limiting the number of years during which a fund may accumulate funds ensures that ancillary funds fulfil their philanthropic purpose by making distributions to type 1 DGRs.

Both Canada and the United States allow charitable foundations to accumulate funds for specific projects. In Canada, the amount set aside is excluded when calculating the foundation's minimum distribution. In United States, the amount set aside may count towards the foundation's minimum distribution.

Lowering the distribution rate is under consideration in this consultation paper as it would impose a lower compliance burden on ancillary funds.

Questions

1. Should both PAFs and PuAFs be able to accumulate funds?
2. As public ancillary funds are not required to make a distribution in the year of establishment or the following four years, do they have the ability under the existing rules to accumulate capital for large projects?
3. Should a limit be imposed on the amount a fund may accumulate, either as an absolute asset value or a percentage of the value of the fund's assets?
 - 3.1 If so, what would be appropriate values?
4. Are the matters for the Commissioner's consideration appropriate? Should the Commissioner consider other criteria?
5. Is a five-year period for accumulation sufficient, too short, or too long?
6. What should the consequences be if an ancillary fund does not proceed to support the project for which it accumulated funds? For example,

6.1	Should an administrative penalty be applied to the fund's trustees?
6.2	Should the fund be required to immediately distribute to type 1 DGRs an amount equivalent in value to the distributions it would have had to make if the lower distribution rate had not been agreed?

Flexibility in transferring assets between ancillary funds

Ancillary funds (or a sub-fund of a PuAF) may only transfer assets to another ancillary fund if all net assets are transferred and the fund (or sub-fund) has not received assets from another fund in the previous two financial years. This ensures deductible gifts are not churned between funds but end up with type 1 DGRs.

There are limited circumstances where it might be appropriate for a fund to transfer assets to another fund. For example, the founders of a PAF might wish to support type 1 DGRs operating within a particular region or operating in a particular sector such as arts or welfare. The PAF could make distributions to such entities in its own right. However, it might prefer to transfer part of its assets to another ancillary fund established specifically support to such DGRs and which has a better understanding of appropriate entities to support.

The *Income Tax Assessment Act 1997* requires ancillary funds to have the sole purposes of providing property or benefits to type 1 DGRs or to establish such DGRs. Permitting a transfer of assets between funds under the options set out below requires amendments to the Act to allow ancillary funds to have added purposes.

The Government notes that altering the permitted purposes of ancillary funds could affect all funds, not just those wishing to take advantage of the ability to transfer assets to another fund. The regulatory effects of doing so would need to be considered carefully before going ahead with any change. Nevertheless, the Government is consulting on these options to gauge the interest of the philanthropic sector in broadening the ability to make transfers between ancillary funds and to seek views on the practicalities of implementation.

If new types of fund-to-fund transfers become permitted, a core consideration is to ensure the total value of distributions made to type 1 DGRs is broadly the same as if the transfer had not occurred. If a transfer is to count towards the giving fund's minimum annual distribution requirement, it is expected the receiving fund would be required to distribute to type 1 DGRs an amount equivalent in value to the transferred assets within a reasonable timeframe after receiving the assets. Alternatively, the transferred funds could be in addition to the giving fund's minimum annual distribution.

Transfers not to count towards minimum distribution

Under this option an ancillary fund may transfer part of its assets to another ancillary fund, but only if it has already made its minimum distribution to type 1 DGRs for the financial year in which the transfer is made.

These assets would appear on the receiving fund's balance sheet and contribute towards the calculation of its minimum annual distribution the following financial year.

The requirement to have first made the minimum distribution ensures the giving fund does not transfer assets such that it does not have resources to make its minimum annual distribution.

The Government notes this option could possibly slow the distribution of ancillary fund assets to type 1 DGRs, for example where a fund transfers assets to a fund that has a lower minimum distribution rate. Where funds have different accounting periods or use differing accounting bases

and multiple asset transfers occur, transferred assets might not initially appear on any fund's end of year balance sheet and not contribute to distribution requirements.

Questions

7. Is there a concern if a PAF transfers assets to a PuAF given the latter has a lower minimum distribution rate?
8. To address the risk of churning of funds between ancillary funds with different accounting periods, should the existing prohibition on transferring assets if any have been received from another ancillary fund with the two previous years apply to such transfers?
9. Should any ancillary fund be able to transfer assets to any other ancillary fund, or should transfers be limited, for example a PAF may transfer to a PuAF but not the other way around?
- 9.1 Should the existing prohibition on moving assets contributed, either directly or indirectly, by the public from a PuAF to a PAF apply to these transfers?
10. Should a fund require the Commissioner's consent before transferring assets?

Transfers counting towards the minimum distribution

Under this option, an ancillary fund may transfer part of its assets to another ancillary fund. The transfer would count towards the giving fund's minimum annual distribution in the financial year in which the transfer occurred.

The receiving fund would need, within 12 months of receipt, to make distributions to type 1 DGRs equivalent to the value of the assets received. The value of the transferred assets would be determined on the day the transfer was made. This distribution would not count towards the receiving fund's minimum annual distribution.

If the transferred assets are on the balance sheet of the receiving fund at the end of a financial year occurring within the 12-month period, the receiving fund could opt to deduct an amount equivalent to the value of the transferred assets (as valued on the day of transfer) from its net asset value when determining its minimum distribution in the following financial year. This accounts for the fact that the value of those assets has been counted as part of the giving funds minimum distribution.

As an integrity measure, additional compliance requirements would likely be imposed to provide assurance the receiving fund has distributed the transferred assets to type 1 DGRs. In the United States, for example, the giving fund is required to obtain evidence the receiving fund has distributed an amount equivalent to the value of the transferred assets.

Questions

11. Who should be required to ensure the receiving fund distributes an amount equivalent to the value of the transferred assets: the giving fund or the receiving fund?
12. Would the benefits to receiving funds of receiving additional resources be outweighed by the costs of administering the transferred assets?
13. What consequences should apply if the receiving fund does not distribute to type 1 DGRs an amount equivalent to the value of the transferred assets? For example, should an administrative penalty be imposed on the trustee of the fund?

14. Should a fund require the Commissioner's consent before transferring assets? Should the receiving fund require consent?
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Other suggestions for improvement

As the ancillary fund guidelines have now been in place for some time, the Government would welcome general feedback on their operation and suggestions for improvement.

Questions

15. Are there other improvements that could be made to the operation of the ancillary fund guidelines?
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