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Dear Jacky

## Distribution guidelines for ancillary funds

Chartered Accountants Australia and New Zealand (CA ANZ) welcomes the opportunity to comment upon the consultation about possible policy changes to the distribution guidelines for ancillary funds.

The consultation paper acknowledges that the:

- Requirement for funds to make a minimum distribution each financial year might prevent ancillary funds working with type 1 deductible gift recipients (DGR1s) to support large projects, particularly capital-intensive projects; and
- Limitations on moving assets between ancillary funds prevent private ancillary funds contributing to the work of public ancillary funds that are better placed to support particular types of DGR1s.

CA ANZ welcomes the acknowledgement of these limitations. Both issues have been of concern to our members.

The consultation paper discusses several possible regulatory solutions to these problems.

CA ANZ also questions the policy behind the regulations that require minimum annual distribution rates and limits the ability to transfer assets with the not for profit (NFP) sector.

### Policy rationale for 5% minimum distribution rate should be questioned

CA ANZ agrees that a minimum distribution amount may be required to ensure that the ancillary fund is economic to maintain. However, as is currently the case, that amount should not apply where an ancillary fund is accumulating funds to support large projects.

The policy rationale for requiring a minimum annual distribution rate is stated in the consultation paper as ensuring ancillary funds meet their philanthropic goal. The minimum annual distribution rate was legislated in guidelines (which are a legislative instrument) for private ancillary funds (PAFs) in 2009 and public

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ancillary funds (PuAFs) in 2010. Submissions made regarding consultation on these guidelines recognise that the need for a minimum distribution rate was a contentious issue.[1]

Given the multitude of regulatory requirements and trust law principles that ancillary funds are required to adhere to, it is unclear why there is a perceived need for a minimum distribution rate. It seems that the minimum distribution requirement is really driven by a belief that:

- An ancillary fund should benefit the charitable sector much more than if the government had taken the revenue foregone (tax concessions) and given it directly to that sector2; and
- A perceived need to simplify the regulation of charities by eliminating individual accumulation systems that existed at that time.3

Philanthropy Australia's submission[4] at the time of the draft guidelines was supported by many. This submission argued that "the minimum distribution rate that should be applied to a foundation should be consistent with maintaining the real value of foundations over the economic cycle and in the long term."[5] It noted that a "5% minimum distribution is the rate used in the United States and is easy to understand, comply with and monitor...[and that] A minimum rate of 5% will enable a PPF to maintain its real value over the economic cycle as well as to maintain the real value of distributions over time."[6] "A higher distribution rate would mean that PPFs will lose their value in real terms over time, losing the ability to sustain a constant stream of grants in real terms for the charitable sector."[7]

The economic environment in 2022 is very different to that in 2009 and 2010. The US still has a 5% minimum distribution rate, but Canada is currently consulting about whether its minimum distribution rate of 3.5% is still appropriate.[8] The Canadian Bar Association's Charities and Not-for-Profit Section, maintain that interest rates have dramatically decreased in the years since the 3.5 percent figure was set and that an increase in the DQ [distribution quota] may promote an encroachment of capital that may contravene many donor agreements and encourage a boosting of returns through imprudent investments[9]. Others are arguing that during COVID, ancillary funds should be required to pay out more to beneficiaries.

Given the different economic environment that ancillary funds now operate in, CA ANZ feels there should be reconsideration of the 5% minimum distribution rate.

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[1] See page 1 of https://treasury.gov.au/sites/default/files/2019-03/Taxation_Institute_of_Australia-1.pdf
[2] Paragraph 13 item 1 of https://treasury.gov.au/sites/default/files/2019-03/Prescribed_Private_Funds.pdf
[3] Paragraphs 18 and 19 of https://treasury.gov.au/sites/default/files/2019-03/Prescribed_Private_Funds.pdf
[4] https://treasury.gov.au/sites/default/files/2019-03/Philanthropy_Australia.pdf
[5] Paragraph 3.4 of above
[6] Paragraph 4.2 of above
[7] Paragraph 4.3 of above
[8] https://www.withersworldwide.com/en-gb/insight/comparing-foundation-minimum-distribution-in-the-us-canada-and-the-uk
[9] Ditto The 3.5 percent minimum is expected to roughly match reasonably expected investment returns on endowments



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## Annual distribution rate and capital projects

Members have experienced situations where ancillary funds have been called upon to assist DGR1s with a capital-intensive project and have had difficulty doing so due to the annual distribution rate rules.

Members have also pointed to the annual distribution rate rules operating inappropriately where a fund has lost value due to market movements and volatility; often this loss of value may be unrealised and if the investment is retained there is a chance for the investment to regain some of that lost value. If the fund is required to sell the investment in order to have the cash to make its annual distribution the loss is crystallised with no opportunity to withstand the market fluctuations. Meeting the annual distribution rules may also result in the ancillary fund generating a loss. Whilst the Commissioner's discretion could be applied for before year end in theory to avoid this situation, in practice this is difficult to achieve. There should be a wider range of events contemplated to allow a reduction in the distribution percentage to include the trustee determining what is best for the long-term objective of the fund

As noted in the consultation paper, the regulatory issues that prevent ancillary funds from mitigating the impact of the annual distribution rate rules are that:

- Accumulating funds to undertake a capital-intensive project is insufficient of itself to allow the Commissioner to approve a lower annual distribution rate; and
- The Commissioner can only approve a lower distribution for a particular year and that rate cannot be zero.

The consultation paper suggests that Commissioner's discretion to lower the minimum annual distribution rate could be altered to zero (and the minimum distribution amount also lowered to zero) for up to 5 years and could be subject to conditions imposed by the Commissioner.

In exercising the Commissioner's discretion consideration would be given to:

- The purpose and objects of the trust
- 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
- Whether the fund failed to fund projects for which it previously received approval for a lower minimum or zero distribution rate.

The consultation paper states that to ensure ancillary funds meet their philanthropic goal, guidelines require funds to make a minimum distribution each financial year to DGR1s. The fixed minimum distribution amounts encourage winding up of funds whose expenses are similar to or exceed investment returns – this is to prevent tax deductible donations funding administrative costs.



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Responses to the specific questions in the consultation paper are:

1. ***Should both private and public ancillary funds be able to accumulate funds***?
Yes. All types of ancillary funds may have a need to accumulate funds to assist in funding the delivery of capital-intensive projects.

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?***
The need to undertake a large capital-intensive project to further an ancillary fund's charitable objectives can occur at any stage of the ancillary fund's life cycle. The inability to obtain zero distribution requirements at a later stage in the public ancillary fund's lifecycle could result in an important project not being funded and a charity's funds being used for projects with less enduring social impact. There should be no restriction as to when an ancillary fund can apply for zero distribution amounts.

3. ***Should a limit be imposed on the amount a fund may accumulate, either as an absolute value or a percentage of the value of the fund's assets? If so, what would be appropriate values***?
No. The size of a project and the size of the ancillary will vary. Having an absolute value or percentage restriction may inappropriately prevent an ancillary fund meeting its charitable objectives. The proposed assessment by the Commissioner of the ancillary fund's accumulation strategy as part of the application of the discretion should be enough.

4. ***Are the matters for the Commissioner's discretion appropriate? Should the Commissioner consider other criteria?***
Most discretions have an additional clause "any other matter that the Commissioner considers relevant". Consideration should be given to adding a similar clause to this proposed discretion.

5. ***Is a five-year period for accumulation sufficient, too short, or too long?***
The fund should be able to determine the project and the amount of funds required to make that project achievable. How long that takes will depend on donations received and investment returns – both are influenced by factors that are outside the control of the fund trustees. The target should be focused on the project milestones rather than an arbitrary time period.

6. ***What should the consequences be if an ancillary fund does not proceed to support the project for which it accumulated the funds? For example, should an administrative penalty be applied to the fund's trustees? Should the fund be required to immediately distribute to DGR1s an amount equivalent to the distributions it would have had to make if the lower distribution rate had not been agreed?***

   Rather than imposing administrative penalties or a requirement to immediately distribute to DGR1s, a new strategy should be required to be made by trustees. What is important is the efficient use of funds rather than a 'tick the box' process. Many funds have a long-term vision and a small amount of seed capital that needs to grow to fulfil the vision. There are real life examples of this longer-term focus that can be provided on request.

   The annual information statement that is lodged with the Australian Charities and Not for Profits Commission contains data about a charity's activities and basic financial information. In addition to this,



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medium and large charities are required to submit a financial report with their Annual Information Statement. This information should be considered when developing rules regarding how ancillary funds are regulated by the ATO.

In recent years, private ancillary funds that hold cash as a major investment category have suffered the impact of earnings being less than CPI and less than the distribution percentage. Under trust law, trustees have a duty to invest funds under their control for the benefit of the trust/beneficiaries and in the case of ancillary funds to do so in line with the objects. A private ancillary fund can only distribute to DGR1s, so the assets of the funds cannot leave the not-for-profit sector.

## Transferring funds between ancillary funds

Concerns about “churning” donations has resulted in the current rule that ancillary funds may only transfer assets to another ancillary fund if **all** net assets are transferred **and** the transferor fund has not received assets from another fund in the previous two financial years.

CA ANZ members have indicated that this rule is stifling as an ancillary fund may be able to identify another ancillary fund that can better meet its objectives. CA ANZ supports changing legislation to permit ancillary funds to transfer between themselves. CA ANZ also supports removal of the two-year restriction as this is considered artificial.

The consultation paper states that a core consideration, if the ability to transfer is implemented, is that the total value of distributions made to DGR1s is broadly the same as if the transfer had not occurred.

It is questionable whether this is appropriate. The funds are in the not-for-profit system and can only be used to either fund DGR1s or accumulate capital for a project that has received the ATO tick of approval. Both are appropriate uses of the transferred funds and requiring the same level of funding to occur at DGR1 level is irrelevant. For example, if an ancillary fund has identified that a capital intensive project is required to meet a charitable objective and that another fund is accumulating funds for that purpose, it would be more efficient (less red tape) for that fund to transfer part of its assets to the fund that is already accumulating funds than to go through the administrative steps to obtain a discretion from the Commissioner to accumulate funds themselves (which may also be denied due to lack of size of the fund). Requiring a minimum distribution in this context would adversely affect the ability of the not-for-profit sector to fund the needed capital intensive project.

The consultation paper then proposes two models:

- An ancillary fund can transfer part of its assets to another fund if it has made its minimum distribution to DGR1s during that financial year. The receiving ancillary fund will make a minimum distribution payment on the amount transferred in the following financial year.
- An ancillary fund can transfer part of its assets to another fund. The receiving fund would, within 12 months of receipt, make the minimum distribution to DGR1s that relate to that transfer amount.

Under either option there is a requirement to distribute to DGR1s – the first option requires the transferor to make the distribution, the second option requires the transferee to make the distribution.



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Responses to the specific questions in the consultation paper are:

***7 Is there a concern if a private ancillary fund (PAF) transfers assets to a public ancillary fund (PuAF) given the latter has a lower minimum distribution rate?***

No. The funds are within the not-for-profit sector (NFP) and can only be used for charitable purposes.

**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?***

No. The funds are within the not-for-profit sector (NFP) and can only be used for charitable purposes.

***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?***

No. The funds are within the not-for-profit sector (NFP) and can only be used for charitable purposes.

***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?***

No. The funds are within the not-for-profit sector (NFP) and can only be used for charitable purposes

**10 *Should a fund require the Commissioner's consent before transferring assets?***

No. Ancillary funds are trusts. Trustees are obliged to act in accordance with the trust deed.

***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?***

Neither as the funds may be part of an accumulation towards a capital-intensive project. The funds should be treated as a donation in line with the existing guidelines.

***12 Would the benefits to receiving funds of receiving additional resources be outweighed by the costs of administering the transferred assets?***

This depends on the amount that is transferred and the regulations that are put in place around the transfer. Ideally regulations about the transfer should be minimal.

***13 What consequences should apply if the receiving fund does not distribute to DGR1s an amount equivalent to the value of the transferred assets? For example, should an administrative penalty be imposed on the trustee of the fund?***

None as the amount may be for the accumulation of funds for a capital-intensive project.

***14 Should a fund require the Commissioner's consent before transferring assets? Should the receiving fund require consent?***

No. The funds are within the not-for-profit sector (NFP) and can only be used for charitable purposes.



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If you would like to discuss any aspect of this submission, please contact Susan Franks on 0401 997 342 or susan.franks@charteredaccountantsanz.com

Yours sincerely

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