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Wealth Management and Executive Financial Planning

14 January 2009

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Philanthropy & Exemptions Unit
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The Treasury
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Attention: Mr Chris Leggett

By email to: ppfreview2008@treasury.gov.au

Improving the integrity of
Prescribed Private Funds (PPFs)

Submission

re Treasury Discussion Paper dated November 2008

We refer to the November 2008 Treasury Discussion Paper.

Attached is our joint Submission on the Paper, including an Executive Summary of our key comments.

Please do not hesitate to contact either of us if you would like us to elaborate on any of the comments in the Submission.

Yours sincerely

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Improving the integrity of
Prescribed Private Funds (PPFs)

Submission

re Treasury Discussion Paper dated November 2008

EXECUTIVE SUMMARY

We welcome any changes that will -

- strengthen the integrity of PPFs,
- stop the misuse of funds (or breaches of Rulings, Guidelines, trust deeds and other relevant laws) and the incurring of excessive operating expenses,
- simplify how PPFs operate, and
- generally make them more accountable and subject to greater regulatory control.

However, any changes -

- should be appropriate for the objectives at which they are aimed, and
- should not undermine either the increasing culture of giving in Australia, especially by high net wealth individuals, and their families and associated entities (to which PPFs have made a substantial contribution), or the attractiveness of PPFs to genuine potential donors.

In this regard, in particular:

- The proposed 15% minimum distribution rate is plainly too high. A rate of 5% of the year end balance would be more appropriate.
- Existing PPFs should be grandfathered from the application of any new minimum distribution requirement, to the extent that it exceeds 5% (and, in any event, should be allowed to transition to any new 5% rate, should they need to do so, in order to realise any assets in an orderly manner).
- There must be a better, and more targeted, solution to any instances of excessive operating expenses than imposing a minimum fund size, with all the adverse arbitrary consequences of such a requirement.
- There is no need to cap the number of fund donors.
- There are other changes to the proposed amendments that we mention in our attached detailed comments.

Improving the integrity of
Prescribed Private Funds (PPFs)

Submission

re Treasury Discussion Paper dated November 2008

DETAILED COMMENTS

1 Introduction

We:

- recognise that there may have been isolated perceived misuses of funds by PPFs or other Guideline breaches of the kind referred to in paragraph 27 of the Discussion Paper; and

- welcome any appropriate or desirable changes to Guidelines, Rulings or legislation to improve the integrity of PPFs, including bringing PPFs under the full regulatory control of the Commissioner of Taxation, giving the Commissioner of Taxation greater regulatory powers, and renaming PPFs as Private Ancillary Funds.

However, for the reasons mentioned below and in the attachment:

- We consider that some of the proposed changes are unnecessary and inappropriate.

- In particular, we consider that the proposed 15% minimum annual distribution requirement -

    - is significantly excessive,

    - conflicts with one of the primary objectives of genuine PPFs, and

    - will discourage existing donors from continuing to donate to existing PPFs, and potential future donors from establishing PPFs, to the medium and long term detriment of the national interest.

  In other words, the opportunity to continue to encourage the establishment of genuine private charitable foundations with significant capital (being applied for the public good), along American and European lines, would be lost.

- Instead, if greater simplicity and certainty is required as regards the size of compulsory distributions, we recommend that the minimum annual distribution be set at 5% (and not 15%) of the year end Market Value of fund investments.

2 PPFs in context - generally

- The overall level of philanthropy in Australia is well below that of the USA or Europe.

- PPFs were established to encourage both private and corporate philanthropy, to try to attract in particular the surrender of wealth by high net wealth individuals and their associated entities, along US and European lines.

- Indications are that PPFs have achieved this goal, with almost 800 being set up in the last seven years.

- This website gives statistics on how PPFs have contributed to philanthropy in Australia: http://www.bus.qut.edu.au/research/cpns/documents/2008_6_PPFs_Final_Web.pdf

- Thus, it can be seen that PPFs are helping to foster a more widespread culture of philanthropy in Australia amongst people who have the financial means to make valuable financial contributions to the community.

- At the current time, (and irrespective of the current global financial crisis) many baby boomers in Australia are beginning to be in a financial position to pass on a significant amount of wealth to the next generations. (This is particularly so if there is an event, such as the sale of a business, a private company or a valuable investment property or family home, which produces a very large lump sum which is significantly in excess of the ongoing anticipated financial needs of the current generation of high net wealth clients, whose families may all be grown up and already financially independent.) This trend will grow and continue for some years to come.

- Therefore, at the current time, and in the years to come, it is clearly in the national interest to have philanthropic vehicles available to try to attract and retain some of these funds, for the benefit of Australian society.

- The alternative is simply to allow all that wealth to be passed on to the descendants of the baby boomers. In that situation, future generations may not have instilled in them the importance of philanthropy that involvement in their family PPF provides. Therefore, the opportunity to capture a significant portion of that wealth for the benefit of Australian society may be permanently lost. And the growing and more widespread culture of philanthropy inspired by PPFs would wane.

- The capture of that wealth for the benefit of Australian society will only happen if the available vehicles -

  - are easy to manage,

  - are subject to a stable set of rules and regulations,

  - offer appropriate benefits, and

  - are encouraged by government.

- Therefore, any government decisions that adversely impact the attractiveness of PPFs should be avoided at all costs.

- If these vehicles are not easy to manage, are not subject to a stable set of rules, or do not offer appropriate benefits, many of those baby boomers or other high net worth individuals may choose to simply gift a small sum to charity now, in future years or under their wills (or, worse still, do nothing), rather than establish a PPF with a much more substantial initial gift and an ongoing gifting program.

3 PPFs in context - our experience

- We (that is, both Stewart Partners and Mallesons Stephen Jaques), as well as many other eminent and ethical advisers, have a genuine and passionate interest in, and commitment to, the charitable sector. It is this interest (and not the tax deduction for our clients) which motivates us to act as the catalyst to sow the seeds of an interest in philanthropy in our respective high net wealth clients. Having done so, we often persuasively encourage them to gift significant sums to PPFs which they had not previously seriously considered gifting to charity, and otherwise would not have done so.

- We are aware of many circumstances where the catalyst for commercial transactions has been the commencement of a gifting program through the establishment of a PPF. The tax deduction, whilst important, is only one factor among many others.

- Importantly, we can say with absolute confidence in the case of our respective clients that the philanthropic motivation is completely genuine, and there is no misuse of funds of which we are aware.

- Rather, in each case the PPF has become a vehicle by which the donors and their families become engaged to assist others in Australian society, in perpetuity. This should be fostered and supported – not discouraged.

- In the case of **Stewart Partners**, of the eight PPFs that Stewart Partners has established for its clients:

    - It was clear in each case that the desire to establish a family legacy was imperative to the decision.

    - These legacies inherently focus on long term horizon gifting programs, based on a substantial capital foundation.

    - In most cases, adult children are involved as trustees and decision makers in selecting appropriate Deductible Gift Recipients (DGRs) to which the PPF will donate.

    - Had the 15% minimum policy been in place since the inception of PPFs, it is likely that we would not have been able to successfully persuade our relevant clients to establish a PPF. This is because, in our experience, a significantly attractive feature was the prospect of being able to assist others in society in perpetuity (or at least over a very long time, covering the next generation).

- In the case of **Mallesons Stephen Jaques**, our experience has been slightly different:

    - Some clients needed little encouragement to consider gifting substantial sums to charity. But, as with Stewart Partners, what appears to have been of decisive importance was the opportunity to establish a family legacy, with a long term horizon gifting program, based on a substantial capital foundation.

    - In other cases, our clients seem to have started out with the sole intention of leaving all (or virtually all) their substantial wealth to their descendants. The ultimate decision to "give something back" to the Australian community by donating a substantial sum to a PPF followed a quite extensive educational program, over a lengthy period of many months or several years. The features of a PPF, and the opportunity to establish a family legacy, with the personal involvement of their families, seemed to be decisive in the ultimate decision to proceed.

4 PPFs in context - one regime or two regimes ?

We agree that a PPF is one of two types of ancillary trust funds.

But, in our opinion:

- There is no apparent justification for subjecting PPFs to a different regime from that applicable to other ancillary funds.

- On the contrary, both types of ancillary fund should be subject to the same treatment, except for:

  - there being no requirement for a PPF to be a public fund; and

  - possible different control requirements (it being sufficient in the case of a PPF that there be a single Responsible Person (rather than a majority of Responsible Persons) as trustees or on the governing body of a corporate trustee).

- On that basis, except in such identified respects, the same principles ought to apply to a PPF as apply to an ancillary fund, and vice versa.

Thus, as regards the four Principles listed in the table on page 3 of the Discussion Paper:

- **Principle 1**, first paragraph, should apply equally to an ancillary fund.

  (We are puzzled by the second paragraph of that Principle and are unable to understand why it is considered that PPFs should be subject to a more onerous distribution requirement than an ancillary fund. We can only presume that it is an (over) reaction to the apparent misuses of funds by some PPFs. In our opinion, the proper response to such misuses is to give the Commissioner greater regulatory powers to prevent or put a stop to any such misuses and to penalise those who wilfully or recklessly are involved in or permit such misuses, and not to completely undermine the achievement of goals which genuine PPFs are intended to achieve (as referred to in part 3 above).)

- **Principle 2** should equally apply to an ancillary fund.

- **Principle 3** is unique to a PPF.

- **Principle 4** should equally apply to an ancillary fund.

5 Proposed Amendments

There are a number of amendments proposed.

We will comment on each of them in turn.

5.1 Required distributions

5.1.1 Minimum distribution rate

There is no stated or other apparent justification for subjecting PPFs to a more onerous distribution policy than that which applies to other ancillary funds.

As far as we are aware, there is no legislation, and there are no ATO prescriptive requirements, for the levels of distributions by other ancillary funds.

If simplification and greater conformity are regarded as desirable, then the minimum distribution rate should be set at 5%, and not 15%.

See our comments in parts 2 and 3 above and the comments in the attached Stewart Partners paper as to why the proposed 15% figure:

- is manifestly excessive;
- will discourage donors to existing PPFs from continuing to donate; and
- will curtail the making of significant contributions to new PPFs;

which is contrary to the national interest.

In any event, there should be an exclusion from the calculation for any assets provided or made available to DGRs (eg property leased or licensed to a DGR).

5.1.2 Possible need for an alternative rate

If a 5% minimum distribution rate was adopted, then there may be no need to permit any modification to that rate.

However, if any rate higher than 5% was adopted, then there should be an alternative which can apply to take account of market conditions (and especially adverse market conditions). Such an alternative lower rate may for, example, be based either on average or rolling fund earnings say over the last 3 years, or during the current or immediately preceding year (this is relevant in the current economic climate, when unrealised losses in an investment portfolio may well exceed annual income).

5.1.3 Commencement Date

Any new minimum distribution requirement should not apply to PPFs existing as at November 2008, as the new rule would otherwise have the effect of retrospectively changing the rules applicable to them.

Alternatively, PPFs existing at that date should be grandfathered from the application of any new minimum distribution requirement to the extent that it exceeds 5% (and, in any event, should be allowed a period (say five years) to transition to any new 5% rate, should they need to do so, in order to realise any assets in an orderly manner).

5.1.4 Start up phase for new PPFs

There may be merit in allowing a lower distribution rate in the start up phase of a new PPF.

Certainly, it should apply if the minimum distribution rate exceeds 5%.

However, there may be no need for this concession if the standard minimum rate is set at 5%.

5.2 Regular valuation of assets at market rates

We support the change. However, there should be an exclusion from the calculation for any assets provided or made available to DGRs (eg property leased or licensed to a DGR).

5.3 Minimum PPF size

5.3.1 **Should there be a minimum size?**

We agree that it would be inappropriate for a large proportion of a PPF's capital to be eroded through operating expenses.

However, many donors manage their PPFs so as to minimise operating expenses. In those circumstances, it may be unfair if a fund was precluded from being a PPF simply because it was less than a certain size. This is especially the case if the founders plan to leave property to the PPF in their wills even though the contribution will not be tax deductible.

Further, how will the minimum size apply?

- Would the fund just have to have a target of at least, say, $500,000? Or would it have to reach that target within a certain time? If the latter, what would be the permitted period of years? A definite period of years would penalise founders who plan to leave property to the PPF in their wills, as it is obviously impossible to predict when this will occur.

- What happens if the fund fails to meet the target (and especially if its operating expenses are low)?

For all the above reasons, it seems to us that imposing a minimise size may be an inappropriate response to a legitimate concern about fund expenses. There should be another preferable solution.

5.3.2 **Minimum size**

If there is to be a minimum size, then a target of at least $300,000 would not seem inappropriate. (The approximate sum of $300,000 is consistent with the additional work required to establish and maintain a Self Managed Superannuation Fund.)

However, again, there is a problem in the case of people who wish to leave say a proportion of their residuary estate to a PPF under their wills. They do not know how long they will live or what their aged care costs will be in the future. And therefore they do not know in advance how much will end up being donated to the PPF.

5.3.3 **Consequences of falling below, or failing to reach, any specified minimum size**

We do not have a fixed view on this issue.

However, if there was to be such a principle, then:

- Logically, it should apply to all ancillary funds, and not just PPFs.

- The consequences should only be triggered if the minimum size was not met say at the end of 2 or 3 successive years.

- And, to permit the orderly winding up of the fund, the distributions should be permitted over say the two tax years following the trigger event.

5.4 Increased public accountability?

5.4.1 **ABN requirement**

We support the introduction of the ABN requirement, subject to normal privacy rules.

5.4.2 **Contact details**

Provision can be made for contact details to be publicly available.

However, in our opinion, it should not be mandatory that contact details be publicly available. This is because many high net worth benefactors wish to maintain their privacy and do not wish their identities to become known or to become the recipient of unsolicited approaches from charities, not for profit organisations and professional fund raisers. Rather, it should be up to the PPF to choose whether or not to provide contact details.

Alternatively, if it is decided that some contact details must be given, then those details should just be for the auditor of the PPF (every PPF must have an auditor). In that way, the auditor could act as a "filter", in addition to their audit role.

5.5 Giving the ATO greater regulatory powers

5.5.1 **Requirement to have a corporate trustee**

As a general rule, in our opinion, PPFs ought to be subject to the same requirement as other ancillary funds in this regard.

We accept that the requirement for a fund to have a corporate trustee may be necessary in order to better give the Commissioner a wider range of remedies to apply to breaches of any applicable Rulings, other Guidelines, the trust deed or other relevant laws.

If such a requirement was introduced, and was able to be implemented under applicable State or Territory law (we understand that there may be a problem in Victoria if there are more than two individual trustees), a two year transitional period should be adequate.

However, as a matter of principle, we believe that existing PPFs either should be completely grandfathered from any new minimum distribution requirement (which is preferable), or at least should be grandfathered from the application of any new minimum distribution requirement to the extent that it exceeds 5% (and, in any event, should be allowed a period (say five years) to transition to any new 5% rate, should they need to do so, in order to realise any assets in an orderly manner).

5.5.2 **Giving the ATO greater and more flexible regulatory powers, including access to a wider range of penalties**

We support any appropriate changes, including enabling the ATO to make enquiries of relevant State and Territory bodies and to disclose information to State or Territory Attorneys-General, to the extent reasonably necessary to counter flagrant or repeated breaches of Rulings, other Guidelines, the trust deed or other relevant laws (as opposed to genuine mistakes or oversights).

However, again, it seems to us that there ought to be uniform provisions for all ancillary funds.

5.6 Introduction of "fit and proper person" test for trustees

We oppose the introduction of any test limited to PPF trustees.

As a general rule, there should be a uniform test for all ancillary funds (subject to PPFs not being required to have a majority of "responsible persons").

5.7 Role of model trust deed

We agree that there should be no binding model deed. (The model deed has not been mandatory in all respects to date).

However, in our opinion, there is considerable merit in continuing to publish a model trust deed, to assist new PPFs. (This is consistent with a general trend in business to have increased standard form documents, with provision for identifiable variations from the standard. This is especially true of ISDA and other documents used in the financial markets).

5.8 Limiting the number of PPF donors

We have concerns about possible unforseen consequences of imposing an arbitrary cap on the number of donors to a PPF.

We would prefer to see a principled approach.

In any event, if a cap was to be imposed, we are concerned that a cap of 20 may be too low in some instances. We would prefer say at least 50 (similar to the number of members permitted in a private company under the Corporations Act). But even that number may be too low either in the case of an extended family, or for say a one off public appeal.

5.9 Restricting investments to liquid assets

We recognise the sound policy reasons for the suggested change (including to stop any misuse of funds). However, if the fund is to grow at a rate greater than cash, then it is imperative that normal growth assets be included in the investment policy statement.

We are concerned about the imposition of any rule limited to PPFs. Rather, perhaps any such rule should apply to all ancillary funds.

Generally, we would prefer a principled approach to any prescriptive one. A principled approach might be linked to the sole purpose of the fund (being to pursue its charitable or other philanthropic objects) and the application of a "Prudent Investor Rule" to the investments of the fund (other than to those assets used to benefit a DGR, such as property leased or licensed to a DGR).

The Prudent Investor Rule has been adopted by most US states to provide guidance to investment managers regarding the standards of managing an investment portfolio in a legally satisfactory manner. The rule espouses that investing prudently is a process, not a performance guarantee.

We have outlined below the five principles of the Prudent Investor Rule, which appear to closely align with the motives for the proposed PPF changes:

1. Sound diversification is fundamental to risk management and is therefore ordinarily required of trustees.

2. Risk and return are so directly related that trustees have a duty to analyse and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other circumstances of the trusts they administer.

3. Trustees have a duty to avoid fees, transaction costs and other expenses that are not justified by needs and realistic objectives of the trust's investment program.

4. The fiduciary duty of impartiality requires a balancing of the elements of return between production of income and the protection of purchasing power.

5. Trustees may have a duty, as well as having the authority, to delegate, as prudent investors would.

If a prescriptive rule was to be introduced, a reasonable transition period should be allowed (perhaps up to five years).

In any event, there may need to be an exception for assets that are actually used to benefit DGRs (for example real estate leased or licensed to one or more of them). These assets should also be excluded from the calculation of any minimum distribution requirement.

6 Miscellaneous

In any event, we recommend that consideration be given to a further change to the rules governing PPFs:

- Upon the winding up of a PPF, it should be permissible to hand over all or some surplus assets to another ancillary fund. It should not be mandatory that all the surplus assets be given directly to DGRs.

14 January 2009

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