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trust

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Manager
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The Treasury
Langton Crescent
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Dear Sir,

Re: Trust Company Limited - Response to ATO Discussion Paper; Improving the Integrity of Prescribed Private Funds

We refer to the Treasury's initiative to improve the integrity of Prescribed Private Funds released on 26 November 2008.

Trust Company provides the following comments to the consultation questions.

What is the appropriate minimum distribution rate? Why?

We believe the minimum distribution each year should be all the income (less that necessary to maintain the real value of the fund by CPI, commission etc) or the 5 percent of the capital.

We understand that (i) the proposed minimum distribution of 15 per cent of the value of the fund would preclude the present arrangement of maintaining the real value by an augmentation of the capital from income equal to the CPI and (ii) capital and income would together constitute the value of the fund at any time. As a result, the trustee would be required to distribute in any year not only all the income but also part of the capital. The consequence would be that in the absence of augmentation of the capital, the value of the fund would be progressively eroded.

We acknowledge that the current arrangements concerning accumulation plans are complex, not readily understood and may be unnecessarily difficult for a trustee to administer properly.

We submit:

- there is a distinction between a trustee maintaining the real value of a fund and it being a "prolonged accumulator of funds";
- if not expended, augmentations to capital are a charitable endowment, that earns income in perpetuity for charitable application; the larger the capital the greater the income available for the charitable trust purpose;

- if it is a requirement that a percentage of the value of a fund must be distributed, unless a fund attracts each year sufficient capital augmentations to maintain its original value, the capital of a trust, will be progressively eroded. For example if income is 5 per cent and the Trustee is required to distribute 15 per cent of the value of the fund, a fund of $1,000,000 that does not receive any augmentation to the capital will decline, in successive years to approximately $900,00, $810,000, $731,000, $658,000, and in the fifth year be reduced to $493,000. If the income is also required to be distributed, capital will deplete at a faster rate.

- requiring a trustee to distribute 15 per cent of the value of the fund is unreasonably high.
  [See comment at end of this submission.]

Should the Commissioner have the ability to modify the minimum amount according to market conditions (for example, based on average fund earnings)?

We submit:

- if the trustee of a PPF is required to distribute each year a prescribed percentage of the value of the fund at the commencement of that year, this percentage should be constant;

- recognising that fund income invariably will vary from year to year, if the percentage of the fund that the trustee is required to distribute was calculated each year on fund earnings, the administration and monitoring would be rendered unnecessarily complicated and impractical.

Should a lower distribution rate apply for a period (for example 1-2 years) to allow newly established PPFs to build their corpus?

We submit:

- allowing a trustee to distribute only a lower level of income would enable the value of a fund to grow by accretion of income and increased value of investments (where that is the case);

- notwithstanding the above, it is important that anyone considering establishing a PPF should be required to ensure that the sum to be settled is adequate and not rely on unrealistic expectation of corpus growth over such limited period as may be accorded a preferential rate of distribution;

- if the settled sum is not such as will provide a viable fund the Founder should consider alternative charitable options.

Are there any issues that the Government needs to consider in implementing the requirement to ensure PPFs regularly value their assets at market rates?

We submit:

- the ATO should:
  - (i) provide guidelines for fund valuation; and
  - (ii) include in the PPF report a section for the trustees to certify that the annual valuation is correct.

Is setting a minimum PPF size appropriate?

We believe that prescribing a minimum PPF fund value is inappropriate.
We submit:

- it is our experience that although many founders of PPFs establish the fund with a relatively small sum with the intention of substantially augmenting the initial fund by a bequest. They do this because they want to establish a fund in their lifetime that has received DGR endorsement, and have an active involvement in its administration. Equally importantly, the subsequent bequest is transferred to the PPF free of Capital Gains Tax. The availability of this CGT exemption for a bequest to a PPF may result in an amount being provided for charitable purposes substantially larger than would be the case if subject to CGT.

- if with a relatively small founding capital, 15 per cent of the fund value must be distributed every year and there is a minimum fund value at which the entire capital must be distributed, such funds will be extinguished before the bequest is received;

- a founder in these circumstances should indicate the approximate size of the testamentary augmentation; if this does not eventuate, the fund would be subject to any requirements that may be introduced concerning the allowable value of a PPF; and

- consequently the charitable benefit should be assessed with regard, not to the value of the fund when established, but the value it will have on the death of the Founder.

What should the minimum PPF size be in dollar terms?

We believe there should be a minimum fund value, for example $100,000.

We submit:

- if a trustee is required to distribute a percentage of the capital value of the fund annually, it is inappropriate to allow a founder to establish a PPF with a capital that, unless further donations are made, in a relatively short period will cease to be a sustainable fund;

- any minimum value should be subject to review and, when thought appropriate, increased for new PPFs.

Should a fund have to distribute all its capital when its total value falls below this minimum amount?

We acknowledge that, since the costs of administering a PPF are not necessarily proportionate to the size of the fund, it is undesirable that a fund for charitable purposes should be depleted by unduly large administration costs relative to the value of the fund.

We submit:

- if (i) a fund is less than such minimum value as may be introduced and (ii) the Trustee wishes the fund to continue as a PPF, the onus should be on the Trustee to take steps to increase the value;

- if a Trustee is required to distribute the capital to extinction, it should be allowed a period, eg two years, in which to do this.

Are there any relevant issues that need to be considered in improving and standardising the public accountability of PPFs?

We agree that a PPF should be required to have an ABN, and the Australian Business Register, for public information, state it is a PPF.

Are there any concerns with the proposal to require that the contact details of PPFs be provided to the public? What information should be provided publicly?

Some PPFs exist because the founders wants to benefit particular charitable fields, themselves decide the charities to benefit, and do not want to receive applications from charities that require processing, acknowledgment etc.

We submit:

- since income tax exemptions are given to provide a public benefit; if a PPF supports a particular charitable interest, charities within that should not be precluded from applying (indeed it would be impossible to prevent them doing so).

Will two years be a long enough period for existing PPFs to comply fully with the new guidelines?

We are unable to identify any sustainable reason why a longer period would be necessary.

Are there any cost or other concerns relating to the corporate trustee proposal?

There would be if the trustees were to establish a company especially for this purpose. But that is the concern of the trustees (and such cost should not be a charge against the PPF) who might readily satisfy such requirement (and avoid unnecessary cost) by appointing a Trustee Company.

We submit:

- The term "corporate trustee" should be defined since a "corporate trustee" per se may not guarantee a trustee with the necessary knowledge and experience;

- that since 84 out of a PPF sample of 129 already have a corporate trustee this indicates that the arrangement would be a practical and satisfactory requirement.

Are there any privacy concerns that the Government needs to consider?

The division between trusts being governed by State legislation with regard to charitable status and by the Federal Government with regard to matters of taxation is inherently unsatisfactory.

We submit:

- it is surely contrary to PPF transparency and accountability that the ATO could be thwarted in making enquiries about abuse of a PPF because of State legislation;

- the ATO should ensure that it has all the powers it might need to pursue its legitimate investigations otherwise it may be reluctant or unable to do so.

Are there any concerns over particular penalty types?

We submit:

- an "all or nothing" approach is not satisfactory especially if, in some circumstances, it dissuades the ATO from taking action where there has been a violation; penalties should address the particular failure with an appropriate penalty;

- the ATO should be empowered to impose any penalty it considers appropriate – if Trustees do not like some forms of penalty they readily may avoid them by avoiding the behavior that attracts the penalty.

If a fit and proper person test were introduced, what criteria should be imposed on trustees?

We recognise that demonstrably sincerity and good intentions do not necessarily mean the relevant knowledge and experience necessary to avoid errors and it is necessary that some of the Trustees should have these attributes in sufficient measure to ensure compliance.

We submit:

- it might reasonably be required that a majority of trustees should satisfy the definition of persons with a degree of responsibility to the community required for members of a Public Fund Committee. However, if this standard was required of *all* Trustees, an Founder who wishes to establish a PPF and be a Trustee may not satisfy such a condition and, consequently, be deterred from doing so if thereby they were to be denied an active role;

- a Trustee company should be recognised as having the necessary knowledge and experience in administering trust funds to qualify as "a fit and proper person" for trustee of a PPF and to guarantee the integrity of its administration;

- that section 7 of the PPF Model Trust Deed be amended to provide that:
  (i) the Trustee be required to be a Trustee Company *or* a Responsible Person as currently defined; and
  (ii) where a Trustee Company is Trustee, if at any time it ceases to be the Trustee, the other requirements of the section must be satisfied.

Are there any other provisions presently in the Model Trust Deed that should be covered in the updated Guidelines?

We submit:

- if auditing requirements (11.3 in the Model Trust Deed) are to be legislated, it might be appropriate to similarly treat the Trustee's requirement to keep accounts (11.1) and financial statements (11.2)

Are there any provisions not in the Deed that should be in the updated Guidelines?

Since many of the abuses of PPFs income are associated with founders perverting the charitable purpose of income tax exemption to benefit, in one way or another, family members we believe that the ATO should more actively address this issue. The rules for self managed superannuation funds forbids any trustee fees or other benefits to be paid to members of the fund.

We submit:

- that rules similar to those applicable to self managed superannuation fund be prescribed with regard to the trustees of a PPF, forbidding any wage, salary or other benefit to family members and such term defined;
- there should be substantial penalties (cancellation of DGR and TCC endorsements) for violations of such rules;
- it would be appropriate to include in the Guidelines any new requirements (eg how any prescribed percentage of the fund to be distributed is to be determined, how when the number of donors exceeds any prescribed number the PPF informs the ATO that it has ceased to be a PPF and is a Public Fund, the steps necessary to convert such a PPF to a public Fund.

Would there be any disadvantage if a cap were introduced on the number of donors to a PPF (for example, a maximum of 20 donors over the life of the fund)?

We acknowledge that having a maximum number of allowable donors emphasises the important distinction been a PPF and a Public Fund. However, if a requirement that a prescribed percentage of the value of the fund must be distributed each year in introduced, a PPF would have to receive capital augmentations to prevent it being depleted.

We submit:

- any limitation of donors should relate to a period of time; eg the donors not to exceed twenty over a period of twenty years.
  [See comment at end of this submission.]

Is conversion from PPF to PAF an acceptable mechanism to deal with changing PPF circumstances?

We submit:

- *subject to the above,* if PPF trustees know that to preserve a fund as a PPF, there cannot be more than a prescribed number of donors, they know that they either must ensure the number does not exceed the maximum allowed, or become a public fund. If the trustees wish to preserve the fund as a PPF they know what they must do in this regard.

What rules could be used to deal with the conversion from PPF to PAF?

We submit:

- if there is to be a maximum allowable number of donors, the trustees must be required to report each year the number of donors to the fund *to date*, not just in that particular year;

- there should be a duty imposed on the trustees to inform the ATO when the number of donors has exceeded the prescribed allowable number and the fund ceases to qualify as a PPF;

- the ATO should provide guidelines of the procedure a trustee will be required to follow eg executing a PAF Deed to satisfy PAF requirements, eg a committee with a majority of members have a degree of responsibility to the community instead of a Responsible Person.

Would there be any disadvantages from introducing the limitation of investment only in liquid assets to the existing PPF investment rules.

Having regard to the charitable purpose of a PPF we acknowledge the desirability of the fund comprising liquid assets.

We submit:

- having regard to the purpose of a PPF, requiring that it must convert illiquid assets to liquid assets is reasonable and makes it much easier to unequivocally determine the value of the fund's assets at any time;

- a disadvantage to the trust may be that, after receiving an illiquid donation, a donor would not want the PPF to convert it to liquid assets - but if that is the case the donor should not be giving the donation in that form to the fund. The donor who does not want an illiquid gift converted, cannot expect it to be applied to any charitable purpose.

Additional submission

We acknowledge that the ATO Discussion Paper focuses on improving the integrity of PPFs, and is not directly concerned with the fees that the trustee of a PPF may receive. However we believe that, in the context of the Paper, we may validly include a submission that addresses the remuneration of such trustees. It is our experience that being trustee of PPFs often necessitates substantial time and resources, not only to establish the fund itself but also for its continuing administration, and providing support and guidance to the founder. These are significantly beyond the core trustee services generally provided by a Trustee Company and, in relation to which, the statutory remuneration is predicated.

While a PPF may be established in any of the States or Territories of the Commonwealth, both the structure, nomenclature and level of fees varies, as prescribed in the relevant Trustee Companies Act.

We submit:

- in some States, such as New South Wales, the maximum statutory fee allowed to a Trustee Company is often insufficient adequately to compensate it for the work it must perform;

- in Victoria a Trustee Company may charge a maximum of 1.056 per cent of capital for the administration of a perpetual trust (section 21A(1) but, if it does so, it must not charge the commission otherwise provided (section 21(1)) in the Trustee Company Act (Vic);

- if the proposed changes are effected, PPFs cannot be represented as perpetual trusts but only as charitable trusts of indeterminate duration and with a high probability that their capital will be expended and the Trust extinguished in a relatively short period; and in these changed circumstances, where the PPF is established in Victoria, a Trustee Company will cease to be entitled to the remuneration prescribed for a perpetual trust but only, in the alternative, to the income commission which would provide insufficient remuneration for the word performed;

- in those States where the remuneration is inadequate, there is an inescapable disincentive to Trustee Companies to continue to promote, establish and administer PPFs.

COMMENT

It is proposed that PPF be renamed Private Ancillary Fund. For most people, the meaning of "ancillary" in Private Ancillary Fund and Public Ancillary Fund is not apparent. Unless the word has some immediate and readily understandable meaning, the value of including it in the name of these funds is not evident.

Our understanding of the intention of the proposed changes is to ensure that, effectively, PPFs will cease to be perpetual funds.

Without regular augmentations of capital, a fund will be eroded relatively quickly. Even if founders are able, and willing, to make such necessary augmentations in their lifetime, it is not to be expected that other parties will continue to make such donations after a founder dies and then when a fund is below any prescribed minimum value, it must be distributed and the PPF cease to exist.

A requirement that donors to a PPF must not exceed a prescribed number during its lifetime, tends to the same end and, combined with the above, will ensure that PPFs are no longer perpetual charitable funds.

It is the perpetual nature of a PPF that has been a significant attraction for founders; when this disappears we expect that significantly fewer will wish to

establish such a fund. Denied the opportunity of a perpetual charitable endowment inter vivos, we believe that they either will save the costs of executing a Deed and distribute directly to charities such sums as they may feel inclined, or direct their executors to establish a testamentary charitable trust.

Notwithstanding that matters of income tax exemption and the conditions that govern PPFs are the sole determination of the Commonwealth Government and matters of statutory Trustee remuneration the prerogative of individual State Governments, it is neither consistent nor desirable that PPFs are subject to differing charges, those applicable depending on the State in which the PPF was established, and in some States providing inadequate remuneration to the Trustee.

We trust this commentary is of assistance to the Treasury.

We would be happy to discuss any aspect of the foregoing.

Yours faithfully

Clare Stanford
Head of Philanthropy