PAFs BY MICHAEL NORBURY AND PHIL HAYES-ST CLAIR, MADGWICKS AND HSC & COMPANY

Engaging clients in philanthropy and the PAF

PRIVATE ANCILLARY FUNDS PERMIT PHILANTHROPISTS TO ENGAGE WITH CHARITIES IN A TAX EFFECTIVE MANNER AND WITH OTHER POSITIVE BENEFITS.

Philanthropy in Australia began to take a different form in 2001 with the introduction of the Prescribed Private Fund (**PPF**). At that time, there was a concern that the level of philanthrophy in Australia was low compared with the levels in other countries in the developed world. PPFs were designed to encourage individuals and families to contribute capital to specific non-profit organisations with the longer term view of increasing the pool of funds available in Australia for philanthropy.

PPFs proved popular. At the end of the 2008 financial year 769 PPFs had been approved with a combined $1.89 billion funds under management.[1] Key features of PPFs included:

- Tax deductions for donations
- Exemption from ongoing income tax
- No public fundraising requirement.

With PPFs fast becoming the popular choice for people wishing to participate in private philanthropy and with reports of a small number of trustees breaching the PPF guidelines, the Rudd government launched a review in late 2008 called "Improving the Integrity of Prescribed Private Funds". This review resulted in an unprecedented response by philanthropists and the consequent replacement of the PPF with the Private Ancillary Fund (**PAF**).

Philanthropy is a growth industry. This is important and relevant to accountants and lawyers for three reasons:

1. First, discussing and helping clients engage in philanthropy will almost certainly deepen the client relationship. This is largely because philanthropy tends not to be a tactical pursuit. It requires a longer-term perspective that combines a client's personal passion with their financial and legal affairs.
2. The second reason is that unlike investment managers (who play an important yet downstream role in growing the corpus of funds), accountants and lawyers usually have a more intimate understanding of client circumstances. This, combined with the understanding of legal and accounting frameworks and existing processes necessary to engage key institutions such as the Australian Taxation Office (**ATO**), means they are able to help clients realise financial benefits of engaging with philanthropy sooner.
3. Finally, accountants and lawyers can provide ongoing support to clients in translating and maintaining the fiduciary responsibilities of, in particular, PAFs.

In describing the PAF vehicle in more detail it is important to acknowledge that the PAF is one of a suite of options available to people wishing to engage in private philanthropy.

THE ANATOMY OF THE PRIVATE ANCILLARY FUND

The PAF is a philanthropic trust structure that replaces the PPF.

Although the primary thrust of the PAF is similar to the PPF (in terms of promoting private philanthropy and delivering public benefit) the major changes for PAFs include the following:

1. Trustees must be corporations (existing individual trustees of PPFs can continue).

   This means that:

   - Trustees must be either a company (a "vanilla" proprietary company is acceptable), an incorporated association or a statutory trustee company (the majority of existing PPFs – now PAFs – were established with a trustee company in place).
   - Each PAF must have one individual director who has a responsibility to the community – a "responsible person". This person cannot be the founder, a donor of more than $10,000, family member or an associate of the founder.[2] The other directors can be family members or business associates of the founder.
2. The Accumulation Plan is replaced by a 5% minimum distribution requirement.

   This means that PAFs must distribute to eligible organizations[3] at least 5% of the net capital value of the fund at 30 June during the following financial year (with a minimum annual distribution of $11,000, unless expenses of the fund are being met from outside the fund).
3. PAFs must have a formal investment policy.

   This means that:

   - Each PAF must have a documented investment strategy that includes the objectives of the PAF and the investment of fund assets to protect and grow the real value of the fund.
   - Directors can take outside advice on investment matters, which can be paid for by the fund.
4. The annual audit must comply with the PAF Guidelines as well as the Financial Statements.

   This means that record keeping, accounts, reporting (ie including annual income tax returns and trustee company related ASIC reporting requirements) are maintained and audited **annually by a qualified** auditor.

5. The Commissioner of Taxation has increased powers to tighten the compliance regime including administrative penalties, sharing information about non-compliance with the relevant state Attorneys General and ultimately suspending or removing the trustee.

   More information about these penalties can be seen in the section below.

RECEPTION OF THE NEW PAF LEGISLATION

The attitude toward the new PAF legislation, which came into effect 1 October 2009, is positive amongst the Australian philanthropy community. This is largely due to the clarity it provides in the three key areas of administration, investment and distribution.

In addition:

1. A streamlining of PAF management by Government is occurring with all responsibilities being transferred to the ATO instead of being split between the ATO and Treasury.
2. The ATO has issued a model trust deed for PAFs as well as guidance to support new PAF establishment.[4]
3. Frequently asked questions are due for release in late April 2010.
4. The domestic peak body, Philanthropy Australia recently issued a plain language PAF Trustee Handbook that goes into more detail about the PAF (available for down load and free of charge from their website – www.philanthropy.org.au).

NEW GUIDELINES EXTENDS TO NEW GOVERNANCE

The focus on overall governance has also extended to the introduction of administrative penalties (and broader powers held by the ATO) to ensure PAFs remain true to their mission.

These penalties, which can be avoided by implementing sound yet not all-consuming governance, indicate that the ATO is focused on ensuring the benefactors and beneficiaries of PAFs are being treated in a fair and consistent manner.

Current penalties payable by the trustees or the directors (and not by the PAF itself) are $110 per penalty unit and include:[5]

Issue	Guideline	Penalty
Failure to distribute 5% of capital	Clause 19	30 units*
Breach of investment limitations (incl related party transactions, pledging and borrowing)	Clauses 33 – 38	30 units
Un-commercial transactions	Clause 41	30 units
Soliciting donations from public	Clause 45	30 units

** If shortfall in distribution is greater than $1000*

TRANSITIONING FROM A PPF TO A NEW PAF

As a result of the new PAF Guidelines which came into effect from 1 October 2009 the minimum distribution for the 2009-10 financial year will be 5% of the 20 June 2009 valuation. Where existing PPF deeds comply with the new PAF Guidelines, the PPF can pass a resolution to “opt in” immediately.

Philanthropy Australia’s PAF Trustee Handbook outlines other (non exhaustive) transition arrangements (see below):

SUPPORTING CLIENTS WITH AN INTEREST IN PHILANTHROPY

Supporting clients on a philanthropy journey is an important and mutually rewarding way to engage with clients. The journey begins with identifying clients who are likely to embrace private philanthropy. It then continues with actioning and fulfilling client requests through a deeper understanding of their existing affairs and social aspirations.

Both of these steps *can* be challenging yet manageable.

PPF TRANSITION ARRANGEMENTS

Administration

Where the governing rules of the PPF as at 25 June 2009 prevent compliance with the Guidelines the fund is exempt and has until 1 October 2012 to change the rules to comply. However the trustee must comply with the Guidelines as far as possible without breaching the rules.

A PPF with individual trustees can continue as a PAF without changing trustees. One of these must be a “responsible person”, and while the Commissioner does not have powers to suspend or dismiss such individual trustees they must still comply with the Guidelines and the Commissioner has power to revoke DGR endorsement and pursue legal action should breaches occur.

Investments

Where a PPF holds investments that are prohibited by Clause 38 of the Guidelines (borrowings, asset pledged as security, collectables, non arms length investments) then the trustee has until 1 October 2010 to rectify.

Where a PAF has current borrowings as at 30 September 2009 these may be maintained but any change in terms requires the Commissioner’s approval.

Distribution

Funds can operate in accordance with an existing approved Accumulation Plan until the earliest of the plan expiring; meeting the target capital amount; 30 June 2014; or adopting for full transition into new Guidelines. During this transition period the fund must distribute:

- 5% of each gift received the previous year; and
- Trust income (rent, interest, normal dividends and franking) within the financial year, but an amount equal to the 30 June capital value of the fund multiplied by the CPI of the previous year may be retained.

Source: Philanthropy Australia PAF Trustee Handbook (pp 15)

IDENTIFYING CLIENTS

Consider reviewing your client base asking the following questions of each client:

i) Does the client have a self-managed super fund?

Clients maintaining SMSFs will have a functional understanding of this structure and the importance of fiduciary responsibility. Private Ancillary Funds share numerous similarities with SMSFs. Reducing a barrier to engagement – familiarity of structure – increases likelihood of participation in private philanthropy.

ii) Does the client currently donate in an adhoc way or has donated consistently over the last five years?

A history of donating demonstrates a clear preparedness to engage with social issues.

iii) Has the client experienced (or about to experience) a liquidity event?

A liquidity event often inspires a client to consider how to "give back" whilst also managing the taxation implications of the liquidity event.

iv) Has the client been exposed to a life changing event in the recent past (eg a medical or family issue)

This can often shift the perspective of the client and their family.

v) Does the client have a substantial taxation liability forecast for this year or the following years?

Taxation incentives are a key financial motivator for engaging in philanthropy. A forecast of current or future year taxation liability (and how it may be reduced by philanthropy-related incentives) helps clients realise one benefit of philanthropy.

vi) Does the client maintain provisions in an estate for a charitable foundation?

Provisions in estates that allow for a charitable trust or foundation to be established signals a strong intent which can be brought forward so that the client can enjoy the benefits of their contribution.

These questions are often key trigger points for an individual or family to engage and participate in private philanthropy.

THE PROCESS

The advantage of a PAF to clients needs to be considered on a client by client basis. The following case study illustrates the financial advantages of establishing a PAF. However, the advantages are not merely financial. People who have establish PAFs report greater engagement with family members. In addition a PAF introduces the opportunity to collaborate with other philanthropists to create larger scale social impact in specific fields of interest.

The following steps are involved in engaging clients in private philanthropy:

1. Identify the trigger for clients to become engaged in private philanthropy (noted above)
2. Understand the clients' social focus and the resources they are willing to commit initially and over time
3. Determine and establish the appropriate structure to facilitate the benefits of private philanthropy
4. Establish the (ongoing) framework needed to ensure fiduciary responsibilities are met

CASE STUDY

Katherine recently sold some investment properties for a $1,000,000 profit. The properties were regarded as trading stock. Katherine is already on the highest marginal tax rate of 46.5% including Medicare levy. This means the tax payable would be $465,000. She may choose to pay this tax and invest the remaining $535,000 personally.

Katherine is a very strong supporter of disadvantaged children. She constantly donates $20,600 per annum to related charities. Currently age 51, her adviser points out that she would have effectively given $1 million in today's dollars (discounted at the inflation rate of 3%) from now until age 100. The accumulated tax savings over the next 50 years from these donations would be valued at $465,000 in today's dollars.

As an alternative, Katherine's adviser suggests that she establishes a PAF and donate $1 million today. The effect of this is as follows:

- She gets a $1 million tax deduction for the donation. This will offset her $1 million assessable income and therefore save her $465,000 in tax this year
- She donates upfront the $1 million that she intends to donate over her lifetime; and
- The donation goes into a tax-exempt environment and she can donate the income generated from this $1 million to the charities of her choice which have Deductible Gift Recipient status.

Her adviser cautions that this is only appropriate if she is committed to gifting $1 million now and has sufficient funds elsewhere to meet her expenditure needs.

By doing so, Katherine's adviser concludes that her PAF can effectively donate on average $75,000 p.a. in real terms compared with $20,600 pa.[6] This means she can give more than three times the amount over her lifetime to causes that are important to her.

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References

Charities and Deductible Gifts Fact Sheet (ATO Taxation Statistics 2007/08) Website reference: http://www.ato.gov.au/corporate/content.asp?doc=/content/00225078.htm&page=45&H45.

PAF Trustee Handbook (2009), Philanthropy Australia, Melbourne.

Australian Taxation Office (2010). Private Ancillary Fund reference site Website reference: http://www.ato.gov.au/nonprofit/content.asp?doc=/content/00215720.htm&page=4&H4.

Reference notes

1. *Charities and Deductible Gifts Fact Sheet (ATO Taxation Statistics 2007/08)*
2. *Philanthropy Australia PAF Trustee Handbook (pp 5).*
3. *These include not for profit organisations with Deductible Gift Recipient status (DGR).*
4. *Refer to ATO website: http://www.ato.gov.au/nonprofit/content.asp?doc=/content/00215720.htm&page=4&H4.*
5. *Extract from Philanthropy Australia PAF Trustee Handbook pp 16.*
6. *Investment return of 4% income (re-invested after donation & tax) and 5% growth.*