

# Freehills

## INTRODUCTION TO PRESCRIBED PRIVATE FUNDS<sup>1</sup>

### Overview

- 1 A prescribed private fund (**PPF**) is a fund established by a trust instrument with:
  - deductible gift recipient (**DGR**) status (so that, among other things, gifts to it are tax deductible to the donor);
  - income tax exempt charity (**ITEC**) status (so that, among other things, its income is exempt from income tax); and
  - the ability to attract a variety of other Commonwealth, State and Territory tax and duty concessions.
- 2 There is no need for gifts to a PPF to be sought and received from the public and a PPF can be controlled by an individual, family or corporate group.
- 3 The term "prescribed private fund" is defined in the tax legislation as being a fund prescribed by the regulations for the purposes of the definition.

Accordingly, as the Government makes regulations (subject to a right of either House of Parliament to disallow a regulation), the Government has a broad discretion to implement and amend its policy with regard to the attributes of prescribed private funds.
- 4 They are normally very easy to establish. The ATO has released a model trust deed and guidelines on its website.

### History of PPFs

- 5 The proposal to permit the creation of PPFs was announced by the Government in March 1999. The most recent guidelines and model deed were released in May 2004.

As at May 2004, about 155 PPFs had been approved by the Government.

### Purpose of PPFs

- 6 The **sole** purpose of a PPF must be to provide money, property or benefits to funds, authorities or institutions, gifts to which are deductible gift recipients (**DGRs**). These include public benevolent institutions, health promotion charities, overseas aid funds, organisations on the register of cultural organisations, and organisations on the register of environmental organisations. A PPF can not have other purposes.
- 7 The trust instrument can permit grants to be made to all DGRs or, if desired, the instrument can name specific DGRs or specific types of DGRs.

### *Examples of extrinsic purposes*

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<sup>1</sup> This paper takes into account the revised guidelines and model deed released by the ATO in May 2004. The paper is very general in nature and is only an introduction to PPFs. It does not provide a comprehensive outline of the relevant principles and should not be relied upon without specific professional advice.

- 8 Extrinsic purposes would exist if a PPF were established to, say, collect and exhibit artefacts or awarded scholarships to university students or carried out scientific research.
- 9 While there does not appear to be a difficulty in PPFs making grants to DGRs on condition they are used by the recipient for a particular program or purpose, the PPF must not itself carry on that program or purpose.
- 10 It is, of course, quite appropriate for a PPF to carry on activities for the purposes of assessing appropriate DGRs to receive grants and these activities may well involve an ongoing relationship with DGRs. However, this investigation and relationship must be directly related to the grant making purposes of a PPF, not to enable it to carry out its own programs etc.
- 11 If a PPF employed a person as its executive officer whose salary absorbed a disproportionate part of the income of the trust, it may be open to conclude that the trust was not being maintained exclusively for the purpose of providing benefits to DGRs.
- 12 Paragraphs 35 to 37 of Taxation Ruling TR 95/27 provide some examples of appropriate benefits that can be provided to DGRs.

"35. A benefit arises where some discernible advantage has been bestowed on a specified institution. It may take the form of some tangible addition to, or the removal of some detriment from, the conduct of the particular institution.

36. The creation and maintenance of a holiday camp exclusively for children in orphanages would represent [an appropriate] benefit to the orphanages .... So also, the creation of a scholarship scheme where, for example, a university generally controlled the terms and award of the scholarship would be a benefit to the university. On the other hand, if an ancillary fund awarded and generally controlled the scholarship and its only connection with the university was that it was tenable there, there would not be [an appropriate] benefit to the university - it would not add to the affairs and activities for which the university is responsible.

37. In the first two examples in paragraph 36 above the fund is providing benefits directly to a qualifying fund or organisation. (The orphanage and university it is assumed are qualifying [DGRs].) In the third example, however, the ancillary fund is providing the benefit or advantage to the students. The scholarship is not providing a direct benefit to the university. "

### **Excluded DGRs**

- 13 A PPF can not make grants to ancillary funds (a common structure for community foundations), other PPFs, political parties, or Artbank.
- 14 Further, it is normally essential that in addition to the recipients being deductible gift recipient, they be income tax exempt charities. This is necessary so that the PPF can itself be an income tax exempt charity and receive cash refunds of franking credits.

### **Responsible person**

- 15 The trustee of the PPF must be:
- a Responsible Person;
  - two persons, at least one of whom is a Responsible Person; or
  - a body corporate whose board includes at least one Responsible Person.

It is not necessary for Responsible Persons to control the trustee. We normally recommend the trustee of the PPF be a proprietary limited company or company limited by guarantee, with the board of, say, three, including one Responsible Person.

16 The definition of "Responsible Person" in the model trust deed is as follows:

**"Responsible Person** means an individual who:

- (a) performs a significant public function;
- (b) is a member of a professional body having a code of ethics or rules of conduct;
- (c) is officially charged with spiritual functions by a religious institution;
- (d) is a director of a company whose shares are listed on the Australian Stock Exchange;
- (e) has received formal recognition from government for services to the community; or
- (f) is approved as a Responsible Person by the Commissioner, and

who, unless the Commissioner otherwise agrees, is not:

- (1) the Founder or a Donor;
- (2) an employee of the Founder, the Trustee or a Major Donor;
- (3) an Associate of the Founder, the Trustee or of a Major Donor or of the directors or members of the board or other controlling committee of the Trustee other than:
  - (A) in a professional capacity;
  - (B) as a member of the board or other controlling committee of the Trustee; or
  - (C) as a member of the Trustee."

Words commencing with an uppercase letter have the meanings defined in the model deed.

17 The person is not prohibited from being a Responsible Person simply because he or she is an acquaintance of the founder or donor.

18 The role of the Responsible Person is to monitor the administration of the PPF to ensure it is complying with the terms of the trust instrument, the particular version of the ATO guidelines applicable to it, and any special arrangements made with the ATO (such as a gift accumulation plan). The ATO does not expect Responsible Persons to conduct quasi audits of the PPF or be "whistle blowers". But they should give particular attention to compliance issues<sup>2</sup> and insist on a high level of integrity in the administration of the PPF. Where issues arise, the Responsible Person should ensure that proper professional advice is obtained and acted upon.

## Uncommercial transactions

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<sup>2</sup> See paragraphs 34 and 35 below

- 19 The PPF may not provide a direct or indirect benefit to the founder, the trustee, a donor or their associates by way of an Uncommercial Transaction. In broad terms, this prevents the provision of a financial or other benefit on terms which would not be reasonable in the circumstances if a benefit were provided on an arm's length basis and which a reasonable person in the position of the trustee would not have entered into having regard to all relevant circumstances.

### **Investments by PPFs**

- 20 PPFs may invest only in ways that a law of the Commonwealth, a State or Territory allows trustees to invest trust money.
- 21 In turn, the Trustee Acts and Trusts Acts of the States and Territories require trustees to exercise a power of investment with, at a minimum, the care, diligence and skill that a prudent person would exercise in managing the affairs of other persons. At least once in every year, a trustee must review the performance (individually and as a whole) of the investments of the trust.
- 22 In making an investment, a trustee must have regard to a number of matters including the desirability of diversifying trust investments. It seems that this requirement would often prevent a PPF investing in a single investment such as shares in a particular company or a single income producing building. Similarly, where a single asset is given to a PPF, this requirement would often prevent it retaining that asset for an inappropriate period. It is suggested that specific financial advice be obtained in relation to this requirement where a single or undiversified holding is proposed.

### **Accumulation of gifts**

- 23 The guidelines outline the Government policy with regard to accumulation of gifts by PPFs.
- 24 While the guidelines state that the initial settled sum can be retained indefinitely, this is unlikely to be of much practical benefit as the initial settled sums are normally a nominal amount - they are not deductible to the donor as at the time the trust is established, the PPF is not approved as a DGR.
- 25 All other accumulations of gifts must be approved by the ATO. The ATO recognises the desirability of establishing a significant capital base and attachment C to the guidelines outlines four types of accumulation plans that have been approved by the ATO.

Example 3 – The Green Foundation, illustrates an acceptable basis for obtaining ATO approval to accumulate a capital base of \$40 million .

- 26 Where ongoing gifts are proposed, the ATO typically requires there to be some distribution of each gift, normally in the year following the date of the gift. The normal requirement is a minimum of 5% or 10% distribution of the amount of the gift on a one-off basis.

For example, if a donor gives, say, \$100,000 to a PPF in a year, not less than \$5,000 must be distributed by the PPF by way of grant to DGRs on a one-off basis in the following year. The balance of \$95,000 can be retained indefinitely by the PPF.

### **Accumulation of income**

- 27 Generally, the income derived by a PPF in a particular year may be accumulated only to the extent necessary to maintain the real value of the capital of the PPF at the end of the previous year<sup>3</sup>. The balance must be distributed to DGRs.

### Accumulation of capital gains

- 28 These are covered in paragraphs 29 to 32 of the guidelines.
- 29 Realised capital gains do not need to be distributed by the PPF provided the approved capital base (including adjustments for CPI movements) has not been reached.
- 30 After the approved capital base as so adjusted has been reached, then:
- (a) income from earnings of investments could be accumulated to the extent necessary to maintain the real value of the capital of the PPF at the end of the previous year and the balance distributed; and
  - (b) to the extent realised capital gains exceeded the adjusted capital base, they would need to be distributed.
- 31 Unrealised capital gains also can be disregarded until the approved capital base as adjusted has been reached.

"[Once the] approved capital base has been reached the trustee must continue to monitor the fund's investments. If the capital base continues to appreciate beyond the approved level, adjusted each year in accordance with the CPI formula, then the trustee must give consideration to selling that portion of the current capital base which exceeds the approved capital base and distributing the proceeds as income ....

As a guide, if unrealised gains in excess of the approved capital base, adjusted each year in accordance with the CPI formula, have occurred over any two consecutive financial years the excess should be sold and the proceeds distributed ....

Alternatively, the trustee may consider applying to the Commissioner to increase the approved capital base of the fund... Such an application must include sound fiduciary reasons as to why the capital base should be increased. Long term or unfettered accrual of capital gains within a PPF would be construed as being contrary to the fund's sole intended philanthropic purpose."<sup>4</sup>

### Other requirements

- 32 A PPF may not carry on a business - this does not prevent limited dealings with share investments.
- 33 While a PPF may solicit and receive gifts from the public<sup>5</sup>, gifts from the public can not be the primary source of gifts to it.

### ATO compliance requirements

<sup>3</sup> See clause 4.4(a)(1) of the model deed

<sup>4</sup> Paragraphs 30 to 32 of the guidelines

<sup>5</sup> Note the possible requirement to register under the fundraising appeals legislation of each state and territory other than Northern Territory

- 34 An annual information return must be lodged for each financial year, normally by the end of the following February. The form of the 2003 return and instructions for its completion can be found at the website.
- 35 The PPF may also be asked to respond to specific requests for information. The annexure to this paper outlines the terms of a letter from the ATO issued to certain PPFs in July 2003.

### **Administrative processes**

- 36 The approval of a PPF is made by the Minister for Revenue and Assistant-Treasurer, not the ATO. However, the ATO is the appropriate recipient of applications for approval and after assessing them, recommends approval to the Minister.

### **When are PPFs useful?**

- 37 It is suggested that before establishing a PPF, consideration be given to simpler options. These include:
- (a) making direct gifts to DGRs;
  - (b) making direct gifts to ancillary funds; and
  - (c) where gift deductibility is not needed, establishing a private charitable trust, .
- 38 Arguably, the making of direct gifts to the DGRs you wish to support is of as much benefit as establishing your own PPF. For example, is it more advantageous for a welfare agency to receive, say, a gift of \$100,000 now, or for the \$100,000 to be given to a PPF so that it can, hopefully efficiently and profitably, invest the \$100,000 for the future benefit of the particular welfare agency?
- 39 There are a number of ancillary funds that receive gifts from the public and take into account the wishes of donors when making grants to DGRs. Some of these have "sub-fund" capabilities so as to enable them to maintain a management account in the name of a particular donor. While these ancillary funds have some administrative costs which must be met before grants are made to DGRs and are not subject to the control of the donor, they can be a cost effective way of benefiting DGRs.
- 40 It is also possible for a individual, family or corporate to establish and control a private charitable trust. These trusts are not subject to the restrictions contained in the PPF guidelines with regard to, say, the appointment of a Responsible Person and an auditor. They are normally entitled to be endorsed as income tax exempt charities and in consequence, their income is exempt from tax and they are entitled to receive cash refunds of franking credits. They are also entitled to the other Commonwealth and State and Territory tax concessions attributable to charities. They are, however, not DGRs and cannot receive tax deductible gifts.
- 41 This having been said, a PPF can well be the appropriate structure where it is desired to establish a perpetual trust controlled by an individual, family or corporate group with DGR and income tax exempt charity status to:
- (a) accumulate and invest gifts in a tax free environment where franking credits are refundable in cash so as to create a capital base enabling, hopefully, the making of more effective grants to DGRs than simply making annual gifts;
  - (b) permit deductible gifts to be made in one year (perhaps in the year a large capital gain subject to tax has been made) and to have time to consider what DGRs should receive grants from the PPF in later years;

- (c) make conditional grants to DGRs (there is an issue as to the extent to which conditions can be attached to gifts from individuals or corporates to DGRs);
  - (d) perpetuate a family or other name;
  - (e) assist parents to instil in their children an ethos of philanthropy (by, for example, including adult children on the board of the trustee company or otherwise consulting them in the grant making processes); and
  - (f) create an entity to receive capital gains tax exempt testamentary gifts of property valued by the ATO at more than \$5,000.
- 42 Other considerations that should be taken into account before establishing a PPF are the costs and effort of administering the trustee company and the trust. These include bookkeeping, accounting and audit costs and the costs of lodging a short annual information return with the ATO<sup>6</sup>. In addition, there can be costs associated with obtaining investment advice and in paying fees to a professional trustee company if one acts as trustee of the PPF.
- 43 Regard should also be had to the duties and liabilities of directors of a company acting as trustee or attaching directly to individuals acting as trustees. Directors' and officers' insurance cover can well be appropriate where a company is the trustee. Finally, it should be recognised that a PPF and those controlling it have direct accountability to the ATO and to the Attorneys-General of the States and Territories.

#### **MORE INFORMATION**

44 The May 2004 ATO guidelines and model deed can be found at:

<http://www.ato.gov.au/content.asp?doc=/content/notforprofit/20926.htm>

**John Emerson**  
**Partner**

June 2004

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<sup>6</sup> See paragraph 34 above

## Annexure (paragraph 35)

### Terms of letter from the ATO to certain PPFs sent in July 2003

*"Dear Trustee*

#### **Prescribed Private Fund (PPF) Information Return 2002**

*As part of the Australian Taxation Office's (ATO) ongoing compliance activities, regular reviews are conducted of a variety of matters affecting the taxation liability of individuals and entities.*

*On this occasion all Prescribed Private Funds (PPF), for the year ended 30 June 2002, have been selected to participate in a review.*

*Please provide, within 28 days, the following information in respect of your PPF Information Return for the year ended 30 June 2002:*

- (1) copy of the audited report of the Prescribed Private Fund;*
- (2) copy of the bank statement/s or other investment records verifying the receipt into and retention of monies in the PPF;*
- (3) copies of the minutes of Trustee meetings;*
- (4) evidence of source of each donation of property, as listed in the Return, confirming the transfer of ownership to the PPF;*
- (5) where not already provided with the return, valuation certificates from the Australian Valuation Office (AVO) for any donations or gifts that were in the form of shares or other property;*
- (6) documentary evidence to support distributions to Deductible Gift Recipients (DGR's);*
- (7) evidence as to how the Fund decided which DGR(s) were to be supported (if not shown in the minutes of the Trustee meetings;*
- (8) where your Prescribed Private Fund had a negative balance as at 30 June 2002, an explanation as to why it was negative;*
- (9) where your fund has made a claim for expenses, documentary evidence to verify/explain the expenses – in the case of wages, a summary of the employee/s name, tax file number, total wages paid and position held will suffice;*
- (10) where loans have been made by the PPF, please outline the amount loaned, the repayment schedule, the interest rate applicable and the name and relationship to PPF, if any, of the recipient of the loan;*
- (11) what is the Fund's investment policy? Please provide examples of how you have followed this policy.*

*For the purpose of this review, documentary evidence may include:*

- receipts for donations or contributions;*
- valuations by 2 or more approved valuers for any donations of property under the Cultural Gifts Program or to a body of the National Trust;*
- valuation certificates from the Australian Valuation Office (AVO) for any donation of property valued at more than \$5000;*

*You are also asked to provide a brief comment about how you feel you are progressing toward the achievement of your accumulation plan."*