Private Ancillary Funds (PAF) Overview

Executive Summary

- Private Ancillary Funds (PAFs) are trust funds set up with a corporate trustee, designed to encourage private philanthropy by providing businesses, families and individuals with greater flexibility to start their own foundation.
- PAFs are Deductible Gift Recipients (DGR), meaning all gifts to a PAF are tax deductible.
- Income and realised capital gains received by a PAF are tax exempt.
- The Treasurer has issued legally enforceable guidelines setting minimum standards for the governance and conduct of a PAF and its trustee.
- The PAF structure gives trustees considerable control and flexibility to determine the PAF's philanthropic objectives, to adapt those objectives to changing needs, and within Australian Tax Office (ATO) guidelines, control the timing of distributions to DGRs.
- The PAF must have at least one independent trustee. The trustees have ongoing fiduciary responsibilities.
- Expert tax, legal and financial advice is typically required for the establishment and ongoing management of a PAF.
- PAFs can invest in a wide range of investments including cash, fixed interest securities, shares, derivatives and property.

- APW Partners specialises in assisting clients develop and manage their philanthropic strategies. We have established and continue to manage over 12 PAFs for our clients.

What is a PAF?

A PAF is essentially a private charitable trust under State law or Territory law established by trust deed or under a Will with a corporate trustee, DGR status and in most cases with income tax exempt charity status.

The donor has total control over the distribution of funds, although recipients must have DGR status. This covers approximately 19,000 charities in Australia.

Why establish a PAF?

We have outlined below some of the advantages and disadvantages of establishing a PAF.

Advantages

- All gifts to a PAF are tax deductible. This can be particularly useful in an income year where a large capital gain has been realised by the donor. Gifts to the PAF can be in the form of cash, shares or physical goods such as real estate.
- The income of a PAF is normally exempt from income tax (if the PAF seeks and received endorsement from the ATO as an Income Tax Exempt Charity (ITEC)), so the earnings and realised capital gains are tax-free.
- As an ITEC, the PAF will be entitled to cash refunds of franking credits it receives.
- PAFs are comparatively simple and inexpensive to establish compared to other structures. They operate in a similar manner to Self-Managed Superannuation Funds (SMSF).
- The trustees of the PAF can be an individual, family or corporate group. However, one of the trustees must be an independent party, known as the 'Responsible Person'. Please refer to Annexure A for a definition of Responsible Person.
- The PAF structure gives trustees considerable control and flexibility by enabling them to determine the PAF's philanthropic objectives, to adapt those objectives to meet changing needs, and within ATO guidelines, to control the timing of distributions to DGRs.

  The gifting strategy can be broad in purpose, or directed to specific organisations, projects, purposes and/or geographic locations.
- The trustees can control how the assets of the PAF are invested. However, donors are able to have as much or as little involvement in the PAF as they wish.
- PAFs can make invaluable contributions to social/community programs that are carried out by DGRs. PAFs can provide new opportunities for the community by funding DGRs to carry out projects and programs that would otherwise not happen. DGRs particularly

value longer term funding commitments, as they enable the DGR to have certainty of cashflow for projects.

- A PAF allows people to establish a philanthropic legacy in their own lifetime, and can thereby perpetuate the name of an individual or family. Most PAFs are set up to survive into perpetuity, but they can have a 'sunset clause' which limits the life (generally between 25 and 50 years). This is typically done when the donor believes that funding is more effective if expended in the shorter term.
- A PAF can provide a valuable tool for intergenerational bonding to assist parents foster in their children their own philanthropic values and financial responsibility. Even children under 18 can be involved by providing their views on particular causes, etc, and inviting them to visit projects.
- Donors can make their PAF a beneficiary of their estate.

Disadvantages

- PAFs must make decisions solely for the public benefit without regard to the commercial interests of the trust or trustees.
- PAFs cannot carry out their own programs – they must donate to charities or specific projects with DGR status. However as mentioned, this does cover approximately 19,000 charities in Australia alone. It is also possible to engage specialists to help establish specific projects for the PAF to support if such projects do not currently exist.
- Requires ATO endorsement as a tax concession charity and government gazettal as a DGR, and incurs legal, accounting, financial advice and audit fees in relation to its establishment and ongoing administration.
- PAFs cannot make grants to other PAFs, political parties or public ancillary funds.
- Trustees must ensure they maintain adequate records of their decision making, including issuing a receipt for every donation the PAF receives.

Who can establish a PAF?

A PAF is typically established by an individual, family, business or corporate group who:

- Are looking to establish a philanthropy program; or
- Already give to a charity; or
- Have a large tax event.

The PAF must have at least one independent person, known as a 'Responsible Person', act as a trustee, but the other trustees can be family or associates of the founder.

In practice, the family accountant, wealth adviser or solicitor commonly performs the Responsible Person role. However, members of any professional body having a code of ethics or rules of conduct also qualify as responsible persons.

How to establish a PAF?

Expert tax, legal and financial advice is typically required to establish a PAF. The ongoing timing and size of additional contributions should also be subject to financial advice.

A PAF's trust deed must contain specific provisions and be approved by the ATO. The approval process can take several months, so it is recommended that submissions for new PAFs be made to the ATO by 31 March each year to ensure establishment prior to 30 June. This timetable is of particular importance to donors who are establishing a PAF in the same year as a significant tax event.

Some of the documents that need to be prepared for a PAF include:

- Trust Deed
- Corporate Trustee Deed
- Accumulation & Investment Strategy (does not need to be submitted to ATO)
- Advice for the investment of funds in the PAF

As a guide only, gifts of several hundred thousand dollars within the first few years of establishing a PAF should be proposed so that from a practical viewpoint, the costs of establishing the PAF and the accounting and auditing costs of administering it are justified.

It is possible to give property, including cash and shares, to a PAF. Although a gift of property can attract capital gains tax, the taxable gain is offset by a tax deduction equal to the current value of the property as determined by the ATO.

It is generally more tax effective to establish a PAF and donate to it during your lifetime than to make bequests to other types of DGRs in your Will as gifts made under a Will are generally not tax deductible for your estate or beneficiaries.

What must a PAF do?

The main operational requirement of a PAF is to make grants for the sole purpose of benefiting DGRs. Grants can be made on condition they are used by the DGR for a specified program or activity that is within the DGR's own objectives.

To enable a PAF to be endorsed as an ITEC, its trust deed must provide that only DGRs that are also charities can benefit from the PAF and, of course, the terms of the deed must be strictly followed.

A PAF must operate on a not-for-profit basis, not provide any benefit to its associates, except for reasonable administration and out-of-pocket expenses incurred on behalf of the PAF or appropriate payment for goods or services provided to the PAF, such as accounting and financial advice.

The trustees must ensure all investments are managed in accordance with the 'prudent person principle' as outlined in the legislation governing trusts in each State and Territory. That principle includes a requirement that regard be made to the desirability of a sufficient diversification of investments.

PAFs are required to be audited and provide a simple annual information return to the ATO by 28 February each year with a summary of the activities of a fund for the year.

Investments

PAFs can invest in a wide range of investments including cash, fixed interest securities, shares, derivatives and property.

Trustees can, if they choose, manage their own investments in the same way they manage their personal investment portfolios. However, to ensure that their fiduciary responsibilities are met, trustees should engage the services of professionals where appropriate.

PAF Regulation & Guidelines

The ATO is responsible for the regulation of PAFs and has the power to impose penalties on trustees who fail to comply with the guidelines. It is also the role of the ATO to determine if a trust meets the PAF definition and is therefore entitled to be endorsed as a DGR.

The Treasurer has issued legally enforceable guidelines under section 426-110 in Schedule 1 of the *Taxation Administration Act 1953* setting minimum standards for the governance and conduct of a PAF and its trustee. A copy of these Guidelines is available on our website.

Some of the features of PAFs (as outlined in the guidelines) include:

- PAFS must be established and operated as a not-for-profit entity and not solicit donations from the public.
- Operate solely in Australia, though distributions to DGRs that operate outside Australia are acceptable.
- Distribute or give commitments to distribute at least 5% of the fund's net assets each financial year (with a minimum distribution of $11,000), except in the year of establishment. For example, if the PAF needed to distribute a minimum of $20,000 in a financial year, a commitment to provide $20,000 to a particular project over the next three years would satisfy this obligation.
- Estimate the market value of the fund's assets (other than land) at least annually.
- Prepare financial statements every year and have these audited.
- Prepare, maintain and implement an investment strategy for the fund that sets out its investment objectives and consider the risks, composition, diversification and liquidity of the fund's investments and its ability to discharge its liabilities.
- Maintain a Responsible Person on the Board.

PAFs are also required to adhere to investment limitations that are similar to restrictions on superannuation funds. For example, PAFs are not able to borrow money (except in limited circumstances), must maintain investments on an arm's length basis and are not able to acquire assets from or provide financial assistance to related parties.

Trustees have ultimate legal responsibility for the PAF's governance and must act to ensure that it is well run, compliant with the law and the Trust Deed, and provides funds for the benefit of the community. The guidelines set out the penalties that apply for any breaches by trustees.

If the trustees choose to disregard any advice they receive from professionals appointed to assist with the running of the PAF, such as lawyers or financial advisers, the trustees must be able to demonstrate reasoning for their decision to ensure they are meeting their fiduciary responsibilities.

APW Partners' experience with PAFs

To be effective, philanthropy requires a strategic approach. Key considerations in a strategic approach include:

- Identifying goals – what do you wish to achieve over the long term?
- How much control do you wish to have over your donations?
- The type of charitable recipients to support, and do they have DGR status;
- The level and pattern of giving, and your financial position over time;
- How actively engaged you wish to be, and does the family get involved?
- Type of structure; and
- Ongoing management of the charity and the review process.

People who have turned to philanthropy after a successful business career often say it is their most satisfying work.

The team at APW Partners takes great professional and personal interest in assisting our clients develop and manage their philanthropic strategies. As a member of Philanthropy Australia, we have significant experience and skills to help people make their philanthropic wishes a reality.

To date, we have established and continue to manage more than 12 PAFs for our clients.

Areas APW Partners traditionally assist clients with their philanthropic needs include:

- Formulating the client's philanthropy strategy, and if appropriate, assisting them establish a PAF.
- Establishment of the PAF. The project management required to establish a PAF is complex and administratively intensive. Our experience has enables us to project manage the process which minimises the time and cost involved for clients.
- Align the PAF's investment strategy and timing of donations with the tax position of the client and their family. We have also developed a comprehensive investment strategy document that will ensure you remain compliant with the PAF Guidelines.
- Ongoing management of the PAF, including investment portfolio reviews and rebalancing, compliance with governing legislation and calculation of annual donations

in accordance with ATO guidelines. It is essential that the trustees are perceived to, and actually do, fulfil the fiduciary duties of their role.

The ongoing management of a PAF is similar to the effort involved in administering a Self-Managed Superannuation Fund (SMSF).

- Provide information on deductible gift recipient projects and charities that may be of interest to the client.
- Provide introductions to philanthropic specialists who can assist clients locate or establish projects to target specific sectors of the community that they wish to support. This is ultimately the most reward feature of establishing a PAF.
- Help to ensure that Trustees maintain adequate records of their decision making, including issuing a receipt for every donation the PAF receives.
- We have developed a comprehensive annual checklist that we walk through with our clients to ensure their PAF remains compliant.

ANNEXURE A – Definition of 'Responsible Person'

Responsible Person means an individual who fits one of more of the following categories:

1) performs a significant public function;
2) is a member of a professional body having a code of ethics or rules of conduct;
3) is officially charged with spiritual functions by a religious institution;
4) is a director of a company whose shares are listed on the Australian Stock Exchange;
5) has received formal recognition from government for services to the community; or
6) is approved as a Responsible Person by the Commissioner, and
7) who, unless the Commissioner otherwise agrees, is not:
    i) the Founder or a Donor;
    ii) an employee of the Founder, the Trustee or a Major Donor;
    iii) 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:
        (1) in a professional capacity;
        (2) as a member of the board or other controlling committee of the Trustee;
        or
        (3) as a member of the Trustee.

Case Study

The following case study illustrates one example of the financial advantages of establishing a PAF.

Katherine recently sold her commercial investment property and her accountant had calculated an assessable capital gain of $1 million. 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[1].

Katherine is a very strong supporter of disadvantaged children. She regularly 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 Private Ancillary Fund (PAF) and donate $1 million today[2]. The effect of this is as follows:

- She gets a $1 million tax deduction for the donation. This will offset her $1 million assessable capital gain 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 that has 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 p.a. This means she can give more than three times the amount over her lifetime to causes that are important to her.

[1] Investment return of 4% income (re-invested after donation & tax) and 5% growth.
[2] Investment return of 4% income (donated) and 5% growth.