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26 August 2014

Mr David Murray AO  
Chair  
Financial System Inquiry  
GPO BOX 89  
SYDNEY, NSW 2001

Dear Mr Murray,

***Financial System Inquiry Interim Report***

Please find attached Philanthropy Australia's submission in response to the Financial System Inquiry's Interim Report.

If the Inquiry wishes to discuss the matters raised in this submission further, please do not hesitate to contact Krystian Seibert, Policy & Research Manager, on (03) 9662 9299.

Yours Sincerely

A handwritten signature in black ink, appearing to read "Louise Walsh".

Louise Walsh  
**Chief Executive Officer**

# Philanthropy Australia Submission – Financial System Inquiry Interim Report

## 1. Introduction

Philanthropy Australia is the national peak body for philanthropy and is a not-for-profit (NFP) membership organisation comprising more than 800 Members and Associates. These include trusts and foundations, businesses, families and individuals who want to make a difference through their own philanthropy and to encourage others with their giving.

Our vision is for ‘A More Giving Australia’ and our mission is to ‘Lead an innovative, growing, influential and high performing philanthropic sector in Australia’.

Philanthropy Australia has a strong interest in growing impact investment in Australia, given its potential as an emerging approach for financing social change, as well as its potential to compliment and amplify existing grantmaking and philanthropic practices.

We therefore welcome the Financial System Inquiry’s (‘the Inquiry’) consideration of impact investment, including social impact bonds, within its Interim Report (‘the Report’). This is recognition of the fact that Australia’s financial system has a broad role, including facilitating improved social outcomes as well as delivering economic returns and other objectives.

Philanthropy Australia has examined the policy options put forward for consideration in Part 3 of the Report, and has prepared this submission to inform the Inquiry’s consideration of a number of these issues.

The submission also comments on the Interim Report’s discussion of dividend imputation.

## 2. The Role of Private and Public Ancillary Funds

### *More Effective Guidance regarding Impact Investment*

The Report points out that Private and Public Ancillary Funds are unclear whether they may count discounted returns toward minimum distribution requirements and puts forward the option of providing better guidance to address this.

Philanthropy Australia believes that there is already sufficient clarity in the case of Public Ancillary Funds (‘PuAF’).

Example 3 in Rule 19.3 of the *Public Ancillary Fund Guidelines 2011* states that:

*If a public ancillary fund invests in a social impact bond issued by a deductible gift recipient with a return that is less than the market rate of return on a similar corporate bond issue, the fund is providing a benefit*

*whose market value is equal to the interest saved by the deductible gift recipient from issuing the bond at a discounted rate of return.*

However, the uncertainty arises in the case of Private Ancillary Funds ('PAF'), as no such example is included in the *Private Ancillary Fund Guidelines 2009*.

Although some PAF trustees correctly assume that the same arrangements apply for PAFs as they do for PuAFs, Philanthropy Australia believes there would be merit in replicating Example 3 in Rule 19.3 of the *Public Ancillary Fund Guidelines 2011* within the *Private Ancillary Fund Guidelines 2009* to remove any uncertainty.

### **Recommendation 1**

***That Example 3 in Rule 19.3 of the Public Ancillary Fund Guidelines 2011, be replicated in Rule 19.3 of the Private Ancillary Fund Guidelines 2009.***

In terms of broader guidance for philanthropic trustees regarding impact investment, and in particular guidance about how the corpus of trusts and foundations can be invested in impact investments, Philanthropy Australia notes that there is already relevant guidance available.

In particular, we note the publication 'Impact Investments: Perspectives for Australian Charitable Trusts and Foundations'<sup>1</sup>, produced by The University of Sydney Business School with the support of a number of partners.

This publication provides a very useful and informative source of guidance about impact investment and how it relates to the duties of charitable trustees. Importantly, the publication makes the point that:

*With a little care and due attention, the trustees of many charitable trusts and foundations can pursue impact investments, incorporating them where appropriate in the investment portfolio they craft in satisfaction of their statutory and general law duties.<sup>2</sup>*

There may also be merit in the Australian Taxation Office including information about impact investment in the 'Frequently Asked Questions' information for PAFs and PuAFs which it makes available on its website. Such guidance could provide further clarity regarding how impact investment can form a legitimate part of a PAF or PuAF investment strategy.

It is important to promote broader awareness across the philanthropic community about how trusts and foundations can undertake impact investment.

This is something Philanthropy Australia aims to do through initiatives such as our 'Impact Investing 101' workshops. These workshops assist participants to

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<sup>1</sup> K. Charlton, S. Donald, J. Ormiston, R. Seymour, *Impact Investments: Perspectives for Australian Charitable Trusts and Foundations*, The University of Sydney Business School, March 2014, available at: [http://sydney.edu.au/business/\\_data/assets/pdf\\_file/0004/199768/BUS10008\\_Impact\\_Investments\\_web\\_sml\\_3.pdf](http://sydney.edu.au/business/_data/assets/pdf_file/0004/199768/BUS10008_Impact_Investments_web_sml_3.pdf)

<sup>2</sup> Ibid p.14

develop an understanding of how to approach impact investing in the context of philanthropy, and provide practical information about how to develop and implement an impact investing strategy.

### *Classification of Private Ancillary Funds as Sophisticated or Professional Investors*

The Report also identifies that some PAFs do not meet wholesale investor tests under the *Corporations Act 2001 (Cth)*, despite high net worth individuals or organisations having established them. This is known to be a barrier for PAFs who wish to invest in social impact bonds which are put to market only as a wholesale offering.<sup>3</sup>

Philanthropy Australia believes that this is an area of unnecessary uncertainty, which presents a barrier to PAFs investing in Social Impact Bonds and potentially other forms of impact investment products.

Philanthropy Australia notes that the Australian Securities and Investments Commission ('ASIC') recently clarified how it will apply the wholesale investor tests under the *Corporations Act 2001 (Cth)* to self-managed superannuation funds.<sup>4</sup>

There would be merit in the ASIC providing similar guidance specifically directed at PAFs.

Philanthropy Australia would welcome the opportunity to participate in any consultation process to develop this guidance.

### **Recommendation 2**

***That the Australian Securities and Investments Commission provide guidance specifically directed at Private Ancillary Funds, which clarifies the operation of the wholesale investor tests under the Corporations Act 2001 (Cth).***

### *Provision of Third Party Guarantees by Private Ancillary Funds*

Access to capital is recognised as a challenge for Australia's not-for-profit sector.<sup>5</sup> Charities can be risk averse in terms of taking on debt, but the availability of debt finance itself can be limited.

Improving access to capital requires a multi-faceted strategy, and other submissions to the Inquiry have already discussed this issue in some detail.<sup>6</sup>

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<sup>3</sup> See: 'Private Ancillary Funds suffer same 'retail' treatment as SMSFs', 09/05/14, available at: <http://cuffelinks.com.au/private-ancillary-funds-suffer-retail-treatment-smsfs/>

<sup>4</sup> 'Statement on wholesale and retail investors and SMSFs' (Media Release), Australian Securities and Investments Commission, 08/08/14, available at: <http://www.asic.gov.au/asic/asic.nsf/byHeadline/14-191MR%20Statement%20on%20wholesale%20and%20retail%20investors%20and%20SMSFs?opendocument>

<sup>5</sup> See: 'Contribution of the Not-for-profit Sector', Productivity Commission, 2010, available at: <http://www.pc.gov.au/projects/study/not-for-profit/report>

<sup>6</sup> See: First round submission by Social Ventures Australia

Philanthropy Australia believes that one practical step that could improve access to debt finance by certain types of charities, is allowing PAFs to provide third party guarantees to eligible entities.

PAFs are required to distribute funds to eligible entities and a minimum distribution requirement applies for each financial year. PAFs can already provide concessional debt finance to a deductible gift recipient ('DGR') charity, and count the discount to the market interest rate towards their minimum distribution. They could also provide debt finance with a commercial interest rate as part of their investment strategy.

However they are currently prohibited from giving a security over or in relation to an asset of the fund, even if this is as a guarantee for borrowing by a DGR charity.<sup>7</sup>

Philanthropy Australia believes that this restriction is somewhat illogical. As with a donation, the provision of a guarantee to an eligible entity involves providing a form of financial benefit to the eligible entity, which is used to further their charitable purposes. They are just different means to achieving the same end.

The total PAF corpus is currently estimated to be in the range of \$3.5 to \$4 billion. This corpus has been growing since the introduction of the forerunner of PAFs, Prescribed Private Funds.

This is a sizeable corpus which could be used more effectively to unlock considerably more capital for eligible entities, if PAFs were able to provide third party guarantees to eligible entities. This would in turn assist these eligible entities to further their charitable purposes.

In putting forward this proposal, Philanthropy Australia acknowledges that some restrictions would still be necessary, such as a prohibition on providing guarantees to related eligible entities, as well as appropriate reporting of such transactions in financial statements provided to the Australian Taxation Office.

### ***Recommendation 3***

***That the Private Ancillary Fund Guidelines 2009 be amended to enable the Private Ancillary Funds to provide third party guarantees to unrelated eligible entities.***

### **3. The Role of Government**

#### *Tax Incentives and Impact Investment*

The Report proposes that the appropriateness of tax incentives be considered as part of the Tax White Paper process. Philanthropy Australia agrees with this approach.

However we would also recommend that once established, the Australian Government's Community Business Partnership should also be closely

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<sup>7</sup> Rule 35 of the *Private Ancillary Fund Guidelines 2009*

involved in this process, and have the opportunity to provide input and advice on options considered as part of the development of the Tax White Paper.

Recent initiatives in the United Kingdom provide an example of the types of tax arrangements that could be pursued to support impact investment. Under the United Kingdom's *Finance Act 2014*, tax relief is provided for investments in charities, community interest companies and community benefit societies, and in certain types of social impact bonds.<sup>8</sup> Similar tax incentives could have a transformative effect on the impact investment market in Australia.

Philanthropy Australia notes that Appendix 2 to the Report refers to 'Tax treatment of social impact bonds' as an area warranting further examination by the Tax White Paper.

Social impact bonds are only one form of impact investment, and therefore we believe that the reference in Appendix 2 should be amended to refer to 'Tax incentives for impact investment' to reflect the fact that, as in the United Kingdom, a broader range of activities may warrant support through tax incentives rather than just social impact bonds.

#### ***Recommendation 4***

***That the Tax White Paper undertakes a detailed examination of the various tax incentives which could support different forms of impact investment.***

***Once established, the Australian Government's Community Business Partnership should also be closely involved in this process.***

#### ***More Direct Government Involvement in Impact Investment***

The Report also discusses how Government could take a more active role in expanding impact investment through the provision of risk capital.

Such active participation in impact investment activities is another policy tool which Government may consider using where it can assist in meeting its particular policy objectives. Depending on the circumstances, it may enable Government to use public resources to leverage private investment in order to achieve particular policy outcomes more effectively and efficiently.

#### ***More Government Support for Capacity Building of Social Enterprises***

Philanthropy Australia points out that one of the challenges for growing impact investment in Australia is not necessarily the supply of willing investors or risk capital, but the lack of appropriate investment opportunities.

Whilst there may be existing or potential social enterprises in which investments could be made, these opportunities may not be 'contract ready' and without appropriate support, they may struggle to become contract ready.

This is essentially a question of capacity building, and there may be a role for Government to assist social enterprises to become 'contract ready', and thereby attract impact investment.

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<sup>8</sup> See: <http://www.legislation.gov.uk/ukpga/2014/26/schedule/11/enacted>

The United Kingdom's £10 million 'Investment and Contract Readiness Fund' enables social ventures to access new forms of investment and compete for public service contracts.<sup>9</sup>

Grants between £50,000 and £150,000 are available on a rolling basis to social ventures who will go on to raise at least £500,000 investment, or who want to bid for contracts over £1 million.

Consideration could be given to the establishment of such a fund in Australia, including an examination of Government and non-Government sources of funding.

Alternatively, the option of providing additional funding for existing entities which provide some support for capacity building could be considered.

### ***Recommendation 5***

***That options for better supporting capacity building of social enterprises be examined further, with the objective of growing the number of 'contract ready' social enterprises which can attract impact investment.***

#### *Establishing a Social Investment Bank*

With regards to establishing a Social Investment Bank, there are a variety of models which could be considered. As pointed out in first round submission by Social Ventures Australia, the United Kingdom's 'Big Society Capital' is a wholesale lender established by unclaimed bank account monies as well as UK clearing bank and Lotteries contributions.

Such a model merits further examination given its potential to dramatically increase the scale of the impact investment market in Australia and unlock funds from other sources.

However Philanthropy Australia notes that relatively recent changes to Commonwealth unclaimed money laws may have an impact on the availability of using unclaimed money as a source of funding for a Social Investment Bank.

One alternative to a model based on unclaimed monies could involve establishing a Social Investment Bank using some of Australia's 'lost super', again as pointed out in the first round submission by Social Ventures Australia. According to the Australian Taxation Office, there is over \$14 billion of lost super in Australia. Even if a very small proportion of this is set aside to fund impact investments through a Social Investment Bank, it could have a transformative effect on the impact investment market in Australia.

Another alternative to a model based on unclaimed monies could involve establishing a Social Investment Bank with a smaller seed contribution from Government, with additional funds to be obtained from other sources including philanthropy, superannuation funds and other investors.

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<sup>9</sup> See: <http://www.beinvestmentready.org.uk/>

As proposed in the second round submission by Social Ventures Australia, a Social Investment Bank could be funded by the Government at the Commonwealth bond rate and managed by a suitable intermediary. This could assist in offsetting the budgetary impacts of the contribution.

#### **Recommendation 6**

***That options for establishing a Social Investment Bank in Australia be examined further, including consideration of possible structures and funding models.***

#### **4. Dividend Imputation**

Philanthropy Australia notes with some concern the Interim Report's comments regarding dividend imputation, given the role played by refundable franking credits as a source of income for philanthropic trusts and other charities.

In stating that 'The case for retaining dividend imputation is less clear than it was in the past'<sup>10</sup>, the Interim Report only considers the effects of dividend imputation in a narrow manner which focuses on how it may or may not impact on other forms of finance. It therefore omits to consider the broader role of financial markets, and the broader significance of dividend imputation.

Philanthropic trusts and other charities, are able to reclaim the value of the franking credits from the Australian Taxation Office. This policy was introduced by the Howard Government in 2000.<sup>11</sup> This change recognised the fact that although technically income tax exempt, philanthropic trusts and charities were indirectly paying tax on their income through the corporate taxation system.

Therefore, in the case of philanthropic trusts and other charities, the debate around dividend imputation arrangements does not involve questions about double taxation, rather it involves questions about whether these entities are entitled to be fully income tax exempt rather than just partially.

Since their introduction, refundable franking credits have become a major source of income for philanthropic trusts and other charities.

In 2012-13 there were 4,815 philanthropic trusts and other charities in Australia which claimed franking credits as a result of their Australian company investments. In the same year, over \$580 million in refundable franking credits were returned to philanthropic trusts and other charities to fund grants and programs.<sup>12</sup>

Any adverse changes to dividend imputation arrangements for philanthropic trusts and other charities would therefore impact upon the ability of these organisations to support charitable causes in our community, and therefore

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<sup>10</sup> Interim Report, Appendix 2: Tax summary

<sup>11</sup> Treasurer of Australia, Refunding Excess Imputation Credits to Charities (Media Release), Canberra, 13 April 2000

<sup>12</sup> *Taxation Statistics 2011-12*, Australian Taxation Office



would ultimately be harmful to the community. Philanthropy Australia would therefore strongly oppose any such changes.

***Recommendation 7***

***That it is recognised that the refunding of franking credits ensures that charities with relevant investments receive a full income tax exemption.***

***Refundable franking credits are an important income source for philanthropic trusts and other charities, and no adverse changes should be made to the arrangements which apply to them.***