

Sydney Community Foundation Professional Advisers Network



Charitable Giving and Tax Issues (including Social Investment)

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Outline

- § Introduction
- § (I) Charitable Giving and Tax Issues in Practice
- § (II) Social Investment (the “GoodStart” example)
- § (III) What does the future hold?
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- § Questions

This presentation is intended as a supplement to my last presentation to the Network, on 4 February 2008, entitled “Navigating through the tax maze in Charitable Giving and Philanthropy Generally”.

[Statutory references are to Income Tax Assessment Act (ITAA) 1997, unless otherwise indicated.]

Disclaimer: Please note that the comments in this presentation and the accompanying examples are in the nature of general information and should not be relied on. Attendees and readers should seek and rely on their own advice.

(I) Charitable Giving and Tax Issues in Practice

§ The principal focus of part I of the presentation is on income tax. In particular, the focus is on deductions for gifts to DGRs.

Alternative types of donors

In my experience, donors typically fall into one of two broad categories:

§ Someone who has a genuine, and usually deep, philanthropic bent, who wants to donate more to one or more worthy causes, and who wants professional assistance about how to do so in a manner appropriate to their circumstances.

OR

§ Someone with the financial means to donate a substantial sum to worthy causes, but who needs to be persuaded why they should do so.

Generally, an adviser needs to approach their different clients in an entirely different way.

However, as will be seen in the accompanying examples, the maths are the same in each case.

(I) Charitable Giving and Tax Issues in Practice (cont'd)

§ **Alternative donees**

You are familiar with the range of alternative DGRs open to donors, such as:

- ⇒ PAF;
- ⇒ donor advised public charitable trust (eg Perpetual or Trust);
- ⇒ donor advised community foundation (eg Sydney Community Foundation);
- ⇒ other ancillary funds; or
- ⇒ the wide range of item 1 (in the table in s 30-15(1)) DGRs.

§ **The maths**

A previous paper by Richard Friend to the SCF Professional Advisers Network on 4 June 2007 gave numerical examples of a range of circumstances where a deductible gift of cash or property could achieve enhanced tax benefits in a range of situations.

I will work through a range of similar examples, set out in a separate accompanying attachment.

(a) Where either:

the donor receives franked dividends; or

the donor is a shareholder or is otherwise (eg via family trust) entitled to receive fully franked dividends from a company with substantial taxed profits or retained earnings:

(I) Charitable Giving and Tax Issues in Practice (cont'd)

In this case (Proposition 1 and Tables 1 and 2 in the attachment), the donor only loses an extra 27.1% of the cash fully franked dividend (contrast 53.5% of other income) in order to eliminate their tax bill, while at the same time substantially benefiting the DGR.

Alternatively (Proposition 2 and Tables 4 and 5 in the attachment), the donor donating 100% of the cash dividend can generate a cash refund of tax for themselves, while at the same time substantially benefitting the DGR.

(In either case, this is more tax efficient than the company with the taxed profits or retained earnings making a deductible donation of the same amount.)

- b) How (Proposition 1 and Tables 1 and 2 in the attachment) the payment of a franked dividend to the donor, coupled with a deductible cash donation by the donor and the use of the after tax cash to reduce the amount owing by the shareholder to the company, can help reduce or eliminate non-deductible interest on a Division 7A loan owing by the donor to the company and clean out taxed retained earnings in the company (which would otherwise be liable to top up tax on the winding up of the company).

(I) Charitable Giving and Tax Issues in Practice (cont'd)

- c) Where the donor sells an asset (eg shares or real estate) and the gain is eligible for the CGT discount (reducing the tax by half, to 23.25%), even greater enhancements apply to a gift or cash or property (Propositions 3 and 4 and Tables 6-9 in the attachment) .

These are enhanced even further if the disposal is eligible for additional CGT Small Business Concessions, to reduce the tax to nil. [No examples in the attachment.]

- d) Where the donor gifts property which is eligible for the CGT Small Business Concessions, the donor may also generate the ability to make non-concessional superannuation contributions which come within the CGT gap. [No examples in the attachment.]
- e) Further, by making a donation of a large lump sum today (eg to a PAF), a donor can effectively donate today a total nominal amount that the donor might wish to give over their lifetime, but (because of tax free income and growth within the PAF, after compulsory distributions) with the result that the amount available to be donated to type 1 DGRs is several times what would otherwise be the investor's annual deductible contributions.

(I) Charitable Giving and Tax Issues in Practice (cont'd)

§ Gifts of property

- ⇒ Involve a plethora of very prescriptive rules.
- ⇒ Generally better to sell asset and gift cash. But may be no choice for cultural or heritage items.

§ Gifts cannot generate tax losses (s 26-55(1)(ba))

- ⇒ But deductions can now be spread over up to 5 years, subject to compliance with prescriptive requirements in Subdivision 30-DB.

§ Timing (ie synchronisation)

- ⇒ CGT timing rules can give rise to acute practical problems in timing a deductible gift:

- ← Eg: on 15 June 2010, A agrees to sell shares in a company, for settlement on 30 September 2010, intending to make a deductible gift before the succeeding 30 June 2011.

- § **Problem:** the capital gain is deemed to arise on the date of contract - ie in the Y/E 30/6/10. **Result:** The proposed gift in the 2011 year cannot reduce the tax payable on the capital gain for the 2010 year!

(I) Charitable Giving and Tax Issues in Practice (cont'd)

§ **Solution:** If date of contract cannot be delayed, possibly enter into put and call options (incorporating some risk to each party) on 15/6/10, which can be exercised after 30/6/10. If an option is exercised, relevant date of contract is date of exercise of option, not date of option. (Ensure options are in form of irrevocable offers, not conditional contracts.)

⇒ **Other possible solutions?:** A cash gift in Y/E 30/6/10 is impracticable, because the donor normally won't have cash till 30/9/10. Also, the sale may never settle, because of let-out clauses (eg GFC or other circumstances); so, very risky to make gift before relevant assessable income is assured. As a last resort, it may be possible to create valuable property (eg a promissory note or some other security) which can be gifted, but subject to the need to get an ATO valuation.

(I) Charitable Giving and Tax Issues in Practice (cont'd)

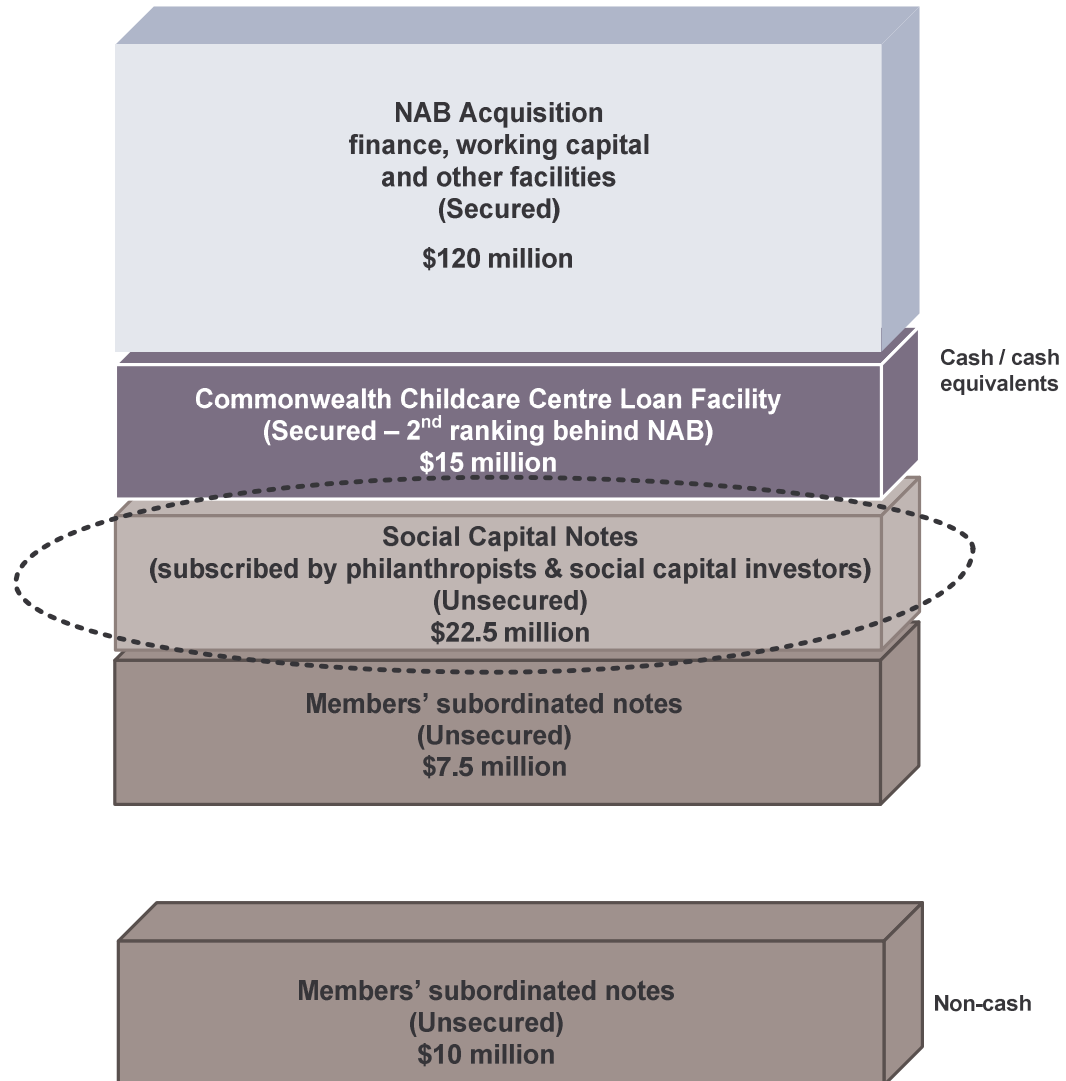
§ “Don’t wait till it’s too late! Death is a killer!”

- ⇒ Subject to limited exceptions (eg re cultural bequests), testamentary gifts do not generate tax deductions: s 30-15(2). (There are limited CGT concessions.) As a consequence, gifts to charities or other DGRs under a will are extraordinarily inefficient from a tax point of view.
- ⇒ Therefore, even though we do not have death or estate duties (and a bequests tax should not be introduced by a Rudd government), potential donors with sufficient assessable income to absorb substantial deductions should be encouraged to make gifts while they are alive and in good health, and **not** under their wills.

(II) GoodStart – Great stuff!: an example of Social Investment

- § This week GoodStart Childcare Limited (“**GoodStart**”) is scheduled to complete the purchase of 550 ABC Learning child care centres. The purchase of another 128 centres is to be completed over the next four months. The purchase price is reputed to be about \$100 million.
- § Sponsored by Mission Australia, the Benevolent Society, the Brotherhood of St Laurence, and Social Ventures Australia (“**SVA**”).
- § A not-for-profit company, run with business discipline, for a social purpose.
- § Capital structure – underpinned by a layer of “Social Capital” Notes (“**SC Notes**”), effectively a subordinated debt instrument paying 12% p.a.

GoodStart Capital Structure



(II) GoodStart (cont'd)

- § The total cash funding is \$165m. (This includes a \$15m loan from the federal Government.)
- § \$135m of this has priority over the unsecured \$22.5m SC Notes.
- § The free cash flow forecasts in the IM for the SC Notes suggests that:
 - ⇒ The Senior Debt of \$120m should be repaid within 5 years.
 - ⇒ The federal Government loan should be repaid within 7 years.
 - ⇒ Interest should be paid on the SC Notes starting in 2011.
 - ⇒ The whole of the \$22.5m of SC Notes should be repaid at maturity (after 8 years), if not earlier.
- § Nonetheless, because of the deep subordination of the SC Notes, it is regarded as a risky “investment” (or at least not “investment grade”), under normal investment criteria. And even the 12% p.a. coupon might be thought commercially low, having regard to the degree of subordination, its inherent equity type nature and the lack of liquidity.
- § Unquestionably, this is a novel transaction. But it is well researched and well managed and involves an area of vital national interest and importance. In short, it deserves to succeed; and it is important in the national interest that it does so.

(II) GoodStart (cont'd)

§ But how should a venture such as this be viewed by philanthropists such as PAFs, public ancillary funds and other not-for-profit entities (each a “**fund**”)?

- ⇒ May not meet normal conservative (albeit appropriate) “investment” criteria.
- ⇒ But perhaps can and should be viewed as a new form of “social investment” – ie:
 - ← If prepaid to **donate** \$20,000 p.a. for 5 years to support such a novel, well researched and well managed venture, backed by four leading NFPs, consistent with the donation strategy or focus of the fund, why not **invest** \$100,000 in SC Notes in year 1?
 - ← If venture unexpectedly fails to meet financial forecasts, view as donations to support the charitable activities carried out by the venture in the meantime.
 - ← If principal is repaid, regard as a bonus.
 - ← If interest is paid, regard as an additional bonus – Win / Win / Win.

(II) GoodStart (cont'd)

- ⇒ Perhaps only disadvantage is that the “investment” won’t count towards any minimum distribution requirement (such as that presently applicable to PAFs and that which is to apply to public ancillary funds from 1 July 2011). [Lobby to get rules changed to permit this and an investment in any similar kind of project of national or local significance to count towards the distribution requirement?]
- ⇒ I am also aware that, after considering and applying their super fund’s investment strategy (s 52(2)(f) of the SIS Act), some philanthropists have viewed the SC Notes as an appropriate high yielding investment for their self managed superannuation funds, even if it involves a degree of investment risk and illiquidity. They did so by applying modern portfolio theory, without regard to the worthiness of the SC Notes as a “social investment”.

(III) What does the Future Hold?

§ Henry, December 2009 (Government response, 2 May 2010):

- ⇒ Government will not “at any stage” make any changes to the tax system that “harm” the NFP sector, including:
 - ← removing [or modifying] the benefits of tax concessions, especially re FBT (Recs 9(e), part 41, and 43);
 - ← raising the gift deductibility threshold (Rec 13); and
 - ← changing income tax arrangements for clubs (Rec 44).
- ⇒ Also, will not introduce a bequests tax (raised in Rec 25).
- ⇒ Query status of Rec 41 re charities commission (cf Productivity Commission’s January 2010 preference for a national Registrar for Community and Charitable Purpose Organisations) and possibly streamlining application process for DGR status.
- ⇒ Silence re Rec 42: that NFPs should be permitted to apply their income tax concessions to their commercial activities (*Word Investments* type issue).

(III) What does the Future Hold? (cont'd)

§ Budget, 11 May 2010

- ⇒ PAF 2009 changes to be extended to public ancillary funds, from 1 July 2011. Policy Discussion Paper to come. [Assistant Treasurer Media Release No. 093.]

Concluding Comments / Questions

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