1 Overview of the issue

The complex and inconsistent laws create barriers for State government DGRs (such as hospitals, galleries, museums) to raise necessary funds from philanthropic foundations.

Since the creation of the ACNC, charities and philanthropic foundations are more aware of the ACNC requirements and the *Charities Act 2013 (Cth)* and are not aware of State requirements or that these may be inconsistent.

The *Charities Act 2013 (Cth)* automatically accepts that trusts which make grants to government entities which would be charitable if they were not a government entity, are charitable for Commonwealth purposes. However, under the various State legislation, in order to make grants to government entities, philanthropic funds need to take action (in the form of a declaration or selecting specific wording when drafting the trust deed).

Trustees currently make distributions not authorised under State laws (other than WA), in mistaken reliance on the *Charities Act 2013 (Cth)*, and also then can make distributions which threaten the trust's charitable status under Commonwealth law, in mistaken reliance on the State laws.

2 Overview of the solution

All State and Territory Acts regulating charitable trusts be harmonised to adopt the recent amendments in Part 6 *Charitable Trusts Act 2022 (WA)*:

(a) Provide an *automatic* power for trustees of any charitable trust[1] to distribute to government entity Item 1 DGRs[2], so no action is required by the trustees to enable the trust to make these grants.

(b) The power needs to have retrospective effect to cover any breaches which have been occurring, particularly since the introduction of the Commonwealth *Charities Act 2013*.

(c) The provision must:

  (1) ensure that the trust remains charitable under the relevant State and Territory law.

  (2) be drafted consistently with the *Charities Act 2013* so these trusts remain charitable under Commonwealth law and income tax exempt.

This would significantly reduce red tape and compliance risks for ancillary funds and other charitable trusts and simplify access to philanthropic funds by government DGRs.

[1] While this issue is particularly relevant for ancillary funds, all charitable trusts would benefit from a clear, consistent approach across the Commonwealth, States and Territories.

[2] These are DGRs listed in item 1 of the table in section 30-15 of the *Income Tax Assessment Act 1997* (Cth).

HERBERT SMITH FREEHILLS

3 The detailed explanation

3.1 What is an ancillary fund?

An ancillary fund is a trust which is a type of deductible gift recipient (**DGR**) under item 2 of the table in section 30-15 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA97**).

Item 2 specifies that an ancillary fund can only provide money, property or benefits to Item 1 DGRs[3].

3.2 Charitable status of trusts

In order to be a valid charitable trust, a trust must meet the requirements of being charitable under its relevant State or Territory laws.

In order to be income tax exempt as a charity, a trust must meet the requirements of being charitable under the Commonwealth laws.

This is where the confusion and complication arises which we submit should now be simplified.

3.3 Position before 2006

(a) Charitable under State and Territory laws

To be a valid charitable trust under State and Territory laws, an ancillary fund could only make distributions to Item 1 DGRs which were themselves 'charitable at law'. That is, as a charitable trust, an ancillary fund could only give to other charities.

(b) Income tax exempt status under Commonwealth laws

In order to be income tax exempt under Commonwealth laws, an ancillary fund also had to meet the legal meaning of charity and was therefore restricted to only making grants to charitable Item 1 DGRs.

(c) Definitions the same

As the meaning of 'charitable' at Commonwealth and State and Territory laws was the same, there was no confusion and all trust deeds for charitable ancillary funds prior to and including 2006 would be restricted to giving only to charitable item 1 DGRs.

3.4 Government entities

Relevantly, some Item 1 DGRs are not charities due to their connection with government. For example, government controlled hospitals, libraries, museums and art galleries. Most of these rely to some extent on philanthropic support for their operations, for example, medical research at hospitals.

[3] The requirements of an ancillary fund are otherwise substantially set out in the Private Ancillary Fund Guidelines and the Public Ancillary Fund Guidelines.

If ancillary funds and other charitable trusts could only give to charities, these government DGRs could not receive grants from the growing number of philanthropic funds.

3.5 2006 to 2013

(a) Charitable under State and Territory laws

In order to ensure that these types of DGRs could benefit from the philanthropy provided by ancillary funds, the State governments in Victoria, New South Wales, Western Australia, South Australia and Queensland all inserted amendments into their respective legislation which allowed ancillary funds to remain charitable at law while distributing to non-charitable Item 1 DGRs[4]. But required specific action by the trustees to come within these amendments.

The legislation in Victoria, New South Wales and Western Australia, provided protection for trusts which may have made grants to non-charitable DGRs prior to the date of the amending Act (but not for trusts which make grants to non-charitable DGRs after the date of the relevant amending Act and before they take the specific action to come within these amendments).

In addition, the laws in the different jurisdictions are not consistent, and involve different requirements.

Generally, a separate declaration made as a deed by the trustee of the ancillary fund is required to 'opt in' to the power to give to non-charitable Item 1 DGRs or specific wording is required in the drafting of the trust deed.

(b) Income tax exempt status under Commonwealth laws

The State law amendments enabled ancillary funds to remain charitable under the relevant governing law of the ancillary fund. However, the State laws could not make the ancillary funds charitable under Commonwealth law for tax purposes.

Therefore, in order for the ancillary funds which did 'opt in' to the relevant State legislation to remain income tax exempt, the ITAA97 was amended to create a new category for income tax exemption referred to as an income tax exempt fund (**ITEF**).

The forms for the declaration in the State laws recognise the change in tax status by requiring the trustee to have regard to the liability of the trustee to income tax.

During this period the trustee had to apply to the ATO to change the tax status to an ITEF from an income tax exempt charity (**ITEC**).

It was easy to identify those ancillary funds which had 'opted in' as the ABR identified the trust as either an ITEC or an ITEF.

[4] The laws differ as to whether grants can be made to any Item 1 DGR or only Item 1 DGRs which are charitable, or which would be charitable but for their connection to government – see table annexed.

3.6 After 2013

(a) Income tax exempt status under Commonwealth laws

After the introduction of the *Charities Act 2013* (Cth) (**Commonwealth Charities Act**), ancillary funds are effectively deemed charitable under Commonwealth law, if they can make grants to government entities which are Item 1 DGRs and which would be charities if they were not 'government entities' (referred to as **government entity Item 1 DGRs**).

As a result of these changes, the ITEF provision in the ITAA97 was no longer required and was repealed as these ancillary funds became charitable under Commonwealth law and could access income tax exemption on that basis.

The ABR then removed all references (even in the historical data) to ITEF endorsement.

Due to the wider provisions in New South Wales, Western Australia and Queensland, transitional laws[5] were required to 'grandfather' those ancillary funds which had 'opted in' to the wider powers available prior to the Commonwealth Charities Act. Since 1 January 2014, ancillary funds established in these jurisdictions, which can give to *any* DGR (not only DGRs that are charitable or would be charitable if they were not a government entity) can no longer access income tax exemption.

(b) Charitable under State and Territory laws

Only Western Australia has recently made changes to recognise this change to Commonwealth law – no other States or Territories have adopted this as yet which is causing confusion and lack of compliance with State and Territory laws.

4 The problems

4.1 The differences between State and Commonwealth legislation create uncertainty and confusion[6]

Every ancillary fund or other charitable trust that wishes to be a valid charitable trust and obtain income tax exemption needs to ensure that it is charitable under both the State law, and the Commonwealth law. In the context of an ancillary fund that wishes to make grants to a government entity Item 1 DGR, there is inconsistency between how the State law and the Commonwealth law operates, which results in unnecessary confusion and red-tape.

For example, section 13 of the Commonwealth Charities Act appears to operate automatically while the State laws might require a separate action to be taken by the

[5] *Charities (Consequential Amendments and Transitional Provisions) Act 2013* (Cth).

[6] The differences between the jurisdictions is set out in the table in Annexure A.

trustees (in the form of making a declaration and selecting specific wording when drafting the trust deed).

Section 13 may be viewed as allowing a charitable trust to make distributions to a government entity Item 1 DGR, without appreciating that section 13 only operates for Commonwealth charity law purposes, not State charity law purposes. As a result, a trustee might make a distribution which threatens the trust's charitable status under State law (albeit, that the distribution is authorised under Commonwealth law). On the other hand, the legislation in New South Wales, Queensland and Western Australia enables ancillary funds to make distributions any DGRs, and still remain charitable. This is broader than what section 13 allows, which means that a trustee might make a distribution which threatens the trust's charitable status under Commonwealth law (albeit, that the distribution is authorised under State law).

In other words, the discrepancy between State and Commonwealth laws in this area creates a situation where mistakes will likely be made.

In addition, the concepts used to describe 'government entity Item 1 DGR' for State purposes and for Commonwealth purposes are different. Trustees must therefore go through a two step-process, such as the following (for South Australian ancillary funds):

1) Would the entity be a charity within the meaning of the *Charities Act 2013* (Cth) if it were not a 'government entity' as defined in that Act?

2) Would the entity be a charity as set out in section 69D of the *Trustee Act 1936* (SA), but for its connection to government?

These concepts likely overlap in a significant if not complete way. Nevertheless, the fact that two slightly different tests exist creates unnecessary red tape and burden on philanthropy.

There is also inconsistency between the States, with Victoria always requiring a declaration, South Australia requiring a power in the trust deed and New South Wales, Queensland and Western Australia allowing a declaration in the absence of a power in the trust deed. In the other jurisdictions, the absence of legislation means that ancillary funds can only make distributions to charities.

Given the above, money that could be used for grant making, is instead spent on legal advice and compliance, due to the complex legal framework in which ancillary funds operate. It is in the interests of both the philanthropic community, and State governments (which benefit from the significant donations to public institutions), to ensure that the law facilitates philanthropy and is as clear and easy to apply as possible.

4.2 It can be difficult to identify which ancillary funds have 'opted-in'

As mentioned above, State law (other than WA) does not apply automatically to all ancillary funds. In Victoria, in order to make distributions to government entity Item 1 DGRs, trustees are required to 'opt-in' by signing a particular declaration. This is also required in New South Wales and Queensland unless the trust deed already allows for this type of distribution.

Previously, ancillary funds that had opted in, or which were otherwise able to make grants to government entity Item 1 DGRs were identifiable by reference to their tax status as an

income tax exempt fund (or ITEF). However, this income tax exempt category no longer exists, and instead, these ancillary funds obtain income tax exemption as charities.

As there is no longer a way of identifying ancillary funds that have 'opted in' by reference to their tax status, many trusts do not know if they have opted in or not. Declarations may have been entered into but not kept with the trust deed. There is confusion in the ancillary fund sector as to how they work out if they have, at some stage in the past 15 or so years, made this declaration. This situation will only get worse as time goes on.

4.3 Risks from inadvertent lack of compliance

Due to the complexity of these laws, there are a number of ancillary funds unaware that they may be operating in a manner which is not charitable at State and Territory law.

In practice, if and when this is identified, a declaration to 'opt in' can be made in those States permitting this, but, even then, it cannot operate retrospectively under the various State laws. Whereas the ATO can decide that it will not take any action in respect to a breach of the trust deed, there is no equivalent power at State law, so the position of these trusts, and the liability of the trustees remains unclear.

5 Opportunity to simplify

The introduction of the Commonwealth Charities Act provides an opportunity for the States and Territories to reduce uncertainty and facilitate philanthropy by harmonising the various laws and by providing automatic powers to trustees of charitable trusts to distribute to government entity Item 1 DGRs.

All State and Territory laws regulating charitable trusts should be amended to:

1) Provide an automatic power for trustees of any charitable trust[7] to distribute to government entity Item 1 DGRs with retrospective effect, so no action is required by the trustees to enable the trust to make grants to government entity Item 1 DGRs.
2) Ensure the drafting is consistent with the operation of section 13 of the *Charities Act 2013* so these trusts remain charitable under Commonwealth law and income tax exempt.

WA has done this and we urge all States and Territories to adopt the wording in Part 6 of the *Charitable Trusts Act 2022 (WA)* – extracted in Annexure B.

[7] While this issue is particularly relevant for ancillary funds, all charitable trusts would benefit from a clear, consistent approach across the Commonwealth and States.

Annexure A: Comparison of State and Commonwealth Laws

INCOME TAX EXEMPTION - COMMONWEALTH		
Legislation	The provisions apply to:	How the provision operates
Income Tax Assessment Act 1997 (Cth): section 50-1 and item 1.1 in the table in section 50-5	Registered charities	Subject to certain conditions, charities that are registered with the ACNC are eligible to be endorsed as exempt from income tax.
Income Tax Assessment Act 1997 (Cth): section 50-1 and item 1.4 in the table in the former section 50-20	Ancillary funds which were: • established and maintained solely for the purpose of providing money, property or benefits to, or for the establishment of, an item 1 DGR • not eligible to be endorsed as a charitable trust These funds were referred to as income tax exempt funds (or ITEFs).	Subject to certain conditions, these types of funds were eligible to be endorsed as exempt from income tax.

INCOME TAX EXEMPTION - COMMONWEALTH		
Legislation	The provisions apply to:	How the provision operates
Charities (Consequential Amendments and Transitional Provisions) Act 2013 (Cth): Item 4, Part 2, Division 2, Schedule 2	A fund that was endorsed as an ITEF[8] on 31 December 2012	A fund that was endorsed as an ITEF on 31 December 2012 was automatically registered as a charity with the ACNC and endorsed to access income tax exemption as a charity with the ATO on 1 January 2013. Its purposes are treated as charitable purposes.

[8] Under Subdivision 50-B of the *Income Tax Assessment Act 1997* (Cth) because of being covered by the item 4.1 of the table in the former section 50-20 of that Act.

	CHARITABLE STATUS				
Jurisdiction	Legislation	Year that the provisions came into effect	The provisions apply to:	Who can grants be made to:	How the provision operates
Commonwealth	*Charities Act 2013* (Cth): section 13	2014	This provision applies to any 'fund'. While it may extend to all charities, it certainly applies to all charitable trusts.	A 'government entity' that would be a charity were it not a government entity. 'Government entity' is defined in section 4.	The government entity is treated as a charity when determining whether the fund has a charitable purpose. As such, any grants made by the fund to a government entity Item 1 DGR will be deemed to be made to a charity and therefore, the fund will continue to have a charitable purpose.

	CHARITABLE STATUS				
Jurisdiction	Legislation	Year that the provisions came into effect	The provisions apply to:	Who can grants be made to:	How the provision operates
Victoria	*Charities Act 1978* (Vic): section 7K Came into effect in 2006	2006	Charitable trusts	DGRs which would be charities but for their connection to government.	Trustees can make a declaration in the form provided in the Schedule of the Act. The declaration gives them the power to make distributions to, or for the establishment of, a DGR that would be a charity but for its connection to government. The trust remains charitable under Victorian law despite these distributions to non-charitable DGRs. This applies despite anything contrary in the trust deed.

	CHARITABLE STATUS				
Jurisdiction	Legislation	Year that the provisions came into effect	The provisions apply to:	Who can grants be made to:	How the provision operates
South Australia	*Trustee Act 1936* (SA): section 69D	2010	Charitable trusts	Any entity that would be a charity but for its connection to government.	Any trust that provides money, property or benefits to, or for the establishment of, an entity that would be a charity but for its connection to government, remains charitable. This provision operates automatically, without requiring any special action by the trustee. However, the trust deed will need to include the power or a purpose to make these distributions.

Queensland New South Wales	*Trusts Act 1973* (Qld): Part 9 *Charitable Trusts Act 1993* (NSW): Part 4A	**Queensland** 2009 **New South Wales** 2006	**Queensland** Ancillary funds and certain prescribed entities. There are currently no prescribed entities. **New South Wales** Ancillary funds and prescribed entities. Currently trusts which are endorsed as registered charities have been prescribed in the Regulations.	Any DGR	The trustee is empowered to make grants to, or for the establishment of, a non-charitable DGR, and the trust remains charitable if either: 1. its trust deed allows for these distributions to be made; or 2. the trustee makes a declaration in the approved form. Where a declaration is made, the power given to the trustee under Part 9 applies despite anything to the contrary in the trust deed, except where the trust deed expressly prohibits a distribution to a particular recipient or class of recipients. The declaration can be limited only include certain recipients or classes of recipients.
Tasmania, NT and the ACT	No legislation addressing this issue	NA	NA	NA	Ancillary funds set up in these jurisdictions can only make grants Item 1 DGRs that are charitable at law.

Annexure B - Charitable Trusts Act 2022 (WA)

Part 6 — Gifts by certain trusts for philanthropic purposes

48. Terms used

In this Part —

eligible recipient means a deductible gift recipient —

(a) listed in item 1 of the Table to the *Income Tax Assessment Act 1997* (Commonwealth) section 30-15; and

(b) that is not a charity due to its connection with government or by being a government entity but would be a charity if it did not have the connection with government or it was not a government entity;

former commencement day means the day on which the *Charitable Trusts Amendment Act 2011* came into operation;

former prescribed power means a prescribed power as defined in the *Charitable Trusts Act 1962* section 22D(1);

government entity has the meaning given in the *Charities Act 2013* (Commonwealth) section 4;

prescribed power, for a prescribed trust, means a power referred to in section 49 or 50;

prescribed trust means —

(a) a fund referred to in item 2 of the Table to the *Income Tax Assessment Act 1997* (Commonwealth) section 30-15, whether created before, on or after former commencement day; or

(b) a trust that is established and maintained for charitable or philanthropic purposes and is of a class prescribed by the regulations, whether created before, on or after former commencement day;

trust instrument, in relation to a prescribed trust, means the will or instrument of trust establishing the prescribed trust, as modified by all validly executed amendments.

49. Prescribed trust: trust instrument containing express power to give to eligible recipients

The trust instrument of a prescribed trust may include an express power for the trustees to provide property or benefits to or for an eligible recipient or for the establishment of an eligible recipient.

50. Prescribed trust: trust instrument not containing express power to give to eligible recipients

(1) The powers of the trustees of a prescribed trust, whose trust instrument does not contain an express power to do so, include a power to provide property or benefits to or for an eligible recipient or for the establishment of an eligible recipient.

(2) Subsection (1) —

(a) applies despite any provision to the contrary in the trust instrument; but

(b) does not apply in relation to a particular eligible recipient or a particular class of eligible recipients to the extent that there is an express prohibition in the trust instrument against the provision by the trustees of property or benefits —

(i) to or for that eligible recipient or class of eligible recipients; or

(ii) for the establishment of that eligible recipient or class of eligible recipients.

51. Ancillary provisions

(1) This Act applies to a prescribed power as if it were a power exercisable for a charitable purpose.

(2) Without limiting subsection (1) —

(a) neither the existence nor the exercise of the prescribed power affects the validity or status of a charitable trust as a charitable trust; and

(b) a prescribed trust is to be construed and given effect to as if —

(i) the prescribed power were a power exercisable for a charitable purpose; and

(ii) any application of property held by the trust in the way allowed by the power were to or for a charitable purpose;

and

(c) the existence or exercise of the prescribed power does not affect the control of a prescribed trust by the Court in the exercise of the Court's general jurisdiction in relation to charitable trusts; and

(d) the jurisdiction mentioned in paragraph (c) extends to the prescribed power as if the power were exercisable for a charitable purpose.

52. Validation provisions for period preceding former commencement day

(1) In this section —

former eligible recipient means an eligible recipient as defined in the *Charitable Trusts Act 1962* section 22A.

(2) The provision, before former commencement day, by the trustees of a prescribed trust of property or benefits to or for a former eligible recipient or for the establishment of a former eligible recipient —

(a) is taken to be, and always to have been, a provision for an authorised and valid purpose of the prescribed trust; and

(b) does not affect, and is taken never to have affected, the status of the prescribed trust as a charitable trust.

(3) Subsection (2) applies despite a failure by the trustees of a prescribed trust to do any of the following —

(a) make a declaration under the *Charitable Trusts Act 1962* section 22C(3);

(b) adhere to a limitation applicable in relation to the prescribed trust under the *Charitable Trusts Act 1962* section 22C(4) and (5);

(c) comply with the *Charitable Trusts Act 1962* section 22C(6).

(4) The inclusion of a former prescribed power in the trust instrument of a prescribed trust before former commencement day is taken to be, and always to have been, valid.

53. Validation and transitional provisions for period preceding commencement of this Part

(1) In this section —

new commencement day means the day on which this Part comes into operation.

(2) The inclusion of a former prescribed power for a prescribed trust on and after former commencement day but before new commencement day is taken to be, and always to have been, valid.

(3) The exercise of a former prescribed power on and after former commencement day but before new commencement day is taken to be, and always to have been, valid despite a failure by the trustees of a prescribed trust to do any of the following —

(a) make a declaration under the *Charitable Trusts Act 1962* section 22C(3);

(b) adhere to a limitation applicable in relation to the prescribed trust under the *Charitable Trusts Act 1962* section 22C(4) and (5);

(c) comply with the *Charitable Trusts Act 1962* section 22C(6).

(4) The former prescribed power is, on and after new commencement day, taken to be a prescribed power for the purposes of section 51.