Program Related Investments – an Opportunity for Australia

A report prepared by Philanthropy Australia for the Department of Social Services to assist the work of the Prime Minister's Community Business Partnership

November 2015

This report was commissioned by the Commonwealth of Australia, represented by the Department of Social Services. The purpose of this report is to assist the work of the Prime Minister's Community Business Partnership.

Key Points

- The Commonwealth Department of Social Services commissioned Philanthropy Australia to undertake a project to assist the work of the Prime Minister's Community Business Partnership.
- The project involved examining the 'Program Related Investments' (PRI) framework in the United States, developing a number of options for how such a framework could be implemented in Australia, seeking to ascertain demand for such a framework in Australia within the philanthropic sector, and recommending a model for introducing PRIs in Australia.
- PRIs may provide a new and innovative way to leverage limited philanthropic funds in Australia in order to increase their impact and effectiveness
- They involve investments made by foundations to further their charitable purposes, with the explicit understanding that those investments will earn below-market returns. Although a PRI is not a grant, it counts toward a foundation's minimum distribution requirement in the year a disbursement is made. Once repaid, the funds used for a PRI are recycled by making new grants or PRIs.
- PRIs have a number of benefits for foundations – they can enable them to leverage their assets better, they can help 'crowd-in' private investment on commercial terms as well as public investment and thereby increase the funding available to address social and environmental challenges, and they can support innovative market-based approaches where, due to market failures or social conditions, the market would otherwise not deliver appropriate or desirable outcome.
- In addition to the benefits for foundations, PRIs can provide a new source of investment for charities, not-for-profits and social enteprises and assist in building their organisational capabilities.
- PRIs can also benefit the taxpayer – by enabling foundations to better leverage their assets to further their charitable purposes, PRIs effectively provide more 'value' to the taxpayer in return for the tax concession which has been provided to donors to a PAF/PuAF.
- PRI also present some challenges, for example, they are likely to be more resource intensive to manage compared with grants.
- Although the US PRI framework does not apply in Australia, there are ways that concessionary investments made by PAF/PuAFs in DGRs can still be counted, at least in part, towards the minimum distribution requirement.
- Three potential models, combined with an option to retain the status quo, formed the basis for the consultation process which involved testing reform options with a broad range of stakeholders, including the trustees and management of a range of Australian foundations.
- The key finding of the consultation process was that there is very strong support from a broad range of stakeholders for the introduction of a PRI framework in Australia.
- There was a very strong preference for a PRI framework over the current situation in Australia.
- The preferred model from the consultation process was 'Option 2' – where PRIs could be made in both DGRs, and organisations which are not DGRs. However, the category of non-DGR organisations would be limited to registered charities, organisations issuing social impact bonds in partnership with a government agency, and investments made through suitable impact investment intermediaries.
- The key recommendation of this report is to introduce a PRI framework in Australia based on Option 2, and make the necessary amendments to legislation and regulation to give effect to this.

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1 INTRODUCTION

1.1 Background

The Commonwealth Department of Social Services commissioned Philanthropy Australia to undertake a project to assist the work of the Prime Minister's Community Business Partnership (the Partnership).[1]

The Partnership brings together prominent Australians from the business and community sectors to provide high level advice to Government on practical changes that will foster a culture of philanthropic giving, volunteering and investment in order to strengthen communities.

The Partnership is considering opportunities to grow innovative investment in Australia and promote collaborative cross sector partnerships, and will make practical recommendations to the Government on how this can be achieved.

The Partnership is examining new ways to grow giving, for example through reducing red tape and introducing new giving structures. This work is of critical importance to ensuring that Australians are provided with a range of well-designed giving structures which are targeted to suit different circumstances and preferences.

However, even with growth in philanthropy, by its very nature the 'demand' for philanthropy will always exceed supply.

Therefore, we not only need to look at new ways to grow giving, but also embrace new ways to leverage limited philanthropic funds in order to increase their impact and effectiveness. This directly relates to one of the terms of reference for the Partnership, which is tasked with considering the potential of innovative investment and finance models.[2]

We not only need to look at new ways to grow giving, but also embrace new ways to leverage limited philanthropic funds in order to increase their impact and effectiveness.

In recent years, philanthropic organisations have been examining how they give as well as how they collaborate with other actors, including the organisations they fund and beyond, in order to achieve better outcomes. There is a focus on innovation within philanthropy – for example through adopting 'collective impact' approaches, or through providing multi-year grants to organisations to build and support their capacity.

There is also a focus on innovation within the broader not-for-profit sector, driven by a number of factors. It reflects pressure on not-for-profit organisations to diversify their income sources to support their ongoing sustainability. But it also is driven by recognition that 'traditional' approaches to addressing social and environmental challenges can fail to address the entrenched nature of many of these challenges.

[1] More information about the Prime Minister's Community Business Partnership is available on the Partnership's website: <http://www.communitybusinesspartnership.gov.au>

[2] The terms of reference for the Prime Minister's Community Business Partnership are available on the Partnership's website: <http://www.communitybusinesspartnership.gov.au/about/terms-of-reference>

For these reasons, many not-for-profit organisations are not only looking to social enterprise as a way to provide new income sources, but to actually use enterprise-based models to address social and environmental challenges and the systemic issues which underpin those challenges. And it is important to note that social enterprise is not only the domain of not-for-profit organisations, but that many social enterprises are also for-profit.

This need for innovation within philanthropy and the broader not-for-profit sector reflects the emphasis and role of innovation within the wider economy, and is at the centre of the Australian Government's policy agenda. The Prime Minister recently stated that:

> *If we want to remain a prosperous, first world economy with a generous social welfare safety net, we must be more competitive, we must be more productive. Above all we must be more innovative. We have to work more agilely, more innovatively, we have to be more nimble in the way we seize the enormous opportunities that are presented to us.*[3]

It is within this strategic context that the project has been undertaken – with the project examining a particular policy change which may provide a new and innovative way to leverage limited philanthropic funds in order to increase their impact and effectiveness, namely the introduction of a so called 'Program Related Investments' (PRI) framework for Australian trusts and foundations.

In the United States, a number of foundations use so called 'program related investments' (PRIs) to complement their grant making activities.

In the United States, a number of foundations use PRIs to complement their grant making activities.[4]

PRIs involve investments made by foundations to further their charitable purposes, with the explicit understanding that those investments will earn below-market returns. Although a PRI is not a grant, it counts toward a foundation's minimum distribution requirement in the year a disbursement is made. Once repaid, the funds used for a PRI are recycled by making new grants or PRIs.

The project involved examining the PRI framework in the US, developing a number of options for how such a framework could be implemented in Australia, seeking to ascertain demand for such a framework in Australia within the philanthropic sector, and recommending a model for introducing PRIs in Australia.

None of the options considered involve a cost to government revenue, but rather focus on providing more flexibility regarding how foundations can use their distributions.

This report documents the findings of the project.

1.2 Project Methodology

The project involved a number of components, which are addressed sequentially within this report.

Part 2 examines how PRIs operate in the US. This included providing a number of case studies of how they are used by US foundations.

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[3] Turnbull, M; *Changes to the Ministry.* Media Release. 20 September 2015.

[4] A PRI framework also exists in Canada, however the focus of this report is on the US framework. More information about the Canadian framework is available on the Canada Revenue Agency website <http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/cmtycnmcdvpmt-eng.html#N10450>

Part 3 considers some of the arguments in favour of PRIs, in order to identify how they can increase the effectiveness of philanthropic giving, as well as some potential challenges associated with PRIs.

Part 4 examines the current situation in Australia, in terms of what options are currently available to trusts and foundations and how they compared with PRIs.

Part 5 proposes a number of reform options, as set out in Table 1.1.

1. No change from the status quo **2.** Introducing a PRI framework but limiting its scope to Deductible Gift Recipients (DGR) **3.** Introducing a PRI framework which is not limited to just DGRs, but whose scope also includes a restricted set of non-DGR entities **4.** Allowing PRIs in all organisations with a social/environmental purpose

Table 1.1 – Reform Options

Part 6 of the report, summarises the outcomes of the consultation process undertaken as part of the project. This process involved stakeholders including the management and trustees of various Australian trusts and foundations, with a particular focus on private and public ancillary funds (PAF/PuAF) both large and small, as well as other advisers and experts.[5]

Informed by the outcomes of the consultation process, Part 7 of the report makes recommendations regarding a way forward, including the proposal of a PRI model suitable for implementation in Australia.

A legal opinion was also sought from ProLegis Lawyers regarding any changes to legislation and regulation which would be required to give effect to the recommendation in Part 7 of the report.

[5] Individuals consulted as part of this process are listed in Appendix 1.

2 WHAT ARE PROGRAM RELATED INVESTMENTS

2.1 Key Characteristics

As mentioned above, PRIs are a tool available to US foundations to complement their traditional grant making activities.

They involve foundations making investments to further their charitable purposes, with the explicit understanding that those investments will earn below-market returns. This can be contrasted with so called 'Mission Related Investments' (MRIs), which are commercial investments which also provide a social or environmental return. MRIs are what some commonly refer to as 'impact investments' although the term 'impact investment' could also include PRIs.

There are a variety of different PRIs which US foundations can make, including:

- Low cost loans – the most common PRIs, accounting for about 60 per cent of all PRIs,[6] which provide a low cost form of growth capital for a charity, not-for-profit or social enterprise
- Equity investments – in funds with a social/environment purpose or a social enterprise
- Loan guarantees – where a foundation guarantees the borrowing of a charity, not-for-profit or social enterprise, so it can access finance from a commercial provider

Although a PRI is not a grant, it still counts toward a foundation's minimum distribution requirement in the year a disbursement is made.

As with PAFs and PuAFs in Australia, US foundations are subject to a minimum distribution requirement, which is equivalent to 5 per cent of the market value of their net assets.

A PRI can be an attractive option because although a PRI is not a grant, it still counts toward a foundation's minimum distribution requirement in the year a disbursement is made.

In addition, for the purposes of calculating a foundation's net assets, the value of the PRI also does not have to be included as part of the foundation's assets until it is repaid, even though it would normally be considered an asset. This reduces a foundation's minimum distribution requirements, until the PRI is repaid.

When the principal of a PRI is repaid, the repaid amount is added to the foundation's minimum distribution for the following year and distributed again as either another PRI or as a grant. It is important to note that because a PRI has already been counted toward the foundation's minimum distribution when it was originally made, any repaid amount must be distributed *in addition* to the foundation's minimum distribution in the year following a repayment.

For example, if a PRI in the form of a zero interest loan of $100,000 was made in financial year 1 and counted towards the foundation's minimum distribution in that year, and

[6] *Leveraging the Power of Foundations: An Analysis of Program Related Investments*, Lilly Family School of Philanthropy, Indiana University, <https://philanthropy.iupui.edu/files/research/complete_report_final_51713.pdf>

$20,000 was repaid in year 2, then in year 3 the foundation would need to distribute 5% of the value of its assets as at the end of financial year 2 *plus* $20,000.

In this way PRIs can be said to 'recycle' a foundation's assets to further its charitable purposes, as compared to a grant which is distributed but not repaid and therefore cannot be distributed again – and this is how PRIs can increase the effectiveness of philanthropic giving, by leveraging more impact from the same amount of funds.

Although a PRI does not have to be invested in a charity or a not-for-profit, about 60 per cent of PRIs are.[7] However, they may be invested in for-profit funds and social enterprises as well. Figure 2.1 illustrates how a PRI works in the case of a loan from a foundation to not-for-profit organisation under the US PRI framework.

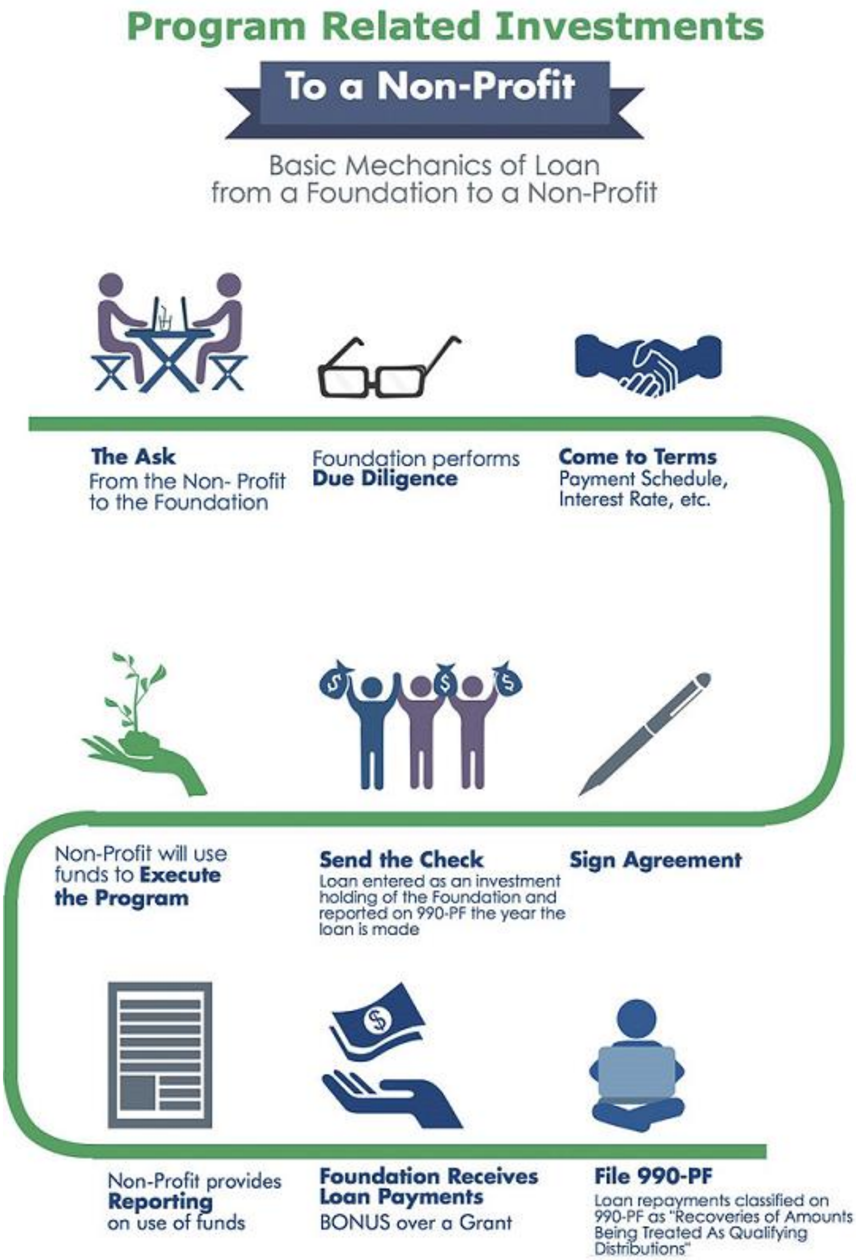

Figure 2.1 – A PRI from a foundation to a not-for-profit organisation[8]

[7] Ibid

[8] *Program Related Investments to a For Profit or a Non-Profit*, Wash Cycle Laundry and Harp Weaver, < http://www.washcyclelaundry.com/blog/program-related-investments-to-for-profit-or-non-profit>, 2015

2.2 The Legal Requirements

In order to be classified as a PRI, investments must comply with three criteria set out in the US Internal Revenue Code:

1. The primary purpose of the investment must be to accomplish one or more of the charitable, religious, scientific, literary, educational, and other exempt purposes described in section 170(c)(2)(B) of the Internal Revenue Code;
2. No significant purpose of the investment is the production of income or the appreciation of property; and
3. No purpose of the investment is to lobby, support, or oppose candidates for public office or to accomplish any of the other political purposes forbidden to private foundations by section 170(c)(2)(D) of the Internal Revenue Code.

PRIs are an 'investment' intended to primarily further a charitable purpose rather than generate a commercial return.

The practical effect of criteria 1 and 2 is that PRIs are an 'investment' intended to primarily further the foundation's charitable purposes rather than generate a commercial return. As outlined above, this can be contrasted with so called MRIs, which are commercial investments which also provide a social or environmental return. [9]

One approach commonly applied in order to assist in determining whether an investment is a PRI as opposed to an MRI is to consider whether a commercial investor would make the investment, knowing what the likely risk and return is. If a commercial investor would make the investment, having assessed the risk and return profile, then it's not suitable for a PRI, rather it's an MRI.

2.3 Examples of Program Related Investments

Whilst there are a number of different types of PRIs, Table 2.1 provide a picture of how they are used by US foundations.

THE ERICH AND HANNAH SACHS FOUNDATION of Yountville, California, made a $200,000 PRI in the Plymouth Housing Group, which works to eliminate homelessness by preserving, developing and operating safe, decent, affordable housing in the metropolitan Seattle area. Its housing facilities provide opportunities for tenants to manage their lives more effectively by providing employment, drug rehabilitation and health and human services, in addition to housing.
THE SKOLL FOUNDATION in Palo Alto, California, made $2.5 million PRI to Root Capital to help fund a loan pool to support community and economic development. Since its launch, Root Capital has provided more than 780 loans totaling $200 million in credit to 290 small and growing businesses in 30 countries across Latin America and Sub-Saharan Africa. This has financed the cultivation of 1.3 million acres of sustainable agriculture.
THE ANNIE E. CASEY FOUNDATION in Baltimore Maryland, made an equity investment of $1.65 million in the Bay Area Equity Fund to invest in companies that create jobs in low and moderate income communities in the Bay Area. One portfolio company is Revolution Foods, a high-growth business that provides affordable and healthy school meals for more than 120,000 children each day.

Table 2.1 – Three examples of how PRIs are used by US foundations[10]

[9] The Internal Revenue Service provides various examples of different types of investments in order to assist foundations to assess whether an investment they are making is a PRI. See Internal Revenue Code Regulation 53.4944-3, *Exception for program-related investments*, < https://www.law.cornell.edu/cfr/text/26/53.4944-3>

Other examples of PRIs include:[11]

- An equity investment by a foundation in a subsidiary of a for-profit pharmaceutical company to aid in the development and distribution of a vaccine to prevent a disease that primarily affects the poor in developing countries. Neither the pharmaceutical company nor other commercial enterprises will devote their own financial resources to develop the vaccine because the potential return on investment is significantly less than they require
- An equity investment by a foundation in a new recycling company in a developing country. Although there is the possibility of a high rate of return, the investment is also high risk and therefore it is difficult to attract commercial investors to finance the company
- A below-market loan by a foundation to a charitable arts organisation formed to develop and encourage interest in the fine arts, in order to purchase an art exhibition space. Commercial lenders are unwilling to provide finance at a rate which the arts organisation could make the purchase commercially feasible
- A linked deposit by a foundation, earning below-market interest, in order to induce a commercial lender to lend the same amount of funds to a charitable child care organisation to build a child care facility in a low-income neighbourhood

2.4 The Uptake of Program Related Investments

There is a lack of up to date data on PRIs in the US. The most recent data is from 2009, and is set out in Table 2.2.

Percentage of total qualifying distributions by US foundations	1.4%
Number of PRIs entered into	244
Value of PRIs	$US389 million
Average size of PRI	$US1.5 million
Median size of PRI	$US398,000
Number of foundation undertaking PRIs	97

There is a lack of up to date data on PRIs from the US, however a number of major US foundations use PRIs as a key component of their strategy.

Table 2.2 – Key figures on PRIs in the US[12]

Because this data is 6 years old, it should be used with caution. In recent years, there has been a much stronger focus on impact investment and the use of new and innovative

[10] *Strategies to Maximise Your Philanthropic Capital: A Guide to Program Related Investments*, Mission Investors Exchange/Linklaters/Thomson Reuters Foundation, 2012; and the website of the Erich and Hannah Sachs Foundation, <http://www.sachsfamilyfoundation.org/funding.html>

[11] Adapted from *Examples of Program-Related Investments*, A Proposed Rule by the Internal Revenue Service, <https://www.federalregister.gov/articles/2012/04/19/2012-9468/examples-of-program-related-investments#h-18>, 2012

[12] *The PRI Directory*, the Foundation Center, 2010

financing mechanism for addressing social and environmental challenges, and therefore it is reasonable to expect that there has since been growth in the popularity of PRIs.

Many major US foundations use PRIs as a key component of their strategy.

For example, the Packard Foundation has made over $US750 million in PRIs since 1980 and the MacArthur Foundation has made over $US500 million since 1986. The Ford Foundation is regarded as the 'inventor' of PRIs as it initially lobbied the Unites States Congress to allow PRIs in the 1960s. Since then it has committed $560 million for PRIs, and sets aside annually an average $25 million for new investments each year. Other foundations such as the Rockefeller Foundation, the Gates Foundation, and the Heron Foundation actively use PRIs.

3 WHY EXAMINE PROGRAM RELATED INVESTMENTS

3.1 The Benefits of PRIs

The taxation and regulatory framework within which philanthropy operates is critical to its effectiveness. It is not only important to have the right taxation incentives in place, but also to have well designed and flexible structures which provide different options for how philanthropic assets can be deployed.

Although grant making will always be a key component of any foundation's activities, there is a growing view that we need more 'tools in the toolbox' in order to maximise philanthropy's impact and effectiveness.

This is one of the reasons for why there is growing momentum for impact investing within philanthropy, and for this same reason, it is worthwhile examining the benefits of PRIs in order to inform any decision about whether a PRI framework is introduced in Australia.

PRIs have a number of benefits to foundations, the charities, not-for-profits or social enterprises they are invested in, and also the taxpayer. These benefits are unified by a common theme – they all relate to the more efficient use and allocation of limited philanthropic capital.

3.2 Benefits for Foundations

The most obvious benefit for foundations is that PRIs enable them to leverage their assets better.

If a foundation makes a grant, then those funds are never returned and hence cannot be used again to further the foundation's impact. However in the case of PRIs, because those funds are intended to be returned to the foundation, they can be 'recycled' as either new grants or PRIs. Therefore, PRIs can increase the foundation's impact beyond just grant making.

PRIs can enable a foundation to leverage its assets better by recycling them, helping them to increase their impact.

Foundations can use PRIs to leverage additional private investment on commercial terms as well as public investment, and thereby assist in bringing solutions to scale. A particular investment in a social enterprise may not be attractive to commercial investors on its own, however a foundation could make a PRI which takes on more risk or accepts a lower return (or both), which can then lower the risk or increase the return (or both) on an investment in the social enterprise, making it more attractive for commercial investors. Such layering can 'crowd-in' additional investment where previously there would have been none.

Following on from this, PRIs can support innovative market-based approaches where, due to market failures or social conditions, the market would otherwise not deliver appropriate or desirable outcomes. There are some areas where commercial investors will simply not be willing to invest, but that does not mean those areas are necessarily suitable for grant based support from foundations. PRIs provide an alternative.

3.3 Benefits for Charities, Not-for-profits and Social Enterprises

Many of the benefits for foundations are 'mirrored' by the benefits for charities, not-for-profits and social enterprises.

PRIs can provide funding which supports innovative enterprise-based models to address social and environmental challenges.

Most importantly PRIs provide a source of investment which can be directed toward achieving a social or environmental purpose. As stated in the introduction to this report, many not-for-profit organisations are not only looking to social enterprise as a way to provide new income sources, but to actually use enterprise-based models to address social and environmental challenges and the systemic issues which underpin those challenges. Social enterprise is not only the domain of not-for-profit organisations, with many social enterprises being for profit as well. PRIs can provide funding which supports such innovation.

As described above, this investment can assist in attracting other investors as well, both private and public.

Servicing a PRI generally requires more effort than a grant. Because a foundation is expecting a return of at least its principal, it will undertake additional due diligence and may require the development of a business plan as part of making the PRI. Although this can come across as potentially negative aspect of PRIs, the opposite is the case as it can assist the organisation in whom an investment is made to build its capacity and promote rigour around its processes and systems. The introduction of such market driven discipline can translate into improved organisational effectiveness and impact.

3.4 Benefits for the Taxpayer

Given that donors to a PAF/PuAF receive a tax deduction, the Government, representing the taxpayer, should rightly seek to ensure that the benefits to the community from the provision of this tax concession are maximised.

By enabling foundations to better leverage their assets to further their charitable purposes, PRIs effectively provide more 'value' to the taxpayer in return for the tax concession which has been provided to donors to a PAF/PuAF.

3.5 Potential Challenges

Whilst PRIs have a range of benefits, they can also present a number of challenges.

PRIs require a certain level of sophistication from foundations, and are likely to be more resource intensive to manage than grants. As they impose certain obligations on the organisation in which the investment is made, they may at times require more complex legal agreements than in the case of grants. PRIs often involve developing and approving business plans together with the organisation in which the investment is being made, and following this, it is necessary to track the performance of the investment.

However, it is worth noting that there is a wider move within the philanthropic sector towards a more engaged model of philanthropy. Many trusts and foundations see it as an intrinsic part of their role to engage more closely and collaboratively with the organisations they fund, and to monitor the outcomes of the programs they are funding. Different foundations will have varying approaches to engagement, however the level of sophistication and the necessary resources to manage PRIs may not be too different to that required for a more engaged approach to grant making.

The provision of guidance by regulators, such as through model loan agreements for PRIs, could also go some way to addressing some of these challenges.

There is a risk that the introduction of a PRI framework could lead to ‘crowding out’ of granting by PRIs. This would occur if foundations reduced their granting considerably, rather focusing on making PRIs. However there are two main reasons for why this may not be a significant problem.

Firstly, not all foundations will be interested in undertaking PRIs, preferring to retain a focus on traditional grant making.

Secondly, for a PRI to be an option, an organisation must have some form of suitable income stream with which it can repay the PRI, or the realistic prospect of such an income stream becoming available.

There are certainly more of these opportunities emerging, with growth in social enterprise as well as developments such as consumer directed care in areas such as disability services and aged care.

But there will still be many activities by charities and not-for-profit organisations which do not produce any income stream, and are therefore not amenable to PRIs. One of the arguments in favour of PRIs is that they enable limited philanthropic funds to be allocated more optimally, given the varying characteristics of different organisations and activities. PRIs can be used where there is, or will be, a suitable income stream available to repay them, enabling these funds to be recycled as either new PRIs or as grants. Grants can be used where there is no such income stream available.

Because PRIs ‘recycle’ a foundation’s assets, foundations may actually make PRIs over and above their existing granting, knowing that these funds will likely be returned.

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4 WHAT IS THE SITUATION IN AUSTRALIA

Like US foundations, Australian PAFs/PuAFs are subject to a minimum distribution requirement of 5 and 4 per cent of their net assets per annum respectively.

Other non-ancillary fund foundations, such as testamentary trusts, are not subject to this strict regulatory requirement. However they would be expected to distribute a substantial proportion of their net income and not excessively accumulate income for no reason. And they would need to comply with their governing documents, which can vary substantially.

In Australia, a PAF/PuAF can only make distributions to eligible 'Item 1' DGRs. Of the 54,000 registered charities in Australia, less than half are Item 1 DGRs.

Although the US PRI framework does not apply in Australia, there are ways that concessionary investments made by PAF/PuAFs in DGRs can still be counted, at least in part, towards the minimum distribution requirement.

Example 3 in Guideline 19.3 in the *Public Ancillary Fund Guidelines 2011* provides 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.*

There is a common view that this example not only applies to PuAFs, but also PAFs. Its consequence is that where a PAF/PuAF provides a loan to a DGR with a discount to the market interest rate, the difference between the discounted and market interest rate can be counted towards a minimum distribution.

The key differences between the Australian and US approaches are summarised in Table 4.1 below.

Australian Approach	**US Approach**
Where a PAF/PuAF makes a concessionary investment such as a loan at a discounted interest rate, *only the difference* between the discounted and market interest rate can be counted towards a minimum distribution	Where a foundation makes a PRI, the *entire investment* is counted towards its minimum distribution requirement
A concessionary investment such as a loan at a discounted interest rate is accounted for as an asset of the PAF/PuAF	A PRI is not accounted for as an asset of the foundation until it's repaid or 'recycled', meaning that a foundation's minimum distribution may be lower until it is repaid (at which point the repaid amount is added to the minimum distribution for the following year and the distributed again either as a grant or another PRI)

Table 4.1 – Key differences between the Australian and US approaches to concessional investments made by foundations

5 POTENTIAL REFORM OPTIONS

5.1 Reform Options

Given the various benefits of PRIs discussed in Part 3 of this report, the project involved setting out three potential models for how a PRI framework could be implemented in Australia, reflective of the different taxation and regulatory framework for philanthropy in Australia compared with that of the US.

These three potential models, combined with an option to retain the status quo, formed the basis for the consultation process which is the subject of Part 6 of this report, and were tested with stakeholders as part of this process.

5.2 No Change

A threshold question asked of stakeholders as part of the consultation process was whether the current framework applying to PAFs/PuAFs is sufficient.

As outlined in Part 4 of this report, the current framework provides that where a PAF/PuAF provides a loan to a DGR with a discount to the market interest rate, the difference between the discounted and market interest rate can be counted towards a minimum distribution. This effectively splits the investment into one component which sits within the PAF/PuAFs assets, and another component which sits within its distribution.

If the current framework was viewed as sufficient, this would weaken the argument for introducing a PRI framework in Australia. On the other hand, if it were viewed as inadequate, then this would strengthen the argument for introducing a PRI framework, but the question would remain as to what model is adopted for this framework.

There are advantages and disadvantages associated with making no changes.

Advantages

- There would be no need to devote resources towards making changes to legislation and regulation

Disadvantages

- The existing framework as discussed in Part 4 of this report, which is limited and restrictive, would be retained
- There would be a missed opportunity to introduce a more flexible framework for how foundations can use their assets to deliver impact

5.3 Option 1 – Limiting PRIs to Deductible Gift Recipients

The first reform option involved the introduction of a PRI framework in Australia, but provided that PRIs could only be made in Item 1 DGRs, which are the types of organisations which PAF/PuAFs can currently distribute to.

As Item 1 DGRs are not-for-profit organisations, they cannot issue equity, and therefore Reform Option 1 would limit PRIs to loans and loan guarantees to Item 1 DGRs.

Table 5.1 provides a case study for how this model could work.

Case Study

An Australian welfare organisation, with Item 1 DGR status, proposes to open a social enterprise. The social enterprise would be a restaurant, which trains vulnerable and disadvantaged youth to improve their prospects of securing stable employment in order workplaces. Under Reform Option 1, a PAF/PuAF could make a concessionary investment in the form of a low cost loan to the welfare organisation, in order to provide the startup capital necessary to establish the restaurant. The entire investment could be counted towards the PAF/PuAFs minimum distribution requirement.

Table 5.1 – Case study of Reform Option 1

There are a number of advantages and disadvantages to Reform Option 1.

Advantages

- Would provide an additional way for PAF/PuAFs to support DGRs
- Would closely align with the existing limitations on which organisations PAFs/PuAFs can distribute to
- Could be implemented through changes to the PAF/PuAF Guidelines, without the need for legislative change

Disadvantages

- Would limit which organisations can be supported, for example by excluding social enterprises which are not DGRs or are even for-profit organisations

5.4 Option 2 – Allowing PRIs beyond Deductible Gift Recipients

The second reform option involved the introduction of a PRI framework in Australia, and provided that PRIs could be made in both DGRs, and certain organisations which are not DGRs.

The category of non-DGR organisations would be limited to registered charities, organisations issuing social impact bonds in partnership with a government agency, and investments made through suitable impact investment intermediaries.

These restrictions would be in place in order to ensure that where PRIs are made in non-DGR organisations, they are made to further the charitable purpose of the PAF/PuAF. All three categories of non-DGR organisation in which PRIs could be made provide this assurance.

Table 5.2 provides a case study for how this model could work.

Case Study

An impact investment intermediary is seeking to put together an investment package to support a community organisation seeking to establish a small solar panel farm to generate power for their town. Any profits from the organisation would be distributed towards community regeneration projects in and around the town. Under reform option 2, a PAF/PuAF could make a concessionary investment in the form of a low cost loan through the intermediary, in order to provide the startup capital necessary to construct the solar panel farm. The entire investment could be counted towards the PAF/PuAF's minimum distribution requirement.

Table 5.2 – Case study of Reform Option 2

There are a number of advantages and disadvantages to Reform Option 2.

Advantages

- Would allow for a broader range of organisations to be supported compared with Reform Option 1, reflecting the fact that many social enterprises are not DGRs and may actually be for-profit organisations
- Would provide an assurance that where PRIs are made in non-DGR organisations, they are made to further the charitable purpose of the PAF/PuAF

Disadvantages

- Would still limit which organisations can be supported, for example by excluding social enterprises which are for-profit organisations (unless they are supported through an intermediary)
- Would create an inconsistency between the organisations which PAFs/PuAFs can distribute to, and those in which they can make PRIs
- Would require legislative and regulatory change, and amending PAF/PuAF deeds

5.5 Option 3 – Allowing PRIs in All Organisations with a Social/Environmental Purpose

The third reform option considered was an extension of the second reform option, in that it would allow PRIs to be made directly to all organisations with a social/environmental purpose consistent with that of the PAF/PuAF. This would mean that a PAF/PuAF would not be limited by the formal legal structure of taxation status of an organisation, nor would it need to make investments through a suitable intermediary. This most closely resembles the US style PRI framework.

Therefore, in the case study in Table 5.2 above, a PAF/PuAF could invest directly in the community organisation seeking to establish a small solar panel farm to generate power for their town, without the need to use an impact investment intermediary.

There are a number of advantages and disadvantages to Reform Option 3.

Advantages

- Would allow for a very broad range of organisations to be supported, providing considerable flexibility for PAFs/PuAFs to support all types of organisations including for-profit social enterprises

Disadvantages

- As there is no legal definition of an organisation with a social/environmental purpose, a social enterprise, or an impact investment, ensuring that PRIs are targeted at organisations that meet this criterion would be a challenge for both PAFs/PuAFs and the Australian Taxation Office, raising integrity issues
- Could result in increased reporting requirements in PAF/PuAF returns in order for the Australian Taxation Office to be able to ascertain the nature of organisations which were invested in
- Would create an even greater inconsistency between the organisations which PAFs/PuAFs can distribute to, and those in which they can make PRIs
- Would require legislative and regulatory change, and amending PAF/PuAF deeds

6 OUTCOMES OF THE CONSULTATION PROCESS

6.1 The Consultation Process

In order to inform the conclusions of this report, a consultation process was undertaken as part of the project. Stakeholders consulted included the management and trustees of various Australian trusts and foundations, with a particular focus on PAF/PuAFs both large and small, as well as other advisers and experts.[13]

The process included two facilitated workshops in Melbourne and Sydney held in October 2015, as well as one on one consultation, and was based around a discussion paper and presentation.[14] The discussion paper and presentation explained the concept of PRIs, the current situation in Australia, and set out the reforms options as discussed in Part 5 of this report.

Before determining whether to introduce a PRI framework in Australia, it is necessary to ascertain whether there would be demand for such a framework. There would be little point in making any legislative and regulatory changes, if the new framework was unlikely to be used.

Therefore, the purpose of the consultation process was to test the level of interest and support for introducing a PRI framework in Australia as well as to seek views regarding the preferred model for doing so. This involved asking participants in the process whether they would find the introduction of a PRI framework attractive, but also whether they would be inclined to incorporate it as part of their foundation's strategy if it were available.

The findings of the consultation process inform the recommendations made in Part 7 of this report.

6.2 Findings of the Consultation Process

Key Finding

The key finding of the consultation process was that there is very strong support from a broad range of stakeholders for the introduction of a PRI framework in Australia.

A number of foundation representatives in both workshops stated that they would be inclined to use a PRI framework were it available, indicating strong demand from those consulted.

There is very strong support from a broad range of stakeholders for the introduction of a PRI framework in Australia.

There was skepticism from a small number of foundation representatives, but this was limited and represented a minority of foundation representatives.

There was consistent support for introducing a PRI framework in Australia amongst the advisers and experts consulted.

[13] Individuals consulted as part of this process are listed in Appendix 1.
[14] The presentation is included in Appendix 2.

Points Raised in Support of Key Finding

A number of points were raised by stakeholders in support of the key finding.

There was a view, expressed by a foundation representative, that PRIs would be useful as 'layered' funding, sitting in between grants and MRIs. Such layered funding could enable the more effective targeting of philanthropic support by foundations to suit to particular circumstances.

PRIs would be useful for foundations which don't have the capacity to engage in mission related investment.

Another view, also expressed by a foundation representative, was that PRIs would be useful for foundations which don't have the capacity to engage in MRIs, given the higher level of due diligence required in order to make such investments using the foundation's corpus, but also the very cautious approach taken by many trustees in relation to such investments being made using the corpus.

To paraphrase one foundation representative, they stated that 'my trustees view impact investment as a 'grey area' and I would likely have more success convincing them to pursue an impact investment through the foundation's granting by way of a PRI, rather than through the foundation's corpus by way of MRI.'

These views were reinforced by advisers and experts, who considered PRIs as an attractive way for foundations to provide alternative support to charities in appropriate circumstances.

An issue raised in both workshops was that if PAF/PuAFs invested their entire corpus in PRIs, this could reduce granting. However there was a view that this was relatively unlikely to occur. This is discussed in more detail in Part 3 of this report.

One point made during the consultation process was that whilst the process had focused on PAF/PuAFs, it was important to consider how a PRI framework could apply in the case of non-ancillary fund foundations.

Non-ancillary fund foundations, such as testamentary trusts, are not subject to a strict distribution requirement. However they would be expected to distribute a substantial proportion of their net income and not excessively accumulate income for no reason. And they would need to comply with their governing documents, which can vary substantially.

Therefore, if a PRI framework were introduced in Australia, consideration would need to be given as to whether and how it could be applied in the case of non-ancillary fund foundations.

Views on the Current Situation in Australia

In both workshops, the facilitator emphasised that although the US PRI framework does not apply in Australia, there are ways that concessional loans made by PAF/PuAFs to DGRs can still be counted, at least in part, towards the minimum distribution requirement, as discussed in Part 4 of this report.

However, there was no interest in this approach from any foundation representative, with a very strong preference for a PRI framework over the current situation in Australia.

There was a very strong preference for a PRI framework over the current situation in Australia.

One reason for this appeared to be the fact that such a concessional loan involves allocating part of the investment to the foundation's corpus and part of the investment to the foundation's granting.

There was a general view that this approach was somewhat confusing, with the very cautious approach taken by many trustees in relation to investments being made using the corpus also being relevant.

The Preferred Model

Overall, the consultation process revealed that Option 2 was the preferred model. This would allow PRIs to be made in both DGRs, and organisations which are not DGRs. However, the category of non-DGR organisations would be limited to registered charities, organisations issuing social impact bonds in partnership with a government agency, and investments made through suitable impact investment intermediaries.

Overall, the preferred model was Option 2.

Although there was also support for Option 3, which would allow PRIs to be made in all organisations with a social/environmental purpose, there was recognition that although such a broad option would be ideal, it was unlikely to be practical or realistic, at least in the short-term.

There was a view that Option 1, where PRIs could only be made in Item 1 DGRs, was quite restrictive given that the DGR framework itself is quite restrictive and many charities and social enterprises fall outside of it. However, it was noted that a number of DGRs could still benefit from PRIs, and that many DGRs also establish social enterprises which could benefit from PRIs. Most foundation representatives and advisers and experts believed that despite its restrictions, Option 1 was still superior to the current situation in Australia.

7 The Way Forward

7.1 Recommendations

Based on the research undertaken as part of the project, and the outcomes of the consultation process, the following recommendations are made:

Recommendation 1

A Program Related Investments framework should be introduced in Australia, based on Option 2 as set out in this report.

The necessary amendments to legislation and regulations should be made to give effect to this framework.

Characteristics of the Proposed PRI Framework

The proposed PRI framework would involve the following characteristics:

- Allowing PAF/PuAFs to make below-market return investments (including loans, loan guarantees and equity purchases where applicable) in eligible entities, including DGRs and certain organisations which are non-DGRs, provided these investments further the charitable purposes of the PAF/PuAF making them
- These investments would count towards the minimum distribution of the PAF/PuAF in the year they are made
- These investments would not be counted towards the PAF/PuAF’s assets until any principal has been repaid either in full or in part
- When the principal is repaid, either in part or in full, the amount repaid would be added to the PAF/PuAFs minimum distribution in the year after it is repaid
- Any income from a program related investment would become an asset of the PAF/PuAF once it is received

The category of non-DGR organisations included as eligible entities would be limited to:

- Registered charities
- Organisations issuing social impact bonds in partnership with a government agency
- Investments made through suitable impact investment intermediaries

These restrictions would be in place in order to ensure that where PRIs are made in non-DGR organisations, they are made to further charitable purposes, even if these are not carried out by a DGR. It would avoid the problems associated with Reform Option 3, whose breadth would make it very difficult to verify that PRIs are being made to further charitable purposes.

All three categories of non-DGR organisation in which PRIs could be made provide the necessary assurance.

Registered charities are regulated by the Australian Charities and Not-for-profits Commission (ACNC), and must have charitable purposes and comply with the ACNC regulatory framework.

Where a social impact bond is issued in partnership with a government agency, there is the a recognition from government that the social impact bond is focused on an issue of sufficient importance to the community and addresses a particular social problem.

A list of ‘approved impact investment intermediaries’ could be included in regulation, following assessment of their suitability by an appropriate government body. Such an assessment would not be expected to be resource intensive, with a focus on verifying that their activities are limited to financing investments with a social and environmental purpose. Such intermediaries could either broker PRIs between foundations and other organisations, or act as a conduit for such PRIs.

A number of stakeholders have identified a need for the introduction of a dedicated social enterprise legal structure in Australia, such as the United Kingdom’s ‘Community Interest Company’.[15] Should this occur, Reform Option 2 could be extended to allow PAF/PuAFs to make PRIs in those organisations, given they are both ‘asset’ and ‘mission’ locked.

The Necessary Amendments to Legislation and Regulation

Based on the legal opinion provided by ProLegis Lawyers, this recommendation would require relatively straightforward amendments to the *Income Tax Assessment Act 1997 (Cth)* and both the *Private Ancillary Fund Guidelines 2009 (Cth)* and the *Public Ancillary Fund Guidelines 2011 (Cth).* Changes to the Australian Taxation Office model deed for both PAFs and PuAFs would be necessary, and individual PAFs and PuAFs also may need to amend their deeds.

These amendments should be developed in close consultation with the philanthropic sector, and avoid unnecessary complexity. A possible approach is put forward by ProLegis Lawyers in their legal opinion in Appendix 3.

In addition to amendments to legislation and regulation, the Australian Taxation Office will need to make appropriate changes to the PAF/PuAF reporting arrangements, in order to maintain the ability to monitor the integrity of the PAF/PuAF regulatory framework.

Recommendation 2

Once the Program Related Investments framework in Recommendation 1 is introduced, the Australian Taxation Office should prepare appropriate guidance to assist stakeholders with their understanding of the framework. This should include preparing model Program Related Investment agreements for use by private and public ancillary funds.

Such guidance will assist PAF/PuAFs with the use of the PRI framework, to ensure that complexity and uncertainty are not barriers to the uptake of PRIs.

Recommendation 3

That the Australian Charities and Not-for-profits Commission and the Australian Taxation Office be asked to consider providing guidance regarding the ability of non-ancillary fund foundations to make Program Related Investments, and the relevant implications of charity and taxation law.

The distribution requirements imposed upon non-ancillary fund foundations, are less clear and consistent than in the case of PAF/PuAFs, given that PAF/PuAFs are regulated through a statutory framework and because non-ancillary fund foundation governing documents can vary considerably. Therefore, consideration is needed regarding whether and how a PRI framework could be applied in the case of non-ancillary fund foundations.

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[15] More information about Community Interest Companies is available on the website of the Office of the Regulator of Community Interest Companies <https://www.gov.uk/government/organisations/office-of-the-regulator-of-community-interest-companies>

7.2 Two Case Studies

The following case studies, provided by individuals consulted as part of the project, are 'real life' practical examples of how a PRI framework based on Option 2 could support emerging social enterprises and innovative solutions to addressing social challenges. The second case study has been de-identified, which has involved making some modifications to the facts.

Scaling Up Reach Enterprises

The Reach Foundation runs school and community-based programs for young people designed to promote their wellbeing, and is an Item 1 DGR.

Thanks to a seed grant from The Lord Mayors Charitable Foundation, The Reach Foundation was able to launch Reach Enterprises. Reach Enterprises has utilised its team of skilled Reach facilitators, which have come up through the Reach Foundation community program, to develop and implement training workshops for the corporate sector. Reach Enterprises delivers leadership camps, conference workshops, and staff training programs on a fee-for-service basis to a variety of corporate partners. As a result of these experiences, corporate clients have seen a positive impact on employee engagement and individual wellbeing, by build social and emotional skills, improving self-awareness and encouraging deeper connections within the workplace.

Reach Enterprises not only provides fulfilling work for Reach facilitators and value for corporate clients, but the income it generates is also used to support the Reach Foundation's community program, contributing to its ongoing financial sustainability.

The grant from the Lord Mayor's Charitable Foundation has resulted in Reach Enterprises delivering a substantial profit in year one. The grant was utilised to commit a part-time resource to the development and implementation of Reach Enterprises. After generating a profit in year one and contributing a sustainable self-generated income stream to The Reach Foundation, the organisation is now looking to scale up the operations of Reach Enterprises.

The Reach Foundation has currently planned for organic growth within current organisational resource capacity. For Reach Enterprises to scale faster and enter a more aggressive growth phase, the organisation would need funding to recruit more facilitators, invest in the capacity building of facilitators and recruit behind the scenes staff and wellbeing professionals, to further support the increased demand.

A PRI would enable Reach Enterprises to enter a more aggressive growth phase. The repayment of such a loan would instil sound business discipline into the practices of Reach Enterprises.

A PRI from an organisation like The Lord Mayor's Charitable Foundation would enable Reach Enterprises to enter into this more aggressive growth phase. The repayment of such a loan would instil sound business discipline into the practices of Reach Enterprises.

Innovative Approaches to Delivering Mental Health Services in Remote Northern Australia

A group of Australian foundations has been funding into a remote community in Northern Queensland to trial a new model of delivery for mental health services. In the first instance this was a pilot program, followed by a detailed analysis of the outcomes of the pilot.

The pilot was found to be most effective when it involved a collaboration which combined the training of social workers drawn from the community and employed within a community organisation (funded through philanthropy and government), with a for-profit medical clinic delivering services in partnership with the community organisation (funded through Medicare).

To expand the model beyond the first initial community and expand it further into the region, greater philanthropic funding is necessary, however investment is also required into the medical clinic. Due to the remoteness of the region and the complexity of the medical care required in many cases, it is difficult to make the medical clinic profitable enough to provide a return which would attract commercial investors. However, without the investing in the medical clinic, the model cannot be expanded given that it involves a partnership between the community organisation and the medical practice.

Combined with philanthropic funding for the community organisations, a PRI could provide the funding needed to support the medical clinic, so this innovative healthcare model can expand further into the region.

A foundation could make a PRI in the medical clinic, which would be combined with the philanthropic and government funding which is provided to the community organisation. This blended funding approach, using different sources, would provide an innovative way to expand the model and deliver better mental health outcomes in this remote region.

As the PRI would be made in a for-profit enterprise, under Option 2 it would need to be made through an impact investment intermediary.

This case study illustrates the limitations associated with Option 1, in which PRIs can only be made in Item 1 DGRs. Under Option 1, this model would likely not be able to be expanded.

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