Submission to the Senate Economics References Committee Inquiry into Not-for-profit Entities Tax Assessments

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Introduction

New tax rules for Not-For-Profit (NFP) organisations came into effect on 1st July 2023, and the impact has been felt since 1st July 2024 when the need for NFPs to complete and file a self assessment was replaced by the need to complete and submit a self review. For many of the tens of thousands of small NFP organisations in Australia, the obligation to report annually to the ATO came out of the blue, despite extensive consultation by the ATO. As a consequence, there is widespread misunderstanding and considerable anxiety in the small-scale NFP sector.

The new focus on taxation of small-scale NFPs is also seen as unfair in several ways. Not only does it place an unwarranted burden on small-scale NFPs that are operated by unpaid volunteers, but it also makes it impossible for the ATO to be effective and efficient in administering the rules.

By addressing the issue of fairness in the tax laws, the burden of regulatory compliance on small-scale NFPs could be relieved and the difficulty of the ATO's administrative task could be simplified.

The failure of the self-assessment principle

Until 1st July 2023, small-scale NFPs were required to complete an annual self-assessment of their eligibility for exemption from taxation. However, after decades of self-assessments being ignored by the ATO – virtually no audits or publicity about their importance – many small-scale NFPs have come to assume they are tax exempt and not required to be involved with the ATO. By 2023, compliance with the requirement to complete an annual self-assessment had eroded so extensively that a significant number of small-scale NFPs (probably a majority) were either not completing them at all, or were incorrectly assessing themselves as tax exempt.

The governing committees of these organisations are made up of well-meaning volunteers who are not necessarily informed about evolving governance standards and compliance requirements. As volunteer committee members step down and move on, organisational memory is lost. Unless a small-scale NFP is plugged into an active peak body that informs and educates its member organisations, it is inevitable that compliance will fall away.

By ignoring this issue for decades, the ATO has allowed a belief to take root that is now widely accepted in the community - that small-scale NFPs ***are*** tax exempt. The practice of completing and filing a self-assessment every year has waned in the absence of any official checks or audits, and in many cases the practice has disappeared. Even in organisations that have kept up their self-assessments, many have mistakenly assessed themselves as exempt when in fact their governing documents are out-dated, and they no longer qualify for an exemption. The lack of any official oversight by the ATO has contributed to this delusion.

The burden of the self-review

The ATO maintains that "eligibility for tax exemption has not changed", which is technically true. However, as self-assessments have fallen away in years gone by, the recent publicity about the self-review has created a perception within the small-scale NFP sector that the self-review is a new obligation rather than a simple replacement of an existing obligation. For many small-scale NFPs, the recent letter from the ATO to ABN holders was the first they had heard about the changes to the tax rules.

Some comments I heard in the lead up to the new requirements include:

> *We report to Consumer Affairs Victoria, not the ATO.*
>
> *We don't get involved with the ATO.*
>
> *I'm stepping down at the next AGM, so that will be the next person's problem.*
>
> *No, that stuff doesn't affect us. We are a not-for-profit.*
>
> *We don't have to pay tax.*
>
> *I don't know about that.*
>
> *We have never had to do that before.*

Any organisation that has had no prior experience with annual self-assessments will see the self-review as a new burden, even if it is simple to complete. When you add the possibility that the organisation may have to pay tax, it is not surprising that the volunteer members of many committees feel put upon.

Extra work for the ATO

The ATO has noted that handling the escalating number of enquiries about the new requirements has affected their "service window" and resulted in delays. In a way, the extra work the ATO is doing now is simply catching up on the lack of focus they placed on auditing and checking self-assessments in past years. If the small-scale NFP sector had been broadly complying with self-assessment principles, then switching over to the annual self-review would not be so difficult or burdensome. However, regardless of the reason for the extra work, the effect is that the ATO is less efficient and less effective because of the need to devote resources to bringing tens of thousands of small-scale NFPs up to speed in a relatively short time. The likelihood is, many organisations will fail to comply and then the ATO will have to devote even more resources in order to take punitive measures.

The question of fairness

One key question posed by the small-scale NFP sector is that of fairness. There are at least four ways in which the tax law is unfair to small-scale NFPs.

1. The tax threshold that applies to non-exempt NFPs is currently set at just $417. This figure has not been adjusted since it was introduced in 1986 and represents an egregious example of bracket creep. There is no justification for saying that the threshold that applied in 1986 is still valid today. A Treasury study in 2013* recommended it be lifted to $10,000. After adjusting for fairness and the passage of time it should be significantly higher now.

   * *Fairer, simpler and more effective tax concessions for the not-for-profit sector* Final report of the NFP Sector Tax Concession Working Group, May 2013 https://treasury.gov.au/sites/default/files/2019-03/NFP-Sector-WG-Final-Report.pdf

2. Currently, a "phase-in" method is used to calculate tax payable. This should be replaced by a true tax-free threshold as applies in the case of personal income tax to exempt income below the threshold from taxation.

3. By counting revenue from fundraising as assessable income with no allowance for the value of volunteer labour, the tax system is discriminating against community-minded clubs and exploiting the volunteer workers. For example, if a non-exempt small-scale NFP holds a sausage sizzle, all the value added by the donated labour of volunteer workers becomes assessable income. Another way of expressing this is that 25% of the volunteer fundraisers are working for the ATO rather than their organisation. For the sake of fairness, funds raised by small volunteer-based clubs and associations that have no paid employees or

contractors should be treated as non-assessable to avoid taking unfair advantage of volunteers who add value by donating their time.

4. The tax rate applied to a non-base rate NFP is higher (30%) than the rate applied to a base rate NFP (25%). This discriminates against non-exempt small-scale NFPs that have been able to save money and increase the proportion of their income that comes from interest on savings. When an organisation is fundraising over a long time period for a major acquisition or expense, it is both demoralising and unfair that not only is tax levied on the funds raised, but the residue that is banked then incurs a further tax liability as it earns interest. For the sake of fairness, if small volunteer-based non-exempt NFPs are to be taxed, then they should be treated as base rate entities regardless of how much passive income they earn so their savings are not unfairly eroded.

When the ATO has to devote resources to enforce unfair laws, it is debilitating for the ATO as well as the small-scale NFPs that are directly affected. If the law could be made fairer by addressing points 1 to 4 above, there would be no need to pursue small-scale NFPs and burden them with the weight of regulatory compliance. Small-scale volunteer-based NFPs could flourish and the ATO could concentrate on directing its efforts where they would add to the "national asset" that is our tax system.

Conclusion and Recommendations

By neglecting taxation compliance of the small-scale NFP sector for decades, the ATO has contributed to a widespread myth that small-scale NFPs are tax exempt. As a result, the introduction of the annual self-review is widely seen as a new burden that has been imposed on small NFPs. This has led to widespread misunderstanding and anxiety in the small-scale NFP sector. Enforcing compliance will be a difficult task for the ATO, and will add to the stress being experienced by the volunteers that run the committees of the myriad of small-scale NFPs throughout Australia. By addressing the unfairness in the way small-scale NFPs are taxed, many of the inherent problems for both NFP organisations and the ATO could be overcome.

The following changes to the way tax is levied on non-exempt small-scale NFPs are recommended to improve the situation:

1. increase the tax threshold from its 1986 level of $417 to a fairer and more realistic level
2. replace the phase-in method of taxing income with a true tax-free threshold
3. classify income derived from volunteer labour as non-assessable
4. treat all small-scale NFPs as base rate entities for taxation purposes.

Simply increasing the tax threshold (#1) will remove the taxation question for many small-scale NFPs and relieve their volunteer committees of the burden of dealing with the issue. Going further (#2,#3,#4) will provide additional benefits for the operational viability of NFPs as well as improving the efficiency and effectiveness of the way the ATO interacts with the NFP sector.

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