Chapter 2

Objects of the bill

Non-commercial losses (Schedule 2)

The existing provisions

2.1 Division 35 of the ITAA 1997 was introduced to prevent 'losses' of individuals from non-commercial business activities being offset against other assessable income in the year the loss was incurred. These provisions were introduced in 2000 following the 1999 Review of Business Taxation (the *Ralph Review*) which recommended that systemic changes were required to prevent 'revenue leakage from unprofitable activities carried out by taxpayers' as many of those activities were more like hobbies and/or lifestyle choices.[1]

2.2 As a result of the changes, a series of tests were introduced to determine whether or not a business activity would be treated as being non-commercial and where the tests were not satisfied the losses were deferred. A discretion empowering the Commissioner to determine that in any particular year deferred losses could be offset against other income was also introduced. Other exceptions to protect start-up businesses and certain primary producers were also introduced.

2.3 In his Second Reading speech the then Treasurer explained of the four tests:

> The tests look at the activity's level of turnover, history of profitability, the value of real property used in carrying on the business and the value of other assets used in carrying on the business. Only one of the tests needs to be passed to enable an individual's loss from a business activity in a year to be deducted against the individual's other assessable income, such as wages and salary.
>
> …Where a test is not satisfied in an income year, the loss is deferred and can be offset in a future year against income from the activity or against other income if one of the tests is satisfied. [2]

The proposed amendments

2.4 In its 2009-10 Federal Budget the Government moved to tighten the rules of Division 35 through the introduction of another test – an income threshold. The

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1 The Hon. Peter Costello, Treasurer of the Commonwealth of Australia, Second Reading Speech, House of Representatives, *New Business Tax System (Integrity Measures) Act 2000*, 2000, p 1.

2 Second Reading Speech, House of Representatives, *New Business Tax System (Integrity Measures) Act 2000*, 2000, p 1.

amendments propose that above this threshold amount, losses are required to be quarantined to be offset against future profits of the activity.

2.5 The introduction of new subsection 35-10(2E) will ensure that where the sum of:

a) a person's taxable income for a year;

b) reportable fringe benefits total for that year;

c) reportable superannuation contributions for that year; and

d) total net investment losses for that year

exceeds $250,000, any amounts attributable to a business activity that could otherwise be deducted and which exceed the assessable income of the business activity to which they are attributed, are quarantined and carried forward to be deducted from the future assessable income of that business activity.

2.6 Below this threshold, the current rules will continue ie a person with an adjusted taxable income of less than $250,000 may deduct expenses of a non-commercial business activity that exceed the assessable income of that business activity from their other income provided they satisfy one of the four objective tests (set out in sections 35-30, 35-35, 35-40 and 35-45 of the ITAA 1997).

2.7 Where a person exceeds the income threshold but is unable to satisfy one of the four tests, they are entitled to apply to the Commissioner, in the approved form, seeking that he exercise his discretion pursuant to section 35-55 and allow the excess amounts to be deducted.

The Commissioner's discretion

2.8 Under the current law, a person may apply to the Commissioner for exercise of his discretion pursuant to section 35-55 if they do not satisfy one of the four tests. This was the case for taxpayers at any income level, but under the proposed amendments those taxpayers with adjusted taxable income greater than $250,000 will be subject to the following new rules.

2.9 Where a taxpayer's adjusted taxable income exceeds the $250,000 threshold and the farm business is non-profitable (non-commercial), the taxpayer may apply to the Commissioner seeking that he exercise his discretion. Where the Commissioner is satisfied that, based on evidence from independent sources, the business will produce assessable income greater than the available deductions in a timeframe that is considered commercially viable for the industry concerned he can exercise his discretion and advise the taxpayer that the non-commercial loss provisions do not apply to them.[3] The taxpayer would then be able to deduct farm losses against other non-farm income.

2.10 The Explanatory Memorandum to the Bill further explains that the discretion is not intended to be available 'in cases where the failure to make a profit is for reasons other than the nature of the business, such as, a consequence of starting out small and needing to build up a client base, or business choices made by an individual that are not consistent with the ordinary or accepted practice in the industry concerned…'[4]

2.11 Over the past three years, on average, the Commissioner has received 237 requests to exercise his discretion under section 35-55; an average of 38 per cent of those requests being decided in favour of the taxpayer. Although the number of requests likely to be received in the initial year of the measure cannot be forecast, Treasury and the Commissioner have advised that in later years they expect around 350.[5] As the Commissioner can exercise his discretion in respect of one or more income years, is required to make such decisions within 28 days of receiving all of the information, and has given a commitment to provide material concerning this measure to assist taxpayers with their applications, it is considered that mechanisms are in place to provide some certainty and enable affected taxpayers to make future investment decisions.[6]

Exceptions

2.12 Provision is made within the bill to ensure that deductions allowable pursuant to Division 41 of the ITAA 1997 - the Government's small business and general tax break are not inadvertently caught by the amendments.

2.13 Grandfathering provisions to protect taxpayers claiming deductions for excess non-commercial losses in circumstances where the Commissioner has previously exercised his section 35-55 discretion are also proposed including those relating to managed investment schemes.[7]

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3 Explanatory Memorandum, p 107.

4 Explanatory Memorandum, p 108.

5 Department of the Treasury, answer to question on notice, 9 November 2009 (received 13 November 2009).

6 Department of the Treasury, answer to question on notice, 9 November 2009 (received 13 November 2009).

7 Explanatory Memorandum, p 111.