

SUBMISSION TO THE BOARD OF TAXATION

**Post-implementation review of the quality
and effectiveness of the non-commercial
losses legislation in Division 35 of the
Income Tax Assessment Act 1997**



The Institute of Chartered Accountants in Australia

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INTRODUCTION

The Institute of Chartered Accountants in Australia (ICAA) welcomes the opportunity to provide comments to the Board of Taxation to assist its post-implementation review of the quality and effectiveness of the non-commercial losses legislation contained in Division 35 of the Income tax Assessment Act 1997 (ITAA 1997).

The ICAA, as the leading professional accounting organisation in Australia, represents some 39,000 members in public practice, commerce, academia, government and the investment community. Our members are advisers to businesses at all levels, from small and medium sized businesses to the largest global corporations operating in Australia.

The ICAA offers the following comments in relation to the non-commercial losses provisions, which may assist the Board of Taxation in its review. These fall into two broad categories:

1. Certain administrative issues relating to the exercise of the Commissioner of Taxation's discretion under section 35-55 ITAA 1997 that the provisions not apply to a taxpayer, namely:
 - 1.1 Onerous compliance burden of preparing applications
 - 1.2 Unreasonable delays in processing applications

2. Certain inequities arising from the design of the legislation, namely:
 - 2.1 Quarantined losses permanently trapped when a sole trader incorporates
 - 2.2 Issues relating to the \$40,000 exemption for primary producers and artists.

These are discussed more specifically below.

SPECIFIC COMMENTS

1. Commissioner's discretion

Broadly, and subject to limited exemptions discussed below, Division 35 will apply to an individual who generates tax losses from a business activity, unless they satisfy one of four tests relating to the scale of assets employed, the income generated, or history of profitability. If the provisions apply, these "non-commercial losses" cannot be offset against other assessable income in the year incurred, and are instead "quarantined" to be offset against future profits from the business, or until one of the tests are satisfied.

Section 35-55 of the ITAA 1997 provides an important exception, giving the Commissioner a discretion to decide that Division 35 does not apply to an individual. The Commissioner may exercise this discretion if satisfied it would be unreasonable to apply the provisions because, broadly:

- (a) the business activity was affected by special circumstances outside the control of the business operator, including natural disaster, and would have otherwise satisfied one of the four tests; or



- (b) in the start-up phase of the business, because of its nature it has a lead time before becoming profitable but there is an objective expectation, based on independent evidence where available, that within a commercially viable period it will meet one of the four tests or will cease to be loss-making.

The Australian Taxation Office (ATO) established a process whereby individuals otherwise caught by the non-commercial losses provisions could seek the Commissioner's discretion by way of a private binding ruling application. The application process has raised a number of administrative issues since its inception, relating to the time and expense of preparing the applications, and unreasonable delays in processing them. These issues are outlined below in more detail.

1.1 Onerous compliance burden of preparing applications

The application requires detailed information and supporting material. It is understood that the ATO places particular importance on the individual providing independent evidence tailored to the business operations in question, in terms of substantiating lead times and the commercial viability of that particular industry or activity.

Obtaining the necessary information and completing the application form is a time consuming and costly exercise. It is inevitably small businesses that fail the four tests and must seek the Commissioner's discretion and most feel compelled to seek the advice of an accountant to complete the application. As such, preparing an application represents a very significant cost to these small businesses when compared to the scale of the business activities involved.

Indeed, it is understood that the cost of preparing the application is so prohibitive to some small businesses that it is not uncommon for them to opt to bear the quarantined losses instead. This in turn deprives them of much-needed cash in the form of tax refunds to which they would otherwise be entitled.

The non-commercial loss provisions are a very real deterrent for individuals wanting to operate a business on a small scale, and make it hard for these people to get started.

1.2 Unreasonable delays in processing applications

The ATO has an administrative undertaking that it will process the applications within 28 days, however this has often not been the case in practice.

As outlined in the draft National Tax Liaison Group meeting minutes for 3 December 2003, the ATO reported the following statistics on the turnaround times for processing applications for the Commissioner to exercise his discretion under section 35-55:

Number of Applications Finalised (year to date 2002-03)	1,927
Average Completion Time	94 Days
Number of Applications Finalised (year to date to 30/10/03)	363
Average Completion Time	66 Days

These delays invariably place cash flow strain on the business, with the associated uncertainty of whether the Commissioner will exercise his discretion and allow a tax refund. Until they receive confirmation that the Commissioner has exercised his discretion, the small



business is left “in limbo”, unable to make business decisions for the future including whether to continue incurring business expenses.

These delays are, in our view, indicative of both the complexity and volume of information that individuals are required to provide, and raises questions as to the efficiency of ATO processes in analysing and processing the applications.

The ICAA recommends that the Board of Taxation review the application form and suggest that the ATO streamline its size and content, with the aim of making the application process simpler and more manageable.

2. Inequities arising from the design of the legislation

The ICAA has concerns about certain inequities arising from the design of the legislation, discussed below in more detail.

2.1 Quarantined losses permanently trapped when a sole trader incorporates

Under our current tax law, losses incurred by an individual taxpayer can only be utilised by that individual. Most people accept this, on the basis that the individual will have a reasonable opportunity to offset the losses against other income.

In the past, this was not ordinarily of concern to a sole trader who incorporated their business. Carry forward losses from operating as a sole trader could be offset in future years against other sources of assessable income, for example salary earned as an employee or director of the company now operating the business, or dividends.

The situation is much harsher with the introduction of the non-commercial loss provisions, where an individual taxpayer has losses “quarantined” from operating as a sole trader and then incorporate the business. They may never be able to utilise those losses, due to the restrictions on the type of income the quarantined losses can be offset against, ie income of the business that is now being operated by a different legal entity and may indeed now be profitable.

The policy intent of Division 35 was presumably that genuine commercial business losses would not be affected – that is, the business activity should satisfy one of the four tests, or it would be “reasonable” for the Commissioner to exercise his discretion. However, as indicated above, this has not always happened in practice with smaller businesses, due to the prohibitive cost of making an application and the difficulty in persuading the Commissioner it is appropriate to exercise his discretion.

It is common for an entrepreneur to establish a business as a sole trader due to the minimal costs associated, and then as the business grows to ‘roll over’ the business into a company. There are a variety of commercial reasons why it is desirable for an expanding business to be operated by a company, yet inability to utilise deferred non-commercial losses is a powerful disincentive for a sole trader to take that next step. It means the business is not being operated through the most effective business structure, and stifling its growth potential.



The ICAA believes that the inequity can be overcome by amending the non-commercial losses provisions to give the Commissioner a further discretion to allow quarantined non-commercial losses of an individual to be offset against profits in the company where the same activities are performed.

2.2 Issues relating to the \$40,000 exemption for primary producers and artists

A further exception to the application of the non-commercial losses provisions is where an individual operating a primary production or a professional arts business also derives assessable income from other sources of less than \$40,000.

As the Second Reading Speech to the Bill introducing the non-commercial losses provisions indicates, the intent of this exception was to assist primary producers and professional artists who find it necessary to support themselves through other activities. There are, however, some issues with this exception.

- (a) Firstly, section 35-10(4)(b) ITAA 1997 provides for a fixed amount of \$40,000 of other income with no adjustments for inflation. Over time, this exception will become less and less meaningful and will cease to serve the policy intent.

There are a number of possible ways to address this, for example indexing the \$40,000 amount by the CPI or other index of inflation, or making it “\$40,000 or such greater amount as set by regulation”.

- (b) Secondly, there continues to remain uncertainty as to the meaning of the term “professional arts business”.

While the phrase “professional arts business” has broad connotations, its definition in section 35-10(5) ITAA 1997 is limited to certain specified terms, namely an “author” as meant by the copyright law, a “performing artist” and a “production associate”. The definitions of a “performing artist” and “production associate” are found in sub-sections 405-25(2) to (5) ITAA 1997, in the “income averaging” provisions for authors, inventors, performing artists etc. These definitions include the phrases “any similar activity” and “similar services”. However there is no ATO publication or public ruling that clarifies what will constitute a similar activity or similar services.

It is unclear how broadly these terms should be interpreted. For example, would an agent looking after a dancer’s overall affairs meet the requirements of a “professional arts business”? This has been raised as an issue on the ATO’s ATPF Non-Commercial Losses Issues Log, and at the time of preparing this submission remains unresolved.

Pending some more specific guidance from the ATO as to how it interprets these terms, it is difficult to comment on the extent of this issue. Suffice to say that if the policy intent of section 35-10(4) was to recognise the erratic earnings of all the various individuals who are operating genuine commercial businesses in connection with the arts, it would seem that the restrictive definition at section 35-10(5) may not be delivering that intent.

In summary, the ICAA is concerned that the administrative process of seeking the Commissioner’s discretion under section 35-55 ITAA 1997 severely impacts upon small businesses due to the excessive cost and effort of preparing the application and the unreasonable delays in its processing. In addition, the design of the legislation results in



certain inequities, being the likelihood that a sole trader will be unable to utilise quarantined non-commercial losses when they incorporate the business and there are limitations associated with the “\$40,000 other income” exemption applicable to primary producers and “professional arts businesses”.

CONTACT DETAILS

The ICAA would be happy to work with the Board of Taxation to provide further information or clarify any issues raised in this submission. Please contact:

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