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## **SUBMISSION FOR POST-IMPLEMENTATION REVIEW OF NON-COMMERCIAL LOSS RULES**

The Tasmanian Divisional Council of Taxpayers Australia Inc believes that the current (Ralph) non-commercial loss provisions are having a detrimental effect on the entrepreneurial climate in Australia. The effect of these provisions is restricted to micro businesses operated by ordinary working taxpayers. The anomalies are causing financial hardship to people who are least able to afford to pay tax on money they no longer have due to their business losses and the capital they have invested in their businesses.

The following are real examples from one tax practice in which over 35 micro businesses have had their losses deferred.

### **Example 1**

A small refrigeration mechanical contractor with a turnover of \$42,000 makes a taxable profit of \$12,000. To supplement his income he plants potatoes on a debt free acreage in years when he believes the rain will be sufficient to produce a crop. Due to drought conditions his crop fails. His potato growing expenses cannot be claimed because:

- His assessable income (for a sole proprietor this is his/her turnover) is over \$40,000.
- The Commissioner cannot exercise any discretion although the drought is an unusual event because his income would never exceed \$20,000 from this source, he cannot rely on a profit 60% of the time and the land is not worth \$500,000.

His taxable income was \$12,000 but he spent \$6,000 planting the crop, leaving him with only \$6,000 to live on and a taxation liability of \$1,000 which he had no ability to fund and is still not able to pay.

**Issues:** If the refrigeration mechanic was an employee who received a salary of \$30,000 pa, he would have been able to claim the potato growing losses, as his assessable income would have been less than the stipulated \$40,000.

**Outcome:** The taxpayer cannot take the risk of planting again, therefore sells the land to pay the tax and it is taken out of production.

### **Example 2**

A university lecturer who has had the threat of reduced funding causing early retirement collected sufficient information to write several books. He self-published and had modest success but did not make a profit. He chose to prepare the books for sale directly on the internet without printing. The high costs of preparation were incurred in one financial year but the income will flow in over many years as it is useful for reference without obsolescence. As each book is placed on the virtual bookshelf by a USA internet book store there are no further expenses and all income is devoid of a variable cost.

The taxpayer's claim to offset his expenses against his other income was denied.

A request was made for the Commissioner to exercise his discretion; however it failed as essentially it was not a primary production business. There was no experienced person or industry body in this new type of publishing who could satisfy the ATO as to the typical nature of the expenses.

**Outcome:** The taxpayer threatened, as he could not claim the losses, to take the business offshore and not declare the income with a possible loss of an export business.

**Issue:** The taxpayer's marginal tax rate has dropped from 47% to 17% following his retirement, so the tax losses have lost 63% of their value.

**Issue:** No comparable industry figures were available due to the specialised nature of the business, so the taxpayer suffers for being innovative.

### **Example 3**

A couple decide to take over a Bed & Breakfast and upgrade it. Considerable costs were incurred, many of which were claimable under the Simplified Taxation System rules of a full deduction under \$1,000 and establishment advertising. Due to the demise of Ansett, 3 months of potential income was lost and turnover did not exceed \$20,000.

The taxpayers were unable to claim the expenses as:

- Turnover was less than \$20,000
- The property is not worth over \$500,000.

The high upfront costs were not considered to be unusual for this type of business, so an appeal for the Commissioner to exercise his discretion failed.

As the couple had already invested substantial capital, they will carry on building up their business but the payment of the taxation has eaten into their working capital.

**Outcome:** The taxpayers believe the taxation system is unfair and penalises those who are trying to establish a genuine business. They felt that if they couldn't claim the losses, why declare the income?

### **Example 4**

A musician who is also employed with an income of over \$40,000 plays live music at venues and is in a partnership which produces a music CD.

The musician is unable to write off the losses as a musician (high depreciation and transport costs), although the skills and instruments are the same, against CD profits as future batches are produced. This is because he is deemed to have dissimilar businesses as the industry codes, which the ATO uses to classify business incomes, are different – by 1!

**Outcome:** The musician is reconsidering the future of both businesses due to the tax paid on the deferred losses.

**Issue:** Industry codes are an issue and a potential minefield for taxpayers subject to tax audits.

### **Example 5**

A share trader in the heady years of tech stock trading has done no trading in subsequent years however his stocks of unsold shares are falling in value. As he values his stock on a market basis he has a taxable loss which he is unable to claim. He can overcome this by simply carrying out one \$20,000 trade on one day, which makes his assessable income \$20,000 and he is therefore able to satisfy the first test.

**Issue:** Some taxpayers can easily manipulate the rules.

### **Example 6**

A bush lodge which provided accommodation for a horse trail riding business was building up from establishment several years ago. It was badly affected by the Port Arthur massacre and was recovering when the operator of the trail riding business was unable to get insurance and was forced to close.

Due to the subsequent drop in income, the operators of the lodge have a taxation loss. They are unable to claim this loss as

- Their property is now valued less than \$500,000
- Their turnover is less than \$20,000

The loss will now be non-recoverable as the taxpayers must sell the property and are unlikely to take the risk of establishing a similar business or in fact any business in the future.

The taxpayers are also unable to carry forward the losses to offset them against any future income.

Similarly the operator of the horse trail business cannot carry forward the taxation loss as he is unlikely to ever go into this business again.

**Outcome:** Two businesses closed with the proprietors unlikely to go into business again.

**Issue:** Having been forced out of business, the taxpayers are unable to claim the losses against other future income and will find it very difficult to get back on their feet.

**Issue:** The business had been established well before the introduction of the legislation, so there is a strong element of retrospectivity.

### **Example 7**

The taxpayer purchased a property comprising two self-contained accommodation units, specifically designed to be suitable for occupation by disabled and handicapped persons and their carers. The premises had not been utilised for this purpose for sometime, which required the taxpayer to spend in the order of \$22,000 in the financial year ended 30 June 2001 to bring the premises up to standard required by government, fire, tourism and licensing authorities for accreditation as a 4-star tourist facility.

The taxpayer retired from her employment when she reached Age Pension Age in February 2001, having earned \$37,000 for the year to date.

The taxpayer was refused a deduction for the expenses incurred for the year ended 30 June 2001, on the grounds that her business was "Non-Commercial" as it could not satisfy any one of the required tests.

A request for the Commissioner to exercise his discretion under the Act failed because it did not meet any of the criteria for an exception to be granted.

The taxpayer requested a Private Ruling, but this also met with no success. To add insult to injury, when the taxpayer was issued with a revised assessment notice for the year ended 30th June 2001, a General Interest Charge of \$468.25 was applied in addition. (This has since been reversed)

The taxpayer has subsequently lodged an appeal to the Administrative Appeals Tribunal and has had two meetings with another one scheduled to be held in the near future, pending a decision in the *Eskandari vs the ATO* case.

The taxpayer's only income apart from that from the business is her Age Pension. Whilst the taxpayer can carry forward the losses, she will need to have a taxable income in excess of \$20,000, because of the effect of the Senior Australian Taxation Offset, before she can claim the losses. As the taxpayer's carry-forward losses are less than \$20,000, they could all be swallowed up in one year with no financial benefit to her.

In addition to this, the taxpayer's Age Pension will be reduced by 40c for each \$ of income in excess of \$3,016 per annum including the net profit of the business.

The taxpayer has had to redeem some of her superannuation to meet the additional taxation she has been required to pay and the costs of the appeal to the Administrative Appeals tribunal. Her

superannuation had already been eroded as a result of having to spend money to bring the accommodation up to scratch.

The taxpayer is unable to come up with any industry figures to confirm that losses of this nature are typical for the industry.

**Issue 1:** If the taxpayer had not gone to the trouble of establishing a business, but had 2 residential investment properties, then the loss claimed would probably have been allowed in the year it was incurred.

**Issue 2:** The taxpayer is at a severe disadvantage as there are no industry figures for specialised accommodation businesses such as hers. The Commissioner is unable to exercise any discretion.

**Issue 3:** The taxpayer may be able to claim the taxation losses in subsequent financial years, but they are not worth anything unless her taxable income exceeds \$20,000.

## **SUMMARY**

It has been a tradition in Australia and history shows many substantial businesses have grown from very small beginnings subsidised by employment or other business income. It is considered wise to spread the risk of unemployment by diversifying sources of income, especially given the lack of employment security.

It is an oft-stated statistic that 80% of businesses fail within the first five years of operation; therefore the chances of non re-coverable losses for a small taxpayer are considerable.

The proprietor of one tax practice, which now employs 6 staff, commenced his practice in 1983 by purchasing a \$14,500 computer, funding this purchase from other employment. Had he been forced to start under the non-commercial loss rules, he could not have afforded the tax and the repayments on the computer and the business would not exist today.

The opportunity for ordinary taxpayers to take a risk and invest in starting and building a small business while still dependent on other income has been severely restricted especially where the business requires active participation.

Small (micro) business operators are unfairly discriminated against in comparison with taxpayers who borrow to invest in income earning assets which may be passive in nature such as yacht hire, rental property, property syndicates and the like. This seems to be against the Australian ethos of getting in and having a go to make things happen. If you are a passive investor you can claim losses, but if you get in and do the work yourself, you cannot. Where is the justice in this?

We do not consider that all non-commercial losses should be claimable as there are probably a lot of cases where the quantum of the claimable business expenses cannot be justified against the gross profit of the business. We support the intent of the legislation to deny losses where the business is a hobby, but we thought the ATO already had the power to deny losses in such circumstances.

The law and the ATO's interpretation of the law are penalising the owners of genuine businesses. The owner of tax practice who gave us the examples advised he had many other non-commercial losses denied and that he has no argument about these, as they were not genuine small businesses.

In 1984 the Labour government sought to quarantine rental losses. The effect on the rental market was so profound that the legislation was withdrawn within 18 months. This legislation will not have the same dramatic effect; however it will cause long term damage to the economy. Also, it will force potential self employed business persons to remain dependent on employment or Centrelink.

The ATO officers who apply the legislation do not understand the enterprise needed to start a small business and are not sympathetic to the proposition that some taxpayers will never recover the loss. "Why would anyone start a business which would not make a profit in the first year?" is a direct quote from one ATO Officer.

The legislation is based on assessable income. Why is this used, when all it is the turnover of a business? Why not base it on the taxable income (net profit) of the taxpayer's other business enterprises or salary? The use of assessable income as a measure is inequitable (this is not confined to this legislation). Consider Example 1 above. On the other hand assessable income can easily be artificially inflated by increasing the value of sales and allowing a discount.

Primary producers have been instructed to diversify their income for obvious reasons. If a farmer owns a farm which is worth less than \$500,000 and the turnover of the off-farm venture – eg contracting – was more than \$40,000, the farmer is not able to offset his/her primary production losses against the off-farm income.

The rules have a level of retrospectivity. If you start a business now under these rules at least you understand the risk you are taking. Some businesses which may have made small losses in the past have declined in turnover to below \$20,000, often due to circumstances beyond their control eg. Sept 11, Ansett collapse, illness, drought etc.

Consider also the case of a business which is in a downward spiral and has 3 or more years of losses in the last 5 years before finally closing. The losses for the last year(s) must be quarantined and cannot be off-set against future income.

Consider also Example 7 above, where the taxation loss was for a one-off, penalising an Age Pensioner, not your Collins Street farmers that may have been the object of the legislation.

It is only now that we are starting to see the (unintended) consequences of the legislation.

No doubt the ATO has a special unit reviewing these cases, whose success is judged on how much additional revenue it can generate for the Government in the short term with no regard to the long-term effects on the economy.

The imposition of the legislation can result in a business being deprived of its working capital at a crucial time. It penalises owners of businesses which get into financial trouble and the owners seek alternative incomes to meet living requirements and endeavour to keep the business afloat. When a business is going through a difficult time the legislation is a disincentive for the proprietor to invest more money in the business. The Government is quite happy to take tax revenue when a business is going well, but is not happy to allow the taxation losses if something goes wrong.

## **Conclusion**

- The legislation has been effective in eliminating claiming of tax losses by small and micro non-commercial businesses.
- We believe the legislation is reasonably comprehensible and workable, except for:
  - The grey area with industry codes. Many small businesses are multifaceted and the legislation fails to recognise that profits in one area can be used to prop up losses in another area. In addition, it could create an accounting nightmare to identify the overheads peculiar to each facet of the business.
  - The Commissioner not having any discretion in cases where genuine small businesses are disadvantaged by the legislation, eg where no comparable industry figures are available.
- There is no doubt in our minds that there are unintended consequences of the legislation, as demonstrated above. These may not be substantive according to the ATO and the Government, but they are punitive and drastic to some owners of genuine small businesses caught by this legislation.
- The legislation fails to take account of taxpayers' circumstances and commercial practices. In the first financial year of a business, taxpayers can sometimes legitimately claim large

amounts of depreciation or uniform capital allowances, but the legislation penalises the taxpayers for claiming this. The use of assessable income can penalise the self-employed.

- The legislation is inconsistent with other tax legislation. As we have mentioned above, taxpayers with passive investments, such as residential investment property and boats are able to claim the losses.
- The legislation provides certainty – certainty that it will kill off many genuine small businesses.

The Tasmanian Divisional Council of Taxpayers Australia Inc believes there is a strong case to have the tax legislation reviewed or revoked to avoid the unintended consequences to the entrepreneurial environment. Alternatively, it would like to see the Commissioner's discretion broadened to allow him to appoint an advisory board with business experience to exercise his discretion.

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