

Post-implementation Review of the
Quality and Effectiveness of the
Non-commercial Losses Provisions in
Division 35 of the *Income Tax
Assessment Act 1997*

A Report to the Treasurer

The Board of Taxation

June 2004

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FOREWORD

In March 2002, the Board of Taxation provided the Treasurer with a report, *Government Consultation with the Community on the Development of Taxation Legislation*. The report included a recommendation that the Board conduct post-implementation reviews of significant tax legislation initiatives, consistent with one of the functions set out in its Charter: to advise on the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design.

The Government's response¹ to the Board's report accepted that recommendation, agreeing to the Board conducting post-implementation reviews of major pieces of tax legislation to ensure that Government policy intent has been effectively translated consequent upon consultations undertaken.

The Treasurer subsequently agreed that the Board's first post-implementation review would be conducted on the non-commercial losses measure in Division 35 of the *Income Tax Assessment Act 1997*. Division 35 took effect from 1 July 2000, so that a review at this stage is timely and based on reasonable experience of its operation.

The Board commenced substantive work on the review in September 2003 and formed a Working Group of three of its members to take day to day carriage of this work.

Consistent with its Charter function referred to above, the Board has carried out this first review essentially with a forward looking perspective, although where appropriate it has referred to past events with the aim of promoting future improvements in the tax system.

Although policy issues are explicitly excluded from the scope of the review, they were nevertheless raised with the Board during the review process. Reflecting its mandate in conducting post-implementation reviews, the Board has only noted the policy issues raised and has not made any recommendations on them.

The *ex officio* members of the Board – the Secretary to the Treasury, Dr Ken Henry, the Taxation Commissioner, Mr Michael Carmody, and the First Parliamentary Counsel, Mr Peter Quiggin – reserved their final views on the issues canvassed in this report for advice to Government.

The Board is mindful this is the first post-implementation review it has conducted, and intends to conduct its own assessment of the review process. The Board would welcome any suggestions for improvements to the process.

Richard F.E. Warburton
Chairman
The Board of Taxation
29 June 2004

1 Treasurer's Press Release No. 22 of 2 May 2002: 'Reforms to Community Consultation Processes and Agency Accountabilities in Tax Design'.

CHAPTER 1: OVERVIEW, FINDINGS AND RECOMMENDATIONS

1.1 In March 2002 the Board of Taxation provided the Treasurer with its report *Government Consultation with the Community on the Development of Taxation Legislation* (Consultation Report). That report recommended a number of reforms to community consultation processes and agency accountabilities in tax design, and included a recommendation that the Board conduct and report to the Treasurer on post-implementation reviews of significant tax legislation initiatives. On 2 May 2002, the Treasurer announced that the Government had largely adopted these recommendations and that he had 'agreed to the Board conducting post-implementation reviews of major pieces of tax legislation to ensure that government policy intent has been effectively translated consequent upon consultations undertaken'.¹

1.2 Conducting post-implementation reviews is consistent with one of the Board's functions,² namely to advise the Treasurer on 'the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design'. In undertaking these reviews the Board will assess legislation against criteria based on its Consultation Report to determine the extent to which the legislation:

- gives effect to the Government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and
- provides certainty.

1 Treasurer's Press Release No. 22 of 2 May 2002: 'Reforms to Community Consultation Processes and Agency Accountabilities in Tax Design'.

2 The Charter of the Board of Taxation.

1.3 The Board's intention in undertaking post-implementation reviews is not to reopen debates about the merits of the policy underlying the legislation. Rather the intention is to gauge how effective the legislation has been in delivering that policy intent and to find out whether its implementation can be improved.

1.4 For its first post-implementation review, the Board has examined the quality and effectiveness of the non-commercial losses provisions in Division 35 of the *Income Tax Assessment Act 1997* (ITAA 1997). The non-commercial losses measure was announced by the Treasurer on 11 November 1999³ as part of the Government's second stage response to the Ralph Review of Business Taxation. The policy intent is set out in the legislation which states 'The object of this Division is to improve the integrity of the taxation system by preventing losses from non-commercial activities that are carried on as businesses by individuals (alone or in partnership) being offset against other assessable income.' The legislation applies to individuals able to claim business deductions under the existing taxation law on the grounds they are carrying on a business and meet all the existing tests of deductibility.

1.5 The legislation, which applies from 1 July 2000, achieves the policy intent by permitting an individual to offset a loss from a business activity against other income in an income year if the activity passes at least one of the following four objective tests for that income year:

- has assessable income from the activity of at least \$20,000;
- has produced a profit in at least three out of the past five income years;
- uses real property or interests in real property worth at least \$500,000 on a continuing basis; or
- uses other assets worth at least \$100,000 on a continuing basis.

1.6 If a business activity does not pass any of these tests, an individual may still claim a loss if the Commissioner of Taxation (Commissioner) exercises the discretion to allow the loss to be offset against other income.

1.7 If an activity does not satisfy any of the tests, and the Commissioner does not exercise the discretion, the loss from that business activity cannot be offset against the individual's other assessable income for that income year. The loss is then deferred, but may be offset against:

- assessable income made by that business activity in future years; or

³ Treasurer's Press Release No. 74 of 11 November 1999: 'The New Business Tax System: Stage 2 Response'.

- assessable income from sources other than that business activity if, in a following year, the business activity passes one of the four tests, the Commissioner exercises the discretion or the following exception applies.

1.8 Division 35 does not apply if the business activity is a primary production business or a professional arts business and the individual's assessable income for the year (excluding net capital gains) from other sources is less than \$40,000. This exception allows these individuals to deduct losses from their primary production or professional arts businesses from their other income without having to meet any of the four objective tests.

1.9 The legislation does not change the existing income tax concept of what constitutes the carrying on of a business, which often needs to be determined using a case by case approach. This threshold test needs to be satisfied prior to any application of Division 35.

HOW THE BOARD'S REVIEW WAS CONDUCTED

1.10 In undertaking the review the Board sought submissions from interested stakeholders, including taxation professional bodies, peak artistic organisations and primary producer associations, and advertised the review on the Board of Taxation website.⁴ The Board also commissioned:

- a study from the Australian Taxation Studies Program (Atax) to evaluate the compliance and administration costs of the non-commercial losses legislation; and
- a study from BDO Kendalls to assess the quality and effectiveness of the legislation.

The Board also sought information on the development of the legislation and its implementation from the Treasury and the Australian Taxation Office.

The studies

1.11 Atax found that taxpayers experienced minimal compliance costs and tax practitioners had only moderate transitional compliance costs and minimal recurrent compliance costs. Atax noted that the ATO's administration costs were minimal.

1.12 BDO Kendalls found '...the predominant view is that the legislation has prevented revenue leakage as a consequence of non-commercial activities' and '...the systematic solution to be found in the objective tests do work, subject to the broader issue of what constitutes a business.' BDO Kendalls also noted that the legislation was a useful tool in focussing taxpayers' attention on the commercial issues affecting their

4 www.taxboard.gov.au.

businesses. However, as was expressed in many of the public submissions, BDO Kendalls found some practitioners were concerned about the difficulty and cost of applying for the Commissioner's discretion and some of the consequences of applying the objective tests.

The submissions

1.13 The Board received a total of 24 written submissions from individuals and a range of cultural, industry and professional organisations.

1.14 The Board notes the relatively small number of submissions when compared to the number of taxpayers (over 400,000) who report losses under Division 35 (with about a quarter of these taxpayers being required to defer their losses).

ISSUES OF POLICY

1.15 The submissions and the Atax and BDO Kendalls studies raised a number of issues which are of a policy nature. For example, some groups claimed artists should either be completely exempted from the operation of Division 35 or that the existing other income exception threshold of \$40,000 for professional artists should be increased. The main policy issues that were raised with the Board are summarised in Chapter 6.

1.16 The Board appreciates that the issues raised are significant for the individuals concerned, but notes that they are policy issues which fall outside the scope of the Board's post-implementation reviews.

1.17 Policy issues concerning the application of the objective tests and their composition and thresholds, the exception for primary production and professional arts businesses and the exercise of the Commissioner's discretion were considered during Parliamentary debate on the provisions. The Board notes that a wide range of issues, including revenue consequences and equity issues, would need to be taken into account if this legislation was to be revisited. Moreover, amendments, particularly to the objective tests, would lead to another set of transitional compliance and administration costs that should be taken into account in assessing any calls for amendment to the legislation.

FINDINGS AND RECOMMENDATIONS

1.18 The Board's review of the quality and effectiveness of Division 35 has found that the intent of the legislation was delivered in a manner that was easily understood without any substantive unintended consequences or significant compliance burdens on the community. The ATO's implementation strategy was a significant factor in the

smooth implementation of this legislation. The National Association of Forest Industries (NAFI) concluded in its submission ‘...it is reasonable to state that the current legislation, tax ruling and product ruling processes, all reflect normal commercial practices while providing industry with certainty, clarity and relatively low compliance costs.’

1.19 After considering all of the information available to it, the Board’s specific findings against each of its review criteria are:

Gives effect to the Government’s policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure

- The Board considers that the legislation has been effective in delivering the Government’s policy intent.
 - The BDO Kendalls study stated ‘...there is little doubt that the Division has achieved its desired effect...by use of the objective tests. These tests provide a “line in the sand” that allows for easy demarcation based on the grounds of commerciality.’
 - The ATO advised that revenue estimates had largely been achieved and that approximately one quarter of individuals reporting business losses now defer those losses.
- The Board considers that the compliance and administration costs of the legislation are commensurate with those foreshadowed in the Regulation Impact Statement.
 - The Atax study concluded that ‘Overall transitional and recurrent compliance costs and administrative costs associated with the non-commercial loss provisions (NCL) are not significant’. This is consistent with the Regulation Impact Statement which, while not quantifying compliance and administration costs, noted that taxpayers affected by this legislation ‘...will need to incur a small up-front cost in either familiarising themselves with the new law or having advisers familiarise themselves with the new law and, if necessary, communicating the necessary information to taxpayers affected’.⁵ In relation to administration costs, the statement said ‘The measures will be administered by the ATO using existing resources’.⁶ The ATO advised that the legislation had been implemented using existing resources.
 - However, some submissions expressed concern about the cost and information requirements relating to applications seeking the Commissioner’s discretion under section 35-55 of the ITAA 1997. The Board notes that these costs can be

5 New Business Tax System (Integrity Measures) Bill 2000 – Explanatory Memorandum paragraph 3.11.

6 New Business Tax System (Integrity Measures) Bill 2000 – Explanatory Memorandum paragraph 3.19.

relatively high in relation to potential deductions, particularly in instances where a new activity is commenced without the level of research and planning that more experienced business people would consider prudent. In such instances taxpayers may find it difficult and costly to provide the information required for the exercise of the Commissioner's discretion.

Is expressed in a clear, simple, comprehensible and workable manner

- The Board considers that the legislation and guidance material are expressed in a clear, simple, comprehensible and workable manner.
 - The consultants' studies found a high level of acknowledgement of the simplicity, objectivity and ease of implementation of the legislation. BDO Kendalls noted 'There has been limited need for the ATO to provide supplementary guidance as to the meaning or interpretation of the Division. The areas that have received guidance deal with important specific aspects of the legislation; however generally, there have been few issues with the working of the Division'.

Avoids unintended consequences of a substantive nature

- The Board has not identified any unintended consequences of a substantive nature arising from the legislation.
 - However, some submissions, predominantly from arts organisations, contend that having to defer losses was an unintended consequence, not recognising that this loss deferral was the intent of the legislation. The unique business circumstances of professional artists (and primary producers) were acknowledged through the inclusion of the \$40,000 (other income) threshold exception in the legislation.
 - The submission from the National Tax and Accountants' Association (NTAA) considered that it was an unintended consequence that 'Taxpayers who have entered the Simplified Tax System ('STS') **cannot** count depreciable assets in an STS pool towards the \$100,000 threshold. That is, Item 1 in the table to S.35-45 **only** makes reference to those assets whose decline in value can be deducted under Division 40 of ITAA 1997 (generally, for non-STS taxpayers).' The Board notes that the STS was introduced after Division 35 and it seems inequitable that STS assets be excluded from the 'Other Assets' Test in Division 35. The Board also notes that 'cars, motor cycles and similar vehicles' are not counted towards the Other Assets Test. Consequently, although individual assets are not identified within an STS assets pool, taxpayers wishing to count STS assets towards the Other Assets Test in Division 35 would need to separately calculate the written down value of any 'cars, motor cycles and similar vehicles' to reduce the value of their STS assets pool for Division 35 purposes.

Recommendation 1: The Board recommends that STS assets (excluding cars, motor cycles and similar vehicles) be counted towards the 'other assets' test in Division 35.

Takes account of actual taxpayer circumstances and commercial practices

- The Board notes that submissions and responses to the BDO Kendalls survey reflect a strong perception that Division 35 does not take sufficient account of actual taxpayer circumstances and commercial practices. The Board notes the dominant issues raised related to the exercise of the Commissioner's discretion. The main issues concerning the Commissioner's discretion raised in submissions are outlined below.
 - The criteria for obtaining the Commissioner's discretion are too narrowly interpreted and have a primary production focus.
 - : The Australia Council for the Arts (Australia Council) in its submission noted 'The Commissioner's discretion in section 35-55 is a bounded one – it may only be exercised in 2 limited situations, which make up the 2 limbs of the discretion set out in sub-sections (a) and (b) of that section. Neither (a) nor (b) is likely to be easily satisfied in the case of a professional arts business.'
 - : The National Association for the Visual Arts Limited stated 'In looking at the way the Commissioner's discretion clause could apply to the visual arts and craft sector it is apparent that it was written for the primary industry.'

Recommendation 2: The Board recommends that the application form for the Commissioner's discretion and taxation rulings include additional non-primary production examples to make it clear that these business activities can also qualify for the discretion.

- The criteria for obtaining the Commissioner's discretion do not recognise the long lead times for certain business activities to become established.
 - : NAFI noted that the original legislation was amended in 2002 to enable the Commissioner's discretion to be obtained for forestry operations, even in instances where profits were realised from thinning operations prior to harvesting.
 - : The Music Council of Australia noted 'Musicians and composers who more directly address mainstream tastes may conduct their affairs in a professional and businesslike way but until they achieve a sufficient level of public interest and acclaim, find themselves with a loss-making business which they cross-subsidise from other activity. The gestation period may extend over years.'

The Board considers there may not be well documented or defined lead times for many business activities, particularly for novel or innovative activities that may be important for sustained economic growth.

Recommendation 3: The Board recommends that the assessment process for the Commissioner's discretion take more account of the intricacies of a particular business activity rather than relying on broad industry precedents.

- Applications for the Commissioner's discretion should be processed in a timely manner.
- : Under the Taxpayers' Charter the ATO is to finalise applications for the Commissioner's discretion within 28 days of receiving all the required information⁷ although a longer period may be agreed with the applicant. If additional information is required it is requested within 14 days of receipt of the application. The ATO has advised the Board that currently 92 per cent of applications for Commissioner's discretion are being processed within 28 days of receipt of all the required information.
- : However, The Institute of Chartered Accountants in Australia (ICAA) raised concerns about delays in processing applications for the Commissioner's discretion. The ICAA stated that '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.' The ICAA suggested that these delays raise '...questions as to the efficiency of the ATO processes in analysing and processing the applications.'
- : The Board considers that the ATO is processing applications for the Commissioner's discretion in a timely manner. The Board notes the concerns raised by the ICAA and acknowledges the impact that delays in obtaining the Commissioner's discretion can have on small businesses. In view of these concerns the Board has referred the ICAA's submission to the Review of Aspects of Income Tax Self Assessment which is examining a range of issues concerning the effectiveness of the ATO's rulings processes, including the timeliness of issuing private binding rulings.

Is consistent with other tax legislation

- The Board considers that Division 35 is consistent with other tax legislation.
 - The BDO Kendalls study found that 84 per cent of survey respondents considered that Division 35 was consistent with other tax legislation. NAFI noted 'The Non-Commercial Loss Provisions are consistent with other tax legislation

⁷ Australian Taxation Office - Taxpayers' Charter.

applying to forestry business activities.’ Some respondents considered it an anomaly that STS assets could not be counted for the ‘other assets’ test. The NTAA suggested ‘This clearly appears to have been an oversight when the legislation was drafted. Therefore, the NTAA strongly recommends that the Government amend the legislation to include a reference to depreciating assets whose decline in value can be deducted under Division 328 (ie, for STS taxpayers).’ This issue is addressed in Recommendation 1 above.

Provides certainty

- The Board considers that the application of the objective tests in Division 35 provides taxpayers with a high degree of certainty of outcome. However, a number of submissions and the BDO Kendalls study considered that clarification was required in relation to the grouping of business activities and the exercise of the Commissioner’s discretion.
 - In relation to the grouping issue the NTAA’s submission advised that ‘...based on feedback the NTAA has received from its members, the NTAA believes that taxpayers need further guidance in this area by way of more practical examples. This would enable taxpayers (and tax practitioners) to gain a better understanding of how the grouping rules apply to different factual circumstances and, therefore, would reduce the uncertainty that currently exists in this area.’
 - The Board notes a degree of uncertainty about what activities are regarded as similar and can be grouped and what activities need to be considered separately. However, the ATO considers its rulings and practices take a reasonable position in relation to grouping of activities.

Recommendation 4: The Board recommends that the ATO considers issuing additional guidance material on grouping, incorporating examples at the margin, to clarify the types of activities that may be grouped.

Other issues

1.20 The Board notes that the issue of whether a business is being carried on is not addressed by Division 35 and this is regarded as contributing to uncertainty. In particular, the submissions from the arts community raised concerns about the delay in finalising a public ruling on what constitutes a professional arts business. The ATO has advised the Board that this ruling is currently under consideration, but its issuance may be delayed by an appeal to the High Court of a case which is integral to this ruling.

Recommendation 5: The Board recommends that the ATO should expedite a public ruling on what constitutes a professional arts business.

CHAPTER 2: THE REVIEW PROCESS

2.1 As part of its function of advising the Treasurer on the quality and effectiveness of tax legislation, the Board will be reviewing legislation that has been in operation for at least two years. This timeframe will ensure that taxpayers and their advisers have had a reasonable opportunity to become familiar with its operation. For its first review, the Board will examine the quality and effectiveness of Division 35 of the *Income Tax Assessment Act 1997*.

THE SCOPE OF THE REVIEW

2.2 The Board's intention in undertaking post-implementation reviews is not to reopen debates about the merits of the policy of a measure. Rather, the intention is to establish if the legislation is having its intended effect and to find out whether its implementation can be improved.¹ This can have the added benefit of improving future policy development and its implementation.

THE REVIEW CRITERIA

2.3 The Board will assess the quality and effectiveness of Division 35 and will have regard to the extent to which the legislation:

- gives effect to the Government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and
- provides certainty.²

1 Board of Taxation Consultation Plan for the post-implementation review of non-commercial losses.

2 Board of Taxation Consultation Plan for the post-implementation review of non-commercial losses.

2.4 These principles are drawn from the Board's report on *Government Consultation with the Community on the Development of Taxation Legislation*.³

HOW THE REVIEW WAS CONDUCTED

The studies

2.5 The Board engaged two consultants to assist with the review. BDO Kendalls were engaged to provide a general evaluation of Division 35 including surveying and conducting focus groups for practitioners. Atax was engaged to identify, estimate and evaluate the compliance and administration costs of Division 35. To gather the necessary information, Atax conducted focus groups involving taxpayers, tax practitioners and professional bodies and also surveyed taxpayers and tax practitioners.

Public submissions

2.6 The Board developed a consultation plan setting out details of its proposed consultation process and matters that should be addressed in submissions. The consultation plan was made available on the Board's website.⁴

2.7 The Board also made available on its website extracts of the Treasurer's 11 November 1999 Press Release, and the second reading speech and Regulation Impact Statement accompanying the New Business Tax System (Integrity Measures) Bill 2000.

2.8 The Board:

- advertised the review on its website; and
- wrote to 23 selected industry and professional bodies seeking written submissions addressing the Board's review criteria.

2.9 The Board sought submissions by 27 February 2004. The Board received 24 submissions, the majority coming from artists' organisations. The Board considers the low level of responses is consistent with its overall conclusion that the intent of the legislation was delivered in a manner that was easily understood without any substantive unintended consequences or significant compliance burdens on the community.

3 Board's report to the Treasurer and Minister for Revenue and Assistant Treasurer on *Government Consultation with the Community on the Development of Taxation Legislation*, March 2002, paragraph 61.

4 www.taxboard.gov.au.

Consultation with the Treasury and the Australian Taxation Office

2.10 The Board also sought information on the development of the legislation and its implementation from the Treasury and the Australian Taxation Office.

Board processes

2.11 The Board appointed a Working Group of its members comprising Messrs Brett Heading, Tony D'Aloisio and John Bronger to oversee the Board's post-implementation review of Division 35.

CHAPTER 3: DEVELOPMENT AND IMPLEMENTATION OF DIVISION 35

RALPH REVIEW OF BUSINESS TAXATION RECOMMENDATIONS

3.1 In July 1999, the Ralph Review of Business Taxation¹ (Ralph Review) identified significant revenue leakage from unprofitable activities carried out by individual taxpayers, either acting alone or in partnership with another individual. Many of these activities were no more than hobbies and/or lifestyle choices, but even those that had business like characteristics were often unlikely to ever make a profit and did not have a significant commercial purpose or character.

3.2 The Ralph Review also noted that, while the Australian Taxation Office (ATO) had sought to minimise the loss to revenue associated with non-commercial losses, the administration of the law in relation to carrying on a business was very difficult, resource intensive and created uncertainty.

3.3 The Ralph Review believed a systemic solution to better deal with losses arising from non-commercial activities was warranted.² It recommended a number of tests that would be applied to each separate activity giving rise to a loss. Satisfying none of the tests would not mean that the activity was not a business – the tests would simply determine the taxation treatment for the net loss from the activity. These tests were modelled on comparable provisions in other countries and designed so as not to disadvantage genuine business activities.

3.4 As a safeguard, the Ralph Review also recommended that, where special circumstances could be demonstrated that would warrant the recognition of losses in the year they arose, the Commissioner of Taxation (Commissioner) should have the authority to recognise the losses in that year. This authority could be exercised where the activity was affected by circumstances outside the control of the taxpayer (such as prolonged drought, flood, bushfire or other natural disasters), or in relation to losses from start-up activities, particularly those with long lead times, provided a significant commercial purpose or character could be demonstrated for the activity.

1 Ralph Review of Business Taxation, *A Tax System Redesigned*, Commonwealth of Australia, 1999, p. 296. Report available at www.rbt.gov.au.

2 *A Tax System Redesigned*, p. 296.

Activity tests enabling loss offset

3.5 Recommendation 7.5 of the Ralph Review recommended a number of activity tests enabling loss offset as a means of ensuring more equitable and certain taxation treatment. A loss arising in a year of income from an activity conducted or carried out by an individual taxpayer could not be offset against other income of that taxpayer in that year unless the particular activity satisfied at least one of the following tests:

- (i) the loss arose in relation to the rental of real property;
- (ii) the particular activity from which the loss arose had an annual turnover of greater than \$20,000;
- (iii) assets, not being assets that are primarily used for private purposes, have a value:
 - that, in respect of real property, exceeds \$500,000; or
 - that, in respect of all other assets, excluding passenger motor vehicles, exceeds \$100,000; and
 - were used on an ongoing basis in the particular activity;
- (iv) the particular activity resulted in taxable income in three out of the last seven years; or
- (v) it would be unreasonable for the loss from the activity not to be offset against other income for that year because:
 - the activity was affected by circumstances outside the control of the taxpayer, including drought, flood, bushfires or other natural disasters; or
 - an activity with a significant commercial purpose or character has been commenced.

3.6 The Ralph Review also recommended that, if a loss is unable to be offset against other income in the year in which it arose, the loss be deferred until a future year where:

- (i) income from the same or a like activity is available; or
- (ii) at least one of the above tests is satisfied – at which time a deferred loss or deferred losses will be able to be offset against other income.

GOVERNMENT'S RESPONSE TO THE RALPH REVIEW

3.7 The Government's response to the recommendations of the Ralph Review was announced by the Treasurer on 11 November 1999. The Government accepted the Ralph recommendation 7.5 with the following amendments: a loss arising in relation to share (or similar) investments by individuals would be excluded from the operation of the measure; and the number of years within the profit test would be reduced to three out of the last five years.

3.8 The Government's response noted that the non-commercial losses measure was an important integrity measure that contributed to the fairness and equity of the tax law.

Consultation

3.9 After the release of the Ralph Review, the Treasury conducted consultations with professional associations, tax advisors and peak industry bodies, including primary producers, on the substance of the proposed legislation that would address the Ralph recommendations. Arising from the consultation process was a proposal to include an exception from the operation of the measure for primary production businesses, where the assessable income of the individual from sources other than the primary production business is less than \$40,000.

LEGISLATIVE HISTORY

3.10 The non-commercial losses measure was included in the New Business Tax System (Integrity Measures) Bill 2000 (the Bill) introduced into the House of Representatives on 13 April 2000. The Bill provided for a new Division 35, titled 'Deferral of losses from non-commercial business activities' that would be inserted into the *Income Tax Assessment Act 1997* (ITAA 1997).

3.11 The second reading speech for the Bill noted that the measure had been recommended by the Ralph Review and that the primary producer exception had been added. The second reading speech also indicated that the measure would apply to assessments for the 2000-01 and later income years, and result in estimated increases in revenue in the region of \$30 million in 2000-01, \$230 million in 2001-02 and \$170 million in 2002-03.

3.12 The explanatory memorandum for the Bill noted that the measure had been recommended by the Ralph Review and also noted that it did not change the existing income tax concept of what constitutes the carrying on of a business.

3.13 While the explanatory memorandum recognised that the measure could lead to increased compliance costs for some taxpayers, it considered these costs were

outweighed by the improvement in the equity, fairness and integrity that the measure would introduce to the tax system.

3.14 The explanatory memorandum noted that the measure would apply to those individuals able to claim business deductions under the existing law, on the grounds that they were carrying on a business and met all existing tests of deductibility.

3.15 The explanatory memorandum also detailed the provision for grouping similar business activities undertaken by an individual and noted that, if the activity was not a part of another business activity, it should be viewed in isolation and treated as separate.

3.16 The explanatory memorandum explained the application of the rule to partnerships and that the treatment of exempt income and bankruptcy was modelled on similar rules within Division 36 of the ITAA 1997. These rules ensure that losses deferred under Division 35 are treated in a similar way to normal losses.

3.17 During consideration of the Bill in the House of Representatives, the Opposition supported the Bill but sought to amend the second reading motion to address concerns raised by arts bodies for the application of the legislation to the business activities of professional artists. The Bill passed the House of Representatives on 8 June 2000 without the amendment sought by the Opposition.

3.18 Following a report by the Selection of Bills Committee, the Senate referred the Bill to the Senate Economics Legislation Committee for examination and report. The Senate Economics Legislation Committee received 18 submissions to the inquiry into the Bill and held a public hearing on the Bill on 19 June 2000.

3.19 The Senate Economics Legislation Committee report noted representations by a range of arts organisations opposing the application of Division 35 to the business activities of artists and authors. The Committee report also noted concerns raised by primary producers about the operation of the profits test, with the National Farmers Federation recommending that the test be modified to two out of the last five years.

3.20 During consideration of the Bill in the Senate, an amendment was passed that provided for the inclusion of professional arts business within the exception provision in the measure. The Government subsequently accepted this amendment and the Bill was passed by both Houses and become operative on 1 July 2000.

3.21 Concerns by individuals in the plantation forestry industry on the application of Division 35 to their businesses, led to subsequent amendments to section 35-55 within Division 35 in April 2002. The amendments allow the Commissioner's discretion to be exercised for all relevant years where this is consistent with the nature of the business activity. This is of particular relevance to the plantation forestry sector where normal practices such as thinning may produce a one-off profit or passing of a test. The date of effect of the amendment is from the 2000-01 income year.

3.22 The explanatory memorandum stated that the amendments would not have any revenue impacts as they merely ensure the provision operates as intended.

IMPLEMENTATION BY THE ATO

3.23 The ATO is responsible for the implementation of legislation including the non-commercial losses provisions. The Board sought information from the ATO on its implementation program. The information provided by the ATO is consistent with other information available to the Board, including the consultants' reports.

3.24 During the 2000-01 financial year the ATO undertook an education campaign targeted at tax professionals.

3.25 Once the legislation was introduced, the ATO contacted both tax professionals and known self-preparers to explain the legislation.

3.26 A specific non-commercial losses website was created on the ATO's website³ and has been continually developed and refined.

3.27 Appropriate changes were made to the 2001 tax forms and instructions and ATO systems were modified to support these changes.

3.28 The non-commercial losses Centre of Expertise and Tax Counsel within the ATO developed public rulings on non-commercial losses and played a major role in forming the ATO view on unusual and complex issues of interpretation. Call centres were provided with scripts and escalation points for complex enquiries.

3.29 ATO officers gave presentations at seminars around Australia. Specific skilling sessions were conducted for all ATO staff dealing with the legislation.

3.30 Articles were made available to the general media and were included in ATO publications such as the small business newsletter and tax agent's newsletter. Information on non-commercial losses was also included in the ATO's 'tax time' satellite seminars for tax agents.

Sub group of the ATO/Tax Practitioner Forum

3.31 A sub group of the ATO/Tax Practitioner Forum was set up to ensure open communication between the ATO, industry organisations and tax professional associations during the implementation stage. The sub group provided input into Taxation Ruling TR 2001/14 and helped to refine the application form for the Commissioner's discretion. The sub group also provided a forum for ascertaining the

3 www.ato.gov.au

likely impact of proposed strategies and for the discussion and resolution of technical and administrative issues such as errors in completing non-commercial loss labels on income tax returns. The sub group disbanded in July 2003.

Errors in tax returns

3.32 Although early intelligence indicated tax professionals generally understood the legislation, early analysis of lodgements showed a high error rate in non-commercial loss labels on 2001 income tax returns. The sub group of the ATO/Tax Practitioner Forum decided to set up a verification team to educate agents and correct errors. A broadcast letter was sent to agents and an article appeared in the tax agent's newsletter explaining the common errors that were being made. The ATO also ensured appropriate mechanisms were in place to identify incorrect categorisation of losses as being available for offset against other income rather than being deferred.

ATO publications

3.33 The ATO issued two taxation rulings about Division 35:

- Taxation Ruling TR 2001/14 Income tax: Division 35 – non-commercial business losses (and addendum); and
- Taxation Ruling TR 2003/3 Income tax: Non-commercial losses – application of subsections 35-10(2) and 35-10(4) of the ITAA 1997 to business activities carried on in partnership.

3.34 The ATO has indicated that it is not planning to issue any other rulings or any determinations about Division 35 in the foreseeable future.

3.35 Other relevant rulings are Taxation Ruling TR 97/11 Income tax: am I carrying on a business of primary production? which addresses the threshold question of carrying on a business. The ATO is currently developing a Taxation Ruling on carrying on business as a professional artist.

3.36 The ATO has also published a number of ATO Interpretative Decisions (ATO IDs), fact sheets and questions and answers dealing with interpretation issues.

3.37 In addition, the ATO has published a specific application form to use when applying for the Commissioner's discretion and instructions on how to complete the non-commercial loss labels in the individual tax return form using worked examples.

3.38 All of these documents are available electronically on the ATO's website⁴ and are listed in Appendix B to this Report.

3.39 Promoters of Managed Investment Schemes that are carrying on a business and have individual investors can request the exercise of the Commissioner's discretion as part of the application for a product ruling. Investors covered by the product ruling do not need to apply for the exercise of the discretion on an individual basis.

⁴ www.ato.gov.au

CHAPTER 4: SUBMISSIONS

OUTLINE OF SUBMISSION PROCESS

4.1 The Board sought submissions for the review from interested stakeholders, including industry and professional bodies. The Board developed a consultation plan that was published on the Board's website.¹

4.2 Stakeholders were advised of the Board's review criteria which were derived from the recommendations contained in the Board's report entitled *Government Consultation with the Community on the Development of Taxation Legislation*.²

4.3 The criteria examine the extent to which the legislation:

- gives effect to the Government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and
- provides certainty.

SUBMISSIONS RECEIVED

4.4 The Board received 24 written submissions from individuals and a range of cultural, industry and professional organisations. Ten submissions were received from artists or their representative bodies and ten submissions were made by accounting firms or professional bodies. The Board received two submissions from primary producer organisations, one from a language therapist and one submission comprising

1 www.taxboard.gov.au

2 Board of Taxation, 2002, *Government Consultation with the Community on the Development of Taxation Legislation*, p. 18.

a paper presented at a recent conference of the Australian Agricultural and Resources Society. The names of those who made submissions are listed in Appendix C.

4.5 The submissions were generally structured either around the review criteria or the provisions of Division 35. To more fully reflect the submissions, this chapter summarises the submissions under both approaches – hence there is some overlap.

SUBMISSIONS' COMMENT ON THE REVIEW CRITERIA

4.6 The majority of comments against the review criteria focussed on whether the legislation avoids unintended consequences or takes account of actual taxpayer circumstances. Artists or their representative bodies provided significant comment in the form of examples that sought to illustrate the legislation did not meet these criteria.

Avoids unintended consequences

4.7 A number of submissions advised that the legislation was unfair to artists in particular, with reference to the Throsby and Hollister study indicating that 54 per cent of visual artists and 64 per cent of craft practitioners were adversely affected by the legislation.³ The Arts Law Centre of Queensland Inc submitted:

‘While this integrity measure was intended to contribute to the fairness and equity of the tax law, it creates significant negative consequences in circumstances where the individual taxpayer is an artist because, for a majority of practitioners, working as an artist will not in its own right provide a wage.’

4.8 Additionally, the Australia Council for the Arts (Australia Council) saw the \$40,000 other income threshold within the exception provision (section 35-10(4)) proving a disincentive for artists to subsidise their practice as they had done in the past. The Australia Council maintains that an arts business is unlikely to pass the commerciality tests resulting in artists being ‘...unable to claim the losses from their arts businesses unless they can bring themselves within the \$40,000 threshold’.

4.9 Other concerns raised included the exercise of the Commissioner’s discretion, as well as a view put by Taxpayers Australia Inc. – Tasmanian Divisional Council (Taxpayers Australia) that the measure was ‘...punitive and drastic to some owners of genuine small businesses caught by this legislation.’

4.10 On the positive side the Australian Forest Growers (AFG) whilst raising concerns with the consultative mechanisms for reviewing tax legislation, did

3 David Throsby and Virginia Hollister, *Don't Give Up Your Day Job: An Economic Study of Professional Artists in Australia*, Australia Council, 2003, Table 43, p. 54.

acknowledge that amendments to the measure in 2002 addressed an anomaly that penalised their industry.

Takes account of actual taxpayer circumstances

4.11 A number of submissions from arts organisations stated the measure failed this criterion, on the basis it does not adequately take into account the actual circumstances of individual artists and the commercial practices of the arts industry generally. There was a strong view within these submissions that the commerciality tests within the legislation are inappropriate and they preferred the application of the proposed draft taxation ruling titled 'Carrying on business as a professional artist'.

4.12 Other comment received on this criterion included:

- the exercise of the Commissioner's discretion;
- quarantined losses being 'trapped' if a sole trader incorporates;
- the need to increase the section 35-10 threshold to \$80,000 in the case of family partnerships; and
- reconsidering 'similar activity' interpretations.

4.13 Both the AFG and The Institute of Chartered Accountants in Australia (ICAA) advise that the introduction of Division 35 has adversely affected sole traders who subsequently incorporate, on the basis their quarantined losses will be forfeited once the new company takes over the business. The ICAA submitted the issue can be addressed by giving 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.'

4.14 Taxpayers Australia and the Taxation Institute of Australia (TIA) both expressed a general concern with the legislation under this criterion. They considered that the legislation severely impacted both on existing, as well as new and emerging businesses. Both submissions expressed strong doubts as to whether Division 35 met the goals set for the legislation, and Taxpayers Australia called for the review or revocation of Division 35.

Other review criteria

4.15 Whilst only a minority of comments were received in relation to the other review criteria, they nevertheless contained a number of observations and recommendations in regard to the overall effectiveness of the legislation.

4.16 The AFG, in relation to policy intent, recommended the abolition of both the 'real property' and 'other asset' tests on the basis they '...are not measures of

commerciality or even commercial purpose, they discriminate in favour of the already wealthy, and they can actually increase rather than prevent tax abuse'. They also recommended, under the compliance and administration costs criterion, that the Australian Taxation Office (ATO) provide better training for its officers to address the complexities of farm forestry. The AFG recommended that the ATO should also work with industry groups 'to develop acceptable surrogate "independent evidence" for innovative and pioneering enterprises for which there is no "industry standard".'

4.17 The TIA and National Association for the Visual Arts Ltd. (NAVA) both submitted that the treatment of the measure of multiple activities was still an issue in relation to the clarity and workability of the legislation. A number of submissions said the legislation was inconsistent with the self assessment system, tax averaging and trading stock provisions. Nevertheless, the National Association of Forest Industries (NAFI) submitted that Division 35 is consistent with other tax legislation applying to forestry business activities.

4.18 On the criterion of certainty, there was support for broadening the definition of professional arts business and for the ATO to provide better guidance on 'grouping' like activities within section 35-10.

Summary of comment on review criteria

4.19 While a number of submissions supported the intent of the legislation, a majority of submissions expressed serious reservations about particular aspects of Division 35. The proposal that professional artists should be exempted from the operation of Division 35 was presented by the Australia Council and supported by other arts organisations.

SUBMISSIONS' COMMENT ON THE OPERATION OF DIVISION 35

4.20 The majority of submissions that commented on the operation of Division 35 were concerned with either section 35-10 Deferral of deductions from non-commercial business activities or section 35-55 Commissioner's discretion. A small number of comments were also received on the operation of sections 35-30 to 35-45 (the four objective tests).

Deferral provisions — section 35-10

4.21 Artists or their representative bodies provided most of the comments on section 35-10. They sought either removal or an increase in the other income threshold from its current level of \$40,000 or questioned the rationale for a threshold at all.

4.22 The NAVA asserted that there is no discernible basis for the threshold and that it would seem to be completely arbitrary. NAVA also submitted that the threshold

'...discriminates unfairly against the estimated 13 per cent of professional practitioners who earn more than \$40,000 of other income, and creates a great deal of anxiety for those on the borderline...' This proposition was supported by the Australian Society of Authors (ASA) who advised that '...there are a substantial number of Australian authors who work in non-arts related professions and earn incomes above the \$40,000 threshold...' Bill Leung of Lowenstein Sharp Pty Ltd suggested that the fixed nature of the threshold '...is to subject the artists of our nation to be potentially both income and asset poor.'

4.23 The ICAA recommended either indexing the dollar amount of the other income threshold or making it '\$40,000 or such greater amount as set by regulation'.

4.24 The National Tax and Accountants' Association (NTAA) suggested that taxpayers need further guidance in grouping business activities through the use of more practical examples.

Commissioner's discretion — section 35-55

4.25 Submissions raised two main issues in relation to the exercise of the Commissioner's discretion. The first concerned the excessively narrow interpretation of the discretion or the failure by the Commissioner to take into account the actual circumstances of the business activity. The second issue concerned the cost of compliance in seeking the exercise of the discretion, as well as delays by the ATO in processing applications.

4.26 The Australia Council said that the Commissioner's discretion '...appears to be primarily focused on taxpayers engaged in a primary production business and fails to take into account the actual circumstances of individual artists and the commercial practices of the arts industry generally.' NAVA recommended that the draft public ruling dealing with carrying on business as a professional artist was a much more accurate set of tests which reflect standard practices in this industry. The AFG also called for a broader interpretation to the operation of subsection 35-55(1)(b).

4.27 Bill Leung of Lowenstein Sharp observed that 'The amount of information, details and time involved in completion (sic) the applications properly often are enormously large when compared with the scale of the business activities in question.' He recommended the Board '...should also re-assess/relax the onus of the taxpayer in providing independent industry evidence regarding commercial viability and lead time, where such information may be more easily gathered/sourced from within ATO or from the Australian Bureau of Statistics'.

4.28 The ICAA submitted that ‘...obtaining the necessary information and completing the application form is a time consuming and costly exercise.’ The ICAA also said that preparing an application represents a very significant cost to these small businesses. The ICAA went on to recommend 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.’

4.29 Whilst the NAFI advised that the compliance and administration costs have been minimised by the release of Tax Ruling TR 2001/14, the AFG still believe compliance costs are onerous. On a different note, Taxpayers Australia would like to see the Commissioner’s discretion broadened ‘to allow him to appoint an advisory board with business experience to exercise his discretion.’

The four objective tests (sections 35-30 to 35-45)

4.30 In relation to the Assessable Income Test (section 35-30), Brian Tucker, NAVA and the Australia Council, all submitted that it is unrealistic to expect arts businesses to meet the test. The Australia Council said the data drawn from page 45 of the Throsby Report makes it ‘...clear that most taxpayers carrying on a professional arts business are unlikely to meet the \$20,000 assessable income test contained in section 35-30.’

4.31 Artists expressed similar concerns about the Profits Test (section 35-35). The Australia Council submitted the test discriminates against ‘...taxpayers engaged in a professional arts business as it fails to take [into] account the factors that tend to dictate against any consistent picture of past profitability, even for a commercially successful artist.’ The lead time in the provision was also believed to be far too short to address commercial reality for artists. On a different issue, the AFG called for the inclusion of on-farm use of farm produce to be included in both the ‘assessable income’ and ‘profit’ tests in specific circumstances.

4.32 The Real Property Test (section 35-40) was seen to be inappropriate for the majority of artistic enterprises. The AFG submitted that the Real Property Test should be abolished or alternatively should be broadly and consistently interpreted to include licences and agreements for the use of land, so as not to advantage the wealthy.

4.33 The AFG also submitted that the Other Assets Test (section 35-45) had a similar effect in discriminating in favour of those with the wealth or borrowing power to purchase farm implements and equipment, and against those who prefer to hire equipment. Concerns were also raised by the AFG with the interpretation of subsection 35-45(4), with their submission supporting the proposition that unregistrable specialised farm vehicles should also be included in the test.

4.34 The Australia Council and NAVA believed that the Other Assets Test was inapplicable to the majority of artists. NAVA submitted that ‘...the value is not in the raw materials and services used, but rather in the ideas and skill invested in making the work.’ Bill Leung of Lowenstein Sharp recommended that ‘...the test would be more fairly employed by having the value of the assets measured at their original acquisition costs and not their written down values.’ The NTAA strongly recommended ‘...that the Government amend the legislation to include a reference to depreciating assets whose decline in value can be deducted under Division 328 (ie, for STS taxpayers).’

Summary of comment on the operation of Division 35

4.35 There is strong support from those organisations representing the artistic community to remove the threshold within section 35-10, as it applies to a ‘professional arts business’ and to rely on the proposed draft ruling ‘Carrying on business as a professional artist’ to determine commerciality. The Painters and Sculptors Association of Australia Ltd said that ‘...once artists have met this criteria [professional arts business] and are accepted as professional artists carrying on a business, there is no justification in putting additional conditions on their ability to claim legitimate business expenses.’

4.36 The Australia Council, the ASA and NAVA submitted that the taxation ruling being finalised by the ATO, in relation to determining whether a person is carrying on a business as a professional practising artist, is preferred to applying Division 35, with its ‘commerciality’ tests.

4.37 In a similar vein, Jane Blanckensee believed that the policies, guidelines and criteria issued by the ATO in respect to the provisions, unfairly disadvantage those whose business activities are not primary production businesses.

4.38 In the Lacey and Watson submission ‘...the authors believe that the existing “objective tests” have a fundamental flaw in that they are skewed to measures of inputs to agricultural production. A better approach to judging the “commerciality” of operations by non full-time farmers are measures of output or potential output per unit of input.’ They also believed that ‘Division 35 is a potential threat to full-time farmers because innovative farm value-adding activity – or even on-farm diversification – runs the risk of being classified as a separate business activity.’

CHAPTER 5: THE CONSULTANTS' REPORTS

5.1 The Board commissioned two studies to provide input to its report. One study was from Australian Taxation Studies Program (Atax), part of the Law Faculty of The University of New South Wales, and the other was from BDO Kendalls.

THE ATAX REPORT

5.2 The Board commissioned Atax to produce a report to identify, estimate and evaluate operating costs of the non-commercial losses provisions in Division 35.

5.3 The Atax report disaggregated operating costs into transitional (one-off) and recurrent (ongoing) compliance costs. Compliance costs may be actual expenses or time costs and could be incurred by either a taxpayer or a tax practitioner. For taxpayers, these costs normally comprise a dollar value of the time that taxpayers spend in dealing with their tax affairs, together with the dollar costs incurred by the taxpayer. Tax practitioners may pass a proportion of their costs to their clients.

5.4 Australian Taxation Office (ATO) administration costs are described in the Atax Report as transitional costs principally associated with educating and training ATO staff, while the recurrent costs mainly comprise the continuing provision of advice, verification and project management associated with Division 35.

Methodology

5.5 The methodology Atax employed was to survey taxpayers affected by, and tax practitioners experienced in dealing with, Division 35.

5.6 The major steps in this process were:

- establishing focus groups – taxpayers, tax practitioners and professional bodies (to obtain information to assist in questionnaire design and content);
- sample selection – in liaison with the ATO;
- questionnaires – taxpayer and tax practitioner; and
- analysis of responses and preparation of a report.

5.7 Information on ATO administration costs was based on information provided by the ATO to the Board on its experience in administering Division 35.

5.8 Confidentiality of the contributions of participants in the survey was maintained through a structured division of responsibility between Atax, ATO and the Board for the development, mailing and analysis of the survey questionnaires.

5.9 In order to obtain the compliance cost data and information required for its analysis, Atax used a combined methodology primarily involving focus groups and mail surveys.

Focus groups

5.10 The focus groups were designed as a forum in which stakeholders such as taxpayers, tax practitioners and representatives of tax professional bodies (including interstate representatives) could identify key compliance cost issues relating to Division 35. The three focus groups were held in Sydney, with the first comprising tax practitioners, the second comprising representatives of tax and tax related professional bodies, and the third comprising taxpayers affected by Division 35.

5.11 Atax used the qualitative data collected as the basis for designing and conducting mail surveys of taxpayers and tax practitioners potentially affected by Division 35. Atax also examined the submissions made to the Board to identify any compliance cost issues, which were then factored into the design of the mail surveys.

Mail surveys

5.12 Atax chose the mail survey method to cost-effectively reach a large number of targeted taxpayers residing in a wide geographical area. Atax were assisted by the ATO in the selection of stratified random samples of the relevant population.

5.13 The surveys were designed to meet the objectives of user friendliness, administrative simplicity, comprehensiveness and compliance with the guidelines of the ABS Statistical Clearing House.

5.14 Two surveys were developed, one for taxpayers potentially affected by Division 35 and one for tax practitioners experienced with the legislation.

5.15 The questionnaire for taxpayers collected both quantitative and qualitative information about the compliance costs relating to Division 35 incurred by individual taxpayers. It emphasised that the surveys sought information on the incremental nature of compliance costs (rather than information on overall tax compliance costs) and distinguished between transitional and recurrent costs.

5.16 A critical aspect of the taxpayer survey was the inclusion of a question designed to filter out recipients who were not aware they were affected by Division 35. Atax viewed the question as critical to avoid contaminating the remaining data by

taxpayers answering the survey through 'guessing the answers' or confusing Division 35 with other provisions of the Income Tax Assessment Acts.

5.17 The questionnaire for tax practitioners also sought to identify and determine compliance costs and the extent to which they were able to pass them on to their clients. It also covered both qualitative and quantitative aspects relating to both transitional and recurrent compliance costs of Division 35.

5.18 The taxpayer survey achieved a response rate of 30 per cent, while the response rate for the tax practitioner survey was 41 per cent. Atax considered that both rates were satisfactory in light of the target response rate of 30 per cent that had been set for each of the surveys. Atax also reported there was no response bias in the conducted surveys.

Sample selection

5.19 The participants in the two surveys were selected from the ATO's tax return database using the following criteria for each category:

Taxpayers

- the relevant tax year was 2001-02;
- the relevant population was the population of Australian individual taxpayers who incurred business losses in 2001-02. Individual taxpayers who incurred business losses are the taxpayers who are potentially affected by Division 35 (regardless of whether or not they are allowed to claim those losses as deductions against their other income after considering Division 35);
- the above population was stratified by taxpayers' taxable income level and non-commercial loss classification as follows:
 - annual taxable income (three levels): \$20,000 or less, \$20,001 to \$60,000 and \$60,001 or more;
 - non-commercial loss classification (seven groups): assessable income and profits tests; real property or other assets tests; exception (artist); exception (primary producers); Commissioner's discretion; deferred losses; and losses from passive investments (while Division 35 does not apply to taxpayers with losses from passive investments which are excluded under subsection 35-5(2) – taxpayers are required to consider whether their loss is passive when completing their returns); and
- from each cell of the above stratified population, 20 to 40 taxpayers were chosen by the simple, systematic random sampling method. The sampling method is a two step selection process as follows:

- step 1 – the relevant population of individual taxpayers is classified by two factors, level of taxable income (three levels) and non-commercial loss classification (seven categories). This means that the relevant population is divided into 21 mutually exclusive cells; and
- step 2 – from each of the 21 cells, 20 to 40 taxpayers are chosen randomly. This gave rise to a mail out sample of 660 individual taxpayers.

5.20 Atax had given consideration to randomly surveying taxpayers who may not have indicated on their tax returns that they had a business loss, but who may have incurred compliance costs in examining the non-commercial loss provisions to determine if it was worthwhile to claim a loss. However, Atax determined that this was not feasible, as it would entail drawing a significantly larger sample with no guarantee that sampled taxpayers would have examined Division 35.

Tax practitioners

5.21 The sample of tax practitioners was also chosen from the stratified population of individual taxpayers who incurred business losses in 2001-02. Tax practitioners were selected by the simple, systematic, random sampling method. This resulted in a mail out sample of 500 tax practitioners. The sample of tax practitioners is not matched to the sample of surveyed taxpayers.

Survey findings

5.22 Atax used the following methodology. Total compliance costs to taxpayers is equal to the number of individual taxpayers multiplied by the average compliance costs per taxpayer. The number of individual taxpayers is derived from data provided by the ATO and the average compliance cost is ascertained from data obtained in the Atax survey. Whilst these quantitative findings are estimates, Atax has sought to refine the methodology by stratifying the taxpayers according to their taxable income and then obtaining an estimate comprising the average compliance costs per taxpayer for each income level. Atax is of the view that this improved the reliability of the aggregate estimates.

Taxpayer survey

5.23 The main findings from the Atax survey of taxpayers are:

- only just over 15 per cent of those surveyed had heard of Division 35 and were aware of the provisions. Given ATO advice that around 400,000 taxpayers were affected by Division 35 in 2001-02, the sample result suggests only 64,000 individuals are aware that they are affected by Division 35;

- those individuals who are aware of Division 35 spent, on average, 4.19 hours learning about those provisions. Multiplying the time spent by the wage rate declared by the taxpayers, Atax estimates the average value of time spent is \$192;
- just over half of the taxpayers who are aware of Division 35 did not have to pay in order to learn about the legislation. For those who had to pay, Atax estimates the average fee paid to tax advisers was \$234. For the entire group of taxpayers who are aware of Division 35, the average fee was \$109;
- combining the value of the time spent by taxpayers and fees paid to advisors, the average transitional costs to those individuals who learned about Division 35 was about \$300;
- those respondents who are affected by Division 35 on a recurrent basis spent 1.4 hours in 2001-02 to comply with the provisions. Combining this data with their wage rates, corresponds to an average of \$71 for the time component of recurrent compliance costs per person in that year; and
- the recurrent fees paid to tax advisors by surveyed taxpayers affected by Division 35 are estimated to be \$25 on average in 2001-02. Adding this to the recurrent value of time spent by taxpayers, the average recurrent costs of individuals affected to Division 35 was about \$96 in 2001-02.

5.24 A number of qualitative findings were also obtained by the surveys, although Atax recommends that due to the relatively small number of responses they should be regarded as tentative.

5.25 A number of respondents indicated that Division 35 was difficult to understand. A small number of surveyed taxpayers felt they needed to rearrange their business activities as a result of Division 35. Fifty per cent of respondents agreed that their transitional compliance costs were small, while 53 per cent of respondents did not consider their recurrent compliance costs had increased significantly as a result of Division 35.

Tax practitioners survey

5.26 The survey also revealed that the transitional costs incurred by tax practitioners were in the order of \$3,000 per practitioner, but that they varied with the size of the practice – the larger the practice (measured by the number of clients) the higher the average transitional costs. For very small practices the average transitional costs of Division 35 were less than \$1,000, while for the large practices the average was closer to \$5,000.

5.27 Tax practitioners claimed that it was difficult to pass their transitional costs on to their clients. Over a third of tax practitioners who responded stated they were unable to pass any transitional costs on to their clients.

5.28 Atax reported the average transitional costs for tax practitioners were comprised primarily of the time costs involved in learning about Division 35 (generally through personal research and attendance at external seminars) and were largely absorbed by their practices rather than charged to their clients.

5.29 Based on the survey, Atax estimated an average recurrent cost of \$123 (net of time savings for some clients) and that tax practitioners could pass about 60 per cent of the costs on to clients.

5.30 However, tax practitioners surveyed identified a number of factors as potentially leading to high recurrent Division 35 compliance costs in some instances. The three most significant factors identified were obtaining exercise of the Commissioner's discretion because of special circumstances, obtaining exercise of the Commissioner's discretion because of the start-up nature of the activity, and valuing assets to satisfy either the real property or other assets test.

5.31 Qualitative findings that were obtained in the survey of tax practitioners included that 77 per cent of surveyed tax practitioners were routinely advising clients about Division 35 compliance as part of their advice on business restructuring, 44 per cent of respondents agreed that Division 35 'rules are easy to understand and apply' and that 84 per cent of respondents disagreed that Division 35 affects the tax affairs of most of their clients.

5.32 The survey established that on average 5.5 per cent of tax practitioners' clients were affected by Division 35. For most tax practitioners the proportion of clients affected was very low, although in the highest case up to 90 per cent of a practitioner's clients were affected.

Aggregating transitional and recurrent compliance costs

5.33 The Atax report concluded that a very small number of taxpayers were directly affected by Division 35 and those taxpayers incurred, on average, \$301 of transitional compliance costs. Atax calculated the aggregate estimated value of transitional time spent by taxpayers at about \$9.7 million. The Atax estimate for the average transitional compliance costs for tax practitioners was \$3,039 per tax practitioner, with an aggregate estimated transitional cost of \$52.6 million. The aggregate transitional compliance cost for taxpayers and tax practitioners is about \$62 million.

5.34 The Atax report estimated that the aggregate recurrent costs for taxpayers were in the order of \$2.7 million, whilst the aggregate recurrent costs to tax practitioners were about \$2.6 million. The aggregate recurrent compliance cost of taxpayers and tax practitioners is estimated at about \$5.3 million.

- Only the time spent by taxpayers (not fees paid to tax practitioners) is included in the overall aggregate transitional and recurrent costs of taxpayers and tax practitioners to avoid double counting.

ATO administration costs

5.35 The information obtained by Atax from the ATO indicated it incurred transitional administration costs in education and training of its staff and recurrent administration costs in three main areas: provision of advice, verification and project management. The bulk of the recurrent administration costs of Division 35 involve the provision of advice.

5.36 The ATO transitional administration costs were estimated at \$2.1 million, with recurrent administration costs of \$6.6 million in 2001-02 and \$4.8 million in 2002-03.

Atax conclusions

5.37 Atax drew four main conclusions from their analysis of replies to the taxpayer and tax practitioner compliance cost questionnaires, information from focus groups and ATO analysis of administration costs.

- Overall transitional and recurrent compliance costs and administration costs associated with Division 35 are not significant.
- Individual taxpayer compliance costs were either non-existent or mostly of a transitional nature.
- Tax practitioners have borne most of the compliance costs that do arise.
- The ATO has been able to cope with the provisions without undue administration costs.

THE BDO KENDALLS REPORT

5.38 BDO Kendalls were engaged by the Board to provide an evaluation of the non-commercial losses provisions against the Board's review criteria. Their methodology and findings are summarised below.

Methodology

5.39 BDO Kendalls' methodology consisted of the following steps:

- reviewed the non-commercial losses provisions and explanatory memorandum;
- searched and reviewed learned commentary and other literature;

- reviewed ATO publications including public rulings, product rulings, tax determinations, fact sheets and ATO Interpretative Decisions (ATO IDs);
- held discussions with the ATO about their practical experience with the application of the non-commercial losses provisions;
- prepared and distributed a survey to practitioners connected with BDO Kendalls throughout Australia and analysed results;
- conducted focus group discussions with accountants; and
- reviewed public submissions to the Board.

Survey

5.40 BDO Kendalls designed and distributed 106 surveys through associates in Melbourne, Brisbane and New South Wales. A total of 25 surveys were completed and returned (a 25 per cent response rate).

5.41 Additional surveys were distributed by BDO Kendalls' associates in Perth, Adelaide and Darwin with seven surveys completed and returned.

5.42 Partners in the Business Accounting Section of BDO Kendalls were also surveyed. Respondents were either partners or managers in accounting firms with at least 5 years industry experience in relevant industries.

Focus groups

5.43 BDO Kendalls held focus groups with accountants with considerable small business experience. During discussions, participants were invited to analyse the implementation of Division 35 in light of the Board's review criteria. Comments were also invited to complement the results of the survey.

Findings

Gives effect to the Government's policy intent

5.44 BDO Kendalls found that the predominant view is that the legislation has prevented revenue leakage. They found the systematic solution in the objective tests is effective, subject to the broader issue of what constitutes a business. The difficulty in determining this threshold test remains.

Is expressed in a clear, simple, comprehensive and workable manner

5.45 BDO Kendalls concluded there has been limited need for the ATO to provide supplementary guidance as to the meaning or interpretation of the Division.¹ The areas that have received guidance deal with important specific aspects of the legislation. Generally there have been few issues with the working of the Division.

5.46 The Division is written in a reader friendly format with simple language and an easy to follow design. The objective tests are easy to understand. However, there are areas that are not expressed in a simple, comprehensible and workable manner such as the grouping of business activities, the evidence required to obtain an exercise of the Commissioner's discretion and the means of determining the level of income from a particular business activity.

5.47 Generally the practitioners surveyed agreed that the legislation met this criterion although there were conflicting views in relation to the grouping of business activities and the Commissioner's discretion.

Avoids unintended consequences of a substantive nature

5.48 BDO Kendalls cited a number of consequences which it described as unintended:

- a sole trader who later incorporates loses any deferred losses;
- the Real Property Test may be passed based on location of the land rather than purpose;
- the difficulty for start-up businesses and novel businesses in accessing the Commissioner's discretion;
- the future issues that will arise with the use of absolute dollar amounts as benchmarks without any apparent legislative scheme to index these amounts; and
- the exclusion of STS assets from the Other Assets Test.

5.49 BDO Kendalls reported that approximately two-thirds of respondents surveyed considered that the provisions do not avoid unintended consequences of a substantive nature.

Takes account of actual taxpayer circumstances and commercial practices

5.50 BDO Kendalls considered that if the taxpayer relies on the objective tests in Division 35 then individual circumstances are irrelevant. If the taxpayer needs to rely on the Commissioner's discretion, BDO Kendalls considered the Division does not

¹ The ATO has issued only two taxation rulings in relation to non-commercial losses.

necessarily deal with the individual's peculiarity in conducting their business. This has been confirmed by the decision in the *Eskandari* case in which the court said that subparagraph 35-55(1)(b)(i) requires that the business activity has failed to satisfy one of the tests because of its nature. The reference to the 'nature' of the business is a reference to some inherent feature of the business that is common with other business activities of that type. Therefore the test looks to the nature of the industry rather than the way in which the taxpayer has conducted the business.

5.51 A large proportion of respondents to the BDO Kendalls survey felt the tests were not sufficient to take account of taxpayer circumstances and commercial practices.

Is consistent with other tax legislation

5.52 BDO Kendalls found that there are no apparent inconsistencies with existing legislation.

Provides certainty

5.53 BDO Kendalls found that, overall, Division 35 provides taxpayers with additional certainty, with a total of 57 per cent of those surveyed agreeing that the tests provided certainty for taxpayers. However, some uncertainty remains in the following areas:

- the determination of whether a business is being carried on;
- the circumstances in which the Commissioner will exercise the discretion; and
- the grouping of business activities.

5.54 BDO Kendalls found the relatively low number of ATO publications is a positive indicator of the certainty provided by the legislation. Only two public rulings have been issued by the ATO and a relatively small number of ATO IDs have been issued on common problems encountered by taxpayers and practitioners. A list of ATO IDs is included at Appendix B.

Other comments

5.55 BDO Kendalls noted that the cost associated with applying for the Commissioner's discretion is considerable and it is likely that only more affluent taxpayers will be able to satisfy the Commissioner to exercise the discretion.

5.56 BDO Kendalls made a number of suggestions to improve the effectiveness of Division 35:

- To overcome the perceived inequity of the Real Property Test, it was suggested that the test be based upon the area of land used rather than its value. The area of land

required to be used in order to pass the test could be determined for each type of industry and published in a ruling or regulations.

- BDO Kendalls suggested that internally generated intellectual property be measured at its market value and that the test be extended to include assets subject to a deduction in accordance with Division 328. BDO Kendalls also suggested the test should be changed so that assets are measured at original cost rather than written down value.
- A provision should be enacted to allow a sole trader that incorporates to offset deferred losses against income from the incorporated entity provided the taxpayer is the sole shareholder and the same business is carried on.
- An indexation formula should be applied to the objective tests to take account of the increased cost of living and inflation.
- The Commissioner's discretion should be broadened to take account of appropriate lead-times for particular businesses.

CHAPTER 6: ISSUES OF POLICY RAISED WITH THE BOARD

6.1 Policy issues are outside the scope of the review and are not covered in the Board's recommendations. This approach was set out in the Board's published Consultation Plan for the post-implementation review of non-commercial losses which stated:

'The Board's intention in undertaking post-implementation reviews is not to reopen debates about the merits of the policy of a measure. The intention instead is to gauge how effective the legislation has been in delivering that policy intent.'

6.2 The policy intent of the non-commercial losses legislation is to improve the integrity of the taxation system by preventing losses from non-commercial activities that are carried on as businesses by individuals being offset against other assessable income.

6.3 This Chapter summarises the main policy issues raised with the Board.

ISSUES RAISED

6.4 The main policy issues raised with the Board were claims that:

- Division 35 does not remove the uncertainty around whether or not a business is being carried on.
 - The BDO Kendalls report noted that '...notwithstanding the introduction of the four objective tests, there is still a threshold test that must be satisfied. The threshold question is whether the taxpayer is conducting a business. In our opinion, this issue is present with the present law as much as it was with the former law. Division 35 still requires this threshold question to be satisfied. The question can only be answered on a case by case examination. Public rulings on what constitutes a business have been in existence for considerable periods of time. (Example TR 97/11) ...The Division still relies on the discernment of what constitutes a business.'
 - The Australia Council for the Arts (Australia Council) submitted 'that the policy intent of Division 35, in the context of artists, must be met at the threshold inquiry of whether or not the taxpayer is actually carrying on a business at all. If

a taxpayer is able to demonstrate that they are carrying on a professional arts business, then there is no need for the additional hurdle represented by Division 35 to apply to the deductibility of losses generated by that arts business.’ The Australia Council noted that the ATO is currently developing a ruling on what constitutes a professional arts business. The Australia Council contended that ‘...the development of a binding public ruling on the issue of when an artist will be carrying on a business for tax law purposes has rendered Division 35 otiose in its application to artists.’

- Artists should either be completely exempted from the operation of Division 35 or the existing other income exception threshold of \$40,000 for professional artists should be increased or indexed.
 - The Australia Council submission noted that ‘...the tax system also plays an important role in providing support to the arts industry. Measures such as the tax averaging provisions (Division 405) and the current exemption contained in Division 35 (i.e. the \$40,000 cap) recognise the particular economic circumstances of professional artists.’ The Australia Council submitted that ‘...all professional artists should be exempted from the operation of Division 35 because the division does not adequately take into account the actual circumstances of individual artists and the commercial practices of the arts industry generally’, and that ‘...it is only through a complete (that is, uncapped) exemption from Division 35 for taxpayers who are carrying on a professional arts business that substantive equality with taxpayers in other kinds of businesses can be achieved.’
 - The National Association for the Visual Arts Ltd (NAVA) also supported a complete exemption from Division 35 for professional artists. NAVA referred to the Throsby and Hollister study which it said ‘...indicated that 54 per cent of visual artists and 64 per cent of craft practitioners say they have been adversely affected by the new tax system. The findings would seem to indicate that most artists and craft practitioners would be able to meet the Exception criterion in Division 35, of earning less than \$40,000 from non-arts related income. In the majority of cases this is true however, disaggregated figures produced on request by Virginia Hollister showed that about 13 per cent were earning over \$40,000 from non-arts income. This figure is corroborated by one of the largest arts accountancy firms in response this year to NAVA's request for information. The group most affected are those who earn income from teaching.’
 - The submission from Bill Leung of Lowenstein Sharp Pty Ltd (Lowenstein Sharp) noted that the exception threshold for primary producers and professional artists ‘...is legislated at a fixed amount of \$40,000, and is not adjusted to account for inflation, ie the “rising costs of living” unlike some other areas of the taxation system, which are indexed or subjected to regular review and adjustment.’ The submission considered that this failure to provide for indexing the threshold is

an unintended consequence which will ‘...subject the artists of our nation to be potentially both income and asset poor’.

- The threshold that applies in the objective test for assessable income is too high.
 - The Australian Society of Authors contended that ‘...the \$20,000 income test is woefully inadequate’ as ‘...authors will not earn anywhere near \$20,000 from their work’. This view was supported in most of the submissions from arts organisations which pointed to difficulties that their members have in meeting the assessable income test, or any of the other objective tests, so that they do not have to defer their losses.
- The threshold that applies in the objective test for real estate assets should be modified to take account of regional differences in land prices.
 - BDO Kendalls noted that real property located in different parts of Australia may have the same area but different market values. BDO Kendalls suggested that, to overcome this inequity, it may be more appropriate to determine the commerciality of a business activity based upon the area of the land as opposed to the value of the land or some other physical attribute associated with the land. BDO Kendalls proposed that a ruling or regulations could identify the area of land required to be used for each industry to be considered commercial for Division 35 purposes.
- Farm vehicles should be eligible for inclusion in the ‘other assets’ test.
 - The submission from Australian Forest Growers (AFG) noted:

‘The Treasurer’s announcement of 11 November 1999 states “...or \$100,000 of other assets excluding passenger motor vehicles.”

However, the legislation took this further. Section 35-45(4) of the ITAA 1997 expresses this intention as “cars, motorcycles and similar vehicles”. Although ITAA 1997 contains a definition of “car”, it does not contain definitions of motor cycles and similar vehicles. This left open the question of how the ATO would treat farm vehicles such as three and four-wheel motorbikes, agricultural bikes, other all-terrain vehicles (ATVs), bullcatchers and the like.

All of these categories of motor vehicles are unregistrable for use on public roads, except in very restricted special circumstances. None could be seriously considered as “passenger motor vehicles” as stated in the Treasurer’s announcement. Nevertheless, in response to a submission from the National Farmers Federation and to subsequent repeated debate in the ATPF (NCL), the ATO’s response was to take a very narrow interpretation and determine that such vehicles should be excluded from the “other assets” test by virtue of

falling within the meaning of “motor cycles and similar vehicles”. The matter was therefore set aside as a “policy issue” to be raised with the Government. ‘

- The ‘original’ value of an asset should be used for the Other Assets Test rather than ‘written down value’ of an asset.
 - Bill Leung of Lowenstein Sharp submitted that ‘...the other assets test is based on the assets “written down values”. Potentially, a start-up business may have satisfied this test, but in future years, the written down values may render the test to be failed, ie beneath the \$100,000 threshold.’ He suggested that ‘...the test would be more fairly employed by having the value of the assets measured at their original acquisition costs and not their written down values. These original acquisition costs of the assets are maintained in calculating the threshold for this test as long as the earlier of either the effective life of the assets or the disposal of the assets. By adapting to this alternative method of measurement, it is submitted this better reflects the underlying intention of this test, ie the “use” of the assets. ‘
- For the Other Assets Test, internally generated intellectual property should be measured at ‘market value’ rather than at cost.
 - BDO Kendalls noted that ‘...a business that relies on internally generated intellectual property will encounter difficulties in meeting the other assets test.’ BDO Kendalls proposed ‘...that internally generated intellectual property is measured at its market value for these purposes.’
- Individuals converting their business activities to an incorporated or trust structure lose the benefit of deferred losses.
 - The Institute of Chartered Accountants in Australia (ICAA) submitted that:

‘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 ICAA suggested ‘...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. ‘
 - The AFG submission expressed similar concerns. The AFG suggested that ‘...appropriate action should be taken to prevent a primary production sole trader or partnership being forced to forfeit a carried forward non-commercial business loss when converting to a proprietary company structure.’

- An independent board should be appointed to assist with the exercise of the Commissioner's discretion.
 - Taxpayers Australia Inc. – Tasmanian Divisional Council (Taxpayers Australia) submitted that '...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', and '...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'. Taxpayers Australia also submitted that '...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.'

6.5 The Board appreciates that policy issues may be of significant concern to individuals. However, the Board notes that policy concerned with the composition, application of, and thresholds for the objective tests, the exceptions for primary producers and professional artists, and the exercise of the Commissioner's discretion were considered during Parliamentary debate on the legislation.

6.6 The Board also notes that a wide range of issues, for example revenue consequences and equity issues, would need to be taken into account if this legislation was ever revisited. Moreover, any amendments would lead to another set of transitional compliance and administration costs that should be taken into account in assessing any calls for amendment to the legislation.

APPENDIX A: DIVISION 35 OF THE INCOME TAX ASSESSMENT ACT 1997

DIVISION 35 – DEFERRAL OF LOSSES FROM NON-COMMERCIAL BUSINESS ACTIVITIES

This appendix contains Division 35 of the *Income Tax Assessment Act 1997*.

Division 35—Deferral of losses from non-commercial business activities

Guide to Division 35

35-1 What this Division is about

This Division prevents losses of individuals from non-commercial business activities being offset against other assessable income in the year the loss is incurred. The loss is deferred.

It sets out a series of tests to determine whether a business activity is treated as being non-commercial.

The deferred losses may be offset in later years against profits from the activity or, if one of the tests is satisfied or the Commissioner exercises a discretion, against other income.

Table of sections

Operative provisions

35-5	Object
35-10	Deferral of deductions from non-commercial business activities
35-15	Modification if you have exempt income
35-20	Modification if you become bankrupt
35-25	Application of Division to certain partnerships
35-30	Assessable income test
35-35	Profits test
35-40	Real property test
35-45	Other assets test
35-50	Apportionment
35-55	Commissioner's discretion

[This is the end of the Guide.]

Operative provisions

35-5 Object

- (1) The object of this Division is to improve the integrity of the taxation system by preventing losses from non-commercial activities that are carried on as *businesses by individuals (alone or in partnership) being offset against other assessable income.
- (2) This Division is not intended to apply to activities that do not constitute carrying on a *business, for example, the receipt of income from passive investments.

35-10 Deferral of deductions from non-commercial business activities

- (1) The rule in subsection (2) applies for an income year to each *business activity you carried on in that year if you are an individual, either alone or in partnership (whether or not some other entity is a member of the partnership), unless:
 - (a) one of the tests set out in section 35-30 (assessable income test), 35-35 (profits test), 35-40 (real property test) or 35-45 (other assets test) is satisfied for the business activity for that year; or
 - (b) the Commissioner has exercised the discretion set out in section 35-55 for the business activity for that year; or
 - (c) the exception in subsection (4) applies for that year.

Note: This section covers individuals carrying on a business activity as partners, but not individuals merely in receipt of income jointly. Compare the definition of *partnership* in subsection 995-1(1).

Rule

- (2) If the amounts attributable to the *business activity for that income year that you could otherwise deduct under this Act for that year exceed your assessable income (if any) from the business activity for that year, or your share of it, this Act applies to you as if the excess:
 - (a) were not incurred in that income year; and

- (b) were an amount attributable to the activity that you can deduct from assessable income from the activity for the next income year in which the activity is carried on.

Note: There are modifications of this rule if you have exempt income (see section 35-15) or you become bankrupt (see section 35-20).

Example: Jennifer has a salaried job, and she also carries on a business activity consisting of selling lingerie.

Jennifer starts that activity on 1 July 2002, and for the 2002-03 income year, the activity produces assessable income of \$8,000 and deductions of \$10,000. The activity does not pass any of the tests and the discretion is not exercised so the \$2,000 excess is carried over to the next income year in which the activity is carried on.

For the 2003-04 income year, the activity produces assessable income of \$9,000 and deductions of \$10,000 (excluding the \$2,000 excess from 2002-03). Again, no tests passed and no exercise of discretion.

\$3,000 is carried over to the next income year (comprising the \$1,000 excess for the current year, plus the previous year's \$2,000 excess) when the activity is carried on.

Grouping business activities

- (3) In applying this Division, you may group together *business activities of a similar kind.

Exceptions

- (4) The rule in subsection (2) does not apply to a *business activity for an income year if:
- (a) the activity is a *primary production business, or a *professional arts business; and
 - (b) your assessable income for that year (except any *net capital gain) from other sources that do not relate to that activity is less than \$40,000.

- (5) A ***professional arts business*** is a *business you carry on as:

- (a) the author of a literary, dramatic, musical or artistic work; or

Note: The expression "author" is a technical term from copyright law. In general, the "author" of a musical work is its composer and the "author" of an artistic work is the artist, sculptor or photographer who created it.

- (b) a *performing artist; or

(c) a *production associate.

35-15 Modification if you have exempt income

- (1) The rule in section 35-10 may be modified for an income year if you *derived *exempt income in that year.
- (2) Any amount to which paragraph 35-10(2)(b) would otherwise apply for an income year for you is reduced by so much of your *net exempt income as is not applied for that income year under section 36-10 or 36-15 (about tax losses). This reduction is made before you apply the paragraph 35-10(2)(b) amount against assessable income from the *business activity.

35-20 Modification if you become bankrupt

- (1) The rule in section 35-10 is modified as set out in subsection (3) for an income year if in that year (the *current year*) you become bankrupt or are released from a debt by the operation of an Act relating to bankruptcy.
- (2) The rule is also modified as set out in subsection (3) if:
 - (a) you became bankrupt before the current year; and
 - (b) the bankruptcy is annulled in the current year under section 74 of the *Bankruptcy Act 1966* because your creditors have accepted a proposal for a composition or scheme of arrangement; and
 - (c) under the composition or scheme of arrangement, you have been, will be or may be released from some or all of the debts from which you would have been released if you had instead been discharged from the bankruptcy.
- (3) This Act applies to you as if any amount that:
 - (a) paragraph 35-10(2)(b) had applied to for an income year before the current year for you; and
 - (b) you have not yet deducted;were not an amount attributable to the *business activity that you can deduct for the current year or a later income year.

35-25 Application of Division to certain partnerships

For the purpose of applying the tests in sections 35-30, 35-40 and 35-45 where you carry on a *business activity in an income year as a partner, ignore:

- (a) any part of the assessable income from the business activity for the year that is attributable to the interest of a partner that is not an individual in the partnership net income or partnership loss for the year; and
- (b) any part of the assessable income from the business activity for the year that is derived from the activity by another partner otherwise than as a member of the partnership; and
- (c) any part of the *reduced cost bases or other values of assets of the partnership used in carrying on the activity in that year that is attributable to the interest of a partner that is not an individual in those assets; and
- (d) any part of the reduced cost bases or other values of assets owned or leased by another partner that are not partnership assets and used in carrying on the activity in that year.

35-30 Assessable income test

The rule in section 35-10 does not apply to a *business activity for an income year if:

- (a) the amount of assessable income from the business activity for the year; or
- (b) you started to carry on the business activity, or stopped carrying it on, during the year—a reasonable estimate of what would have been the amount of that assessable income if you had carried on that activity throughout the year; is at least \$20,000.

35-35 Profits test

- (1) The rule in section 35-10 does not apply to a *business activity (except an activity carried on by one or more individuals as partners, whether or not some other entity is a member of the partnership) for an income year (the *current year*) if, for each of at

least 3 of the past 5 income years (including the current year) the sum of the deductions attributable to that activity for that year (apart from the operation of subsection 35-10(2)) is less than the assessable income from the activity for that year.

- (2) For a *business activity you carried on with one or more others as partners, the rule in section 35-10 does not apply to you for the current year if, for each of at least 3 of the past 5 income years (including the current year) the sum of your deductions (including your share of the partnership deductions) attributable to that activity for that year (apart from the operation of subsection 35-10(2)) is less than your assessable income (including your share of the partnership's assessable income) from the activity for that year.

35-40 Real property test

- (1) The rule in section 35-10 does not apply to a *business activity for an income year if the total *reduced cost bases of real property or interests in real property used on a continuing basis in carrying on the activity in that year is at least \$500,000.
- (2) You may use the market value of the real property or interest if that value is more than its *reduced cost base.
- (3) The *reduced cost base or market value is worked out:
- (a) as at the end of the income year; or
 - (b) if you stopped carrying on the *business activity during the year:
 - (i) as at the time you stopped; or
 - (ii) if you disposed of the asset before that time in the course of stopping carrying on the activity—as at the time you disposed of it.
- (4) However, these assets are not counted for this test:
- (a) a *dwelling, and any adjacent land used in association with the dwelling, that is used mainly for private purposes;
 - (b) fixtures owned by you as a tenant.

35-45 Other assets test

- (1) The rule in section 35-10 does not apply to a *business activity for an income year if the total values of assets that are counted for this test (see subsections (2) and (4)) and that are used on a continuing basis in carrying on the activity in that year is at least \$100,000.
- (2) The assets counted for this test, and their values for this test, are set out in this table:

Assets counted for this test and their values		
Item	Asset	Value
1	An asset whose decline in value you can deduct under Division 40	The asset's *written down value
2	An item of *trading stock	Its value under subsection 70-45(1)
3	An asset that you lease from another entity	The sum of the amounts of the future lease payments for the asset to which you are irrevocably committed, less an appropriate amount to reflect any interest component for those lease payments
4	Trademarks, patents, copyrights and similar rights	Their *reduced cost base

- (3) The value of such an asset is worked out:
 - (a) as at the end of the income year; or
 - (b) if you stopped carrying on the *business activity during the year:
 - (i) as at the time you stopped; or
 - (ii) if you disposed of the asset before that time in the course of stopping carrying on the activity—as at the time you disposed of it.
- (4) However, these assets are not counted for this test:
 - (a) assets that are real property or interests in real property that are taken into account for that year under section 35-40;
 - (b) *cars, motor cycles and similar vehicles.

35-50 Apportionment

If an asset that is being taken into account under section 35-40 or 35-45 is used during an income year partly in carrying on the relevant *business activity and partly for other purposes, only that part of its *reduced cost base, market value or other value that is attributable to its use in carrying on the business activity in that year is taken into account for that section.

35-55 Commissioner's discretion

(1) The Commissioner may decide that the rule in section 35-10 does not apply to a *business activity for one or more income years if the Commissioner is satisfied that it would be unreasonable to apply that rule because:

- (a) the business activity was or will be affected in that or those income years by special circumstances outside the control of the operators of the business activity, including drought, flood, bushfire or some other natural disaster; or

Note: This paragraph is intended to provide for a case where a business activity would have satisfied one of the tests if it were not for the special circumstances.

(b) the business activity has started to be carried on and, for that or those income years:

- (i) because of its nature, it has not satisfied, or will not satisfy, one of the tests set out in section 35-30, 35-35, 35-40 or 35-45; and

- (ii) there is an objective expectation, based on evidence from independent sources (where available) that, within a period that is commercially viable for the industry concerned, the activity will either meet one of those tests or will produce assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsection 35-10(2)).

Note: This paragraph is intended to cover a business activity that has a lead time between the commencement of the activity and the production of any assessable income. For example, an activity involving the planting of hardwood trees for harvest, where many years would pass before the activity could reasonably be expected to produce income.

APPENDIX B: ATO MATERIAL

This appendix contains Public Rulings, Fact Sheets, 'Questions and Answers', ATO Interpretative Decisions (ATO IDS) and Guidance Materials published by the Australian Taxation Office. All of these documents are available at www.ato.gov.au.

PUBLIC RULINGS

Taxation Ruling TR 97/11 Income tax: am I carrying on a business of primary production?

Taxation Ruling TR 2001/14 Income tax: Division 35 – non-commercial business losses.

Taxation Ruling TR 2001/14A – Addendum – Income tax: Division 35 – non-commercial business losses.

Taxation Ruling TR 2003/3 Income tax: Non-commercial losses – application of subsections 35-10(2) and 35-10(4) of the *Income Tax Assessment Act 1997* to business activities carried on in partnership.

FACT SHEETS

Overview

Assessable income test

Profits test

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QUESTIONS AND ANSWERS

About the measure

Tests

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Background

ATO INTERPRETATIVE DECISIONS (ATO IDs)

ATO ID 2004/11 – other assets test – rally cars

ATO ID 2004/112 – Farm Management Deposit withdrawal – assessable income 'from' the business activity

ATO ID 2004/262 – assessable income – whether Landcare grant is income 'from' the business activity

ATO ID 2003/62 – assessable income test – income from a personal income protection insurance policy is not income from a business activity

ATO ID 2003/88 – employment income and the exception to Division 35

ATO ID 2003/89 – assessable income test – income 'from' a business activity

ATO ID 2003/279 – assessable income test – whether an increase in the value of trading stock on hand for an income year is assessable income 'from' the business activity

ATO ID 2003/288 – assessable income test – whether a balancing adjustment is income 'from' the business activity

ATO ID 2003/329 – Commissioner's discretion – sale of business activity as a going concern in the lead time

ATO ID 2003/332 – whether business bank interest is assessable income from the business activity

ATO ID 2003/363 – lead time discretion – commercially viable period – purchase of business activity

ATO ID 2003/374 – real property test – partnership assets

ATO ID 2003/407 – profits test and change of business ownership

ATO ID 2003/426 – bounties, subsidies and grants – assessable income ‘from’ the business activity

ATO ID 2003/569 – is exempt foreign employment income included as income ‘from’ a business activity

ATO ID 2003/570 – is exempt foreign employment income included as assessable income from an unrelated source

ATO ID 2003/603 – Commissioner’s discretion – objective expectation of profit – cessation of business

ATO ID 2003/629 – lead time discretion – plant disease affecting the ‘commercially viable period’

ATO ID 2003/630 – assessable income test – reasonable estimate

ATO ID 2003/631 – forestry – business not being carried on

ATO ID 2003/961 – loss deferral rule – long-term averaging of primary producers’ tax liability

ATO ID 2003/963 – artist exception – does incidental arts work in a business qualify the activity for the exception?

ATO ID 2003/1005 – other assets test – assets that have been pooled under the Simplified Tax System (STS)

ATO ID 2002/43 – Commissioner’s discretion contained in section 35-55 of the ITAA 1997

ATO ID 2002/44 – Commissioner’s discretion in section 35-55 of the ITAA 1997 – no objective expectation

ATO ID 2002/575 – Dependant tax offset – separate net income – non-commercial losses

ATO ID 2002/701 – Commissioner’s discretion – special circumstances – expectation of taxation profit not decisive

ATO ID 2001/295 – Pre 2000/2001 carried forward business losses and Division 35

GUIDANCE MATERIALS

ATO Guide and application for a private ruling (NAT 5806-2.2002)

Completing non-commercial losses labels in the 2003 individual tax return

APPENDIX C: SUBMISSIONS RECEIVED

The Board received submissions on the post-implementation review of Division 35 from the following parties.

Artists Foundation of WA

Arts Law Centre of Australia

Arts Law Centre of Queensland Inc.

Australia Council for the Arts

Australian Dance Council – Ausdance Inc.

Australian Film Commission

Australian Forest Growers

Australian Society of Authors

Blanckensee, Jane

Dunne, Ian – Lowe Lippmann, Chartered Accountants

Institute of Chartered Accountants in Australia

Leung, Bill – Lowenstein Sharp Pty Ltd, Certified Practising Accountants

Lowensteins Arts Management Pty Ltd, Certified Practising Accountants

Metcalf, Ronald Wayne – Metcalf Spahn, Certified Practising Accountants

Music Council of Australia

National Association for the Visual Arts Ltd.

National Association of Forest Industries

National Tax and Accountants' Association Ltd.

O'Brien, Peter – Hogg Lawson

Painters and Sculptors Association of Australia Ltd.

Taxation Institute of Australia

Taxpayers Australia Inc. – Tasmanian Divisional Council

Tucker, Brian, Certified Practising Accountant

Watson, Alistair

APPENDIX D: MEMBERS AND CHARTER OF THE BOARD OF TAXATION, CONFLICT OF INTEREST DECLARATION

Members

The members of the Board of Taxation are:

Chairman

Mr Richard F.E. (Dick) Warburton

Members

Mr John Bronger

Mr Tony D'Aloisio

Mr Brett Heading

Mr Keith James

Mr Chris Jordan

Ms Jane Schwager

Ex officio members

Mr Michael Carmody (Commissioner of Taxation)

Dr Ken Henry (Secretary to the Department of the Treasury)

Mr Peter Quiggin (First Parliamentary Counsel)

Secretariat

Members of the Board's Secretariat who contributed to this report were Mr Bruce Paine (Secretary), Mr Vernon Joice, Mr Phil Bignell, Mr Peter Williams, Ms Angela McNally, Mr Mike Kooymans and Ms Michelle Bender.

Charter

Mission

Recognising the Government's responsibility for determining taxation policy, and the statutory role of the Commissioner of Taxation, to contribute a business and broader community perspective to improving the design of taxation laws and their operation.

Membership

The Board of Taxation will consist of up to ten members.

Up to seven members of the Board will be appointed, for a term of two years, on the basis of their personal capacity. It is expected that these members will be appointed from within the business and wider community having regard to their ability to contribute at the highest level to the development of the tax system. The Chairman will be appointed from among these members of the Board. Members may be reappointed for a further term.

The Secretary to the Department of the Treasury, the Commissioner of Taxation and the First Parliamentary Counsel will also be members of the Board. Each may be represented by a delegate.

Function

The Board will provide advice to the Treasurer on:

- the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design;
- improvements to the general integrity and functioning of the taxation system;
- research and other studies commissioned by the Board on topics approved or referred by the Treasurer; and
- other taxation matters referred to the Board by the Treasurer.

Relationship to other Boards and Bodies

From time to time the Government or the Treasurer may establish other boards or bodies with set terms of reference to advise on particular aspects of the tax law. The Treasurer will advise the Board on a case by case basis of its responsibilities, if any, in respect of issues covered by other boards and bodies.

Report

The Chairman of the Board will report to the Treasurer, at least annually, on the operation of the Board during the year.

Secretariat

The Board will be supported by a secretariat provided by the Treasury, but may engage private sector consultants to assist it with its tasks.

Other

Members will meet regularly during the year as determined by the Board's work program and priorities.

Non-government members will receive daily sitting fees and allowances to cover travelling and other expenses, at rates in accordance with Remuneration Tribunal determinations for part-time public offices.

The Government will determine an annual budget allocation for the Board.

Conflict of interest declaration

All members of the Board are taxpayers in various capacities. Some members of the Board derive income from director's fees, company dividends, trust distributions or as a member of a partnership.

The Board's practice is to require members who have a material personal interest in a matter before the Board to disclose the interest to the Board and to absent themselves from the Board's discussion of the matter, including the making of a decision, unless otherwise determined by the Chairman (or if the Chairman has the interest, the other members of the Board).

The Board does not regard a member as having a material personal interest in a matter of tax policy that is before the Board merely because the member's personal interest may, in common with other taxpayers or members of the public, be affected by that tax policy or by any relevant Board recommendations.

