General outline and financial impact

Non-commercial losses

Schedule # to this Bill amends the *Income Tax Assessment Act 1997* to tighten the application of the non-commercial losses rules in relation to individuals with an adjusted taxable income of over $250,000. These amendments will prevent high income individuals from offsetting deductions from non-commercial business activities against their salary, wage or other income.

Date of effect: The amendments apply from the 2009-10 income year.

Proposal announced: This measure was announced in the 2009-10 Budget and in the Treasurer's Press Release No. # of 12 May 2009.

Financial impact: This measure will have these revenue implications:

2008-09	***2009-10***	***2010-11***	***2011-12***	***2012-13***
-	-	330.0	240.0	130.0

Compliance cost impact: Low.

Chapter
Non-commercial losses

Outline of chapter

1.1 Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to tighten the application of the non-commercial losses rules in relation to individuals with an adjusted taxable income of over $250,000. These amendments will prevent high income individuals from offsetting deductions from non-commercial business activities against their salary, wage or other income.

Context of amendments

1.2 The non-commercial losses rules were introduced in 2000, following recommendations from the *Review of Business Taxation*. They are aimed at improving the integrity, fairness and equity of the tax system, by addressing the opportunity for individuals to avoid tax by carrying on unprofitable business activities and claiming deductions for losses arising from such activities against their other income.

1.3 Under the current non-commercial losses rules contained in Division 35 of the ITAA 1997, an individual taxpayer carrying on a business activity either alone or in partnership may only claim a loss from that activity against their other income in an income year if they satisfy at least one of four objective tests in that year. The four tests are:

- assessable income test – the assessable income generated from the activity must be at least $20,000;

- profits tests – the activity must have produced a profit in three of the last five income years, including the current income year;

- real property test – the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least $500,000; and

- other assets test – the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least $100,000.

1.4 If a business activity does not pass any of these tests, the Commissioner has discretion to nonetheless allow a taxpayer to offset the losses against other income, having regard to certain circumstances. For example, if there are exceptional circumstances applicable to the business activity that stop it from meeting one of the four tests. Exceptional circumstances could include adverse weather conditions that prevent a farming business from meeting the assessable income test in a particular year.

1.5 In addition, another exemption is available when the taxpayer is involved in a primary production or professional arts business activity, and the taxpayer's total income from other sources is no greater than $40,000.

1.6 Currently, if any of the above tests is met, the taxpayer can deduct all of the expenses from their non-commercial business activities from both the business and other income. If all of the tests are failed, the deductions are limited to the amount of the income from the business. It does not mean that the costs are not deductible, just that deductions are quarantined to the particular business activity. Quarantined deductions can be carried forward to be used against future income from that business activity.

Summary of new law

1.7 These amendments recognise that the current non-commercial loss rules apply in a discriminatory way, because taxpayers with high incomes are more able to meet one of the four objective tests.

1.8 These amendments limit access to the four objective tests to individuals who meet an income requirement. The income requirement is met when an individual's adjusted taxable income less than $250,000.

1.9 These amendments also provide the Commissioner with a new discretion in cases where an individual does not meet the income requirement, but can nonetheless independently demonstrate that their business is genuinely commercial.

Comparison of key features of new law and current law

New law	***Current law***
Unless the income requirement is met and one of the objective tests is met, losses from non-commercial business activities are quarantined. The income requirement is met when an individual has an adjusted taxable income of less than $250,000 in the relevant income year.	Unless one of the objective tests is met, losses from non-commercial business activities are quarantined.
The objective tests are: • the assessable income test – the assessable income generated from the activity must be at least $20,000; • profits tests – the activity must have produced a profit in three of the last five income years, including the current income year; • real property test – the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least $500,000; and • other assets test – the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least $100,000.	The objective tests are: • the assessable income test – the assessable income generated from the activity must be at least $20,000; • profits tests – the activity must have produced a profit in three of the last five income years, including the current income year; • real property test – the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least $500,000; and • other assets test – the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least $100,000.
The non-commercial losses rules do not apply to individuals that are involved in a primary production business or a professional arts business and who have other income of less than $40,000.	The non-commercial losses rules do not apply to individuals that are involved in a primary production business or a professional arts business and who have other income of less than $40,000.
An individual may apply to the Commissioner to exercise discretion if a business has been objectively assessed as being genuinely commercial, or exceptional circumstances are present.	An individual may apply to the Commissioner to exercise discretion if a business has been objectively assessed as being genuinely commercial, or exceptional circumstances are present.

Detailed explanation of new law

1.10 All references are to the ITAA 1997 unless otherwise stated.

1.11 The exemptions to the general rules about non-commercial losses are aimed at providing relief for individuals where certain characteristics of the business show that it is likely to be commercial, despite having made a loss in an income year. These amendments improve the integrity, fairness and equity of the non-commercial losses rules by recognising that the current exemptions operate in a discriminatory way because high income individuals are more able to satisfy the four objective tests used to work out if an exemption applies, and use these to avoid tax. To address this issue, the new law introduces an income requirement that limits those who can access the exemptions to the general rule about non-commercial losses.

1.12 The income requirement prevents individuals with an adjusted taxable income of more than $250,000 from accessing the exemptions to the non-commercial losses rules. Individuals who do not meet the income requirement, but who can nonetheless objectively demonstrate that their business is commercial can apply to the Commissioner to exercise discretion and not apply the non-commercial losses rules. Individuals can also apply for the Commissioner to exercise discretion when there are exceptional circumstances.

1.13 The income requirement is met when, in a given income year, the sum of an individual's taxable income, reportable fringe benefits, reportable superannuation contributions and total net investment losses is less than $250,000. The four amounts that make up the income requirement, when referred to together, are also known as an individual's adjusted taxable income. The four amounts that make up the income requirement are defined in subsection 995-1(1).

1.14 When working out if an individual has met the income requirement, the individual must exclude any excess deductions from the non-commercial business activity. ***[Schedule #, item 4, subsection 35-10(2E)]***

1.15 Section 35-10(1) and section 35-10(2A) are changed to require an individual to meet the income requirement before accessing the tests that work out if an exemption applies. ***[Schedule #, items 2 and 3, paragraphs 35-10(1)(a) 35-10(2A)(a)]***

1.16 If the income requirement is met, an individual can then apply all of the tests to work out if they are exempt from the non-commercial losses rule. The four tests are:

- the assessable income test – the assessable income generated from the activity must be at least $20,000;
- profits tests – the activity must have produced a profit in three of the last five income years, including the current income year;
- real property test – the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least $500,000; and
- other assets test – the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least $100,000.

1.17 An individual must work out if the income requirement is met each year the individual wants to apply non-commercial losses against their other income, by looking at their adjusted taxable income from that same year.

1.18 A new Commissioner's discretion is inserted for individuals who do not meet the income requirement, but who have excess deductions from a business that – based on an objective assessment – is a commercial business. ***[Schedule #, items 6 and 7, paragraph 35-55(1)(c)]***

Example 1.1

Jane received $150,000 income from her salaries and wages in 2009-10, but then a promotion increased her salaries and wages income to $250,000 for 2010-11. She also had $50,000 in reportable superannuation contributions in both years. She did not have any reportable fringe benefits or total net investment losses.

She also owns a party planning business, that mostly plans parties for her friends and family, which had an assessable income of $30,000 in 2009-10 and 2010-11, but which also had $45,000 of deductions in both years. Jane's party planning business, therefore, had excess deductions of $15,000 in 2009-10 and 2010-11. Jane has not applied for the Commissioner's discretion to be exercised.

In 2009-10, Jane can apply the losses from her non-commercial business against her other income. For 2009-10, the total of Jane's salaries and wages income and her reportable superannuation contributions was $200,000, so she met the income requirement. Jane's party planning business had excess deductions, but it had an assessable income in excess of $20,000, so it met the assessable income test, so she does not have to quarantine her losses from her party planning business. For 2009-10, Jane applies the $15,000 excess losses from her party planning business against her other income.

For 2010-11, Jane cannot apply the $15,000 of losses from her party planning business attributable to the 2010-11 income year because she does not meet the income requirement. For 2010-11, the total of her salaries and wages income and her reportable superannuation contributions is $300,000, so she fails the income requirement. The $15,000 of excess deductions from 2010-11 are quarantined, and can only be applied against assessable income from her party planning business in future income years.

Example 1.2

In the 2009-10 income year, Jack has a taxable income of $200,000, reportable superannuation contributions of $50,000 and reportable fringe benefits of $20,000. Jack also owns a vineyard that is valued at $750,000. The vineyard has excess deductions of $50,000 this year.

Jack does not meet the income requirement because the sum of his taxable income, reportable fringe benefits, and reportable superannuation contributions is $270,000. Despite that his non-commercial business activity is being carried on with real assets worth more than $500,000, he must now apply to the Commissioner if he wants to apply his non-commercial losses against his other income.

Jack has obtained an independent assessment that the vineyard will make assessable income within seven years. Jack applies to the Commissioner to exercise his discretion. The Commissioner decides that there is an objective expectation, based on an independent assessment, that the vineyard will produce assessable income in a period that is considered commercially viable for the industry concerned, and that Jack can apply the $50,000 against his other assessable income in this income year.

Application and transitional provisions

1.19 These amendments will commence from the date the Bill receives Royal Assent. ***[Clause 2]***

1.20 The law will apply to the 2009-10 income year and later income years. ***[Schedule #, item 8]***

Consequential amendments

1.21 The guide to the Division 35 is changed to reflect that the Division now:

- establishes the general rule about quarantining non-commercial losses; and
- establishes an income requirement; and
- where the income requirement is met; allows for individuals to not apply the non-commercial losses rule if one of four tests are met.

[Schedule #, item 1, section 35-1]

1.22 Paragraph 35-55(1)(b) is changed to reflect the new income requirement. ***[Schedule #, item 5, paragraph 35-55(1)(b)]***