TAXATION INSTITUTE OF AUSTRALIA

29 March 2004

Mr Dick Warburton
Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Warburton,

POST-IMPLEMENTATION REVIEW OF DIVISION 35 ITAA 1997 – DEFERRAL OF LOSSES FROM NON-COMMERCIAL BUSINESS ACTIVITIES

The Taxation Institute of Australia (Taxation Institute) supports the Board of Taxation's (the Board) post-implementation review of the quality and effectiveness of Division 35 (the non-commercial loss provisions – "NCL provisions"), and welcomes this opportunity to provide our input.

Set out below are our comments in response to the criteria against which the Board will evaluate these provisions, as detailed in your letter dated 28 October 2003. Whilst we are not in a position to provide an empirical analysis of the operation of the NCL provisions, our comments focus on the extent to which the Taxation Institute believes the NCL provisions meet these review criteria.

Criterion 1: 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.

In addressing this criterion, the Taxation Institute has taken the policy to be that indicated by the Treasurer (in Press Release No 074, 11 November 1999), in acting on the recommendations of the Ralph Review of Business Taxation. The Treasurer stated that the Government's policy underlying the non-commercial loss provisions is directed at

"[l]imiting the extent to which non-commercial losses can be used to reduce the tax paid on other income. Non-commercial losses arise where taxpayers incur expenditures that are constructed as business related and therefore deductible, even though they are unlikely to make a profit and the expenditures do not have a significant commercial purpose. A series of criteria will be introduced to help ensure that only losses arising from commercial activities are deducted from other income."

A significant part of the Government's intention underlying this policy was to address revenue leakage from unprofitable activities that are more like hobbies or lifestyle choices.

The above evaluation criterion invites comment on two issues:

(1) Giving effect to the Government's policy

Whether the NCL provisions give effect to this policy is determined in the large part by our assessment of these provisions against the remaining review criteria set out below.

That said, it is nevertheless appropriate at this point to indicate that the Taxation Institute does not take issue in principle with the need to address the mischief identified in the policy underlying the NCL measures.

However, we question whether the NCL provisions are effective in achieving this policy. The Taxation Institute has a particular concern that these provisions have effect beyond the mischief they were intended to redress, with the significant potential to impact adversely on small business through undesirable and unintended consequences that need to be addressed.

The Taxation Institute also expects that the NCL provisions have the potential to deter people from investing in and carrying on a business, particularly in the small and medium enterprise sphere (in particular, the negative impact on rural industries is already well documented), and where new business activities are involved. This is more likely to be the case if a business is denied access to losses (in the year in which the losses are incurred) that commonly arise in the initial start up phase of a business. We acknowledge that it may be difficult to measure the hidden but nevertheless real economic costs of this deterrent effect.

(2) Compliance and administrative costs

The Taxation Institute is not in a position to quantify the compliance and administrative costs of the NCL provisions as a means of determining whether these costs are commensurate with those foreshadowed in the Regulation Impact Statement for these provisions.

However, we raise the following concern about the level of costs associated with the operation of these provisions.

The NCL provisions introduce a framework for determining whether losses from a business activity should be allowed as deductions against other income in a particular income year. These provisions, which are by no means certain in their application and can be complex to understand, have to be applied each year. The Taxation Institute is concerned in these circumstances that the ongoing annual cost of applying the NCL provisions is unlikely to decrease. Consequently, these provisions have resulted in a permanent additional compliance cost for those taxpayers affected them. This does not sit comfortably with Government's expectations in the Regulation Impact Statement that overall compliance costs will be reduced as part of a more consistent and easily understood business tax system.

Criterion 2: Expressed in a clear, simple, comprehensible and workable manner.

In comparative terms, the NCL provisions are modest in size and format, with 12 sections structured and expressed in the language consistent with the rewrite of the taxation laws under the Tax Law Improvement Project.

However, the key operative phrase in this review criterion is *"workable manner"*, and the Taxation Institute does not believe that the NCL provisions satisfy this aspect of criterion 2.

This concern is best illustrated by reference to the grouping provision in subsection 35-10(3), which allows individuals to choose whether or not to group similar business activities that they carry on.

This is a significant choice because it impacts on whether the individual:

- can satisfy the tests that prevent the NCL provisions from applying (the assessable income test in section 35-30, the profits test in section 35-35, the real property test in section 35-40, and the other assets test in section 35-45); and
- can rely on the two exceptions to the NCL provisions (subsection 35-10(4)).

The decision about whether or not to group may also affect the application of the Commissioner's discretion not to apply the NCL provisions where the individual is not able to rely on the above tests and exemptions (section 35-55).

The issue of whether an individual's business needs to be split up into two or more separate business activities for the purposes of the NCL provisions is one of some contentiousness, as is evident by the treatment of this issue in Taxation Ruling TR 2001/14 and other ATO material applicable to the NCL provisions.

It is not possible for an individual to satisfactorily determine whether a new business activity, whilst nevertheless having some linkages to the existing business, should be treated as remaining part of it overall, or whether it is carried on in such a discrete and self-contained manner that it should be regarded as a new and separate business activity.

As the grouping provision is a fundamental operative concept in the NCL provisions, and one whose application is far from certain or clear, it is indicative of provisions that are not expressed in a *"workable manner"*.

Criterion 3: Avoids unintended consequences of a substantive nature.

The Commissioner's discretion in section 35-55 is crucial to the fair and equitable operation of the NCL provisions. It is the safety net designed to protect individuals who carry on genuine commercial business activities but, due to particular circumstances, are prevented from satisfying any of the tests that render the loss deferral mechanism inoperative.

(a) Restricted ATO approach to exercise of discretion

The circumstances in which the Commissioner will exercise this discretion are unclear, and the Taxation Institute is concerned that the Commissioner is taking a restricted approach to the exercise of his discretion that will result in unintended consequences of a substantive nature.

The narrow approach that the Commissioner is taking to the exercise of his discretion can be illustrated by the recent Federal Court decision of Justice Stone in *Commissioner of Taxation v Eskandari* [2004] FCA 8 (28 January 2004), where the taxpayer was unsuccessful in arguing a case for the Commissioner to exercise his discretion under paragraph 35-55(1)(b).

This case highlights the difficulties and evidentiary hurdles that confront a taxpayer in seeking to secure the exercise of the Commissioner's discretion under section 35-55.

In this case, the Commissioner made reference to the Note accompanying paragraph 35-55(1)(b), which describes the class of cases that are intended to be covered by the Commissioner's discretion, namely, where there is a lead time between the commencement of the activity and the production of any assessable income. The Commissioner took the view that this Note operated as a condition precluding the application of paragraph 35-55(1)(b).

As the taxpayer in this case received some initial fees, the Commissioner argued that the business could not then have a lead time between the commencement of the activity and the production of assessable income, and paragraph 35-55(1)(b) could not be relied on. Whilst Justice Stone was critical of the Commissioner's use of the Note as an operative provision, he did not decide this point because he found that the Tribunal's conclusion that subparagraph 35-55(1)(b)(i) was satisfied was made in error. Hence, the status of the Commissioner's narrow approach to this provision remains unclear.

(b) Application of discretion to existing single business activities

In addition, the second arm of the Commissioner's discretion in paragraph 35-55(1)(b) is particularly problematic on another front.

This part of the discretion provides the Commissioner with a mechanism to allow a taxpayer to offset losses from a business activity that does not satisfy any of the exclusionary tests in the year in question, where there is an objective expectation that it will either pass a test or produce assessable income within a reasonable time.

It would not be uncommon for an established business to start new business activities that are not considered to be separate business activities, but are in fact part of the same activity. A business in this situation may undertake a new (and **not** separate) part of the business activity, which results in losses being incurred, as is commonly the case in the start up phase of a business activity. This occurs in a year after which the business activity had already first met one of the tests rendering the loss deferral mechanism inoperative.

The Commissioner is unlikely to be able to exercise the paragraph 35-55(1)(b) discretion in this situation. This is because the Commissioner can only exercise the discretion in paragraph 35-55(1)(b) where the business activity has not yet satisfied one of the tests (subparagraph 35-55(1)(b)(i)).

This is regardless of the fact that the new (and **not** separate) part of the business has a lead time which will affect the ability of the business to meet any of the exclusionary tests. It is also now questionable in light of the *Eskandari Case* whether the Commissioner would regard there being any lead time in this type of situation at all.

It would appear, therefore, that where a business activity has already satisfied one of the tests in the NCL provisions, the Commissioner cannot exercise the discretion for any subsequent years under paragraph 35-55(1)(b) in respect of that business activity. Nor can the discretion in paragraph 35-55(1)(a) apply, because entering into a new part of the same business is something directly within the control of the taxpayer.

This leads to a result that the discretion appears to be unintendedly best suited to more simple scenarios where the business activity has only recently started to be carried on, rather than one that has been in operation for some time. This will become an increasingly significant issue the longer the NCL provisions operate.

Consequently, the Taxation Institute believes that the operation of this discretion is unclear, and results in inequitable consequences of a substantive nature that limit the scope of application of this safety net.

Whilst this “fall back” discretion is a highly commendable aspect of the NCL provisions, the Taxation Institute recommends the following changes to make the Commissioner’s discretion more streamlined, certain and relevant:

- broadening the Commissioners discretion to circumstances where the taxpayer can demonstrate that their activities constitute a significant commercial activity considering their own individual circumstances even though they may be outside of the circumstances set out in paragraphs 35-55(1)(a) or (b) of ITAA 1997;

- providing clearer and more objective guidance as to the circumstances in which the Commissioner may exercise his discretion to avoid the interpretative difficulties that have arisen in the *Eskandari Case*; and

- providing for Managed Investment Schemes specifically under the non-commercial loss provisions rather than requiring such schemes to utilise the Commissioner’s discretion.

Criterion 4: Takes account of actual taxpayer circumstances and commercial practices.

There is a risk that the NCL provisions impact adversely on new and emerging businesses. This risk in the primary production sector is well illustrated in a paper by Rick Lacey and Alistair Watson, *“Economic Effects of Income Tax Law on Investment in Australian Agriculture: With Particular Reference to Managed Investment Schemes and Division 35 of the Income Tax Act”* (delivered to the RIRCD Session of the 48th Conference of the Australian and Resource Economics Society, February 11-13 2004, Melbourne).

In particular, an individual starting a small business is likely to work harder for less financial return during the lead time it takes to establish a business in these circumstances. However, this type of new business activity runs the risk of being classified as a separate business activity, with the resulting quarantining of losses.

This type of result is indicative of the inability of the NCL provisions to take account of actual taxpayer circumstances and commercial practices with any certainty.

Criterion 5: Consistent with other tax legislation.

Paragraph 1.57 of the Explanatory Memorandum to the *New Business Tax System (Integrity Measures) Bill 2000* explains that section 35-15 – Modification if you have exempt income – was inserted into the NCL provisions to ensure that losses deferred under these provisions are treated in the same way as normal Division 36 losses.

There is some debate over whether this is how the section works as it is currently drafted, which is well documented in the records and minutes of the ATO's Non-Commercial Losses Forum (which ceased to operate in 2002). There may be some further scope for reviewing the operation of section 35-15 in light issues raised at this Forum.

Criterion 6: Provides certainty.

As a general position, rather then creating objective tests and reducing complexity, it is arguable that the NCL provisions introduce new and significant uncertainties, which have been highlighted above.

Conclusions

The Taxation Institute does not take issue with the Government's decision to address the revenue leakage identified by the Review of Business Taxation being caused by the use of non-commercial losses to reduce the tax paid on other income, particularly from unprofitable activities that are more like hobbies or lifestyle choices.

However, we are concerned that the impact of the NCL provisions go well beyond this stated policy underlying the provisions, and do not satisfactorily meet all the review criteria laid down by the Board.

In particular, there is every possibility that these provisions discourage the undertaking of new business activities and impact harshly on the small business sector. These provisions have not simplified small business deductions but have made the issue much more complicated and costly because of the requirements to determine 'separate' and 'similar' business activities on an annual basis. In addition, the Commissioner's discretion designed to ensure the equitable operation of the provisions in cases of genuine commercial activities is unclear and does not afford the protection it was intended to provide.

If you have any queries in relation to any of the issues raised above, please contact the Taxation Institute's Tax Director, Michael Dirkis, on 02 8223 0011.

Yours faithfully

Gil Levy

Gil Levy
President