Post-implementation review of the quality and effectiveness of the non-commercial losses legislation

Brian Tucker CPA

Background

I am an Accountant in public practice, based in Brisbane, operating on a national basis. My clients are mostly engaged in artistic occupations across all artforms – visual artists, actors, musicians, writers, film-makers, composers, dancers, choreographers and the like. Most would be classified as emerging artists, in the early stages of their artistic careers.

When the draft Integrity Measures Bill was initially put up for comment, I posted a notice on an arts industry website mail list. The notice was intended to draw the arts community's attention to the impact that the proposed tests would have on the deductibility of losses incurred in establishing an arts practice. The two most relevant tests, the $20000 assessable income test, and the profit in three out of five years test, would be, practically, impossible to satisfy. That conclusion was based on an analysis of financial statements and income tax returns held in my files. The issue was subsequently considered by the framers of the legislation and government and amendments made to include artists in the same category as primary producers.

In hindsight, it would have been better if the arts had been regarded as a category of its own because the Commissioner regards "circumstances beyond the taxpayer's control" as limited to floods, bushfires, drought and the like, very relevant to a primary producer, but not to a musician or visual artist. In the arts, as I will elaborate, "circumstances beyond the taxpayer's control" is, simply, the marketplace.

At the time the arts community felt it had achieved the best possible outcome but the result of the Non-commercial Loss Provisions (NCLP), in practice, still seriously disadvantages this sector of the business community.

My submission will deal with the quality and effectiveness of the legislation to the extent that it does not

- avoid unintended consequences;
- take account of actual taxpayer circumstances and commercial practices, or
- provide certainty.

These issues will be dealt with as one. The processes by which the Australian Taxation Office (ATO) has interpreted the legislation does not take account of commercial practices – as they exist in the arts sector – and this has led to undesirable consequences and a lack of certainty.

The items that I will consider, as they impact on arts businesses, are

- the profit in three out of five years test;
- the $20000 assessable income test, and

- the $40000 other income test.

Profit in three out of five years

This test requires that an artist (indeed any business, although my comments are directed to the impact that these tests have on artists in particular) must make a profit in the first, second and third years of their arts business. Commercial realities are that businesses may well incur losses in the start-up years, and move into profit as the business develops. A business that commences, and is profitable in the first, second and third year is, in fact, likely to continue to be profitable so this test fails completely to provide any benefit, from a tax point of view, to taxpayers who commence any sort of business involving an element of risk, particularly one where the turnover threshold is unlikely to be achieved.

There might be some logic to the test if losses were allowed in the first, second or third years, with any subsequent losses deferred.

An examination of records of my own arts clients shows that the lead time before profits may be achieved is considerably in excess of even the three year period. The time frames indicated three to five years for a visual artist, four to six years for a band, up to eight years for a writer or film-maker.

This is because an arts business, unlike any other (even a business of primary production, where cash crops generating an immediate return, can be planted alongside longer term crops, such as fruit trees) is a business that is slow to mature. Visual artists need to become recognized, musicians have to develop an audience and film-makers will start with low budget, self funded productions until the investors will be comfortable putting funds into productions. Artists have to generate an audience, and that takes a considerable period of time which this test simply does not acknowledge.

So why are arts businesses inherently unprofitable in the early years? The simple answer is because income is low, and likely, in the first year, to be almost non-existent, and because the costs are high. Materials, equipment, production costs, not to mention overheads, consume all of the income generated, and then some. Emerging artists are at the mercy of the market and I know of many bands who will play for nothing – indeed, many will have to pay a venue for the “privilege” of performing, and of visual artists who start off with a selling price for a piece of $150. Film-makers will enter films in competitions, or conduct screenings with a minimal ticket price, to get their product out into the market. Only when your reputation has been established can you start to charge prices high enough to recover costs and make a profit.

This test should be reviewed and its application made more appropriate to market realities.

$20000 assessable income

This test, as I have stated above, is unrealistic in the context of the arts community. A recent study, "Don't Give Up Your Day Job: an economic study of professional artists in Australia" by David Throsby and Virginia Hollister of the Division of Economic and Financial Studies, Macquarie University, published by the Australia Council, paints a bleak picture of the financial life of an artist in this country. 71% of artists have income from creative sources of less than $20000 (Table 8.2 p103 of the study) – so much for the $20000 threshold.

My own study indicates that an artist, grossing $20000, would probably be in a profit situation (just) apart from really high cost arts such as touring bands and film-makers.

Most artists will not achieve this threshold until their businesses have been in operation for much more than the first three years.

The effect of these two tests, taken together, means that an artist starting up a business in Australia, is highly unlikely to obtain any benefits from the tax system.

This, of course, is not an issue if other income is less than $40000 because in that event the tests do not apply.

This leads me to my criticism of the third factor.

Other income not to exceed $40000

Given the low levels of assessable income, and the near certainty of costs exceeding revenues in the early years of an arts business, artists invariably seek full or part-time work in addition to their arts business (a) to generate a reasonable living income, and (b) to support the costs associated with the development of their arts business. In the study referred to above, at p99, Table 7.2 shows that of the practitioners surveyed, the majority were employed in the teaching of their artform, or in arts administration, or in community arts practice.

This means that many, particularly those lecturing in tertiary institutions, even on a part time basis, will be above the $40000 threshold. For these artists, the profit test and the assessable income test are applied and the losses must be deferred.

I have two issues with the threshold:

1. It unfairly discriminates between an artist who has earned $40000 and one who has earned $39999. I have on my books artists who review their income toward the end of the year and seek time off without pay, from their employer, because the tax benefit of preserving deductions exceeds the after tax pay they forgo. Is this fair? If there is to be a threshold (a situation I do not support), it needs to be much higher than the $40000 (which is, after tax, only $31020 and if your art practice has incurred a loss of $10000, that brings you down to $21020).

2. Most lecturers in visual arts, film-making, writing etc will be required to maintain a professional profile to (a) maintain their own creative and professional skills, and (b) to enhance the reputation and marketability of the institution. In many cases it will be a condition of their contract that such a professional engagement is maintained. But does the ATO recognize this fact of life? Not a jot. This is regarded as income completely independent of the arts practice and precludes any deductibility of the costs associated with the practice. So we create a fiction that these are work related expenses, which might get the taxpayer a deduction for some of the costs but certainly not all, such as the cost of maintaining a studio or darkroom at home. GST registration is impossible.

I have many clients who are accumulating deferred losses which they are subsidizing from their salaried positions, almost all of them lecturing in the field in which they practice, under the terms of their employment contract. In other circumstances they would be considered to be carrying on a business with the intention of making a profit and would be entitled to a deduction for the loss so incurred, but the law, as it stands, denies them that deduction.

I do not have a problem with the NCLP per se. There are many taxpayers who used the system to boost refunds, mostly, I suspect, those engaged in multi level marketing activities, and whose “businesses” never had any likelihood of generating profits. On the other hand, most small, committed businesses may manage to generate $20000 in turnover, or achieve a profit in the second or third year. The arts, however, simply doesn’t work that way.

There are provisions for taxpayers to seek the Commissioner’s discretion to allow losses in circumstances where other income exceeds $40000 and the pertinent tests have not been satisfied. However, that requires the artist to produce detailed business plans, projected profit and loss and cash flow statements, references from independent experts (and the taxpayer’s accountant doesn’t count, even though that person is often in the best position to judge), market surveys etc etc. How does a visual artist conduct a market survey? Go to the shopping centre on a Saturday morning and quiz shoppers: “Excuse me, have you bought any art lately? How much did you pay? What sort of work was it?” The problem is that I’ve been told by the ATO that I should not waste time on these exercises because the Commissioner does not intend to exercise the discretion because “he thinks there’s no reason why an artist should not be profitable from day one”. This

comment, made by an ATO staffer, directly contradicts the statement made in the Key Features of the Policy Intent – "Start-up expenditure, particularly in relation to an activity with a long lead-time, will also be considered under the safeguarding arrangement".

Summary

There are sound reasons for removing the $40000 other income threshold.

The unintended consequences are:

- the creation of an inequality of treatment between taxpayers who are in otherwise identical situations;
- that it forces taxpayers to manage their affairs in a less than efficient manner and to create situations just to satisfy ATO requirements, and
- that legitimate arts businesses are compelled to defer losses to the extent that any eventual benefit is either highly problematic, or, with inflation, practically worthless.

It does not take account of actual taxpayer circumstances or commercial practices in that:

- the low level of creative business income endures for a considerably longer period of time than is the norm in start-up businesses. This long lead time is, contrary to the stated opinion of the ATO, a factor that is beyond the control of the individual practitioner. Cultural purchases are probably the most highly ranked form of general discretionary expenditure and to suggest that individual artists can generate commercially sustainable levels of income from the moment they "open the doors for business" is to ignore the realities of the marketplace. This is even more pertinent when we consider the plight of artists working in remote and regional Australia, where access to markets is further restricted, and
- low levels of income force artists to engage in other income producing activities, generally of a wage and salary nature, and invariably related directly to their art. The ATO position on this issue does not take into account the close relationship that exists between their business and that other source of income, or of the reality that, were it not for the artist's training and artistic skills, that other source of income would not be available to them. The distinction drawn by the ATO is unrealistic, unfounded and unfair.

It does not provide certainty, since:

- the ATO has no clear idea of what constitutes and arts business, particularly a contemporary arts business and therefore draws lines that the arts community regards as illogical. For example, a DJ is as much a creator of music as a composer or a saxophonist but the ATO

does not consider the former to be an artist. There is also scope for increasing the range of businesses included. For example, band management suffers the same problems as musicians and should be included in the category of an "arts business";

- artists are required to conform to conventional (read, mainstream) business practices when the very nature of their business requires unconventional approaches to marketing and promotion, financing, time investment and management;
- artists engaged in other work do not know until year end approaches whether they are likely to be entitled to an immediate deduction for their losses. This prevents them from applying for PAYG variations, Family Tax Benefit entitlements and the like. It also means they are unable to budget for subsequent year outlays, where current year refunds may be earmarked for, say, the production of a CD. They have no clear picture of their tax status, and
- an artist who is GST Registered and who claims input tax credits during the year for costs incurred as business expenses, and who subsequently (and unexpectedly) finds their assessable income under the $20000 threshold, would not be able to then claim the expenses as work related costs because input tax credits cannot be claimed for work related expenses. On the other hand they would have been collecting and remitting GST. Given that the taxpayer may be in the situation where their art practice is part and parcel of their employment, and where the costs could, in that situation be regarded as business or work related, the deductions would be of no value.

If the $40000 "income from other sources" test is to be retained, then in the event that the artist derives PAYG income that is connected to their art practice (such as lecturing, research etc) then that income *should not* be regarded as "income from other sources" for the purposes of the $40000 other income threshold, or alternatively, it *should* be regarded as part of the income from the arts practice, for the purposes of the $20000 income threshold.

The Commercial Purposes tests, used by the ATO, do not take into account the particular circumstances affecting the arts, and reinforces the perception that the ATO prefers cut and dried facts and tests to avoid having to make any sort of subjective decision making. The deductibility of losses incurred should depend solely on the ability of the artist to demonstrate that they are carrying on a business with a commercial objective which is, after all, the intent of the legislation.

No client artist of mine regards their practice as a hobby, and none are happy when they incur a loss. I am a volunteer at the Arts Law Centre of Queensland and talk to many artists (over fifty consultations in 2003) commencing a practice. It is very easy to determine whether an artist considers their practice to be commercially driven, or whether it is, in fact, a non-commercial activity. When you put the relevant questions to the artist,

they too, will recognize whether they are in it for the money or not and there will be some artists who will readily and happily admit that they do not care if they never make money from their art. Many more, however, are driven by a need to create and get out their art, and they know that the only way they will achieve that is by making enough money from their practice to allow them to give up their day job and live comfortably, and without worry, from their art. That doesn't sound like someone who is engaged in art as a lifestyle choice or recreational pursuit.

There are certainly tests that can be applied, questions that can be asked, but, in hindsight, the two tests set in the legislation are simply not appropriate.

To reduce the issue to a question of whether or not a profit has been made in three of the last five years, well, the last two years have shown just how out of touch the tests have been with reality – at least, it has in the arts.

To conclude, an extract from the Throsby and Hollister study (at p79) is telling:

"The contribution of the artistic community to Australian life, when measured in cultural and social terms, is immense. Yet much of the value of this contribution is not reflected in the market prices that artists command when selling their work – whether they sell their labour (actors, dancers, musicians, community cultural development workers) or the works their labour produces (writers, visual artists, craft practitioners, composers). As a result the economic return to artists remains stubbornly low, and is not a true measure of their contribution to Australian society."

Brian Tucker CPA
1/991 Stanley Street
East Brisbane Q 4169

brian@briantuckercpa.org

13 January 2004