NAVA's Submission to the Board of Taxation's
Post-Implementation Review of Non-commercial Losses (Division 35) of the Income Tax Assessment Act 1997

The National Association for the Visual Arts (NAVA) is pleased to provide a response to the invitation from the Board of Taxation to comment on the quality and effectiveness of the Non-commercial Losses (Division 35) of the legislation.

NAVA is the peak body representing and advancing the interests of the Australian visual arts and craft sector. It acts as a powerful force in bringing about improvements in legislative and regulatory conditions which affect its constituency, and provides expert advice to politicians, their advisers and departments. As a membership body it provides professional representation and service for its almost 3,000 paid members and for the rest of the sector, estimated to number nearly 20,000 practitioners and around 1000 infrastructure organisations.

In this submission NAVA will be making the case for a complete exemption for the arts sector from this legislation because the distinctive nature of the arts enterprise is not well addressed by Division 35, and another more effective and fairer mechanism is on the point of becoming available.

1. Background

At the time when Non-commercial Losses (Division 35) legislation was being drafted and debated, NAVA was one of the peak arts organisations involved in negotiating for an exemption for the arts sector on the basis that the criteria had been drafted to fit the nature of the primary industry and were inappropriate as tests to be applied to arts businesses. Intensive lobbying ensued, including NAVA and other arts industry representatives appearing before a Senate Committee to make the case. As a result the Government compromised by adding the extra provision of the $40,000 test. In order to achieve at least partial protection for the arts industry from unintended consequences of this legislation, NAVA and other representative arts peak bodies agreed to this compromise, on the understanding that there would be a review of the application of the legislation.

In addition, NAVA and the Arts Law Centre have assisted the Australian Tax Office (ATO) in relation to a Public Ruling which sets out the appropriate criteria by which it is possible to distinguish between visual artists and craft practitioners who are conducting a professional business enterprise and those who are hobbyists. The crucial element has been the need to secure the agreement by the ATO to take account of all the relevant factors which are indicative of professional practice in this industry rather than relying on profit making as the sole test for professionalism.

The Draft Public Ruling set out a number of objective criteria and due is to be considered at the next meeting of the ATO's Rulings Panel.
Once the Draft Ruling is approved by the Rulings Panel, NAVA would strongly assert that this Public Ruling should be the sole means by which judgments are made and the arts sector should be excluded from the Non-Commercial Losses (Division 35) provisions. NAVA maintains that Division 35 is a clumsy and discriminatory tool which does not deliver the Government's desired outcome. Our reasons are elaborated below.

"If, as a society, we are to comprehend how the arts contribute to our lives, it is important to understand how art is produced and what problems face those who produce it. From a social point of view, as a community we need to accord artists the respect they deserve as

professionals who contribute in so many ways and with such dedication and skill to advancing our cultural life. From a policy point of view, an understanding of the conditions of professional artistic practice is essential if effective measures for nurturing the growth of the arts in Australia are to be developed," quoted from *Don't Give Up Your Day Job: an economic study of professional artists in Australia* by respected cultural economist David Throsby and Virginia Hollister published by the Australia Council in 2003 (pg 12).

2. Surveys of the Arts Industry

According to the figures from Throsby and Hollister, the latest survey of artists' economic circumstances conducted in 2001 found there were about 13,600 professional visual artists and craft practitioners in Australia. If we add to this the estimated 5,000 Indigenous artists working in rural and remote areas who were not included in the study, the total figure was about 18,600. With their estimate growth rate between 2 and 3% per year this would mean that there are currently over 19,000 professional practising visual artists and craft practitioners.

Extremely worrying are the figures in the Throsby and Hollister report showing what has been happening to artists incomes over the 15 years from 1986/7 to 2000/01. They estimate that one third of all artists now earn less than the poverty line. For visual artists the overall mean income fell from $33,900 in 1986/7 to $29,300 in 2000/01. For craft practitioners incomes overall fell from $31,700 to $30,300 over the same period.

In assessing the factors which hold back the artists' development, the visual and craft artist survey respondents identified lack of return from their creative practice as being the most significant factor - 34% of visual artists and 37% of craft practitioners. Because of this, their pattern is typically to have to earn income from other arts related or non-arts related work to support their practice, usually holding multiple jobs with an unsurprising strong preference for taking on arts related work. "It is well known that many professional artists...undertake work beyond their immediate creative practice" (pg 37).

The statistics show that in the visual arts and craft, a very large proportion are freelance or self-employed - 80% of visual artists and 83% of craft practitioners. In looking more closely at how they apportion their time, visual artists were found to spend (mean) 23 hours and craft practitioners 29 hours on their art practice, 37 hours and 39 hours respectively on all arts work with 7 and 6 hours respectively on other work. On average only 14% of visual artists and 25% of craft practitioners were able to work full time on their art practice (pg 42).

Throsby and Hollister say "The incomes of visual artists are a particular concern and suggest justification for the sort of measures for assistance to the visual arts industry recommended in the Myer report (2002)".

The Myer Report was the result of a recent inquiry into the health of the Australian visual arts and craft sector commissioned by the federal government. Its recommendations and findings were released in 2002 and the government has been gradually enacting them. Of the recommendations, two are pertinent to this submission:
“In order to support visual artists and craft practitioners in their practice, the (Myer) Inquiry recommends:
2.1 the Australian Tax Office make a public ruling on what constitutes carrying on an arts business
2.2 The Commonwealth remove the $40,000 limit on secondary income of artists, and the exemption from the non-commercial losses provision to be extended to all visual artists and craft practitioners carrying on a legitimate arts business activity.”

3. Current Tests in the Legislation

The applicability of the tests to professional visual and craft artists is assessed below, with reference to the Throsby and Hollister study.

3.1 Sect 35 - 30 Assessable income test

The median incomes table in Throsby and Hollister (pg 45) shows that out of a total income of $22,900, visual artists earn $3,100 from their art practice while for craft practitioners out of a total income of $22,600, they earn $8,200 from their craft practice. It is therefore apparent that very few visual artists and craft practitioners would pass the test of earning at least $20,000 from their art business activity in any year.

3.2 Sect 35 - 35 Profits test

In assessing whether the sum of deduction is less than assessable income for any year for at least 3 of the past 5 income years, it can be seen from the figures quoted above that most visual artists and many craft practitioners would find it impossible to meet this test.

The Throsby and Hollister report shows that the median expenses that visual artists and craft practitioners incur in conducting their practice were found to be $4,400 for visual artists and $7,000 for craft practitioners. By subtracting the professional arts business expenses from arts income, it can be seen that visual artists in particular but also many craft practitioners are very often not likely to be making a profit from their practice and therefore not able to meet this test.

3.3 Sect 35 - 40 Real Property test

The test of total of real property used for carrying on the activity having a value of at least $500,000, while perhaps having some meaning for primary producers is completely out of reach for most arts practitioners.

3.4 Sect 35 - 55 Other assets test

Similarly in relation to total value of assets used to carry on the activity being at least $100,000, this level of assets would be quite rare in the arts industry. For most visual and craft artists, the value is not in the raw materials and services used, but rather in the ideas and skill invested in making the work. After an artist sells their work, it usually accrues in value as the artist's reputation grows. It is the investors, galleries and agents who reap the benefit of this increase in value of the asset (the artwork).

Therefore the trading stock being held by the artist in the form of unsold artworks, if valued according to the materials used to make it, is unlikely to come anywhere near the level required to pass the test.

3.5 Sect 35 - 55 Commissioner's discretion

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.

The indicative examples of special circumstances outside the control of the person carrying on the business were given as drought, flood, bushfire or other natural disaster. These would extremely rarely impinge on visual and craft artists.

The second Commissioner's discretion test of a business that has started to be carried on but because of its nature it has not satisfied the other tests, is that there is an objective expectation, based on evidence from independent sources that within a period commercially viable for the industry concerned, it will either be able to meet one of the tests or produce a

profit. The example given is again a primary production case of planting hardwood trees for harvest which would take many years to grow and be ready to produce income.

It is critically important for there to be an understanding that in the case of artists, they are not solely motivated by an intention to make a profit from their art practice. The other really important factor is their desire to influence public opinion and taste. In this regard they rarely direct their work to an existing market, but rather try to create a market for their work. This is often a painstaking process that can take many years while the artist/craft practitioner builds a reputation and becomes known and respected and their work sought after by clients and commissioners. Even then, the market is very volatile and fickle - one exhibition may be a runaway success while the next body of work by the same artist may be met with indifference. It would be foolhardy for anyone to try to predict such a roller coaster market, so subject to individual taste and other external factors like the investment market.

The draft Public Ruling criteria mentioned above are a much more accurate set of tests which reflect standard practices in this industry.

3.6. Exception if the activity is a "primary production business" or professional art business" and the assessable income for that year from other sources that do not relate to that activity, is less than $40,000

In regard to this $40,000 criterion, NAVA asserts that this has no discernable basis as a benchmark for the arts industry and would seem to be completely arbitrary. In being set as the level of non-arts earnings, it is hard to understand how it can be regarded as indicative of anything to do with the nature of an arts business.

While it remains the case that a proportion of professional arts practitioners can prove their eligibility using this test, it discriminates unfairly against the estimated 13%[1] of professional practitioners who earn more than $40,000 of other income, and creates a great deal of anxiety for those on the borderline who find it difficult to predict. In fact it acts as a disincentive for those who are able to generate this level of income from another source, because it may mean that the artist is financially worse off in not being able to claim his/her legitimate deductions.

Nor does it prevent hobbyists earning under $40,000 from other income from claiming their expenses. In fact it seems peculiarly irrelevant to the matter at hand.
NAVA asserts that by contrast, the terms agreed in the draft Public Ruling are actually crafted on the basis of the nature of standard practices in this industry.

4. Board of Taxation's Criteria for Evaluation

Below, NAVA comments on criteria against which the Board of Taxation assesses 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 clear, simple, comprehensible and workable manner

- avoids unintended consequences of a substantive nature

[1] At the Australia Council's request, this figure was calculated by Virginia Hollister using the Throsby and Hollister survey results.

- takes account of actual taxpayers circumstances and commercial practices
- is consistent with other tax legislation; and provides certainty

NAVA notes that the objective of Division 35 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.

NAVA's assessment of the extent to which legislation:

4.1 gives effect to the Government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statementfor the measure

NAVA supports the Government's objective to prevent people who are not conducting a professional business from claiming losses against other forms of income. The challenge is to find, for any particular industry sector, the appropriate means to distinguish between taxpayers' activities that genuinely amount to the carrying on of a business and those which are a hobby or lifestyle choice. In this case NAVA contends that the criteria in Division 35 have been designed for the primary industry but are inappropriate for the arts industry. The effect is to penalise many artists who are genuinely conducting an arts business and are not to be able to be used to effectively identify hobbyists (see elaboration below).

4.2 is expressed in clear, simple, comprehensible and workable manner
Though NAVA would not take issue with the way the legislation is expressed, it maintains that the legislation is not workable for the arts industry (see below).

One area of continuing confusion is where artists earnings come from a multiplicity of arts related sources. It is not clear that these would be recognised by the ATO as all being part of the artist's art business and therefore to add up to the required $20,000. If the losses in each case are deferred, the earnings may never present a profit individually, though they might if they could be agglomerated. The guidance is not clear, relying on "a common sense approach". One person's common sense is another's confusion.

4.3 avoids unintended consequences of a substantive nature
NAVA contends that in the case of professional art businesses, there are characteristics of the industry which must be taken into account to avoid the unintended consequence of the tax system discriminating against this professional group in the community.

The Throsby and Hollister study indicated that 54% of visual artists and 64% 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% 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 Throsby and Hollister study showed that three-quarters of artists undertaking arts related work are involved with teaching.

4.4 takes account of actual taxpayers circumstances and commercial practices

As the Division 35 stands, its six tests are not pertinent to the standard practices in the arts industry. The industry statistics quoted above and common sense indicate that the first five conditions are inaccessible to the large proportion of artists and craft practitioners and the sixth has no perceivable relationship to the industry.

By contrast, the indicators used in the draft Public Ruling are the standard tests used by the ATO, but interpreted according to the actual characteristics of the industry. The indicators are:

i) significant commercial purpose or character
ii) intention of taxpayer
iii) a profit motive ascertained through whether the taxpayer is:
iv) there is repetition and regularity of activity in the following ways:
v) activites are of the same kind and carried on in a manner characteristic of the relevant industry
vii) organised in a business-like manner and the use of system
viii) size or scale of activity
ix) not a hobby or recreation

In each case the arts industry has been able to provide detailed interpretations which are based on its standard professional practices. NAVA would like to suggest that the ATO be approached to make the draft ruling available for the Board of Taxation's reference.

4.5 is consistent with other tax legislation; and provides certainty

Consistency
NAVA asserts that Division 35 is inconsistent with other areas of tax legislation, viz:
- tax averaging provisions
- trading stock

Certainty
In response to NAVA's request for information, it was apparent that there were differences in interpretation between the arts accounting firms we consulted. For example, in relation to artists who were involved in teaching, one firm advised its artists to claim all their art making costs as work related expenses, a second one advised that all expenses must be deferred until their art practice made a profit or their other income fell below $40,000, while a third had negotiated with the ATO and was assisting its clients to be able to claim an estimated 50% as work related expenses, with the rest being deferred as in the second example above. To NAVA this seems to indicate a high degree of uncertainty amongst tax experts in interpreting the law, never mind what artists are making of it.

5. Case Studies (provided by CPA accountants):

Case 1 – Visual Artist

J is a visual artist, with a public art and exhibition photography practice. Her works are incorporated into major public buildings, held in significant public and private collections, and have been the subject of a major retrospective.

She is also a senior lecturer in this field, and, in that capacity, exceeds the $40,000 other income threshold. While her gross income from the art practice may exceed $20,000 in occasional years, this is certainly not a regular occurrence, largely because the artist fees for

public exhibitions are low ($500 to $1000 is the norm), and while public art projects may, in the totality of the budget, be well over $20,000, the artist's income is often just the artist fee component of the total budget.

J is required, as part of the conditions of her lecturing position, to maintain a professional practice, and to incur the expenses that this entails.

J has two options:

i) to regard the expenses as "work related expenses" and to claim a deduction accordingly. This will require J to claim only deductions regarded as allowable to an employee, and not those which would also be regarded a business deductions – principally, but not solely, those relating to the construction of a work studio within her residence. Further, no input tax credits will be claimable on any of the costs incurred.

ii) to regard the expenses as business related. To do this she will either get the benefit of the deduction, if her gross income from the arts practice exceeds $20,000 (something not known at all in the first half of the year, and to only a slightly greater extent as the year progresses), together with a credit for GST paid; or, if the income does not reach the threshold, the expenses will be deferred.

J's problem is that she needs to make the decision at 1 July. Perhaps she'll make the correct decision, perhaps she won't.

Case Study 2 – Photographic artist

M is an exhibition photographer, in exactly the same position as J. She has elected to regard the expenses as business and lodge a BAS on that basis. At the end of June 2003 her assessable income – which she had expected to reach $20,000 – did not reach that level because a client postponed the commencement of a project. The project may not go ahead and her art practice expenses will be quarantined until the income threshold is reached.

Case Study 3 - Artist also working as academic

XX Arts Accountants have applied for a private ruling from the ATO in the following case:

The taxpayer is a professional artist who has incurred a loss of $20,653.00 in carrying on the business of a professional artist.

His sales are under $20,000 and he has not made a profit in the past three out of five years. He has invested less than $100,000 in assets in his business and less than $500,000 in real property.

The artist is employed as Head of the Department of Fine Art in a university art school and is in receipt of a salary income of $122,389.

He cannot avail himself of the $40,000 threshold available to professional artists and consequently cannot claim the loss of $20,653.00.

One of the conditions of employment by the university art school is that he be a practising artist and in the submission to the ATO, a letter was attached from the university confirming this as a condition of employment and confirming his status as a professional artist.

Consequently, the accountants considered that the loss of $20,653 should be regarded as an expense incurred in gaining assessable income by the artist and should be deducted pursuant to Division 8-1 of the ITAA 1997 Act.

In the context of the "assessable income test", the accountants asked that the officer at the ATO address the question of activity, as in their view the activity of a visual artist, includes: creating art, lecturing about art, writing about art and consequently all art related activities should be grouped under the same activity test. The appeal was rejected.

Case Study 4 – Multi-media artist

M is an artist who works with his business partner in a multimedia arts practice, and also works as an architect part time. He and his partner have created a number of art installations and have been invited to take part in an international exhibition but the expenses are significant. This is a field of art practice with a long lead-time before significant national and international exposure gives rise to substantial artist fees. Such fees are not unknown, with overseas artists regularly paid significant fees to attend events in this country.

M has asked his employer to reduce his hours so that he can keep his income below $40,000. If his architecture income goes over $40,000 the art practice deductions will be denied, along with the refund that was projected to fund the travel costs for the international exhibition.

Case Study 5 – Artist with a disability

K is an artist who suffers from a disability. Some time ago she received an accident settlement and has been living off the interest income ever since.

This income currently amounts to about $38,000 per annum. She also receives a disability pension of $10,000 per annum which is exempt from tax.

Prior to 2002 K borrowed funds from family members to run her art practice and to live.

Since her settlement in 2002 she has continued her art practice. In 2003 she incurred losses from her practice of $9,800 which were deducted from her interest income.

A concern for K is that when interest rates increase, her assessable income from sources other than her art practice may exceed the $40,000 threshold and deny her a deduction for any art practice related losses.

Case Study 6 – Artist with multiple art related income sources

M a fine artist, is an illustrator for a company and is paid a salary of $38,000 per annum. He also worked last year for TAFE as an art teacher and earned $800 for a week's work. If he were to do two more TAFE sessions he would be over the $40,000 threshold.

Last year he earned a profit from his art practice of $13,000 from gross income of $23,750. If he had to rely on this test, he would have to continue to make a profit in 3 out of 5 years. Meanwhile, he would have to defer losses from his art expenses and wait at least three years before the picture became apparent. As indicated above, income from art practice can be very different from one year to the next.

He is currently in the difficult position of having to decide to keep his "non-arts" income below $40,000 in case the income from sales of his artwork do not make a profit in three out

of five years. If the other work he did was able to be regarded as part of his arts business, he would be earning over the $20,000 threshold and therefore meeting one of the Division 35 tests. This is a very unclear and unsatisfactory situation. His case is similar to many others.

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These case studies illustrate a variety of problems facing many Australian artists as a result of Division 35. As the Throsby and Hollister report shows, survival strategies for artist are challenge enough to negotiate without having to steer around any extra hurdles caused by inadvertently inappropriate legislation.

NAVA wishes to strongly reiterate its recommendation for the arts industry to be exempted from the Division 35 provisions, and reliance instead on the terms of the Public Ruling as agreed between the ATO and arts industry representatives.