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## Non-Commercial Losses – 2009/10 Budget Announcement About to Become Law

The Government has introduced *Taxation Laws Amendment (2009 Budget Measures No. 2) Bill 2009* which contains amendments to restrict access to the non-commercial loss rules for high income earners. These measures were first announced in the May 2009 Federal Budget as a means of preventing high net worth individuals who are engaged in hobby farms, such as the “Pitt Street” or “Collins Street” farmers, or other non-commercial activities from obtaining tax deductions for their hobbies under the non-commercial loss rules. The Government’s view is that these taxpayers should not be allowed to reduce their tax liabilities with losses from activities which amount to no more than a lifestyle choice. The amendments apply from 1 July 2009.

### Non-Commercial Loss Rules

The non-commercial loss rules have applied since July 2000. They apply to individuals who are engaged in an unprofitable business activity. The rules prohibit these taxpayers from offsetting the losses from the non-commercial business activities against their salary and wages, investment or other assessable income in the year those losses are incurred. The losses are quarantined and may be carried forward and utilised in a future year to be offset against any profits which that particular business activity may ultimately generate.

### Current Exceptions to the Non-Commercial Loss Rules

Currently, the legislation contains four exceptions to the quarantining rule. If a taxpayer incurs a loss from a business, they will be able to use that loss to reduce other assessable income in the year the loss is incurred if the taxpayer passes one of the four objective tests of commerciality:

- ▶ **Assessable income test** – the business produces assessable income from the business activity of at least \$20,000 in that year. Where a business commences or ceases operation during the year, a taxpayer may make a reasonable estimate of what the income would have been if they had been in business for the entire year.
- ▶ **Real property test** – the value of land and buildings used by the business on a continuing basis exceeds \$500,000.
- ▶ **Other assets test** – the total value of other assets (excluding motor vehicles, land and buildings) used in the business activity on a continuous basis exceeds \$100,000. Such assets may include trading stock, the written down value of depreciable assets, and the remaining capital component of assets under lease.
- ▶ **Profits test** – the business activity generated a profit in at least three of the last five income years, including the current year.

If the business activity does not pass any of these tests, a taxpayer may still claim a loss if the Commissioner exercises a discretion to allow the loss to be offset against other income. In exercising the discretion the Commissioner must determine that it is unreasonable to apply the tests because:

- ▶ The business activity would have met one of the tests if not for special circumstances which were beyond the taxpayer’s control, or
- ▶ The business is a start-up and, due to the nature of the activity, there is a lead time before the activity passes one of the tests, or a profit can be expected.

There are also special concessional rules for certain classes of taxpayers, notably taxpayers conducting a primary production or performing arts business. These taxpayers can claim a deduction for losses incurred by that activity against other income (such as salary or investment income) if the income from other sources (excluding capital gains) is less than \$40,000.

### Changes for High Income Earners from 1 July 2009

The legislation introduced into Parliament tightens the application of the non-commercial loss rules to high income individuals.

From 1 July 2009, individuals with an ‘adjusted taxable income’ of at least \$250,000 will have excess deductions from their non-commercial business activities quarantined to the business activity irrespective of whether they satisfy any of the four objective tests. An individual’s ‘adjusted taxable income’ comprises the sum of their taxable income, reportable fringe benefits, reportable superannuation contributions and total net investment losses.

In effect, this means the existing non-commercial loss rules, including the ability to access the existing four objective tests, will only apply to taxpayers with an adjusted taxable income of less than \$250,000.

## High Income Earners May Still be Able to Obtain a Commissioner's Discretion

The Commissioner currently has a discretion not to apply the non-commercial loss rules to start up businesses if certain conditions are met. This discretion remains, but will also be extended to those taxpayers who breach the \$250,000 income limit. Therefore, high income earners may be able to deduct their losses provided they can independently demonstrate their business is genuinely commercial. However, high income earners will not be able to apply for the Commissioner's discretion on the basis of special circumstances causing the business to fail the objective tests.

Depending on the income levels, the rules governing the exercise of the discretion operate as follows:

▶ **Individuals with an adjusted taxable income of less than \$250,000:** Taxpayers may apply to the Commissioner where they can demonstrate:

- the nature of the business means it has not met, or will not meet, the objective tests;
- but the business will produce net assessable income or meet one of the tests within a commercially viable period for the industry concerned.

That is, the existing rules in respect of the discretion will continue to apply to taxpayers with an adjusted taxable income below \$250,000.

▶ **Individuals with an adjusted taxable income of \$250,000 or more:** Taxpayers may apply to the Commissioner where they can demonstrate the business will produce net assessable income within a commercially viable period for the industry concerned.

Should you require assistance or additional information, **please contact your PKF Tax Adviser** or:

Lance Cunningham | Director of Taxation, PKF Australia Limited  
02 9240 9736 | lance.cunningham@pkf.com.au  
Level 10, 1 Margaret Street | Sydney | New South Wales 2000 | Australia

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