

TR 2001/14A6 - Addendum - Income tax: Division 35 - non-commercial losses

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Addendum

Taxation Ruling

Income tax: Division 35 - non-commercial losses

This Addendum amends Taxation Ruling TR 2001/14 to reflect the following matters:

- (a) 2006 amendments to Division 35 which accompanied the introduction of section 40-880 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- (b) 2009 amendments to Division 35 to introduce an 'income requirement'; and
- (c) the decision of the Full Federal Court in *Watson v. DC of T* [2010] FCAFC 17; (2010) 182 FCR 104; 2010 ATC 20-167; (2010) 75 ATR 224.

TR 2001/14 is amended as follows:

1. Paragraph 1

- (a) After 'under subsection 35-10(2);', insert:
 - deferral or prevention of pre-business capital expenditure and post-business capital expenditure deductions under section 40-880, in relation to non-commercial activities (subsections 35-10(2A) to (2D) inclusive);
- (b) After 'the four tests in Division 35', omit:

satisfaction of any one of which will allow a 'loss' from a *business activity to be offset against other income in the year in which it is incurred.

Substitute:

which are

- (c) Insert after the paragraph:

1B. For the income years up to and including the 2008-09 income year satisfaction of any one of the four tests allows a 'loss' from a *business activity to be offset against other income in the year in which it is incurred. For the 2009-10 and later income years, in addition to satisfying one of the four tests, the individual must also meet the income requirement in subsection 35-10(2E).

TR 2001/14

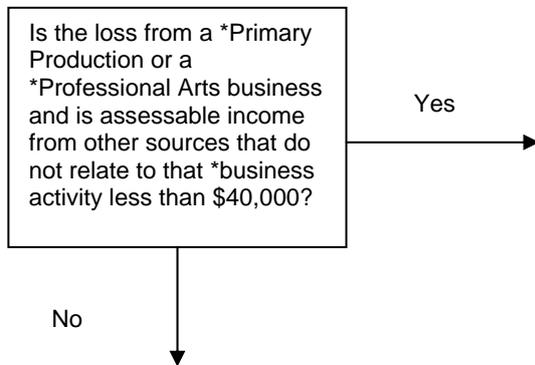
2. Paragraph 4

Omit the Note; substitute:

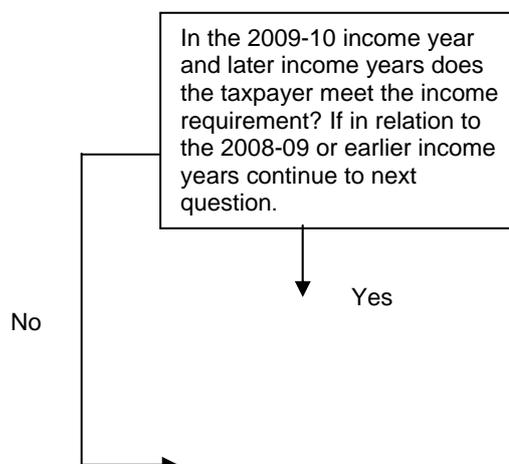
Note: the Addenda to this Ruling which issued on 11 July and 25 July 2007 and 27 April 2011 apply both before and after their dates of issue as required. The application of various new or amended provisions is described in relevant sentences or footnotes.

3. Paragraph 5 - Flowchart: operation of Division 35

After:



Insert the following with a 'no' arrow leading to the Commissioner's discretion box:



4. Paragraph 6

- (a) After 'unless in each year: (a) the individual's *business activity meets one of the four tests' insert ', and for the 2009-10 and later income years, the income requirement is also satisfied.'
- (b) After the last sentence insert 'The law applies as if the loss were not incurred in the income year.'

5. Paragraph 7

Omit the paragraph, substitute:

7. Instead, the loss is deemed to be an amount deductible from the assessable income from the activity for the next year in which this activity is carried on. The deferral of deduction rules in section 35-10 are then applied to that year. **However, Division 35 does not apply to activities that do not constitute carrying on a *business (subsection 35-5(2)).**

6. After 8 Paragraph

Insert:

8A. Division 35 was amended by *Tax Laws Amendment (2006 Measures No. 1) Act 2006* to apply the non-commercial loss provisions to pre-business capital expenditure and post-business capital expenditure incurred on or after 1 July 2005 in relation to a *business activity, and otherwise deductible under section 40-880.

8B. Further changes were made to Division 35 via *Tax Law Amendment (2009 Budget Measures No.2) Act 2009*. For the 2009-10 and later years an income requirement was introduced to tighten the application of the non-commercial rules.

8C. The *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997) was also amended to provide that the non-commercial losses rules in Division 35 do not apply to a *business activity that has greater available deductions than assessable income in a given income year solely because of investment amounts deductible under Division 41 (refer to Note 2, subsection 35-10(2)). This applies to the 2009-10 and later income years.

7. Paragraph 9

Omit 'the rule in subsection 35-10(2), that the loss will be deferred'; substitute 'the rules in subsections 35-10(2), (2A) or (2B)'.

8. Paragraph 13

Omit the paragraph; substitute:

13. The loss deferral rule in subsection 35-10(2) will not apply to the individual undertaking that activity for an income year if the relevant business activity:

- (a) satisfies at least one of the tests, and for the 2009-10 and later income years, the individual in question meets the income requirement; or
- (b) comes within the Exception; or
- (c) has a favourable exercise of the Commissioner's discretion.

The individual will be able to deduct the excess deductions against other assessable income where the rule does not apply.

Income requirement

13A. The income requirement in subsection 35-10(2E) is met when, in a given income year the sum of the individual's taxable income, *reportable fringe benefits, *reportable superannuation contributions and *total net investment losses is less than \$250,000. When calculating whether an individual has met the income requirement, they must disregard any excess deductions that are subject to Division 35.

Pre-business capital expenditure***Income years before the one in which the business activity starts to be carried on***

13B. Subsection 35-10(2B)^{2A} provides that if you are an individual, either alone or in partnership (whether or not some other entity is a member of the partnership), you cannot deduct an amount under section 40-880 for expenditure incurred on or after 1 July 2005 in relation to a *business activity:

- (a) you propose to carry on; or
- (b) another entity proposes to carry on if the other entity is not an individual, either alone or in partnership;

for an income year before the one in which the business activity commences to be carried on.

Income year in which the business activity starts to be carried on

13C. However, a deduction may be allowed in the year in which the *business activity starts to be carried on (subsections 35-10(2C) and (2D)).^{2B} Where the section 40-880 expenditure is attributed under subsection 35-10(2C), to a *business activity you have started to carry on, this may give rise to a 'loss' to which the loss deferral rule in subsection 35-10(2) may apply for the commencement year. That rule will not apply in the circumstances described in paragraph 6 above. However, where the section 40-880 expenditure relates to a *business activity that some other entity (other than another individual) has commenced, subsection 35-10(2D) means that this expenditure can be deducted for the income year in which that activity has started to be carried on.

Post-business capital expenditure

13D For the income year in which the *business activity ceased to be carried on or an earlier income year the conditions that need to be satisfied under subsection 35-10(2A) are the same as those for the loss deferral rule in subsection 35-10(2). That is, for one of those income years:

- (a) the relevant *business activity passed at least one of the four tests and the income requirement (where relevant) was satisfied, or

^{2A} Subsection 35-10(2B) is applicable to expenditure incurred on or after 1 July 2005.

^{2B} Subsections 35-10(2C) and (2D) are applicable to expenditure incurred on or after 1 July 2005.

- (b) the Commissioner has exercised the discretion set out in section 35-55 for the *business activity, or
- (c) the exception in subsection 35-10(4) applied.

9. Paragraph 14

Omit 'the rule in subsection 35-10(2) does not apply to defer any loss incurred by the individual from the activity for that income year'; substitute 'the rules in section 35-10 do not apply'.

10. Paragraph 15

Omit 'the rule in subsection 35-10(2) does not apply to defer any loss incurred by the individual from the activity for that income year'; substitute 'the rules in section 35-10 do not apply'.

11. Paragraph 16

Omit 'the rule in subsection 35-10(2) does not apply to defer any loss incurred by the individual from the activity for that income year'; substitute 'the rules in section 35-10 do not apply'.

12. Paragraph 21

Omit 'the rule in subsection 35-10(2) does not apply to defer any loss incurred by the individual from the activity for that income year'; substitute 'the rules in section 35-10 do not apply'.

13. Paragraph 30 heading

Omit paragraph including heading; substitute:

Exercise of the Commissioner's discretion^{4A}

30. The Commissioner has a discretion under subsection 35-55(1) to decide that the loss deferral rule in subsection 35-10(2) does not apply to a *business activity if certain, limited circumstances affect that activity. For the 2009-10 and later income years two changes apply to subsection 35-55(1):

- (a) paragraph 35-55(1)(c) may apply in relation to individuals who do not satisfy the income requirement in subsection 35-10(2E); and

^{4A} The operation of the Commissioner's discretion is considered in detail in Taxation Ruling TR 2006/7 Income tax: non-commercial business losses: Commissioner's discretion.

- (b) the requirement that an application for a decision of the Commissioner under section 35-55 be made in the *approved form applies.

For further explanation of the operation of subsection 35-55(1) refer to Taxation Ruling TR 2006/7.

Exercise of the Commissioner's discretion - pre-business capital expenditure

30A. Under subsection 35-55(2)^{4B} the Commissioner may, on application, decide that the rule in subsection 35-10(2B) does not apply to a *business activity for an income year if the Commissioner is satisfied that it would be unreasonable to apply that rule because special circumstances of the kind referred to in paragraph 35-55(1)(a) prevented the activity from starting. The effect of the exercise of the discretion under subsection 35-55(2) is that there is no deferral under subsection 35-10(2B), and therefore the taxpayer can claim a deduction for the expenditure under section 40-880.

14. Paragraph 34

Insert after first dot point:

- **'income requirement'**^{5A}

An individual will meet the income requirement for an income year if the total for them of the following amounts is less than \$250,000:

- taxable income (ignoring any 'loss' to which subsection 35-10(2) applies) for that year
- total reportable fringe benefits for that year
- reportable superannuation contributions for that year
- total net investment losses for that year- being financial investment losses and rental property losses.

^{4B} Subsection 35-55(2) is applicable to expenditure incurred on or after 1 July 2005.

^{5A} The income requirement in subsection 35-10(2E) applies in relation to the 2009-2010 income year and later income years.

15. Paragraph 56

After 'business activity'; insert:

For the 2009-10 and later income years the income requirement must also be satisfied annually by the individual taxpayer who is carrying on the business activity, for satisfaction of any of the four tests to be relevant.

16. Paragraph 57

(a) Omit 'and has a causal relationship with, the carrying on of that'; substitute 'and has its source or origin in the'.

(b) Insert after the paragraph:

57A. Amounts attributable to the *business activity that an individual taxpayer can otherwise deduct can include pre-business capital expenditure incurred on or after 1 July 2005 otherwise deductible under section 40-880 (subsections 35-10(2C) and (2D)).

17. Paragraph 58

Insert after the paragraph:

58A. Post-business capital expenditure incurred on or after 1 July 2005 in relation to a *business activity previously carried on, may be deductible if one of the following is satisfied for the income year in which the business activity ceased to be carried out, or an earlier income year (subsection 35-10(2A)):

- (a) the individual meets the income requirement and their *business activity meets one of the four tests (set out in sections 35-30 to 35-45);
- (b) the Commissioner has exercised the discretion under section 35-55 for the business activity; or
- (c) the Exception in subsection (4) applies.

18. Paragraph 59

After 'against other income in the current year'; insert:

In addition, the Exception allows eligible individuals to deduct amounts under section 40-880 (business related costs) for expenditure incurred on or after 1 July 2005 in relation to a *business activity the individual used to carry on.

19. Paragraph 91

(a) Omit 'Where'; substitute 'For income years up to and including the 2008-09 income year, where'.

(b) At the end of the first sentence insert the footnote:

^{14A} For the 2009-10 and later income years however, if the income requirement in subsection 35-10(2E) is not met, then whether any test is met or not will not be relevant.

20. Paragraph 92

Omit 'Instead, the'; substitute 'The'.

21. Paragraphs 92A, 92B and 92C

Omit the paragraph; substitute

92A. *Watson v. Deputy Commissioner of Taxation* [2010] FCAFC 17; (2010) 182 FCR 104; 2010 ATC 20-167; (2010) 75 ATR 224 (*Watson*) concerned whether income protection policy payments were assessable income from the business activity, being the taxpayer's financial planning business. The Full Federal Court held at paragraph 29 that the word 'from' is intended to have its dictionary meaning. It indicates the starting point, source or origin of the assessable income. It was held at paragraph 31 that if the starting point or source of the assessable income must be the business activity, then the extent and nature of that business activity must be identified to determine whether or not particular income is 'from' it'.

92B. At paragraph 30 the Court held that the assessable income referred to in subsection 35-10(2) must be 'from' the business activity in the same year in which it is assessable income of the taxpayer.

92C. In *Watson* the question was whether the source or origin of the policy income was the business activity. At paragraph 32 the Court concluded that the policy income was not 'from' the business activity in question because it was derived from the taxpayer's incapacity to conduct business activity, not from the activity the taxpayer actually undertook.

22. Before Paragraph 120

After 'Examples' insert:

Introduction

Examples 1 to 9 inclusive, do not consider specific income years. If for a particular year of income the 'income requirement' is relevant, it is taken to have been satisfied.

23. Detailed contents list

Omit:

Exercise of the Commissioner's discretion – two limbs 30

Insert:

Income requirement 13A

*Income years before the one in which the
business activity starts to be carried on* 13B

*Income year in which the business activity starts
to be carried on* 13C

Post-business capital expenditure 13D

Exercise of the Commissioner's discretion 30

*Exercise of the Commissioner's discretion - pre-business
capital expenditure* 30A

24. Legislative references

Insert:

- ITAA 1997 35-10(2A)
- ITAA 1997 35-10(2A)(a)
- ITAA 1997 35-10(2A)(b)
- ITAA 1997 35-10(2B)
- ITAA 1997 35-10(2C)
- ITAA 1997 35-10(2D)
- ITAA 1997 35-10(2E)
- ITAA 1997 35-55(1)(c)
- ITAA 1997 35-55(2)
- ITAA 1997 35-55(3)
- Tax Laws Amendment (2006 Measures No.1) Act 2006
- Tax Law Amendment (2009 Budget Measures No.2) Act 2009

25. Case references:

Omit

- *Watson v. DC of T* [2008] FCA 1173; 2008 ATC 20-042

Substitute:

- *Watson v. DC of T* [2010] FCAFC 17; (2010) 182 FCR 104; 2010 ATC 20-167; (2010) 75 ATR 224

This Addendum applies on and both before and after its date of issue, as appropriate. The operation of new or amended provisions in Division 35 however, apply as shown in the relevant sentences or footnotes.

Commissioner of Taxation

27 April 2011

ATO references

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