# *TR 2007/6 - Income tax: non-commercial business losses: Commissioner's discretion*

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# Taxation Ruling

## Income tax: non-commercial business losses: Commissioner's discretion

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

# What this Ruling is about

1. This Ruling provides guidelines on how the discretion contained in subsection 35-55(1) of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] may be exercised to determine that it would be unreasonable for the loss deferral rule in subsection 35-10(2) to apply to a loss attributable to an individual taxpayer's *business activity.[2] It does not consider the operation of the discretion in subsection 35-55(2).

2. In providing these guidelines, there is no intention to lay down conditions that may restrict the exercise of the Commissioner's discretion. Nor does the Ruling represent a general exercise of the Commissioner's discretion. Rather, the guidelines are provided to help officers in the exercise of the discretion and to help ensure that taxpayers do not receive inconsistent treatment.

### The 'special circumstances limb'

3. In relation to paragraph 35-55(1)(a), referred to as the special circumstances limb, this Ruling will consider the types of special circumstances to which paragraph 35-55(1)(a) will be applied.

[1] All references in this Ruling are to the ITAA 1997 unless otherwise stated.
[2] An asterisk before a term in this Ruling denotes that the term is defined in the ITAA 1997. Any subsequent use of the term carries with it the same definition as the ITAA 1997.

**The 'lead time limb'**

4. In relation to paragraph 35-55(1)(b), known as the lead time limb, this Ruling will consider:

- the meaning of 'because of its nature';
- the nature of 'objective expectation'; and
- determining the 'period that is commercially viable for the industry concerned'.

**Partial withdrawal of TR 2001/14**

5. Paragraphs 70 to 82A, 94 to 96, 106 to 114 and 147 to 170 of Taxation Ruling TR 2001/14 were withdrawn on 24 January 2007. The paragraphs are replaced by this Ruling. This Ruling should be read in conjunction with the now amended Taxation Ruling TR 2001/14 Income tax: Division 35 – non-commercial business losses, and TR 2003/3 Income tax: non-commercial losses – application of subsections 35-10(2) and 35-10(4) of the *Income Tax Assessment Act 1997* to business activities carried on in partnership.

# Ruling

6. The object of Division 35 is to act as an integrity measure. One of the ways it achieves this is 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 in the income year the loss is incurred. The rule in subsection 35-10(2) defers losses from business activities unless they satisfy a test, are eligible for an exception or the Commissioner exercises the discretion in subsection 35-55(1).

7. Sections 35-30, 35-35, 35-40 and 35-45 set objective tests, at least one of which should be satisfied by a business activity for it to be regarded as commercial for the purposes of the Division. If a business activity fails to satisfy any of these tests in a loss year then it is treated as a non-commercial business activity and the losses from the business activity are, subject to certain exceptions, deferred. The discretion provided to the Commissioner should be interpreted in the light of this context.

8. Division 35 does recognise, through the inclusion of the discretion in subsection 35-55(1), that there will be certain situations which are outside of the control of the taxpayer that relate to the failure of the business activity to satisfy a test for a particular income year. This will be where they either are special circumstances which directly prevent the business activity from satisfying a test, or where they extend the time within which, objectively, the business activity can be expected to satisfy a test. Broadly speaking, these are situations where it will be 'unreasonable' to apply the loss deferral rule.

9. The discretion should be exercised based on an assessment of the facts of each case, having regard to the two reasons stated in the subsection for the exercise of the discretion, and to the policy and context of the Division.

10. The aim of the Division is to defer losses from business activities which do not satisfy at least one of the four tests.[3] The discretion is not intended to apply where a business activity makes a loss because of factors which can apply to any business and which do not affect the ability of the activity to satisfy one of the four tests.

11. Rather, it is intended to be available for a commercial business activity that has failed, or objectively is expected to fail for a period of time, to satisfy any of the tests in Division 35 for certain reasons outside the control of the operator.

### The special circumstances limb in paragraph 35-55(1)(a)

12. The Commissioner's discretion in paragraph 35-55(1)(a) may be exercised for the income year(s) in question where the business activity is affected by special circumstances outside the control of the operators of the business activity.

13. Special circumstances are those circumstances which are sufficiently different to distinguish them from the circumstances that occur in the normal course of conducting a business activity. Ordinarily, special circumstances are those which have materially affected the business activity, causing it to not satisfy any of the four tests in Division 35. In other cases, where the business activity would have failed a test in any event because it is still within the period that is commercially viable for the industry concerned, the special circumstances may extend the time within which that particular business activity could objectively be expected to pass a test (see further at paragraphs 24 to 27 of this Ruling).

14. The special circumstances must be outside the control of the operators of the business activity. Such circumstances are specifically defined to include drought, flood, bushfire or some other natural disaster[4]. In the case of other events, failure for no adequate reason to adopt practices commonly used in an industry to prevent or reduce the effects of special circumstances may point to the special circumstances not being outside the control of the operator.

[3] The assessable income test in section 35-30, the Profits test in section 35-35, the real property test in section 35-40 or the other assets test in section 35-45.
[4] Those affected by a natural disaster do not have to be in a government declared disaster area for the special circumstances limb of the discretion to apply.

15. The discretion can be exercised in income years after the one in which the special circumstances occurred if the effects of those special circumstances continue to prevent the business activity from satisfying any of the tests in those later income years. However, there may be situations where the special circumstances, because of their continued existence, become the ordinary or usual situation. It would not be appropriate to exercise the discretion once this occurs.

### The lead time limb in paragraph 35-55(1)(b)

16. The Commissioner may exercise the discretion in paragraph 35-55(1)(b) for a business activity that has started to be carried on, where, for the income year(s) in question:

- 'because of its nature', it has not satisfied, or will not satisfy, any of the tests; and
- there is an objective expectation, based on evidence from independent sources (if available) that, within a period that is commercially viable for the industry concerned, the activity will satisfy one of the tests or produce a 'tax profit'.[5]

#### *The meaning of 'because of its nature'*

17. For the failure to satisfy one of the four tests to be 'because of its nature', the failure must be because of some inherent characteristic that the taxpayer's business activity has in common with other business activities of that type (see *Federal Commissioner of Taxation v. Eskandari* (*Eskandari*)).[6]

18. Where the activity's failure to satisfy a test is because of such an inherent characteristic, the requirement in subparagraph 35-55(1)(b)(i) will be met for any income year within the period from the time the business activity starts to the end of the last income year in which that characteristic still affects the activity's ability to satisfy a test (the 'initial period').

19. Where this initial period has passed, any continuing failure to satisfy a test will be for reasons outside of subparagraph 35-55(1)(b)(i), and the discretion will not be exercised (unless the special circumstances limb is satisfied).

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[5] Tax profit refers to the subparagraph 35-55(1)(b)(ii) requirement for a business activity to produce assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsections 35-10(2) and (2C)).

[6] (2004) 134 FCR 569 at 578; [2004] FCA 8 at FCA 32; 2004 ATC 4042 at 4050; (2004) 54 ATR 695 at 702.

### *Objective expectation about future performance*

20. The Commissioner must be satisfied that an objective expectation exists, for each of the year(s) in question, that the business activity will satisfy a test or produce a tax profit within a period that is commercially viable for the industry concerned. The objective expectation must be based on independent information, where such information is available.

### *The 'period that is commercially viable for the industry concerned'*

21. The period that is commercially viable for the industry concerned is the period in which it is expected that any business activity of that type, which is carried on in a commercially viable manner, would be expected to satisfy one of the tests or produce a tax profit. It is not determined having regard to best practice in the industry concerned.

22. Whether or not the end of the period that is commercially viable can be identified as the end of a particular income year, or instead a range of years, will depend on the facts of each industry.

23. Not all business activities will commence immediately at the start of an income year. In practice, determination of the period referred to in subparagraph 35-55(1)(b)(ii) as the period 'that is commercially viable for the industry concerned' should allow for this. A tolerance of at least one year beyond the income year otherwise identified from the relevant material as the end of this period will be applied.

### Interaction between the two limbs

24. As stated in paragraphs 13 and 14 of this Ruling, ordinarily the operation of the first limb is confined to those situations in which the business activity has been affected by special circumstances outside the control of the operators of that activity where, had these circumstances not existed, the activity would have satisfied one of the four tests in Division 35.

25. The first limb may also apply to a business activity affected by such circumstances during a time when 'because of its nature' it is not able to satisfy a test, but this time is still 'within [the] period that is commercially viable for the industry concerned'. In such a case, the enquiry is not whether the activity would have satisfied a test had the special circumstances not existed (paragraph 35-55(1)(b) already recognises that there are reasons outside the control of the operators of the activity why this would not have occurred, regardless of the existence of the special circumstances).

26. In such cases the appropriate enquiry will be whether or not the special circumstances outside the control of the operators of the business activity have meant that there is no longer an objective expectation that within the period that is commercially viable for the industry concerned the activity will satisfy a test.

27. The number of years for which paragraph 35-55(1)(a) may be satisfied on this basis will need to be determined on a case by case basis. However, where the special circumstances are the sole reason why the activity can no longer objectively be expected to satisfy a test within the period that is commercially viable for the industry concerned, but the activity is now expected to consistently satisfy a test within some later time, the discretion in paragraph 35-55(1)(a) may be exercised.

# Date of effect

28. The Ruling applies both before and after its date of issue[7]. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

**Commissioner of Taxation**
25 July 2007

[7] Taxpayers can continue to rely on product rulings that apply to them, and on private rulings issued to them in relation to schemes that have begun to be carried out: section 357-75 of Schedule 1 to the *Taxation Administration Act 1953*.

# Appendix 1 – Explanation

***This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.***

29. Subsection 35-55(1) provides as follows:

**Commissioner's discretion**

(1) The Commissioner may decide that the rule in subsection 35-10(2) does not apply to a business activity for one or more income years if the Commissioner is satisfied that it would be unreasonable to apply that rule because:

(a) the business activity was or will be affected in that or those income years by special circumstances outside the control of the operators of the business activity, including drought, flood, bushfire or some other natural disaster; or

Note: This paragraph is intended to provide for a case where a business activity would have satisfied one of the tests if it were not for the special circumstances.

(b) the business activity has started to be carried on and, for that or those income years:

(i) because of its nature, it has not satisfied, or will not satisfy, one of the tests set out in section 35-30, 35-35, 35-40 or 35-45; and

(ii) there is an objective expectation, based on evidence from independent sources (where available) that, within a period that is commercially viable for the industry concerned, the activity will either meet one of those tests or will produce assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsections 35-10(2) and (2C)).

Note: This paragraph is intended to cover a business activity that has a lead time between the commencement of the activity and the production of any assessable income. For example, an activity involving the planting of hardwood trees for harvest, where many years would pass before the activity could reasonably be expected to produce income.

### Common object of both limbs

30. The reason for providing the Commissioner's discretion in subsection 35-55(1) is described in paragraph 1.48 of the Explanatory Memorandum to the New Business Tax System (Integrity Measures) Bill 2000 (the EM):

> The discretion is provided to ensure that certain individuals who carry on genuine commercial business activities are not disadvantaged due to particular circumstances which prevent them from satisfying tests 1 to 4...

31. The 'particular circumstances' referred to are those that would result in some unfairness or injustice if the loss deferral rule were to apply to the business activity.

32. In paragraph 35-55(1)(a) the phrase 'outside the control of the operators of the business activity' is used to convey the point that these 'particular circumstances' are not a consequence of the operator's actions or inactions and therefore it would be unreasonable to disadvantage operators by deferring the losses from their business activity.

33. This point is continued in paragraph 35-55(1)(b) with the phrase 'because of its nature'. This takes into account circumstances which are a result of the nature of the business activity itself and which prevent the business activity from satisfying a test. Stone J took this view of 'because of its nature' in the case *Eskandari* when looking at the type of activities referred to by the note and the EM at FCA 31:

> Such activities have an inherent characteristic that cannot be overcome by conducting the business activity in a different way but only by changing the nature of the business.

34. Both limbs, in paragraphs 35-55(1)(a) and (b) respectively, therefore have a common object of preventing unfairness or injustice in the case where a business activity cannot satisfy any of the four tests in Division 35 due to certain reasons that are not able to be overcome or controlled by the operator of the business activity.

### Exercising the discretion

35. In exercising a discretion, the Commissioner must have regard to whether doing so is within the purpose of the Act to ensure that the outcome is not unfair, unjust or unintended. When interpreting a provision of an Act a construction that promotes the purpose or object underlying the Act is preferred (section 15AA of the *Acts Interpretation Act 1901*).

36. Section 35-5 states that the object 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… being offset against other assessable income.

37. Section 35-10 achieves this object by providing a loss deferral rule in subsection 35-10(2) which prevents losses from being offset against other income unless one of the three paragraphs in subsection 35-10(1) are satisfied. These are:

(a) one of the tests in section 35-30, 35-35, 35-40 or 35-45 is satisfied;

(b) the Commissioner has exercised the discretion in section 35-55; or

(c) the primary production or professional arts exception (subsection 35-10(4)) applies.

38. Subsection 35-55(1) provides the Commissioner with the discretion not to apply the loss deferral rule to a business activity if the Commissioner is satisfied that it would be unreasonable to apply that rule in certain circumstances referred to in paragraphs 35-55(1)(a) and 35-55(1)(b).

39. This means that, taking into consideration the purpose of preventing losses from non-commercial activities being offset against other assessable income, the Commissioner needs to be satisfied that it would be unreasonable, by reference to the factors stated in paragraphs 35-55(1)(a) and 35-55(1)(b), to defer the losses because of the particular facts and circumstances of each case.[8]

### The special circumstances limb

40. Paragraph 35-55(1)(a) describes the first of the circumstances where the Commissioner may exercise a discretion not to apply the loss deferral rule in respect of a business activity. This is where the business activity is affected by special circumstances outside of the control of the operators of the business.

41. In regard to this limb there are two main factors that should be considered in deciding if it is appropriate to exercise the discretion, for an income year:

- the business activity is affected by special circumstances such that it is unable to satisfy any of the tests; and
- the special circumstances affecting the business activity are outside the control of the operators of the business activity.

[8] When considering the application of Division 35 in the case of *Re Delandro and Commissioner of Taxation* [2006] AATA 859 Block DP said at [47]:
…a discretionary power should not be exercised where to do so would defeat the policy of the relevant statute.

***Affected by 'special circumstances'***

42. For the exercise of the Commissioner's discretion in regard to the special circumstances limb, the business activity must be affected by special circumstances.

43. No exhaustive definition of 'special circumstances' is provided in the ITAA 1997. However, the term has received considerable judicial consideration in respect of other legislation.

44. In the case *Community Services Health, Minister for v. Chee Keong Thoo* (1988) 78 ALR 307; (1988) 8 AAR 245 Burchett J considered 'special circumstances' in the context of the *Health Insurance Act 1973* and made the following observation at ALR 324:

> Those discretions are intended to be applied to a great variety of situations. In such a context, the core of the idea of 'special circumstances' is that there is something unusual or different to take the matter out of the ordinary course…

45. In the case *Employment, Education, Training Youth Affairs, Department of v. Barrett* (1998) 82 FCR 524; (1998) 52 ALD 499; (1998) 27 AAR 291 'special' was considered in the context of 'special weather conditions' for the purposes of the Austudy Regulations 1990. Tamberlin J observed at FCR 530 that:

> The word 'special' must be read in context. In normal parlance it signifies that the event or circumstances in question are out of the ordinary or normal course.

46. Tamberlin J went on to say:

> The AAT observed in *Re Beadle and Director-General of Social Security* (1984) 6 ALD 1 at 3 (which was approved by the Full Court in *Beadle v. Director of Social Security*) (1985) 60 ALR 225):
>
> > An expression such as 'special circumstances' is by its very nature incapable of precise or exhaustive definition. The qualifying adjective looks to circumstances that are unusual, uncommon or exceptional. Whether circumstances answer any of these descriptions must depend upon the context in which they occur. For it is the context which allows one to say that the circumstances in one case are markedly different from the usual run of cases. This is not to say that the circumstances must be unique but they must have a particular quality of unusualness that permits them to be described as special.

47. In the context of Division 35 special circumstances are ordinarily those affecting the business activity such that it is unable to satisfy a test and it would be unreasonable for the loss deferral rule to apply. Subject to paragraphs 48 and 53 of this Ruling, ordinary economic, weather or market fluctuations that might reasonably be predicted to affect the business activity would not be considered to be special circumstances. These fluctuations are expected to occur on a regular or recurrent basis when carrying on a business activity and affect all businesses within a particular industry. (Refer to Example 1 at paragraph 110 of this Ruling). However, substantial unexpected fluctuations of a scale not regularly encountered previously may qualify on a case by case basis.

48. Although not limited to natural disasters, paragraph 35-55(1)(a) refers to 'special circumstances' as including drought, flood, bushfire or some other natural disaster. These events are taken to be special circumstances outside the control of the operators of the business activity.

49. The special circumstances must have affected the business activity. Some indicators of the effects on the business activity that could lead to the exercise of the discretion in regard to the special circumstances limb are:

- destruction of stock or equipment (refer to Example 2 at paragraph 112 of this Ruling);
- delays in ploughing, planting, harvesting etc (refer to Example 3 at paragraph 115 of this Ruling);
- delay in growth of crops (refer to Example 4 at paragraph 118 of this Ruling);
- inability of operator to perform duties (refer to Example 5 at paragraph 122 of this Ruling); and
- loss of business opportunities (refer to Example 6 at paragraph 125 of this Ruling).

50. In the situation where a business activity would have failed to satisfy a test even if the special circumstances had not occurred, it is unlikely that the Commissioner would consider it to be unreasonable for the loss deferral rules to apply and therefore the Commissioner would be unlikely to exercise the discretion. (Refer to Example 7 at paragraph 128 of this Ruling.)

51. However, in some cases, the business activity may still be within the lead time for the industry and because of the nature of the activity would therefore have failed to satisfy a test even if the special circumstances had not occurred. In such cases the special circumstances may extend the time within which that particular business activity could objectively be expected to pass a test, and the Commissioner could exercise the discretion under paragraph 35-55(1)(a). (Refer to Example 11 at paragraph 154 of this Ruling.)

52. The discretion can be exercised in income years after the one in which the special circumstances have occurred if the effects of those special circumstances on a business activity continue such that it cannot satisfy any of the tests in those later years. However, there may be situations where the special circumstances in question, because of their continued existence, change, and become the ordinary or usual situation, in which case it would not be appropriate to exercise the discretion after that time. (Refer to Example 4 at paragraph 118 of this Ruling and Example 8 at paragraph 130 of this Ruling.)

### *Special circumstances not restricted to 'drought, flood, bushfire or some other natural disaster'*

53. Paragraph 35-55(1)(a) refers to 'special circumstances outside the control of the operators of the business activity, including drought, flood, bushfire or some other natural disaster'. Cyclones, hailstorms and tsunamis are examples of other natural disasters that would come within the scope of the paragraph.

54. However, the use of the word 'including' indicates that the type of circumstances to which the special circumstances limb of the discretion can potentially apply is broader than those which are natural disasters. For example, circumstances such as oil spills, chemical spray drifts, explosions, disturbances to energy supplies, government restrictions and illnesses affecting key personnel might, depending on the facts, constitute special circumstances of the type in question.

### *Outside the control of the operators of the business activity*

55. For these other kinds of events, the operators of the business activity must show that the special circumstances were outside their control. The concept of 'control' was discussed in *Secretary, Department of Employment, Education and Youth Affairs v. Ferguson* (1997) 76 FCR 426; (1997) 48 ALD 593; (1997) 147 ALR 295 for the purposes of subsection 45(6) of the *Employment Services Act 1994*. At 76 FCR 438; 48 ALD 603; 147 ALR 306, Mansfield J said:

> The expression in s45(6)(a) requires that the main reason for the failure was something that the person had within that person's control. The concept of '*control*' in that context is one of fact, but I think it is intended to mean something which the person could have done something about.

56. And at 76 FCR 438, 48 ALD 603; 147 ALR 306:

> It recognises the focus of the expression upon occurrences which the person concerned could not realistically prevent.

57. However, if the operators of the business activity fail for no adequate reason to adopt certain practices commonly used in their industry to prevent or reduce the effects of certain circumstances, such as for example pests or diseases, then that may point to the circumstances being within their control.

58. Similarly, the acquisition of a poorly run but promising business activity would generally be considered to be within the control of the business operator and as such would not, by itself, constitute special circumstances, even though the actions of the former operator may have been outside the control of the current operator.

### Effect of the note to paragraph 35-55(1)(a)

59. Paragraph 35-55(1)(a) includes a note which explains that the paragraph is:

> …intended to provide for a case where a business activity would have satisfied one of the tests if it were not for the special circumstances.

60. Section 950-100 states that the notes and examples that follow a provision form part of the Act. Subdivision 2-E discusses the status of non-operative material. Section 2-35 provides that the non-operative material which is included in the Act is 'to help you identify accurately and quickly the provisions that are relevant to you and to help you understand them'. The non-operative material includes guides and other material.

61. Section 2-45 then discusses 'other material' as follows:

> The other category consists of material such as notes and examples. These also form part of the Act. They are distinguished by type size from the operative provisions, but are not kept separate from them.

62. Although the note to paragraph 35-55(1)(a) forms part of the Act and is not kept separate from the operative provision, it is not an operative provision in itself but instead is intended to help understand the provision.

63. Paragraph 1.48 of the EM described the purpose of paragraph 35-55(1)(a) as follows:

> The discretion is provided to ensure that certain individuals who carry on genuine commercial business activities are not disadvantaged due to particular circumstances which prevent them from satisfying tests 1 to 4...

64. In the case *Delacy v. Federal Commissioner of Taxation* [2006] AATA 198 (*Delacy*) Deputy President Olney discussed the note to paragraph 35-55(1)(a) at 26:

> The Note to s 35-55(1)(a) makes it clear that the paragraph is intended to provide for a case where a business activity would have satisfied one of the four tests if it were not for the special circumstances.

65. The note to paragraph 35-55(1)(a) therefore serves to confirm the view taken at paragraph 47 of this Ruling that paragraph 35-55(1)(a) will apply in the ordinary case in situations where the business activity would have satisfied one of the four tests if the special circumstances had not occurred (refer Appendix 2 – Alternative views at paragraph 105 of this Ruling). However, as outlined in paragraph 51 of this Ruling, paragraph 35-55(1)(a) can also apply in those situations where even if the special circumstances had not occurred, the business activity would not have been expected to satisfy a test because of some inherent characteristic outside the control of the operators of the activity.

66. This is consistent with the general aim of the discretion, which is to address certain situations outside the control of the taxpayer that relate to the failure of the business activity to satisfy a test (refer to paragraphs 10 and 11 of this Ruling). If these situations either directly cause the business activity to fail a test, or extend the time within which the business activity could objectively be expected to pass a test, it would be unreasonable for the loss deferral rule to apply.

### The lead time limb

67. Paragraph 35-55(1)(b) describes the situation where the Commissioner may exercise a discretion not to apply the loss deferral rule in section 35-10 if the tests in sections 35-30, 35-35, 35-40 or 35-45 are not satisfied because of the nature of the business activity.

68. Paragraph 35-55(1)(b) applies to a business activity which has started to be carried on. Paragraphs 69A and 97 to 105 of Taxation Ruling TR 2001/14 consider when a business activity has started to be carried on. Refer also to the cases *Puzey v. Commissioner of Taxation*[9] and *Commissioner of Taxation v. Sleight*.[10]

69. In regard to paragraph 35-55(1)(b), the following factors should be considered in deciding if it is appropriate for the Commissioner to exercise the discretion for an income year for a business activity that has started to be carried on:

- whether because of its nature, it has not satisfied, or will not satisfy, one of the tests set out in section 35-30, 35-35, 35-40 or 35-45; and
- whether there is an objective expectation, based on evidence from independent sources (where available) that, within a period that is commercially viable for the industry concerned, the activity will either meet one of those tests or will produce assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsection 35-10(2)).

#### *The meaning of 'because of its nature'*

70. The first factor considers whether it is 'because of its nature' that the activity has not satisfied, or will not satisfy, one of the tests set out in sections 35-30, 35-35, 35-40 or 35-45.

[9] (2003) 131 FCR 244; [2003] FCAFC 197; 2003 ATC 4782; (2003) 53 ATR 614.
[10] (2004) 136 FCR 211; [2004] FCAFC 94; 2004 ATC 4477; (2004) 55 ATR 555.

71. As stated at paragraph 11 of this Ruling, the discretion is intended to be available for a commercial activity which fails to satisfy any of the tests for reasons outside the control of the operator. This is confirmed by the EM, which states at paragraph 1.48:

> The discretion is provided to ensure that certain individuals who carry on genuine commercial businesses are not disadvantaged due to particular circumstances which prevent them from satisfying tests 1 to 4.

72. In addition, paragraph 1.51 of the EM comments:

> This arm of the safeguard discretion [i.e., that in paragraph 35-55(1)(b)] will ensure that the loss deferral rule in section 35-10 does not adversely impact on taxpayers who have commenced to carry on activities which by their nature require a number of years to produce assessable income. Examples of activities which could fall into this category are forestry, viticulture and certain horticultural activities.

73. Example 1.6 of the EM provides an example of such an activity. In this example, the Commissioner exercises the discretion for an activity that was established as a commercially viable operation and is expected to be highly profitable. However as it is an agricultural activity that requires time for growth and harvesting before becoming profitable it cannot satisfy any of the tests, (specifically, either the Assessable income test, or the Profits test) until such time as the impact of that inherent restriction passes.

74. The note to paragraph 35-55(1)(b) states that the paragraph is:

> … intended to cover a business activity that has a lead time between the commencement of the activity and the production of any assessable income. For example, an activity involving the planting of hardwood trees for harvest, where many years would pass before the activity could reasonably be expected to produce income.

75. Stone J in *Eskandari* confirmed this view when considering whether the Commissioner's discretion should be exercised in regard to losses incurred in a migration consultancy business. When looking at the type of activities referred to by the note and the EM, Stone J stated at FCA 31:

> Such activities have an inherent characteristic that cannot be overcome by conducting the business activity in a different way but only by changing the nature of the business.

76. And further at FCA 32:

> In my view, the phrase 'because of its nature' in s 35-55 indicates that the failure must be a result of some inherent feature that the taxpayer's business activity has in common with business activities of that type.

77. Therefore, the phrase 'because of its nature' refers to inherent characteristics of the type of business activity being conducted by the taxpayer, which are common to any business activity of that type. These inherent characteristics must be the reason why the activity is unable to satisfy any of the tests. The discretion is not intended to be available where the failure to satisfy one of the tests is for other reasons.

78. The consequences of business choices made by an individual (for example, the hours of operation, the size or scale of the activity, and the level of debt funding) are not inherent characteristics of a business activity and would not result in the requirements of subparagraph 35-55(1)(b)(i) being met. (Refer to Example 9 at paragraph 139 of this Ruling.)

79. The inherent characteristics may be present for an initial period from the time the business activity commences. After that initial period has elapsed, which can be several years, the inherent characteristics may cease to be the cause of business activities of the type in question being unable to satisfy any of the statutory tests.

80. The identification of this 'initial period' may often involve some practical difficulty, particularly where causes other than an inherent characteristic appear to be another reason why the business activity is unable to satisfy a test for a particular income year. Where both an inherent characteristic and some other factor are identified, this in itself will not mean that the requirement in subparagraph 35-55(1)(b)(i) is no longer met. It is only where it is clear that the reason the activity is unable to satisfy a test is not because of any inherent characteristic, but because of some other factor, that this requirement will not be met.

81. In effect, then, the initial period is the time from the commencement of the business activity to the end of the last income year for which it can still be said that an inherent characteristic affects the business activity's ability to satisfy a test.

82. However, cases may arise where this initial period has passed, and yet a particular business activity of this type is continuing to not satisfy any of the tests. In this situation it will be appropriate to enquire whether this is the result, not of any inherent characteristic but because of the way in which the operator has chosen to carry on their business activity. (Refer to Example 12 at paragraph 161 of this Ruling.)

83. Paragraph 35-55(1)(b) will typically apply in situations where a lead time exists between the commencement of the activity and the production of assessable income from that activity. However, as noted by Stone J in *Eskandari* at FCR 580:

> In my view the note to s 35-55(1)(b) with its reference to 'lead time' illuminates but does not definitively identify the type of business activity to which the subsection applies. The reference to 'lead time' is an illustration of the type of business which 'because of its nature' might fail the tests referred to in s 35-55(1)(b)(i) but does not limit the section to that type.

### *Objective expectation*

84. The Commissioner needs to be satisfied that there is an objective expectation that the business activity will satisfy a test or produce a tax profit in some future income year falling within a period that is commercially viable for the industry concerned. If the business activity is not expected to satisfy a test or produce a tax profit within this period then the discretion will not be exercised.

85. The objective expectation does not have to be held by, or attributed to, a particular person. The Commissioner need only be satisfied that, based on the available supporting material, an objective expectation exists.[11] (Refer to paragraphs 103 and 104 of this Ruling for further explanation.)

86. Whether the required objective expectation exists can be affected by decisions about how a particular activity is operated. For example, the extent of debt finance used (and as a result the level of allowable deductions for interest attributable to the business activity) can affect the time within which the activity can produce a tax profit or satisfy the Profits test.

87. The objective expectation about future performance of the business activity must exist for each particular year and as such may change from year to year. (Refer to Example 14 at paragraph 175 of this Ruling.)

### *The 'period that is commercially viable for the industry concerned'*

88. Subparagraph 35-55(1)(b)(ii) requires that there is an objective expectation that, within a period that is commercially viable for the industry concerned, the activity will either satisfy one of the tests or produce a tax profit.

89. The EM at paragraph 1.47 refers to there being an objective expectation, 'that it will either satisfy a test or produce profit within a reasonable time'.

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[11] When considering the 'objective expectation' in *Eskandari* Stone J said at FCA 46: There may, because of the nature of the industry, be very little or no independent source material. In such circumstances it will, as an evidentiary matter, be more difficult for the taxpayer to discharge the burden imposed by s 14ZZK(b)(iii) of the *Taxation Administration Act 1953* (Cth) and convince the Commissioner that the requirements for the exercise of its discretion have been met. It may be necessary to refer to the circumstances of the taxpayer. Forming an objective expectation in such cases requires an extrapolation from those circumstances taking into account the nature of the relevant business activity, the costs or losses incurred and an estimated duration for the start-up phase.

90. This approach was taken in the Administrative Appeals Tribunal in the case of *Eskandari v. Commissioner of Taxation* [2003] AATA 295 which concluded at paragraph 23 that:

> …there is other material pointing to an objective expectation that, within a reasonable period, Mr Eskandari's business activity will become profitable or pass one of the four tests in Division 35.

91. In the decision on appeal to the Federal Court in *Eskandari* Stone J did not find that there was an error of law in this aspect of the decision by the AAT but rather that despite the expression used the AAT was referring to the objective expectation being within a period that is commercially viable for the industry concerned as stated in subparagraph 35-55(1)(b)(ii).

92. Division 35 does not require that a determination be made as to how long it will take a business activity to become commercially viable. Rather, it involves an enquiry into whether the business activity in question will satisfy a test or produce a tax profit within the time frame in which other business activities in the same industry, which behave in a commercially viable manner, do so. (Refer *Scott v. Commissioner of Taxation* [2006] AATA 542 at paragraphs 30 and 32.) Any business activity in the industry behaving in a commercial manner, reflecting normal industry practices and behaviour, is expected to be able to satisfy one of the tests or produce a tax profit within this time frame. (Refer to Example 11 at paragraph 154 of this Ruling and to Example 13 at paragraph 167 of this Ruling.)

93. In practice, when calculating this time period within which any business activity in the industry could satisfy a test or produce a tax profit, it may be necessary to ignore a one off satisfaction of a test or one off profits that can occur in the early years in some industries.

94. The reason provided for the repeal of former subsection 35-55(2) which prevented the discretion being exercised after the first time a test is satisfied or a tax profit produced supports this practice. As discussed previously the intention of Division 35 as a whole should be taken into account when deciding whether to exercise the discretion. Paragraph 1.9 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 1) 2002 stated that:

> Paragraph 35-55(1)(b) of the ITAA 1997 is amended to ensure the Commissioner is able to exercise the discretion for a number of income years.

95. Paragraph 1.20 then explained the effect of the amendment:

> This ensures that the discretion can be exercised where the requirements of paragraph 35-55(1)(b) are satisfied, for all the relevant income years, even though the business activity may, on a one-off basis, meet a test or produce a profit. This can occur, for example, as a consequence of a thinning operation in a forestry plantation.

96. Accordingly, the time frame available for a business activity to satisfy a test or produce a tax profit should not be shortened by the occurrence of a one off satisfaction of a test or production of a profit.

97. Similarly, the independent evidence may not always allow for the identification of any one year in which business activities in the industry concerned, operating in a commercially viable manner, are typically expected to satisfy one of the four tests or produce a tax profit. Instead, this evidence at best may point only to the period that is commercially viable for the industry concerned, for the purposes of subparagraph 35-55(1)(b)(ii), being a range of years. (Refer to Example 10 at paragraph 141 of this Ruling.)

98. As a matter of practice to deal with this possibility, and to cater for those business activities which do not commence right at the start of a particular income year, but towards the end of that year, a tolerance of at least one year beyond the income year otherwise identified as the end of this period will be applied. Whether the range should be any greater than that will need to be demonstrated on a case by case basis.

### *Meaning of the 'industry concerned'*

99. What business activities make up the 'industry concerned' for the purposes of the expression 'the period that is commercially viable for the industry concerned' in paragraph 35-55(1)(b) will depend largely on the facts. However, the context and purpose of paragraph 35-55(1)(b) do not suggest that an overly broad grouping of comparable business activities is always called for when identifying those making up the 'industry concerned'. For example, Example 1.6 on pages 19 to 20 of the EM refers to a comparison of the expected future performance of the business activity in question, concerning 'cultivating macadamia nuts', with what can objectively be expected in relation to 'the commercially viable period for the macadamia nut industry'. Notably, a broader grouping of businesses, such as the 'nut industry', was not put forward as the relevant industry against which to compare expected future performance.

100. As the purpose of the provision in this respect is to find an appropriate basis of comparison in terms of the expected future performance of the business activity, it will be important to identify a collection of businesses which are carried on in a commercially viable manner. They will also have broadly similar characteristics in terms of such relevant factors as the assessable income they are typically likely to produce and the type of expenses they are typically likely to incur. The first factor is relevant to satisfaction of the Assessable income test, and the second to satisfaction of the Profits test, or the production of a tax profit.

101. As such, geographical or other differences which materially affect the measures of performance paragraph 35-55(1)(b) is concerned with may make it appropriate to identify a narrower grouping of businesses as the 'industry concerned' than would otherwise be the case. Alternatively, the very nature of the product being produced may mean a more specific and narrower grouping is appropriate especially where, for example, differences in varieties mean that there are material differences in such things as yield and price per unit, which affect the amount of assessable income to be made.

102. This does not mean that, where the ability of a business activity to perform in the sense referred to is affected by decisions of the operator, the activity can only be compared with other business activities where the same decisions have been made. Such a narrow grouping of businesses would be likely to defeat the purpose of finding an objectively appropriate basis of comparison for the purposes of paragraph 35-55(1)(b).

### *Evidence from independent sources*

103. For each income year in respect of which the operator of the business seeks the exercise of the discretion, the operator must establish that there is an objective expectation that the activity will satisfy one of the tests or produce a tax profit and that this will occur within a period that is commercially viable for the industry concerned. This expectation must be based on evidence from independent sources, where it is available. This is not limited to just the predictive model type of material but can also include relevant historical evidence of how the industry in question has performed in the recent past.

104. In order to demonstrate that the objective expectation exists, a business operator should produce evidence showing that the business activity will satisfy one of the tests or produce a tax profit, showing the period within which a commercially viable business would do so. Preferably, this evidence will be documented at the time, and the evidence that the business activity will satisfy one of the tests or produce a tax profit within a certain time will be consistent with evidence from independent sources relating to activities of that type. Appropriate independent sources include industry bodies or relevant professional associations, government agencies, or other taxpayers conducting successful comparable businesses.

# Appendix 2 – Alternative views

***This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.***

### The meaning of paragraph 35-55(1)(a)

105. An alternative view of the proper scope of subsection 35-55(1) is that it allows the Commissioner to decide that it would be 'unreasonable' for the loss deferral rule in section 35-10 to apply, having regard to the matters described in either paragraph (a) or (b) of the subsection, but not confined to those matters. Under this view, the first limb of the discretion could be exercised, for example, in situations where the business activity has been affected by special circumstances outside the control of the operators of the activity, even though, contrary to the note to the first limb, it would not have satisfied a test in any event. This is subject to the qualification that other circumstances were present to justify the conclusion that there was some other basis on which to decide that it would be 'unreasonable' for the loss deferral rule to apply.

106. Support for this view is said to be found in the ordinary meaning of 'unreasonable', and in the fact that in *Eskandari* the Court held that the note to paragraph 35-55(1)(b) illustrated the type of activities to which the second limb of the discretion was intended to apply, but did not exhaustively define them. Under this alternative view the same is said of the note to the first limb. This would mean that the discretion could also be exercised, for instance, where the special circumstances have caused a business activity (with no prospect of ever satisfying one of the tests), to shift from being expected to make a tax profit, to now making a loss to which the loss deferral rule may apply.

107. The Commissioner does not agree that the scope of subsection 35-55(1) is as wide as this. The power under the subsection to decide that the loss deferral rule is not to apply is one that is required to be exercised having regard to the subject matter and scope and purpose of the subsection (see *Water Conservation and Irrigation Commission (NSW) v. Browning* (1947) 74 CLR 492 at 505, *Samad & ors v. District Court of New South Wales & anor* [2002] HCA 24 at [32] and the authorities cited in *Re Delandro and Commissioner of Taxation* [2006] AATA 859). The intended purpose of the discretion in subsection 35-55(1) is to cater for those business activities which might be 'disadvantaged due to particular circumstances which prevent them from satisfying tests 1 to 4', per paragraph 1.48 of the relevant EM, quoted at paragraph 63 of this Ruling. The prevention spoken of may be current, or it may extend into the future, as with the case of a business activity for which the time within which it objectively can be expected to satisfy a test has been affected by special circumstances of the type to which the first limb of the discretion can apply. Having regard to the purpose of the subsection, being to deal with certain situations outside the control of

the operators of business activities which prevent those activities from satisfying any of the four tests in Division 35, it is not accepted that the power in the subsection is to be exercised without regard to whether or not the activities would otherwise have been able to satisfy one of these tests.

108. For these reasons, the alternative view is rejected.

# Appendix 3 – Examples

***This Appendix sets out examples. It does not form part of the proposed binding public ruling.***

109. The operation of subsection 35-55(1) depends heavily on the facts of each case. The Examples which follow are not designed to fetter the exercise of the Commissioner's discretion, but are for illustrative purposes only. They have been simplified to illustrate various aspects of the Commissioner's discretion under the subsection. They frequently use shortcuts in describing whether or not conditions for exercise of the discretion are met. They are not intended to prescribe the level of information required to properly determine whether or not the discretion should be exercised. In practice, a higher level of detail would need to be examined to reach a conclusion on whether or not the business activity in question comes within either paragraph (a) or (b) of the subsection, and what impact the circumstances referred to in either paragraph specifically have on the business activity in relation to its ability to satisfy any of the relevant tests in Division 35. For this reason it would not be appropriate to make any of the Examples part of the proposed binding public ruling.

### The special circumstances limb in paragraph 35-55(1)(a)

#### *Example 1*[12]

110. Oliver has a farming business which produced assessable income of $25,000 from the sale of produce in the 2005 income year and satisfied the assessable income test. In the 2006 income year the market price of his produce dropped because of lower consumer demand and Oliver's farm income fell to $18,000 and a loss resulted. The fall in market price was within the range of normal fluctuations for this industry. Oliver's business activity did not satisfy any of the tests in Division 35 and the exception for primary production business activities did not apply as he received at least $40,000 of non farm income. If the Commissioner does not exercise the discretion in the 2006 income year, the loss from the farming business activity will be deferred.

111. In this case the Commissioner would not exercise the discretion in paragraph 35-55(1)(a) for special circumstances. The reduction in the market prices for produce from his farm is not special circumstances but a normal business fluctuation. As a result, the loss from Oliver's farming business activity will be deferred.

[12] Refer to Explanation, paragraph 47 of this Ruling.

### *Example 2*[13]

112. Mark operated a clothing store specialising in the sale and hire of costumes. During the 2006 income year a fire destroyed all his stock. Mark's business was insured but due to the specialised nature of the costumes, Mark was unable to resume normal operations for 3 months. As a result, Mark's business activity had assessable income of less than $20,000 and a loss was incurred.

113. Mark is able to show that his business activity satisfied the assessable income test in the 2005 income year and his trading before the fire indicated that he was likely to have satisfied this test in the 2006 year if it were not for the fire. His business activity did not satisfy any of the other tests in Division 35 in the 2006 income year. If the Commissioner does not exercise the discretion in the 2006 income year, the losses from Mark's clothing store activity will be deferred.

114. In this case the Commissioner would exercise the discretion in paragraph 35-55(1)(a) for special circumstances. The fire and subsequent lost trading due to the time required to obtain replacement stock amount to special circumstances which were outside of Mark's control. The business activity was expected to have satisfied a test if not for these special circumstances and consequently the Commissioner would be satisfied that it would be unreasonable for the loss deferral rule in section 35-10 to apply. As a result, Mark is able to offset the losses from his clothing store against his other assessable income.

### *Example 3*[14]

115. Evan has a specialised vegetable growing business which satisfied the assessable income test in the 2004 income year and was expected to satisfy this test again in the 2005 income year. Evan's property is located in a region that normally has a mild Mediterranean climate. However in the 2005 income year at the time when the seedlings were due to be planted the property was affected by gale force winds, hail and lightning storms which did not usually occur at that time of the year. Evan was forced to delay planting for some weeks and by the time the crops were harvested it was too late to meet his contracts to supply his customers. As a result of this he did not receive any assessable income from his farm in this year and a substantial loss was incurred.

116. Evan's business did not satisfy any of the tests in Division 35 in the 2005 income year and the exception for primary production business activities did not apply as he had received at least $40,000 of non farm income. As a result, if the Commissioner does not exercise the discretion in the 2005 income year, the losses from the vegetable growing business activity will be deferred.

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[13] Refer to Explanation, paragraph 49 of this Ruling.
[14] Refer to Explanation, paragraph 49 of this Ruling.

117. In this case the Commissioner would exercise the discretion in paragraph 35-55(1)(a) for special circumstances. The delay in planting due to unusual extreme weather would be special circumstances which were outside Evan's control. The business activity was expected to have satisfied a test if not for these special circumstances and consequently the Commissioner would be satisfied that it would be unreasonable for the loss deferral rule in section 35-10 to apply. As a result, Evan is able to offset his losses from the vegetable growing business activity against his other assessable income in the 2005 income year.

### *Example 4*[15]

118. Simon has a fruit growing business which satisfied the assessable income test in the 2004 income year and was expected to satisfy this test again in the 2005 and 2006 income years. In the 2005 income year however, Simon's farm was affected by a prolonged drought and his entire crop was lost. As a result of this he did not receive any assessable income from his farm in this year and a substantial loss was incurred.

119. In addition, the stress on the trees during the drought also affected the fruit set in the following year, causing substantially reduced crops. As a result Simon's business did not satisfy the assessable income test and produced a loss in the 2006 income year.

120. Simon's business did not satisfy any of the tests in Division 35 in the 2005 or 2006 income years and the exception for primary production business activities did not apply as he had received in excess of $40,000 of non farm income. As a result, if the Commissioner does not exercise the discretion in the 2005 and 2006 income years, the losses from the fruit growing business activity will be deferred.

121. In this case the Commissioner would exercise the discretion in paragraph 35-55(1)(a) for special circumstances in both years. The loss of the crops due to drought would be special circumstances which were outside Simon's control. The business activity was expected to have satisfied a test in both of these years if not for these special circumstances and consequently the Commissioner would be satisfied that it would be unreasonable for the loss deferral rule in section 35-10 to apply. As a result, Simon is able to offset his losses from the fruit growing business activity against his other assessable income in the 2005 and 2006 income years.

[15] Refer to Explanation, paragraphs 49 and 52 of this Ruling.

### *Example 5*[16]

122. Allison runs a dance instruction business which satisfied the assessable income test in the 2004 income year and was expected to satisfy this test again in the 2005 income year. However in the 2005 income year Allison broke her leg and was unable to dance for 6 months. Allison had to cancel all her bookings for 6 months and as a result incurred a loss for the 2005 income year.

123. Allison's business did not satisfy any of the tests in Division 35 in the 2005 income year. If the Commissioner does not exercise the discretion in the 2005 income year the losses from the dancing instruction business activity will be deferred.

124. In this case the Commissioner would exercise the discretion in paragraph 35-55(1)(a) for special circumstances. Allison is a key person in the dancing instruction business. Her broken leg and inability to teach for 6 months would be special circumstances which were outside her control. The business activity was expected to have satisfied a test if not for these special circumstances and consequently the Commissioner would be satisfied that it would be unreasonable for the loss deferral rule in section 35-10 to apply. As a result, Allison is able to offset her business losses against her other assessable income in the 2005 income year.

### *Example 6*[17]

125. Tom ran a whale watching business which satisfied the assessable income test in the 2004 income year and was expected to satisfy this test again in the 2005 income year. However, in the 2005 income year an oil tanker came aground and left a large oil slick along the coast where Tom took tourists out in his boat. Tom was unable to take any customers out for 6 weeks of the peak period for whale watching. As a result a substantial loss was incurred in this year.

126. Tom's business did not satisfy any of the tests in Division 35 in the 2005 income year. If the Commissioner does not exercise the discretion in the 2005 income year the losses from the business activity will be deferred.

127. In this case the Commissioner would exercise the discretion in paragraph 35-55(1)(a) for special circumstances. The loss of business due to the oil slick making the area inaccessible would be special circumstances which were outside Tom's control. The business activity was expected to have satisfied a test if not for these special circumstances and consequently the Commissioner would be satisfied that it would be unreasonable for the loss deferral rule in section 35-10 to apply. As a result, Tom is able to offset his business losses against his other assessable income in the 2005 income year.

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[16] Refer to Explanation, paragraph 49 of this Ruling.
[17] Refer to Explanation, paragraph 49 of this Ruling.

### *Example 7*[18]

128. Lucy operates a driving instruction business which has not satisfied a test in previous years. In the 2006 income tax year she had a car accident and the car was off the road for 3 months, during which she could not operate the business. As a result the income from the business activity was reduced and the business produced a loss. Lucy's business activity did not satisfy any of the tests in the 2006 income tax year and would not have expected to even if the car accident had not occurred. If the Commissioner does not exercise the discretion the loss from Lucy's driving instruction business will be deferred.

129. In this case the Commissioner would not exercise the discretion under paragraph 35-55(1)(a) for special circumstances. Although the car accident and the consequent reduction in income would often be considered to be special circumstances, Lucy's business activity would not have satisfied any tests even if this had not occurred. Consequently it would not be unreasonable for the loss deferral rule to apply in this year.

### *Example 8*[19]

130. Sam operated a bluetail fishing business which satisfied the assessable income test in 2003 and was expected to satisfy this test in the 2004 income year. In December 2003 the local environment protection authority placed a temporary restriction on fishing in the area where Sam operated his business as there had been a decrease in the number of bluetails and they needed time to breed. As a result Sam was only able to fish on a limited basis for the rest of the 2004 income year and made a loss for that year.

131. The business activity consequently did not satisfy any tests in the 2004 income year. The exception for primary production business activities did not apply as Sam had received at least $40,000 of non-farm income. As a result, if the Commissioner does not exercise the discretion in the 2004 income year, the loss from the fishing business will be deferred.

132. In this case the Commissioner would exercise the discretion in paragraph 35-55(1)(a) for special circumstances. The loss of business due to the restriction on fishing would be special circumstances which were outside Sam's control. The business activity was expected to have satisfied a test if not for these special circumstances and consequently the Commissioner would be satisfied that it would be unreasonable for the loss deferral rule in section 35-10 to apply. As a result, Sam is able to offset his business losses against his other assessable income in the 2004 income year.

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[18] Refer to Explanation, paragraph 50 of this Ruling.
[19] Refer to Explanation, paragraph 52 of this Ruling.

133. The restriction on fishing bluetails in the area was extended into the 2005 income year and once again the Commissioner would exercise the discretion in paragraph 35-55(1)(a) for special circumstances.

134. Midway through the 2006 income year, the environmental protection authority introduced a permanent reduction in bluetail fish catch limits for each business operating in the area where Sam operated his business.

135. During the 2006 income year Sam continued to carry on his bluetail fishing activity in the area but because of the restriction on catch limits incurred a loss.

136. For the 2006 income year the Commissioner would exercise the discretion in paragraph 35-55(1)(a) as the special circumstances prevented Sam's business from satisfying a test.

137. By the end of the 2006 income year all other bluetail fishermen had moved to other areas but Sam chose to stay even though he knew he would continue to incur losses in future years unless he moved the location of his fishing business. Consequently Sam incurred a loss from bluetail fishing for the 2007 income year.

138. In this case, the Commissioner would not exercise the discretion in paragraph 35-55(1)(a) for the 2007 income year. In the 2004, 2005 and 2006 income years the circumstances that prevented Sam's business activity from satisfying a test were considered special and accordingly it would have been unreasonable to apply the loss deferral rule in section 35-10. However by the 2007 income year the restriction on fishing in the area had been in place for some time and would continue as it had been made permanent. The restriction could no longer be considered special circumstances that would result in it being unreasonable to apply the loss deferral rule in section 35-10.

### The lead time limb in paragraph 35-55(1)(b)

#### *Example 9*[20]

139. Andrew started a clock repair business in the 2001 income year. Andrew was new to the region and the industry and had yet to establish his clientele. Andrew had intended to operate his business full time but as his funding was very limited he chose to continue with his part time employment to support himself and only worked on his business activity in his spare time. Andrew's premises are in the back of a small arcade and he only opens for business on weekends while the other shops in the arcade are open every day of the week. The arcade is not in an area that attracts business on weekends. Andrew cannot afford advertising and has so few clients that he is unable to cover his expenses and has made losses each year. Andrew's business has yet to satisfy one of the four tests. Other businesses of this type are able to satisfy a test in the first year of operation.

[20] Refer to Explanation, paragraph 78 of this Ruling.

140. The inability of Andrew's business activity to satisfy any of the four tests is due to his personal business choices as to hours of business, location and advertising, not any inherent characteristics that affect clock repair businesses. Accordingly the requirement of subparagraph 35-55(1)(b)(i) is not met and the Commissioner would not exercise the discretion.

### *Example 10*[21]

141. Peter commenced a red fruit growing business in the 2001 income year. Peter purchased 10 hectares and planted the recommended number of red fruit bushes per hectare with the appropriate irrigation installed. In the 2001 and 2002 income years Peter's business made losses.

142. Peter's business did not satisfy any of the tests in Division 35 in the 2001 and 2002 income years and the exception for primary production business activities did not apply as he had received at least $40,000 of non farm income in each of those years. If the Commissioner does not exercise the discretion in those years the losses from the red fruit business activity will be deferred.

143. Peter has evidence from the industry body, Red Fruit Growers United, that red fruit bushes would not be expected to produce at full yield until year five.

144. For the 2001 and 2002 income years Peter's business meets the requirements of subparagraph 35-55(1)(b)(i) as there are inherent characteristics that prevent business activities of that type from satisfying the tests during this initial period.

145. However for the Commissioner's discretion to be exercised Peter's business activity will also need to satisfy the requirements of subparagraph 35-55(1)(b)(ii). There must be an objective expectation that, within the period that is commercially viable for red fruit growers, Peter's business activity will satisfy a test or produce a tax profit.

146. The evidence from industry experts shows that most red fruit growing business, conducted in a commercially viable manner, would be expected to be able to produce a tax profit or satisfy a test by the fifth year as it usually corresponds to the time of full yield. However, a significant number of such businesses historically have not satisfied a test or produced a tax profit until the sixth year of their operations.

147. Peter's accountant has put together a business plan for the next 3 income years based on information from industry experts and Peter's business activity's performance to date. The business plan shows the business activity should make a tax profit by the 2005 income year.

[21] Refer to Explanation, paragraph 97 of this Ruling.

148. As there is sufficient information for the Commissioner to be satisfied that there is an objective expectation that, within the period that is commercially viable for red fruit growers, Peter's business activity will satisfy a test or produce a tax profit the discretion will be exercised. Peter's business activity losses can be offset against his other assessable income in the 2001 and 2002 income years.

149. Peter's business activity proceeded according to plan for the 2003 and 2004 income years with the Commissioner's discretion being exercised in regard to the losses for each of those years.

150. In the 2005 income year Peter's red fruit business suffered a set back due to poor rain for the year. Despite the irrigation system Peter had installed and the property being in an area suited to growing red fruit the growth of Peter's red fruit bushes was slower than expected for that year and they did not reach full yield. The business activity made a further loss for the 2005 income year.

151. For the Commissioner's discretion to be exercised for the 2005 year Peter's business activity first needs to satisfy subparagraph 35-55(1)(b)(i). Although the evidence from the industry body shows that red fruit growing businesses would normally have reached full yield by year five in this case Peter's bushes are still growing and have not yet achieved full yield. Therefore it is considered as there are inherent characteristics that prevent it from satisfying a test until around the time of full yield the business activity meets the requirements of subparagraph 35-55(1)(b)(i).

152. Peter's accountant reviewed the business plan and it now shows the business activity not being able to make a tax profit, or satisfy a test until early in the 2006 income year.

153. To satisfy the requirements of subparagraph 35-55(1)(b)(ii) there needs to be an objective expectation that Peter's business activity will satisfy a test or make a tax profit within a period that is commercially viable for the industry concerned. While the information obtained from the industry body shows that business activities in the same industry would most often be expected to satisfy a test or make a profit by the fifth year, the evidence supports a conclusion that the period that is commercially viable for the industry concerned can span the fifth to sixth years of operations, from commencement. Therefore it is accepted that Peter's business activity has been conducted in a commercially viable manner and will have its first full commercial harvest in the start of the sixth year and therefore make a tax profit in that year and that this will occur within the period referred to in subparagraph 35-55(1)(b)(ii). In this case the Commissioner's discretion would be exercised for the 2005 income year as it would be unreasonable to apply the loss deferral rule.

### *Example 11*[22]

154. For Peter's red fruit growing business in Example 10 starting at paragraph 141 of this Ruling, instead of the poor rainfall in the 2005 income year a more severe hardship was suffered.

155. In the 2005 income year, a bush fire burned through a significant area of Peter's property, destroying 40% of his red fruit trees and damaging many of the remaining trees. Due to this fire, Peter was required to re-plant 40% of his red fruit trees and the development of fruit on another 30% of the trees was set back approximately two years. As a result, Peter's red fruit business is now expected to first satisfy the assessable income test and to first produce a taxation profit in the 2008 income year.

156. For the lead time limb of the Commissioner's discretion to be exercised for the 2005, 2006 and 2007 years, Peter's business activity first needs to satisfy subparagraph 35-55(1)(b)(i). Although the evidence from the industry body shows that red fruit growing businesses would normally have reached full yield by year five, in this case Peter's trees are still growing and have not yet achieved full yield. Therefore, it is considered as there are inherent characteristics that prevent it from satisfying a test until around the time of full yield the business activity meets the requirements of subparagraph 35-55(1)(b)(i).

157. To satisfy the requirements of subparagraph 35-55(1)(b)(ii), there needs to be an objective expectation that Peter's business activity will satisfy a test or make a tax profit within a period that is commercially viable for the industry concerned. Information obtained from the industry body indicates that business activities in the same industry would be expected to satisfy a test or make a profit by the fifth or sixth year and the fire was not sufficiently widespread to affect this expected period for the industry. Therefore, the expectation that Peter's business will first pass a test and make a tax profit in the 2008 year is well outside the period that is accepted as being commercially viable for the industry concerned. Consequently, the requirements of subparagraph 35-55(1)(b)(ii) are not met and the Commissioner is unable to exercise the lead time limb of the discretion.

158. Peter asks that the Commissioner instead exercise the special circumstances limb of the discretion for the 2005, 2006 and 2007 income years. On the evidence provided by Peter, the Commissioner is satisfied that the fire was special circumstances outside of Peter's control which affected the business activity.

159. For the 2005 income year, Peter's business was not expected to pass a test even if the fire had not occurred. However it would have been eligible for the exercise of the Commissioner's discretion under paragraph 35-55(1)(b) had it not been for the fire. Under these circumstances the Commissioner is able to exercise the special circumstances limb of the discretion in those years.

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[22] Refer to Explanation, paragraphs 51 and 92 of this Ruling.

160. In the 2006 and 2007 years the business activity would have been expected to pass a test if the fire had not occurred and the Commissioner would also exercise the special circumstances limb of the discretion in those years.

### *Example 12*[23]

161. David commenced a yellow fruit growing business in the 2001 income year. For the 2002, 2003 and 2004 income years the Commissioner's discretion was exercised as the requirements of subparagraphs 35-55(1)(b)(i) and 35-55(1)(b)(ii) were satisfied. David's bushes reached full yield by the 2005 income year and for that year and the 2006 income years the business activity made a profit. However, for the 2005 and 2006 income years, the business activity does not satisfy any of the tests in Division 35. In particular, the small scale of the activity means that it is unlikely it will ever satisfy the Assessable income test. David decides to obtain additional finance to cover his business expenses for the next five years and as a result his business activity is expected to make losses for the 2007 to 2010 income years.

162. The exception for primary production business activities does not apply as he had received at least $40,000 of non farm income. This is expected to continue to be the case. As the business activity is unlikely to satisfy a test, the losses from the yellow fruit business activity will be deferred if the Commissioner does not exercise the discretion for the 2007 to 2010 income years.

163. Evidence from the industry body shows that any yellow fruit growing business would not be expected to satisfy one of the four tests before year five as there are inherent characteristics that prevent it from doing so until around the time of full yield.

164. In order for the Commissioner's discretion to be exercised David's business activity must first satisfy the requirement of subparagraph 35-55(1)(b)(i). It must be 'because of its nature' that the activity has not satisfied, or will not satisfy, one of the tests set out in sections 35-30, 35-35, 35-40 or 35-45.

165. David's bushes achieved full yield by the 2005 income year in line with other business activities of this type. Therefore David's business activity's failure to satisfy a test for the 2007 to 2010 income years is not due to any inherent characteristic, but primarily because David has chosen to carry out the activity on a small scale.

166. In this situation the Commissioner's discretion would not be exercised in regard to David's losses from his business activity from the 2007 income year onwards.

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[23] Refer to Explanation, paragraph 82 of this Ruling.

### *Example 13*[24]

167. In the 2001 income year Philip commenced a red fruit growing business, the same type of business activity as Peter (refer to Example 11 at paragraph 154 of this Ruling). However Philip planted a very small number of red fruit bushes despite the recommendation from the industry body, Red Fruit Growers United, that more bushes should be planted for a commercial activity. Philip planned to increase the size of his orchard in about 15 years when he retired. Philip installed an irrigation system as recommended by the industry body.

168. Philip's business made losses in the 2001, 2002 and 2003 income years and did not satisfy any of the tests in Division 35. The exception for primary production business activities did not apply as he had received at least $40,000 of non farm income in each year. If the Commissioner does not exercise the discretion in those years the losses from the red fruit business activity will be deferred.

169. Evidence from the industry body shows that any red fruit growing business would not be expected to satisfy one of the four tests before year five as there are inherent characteristics that prevent it from doing so until around the time of full yield.

170. For the 2001, 2002 and 2003 income years Philip's business meets the requirements of subparagraph 35-55(1)(b)(i) as there are inherent characteristics that prevent any red fruit growing business from satisfying a test during this initial period.

171. However, for the Commissioner's discretion to be exercised in those years Philip's business would also need to satisfy the requirements of subparagraph 35-55(1)(b)(ii).

172. Philip developed a business plan for his business activity based on the material he had from the industry body. As Philip had planted such a small number of bushes it was not likely that the business activity would make a profit or satisfy a test until he retired in fifteen years time and increased the number of red fruit bushes.

173. The evidence from industry experts shows that a red fruit growing business, conducted in a commercially viable manner, should be able to produce a tax profit or satisfy a test by the fifth year.

174. As there is no objective expectation that Philip's business activity will satisfy a test or make a tax profit within a period that is commercially viable for the industry concerned the Commissioner's discretion would not be exercised and the losses from Philip's business activity would be deferred.

[24] Refer to Explanation, paragraph 92 of this Ruling.

***Example 14***[25]

175. Beth proposes to commence a red nut growing business in the 2007 income year. She has obtained independent evidence from a relevant industry body. This evidence points to an activity of the scale she has in mind being able to be commercially viable once the trees become established and start to produce commercial harvests.

176. This evidence also indicates that red nut growing businesses typically are able to either produce a tax profit, or produce assessable income of $20,000 or more (and thus satisfy the assessable income test), by their sixth year of operation. Beth puts together a business plan which shows (by reference to independent evidence, which now covers additional matters such as current market sales and costs information), that it can be expected that her proposed business will:

- produce a tax profit in the sixth year of operation;
- satisfy the profits test for the eighth year of operation; and
- satisfy the assessable income test for the tenth year of operation.

177. Beth applies for a private ruling from the Commissioner about whether the discretion in section 35-55 will be exercised in relation to anticipated losses from her proposed business activity. The income years for which this is anticipated, and thus, for which the ruling is sought, are 2007 to 2011 inclusive.

178. Beth submits on the basis of the independent evidence and her business plan, that the terms of paragraph 35-55(1)(b) are met for this period. The Commissioner accepts this and issues a favourable private ruling for the 2007 to 2011 income years.

179. Beth commences her business in 2007, and for the first year it proceeds according to plan. However, she begins to find that she is not able to spend as much time as she had initially anticipated in tending her trees. She also has various tests done in the second year, which show that a large number of her trees have been planted in conditions which will significantly affect whether they will ever produce a commercially sized crop.

180. In 2010 Beth's taxation affairs for the 2009 income year, are audited. The auditor concentrates on the loss made from her business activity for this year, and in particular, whether in terms of subparagraph 35-55(1)(b)(ii), there is still an objective expectation that the business activity will produce a tax profit for the sixth year of operation (that is, for the 2012 income year).

[25] Refer to Explanation, paragraph 87 of this Ruling.

181. Based on the information about the actual operation of Beth's business activity since its commencement it is concluded that her circumstances are materially different from those on which the private ruling was based. Specifically, after examining this information in relation to increased labour costs from employing someone to tend her trees, and the likely failure to obtain any sizeable assessable income from a large number of her trees, the auditor considers that objectively, that the business activity cannot be expected to satisfy any test for the foreseeable future, and that at best a tax profit might be able to be produced for the 2014 income year at the earliest.

182. Accordingly, for the 2010 and 2011 income years the auditor concludes that the private ruling is not binding on the Commissioner under section 357-60 of Schedule 1 to the *Taxation Administration Act 1953*. Primarily this is because the facts concerning the objective expectation about how the business activity would perform, on which the ruling was based, differ materially from the relevant facts which apply objectively to the actual conduct and anticipated performance of the business activity for the 2010 and 2011 income years.

183. For the 2010 income year the terms of subparagraph 35-55(1)(b)(ii) will not be met as an objective expectation that the business activity will produce a tax profit for the sixth year of operation (that is, for the 2012 income year) does not exist.

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*Related Rulings/Determinations:*

TR 2001/14; TR 2003/3;
TR 2006/10

*Subject references:*

- commissioner's discretion
- deferred non commercial loss
- lead time
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- non-commercial loss
- special circumstances

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