TR 2000/D16 - Income tax: Division 35 - non-commercial business losses

This document has been finalised by TR 2001/14.

Draft Taxation Ruling
Income tax: Division 35 - non-commercial business losses

Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. This Ruling considers the operation of new Division 35 of the Income Tax Assessment Act 1997 ('ITAA 1997'),[1] specifically:

- the limit on deductions from 'non-commercial'[2] business activities under subsection 35-10(2);
- the four tests, satisfaction of any one of which will allow a 'loss' from a business activity to be offset in the year in which it is incurred against other income:
  - (i) the assessable income test;
  - (ii) the profits test;
  - (iii) the real property test;
  - (iv) the other assets test; and
- the operation of the Commissioner's discretion under section 35-55.

Class of person/arrangement

2. This Ruling applies only to individuals (including an individual as a partner) who carry on a '*business activity' and who incur a non-commercial loss to which Division 35 applies. In this Ruling the term 'non-commercial loss' simply refers to the excess of

[1] The Appendix to this draft Ruling sets out the provisions of Division 35.

[2] Note: in this Ruling the term 'non-commercial' business activity merely refers to an activity to which Division 35 applies.

allowable deductions attributable to a 'business activity' for a particular year, over any assessable income from that activity, to which Division 35 may apply (see **Key Terms** below). It does not mean that the activity has been pre-judged as being 'non-commercial' in any ordinary sense of that term.

Date of effect

3. This Ruling applies to assessments to which Division 35 may apply, i.e., to assessments for the income year ending on 30 June 2001 (or the equivalent substituted accounting period), and subsequent years.

Key terms

4. In this Ruling the following Key Terms are used.

- **'business activity'** means an activity which may be a complete business in itself, or part of a larger business, and includes, applying subsection 35-10(3), '… business activities of a similar kind.'
- **'individual'** means a natural person.
- **'non-commercial loss'** means the excess of allowable deductions attributable to a 'business activity', for a particular year, over assessable income from that activity (see subsection 35-10(2)).
- **'professional arts business'** means a *business as defined in subsection 35-10(5) as:
  '… a *business you carry on as:
  (a) the author of a literary, dramatic, musical or artistic work; or
  (b) a *performing artist; or
  (c) a *production associate'[3].
- **'tax profit'** is where the amount of assessable income from the activity for that year is greater than the sum of the deductions attributable to the business activity for that year (apart from the operation of subsection 35-10(2)).

[3] The terms, '*performing artist', and '*production associate' have the same meaning they have in section 405-25.

Ruling

Introduction to Division 35

5. Division 35 was introduced into the ITAA 1997 via the *New Business Tax System (Integrity Measures) Act 2000*. The main operative provision in the Division is section 35-10. The major rule in section 35-10 is that unless:

(a) the individual's business activity meets one of the four tests; or

(b) the individual satisfies an exception; or

(c) the individual is covered by an exercise of the Commissioner's discretion in relation to that business activity,

a loss from the business activity will not be deductible in the income year in which it arose. However, it will be available in a later year, if one of the four tests is met, an exception is satisfied, or the Commissioner's discretion is exercised. Division 35 does not apply to activities that do not constitute carrying on a business.

6. The changes to the law contained in Division 35 arose as a result of the Government's adoption of Recommendation 7.5 of the Ralph Committee's report, Review of Business Taxation: A Tax System Redesigned. That recommendation focused on significant revenue leakage from individual taxpayers claiming deductions for unprofitable activities, which were 'often unlikely to ever be profitable' (refer to paragraph 1.8, Explanatory Memorandum, *A New Tax System (Integrity Measures) Act 2000).*

Primary Producer or Professional Artist Exceptions

7. Where an individual has a loss from a *primary production business or a *professional arts business in a year of income, and in that year the total of their assessable income from sources unrelated to that business activity (excluding any net capital gain) is less than $40,000, the rule in subsection 35-10(2), that the loss be deferred, will not apply in relation to that business activity (subsection 35-10(4)).

Meaning of '**business activity'*

8. A key concept to understand in applying Division 35 therefore is '*business activity', as it appears in the Division. The asterisk signifies that the term includes the defined term *business, the meaning of which in section 995-1 is:

'business includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee.'

9. The term '*business activity' is otherwise undefined in the ITAA 1997. We do not consider, however, that the inclusion of the extended definition of 'business' in the term alters the ordinary meaning of the term in any significant way. That ordinary meaning is an activity forming part or all of the taxpayer's activities 'engaged in for the purpose of profit on a continuous and repetitive basis' (*Hope v. The Council of the City of Bathurst* 80 ATC 4386 at 4382; (1980) 12 ATR 231 at 236), or of an activity that is one of the activities that makes up the 'course of conduct' (*FC of T v. Murry* 98 ATC 4585 at 4596; (1998) 39 ATR 129 at 145), that is the taxpayer's business.

10. However, it is plain that 'business activity' has a more restricted meaning than this for the purposes of Division 35. Firstly, the scheme and the context of the Division suggest that a relevant business activity needs to be one capable of producing assessable income and having certain amounts 'attributable' to it that an individual taxpayer could otherwise deduct (see, for example section 35-10). The relevant business activity will also be one capable of having various assets used in carrying it on (see the assets tests in sections 35-40 and 35-45).

11. As described in paragraph 6, the relevant changes in the law are directed at activities that are 'unlikely to ever be profitable'. These activities have been made subject to 'a series of tests to determine whether a business activity is treated as non-commercial' (section 35-1) and the identification and tax treatment of them. Division 35 has this as its main purpose.

Identifying separate business activities

12. In *Allied Mills Industries Pty Ltd v. FC of T* 88 ATC 4852 at 4864; (1988) 19 ATR 1724 at 1737, Gummow J acknowledged that a taxpayer might carry on 'several distinct businesses'. This would be where the activities of the taxpayer were 'so discrete in character and so discrete in the manner they are conducted' that this conclusion was called for.

13. We think the same may be said for the purposes of Division 35 about an individual taxpayer carrying on the one business. In certain situations their business activities may be so discrete in character and in the manner they are conducted that the question arises whether they are carrying on separate and distinct business activities for the purposes of Division 35. Whether this is so is clearly a question of fact and overall impression, like the question of whether they are carrying on a business. Factors which could be examined in this

regard are set out in paragraph 63 in the Explanations part of this Ruling.

14. Given the purpose and context in which 'business activity' appears in Division 35, as noted already, such situations would also need to be ones where the separate business activities were each capable in their own right of producing assessable income and having attributed to them amounts that would otherwise be deductible.

15. Further, and most importantly, to be identified as a separate business activity for the purposes of this Division, the activity (or set of activities) will need to exhibit the following:

- produce a non-commercial loss, in the sense that looked at as a separate activity there is clearly assessable income produced, or intended to be produced, from it, and otherwise allowable deductions attributable to carrying it on in excess of that income;
- its conduct is not motivated by factors connected with supporting in any commercial way the carrying on of the individual's other business activities; and
- it shows signs in its own right that it is unlikely to ever be profitable.

16. All these requirements need to be satisfied, though the greatest weight would typically be given to the last two. For example, an activity might exhibit the first, and the last, but not the second, because it assists in a genuinely commercial way, the carrying on of the individual's other business activity: see **Example 2** in the Explanations part of this Ruling. Such an activity would not be identified as a separate business activity for the purposes of Division 35.

17. The following table summarises some of the factors that may be relevant to whether a business is made up of separate and distinct business activities for the purposes of Division 35. The term 'activities' is used in the table simply to refer to the various business operations making up the individual's business. The table is not meant to be a checklist, or to suggest that each factor should be given equal weighting in all cases.

factor	**'for' there being separate and distinct business activities**	**'against' there being separate and distinct business activities**
location	different types of activities carried on at different locations	different types of activities carried on but all at the same location
assets used	different types of assets used in carrying on separate activities, with no, or very little, crossover or commonality of use	some different assets used in carrying on separate activities but many assets common to all
goods/services produced (incl. market conditions)	significant differences in the type of goods/services produced from the separate activities and in the conditions affecting their sale	different types of goods/services produced but significant similarities in the manner produced and/or marketed
interdependency	no, or very little, interdependency between the separate activities	separate activities carried on but significant level of interdependency between them in terms, for example, of working capital support, customer base, manner in which activities carried out
commercial links	one set of activities inherently unprofitable and no, or only minimal, commercial basis on which it could support the other activities	one set of activities may be inherently unprofitable but it supports the other activities, for example through increasing their sales base

A common-sense approach

18. To sum up, identification of what are the individual taxpayer's relevant business activities is to be done on a common sense basis without looking to create artificial distinctions between various parts of their overall business. This will often mean that the relevant business activity is the individual's whole business.

19. However, where an individual taxpayer carries on several distinct businesses it follows that they carry on several distinct business activities for the purposes of Division 35.

Business activities *'of a similar kind'*

20. An individual's business may, adopting the approach described above, be seen as made up of two or more separate and distinct business activities. Subsection 35-10(3) nevertheless provides that those business activities can be grouped together for all purposes in Division 35 if they are 'of a similar kind.' This would produce, for a particular income year, the same result practically as if those activities had not been identified as separate business activities in the first place.

21. Subsection 35-10(3) also plays another role. It will allow the comparison of separate business activities across different income years in which they are carried on. This will be relevant to the operation of paragraph 35-10(2)(b). This paragraph requires, where a non-commercial loss has been deemed not to be deductible for an income year, identification of the '… next income year in which the activity is carried on'. As a result of subsection 35-10(3), this activity need not be the same activity as that from which the non-commercial loss was made. It can be another business activity 'of a similar kind'.

22. The activities must be similar in kind; but strict identity is not required (*Goodfellow v. FC of T* 77 ATC 4086 at 4093; 7 ATR 265 at 273-274). In this respect the requirement in subsection 35-10(3) differs significantly from that discussed in Taxation Ruling TR 1999/9, in relation to the 'continuity of business test', and undertakings, enterprises or transactions 'of the same kind' (see, e.g., paragraphs 16, 71 and 81 of TR 1999/9).

23. What will be a business activity 'of a similar kind' to another business activity will be very much a question of fact and degree. The question will involve a comparison of the relevant characteristics of each, for example:

- the location(s) where they are carried on;
- the type(s) of goods and/or services provided;
- the market(s) conditions in which those goods and/or services are traded;
- the type(s) of assets employed in each; and
- any other features affecting the manner in which they are conducted.

24. Some of these characteristics may be the same for the business activities being compared, but some differences must always be expected. The presence or absence of similarity in respect of a single

characteristic will rarely be determinative (*Goodfellow* at ATC 4094; ATR 274). An overall comparison of the separate business activities will be called for, weighing up the extent of the characteristics which are the same or similar against those where there are significant differences.

25. The broader in scope the separate business activities, as properly identified, are, the more likely it is that there will be some significant same or similar characteristics. For example, in a mixed farming business, in one income year the relevant business activity may involve a certain mix of both grazing certain animals and growing certain crops. A different mix of animals and crops in a later year is unlikely to mean that if the business activity is no longer the same, it is not still 'of a similar kind' to that carried on in the earlier year.

Business needs to be carried on

26. Division 35 applies only to an individual who is carrying on a 'business activity' in an income year, either on their own, or in a general law partnership. Division 35 does not apply to any other entity. Carrying on a business activity requires that a business be carried on, as that term is ordinarily understood.[4] The Division operates by identifying a specific 'business activity' for the purposes of calculating whether a non-commercial loss has been made from that activity, which would, but for Division 35, be able to be offset against other income (in the calculation of the individual's taxable income).

Calculating the non-commercial loss

27. Under subsection 35-10(2), if the amounts attributable to the business activity for a year of income that could, apart from Division 35, be deducted, exceed the assessable income (if any) from the business activity, the excess (i.e., the non-commercial loss) is treated for the purposes of the ITAA 1997 as though it:

(a) were not incurred in that income year; and

(b) were a deductible amount attributable to the next income year in which that business activity is carried on.

28. In determining whether Division 35 applies to the relevant business activity it is necessary to identify both the allowable deductions 'attributable' to the business activity and the assessable income 'from' the activity. The tests in Division 35 are applied to

[4] Our views on when a business of primary production is being carried on, for example, are set out in Taxation Ruling TR 97/11.

each relevant business activity. The 'deductible amounts attributable to the business activity', for the purposes of subsection 35-10(2), are those amounts which are deductible under the ITAA 1997, to the extent that they relate to the particular business activity. The relevant assessable income from the business activity is that income which is derived directly from, and has a causal relationship with, the business activity. Individuals conducting a business activity in partnership are able to aggregate their individual interests for the purposes of passing the tests (other than the profits test): refer below to paragraphs 97-104.

Deductions allowable before or after business carried on

29. Division 35 will only apply to otherwise allowable deductions that are attributable to the carrying on of a business activity (see subsections 35-5(2) and 35-10(1)). This means that typically they will be outgoings incurred in the course of carrying on the business activity in question. There may be amounts however, for example, those deductible under paragraph 8-1(1)(a), that are deductible even though they are incurred for a business purpose, but before the relevant business has commenced, or after it has ceased being carried on. These otherwise allowable deductions are not subject to Division 35.

Effect of passing the tests, satisfying an exception or an exercise of the Commissioner's discretion

30. If the relevant business activity passes at least one of the tests in the income year, the loss deferral rule in subsection 35-10(2) will not apply to the individual undertaking the activity in that income year. They will be able to offset the excess deductions against their other assessable income.

31. Where Division 35 does not apply and the excess deductions for the business activity for the income year (whether in combination with other deductions, or alone) are greater than the individual's other assessable income and any net exempt income, they will have a 'tax loss' under section 36-10. Deductibility of that tax loss in a later year will then be subject to Division 36.

Operation of the tests

Assessable income test

32. If the amount of assessable income derived by the individual from the relevant business activity for an income year is at least $20,000, 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 (paragraph 35-30(a)). Calculation of the assessable income from the activity can involve making a 'reasonable estimate' if the activity has not been carried on for the whole year (paragraph 35-30(b)).

Profits test

33. This test involves determining whether an activity has produced a tax profit in 3 out of the past 5 years. The 5 year period includes the current year in which the loss has arisen. If a tax profit has resulted from the relevant business activity in three out of the last five years, the rule in subsection 35-10(2) does not apply to the individual for that income year (subsection 35-35(1)).

Real property test

34. If the individual uses real property, or an interest in real property, on a continuing basis in the relevant business activity, that has a value of at least $500,000, 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 (subsection 35-40(1)). A holder of an interest in real property, such as a lessee, uses that interest, not the real property itself, for the purposes of section 35-40. Accordingly, the amount such a holder who is an individual and who uses their interest in carrying on their business activity on a continuing basis would use for the purposes of the section is the *reduced cost base or market value (if greater) of that interest, and not of the underlying real property.

35. For the purposes of this test, the following are not included:

- a *dwelling, and any adjacent land used in association with the dwelling that is used mainly for private purposes; and
- fixtures owned by an individual as a tenant (subsection 35-40(4)).

36. To value real property or interests in real property, the individual can choose the *reduced cost base or the market value of the property or interest in real property if that value is more than the *reduced cost base (subsection 35-40(2)). The meaning of *reduced cost base is the same as it is for capital gains tax ('CGT') purposes. This meaning is to be found in Subdivision 110-B.

37. *Dwelling has the same meaning in this test as it does for CGT purposes (refer to the definition in section 118-115).

38. An interest in real property includes a lease of real property.

Other assets test

39. If the individual uses certain other assets, on a continuing basis in the relevant business activity, that have a total value of at least $100,000, 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 (subsection 35-45(1)).

40. The assets and their values counted for this test are those set out in the following table in subsection 35-45(2):

Assets counted for this test and their values

Item	Asset	Value
1	An asset for which you can deduct an amount for depreciation	The *written down value of the asset
2	An item of *trading stock	Its value under subsection 70-45(1)
3	An asset that you lease from another entity	The sum of the amounts of the future lease payments for the asset to which you are irrevocably committed, less an appropriate amount to reflect any interest component for those lease payments
4	Trademarks, patents, copyrights and similar rights	Their *reduced cost base

41. The following assets are excluded under subsection 35-45(2) for the purposes of this test:

- real property, or interests in real property, that are taken into account for the real property test; and
- *cars (as defined in section 995-1), motorcycles and similar vehicles.

Apportionment

42. Where assets that have been taken into account for the real property or other assets tests are partly used in the relevant business activity and partly for some other purpose(s), only that part of their

value that is attributable to their use in the business activity for that year can be taken into account (section 35-50).

Business activity undertaken in partnership

43. Where the relevant business activity is carried on by an individual and one or more individuals or other entities, as partners in a general law partnership, only the interests of the individuals in the assessable income and assets of the partnership may be aggregated for the purposes of the assessable income test, real property test and other assets test (paragraphs 35-25(a) and (c)). In addition, assessable income derived and/or assets owned by an individual partner in their own right, outside of the partnership, can also be taken into account by that partner in considering these tests (paragraphs 35-25(b) and (d)). The interests of companies and trustees are ignored.

44. For the purposes of the profits test, the individual takes into account their share of the deductions and assessable income attributable to their interest in the partnership, along with any of their own assessable income and allowable deductions they may have from the same, or similar, business activity, outside of the partnership (subsection 35-35(2)).

Exercise of the Commissioner's discretion

45. Under subsection 35-55(1) the Commissioner may decide that the rule in section 35-10 is not to apply to a business activity for one or more income years if he is satisfied that it would be 'unreasonable' for the loss from the business activity not to be deductible against other income for that income year or years. This discretion is, however, only able to be exercised in two limited situations. These are 'special circumstances' and when the business activity has started to be carried on.

'Special circumstances'

46. Under paragraph 35-55(1)(a) the Commissioner's discretion may be exercised where there are 'special circumstances outside the control of the operators of the business' that have had an effect on the business activity and the individual's ability to pass the tests in Division 35 (see the 'Note' to paragraph 35-55(1)(a)). Examples of such special circumstances could include drought, flood, bushfire and other natural disasters. Generally, ordinary economic or market fluctuations that might reasonably be predicted to affect the business activity would not be considered to be special circumstances. However, unexpected economic or market fluctuations of a scale not previously encountered may qualify on a case by case basis.

Business activity started to be carried on

47. The Commissioner's discretion may also be exercised where the business activity has started to be carried on but, due to its nature, it has not yet met any of the tests. However, the Commissioner is not allowed to exercise the discretion unless the individual can show that there is a objective expectation, based on evidence from independent sources (if available) that, within a commercially viable period for the industry concerned, the activity will meet one of the tests or produce a tax profit (paragraph 35-55(1)(b)).

48. The requirement that there be a business activity being carried on means an individual must have started to carry on that business activity. This will broadly require that the individual has:

- made a decision to commence the business activity; and
- acquired the minimum level of 'business assets' to allow that business activity to be carried on; and
- actually have commenced 'business operations'.

A mere intention to start carrying on a business activity will not be sufficient.[5]

49. Under subsection 35-55(2) the Commissioner cannot exercise the discretion under paragraph 35-55(1)(b) after the time in which it is reasonable to expect, for example, based on available industry norms, that:

(i) the business activity would first produce assessable income greater than the deductions attributable to it in an income year (apart from the operation of subsection 35-10(2)); or

(ii) meet one of the tests set out in section 35-30, 35-35, 35-40 or 35-45.

Specific application to be made

50. In order to obtain advice about the operation of the Commissioner's discretion under subsection 35-55(1) an individual would ordinarily need to apply for a Private Ruling in the required format.

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[5] But note also paragraphs 148 to 150 concerning Product Rulings.

Application of Division 35 when a taxpayer has exempt income

51. Under section 35-15 a non-commercial loss deferred to the current year under paragraph 35-10(2)(b), or a current year non-commercial loss to be deferred under paragraph 35-10(2)(b) to a later year, may be reduced where the taxpayer has derived exempt income. Such losses will be reduced where any net exempt income derived in the current year is not fully offset against any Division 36 losses allowable for that year.

Application of Division 35 if a taxpayer becomes bankrupt

52. Under section 35-20, a non-commercial loss deferred under subsection 35-10(2) will be treated differently where a taxpayer becomes bankrupt, or is released from a debt by the operation of an Act relating to bankruptcy. A non-commercial loss incurred prior to bankruptcy that was deferred as a result of the rule will not be available for deduction in the current or any future year.

Explanations and Examples

53. Subsection 35-5(1) says 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 by individuals (alone or in partnership) being offset against other assessable income'.

54. Division 35 is not intended to apply to activities that do not constitute carrying on a business, for example, the receipt of income from passive investments (subsection 35-5(2)). The terms 'business' and 'passive investment' are used here in the sense of being mutually exclusive notions.

Primary Producer and Professional Artist exceptions

55. Subsection 35-10(4) contains an exception for *primary production businesses or *professional arts businesses that are carried on by certain individuals. The exception only applies where an individual who carries on a *primary production business or a *professional arts business has less than $40,000 of assessable income, excluding any income from their particular *primary production business or *professional arts business and any net capital gain, in the current year. If a taxpayer satisfies this exception, the loss deferral rule in subsection 35-10(2) does not apply in that year to any

loss from their relevant *primary production business or *professional arts business.[6]

56. These exceptions allow eligible individuals who carry on a *primary production business or *professional arts business to offset any loss (including any deferred amount) from their *primary production business or *professional arts business against other income in the current year. This is regardless of the amount of the business activity's income, assets, real property or profit, as the four tests are not relevant where an exception applies.

Example 1

57. Jessie is a teacher earning a salary of $34,000 a year and has no other non-primary production assessable income. In addition to teaching, Jessie carried on a business of alpaca farming and made a loss from this business activity of $5,000 in the current year. As Jessie's non-primary production income is less than $40,000, the exception is satisfied and she does not need to satisfy any of the tests in Division 35 in order to offset her primary production loss against her teaching income.

58. *Professional arts business is given a wide meaning in subsection 35-10(5) through use of the same concepts found in Division 405 concerning the averaging of incomes of authors, performing artists and production associates. Paragraph 35-10(5)(a) includes as a *professional arts business a business that an individual carries on as the author of a literary, dramatic, musical or artistic work. As noted under paragraph 35-10(5)(a), the term "author" is a technical term from copyright law. Apart from the author of a photograph, which is generally the person who took it, the *Copyright Act 1968* does not define what an author is.[7] Copyright law indicates that the author of a literary, dramatic, musical or artistic work will be the person who has "originated it or brought it into existence and has not copied it from another".[8]

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[6] Our views on whether or not you are carrying on a *primary production business are set out in Taxation Ruling TR 97/11. The indicators of whether or not you are carrying on a business of primary production are no different, in principle, from the indicators as to whether activities in any other area, such as professional arts, constitute the carrying on of a business (TR 97/11 para 11).

[7] Subsection 10(1) of the *Copyright Act 1968* defines the author of a photograph taken after 1 May 1969 as the person who took the photograph.

[8] Ricketson, *The Law of Intellectual Property,* (1984) at 83 as quoted by the High Court in *Data Access Corporation v. Powerflex Services Pty Ltd* [1999] HCA 49 at paragraph 22.

Limit on deductions from non-commercial business activities

59. Under Division 35, a loss from a business activity that is unable to be offset against other income in the year in which it arose is to be deferred until a future year where:

- one of the exceptions in subsection 35-10(4) applies;
- income from the same or a similar activity is available;
- one of the tests of Division 35 is satisfied; or
- the Commissioner's discretion is exercised.

60. Section 35-10 applies on a year-by-year basis to each separate business activity that is carried on by an individual, whether on their own or in partnership with another individual or other entity or entities. There are four tests in Division 35:

- the assessable income test;
- the profits test;
- the real property test; and
- the other assets test.

61. These tests determine the taxation treatment for the net loss from a business activity. If there is no business activity then Division 35 does not apply. Where the loss is from a business activity that does not satisfy any of the test or exceptions of Division 35, the individual carrying on the activity will be unable to claim the loss from the activity as a deduction against other income in that year.

What is the business activity?

62. Division 35 applies only to business activities and individuals. A business activity can consist of more than one activity. However, where all the activities have similar characteristics and are not discrete in character and in the manner in which they are conducted, they will be considered to be part of the one business activity for the purposes of Division 35.

63. In determining the relevant business activity it is necessary to establish the complete business of the individual. The business activity is not to be divided into various components unless there is, for the purposes of Division 35, a sufficient degree of separateness about them (refer to paragraphs 8 to 26). The whole business is to be examined. To decide whether the components of a business equate to one or more separate business activities the following matters may be relevant:

- the assets employed;

- the nature of the business operations involved;
- the goods or services produced;
- the economic and other relevant characteristics of the market(s) for those goods and services;
- the methods of funding the business operations;
- any links between the activities;
- the time spent on the activities;
- the location of the activities;
- the nature of expenses attributable to each activity; and
- any laws, regulations or professional associations that may apply to each activity.

64. An individual's business will not need to be split into separate business activities where all those activities are interlinked, and support each other in a genuine commercial way.

Example 2

65. Bill runs a flower shop which has operated profitably for some time. His business operations include selling a range of products, other than flowers, such as fine china and various novelty items. His business expenses relate equally to all these operations and there was, until recently, no aspect of his business that would suggest any part of it was discrete or separate from the rest.

66. In the last six months he has begun operating a delivery service in order to expand his client base and compete with other sellers. Although a separate fee is charged for the delivery service, looked at as a separate activity, it is not profitable in its own right.

67. However, there is a clear commercial purpose behind operating the delivery service, and it has now become an integral feature of Bill's overall business. There would be no cause to say Bill's delivery service activity is a separate 'business activity' for the purposes of Division 35, even though it is being, when looked at as a separate activity, carried on at a loss.

68. Bill also advertises in his shop that he tells fortunes after hours, by making visits to clients' homes. This activity is also conducted as a business for the purpose of making a profit but travel expenses have meant that it has made losses in some years. It is not part of Bill's flower shop business nor is it a business activity 'of a similar kind' to that business. It is a separate business activity and would have to be accounted for as such under Division 35.

Example 3

69. *Case D26* 72 ATC 158 is an example of an individual taxpayer being involved in carrying on two separate businesses. The taxpayer in partnership with another carried on a business of wheat growing. The partnership purchased a new wheat header, which, in addition to being used to harvest the partnership's wheat, was also used by the partners in carrying out some contract harvesting on land owned by other farmers. All members of the Number 3 Board of Review agreed that while undoubtedly carrying on a business of primary production, the partnership also carried on a separate and distinct business of contract harvesting.

70. Mr Dubout (Chairman) based his conclusion on this point on the fact that the character of the income derived from a contract to provide and operate farm machinery on the land of another was different in character from the income derived from the produce of the land the partnership farmed. He also placed weight on the fact that, as he saw it, '… the element of risk in the two cases is entirely different' (ATC at 160).

Similar activity

71. Subsection 35-10(3) allows business activities to be grouped for the purposes of Division 35 where they are activities 'of a similar kind'. A similar activity may be one that has evolved from the first business activity, or it may simply be another business activity carried on in the same year, that fits the description of being 'similar'. Business activities which are of a similar kind are those which inherently have the same nature or character. The activities must be similar. They do not need to be identical (*Goodfellow*). The term 'similar' involves 'a near identity, a close correspondence, a resemblance in many, but not all respects' (*Galcif Pty Ltd v. Dudley's Corner Pty Ltd & Ors* (1995) 6 BPR 14,134).

72. Identification of the relevant *business activity for the purposes of Division 35 will always need to occur having regard to the possible operation of subsection 35-10(3). In other words, there will be no practical effect achieved in splitting an individual's business up into two or more separate business activities if under subsection 35-10(3) they can be combined back together because they are 'of a similar kind'. However, where an individual does identify that their business is in fact made up of more than one business activity, they may choose not to group those activities under subsection 35-10(3) if it would not be to their advantage to do so.

The loss deferral mechanism

73. Where none of the four tests is satisfied, neither exception is satisfied and the Commissioner does not exercise the discretion in section 35-55, the rule in subsection 35-10(2) applies. Subsection 35-10(2) contains the loss deferral mechanism of Division 35. Under this provision, for a particular income year where 'the amounts attributable to the business activity for that income year' exceed 'the assessable income from the business activity for that year,' then the excess is treated as though it 'were not incurred in that income year'.

74. Instead, the excess is treated as an amount attributable to that activity that the individual could deduct for the next income year in which the activity is carried on. The amounts attributable to the business activity are those that the individual could, apart from Division 35, deduct under the Act for that income year. They do not include a 'tax loss' (as that term is used in Division 36) that might be deductible in that year, but has arisen in respect of carrying on operations in a previous year.

Example 4

75. The operation of subsection 35-10(2) is illustrated by the following example.

Assume the following figures for Michelle's pearl farming business activity where none of the exceptions apply to her:

Year	Assessable Income (1)	Allowable Deductions (2)	Deferred Deduction from previous year	Net (1) – (2)	Deferred Deduction for current year
1	$4,000	$5,000	$0	($1,000)	$1,000
2	$4,000	$5,500	$1,000	($1,500)	$2,500
3	$6,000	$5,000	$2,500	$1,000	$1,500

76. In each year none of the tests of Division 35 is passed. Therefore subsection 35-10(2) is applied. The excess is deemed not to be deductible in the current income year. It is deemed to be a deductible amount attributable to the activity for the next income year in which that activity is carried on and, thus, potentially subject to Division 35 in that year.

77. Subsection 35-10(2) will continue to operate in this manner until one of the tests of Division 35 is met, or the Commissioner's discretion is exercised. If any of the tests had been met in Year 3 in the above example, the $1,500 would have been deductible in full in that year.

Assessable income test

78. The rule in subsection 35-10(2) does not apply to defer a loss incurred by the individual from a business activity for an income year if:

(a) the amount of assessable income derived by the individual from the business activity for the year; or

(b) if the individual, during the year, started to carry on the business activity, or stopped carrying it on – a reasonable estimate of what would have been the amount of that assessable income if the individual had carried on that activity throughout the year

is at least $20,000 (section 35-30).

79. Assessable income is defined in section 995-1 of the ITAA 1997. The meaning of 'assessable income' here is the same as elsewhere in the Act. It includes statutory income as well as ordinary income (see generally, Division 6 of the ITAA 1997) provided that such income can properly be said to have been derived 'from' the relevant business activity. Note that, where relevant, it will not include a Goods and Services Tax ('GST') component: see, for example, section 17-5 of the ITAA 1997.

Reasonable estimate

80. For the purposes of making a 'reasonable estimate' under paragraph 35-30(b), an individual can consider all relevant factors, including:

(a) the cyclical nature of the particular business activity which may result in variations in the pattern of receipts;

(b) any orders received and/or forward contracts entered into;

(c) the amount that could have been derived for a full income year based on a pro rata calculation of the assessable income already derived for the part of the year. The amount derived for the part of the year must be typical of the income derived in a full year;

(d) the type of business activity undertaken, considering the nature and type of income receipts of similar activities typical of the industry; and

(e) current size and investment in the activity.

Profits test

81. The rule in subsection 35-10(2) does not apply to defer a loss incurred by the individual from a business activity for an income year if assessable income from the relevant business activity is in excess of the sum of the deductions attributable to that activity in three out of the past five years, including the current year (subsection 35-35(1)). The sum of the deductions for the income year, however, does not include any deferred loss from the activity brought forward from an earlier year. Initially this test will require the taxpayer to look at years before the commencement of Division 35. However, it is not a requirement that the business activity be carried on for 5 years. If there is a profit in 3 out of 4 years that will be sufficient to satisfy the requirements of the test.

Example 5

82. For the purposes of the example below, assume the profit or loss in each year is from the same or a similar activity and the activity is regarded as a business for taxation purposes but does not satisfy the assessable income test, the real property test or the other assets test. Also, assume that none of the exceptions in subsection 35-10(4) apply.

Yr	Profit or loss from activity	Other income	Taxable income	Cumulative loss deferred
1	Loss $10,000	$50,000	$50,000 Note 1	$10,0
2	Profit $2,000	$50,000	$50,000 Note 2	$ 8,0
3	Profit $5,000	$50,000	$50,000 Note 3	$ 3,0
4	Loss $10,000	$50,000	$50,000 Note 4	$13,0
5	Profit $5,000	$50,000	$42,000 Note 5	$

Notes:

(i) Year 1 - loss deferral rule applies, loss deferred to next year activity is carried on. Loss from Year 1 to be held over.

(ii) Year 2 - the deferred loss from Year 1 can only be offset against the profit from the activity in Year 2 (paragraph 35-10(2)(b)). Balance of loss deemed to be deduction attributable to activity in the next year it is carried on.

(iii) Year 3 – deferred loss from Year 2 offset to the extent of Year 3 profit (paragraph 35-10(2)(b)), balance deemed attributable deduction for activity in next year carried on.

(iv) Year 4 - loss deferral rule applies.

(v) Year 5 - The activity has made profits in three out of the past five years, including the current year. It has passed the profits test. Deferred loss can now be offset against other income in full.

Real property test

83. The rule in subsection 35-10(2) does not apply to defer a loss incurred by the individual from a business activity for an income year if the individual uses, on a continuing basis, real property, or an interest in real property, of at least $500,000 in the activity in that year (subsection 35-40(1)).

84. Real property includes land, or interests in land, and any structures, including buildings, fixed to the land which are used on a continuing basis in the business activity. For the purposes of this test the following are not included:

- a *dwelling, and any adjacent land used in association with the dwelling, that is used mainly for private purposes; and
- fixtures owned by an individual as a tenant[9] (subsection 35-40(4)).

*Dwelling has the same meaning in this test as it does for CGT purposes (refer to the definition in section 118-115).

85. To value real property or interests in real property the individual can choose the *reduced cost base or market value of the property, or the interest in the property, if that market value is more than the *reduced cost base (subsection 35-40(2)). *Reduced cost base has the same meaning in this test as it does for CGT purposes (refer to the rules in Subdivision 110-B). A holder of an interest in real property, such as a lessee, uses that interest, not the real property itself, for the purposes of section 35-40. Accordingly, the amount

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[9] A lessee will be treated as continuing to be the owner of an asset which the lessee has affixed to the lessor's land where:
a) the law of the relevant State or Territory provides for the ownership of the asset to remain with the lessee; or
b) the lessee is regarded as being the owner of the asset within the terms of Taxation Ruling IT 175.
See Taxation Determination TD 46.

such a holder who is an individual and who uses their interest in carrying on their business activity on a continuing basis would use, for the purposes of the section is the *reduced cost base or market value (if greater) of that interest and not of the underlying real property.

86. An interest in real property includes a lease of real property. An individual's interest in real property that they lease is their right to use or occupy the property. The market value of such an interest, i.e., a leasehold interest, to be taken into account for the real property test must be arrived at using a reasonable process. The *reduced cost base of a leasehold interest to be taken into account for the real property test is the same for Division 35 purposes as it is for CGT purposes. It would include such expenditure as any lease premium paid.

Other assets test

87. This test requires that the assets used in the business activity on a continuing basis have a minimum value of $100,000. The value of other assets is the value of the asset specified in the table in subsection 35-45(2) (see paragraph 39 above).

88. The table in subsection 35-45(2) specifies the value for different classes of assets. For example, the tax value of an asset for which an individual can deduct an amount for depreciation is its written down value at the date its value is determined. If an item of machinery has been depreciated to nil, the value to be taken into account for the purposes of this test will also be nil.

Common principles for the real property test and the other assets test

When is an asset's value determined?

89. The *reduced cost bases, market values or other prescribed values of the relevant assets are worked out:

- as at the end of the income year (paragraphs 35-40(3)(a) and 35-45(3)(a)); or
- if an individual stops carrying on the business activity during the year:
  - (i) as at the time the individual stops (subparagraphs 35-40(3)(b)(i) and 35-45(3)(b)(i)); or
  - (ii) if the individual disposed of the asset before that time in the course of stopping carrying on the activity – as at the time the individual disposed

of it (subparagraphs 35-40(3)(b)(ii) and 35-45(3)(b)(ii)).

What is continuing use in the business activity?

90. The use of assets required for the purposes of the two assets tests must be something more than 'transient or insubstantial use' (see *FC of T v. Stewart* 84 ATC 4146; (1984) 15 ATR 387). This is evident also from the requirement in both sections 35-40 and 35-45 that the use of the assets in question must be on a 'continuing basis'. 'Continuing' is not defined for the purposes of Division 35 and therefore takes its ordinary meaning. Whether an asset is used on a continuing basis in the business activity will depend on the circumstances of each case.

91. However, we consider 'continuing' does not cover the following or similar circumstances:

(a) the asset is used on a short-term basis for a specific task or for a one-off activity; or

(b) the asset is acquired under an agreement for taking a unit of property on hire where the agreement is of a kind ordinarily entered into by persons taking property on hire intermittently as the occasion requires on an hourly, daily, weekly, monthly or other short-term basis.[10]

Leased assets

92. The value of leased assets used on a continuing basis in the relevant business activity can be taken into account for both assets tests.

93. The value for the purposes of the real property test is either the *reduced cost base, as determined under Subdivision 110-B, or the market value, of the leasehold interest. For the purposes of the other assets test, the value of the lease is the future lease payments to which the individual is irrevocably committed, less an appropriate amount to reflect any interest component (Item 3, subsection 35-45(2)).

Apportioning assets

94. If an asset is used during an income year partly in carrying on the relevant business activity and partly for other purposes, only that part of its *reduced cost base, market value or other prescribed value

[10] see, e.g., subsection 42-345(3) and the meaning of short-term hiring agreement.

that is attributable to its use in carrying on the business activity in that year is taken into account for either the real property test or the other assets test, whichever is applicable (section 35-50).

Example 6

95. Ron operates as a sole trader. He runs a 4WD driving school on his 40 hectare property. On the same property he also grows dahlias for sale and exhibition. The property also contains his residence and surrounding land he uses for private purposes.

96. The two business activities are not similar activities. The value of the real property and other assets must be apportioned between each business activity and the private use of the property. The value of the dwelling should be excluded before any apportionment exercise is undertaken under section 35-50.

Business activity conducted by individuals in partnership

Assessable income test, real property test and other assets test

97. The assessable income and the two assets tests apply to the business activity of the individual. Where that business activity is carried on in partnership with others, special rules apply. Where the relevant business activity is carried on by an individual and one or more individuals or other entities, as partners at general law, only that part which is attributable to the interests of the individuals in the partnership is taken into account for the purpose of the assessable income test, real property test and other assets test (refer paragraphs 35-25(a) and (c)).

98. In addition, assessable income derived and/or assets owned by an individual partner in their own right, outside of the partnership, can also be taken into account by that partner in considering these tests (paragraphs 35-25(b) and (d)).

Example 7

99. Two sisters, Erin and, Katie, and their family trust, the EK Trust, are partners in a chocolate manufacturing business. The partnership owns a number of 'other assets' which have a written down value of $135,000 and which are used on a continuing basis in the business. Each partner has an equal share in these partnership assets. Erin also owns an item of plant which has a written down value of $15,000. She allows the partnership to use the item of plant in its business activity on a continuing basis. However, at no stage does Erin's asset become a partnership asset.

100. In determining whether Erin satisfies the other assets tests, she can take into account the value of other assets attributable to only the individuals of the partnership, that is, $90,000 (2/3 of $135,000). She can also take into account the value of the plant she owns and allows the partnership to use, that is, $15,000. The total value of other assets that Erin can take into account for the test is therefore $105,000. Erin's business activity satisfies the other assets test threshold of $100,000.

101. Katie cannot include the value of Erin's plant for the purposes of the other assets test. This is because it is not an asset that is either attributable to her, or to an individual's interest in the partnership assets. (The item of plant is not a partnership asset, and so cannot be attributable to the interest of the individuals in the partnership.) The value of other assets attributable to Katie is $90,000 (2/3 of $135,000).

102. Katie (or Erin) cannot count the one-third interest of their family trust for the purpose of any of the tests.

103. Katie's business activity does not satisfy the other assets test. She will need to consider one of the other tests. If her business activity does not satisfy one of the other tests, where it would be unreasonable for the loss deferral rule in subsection 35-10(2) to apply, she could ask the Commissioner to exercise the discretion under subsection 35-55(1).

Profits test

104. For the purposes of the profits test, the individual takes into account their share of the deductions and assessable income attributable to their interest in the partnership, along with their own assessable income and allowable deductions they have in respect of the business activity, or a similar business activity, outside of the partnership (subsection 35-35(2)).

Example 8

105. Bob and Brendan are partners in a general law partnership and they each receive a $2,000 distribution from it. Bob has no other attributable expenses and the result for him is a profit from the business activity for the income year.

106. Brendan took out a loan to fund his contribution to the partnership on which he pays interest of $5,000 during the year. Brendan's $5,000 interest expense is attributable to his interest in the partnership net income. Brendan's deductions that are attributable to the activity ($5,000) exceed the income he derived from it ($2,000). Brendan has a loss for the income year from the activity. If this

pattern of income and attributable expenses continued in three out of five years, Bob's business activity would pass the profits test and Brendan's would fail.

All tests

107. Determination of the existence, or otherwise, of a partnership at general law will be determined in accordance with current case law. Taxation Ruling TR 94/8 outlines the factors we will consider in deciding whether persons are carrying on a business as partners.

108. If the arrangement between the parties is not as partners at general law, the interest of the individuals must be taken into account separately and assessed independently against all of the tests.

Commissioner's discretion- 2 arms

109. The Commissioner's discretion in section 35-55 is designed to apply where it is '**unreasonable'** for the loss not to be offset against other income for that income year because there are either:

(a) 'special circumstances'; or

(b) the business activity has started to be carried on and:

(i) due to its nature it has not met one of the four tests; and

(ii) there is an objective expectation, based on evidence from independent sources (if available), that the activity will produce a tax profit or meet one of the tests within a commercially viable period for that industry.

Special circumstances outside the control of the operators of the business

110. Where special circumstances can be demonstrated that would make it unreasonable not to allow deduction of the loss in the year it arose, the Commissioner will have the authority to allow this deduction against other income. Under paragraph 35-55(1)(a) this authority can be exercised where the business activity is affected by special circumstances outside the control of the operators of the business.

111. The types of 'special circumstances' in paragraph 35-55(1)(a) that might be circumstances outside the control of the operators of the business include natural disasters that materially affect the business operations. Examples are:

- drought;
- flood;
- bushfire;

or other natural disasters such as

- earthquakes;
- diseases which destroy livestock or crops;
- a pest plague; or
- hailstorm.

112. The use of the word 'including' in the legislation expands the scope of the test to special circumstances beyond natural disasters that materially affect the business operations. Other 'special circumstances' that are likely to attract the exercise of the Commissioner's discretion include material effects produced on a business activity by events such as:

- an oil spill;
- a gas plant explosion;
- a power plant shutdown; or
- a water authority malfunction.

113. Generally, ordinary economic or market fluctuations that might reasonably be predicted to affect the business activity would not be considered to be special circumstances. However, unexpected economic or market fluctuations of a scale not previously encountered, may qualify on a case by case basis. This is in keeping with the normal meaning of 'special circumstances' being ones that are out of the ordinary or normal course of business (see *Secretary, Department of Employment, Education and Training & Youth Affairs v. Barrett & Anor* (1998) 52 ALD 499; (1998) 82 FLR 524).

Example 9

114. Simon's farming business activity has been severely affected by drought. However, he has made a profit in two out of the last five years. Simon obtained employment with the local council so that he can support his family until such time as he can again generate sufficient income from his farm. Simon wants to offset his primary production loss against his employment income. However, his employment income exceeds $40,000, so he cannot bring himself within the primary producer exception in subsection 35-10(4). He applies to the Commissioner to have the discretion under paragraph 35-55(1)(a) exercised in his favour. His business activity does not satisfy any of the other tests in Division 35 in this year.

115. In view of the following:

- Simon has been conducting a profitable *primary production business for a number of years;
- his business activity has been affected by drought which has caused a reduction in the income from this activity such that it is unable to satisfy one of the tests;

the discretion would be applied to allow Simon to offset his primary production loss against his employment income for the year in question.

Business activity started to be carried on

116. The exercise of the discretion in paragraph 35-55(1)(b) is aimed at assisting individuals trying to start up small businesses, particularly those with long lead times such as many *primary production businesses. It is not intended that they be affected by the rule in subsection 35-10(2) where they can demonstrate the activity has started to be carried on and is on the path to becoming commercially viable. Commercially viable means, for the purposes of Division 35, that the business activity will grow to a size and scale that will make it viable and profitable, specifically that it will, within a time that is common for the industry concerned, eventually meet one of the tests, or produce a tax profit. Under subsection 35-55(2) the Commissioner will not be able to exercise this arm of the discretion after either the time at which it would be reasonable to expect the activity to:

(a) first produce a tax profit; or

(b) meet one of the four tests.

Whether activity started to be carried on

117. The question of when a business activity starts to be carried on is one that usually arises in relation to the deductibility of expenses incurred in the establishment of the business activity. The actual date of commencement of the business is a question of fact (see *Goodman Fielder Wattie Ltd v. FC of T* 91 ATC 4438 at 4446; (1991) 22 ATR 26 at 35).

118. For a business activity to have commenced a person will have had to:

- made a decision to commence the business activity;
- acquired the minimum level of 'business assets' to allow that business activity to be carried on; and

- actually have commenced 'business operations'.

119. We believe that when a business activity commences is like the question of whether a business is being carried on at all and depends on the 'large or general impression gained' (*Martin v. FC of T* (1953) 90 CLR 470 at 474; 5 AITR 548 at 551).

Decision to commence

120. The chain of events leading to the commencement or start-up of a business activity often begins with the a mere intention to establish the business activity. This is developed by researching the proposed business and, in some instances, by experiment. This process culminates in a final decision on whether to commence business. This process will be an indicator of whether a business has commenced. Not all businesses commence in such an orderly fashion of course.

121. The intention and purpose of the taxpayer in engaging in the activity is relevant to when a business commences. However, a mere intention to commence a business activity is not enough: *Goodman Fielder Wattie*. The taxpayer must have more than an intention to commence business. There must be activity. In *Esso Australia Resources Ltd v. FC of T* 97 ATC 4371 at 4382; (1997) 36 ATR 65 at 77-78 Sundberg J stated:

> 'While the taxpayer may have had the intention ultimately to engage in production, that is not sufficient in itself to constitute a business activity.'

He went on to say that 'commitment' was missing. See also Brennan J in *Inglis v. FC of T* 80 ATC 4001 at 4004-4005; (1979) 10 ATR 493 at 496-497.

122. *Whitfords Beach Pty Ltd v. FC of T* 83 ATC 4277; (1983) 14 ATR 247 is one of the few cases that has examined the issue of the commencement of a business activity and the factors to consider when determining the commencement of a business activity. These factors were a consideration of the taxpayer's purpose and the taxpayer's activities. Bowen CJ, Morling and Fitzgerald JJ said, at ATC 4282; ATR 253:

> 'Of course it does not follow that all the activities engaged in by the taxpayer were necessarily in the course of that business or that some of them were not merely preparatory to it. In order to determine when the taxpayer's relevant business commenced and when its land or the various parts of it were **committed** to or ventured in that business, **it is necessary to have regard both to the taxpayer's purposes and to its activities.**' (emphasis added)

Business structure

123. Most business activities have a structure which provides the framework of the business, or their 'profit yielding subject'. It is usually a collection of capital assets. What the particular capital assets are will depend on the particular business activity. In *Calkin v. CIR* [1984] 1 NZLR 440 Richardson J said at 446-447:

> 'Clearly it is not sufficient that the taxpayer has made a commitment to engage in business: **he must first establish a profit-making structure and begin ordinary business operations**.' (emphasis added)

124. For a business activity to commence, an appropriate business structure should be in place. As to what this structure will consist of, and its size, this will be a question of fact and degree, and depend on the nature of the business activity. A suitable structure might even be established by the execution of certain documents, where independent contractors with the necessary capital assets, are engaged. Even though the taxpayer may have no physical assets themselves, their rights as against the independent contractor secure use of such assets, and those rights can properly be said to be capital assets in the taxpayer's hands. However, each case will need to be determined on its own facts and having regard to industry norms.

Business operations

125. As noted already from Inglis, the level of activity is important. We believe the extent of activity will also determine whether a business activity has commenced and is in its start-up phase. Activity will support the taxpayer's intention to commence a business activity and their decision to do so. Brennan J in Inglis made it clear that there must be activity when he said at ATC 4004-4005; ATR 496-497:

> 'The carrying on of a business is not a matter merely of intention. It is **a matter of activity**. Yet the degree of activity which is requisite to the carrying on of a business varies according to the circumstances in which the supposed business is being conducted. Little activity may suffice for carrying on a business which does not call for much activity, as in *Thomas* and in *Ferguson*. ... **At the end of the day, the extent of activity determines whether the business is being carried on. That is a question of fact and degree.**' (emphasis added)

The level of activity that is required will clearly vary from case to case. Based on the decision in *Calkin* we think two different types of activity are relevant:

- acquisition of the minimum level of 'business assets'; and
- the commencement of 'business operations'.

We believe both are necessary to be able to conclude that a business has commenced.

126. We think that the most useful description though of 'business operations' is that akin to the description used by Windeyer J in *Southern Estates Pty Ltd v. FC of T* [1966-1967] 117 CLR 481; 41 ALJR 270. That is, business operations can include both revenue and capital type activity, but the fundamental purpose of such activity is to give direct effect to commencing the activities directed to an end of deriving profit.

Objective expectation of becoming commercially viable

127. A business activity will be regarded as being on the way to becoming commercially viable, as that term is used in Division 35, where there is an objective expectation, based on available evidence from independent sources, that, within a commercially viable period for the industry concerned, the activity will:

(i) produce a tax profit, or

(ii) meet one of the tests in sections 35-30, 35-35, 35-40 or 35-45 (refer subsection 35-55(2)).

128. The essence of such an activity is that it is carried on for commercial reasons and in a commercially viable manner with the dominant purpose being one of profit. The taxpayer's primary reason for engaging in the business activity must be a commercial one. It should not be to pursue a hobby, recreation or a particular lifestyle.

129. Division 35 imposes a test for the exercise of this arm of the Commissioner's discretion. In order to establish that the taxpayer is pursuing an activity that is commercially viable, the taxpayer will typically need to collect evidence from independent sources showing that the activity will either produce a tax profit or meet one of the tests within the period that this would normally occur in for the industry concerned. Appropriate independent sources include government agencies, an industry body or professional association or a taxpayer with a similar, successful business activity. The evidence collected should concern the nature and extent of the investment required to establish a viable and profitable activity, with specific relevance to growing the activity so that it will eventually produce a tax profit or meet one of the tests. A Business Plan could provide useful evidence where it has been prepared on the basis of this independent evidence and is accompanied by that material.

130. In determining whether to exercise the discretion the Commissioner may have regard to any information provided by the taxpayer or any other information that is available, and relevant to the business activity in question.

Latest time for the exercise of the Commissioner's discretion

131. Under subsection 35-55(2) the Commissioner's discretion will not be exercised after the earlier of the time when it would be reasonable to expect that the activity:

(a) will make a profit; or

(b) will meet one of the four tests set out in section 35-30, 35-35, 35-40 or 35-45.

Example 10

132. Fiona and Dene are both salary and wage earners who each derive a salary in excess of $80,000 per annum. They wish to retire to the country life in approximately 10 years and plan to live off the profits of an olive grove. Fiona and Dene conduct extensive research and purchase a suitable property in rural New South Wales. The property costs $150,000. They borrow $100,000. They plant 500 olive trees which are of two varieties. One variety will give good table olives and the other will produce good quality olive oil. It will be seven years before the olive grove will return any income and approximately 10 years before the crop is considered 'commercial'. This conclusion is based on information received from industry experts. They do not plan to reside on the olive grove property until they retire. They will travel to the property on weekends to undertake maintenance of the trees, etc. They also will hire someone to look after the watering of the trees in times when they cannot do this. During the seven years from the date the olive trees are planted until such time as the first income is produced, Fiona and Dene expect to incur expenses of:

- Interest on the loan used to purchase the property;
- Cost of trees;
- Irrigation equipment;
- Fertilisers & pesticides; and
- Labour costs.

The evidence submitted by them shows a strong likelihood that from the eighth year their income from the activity will begin to exceed their expenses.

133. The discretion would be exercised to allow Fiona and Dene to offset their losses from their olive grove against their salary income for the first seven years of operation in view of the following:

- the conclusion is reached that their olive growing operation will constitute the carrying on of a business and it is accepted that in the olive industry there is considerable lead- time before income will exceed expenses;
- there is sufficient independent evidence that eventually their income from the activity will exceed attributable expenses and Fiona and Dene have been able to show a plan of how and when this would be achieved;
- they can show that their activity is on the path to becoming viable and profitable and is still within the time provided for under subsection 35-55(2).

Examples where discretion would not be exercised

Example 11

134. Emma is an architect who has purchased a 20 hectare property just outside of Cairns, where she works in her own business. Emma loves the farm which she works on in her spare time. However, when the architectural firm is busy Emma is not able to devote very much time to working on the farm. Emma is a hay grower and in one year she did not cut the hay for sale because she did not have the time. Emma has claimed a loss from hay production for a number of years. Each year this loss has been deferred under Division 35.

135. In the current year Emma's hay is affected by disease and is not saleable as it could adversely affect any animals which eat it. Emma's income from the hay growing for the current year is nil. She has some expenses from the hay production activities. However, she is unable to provide sufficient evidence that her hay producing activity will ever be conducted on a scale that would make it commercially viable, or in a way that would make it profitable. She is also not able to show that her business activity would have satisfied one of the tests were it not for the disease affecting the hay.

136. In view of the following:

- Emma has made continual losses from the hay growing activity;
- the disease to the crop is not the major factor contributing to the losses from hay production; and
- it is unlikely the activity will ever be profitable;

the discretion would not be exercised to allow the current year loss.

Example 12

137. Maria is a direct seller. She has been engaged in the activity of direct selling for approximately 10 years. Maria has sold goods for three different Direct Selling Organisations in those 10 years. In all years Maria's assessable income has been less than $20,000 from direct selling activities and in all years she has returned a loss from this activity. Maria is injured in her teaching employment and is hospitalised for 4 months of the year. Maria wants the Commissioner to exercise the discretion to allow her to offset her Direct Selling loss against her other income for the year.

138. In view of the following:

- the fact that Maria cannot show that if it had not been for her illness, the assessable income or the profits test would have been satisfied, particularly having regard to:
- the history of losses made; and
- the length of time Maria has carried on the activity and failed to make a profit for Division 35 purposes,

the discretion would not be exercised in her favour.

Example 13

139. Neil is a keen fisherman. He prides himself on his expert knowledge and has a wealth of fishing experience. Neil has recently retired from full time employment and has decided to write his second book about fishing. His first book was a short one on which he barely made any income. Neil spends some time doing some research about the manner in which books could be published. He writes to a number of publishers about his proposed project. Some publishers have told him that unless he is a well known author, his book will not be published as the prospects of selling the book are not good. All publishers will not publish unless he pays the publishing costs himself. This will also apply to any reprints. Neil spends about 5 hours a week on his book. He and his wife go on a holiday during the year, a large amount of which Neil spends fishing. Neil wishes to claim expenses from the early stages of the book development against his pension and investment income. Neil believes the Commissioner should exercise that arm of the discretion in paragraph 35-55(1)(b), as his writing activity is still in its start-up phase.

140. The discretion is unlikely to be exercised in Neil's favour. There is a threshold question about whether his writing does constitute

the carrying on of a business activity. Assuming that it does, Neil is unlikely to satisfy the Commissioner that he should be satisfied that the loss deferral rule should not apply. This is because he has not shown that in any time period his activity is likely to satisfy any of the tests, or produce a tax profit. If Neil were carrying on a *professional arts business however, and his assessable income (excluding any net capital gain) from sources not related to that activity was less than $40,000, then, under subsection 35-10(4), Division 35 would not apply to any loss from that activity.

Application of Division 35 when a taxpayer has exempt income

141. The application of section 35-10 may be modified if in the current year the taxpayer derived exempt income. This modification was inserted to ensure that losses deferred under Division 35 are treated similarly to those under Division 36.

142. A current year non-commercial loss to be deferred under paragraph 35-10(2)(b) may be reduced if the taxpayer derived exempt income. This non-commercial loss must be reduced by any amount of net exempt income derived in the current year that has not already been used to offset any Division 36 tax losses, before being able to be deferred under paragraph 35-10(2)(b). If the total current year non-commercial loss is fully offset by the taxpayer's exempt income, no amount will be deferred.

Example 14

143. Besides her part time office job Heather has a driving school business. In the current year Heather has a non-commercial loss of $10,000 from her driving school business activity, and derived exempt income of $2,000. Heather has no tax losses under Division 36. The non-commercial loss deferred under paragraph 35-10(2)(b) to Heather's next year of business is $8,000 ($10,000 - $2,000).

144. If the taxpayer has a deferred non-commercial loss and satisfies one of the four tests, the Commissioner's discretion, or the primary producer or professional artist exceptions, the deferred non-commercial loss, plus any current year loss, can be offset against the taxpayer's other assessable income. This is so whether the taxpayer has derived any net exempt income or not.

Application of Division 35 if a taxpayer becomes bankrupt

145. Section 35-20 modifies the operation of the non-commercial loss deferral rule contained in subsection 35-10(2) in certain circumstances relating to bankruptcy. The non-commercial loss

deferral rule is modified in accordance with subsection 35-20(3) where:

- a taxpayer becomes bankrupt or is released from bankruptcy in the current income year (subsection 35-20(1)); or
- in that year their bankruptcy is annulled under section 74 of the *Bankruptcy Act 1966* by a release from debt under a composition or scheme of arrangement accepted by their creditors (subsection 35-20(2)).

146. The effect of subsection 35-20(3) is that a non-commercial loss incurred by the taxpayer prior to any one of the above events, and deferred under the loss deferral rule, will not be deemed to be attributable to the business activity. The deferred loss will not be available to be deducted in that year or any subsequent year.

Example 15

147. In Year 1 Rhonda has a $2,000 non-commercial loss from a business activity. The rule in subsection 35-10(2) defers that loss and deems it to be attributable to that activity in the next year it is carried on. Normally, if in Year 2 Rhonda's business activity makes a profit of $4,000, her Year 1 non-commercial loss would be deductible against her Year 2 profit. However, if she is declared bankrupt in Year 2, her loss from Year 1 will no longer be available for deduction in Year 2 or in any subsequent year.

Product Ruling Arrangements

148. Division 35 is likely to be relevant to many business activities that are the subject of an application for a Product Ruling[11]. This will be where the objective tests are not expected to be satisfied for the business activity in question, and none of the exceptions apply. The applicant for the Product Ruling may therefore request that the discretion in section 35-55 be ruled on for the relevant year(s).[12]

149. Most, if not all, Product Ruling applications, however, are expected to be accompanied by independent evidence addressing the commercial viability and profitability of the relevant business activity. Provided this evidence satisfies the requirements of paragraph 35-55(1)(b), and the year(s) to be ruled on fall within subsection 35-55(2), the discretion will most likely be favourably exercised in

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[11] Product Ruling PR 1999/95 explains the operation of the Product Ruling system.

[12] Product Rulings are given for a period not exceeding three years from the end of the income year in which the Product Ruling is made, unless exceptional circumstances exist (see paragraph 6, PR 1999/95).

such cases. The rule in subsection 35-10(2) will therefore not apply to defer the offset of any loss from the activity against other income where the arrangement actually carried out does not differ materially from that described in the Product Ruling.

150. However, this Ruling can only provide a guide to how the discretion is to be exercised. It cannot operate as a substitute for the actual exercise of the discretion for particular cases. That has to occur having regard to the specific facts of each case.

Detailed contents list

151. Below is a detailed contents list for this draft Ruling:

Your comments

152. If you wish to comment on this Draft Ruling, please send your comments by: **28 February 2001** to:

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Commissioner of Taxation
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Subject references:

- commencement of business

Legislative references:

- ITAA 1997 8-1
- ITAA 1997 17-5
- ITAA 1997 Division 35
- ITAA 1997 Division 36
- ITAA 1997 42-345
- ITAA 1997 70-45
- ITAA 1997 Subdiv 110-B
- ITAA 1997 118-115
- ITAA 1997 405-25
- ITAA 1997 995-1

Case references:

- Allied Mills Industries Pty Ltd v. FC of T 88 ATC 4852; (1988) 19 ATR 1724
- Calkin v. CIR [1984] 1 NZLR 440
- Case D26 72 ATC 158
- Data Access Corporation v. Powerflex Services Pty Ltd [1999] HCA 49
- Esso Australia Resources Ltd v. FC of T 97 ATC 4371; (1997) 36 ATR 65; 98 ATC 4768; (1998) 39 ATR 394
- FC of T v. Murry 98 ATC 4585; (1998) 39 ATR 129
- FC of T v. Stewart84 ATC 4146; (1984) 15 ATR 387
- Ferguson v. FC of T (1979) 37 FLR 310; 79 ATC 4261; (1979) 9 ATR 873
- Galcif Pty Ltd v. Dudley's Corner Pty Ltd & Ors (1995) 6 BPR 14,134
- Goodfellow v. FC of T 77 ATC 4086; 7 ATR 265
- Goodman Fielder Wattie Ltd v. FC of T 91 ATC 4438; (1991) 22 ATR 26
- Hope v. The Council of the City of Bathurst 80 ATC 4386; (1980) 12 ATR 231
- Inglis v. FC of T 80 ATC 4001; (1979) 10 ATR 493
- Martin v. FC of T (1953) 90 CLR 470; 5 AITR 548
- Secretary, Department of Employment, Education and Training & Youth Affairs v. Barrett & Anor (1998) 52 ALD 499; (1998) 82 FLR 524
- Southern Estates Pty Ltd v. FC of T [1966-1967] 117 CLR 481; 41 ALJR 270
- Thomas v. FC of T 72 ATC 4094; (1972) 3 ATR 165
- Whitfords Beach Pty Ltd v. FC of T 83 ATC 4277; (1983) 14 ATR 247

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APPENDIX

Division 35 Deferral of losses from non-commercial business activities

Guide to Division 35

35-1 What this Division is about

This Division prevents losses of individuals from non-commercial business activities being offset against other assessable income in the year the loss is incurred. The loss is deferred.

It sets out a series of tests to determine whether a business activity is treated as being non-commercial.

The deferred losses may be offset in later years against profits from the activity or, if one of the tests is satisfied or the Commissioner exercises a discretion, against other income.

Table of sections

Operative provisions

[This is the end of the Guide.]

Operative provisions

35-5 Object

(1) The object of this Division is to improve the integrity of the taxation system by preventing losses from non-commercial activities that are carried on as *businesses by individuals (alone or in partnership) being offset against other assessable income.
(2) This Division is not intended to apply to activities that do not constitute carrying on a *business, for example, the receipt of income from passive investments.

35-10 Deferral of deductions from non-commercial business activities

(1) The rule in subsection (2) applies for an income year to each *business activity you carried on in that year if you are an individual, either alone or in partnership (whether or not some other entity is a member of the partnership), unless:

(a) one of the tests set out in section 35-30 (assessable income test), 35-35 (profits test), 35-40 (real property test) or 35-45 (other assets test) is satisfied for the business activity for that year; or

(b) the Commissioner has exercised the discretion set out in section 35-55 for the business activity for that year; or

(c) the exception in subsection (4) applies for that year.

Note: This section covers individuals carrying on a business activity as partners, but not individuals merely in receipt of income jointly. Compare the definition of *partnership* in subsection 995-1(1).

Rule

(2) If the amounts attributable to the *business activity for that income year that you could otherwise deduct under this Act for that year exceed your assessable income (if any) from the business activity for that year, or your share of it, this Act applies to you as if the excess:

(a) were not incurred in that income year; and

(b) were an amount attributable to the activity that you can deduct from assessable income from the activity for the next income year in which the activity is carried on.

Note: There are modifications of this rule if you have exempt income (see section 35-15) or you become bankrupt (see section 35-20).

Example: Jennifer has a salaried job, and she also carries on a business activity consisting of selling lingerie.

Jennifer starts that activity on 1 July 2002, and for the 2002-03 income year, the activity produces assessable income of $8,000 and deductions of $10,000. The activity does not pass any of the tests and the discretion is not exercised so the $2,000 excess is carried over to the next income year in which the activity is carried on.

For the 2003-04 income year, the activity produces assessable income of $9,000 and deductions of $10,000 (excluding the $2,000 excess from 2002-03). Again, no tests passed and no exercise of discretion.

$3,000 is carried over to the next income year (comprising the $1,000 excess for the current year, plus the previous years $2,000 excess) when the activity is carried on.

Grouping business activities

(3) In applying this Division, you may group together *business activities of a similar kind.

Exception

(4) The rule in subsection (2) does not apply to a *business activity for an income year if:

(a) the activity is a *primary production business or a *professional arts business; and

(b) your assessable income for that year (except any *net capital gain) from other sources that do not relate to that activity is less than $40,000.

(5) A professional arts business is a *business you carry on as:

(a) the author of a literary, dramatic, musical or artistic work; or

Note: The expression "author" is a technical term from copyright law. In general, the "author" of a musical work is its composer and the "author" of an artistic work is the artist, sculptor or photographer who created it.

(b) a *performing artist; or

(c) a *production associate.

35-15 Modification if you have exempt income

(1) The rule in section 35-10 may be modified for an income year if you *derived *exempt income in that year.

(2) Any amount to which paragraph 35-10(2)(b) would otherwise apply for an income year for you is reduced by so much of your *net exempt income as is not applied for that income year under section 36-10 or 36-15 (about tax losses). This reduction is made before you apply the paragraph 35-10(2)(b) amount against assessable income from the *business activity.

35-20 Modification if you become bankrupt

(1) The rule in section 35-10 is modified as set out in subsection (3) for an income year if in that year (the ***current year***) you become bankrupt or are released from a debt by the operation of an Act relating to bankruptcy.

(2) The rule is also modified as set out in subsection (3) if:
(a) you became bankrupt before the current year; and
(b) the bankruptcy is annulled in the current year under section 74 of the *Bankruptcy Act 1966* because your creditors have accepted a proposal for a composition or scheme of arrangement; and
(c) under the composition or scheme of arrangement, you have been, will be or may be released from some or all of the debts from which you would have been released if you had instead been discharged from the bankruptcy.

(3) This Act applies to you as if any amount that:
(a) paragraph 35-10(2)(b) had applied to for an income year before the current year for you; and
(b) you have not yet deducted;
were not an amount attributable to the *business activity that you can deduct for the current year or a later income year.

35-25 Application of Division to certain partnerships

For the purpose of applying the tests in sections 35-30, 35-40 and 35-45 where you carry on a *business activity in an income year as a partner, ignore:

(a) any part of the assessable income from the business activity for the year that is attributable to the interest of a partner that is not an individual in the partnership net income or partnership loss for the year; and

(b) any part of the assessable income from the business activity for the year that is derived from the activity by another partner otherwise than as a member of the partnership; and

(c) any part of the *reduced cost bases or other values of assets of the partnership used in carrying on the activity in that year that is attributable to the interest of a partner that is not an individual in those assets; and

(d) any part of the *reduced cost bases or other values of assets owned or leased by another partner that are not partnership assets and used in carrying on the activity in that year.

35-30 Assessable income test

The rule in section 35-10 does not apply to a *business activity for an income year if:

(a) the amount of assessable income from the business activity for the year; or

(b) you started to carry on the business activity, or stopped carrying it on, during the year a reasonable estimate of what would have been the amount of that assessable income if you had carried on that activity throughout the year;

is at least $20,000.

35-35 Profits test

(1) The rule in section 35-10 does not apply to a *business activity (except an activity carried on by one or more individuals as partners, whether or not some other entity is a member of the partnership) for an income year (the ***current year***) if, for each of at least 3 of the past 5 income years (including the current year) the sum of the deductions attributable to that activity for that year (apart from the operation of subsection 35-10(2)) is less than the assessable income from the activity for that year.

(2) For a *business activity you carried on with one or more others as partners, the rule in section 35-10 does not apply to you for the current year if, for each of at least 3 of the past 5 income years (including the current year) the sum of your deductions (including your share of the partnership deductions) attributable to that activity for that year (apart from the operation of subsection 35-10(2)) is less than your assessable income (including your share of the partnerships assessable income) from the activity for that year.

35-40 Real property test

(1) The rule in section 35-10 does not apply to a *business activity for an income year if the total *reduced cost bases of real property or interests in real property used on a continuing basis in carrying on the activity in that year is at least $500,000.

(2) You may use the market value of the real property or interest if that value is more than its *reduced cost base.

(3) The *reduced cost base or market value is worked out:
(a) as at the end of the income year; or
(b) if you stopped carrying on the *business activity during the year:

(i) as at the time you stopped; or
(ii) if you disposed of the asset before that time in the course of stopping carrying on the activity as at the time you disposed of it.

(4) However, these assets are not counted for this test:

(a) a *dwelling, and any adjacent land used in association with the dwelling, that is used mainly for private purposes;
(b) fixtures owned by you as a tenant.

35-45 Other assets test

(1) The rule in section 35-10 does not apply to a *business activity for an income year if the total values of assets that are counted for this test (see subsections (2) and (4)) and that are used on a continuing basis in carrying on the activity in that year is at least $100,000.

(2) The assets counted for this test, and their values for this test, are set out in this table:

Assets counted for this test and their values

Item	Asset	Value
1	An asset for which you can deduct an amount for depreciation	The *written down value of the asset
2	An item of *trading stock	Its value under subsection 70-45(1)
3	An asset that you lease from another entity	The sum of the amounts of the future lease payments for the asset to which you are irrevocably committed, less an appropriate amount to reflect any interest component for those lease payments
4	Trademarks, patents, copyrights and similar rights	Their *reduced cost base

(3) The value of such an asset is worked out:
(a) as at the end of the income year; or
(b) if you stopped carrying on the *business activity during the year:
(i) as at the time you stopped; or
(ii) if you disposed of the asset before that time in the course of stopping carrying on the activity as at the time you disposed of it.

(4) However, these assets are not counted for this test:
(a) assets that are real property or interests in real property that are taken into account for that year under section 35-40;
(b) *cars, motor cycles and similar vehicles.

35-50 Apportionment

If an asset that is being taken into account under section 35-40 or 35-45 is used during an income year partly in carrying on the relevant *business activity and partly for other purposes, only that part of its *reduced cost base, market value or other value that is attributable to its use in carrying on the business activity in that year is taken into account for that section.

35-55 Commissioners discretion

(1) The Commissioner may decide that the rule in section 35-10 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:

(i) because of its nature, it has not yet satisfied 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 subsection 35-10(2)).

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.

(2) The Commissioner must not exercise the discretion under paragraph (1)(b) for a *business activity at a time after the earlier of:

(a) the time at which it would be reasonable to expect the activity to first 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)); or

(b) the time at which it would be reasonable to expect the activity to meet one of the tests set out in section 35-30, 35-35, 35-40 or 35-45.