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

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

Contents Para

Preamble

*The number, subject heading, **Class of person/arrangement, Date of effect** and **Ruling** parts of this document are a 'public ruling' for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]

What this Ruling is about

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

- deferral of deductions from 'non-commercial'[1] *business activities[2] under subsection 35-10(2);
- the *primary production and *professional arts businesses Exception in subsection 35-10(4);
- the four tests in Division 35, satisfaction of any one of which will allow a 'loss' from a *business activity to be offset against other income in the year in which it is incurred:
  - (i) the Assessable income test in section 35-30;
  - (ii) the Profits test in section 35-35;
  - (iii) the Real property test in section 35-40; and
  - (iv) the Other assets test in section 35-45.

[1] Note: in this Ruling the term 'non-commercial' *business activity merely refers to an activity to which Division 35 applies or potentially applies. It does not mean that the activity has been pre-judged as being non-commercial in any ordinary sense of that term.

[2] An asterisk before a term in this Ruling denotes that the term is defined in the *Income Tax Assessment Act 1997* (ITAA 1997). Terms that are defined in the ITAA 1997, and identified with an asterisk in that Act, are similarly identified in this Ruling.

1A. It does not consider in detail the operation of the Commissioner's discretion in section 35-55. This aspect is the subject of a separate Taxation Ruling (TR 2007/6 Income tax: non-commercial business losses: Commissioner's discretion).

Class of person/arrangement

2. This Ruling applies only to individuals (including an individual as a partner) who:

(a) carry on a '*business activity'; and

(b) who, for a particular year in relation to that *business activity, have allowable deductions in excess of assessable income.

3. Thus, this Ruling does not apply to taxpayers who are not individuals, or to activities which are not part of a *business.

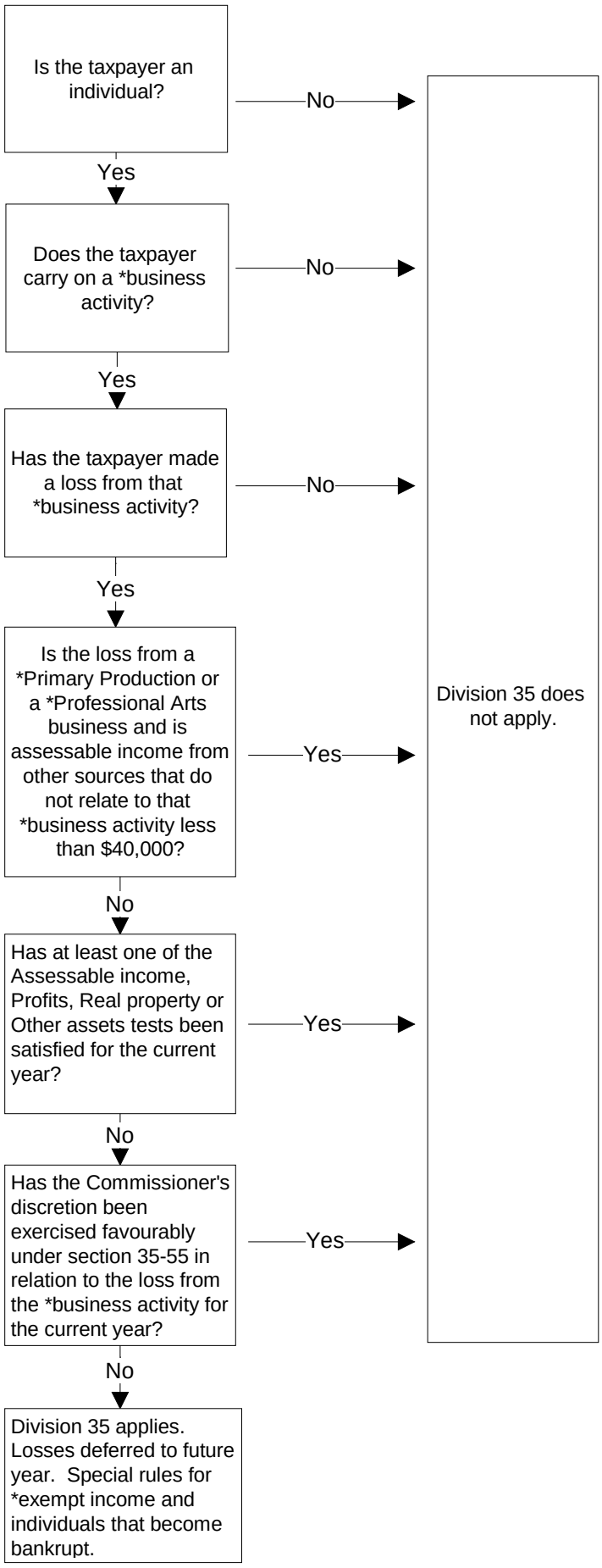
Date of effect

4. 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.

Note: The Addenda to this Ruling that issued on 11 July 2007 and 25 July 2007 apply both before and after their dates of issue.

Flowchart: operation of Division 35

5. In general terms the operation of Division 35 can be represented by the following flowchart, where for an income year:


Is the taxpayer an individual?
No
Yes
Does the taxpayer carry on a *business activity?
No
Yes
Has the taxpayer made a loss from that *business activity?
No
Yes
Is the loss from a *Primary Production or a *Professional Arts business and is assessable income from other sources that do not relate to that *business activity less than $40,000?
Yes
No
Has at least one of the Assessable income, Profits, Real property or Other assets tests been satisfied for the current year?
Yes
No
Has the Commissioner's discretion been exercised favourably under section 35-55 in relation to the loss from the *business activity for the current year?
Yes
No
Division 35 applies. Losses deferred to future year. Special rules for *exempt income and individuals that become bankrupt.
Division 35 does not apply.

Legislative framework

Introduction to Division 35

6. Division 35 was introduced into the ITAA 1997 via the *New Business Tax System (Integrity Measures) Act 2000*. It applies from 1 July 2000 to each and every income year in which an individual taxpayer carries on a relevant *business activity. The main operative provision in the Division is section 35-10. The major rule in section 35-10 is that unless in each year:

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

(b) the individual comes within the 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.

7. However, the loss will be available for deduction in a later year if one of the four tests is met, an Exception is satisfied, or the Commissioner's discretion is exercised, in relation to that later year. **Division 35 does not apply to activities that do not constitute carrying on a *business** (subsection 35-5(2)).

8. 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*. This 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 Business Tax System (Integrity Measures) Act 2000*).

*Primary Production and *Professional Arts businesses Exception

9. 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)).

*Business needs to be carried on

10. 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 (section 35-5). Division 35 does not apply to any other entity. The Division operates by identifying a specific '*business activity' for 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). **Note, a *business may, for the purposes of Division 35, be made up of more than one *business activity** (see paragraphs 36 to 39 of the Ruling section and paragraphs 83 to 85 of the Explanations section below).

Calculating the non-commercial loss

11. Under subsection 35-10(2), if the amounts attributable to the *business activity for a year of income that otherwise could be deducted, apart from Division 35, 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) instead, were an amount attributable to the *business activity that is deductible in the next income year in which that *business activity is carried on.

12. In determining how Division 35 applies to the relevant *business activity it is necessary therefore to identify both the allowable deductions 'attributable' to the *business activity and the assessable income 'from' that activity. Note that the amounts to be 'attributed' to the *business activity in this regard include all the amounts for the activity that otherwise could be deducted; not just those deductible under section 8-1, for example, any deductible under Division 40.

Effect of passing one of the tests, coming within the Exception or an exercise of the Commissioner's discretion

13. If the relevant *business activity passes at least one of the tests, comes within the Exception or has a favourable exercise of the Commissioner's discretion, the loss deferral rule in subsection 35-10(2) will not apply to the individual undertaking that activity for that income year. They will be able to deduct the excess deductions against their other assessable income.

The four tests and their operation

Assessable income test

14. 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' of a notional annual amount if the activity has not been carried on for the whole year (paragraph 35-30(b)).

Profits test

15. This test involves determining whether an activity has produced a tax profit[3] in 3 out of the past 5 years. The 5-year period includes the current year. 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 defer any loss incurred by the individual from the activity for that income year (subsection 35-35(1)).

Real property test

16. 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)).

17. For this test, the following assets are not counted:

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

18. 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.

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

[3] Refer to Key Terms in paragraph 34

20. Where assets that have been taken into account for the Real property test 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).

Other assets test

21. 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)).

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

Assets counted for this test and their values

Item	Asset	Value
1	An asset whose decline in value you can deduct under Division 40[4]	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

23. The following assets are specifically excluded under subsection 35-45(4) from being counted for 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.

[4] This wording only applies from 1 July 2001 (see s2 and s222, *New Business Tax System (Capital Allowances-Transitional and Consequential) Act 2001*). Prior to that the item read 'An asset for which you can deduct an amount for depreciation'.

24. Where assets that may be taken into account for the Other assets test 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).

When is an asset's value determined?

25. The *reduced cost bases, market values or other prescribed values of a relevant asset counted for the Real property test or Other assets test is 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)).

Leased assets and the two assets tests

26. The value of some leased assets used on a continuing basis in the relevant *business activity can be taken into account for either of the assets tests (but not for both). The general scheme is that an individual with an interest in real property comprised of fixtures owned by them as a tenant, takes the fixtures into account under the Other assets test, and not under the Real property test (paragraph 35-40(4)(b)).

Depreciating assets and the two assets tests

27. An owner of real property on which a depreciating asset is fixed is potentially able to take the value of that asset into account under the Real property test and under the Other assets test. This would be where the asset qualifies as part of the real property, but is also an asset in its own right whose decline in value can be deducted under Division 40 (i.e., an asset within Item 1 of the table in subsection 35-45(2)). However, the general scheme in this case is that where such an asset is part of the real property taken into account for

the purposes of the Real property test, then it is not also counted for the Other assets test (paragraph 35-45(4)(a)).

The operation of the tests when the *business activity is conducted by individuals in partnership

28. 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 that part which is attributable to the total of the interests of all the individuals in the partnership may be aggregated for the Assessable income test, Real property test and Other assets test (paragraphs 35-25(a) and (c)). In addition, any assessable income that is *derived and/or assets owned by an individual partner in their own right, or that they may have from the same, or a similar, *business activity, 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 (paragraphs 35-25(a) and (c)).

29. To apply the Profits test the individual partner 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 a similar, *business activity outside of the partnership (subsection 35-35(2)) see **Examples 8** and **9** at paragraphs 141 to 146 below.

Exercise of the Commissioner's discretion – two limbs

30. 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 which make up the two limbs of the discretion. These are:

(a) 'special circumstances' (first limb); and

(b) where the *business activity has started to be carried on but, because of its nature, it has not satisfied one of the four tests, though within a period that is commercially viable for the industry concerned, there is an objective expectation that it will do so, or will produce a tax profit (second limb).

Latest time for exercise of the Commissioner's discretion

31. [Deleted][5]

Application of Division 35 when an individual has *exempt income

32. 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 individual 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 (see **Example 15** at paragraphs 171 to 172 below).

Application of Division 35 if an individual becomes bankrupt

33. Under section 35-20, a non-commercial loss deferred under subsection 35-10(2) will be treated differently where an individual 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 (see **Example 16** at paragraph 173 below).

Key Terms

34. 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 may include, applying subsection 35-10(3), '… *business activities of a similar kind' (see paragraphs 36 to 39 following);
- **'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 (if any) from that activity where the operation of Division 35 has not been excluded by the Exception, the four tests or the Commissioner's discretion (see subsection 35-10(2));

[5] [Deleted]

- **'*professional arts business'** has the meaning given in subsection 35-10(5), namely:
  '… a *business you carry on as:
  (a) the author of a literary, dramatic, musical or artistic work;
  (b) a *performing artist; or
  (c) a *production associate'[6];
- **'tax profit'** is where the amount of assessable income from the activity for a 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));
- **'tenant's fixtures'** means fixtures owned according to property law, by you as a tenant, as that expression is used in paragraph 35-40(4)(b).

Ruling

*Business needs to be carried on

35. Carrying on a *business activity requires that a *business be carried on, as that term is ordinarily understood.[7] 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'. Division 35 is not intended to apply to activities that do not constitute a *business, e.g., a 'passive investment'[8] (subsection 35-5(2)).

Meaning of '*_business activity_'

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

[6] The terms, '*performing artist', and '*production associate' have the same meaning as they have in section 405-25.
[7] The criteria as to when a *business of primary production is being carried on, for example, are set out in Taxation Ruling TR 97/11.
[8] The terms '*business' and 'passive investment' are used here in a mutually exclusive sense.

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

37. The composite term '*business activity' is otherwise undefined in the ITAA 1997. The inclusion of the extended definition of '*business' in the composite term does not, however, alter the ordinary meaning of the composite 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 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.

38. However, while a *business may be subdivided into a number of different *business activities this cannot be carried out to the point where the composite term in Division 35, '*business activity', is deprived of practical meaning. An activity that forms part of a taxpayer's overall *business will not be a separate '*business activity' for the purposes of Division 35 unless it is capable of standing alone as an autonomous commercial undertaking of some sort (see further paragraphs 40 to 46 on identifying separate and distinct *business activities for the purposes of Division 35).

39. As described in paragraph 8, the relevant changes in the law are directed at activities that are 'unlikely to ever be profitable'. *Business activities have been made subject to a series of tests to determine whether they are treated as non-commercial (section 35-1) and the identification and tax treatment of non-commercial business activities is the main purpose of Division 35.

*Identifying separate *business activities*

40. 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'. Gummow J stated:

> 'Viewed in the light of the conduct of *business of the taxpayer as a whole, one cannot sensibly say that the taxpayer went out of *business or that the taxpayer parted with a substantial part of its *business undertaking, or that its profit-making apparatus was materially crippled.
>
> It may be that activities of a taxpayer are so disparate in character and so discrete in the manner they are conducted, that one properly asks questions of the type posed by the facts of this case by reference to some but not the whole of those

> activities; examples of several distinct *businesses conducted by one taxpayer may be provided by the Board of Review decisions *Case H100* (1956) 8 T.B.R.D. 457 (retail jeweller and real estate letting agent) and Case N38 (1962) 13 T.B.R.D. 161 (printer and seller of goods on commission). But, in my view, for the reasons I have given, the present is not such a case.'

41. The same may be said for 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 Division 35 purposes. Whether this is so is clearly a question of fact and overall impression, like the question of whether they are carrying on a *business.

42. 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.

43. Further, and most importantly, to be identified as a separate *business activity for Division 35, within the statutory scheme referred to, the activity (or set of activities) will need to exhibit the following:

- it produces a 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 (otherwise Division 35 has no relevance);
- 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.

44. 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 requirement, because it assists in a genuinely commercial way, the carrying on of the individual's other *business activity: see **Example 1** (paragraphs 120 to 123) in the Examples part of this Ruling. Such an activity would not be identified as a separate *business activity for Division 35 purposes.

*Table 1- relevant factors concerning identifying separate *business activities*

45. 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 Division 35 purposes. 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 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
Inter-dependency	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 is inherently unprofitable and has 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

46. The above list is not meant to be exhaustive. In some cases other factors that may be relevant to determining whether one *business activity is separate and distinct from another might include any difference in methods of funding, any difference in the degree of

commercial risk associated with each of them, and any laws or regulations of any industry body that apply.

A common-sense approach

47. 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.

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

*Business activities *'of a similar kind'*

49. 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. 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.

50. 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'. In other words, it does not have to be 'of the same kind'.

*Determining whether *business activities are 'of a similar kind'*

51. What will be a *business activity 'of a similar kind' to another *business activity is 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.

52. 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 v. FC of T* 77 ATC 4086 at 4094; (1977) 7 ATR 265 at 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. See **Example 2** (paragraphs 124 to 130) for an illustration of how the factors referred to in paragraph 51 above apply to determine whether two separate activities are *business activities 'of a similar kind'.

53. The broader in nature any separate and distinct *business activities are the more likely it will be that they will have some same or similar characteristics, especially when looked at over a period of time. For example, a mixed farming *business consisting nevertheless of only the one *business activity may involve a particular mix of grazing certain animals and growing certain crops. Changes to this mix may mean that at some stage in the future this *business is no longer the *same* *business it once was. However, the relevant *business activity may still be *'of a similar kind'* to the previous one, and Division 35 will apply accordingly.

54. That is, that the whole enterprise in the above example can continue to be treated as a single *business activity if the individual taxpayer so chooses. This means that if the enterprise is profitable overall there is no need to identify any separate loss making activities and, hence, the loss deferral rule in Division 35 will not apply at all (see paragraphs 86 to 88 of the Explanations below).

Ceasing to carry on a *business activity

55. In some cases an individual taxpayer's circumstances may change leaving issues about their ability to deduct the full extent of any loss made. Any amount deferred under subsection 35-10(2) will only be deductible in a subsequent year if the *business activity that gave rise to this amount, or one 'of a similar kind', is carried on in that subsequent year. If the activity, or one 'of a similar kind', is never carried on again, the entitlement to deduct the amount will be lost (see **Example 3** at paragraphs 131 and 132 below).

Application of Division 35 year by year

56. 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' that activity. The four tests in Division 35 are applied annually to each relevant *business activity.

Calculating the non-commercial loss on a year by year basis

57. The 'amounts attributable to the *business activity' that an individual taxpayer can otherwise deduct are, for the purposes of applying the loss deferral rule in subsection 35-10(2), **all** those amounts otherwise deductible under any provision of the ITAA 1997, to the extent that they relate to the carrying on of the particular *business activity in the income year in question. The relevant assessable income from the *business activity is that income which is *derived directly from, and has a causal relationship with, the carrying on of that *business activity for the income year in question (see paragraphs 91 to 92C and **Example 5** at paragraphs 134 to 136 of this Ruling).

Deductions allowable after *business carried on

58. Division 35 will only apply to otherwise allowable deductions that are attributable for a particular year to the carrying on of a *business activity in that year (see subsections 35-5(2) and 35-10(1)). This means that typically they will be outgoings incurred in a particular year in the course of carrying on that *business activity in that year. There may be amounts however, for example, those deductible under paragraph 8-1(1)(b), that are deductible even though they are incurred after the business activity has ceased being carried on.[9] These otherwise allowable deductions are not subject to Division 35.

*Primary Production and *Professional Arts businesses Exception

59. This Exception allows eligible individuals who carry on a *primary production business or *professional arts business to offset any loss (including any deferred amount) from their *primary

[9] When losses or outgoings are deductible, even where incurred after the cessation of income earning activities, is discussed in Taxation Ruling TR 2000/17. Note paragraph 14 of that Ruling: interest may be deductible when borrowed funds have been lost, but if those funds are put to other use, the question of the deductibility of that interest is determined by such other use.

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 the Exception applies if their assessable income (excluding any *net capital gain), from sources not related to the *business, is less than $40,000 for the income year in question (see paragraphs 89 and 90 of the Explanations and **Example 4** at paragraph 133 below).

Distinguishing a Division 35 loss from a Division 36 loss

60. 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 and **not** Division 35.

Assessable income

61. Assessable income is defined in section 995-1 of the ITAA 1997 to include statutory income as well as ordinary income (see generally, Division 6 of the ITAA 1997). This definition governs what income will be counted towards the Assessable income test in section 35-30, provided that such income is 'from' the relevant *business activity. Note that, where relevant, the amount taken into account will not include a Goods and Services Tax ('GST') component: see section 17-5 of the ITAA 1997.

Making a 'reasonable estimate' of assessable income for the purposes of the Assessable income test

62. To make a 'reasonable estimate' under paragraph 35-30(b) of assessable income that would have been *derived from the *business activity if it had been carried on throughout the income year in question (i.e., an estimate of a notional annual amount) an individual can consider all relevant factors, including, but not limited to:

(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

63. 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 (see paragraph 93 of the Explanations and **Example 6** at paragraph 137 below).

Whether to value the real property or the interest in real property in applying the Real property test

64. An issue arises concerning the Real property test in section 35-40. It concerns whether a holder of an interest in real property (e.g., a lessee) uses the *reduced cost base, or the market value (if greater), of that interest or, instead, of the underlying real property, in applying the Real property test. The words of section 35-40 allow an individual taxpayer to choose either of these methods in applying the Real property test to their *business activity i.e., the holder of an interest in real property can choose either the *reduced cost base or market value of:

- the interest; or
- the underlying property,

they use in the relevant *business activity, for the purposes of applying the Real property test.

Values to be used in applying the Other assets test

65. The table in subsection 35-45(2) specifies the values for different classes of assets to be used in applying the Other assets test. For example, the tax value of an asset for which an individual can deduct an amount for its decline in value is its *written down value at the date that that value is to be determined (usually, the end of an income year). If an item of machinery has been depreciated to nil, the value to be taken into account for this test will also be nil. Item 3 of subsection 35-45(2) makes it clear that where the asset is leased, the value of the interest is the future lease payments to which the

individual is irrevocably committed, less an interest component, and not the value of the underlying asset.

What is continuing use in the *business activity for the purposes of the Real property test and the Other assets test?

66. The use of assets required for them to be taken into account under one 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 Division 35 purposes 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.

67. However, '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]

The reference to using an asset on a short-term basis for a specific task does not mean that, for example, an item of machinery, such as a harvester, used in an ongoing *business, but only at harvest time, would be regarded as not being used on a continuing basis. On the other hand, a large item of earthmoving equipment hired on a one-off basis for the construction of a dam would not meet the requirement of being used on a continuing basis.

All tests - determining whether general law partnership exists

68. Determination of the existence, or otherwise, of a partnership at general law will be determined under case law. Taxation Ruling TR 94/8 outlines the factors to be considered in deciding whether persons are carrying on a *business as partners.

69. 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.

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

When does a business activity start to be carried on for the purposes of the second limb of the Commissioner's discretion in section 35-55?

69A Before the Commissioner can consider exercising the second limb of the discretion in section 35-55, a taxpayer must have started to carry on the relevant business activity. Broadly, this requires the taxpayer to have:

- 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 commenced business operations.

A mere intention to start carrying on the business activity will not be sufficient.[10A]

70. [Deleted]

71. [Deleted]

72. [Deleted]

73. [Deleted]

74. [Deleted]

75. [Deleted]

76. [Deleted][11]

77. [Deleted]

78. [Deleted]

79. [Deleted]

80. [Deleted]

81. [Deleted]

82. [Deleted]

82A. [Deleted]

[10A] See paragraphs 97 to 105 of this Ruling.
[11] [Deleted]

Explanations

Meaning of '*business activity' and identification of separate and distinct *business activities within the one *business

83. The meaning of the composite phrase, '*business activity', as it appears in Division 35, is explained in paragraphs 36 to 39 of this Ruling. A major point to note is that an individual's *business will not comprise separate and distinct *business activities for the purposes of Division 35 where all the activities are interlinked, and support each other in a genuine commercial way.

Alternative view

84. During consultation on this Ruling the view was expressed that the term '*business activity' effectively had the same meaning as *business as defined in section 995-1. In other words, there was no warrant for separating out various parts of an individual's *business into separate *business activities. Some support for this view can be found in the objects clause to Division 35, section 35-5, specifically in subsection (1). There reference is made to Division 35 being intended to deal with '... losses from non-commercial activities that are carried on as *businesses'.

85. Such a view ignores the question of why the specific term, *business activity, is otherwise used regularly in the same manner throughout Division 35, especially in the key operative provision, section 35-10. If Parliament had intended the term *business activity to mean *business, it would have been easy enough to use the term *business rather than *business activity. However, on the basis of the view taken in this Ruling on the meaning of *business activity, in many cases it will be an individual's whole *business anyway that will be identified as the relevant *business activity for Division 35. Even under this alternative view there would be a need to perform separate calculations for the purpose of section 35-10 where the same individual taxpayer carries on separate and distinct *businesses.

*Business activities *'of a similar kind'*

86. Subsection 35-10(3) allows *business activities to be grouped for Division 35 purposes 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).

87. Identification of the relevant *business activity for Division 35 purposes 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'. These combined activities will then form the one *business activity for all Division 35 purposes.

88. 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.

*Primary Production and *Professional Arts businesses Exception

89. Subsection 35-10(4) contains an Exception for *primary production businesses or *professional arts businesses that are carried on by certain individuals, where they have less than $40,000 of assessable income (excluding any *net capital gain), from sources not related to their *primary production business or *professional arts business.[12]

90. The term *Professional arts business is given a wide meaning in subsection 35-10(5) through use of the same concepts as 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.[13] Copyright law indicates that the author of a literary, dramatic, musical or artistic work will be

[12] The indicators as to whether an individual is carrying on a *primary production business are set out in Taxation Ruling TR 97/11. These indicators 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).

[13] 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.

the person who has 'originated it or brought it into existence and has not copied it from another'.[14]

Calculating the non-commercial loss

91. Where none of the four tests is satisfied, the Exception does not apply, and the Commissioner has not exercised 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'.

92. 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 or a similar 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.

Assessable income from the business activity

92A. *Watson v. Deputy Commissioner of Taxation* [2008] FCA 1173; 2008 ATC 20-042 (*Watson*) concerned whether income protection policy payments were assessable income from the business activity, being the taxpayer's financial planning business. Mansfield J held at paragraph 41, that this depended upon the particular facts, but that one relevant consideration was the relationship of the payments to the business in question, as illustrated by the purpose of the taxpayer in entering into the income protection policy.

92B. Whilst acknowledging a business/business activity may comprise 'related or incidental activities', Mansfield J held at paragraph 50 of *Watson* that there was no element of the business to which the payments were connected, and they had no 'causative connection' with the taxpayer's business. The decision in *Watson* stands for the proposition that assessable income will not be 'from the business activity' for the purposes of Division 35, unless it has a 'causative connection' with the activity, in the sense of being sourced from or originating in some element of the business activity.

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[14] 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.

92C. At paragraph 43 of *Watson*, Mansfield J also rejected any view that income would be 'from' a business activity where it was a substitute for a revenue stream that would otherwise have flowed from the business, but for the insured event occurring. Nor was the issue to be determined by showing that a substantial purpose of the insurance was to secure an income stream that would enable the business to continue during a period of temporary incapacity (ibid).

Profits test

93. The Profits test in section 35-55 requires that the *business activity has produced 'profits' in 3 out of the past 5 income years (where this five year period includes the current income year), for the activity to satisfy this test. The term 'profit' refers to the excess of the tax law assessable income from the activity for the income year in question, over the tax law deductions attributable to carrying on the activity in that year (but does not include any deduction deemed attributable to the activity under subsection 35-10(2) in relation to a non-commercial loss deferred from a previous year).

94. [Deleted]

95. [Deleted]

96. [Deleted]

Whether a business activity has started to be carried on for the purposes of the Commissioner's discretion in section 35-55

97. The first requirement concerning 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 a *business activity. The actual date of commencement of a *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).

98. For a *business activity to have commenced a person must have:

- 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 commenced 'business operations'.

99. 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

100. The chain of events leading to the commencement or start-up of a *business activity often begins with 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. Not all *businesses commence in such an orderly fashion of course.

101. 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.'

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

102. *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

103. Most *business activities have a structure that 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)

104. For a *business activity to commence, an appropriate business structure should also 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

105. As noted in *Inglis*, the level of activity is important. 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 claims to have commenced a *business activity. Brennan J in *Inglis* made it clear that there must be activity when he said at ATC 4004; ATR 496:

> '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 that does not call for much activity, as in *Thomas* and in *Ferguson*.' (emphasis added)

Brennan J went on to say at ATC 4005; ATR 497:

> '**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* two different types of activity are relevant:

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

Both are necessary to be able to conclude that a *business has commenced.

106. [Deleted]

107. [Deleted]

108. [Deleted]

109. [Deleted]

110. [Deleted]

111. [Deleted]

112. [Deleted]

113. [Deleted]

113A. [Deleted]

113B. [Deleted]

114. [Deleted]

Application of Division 35 when an individual has *exempt income

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

116. A current year non-commercial loss to be deferred under paragraph 35-10(2)(b) may be reduced if the individual *derived *exempt income. The non-commercial loss (apart from any deduction deemed to arise under subsection 35-10(2)) must be reduced by any amount of net *exempt income *derived in the current year that has not already been used to reduce 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 reduced by the individual's *exempt income, no amount will be deferred.

Application of Division 35 if an individual becomes bankrupt

117. 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:

- an individual 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)).

118. The effect of subsection 35-20(3) is that a non-commercial loss incurred by the individual 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.

Applying for a private ruling

119. An individual taxpayer can apply to the Commissioner for a Private Ruling on whether the discretion in section 35-55 would be exercised in relation to their *business activity. Such an application should be in the required format. A taxpayer can apply for a Private Ruling in relation to an arrangement which has not yet commenced, so long as it is being 'seriously contemplated' (paragraph 14ZAN(h), *Taxation Administration Act 1953*). Details of such an arrangement and the reasons why the Commissioner should exercise his discretion under subsection 35-55(1) may therefore extend over a number of years into the future. Further information on applying for a Private Ruling, particularly one involving subsection 35-55(1), can be found on the Australian Taxation Office website (http://www.ato.gov.au).

Examples

Example 1 - no separate *business activities

120. Bill has operated a flower shop *business for several years, in which he sells a range of products other than flowers, such as fine china and various novelty items. Until recently there was nothing about his *business to suggest any part of it was separate or discrete from the rest.

121. In the last six months he has also operated a delivery service for his flowers, to expand his client base and compete with other sellers. Although a separate fee is charged for this service, looked at on its own, it is not profitable.

122. However, there is a clear commercial purpose behind offering the delivery service, and it has now become an integral part of Bill's overall *business.

123. The delivery activity would not be regarded as a separate and distinct *business activity for the purposes of Division 35, even though it is being carried on at a loss.

Example 2 - separate *business activities not 'of a similar kind'

124. Six years ago Des purchased 5 hectares of land on the outskirts of a capital city, for $455,000, where he has since been living. He planted 1 hectare with grapevines, which have now come into full production. For the current income year his sales of grapes total $2,700. Initially his stock of plant and equipment was small. However, recently he has cut back his time worked as an employee in the city to only 2 days a week, and he has been devoting more and more time to providing various contract services, such as spraying, mowing, weeding, digging trenches etc., for other people in the district.

125. For some of this work he can use his original equipment, but he has also bought new equipment, so that for the current income year the *written down value of his depreciating assets will have increased to approximately $85,000. Despite earning income of $19,100 from this contract work, he has made an overall loss in relation to the two activities (grape growing and contract work) of $11,000, in part due to the interest he is paying on the loans taken out to purchase the land and the new equipment.

126. Although insufficient details are given in this example on which to determine this point, a complete examination of his grape growing activity may show that it lacks sufficient of the recognised features of a *business (e.g., those outlined in Taxation Ruling TR 97/11) for it to qualify as a *business activity. Such an examination may also show that on its current size and scale, it cannot reasonably be expected to ever exist as any sort of autonomous commercial undertaking and therefore losses attributable to it are not allowable.

127. Assuming however, that the grape growing is a *business activity, the question then arises, because of the separate and discrete way in which it is largely carried on, whether or not Des is carrying on just the one *business activity of grape growing and providing contract services, or two separate and distinct *business activities. Applying the factors and reasoning described in paragraphs 40 to 46 of this Ruling leads to the conclusion that the grape growing or vineyard activity is a separate *business activity from that of providing the contract services. This is not a case where the earning of income from doing such things as the spraying etc., is merely ancillary or incidental to the carrying on of a *primary production business.

128. On the basis that the two activities in this case are separate and distinct *business activities for the purposes of Division 35, the further question then arises, as to whether or not they are 'of a similar kind'. If they are, then Des can group them together under subsection

35-10(3), and this combined *business activity will then satisfy the Assessable income test. Otherwise, when looked at as two separate *business activities, neither will satisfy any one of the four tests. Would the activities undertaken by Des be *business activities 'of a similar kind'? Applying the factors described in paragraph 51 to the facts in Des' case produces the following comparison:

Factor	**grape growing**	**Contract services**
Location	On Des' small vineyard	On properties of neighbours
Goods or services provided	Sale of grapes	Provision of contract services such as, spraying, mowing, etc.
Market conditions	Governed by domestic and world market conditions for grapes	Dependent on demand of other farmers for services provided using the equipment; whether services of any other contractors available locally
Assets employed	Des' land, and vineyard equipment used for grape growing	Various items of machinery
Other characteristics	Nature of income *derived - from sales of produce from land-affected by risk of crop failures etc.	Nature of income *derived - from the provision of services

129. An overall comparison therefore shows some similarities between the two activities, e.g., use of common assets (the vineyard equipment) in both, and both activities involve, to some degree, the working of land used for growing grapes in a vineyard. However, there are significant differences between the activities as well - the different locations and market conditions, different other assets used, the significantly different way in which income is *derived in each activity, and the different elements of 'risk' that apply to each. If the two activities do constitute two separate and distinct *business activities, they would not be regarded as being 'of a similar kind' for the purposes of Division 35.

130. Therefore, under Division 35 Des will have to attribute those otherwise allowable deductions, such as depreciation on the vineyard equipment, between the two *business activities to determine the profit or loss from each *business activity. As separate activities, neither satisfy any of the four tests. The loss deferral rule will therefore apply separately to losses from both activities (assuming that the Exception does not apply, and that there is no exercise of the Commissioner's discretion).

Example 2A – Retail activities of a similar interrelated kind

130A Theo sells fresh fish from a refrigerated truck and trailer at farmers and regional markets in the southern area of a city each weekend. Initial sales are slow and the marketplace is dominated by larger established retailers but Theo believes there is a niche market. To expand his options he conducts similar activities in the northern area markets of the same city, in partnership with his brother George. Theo and George are employed four days a week in their eldest brother's food distribution business.

130B For the northern area operations Theo borrows money to acquire another refrigerated truck and purchases a trailer which incorporates cooking facilities. He establishes a new supply source with a fisherman and George uses the trailer to give cooking demonstrations. With the new northern area activities and George's cooking demonstrations he is establishing regular customers. The northern area operation performed better than the southern area activities. Theo made a loss for the whole year due to the interest paid on loans and the low sales in the southern area. Taken together the northern and southern area activities will satisfy the assessable income test in Division 35, but individually neither will satisfy any of the Division 35 tests for the year. The rate of growth for the northern area activities indicates that this side of the operations should pass the Assessable income test in the next year.

130C Given the use of different assets and the financial separation of the retail activities (that is, one is conducted as a sole trader, and the other in partnership, for which separate accounts are kept), it is considered that the two operations constitute *business activities in their own right. The further question then arises, as to whether or not they are of a similar kind. If they are then Theo can group them together under subsection 35-10(3) and the grouped activity will satisfy the assessable income test. This is a question of fact and no single issue is determinative. Applying the factors described in paragraph 51 of this Ruling to the facts of Theo's case produces the following comparison:

Factor	**Southern area operation**	**Northern area operation**
Location	From refrigerated truck at various markets and major events within the southern area	From trailer attached to truck at various markets and major events within the northern area
Assets used	Truck and trailer	Truck and trailer

		with cooking facilities
Goods/services produced	Sale of fresh fish	Sale of fresh fish and cooking demonstrations
Market conditions	Dependent on day's catch and passing trade	Dependent on day's catch and passing trade
Commercial links	Currently unprofitable, owned by Theo, inspired northern area activity	Profitable and controlled by Theo and George as partners
Other characteristics	Niche retail market operation	Parallel retail activity with different supplier and added customer attraction

130D An overall comparison shows significant similarities between the two activities such as the use of similar assets, the same targeted market and similar market conditions. There is a limited degree of interdependency between the activities and the locations for the two activities are different, though the process of attending the different locations is the same. Whilst there are some minor differences between the activities the strength of the similarities between the two activities are such that they can be regarded as being of a similar kind for the purposes of Division 35.

Example 2B – Separate *business activities not 'of a similar kind'

130E Roman runs an organic chicken stall at weekend farmers markets in a similar manner to Theo in Example 2A. Like Theo he is encountering price sensitive buyer resistance to his premium grade product and has started a support operation to earn extra money. Roman sets up a take away shop adjoining his house in a small country town which is open four nights a week. The shop specialises in BBQ organic chickens but most sales are of non-organic pizzas and fish and chips. The shop is not highly successful. An older established shop in the town has a loyal clientele and is significantly cheaper than Roman's shop. The tourist trade from nearby attractions that Roman has targeted is not as high as expected. Roman maintains his regular employment for three days per week as a counsellor at the nearby youth correctional facility whilst he strives to develop his belief in organic food into a viable *business.

130F Given the physical separation of the retail activities and their different focus it is considered that the two operations constitute *business activities in their own right. The further question then arises, as to whether or not they are of a similar kind. If they are then Roman can group them together under subsection 35-10(3) and the grouped activity will satisfy the Assessable income test. This is a question of fact and no single issue is determinative. Applying the factors described in paragraph 51 of this Ruling to the facts of Roman's case produces the following comparison:

Factor	**Fresh chicken retail**	**Take away food**
Location	From a refrigerated van at markets	From a shop in a small country town
Assets used	Van	Cooking equipment, building, local produce
Goods/services produced	Sale of organic chickens	Cooked food of mostly non-organic variety
Market conditions	Income derived from sale of organic poultry at produce market – dependent on market for organic produce	Income derived from take away sale of cooked non-organic items – dependent on price sensitive local and passing tourist trade
Commercial links	Occasional and limited use of organic chicken in shop	Limited as sales in take away shop are wider than just organic chicken
Other characteristics	Currently unprofitable but supports other activity in minor way	Marginally profitable with some stock from fresh chicken retail activity utilised

130G An overall comparison of the two activities shows some commonality exists between them as both are retail oriented and involved in the provision of food however there are significant differences between the activities. They are carried on in different locations, are aimed at different markets, utilise different assets to produce their sales and have limited interdependency. In summary, one is a specialist operation aimed at a discerning market and the other a general retail operation with specialist intentions. The general impression gained from this analysis of the two activities is that they are not of a 'similar kind' for the purposes of Division 35 and consequently they cannot be grouped together.

130H Therefore under Division 35 Roman will have to attribute the otherwise allowable deductions between the two activities to determine the profit or loss from each activity. As separate activities neither satisfies any of the four tests and the loss deferral rule will therefore apply separately to losses from both activities (assuming that the Exception does not apply, and there is no exercise of the Commissioner's discretion).

Example 2C – Separate *business activities not 'of a similar kind'

130I Juan and Piotr operate a mixed farm on the edge of a rural town where Piotr is employed as a solicitor. On this farm they are raising a herd of deer and last year established a mushroom and asparagus operation. The Commissioner's discretion in Division 35 has been exercised for this activity, so that losses from it have not been deferred. To further diversify their income base this year Juan has established a bed and breakfast operation in a leased homestead on the edge of a nearby town. The lease is for an initial 12 months and a minor refurbishment of the living and sleeping quarters has been undertaken.

130J The 12 month lease is nearing expiry and although the activity has been neither profitable nor able to meet a Division 35 test, by itself, Juan can see a profitable future for the venture based on current trends. Juan has incurred some losses from this venture and wishes to be able to group this activity with the farm activity to more easily satisfy the relevant tests in Division 35 and therefore offset these losses against his other income.

130K Assuming the bed and breakfast activity is considered to be a *business activity then given the physical separation of the activities and their different focus it is considered that the two operations would constitute *business activities in their own right. The further question then arises, as to whether or not they are of a similar kind. If they are then Juan can group them together under subsection 35-10(3) and the grouped activity will satisfy the Assessable income test. This is a question of fact and no single issue is determinative. Applying the factors described in paragraph 51 to the facts of Juan's case produces the following comparison:

Factor	**Farm based activities**	**Bed and breakfast**
Location	On rural land owned by Juan and Piotr	From a rented building near a country town
Assets used	Land, sheds, farming equipment, fertiliser	Rented building, personal cooking and hosting skills
Goods/services produced	Growth and sale of deer, asparagus and mushrooms	Accommodation and choice of breakfast
Market conditions	Governed by domestic consumption of venison, mushrooms and asparagus	Governed by domestic and some international market for tourism
Commercial links	No discernible links other than provision of some produce to the bed and breakfast	No links bar same owners and use of some farm produce
Other characteristics	Sales of produce	Provision of tourist facility

130L The overall comparison of the two activities shows very little interdependency exists between them, other than the provision of some produce from the farm based activity to the bed and breakfast activity. In further contrast they are carried on in different locations, are aimed at different markets, utilise different assets to produce their sales and have limited commercial links. The overall impression gained is that they are separate and discrete *business activities with one a *primary production activity and the other a tourist focussed service activity. The two activities would not be regarded as being of a 'similar kind' for the purposes of Division 35.

130M Juan will have to attribute the otherwise allowable deductions between the two activities to determine the profit or loss from each activity. As Juan's bed and breakfast activity is treated separately from his other activities and does not pass any test in this year, the loss deferral rule will apply to this activity, (assuming that the Exception does not apply and that there is no exercise of the Commissioner's discretion).

Example 2D – Separate *business activities which are 'of a similar kind'

130N Christan is a journalist employed as a columnist by a newspaper group. He wants to establish himself as a writer in the visual entertainment field. He was commissioned by a former colleague to write some scripts for a popular soap opera. These scripts are his only 'sales' to date. Christan is also a poet and has achieved reasonable sales from a self published book. He has also earned some fees from poetry recitals and some royalties from an earlier book of poems.

130O Christan has written a draft movie script which has been reviewed by a prominent producer and a famous director who have each expressed an interest in buying the rights to it as a possible movie. The offer is conditional on Christan updating certain aspects of the script, which requires him to incur expenses in conducting new research. Since this positive but conditional interest was expressed to Christan, he has put his latest poetry collection on hold, scaled back the frequency of his newspaper column and has committed himself, almost full time, to completing the script from his home office.

130P Christan would like the Commissioner's discretion exercised in order to offset the expenses he is incurring, in updating the movie script, against his salary income derived from writing the newspaper column. To do this Christan needs the scriptwriting activity to be considered a *business activity and for it to be able to satisfy one of the tests contained in Division 35. Christan has yet to satisfy any of the Division 35 tests from either his scriptwriting or poetry activities. To prevent the expenses being deferred, the separate activities need to be considered as activities of a similar kind and therefore able to be grouped together for Division 35 purposes.

130Q Based on Taxation Ruling TR 2005/1 Income tax: carrying on a business as a professional artist, the poetry based activity has achieved sufficient longevity, purpose, peer recognition and profit making intention to be accepted as a *business activity. Despite the developing nature of the scriptwriting activity there is also sufficient profit making intention, repetition and time devoted to the activity to indicate that, for the purposes of this example, this is a *business activity. Applying the factors and reasoning described in paragraphs 40 to 46 of this Ruling to Christan's circumstances leads to some doubt about whether the scriptwriting is a separate *business activity from that of the poetry writing. It seems evident however, that the scriptwriting is not an ancillary activity to the poetry based activity.

130R If the poetry and the scriptwriting are separate *business activities in their own right, the further question then arises, as to whether or not they are of a similar kind. If they are then Christan can group them together under subsection 35-10(3) and the grouped activity will satisfy the Assessable income test. This is a question of fact and no single issue is determinative. Applying the factors described in paragraph 51 of this Ruling to the facts of Christan's case produces the following comparison:

Factor	**Poetry**	**Scriptwriting**
Location	From Christan's home office	From Christan's home office
Assets used	Computer, ergonomic chair and table	Computer, ergonomic chair and table
Goods/services produced	Poetry – written material	TV and film scripts – written material
Market conditions	Governed by market for specialist poetry	Governed by market for popular visual entertainment

Commercial links	Produced from Christan's imagination with limited commerciality and a limited specialist literary audience	Produced from Christan's imagination with potential for mass audience appeal and commercial success
Other characteristics	Income *derived from sale of self published written material	Income *derived from producing written material for visual entertainment industry

130S An overall comparison indicates there are both many similarities and differences between these two activities. The activities are aimed at vastly different markets with the scriptwriting activity having potentially mass market appeal whilst the poetry based activity has limited market appeal and is almost characterised as a labour of love for Christan. There is limited, if any, crossover between the activities such that Christan's reputation as a poet counts for little amongst his scriptwriting peers.

130T Counteracting this initial impression of a lack of similarity are the facts that both 'goods' are written works which are produced from Christan's imagination and experiences. They are the product of his skill and written inventiveness, in addition to which they share the same production location in Christan's home office. They utilise the same skills and assets in their production and, although aimed at different markets, they share the same fundamental means of deriving income – namely they are written works which are sold by Christan to interested parties. On that basis the overall impression is that if these are separate *business activities then they are of a similar kind and therefore may be grouped for the purposes of Division 35.

Example 3 - *business activity ceases

131. Marie owns land on which she previously carried on a *business activity. Due to losses incurred in a prior income year, there is an amount of $11,000 that she could potentially deduct against assessable income earned from the *business activity, or a similar one, in a later income year under paragraph 35-10(2)(b). In the current year, however, she is not carrying on any *business activity, and it is unlikely that she will ever do so again. One fifth of the land is rented out in this year at a commercial rate to someone else.

132. Two consequences from these events should be noted:

(a) Marie will lose her entitlement to a potential deduction unless she carries on the same *business activity (or one 'of a similar kind') to which the amount of $11,000 relates in a later income year; and

(b) Marie's rental income is unlikely, on well established authority, to be income from the carrying on of a *business activity. Therefore, Division 35 **will not apply** to any loss made from the rental activity and she will not be required to defer it. However, as only part of the land is now being used for the purpose of producing assessable income, Marie will need to apportion expenses that relate to the land as a whole, e.g., interest, insurance, rates and taxes, etc. These outgoings will only be deductible to the extent to which they are incurred under section 8-1 in producing the rental income.

Example 4 - the *Primary Production business Exception

133. 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 carries 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.

Example 5 - operation of the loss deferral rule

134. Assume the following figures for Michelle's pearl farming *business activity where the Exception does not apply to her and the Commissioner's discretion has not been exercised in her favour:

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	Nil	($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

135. In each year none of the tests of Division 35 is passed. Therefore subsection 35-10(2) applies. The excess of allowable deductions over assessable income in relation to the *business activity is deemed not to be deductible in each 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.

136. 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.

Example 6 - operation of the Profits test

137. For 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 the Exception in subsection 35-10(4) does not apply.

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

Notes:

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

(2) 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.

(3) Year 3 – the deferred loss from Year 2 can only be offset against the profit from the activity in Year 3 (paragraph 35-10(2)(b)). Balance of loss deemed to be deduction attributable to activity in the next year it is carried on.

(4) Year 4 - loss deferral rule applies.

(5) 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.

Example 7 - apportioning asset values across different *business activities

138. 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. Both are *businesses. The property also contains his residence and surrounding land he uses for private purposes.

139. 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.

140. Ron will need to keep adequate records to allow him to make a reasonable apportionment of his assets between his *business activities and his private *dwelling.

Example 8 - operation of the Other assets test where general law partnership involved

141. Two sisters, Erin and, Katie, and their family trust, the EK Trust, are partners in a chocolate manufacturing *business. The partnership (through the partners) 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 a depreciating asset that has a *written down value of $15,000. She allows the partnership to use the asset in its *business activity on a continuing basis. However, at no stage does Erin's asset become a partnership asset.

142. In determining whether Erin's *business activity satisfies the Other assets tests, she can take into account the value of other assets of the partnership which is attributable to only the individuals of the partnership, that is, $90,000 (2/3 of $135,000). However, she can also take into account the value of the asset 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.

143. Katie cannot include the value of Erin's plant for 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).

144. Katie (or Erin) cannot count the one-third interest of their family trust for any of the tests. 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 can ask the Commissioner to exercise the discretion under subsection 35-55(1).

Example 9 - operation of the Profits test where general law partnership involved

145. Bob and Brendan are partners in a general law partnership which carries on a publishing *business 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.

146. 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 has *derived from it ($2,000). Brendan has a loss for the income year from the activity. If this pattern of income and attributable expenses were to continue for a further two years (years 2 and 3), with the partnership distributing losses to Bob and Brendan in years 4 and 5:

- Bob would pass the Profits test in years 4 and 5, as when testing for each of those years he would have profits from the activity in three out of the past five years (i.e., years 1 to 3); whereas
- Brendan would not pass the Profits test in any of the five years, as even in the years in which he received a distribution of partnership income, his attributable expenses meant that overall he did not make a tax profit from that activity in any year.

147. [Deleted]

148. [Deleted]

149. [Deleted]

150. [Deleted]

151. [Deleted]

152. [Deleted]

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170. [Deleted]

Example 15 - deferral of loss affected by *exempt income

171. 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).

172. If in the following year income year Heather earns more than $20,000 from her driving school *business and passes the Assessable income test, she may deduct the deferred loss of $8,000 from her other income. This is so whether or not she has *derived any net *exempt income in that year.

Example 16 - deferral of loss affected by bankruptcy

173. 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. If in Year 2 Rhonda's *business activity made a profit of $4,000, her Year 1 non-commercial loss would normally 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.

Last Ruling

174. This is the last Taxation Ruling for the 2001 calendar year. The next Ruling will be Taxation Ruling TR 2002/1.

Detailed contents list

175. Below is a detailed contents list for this Ruling:

Commissioner of Taxation
19 December 2001

Previous draft:
Previously issued as TR 2000/D16

Related Rulings/Determinations:
TR 92/1; TR 97/11; TR 97/16; TR 2000/17; TR 2007/6; TR 2005/1

Subject references:
- commencement of *business
- assessable income test
- bankruptcy
- business activity
- ceasing business activity
- commissioner's discretion

- deferred non commercial loss
- exempt income
- lead time
- non commercial loss
- other assets test
- partnerships
- primary production business exception
- professional arts business exception
- profits test
- real property test
- reasonable estimate
- separate business activities
- similar business activities
- special circumstances
- tax profit

Legislative references:
- Bankruptcy Act 1966 74
- Copyright Act 1968 10(1)
- TAA 1953 Part IVAAA
- TAA 1953 14ZAN(h)
- ITAA 1997 Div 6
- ITAA 1997 8-1
- ITAA 1997 8-1(1)(b)
- ITAA 1997 17-5
- ITAA 1997 Division 35
- ITAA 1997 35-1
- ITAA 1997 35-5
- ITAA 1997 35-5(1)
- ITAA 1997 35-5(2)
- ITAA 1997 35-10
- ITAA 1997 35-10(1)
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- ITAA 1997 35-10(2)(b)
- ITAA 1997 35-10(3)
- ITAA 1997 35-10(4)
- ITAA 1997 35-10(5)(a)
- ITAA 1997 35-15
- ITAA 1997 35-20
- ITAA 1997 35-20(1)
- ITAA 1997 35-20(2)
- ITAA 1997 35-20(3)
- ITAA 1997 35-25(a)
- ITAA 1997 35-25(b)
- ITAA 1997 35-25(c)
- ITAA 1997 35-25(d)
- ITAA 1997 35-30
- ITAA 1997 35-30(a)
- ITAA 1997 35-30(b)
- ITAA 1997 35-35
- ITAA 1997 35-35(1)
- ITAA 1997 35-35(2)
- ITAA 1997 35-40
- ITAA 1997 35-40(1)
- ITAA 1997 35-40(2)
- ITAA 1997 35-40(3)(a)
- ITAA 1997 35-40(3)(b)(i)
- ITAA 1997 35-40(3)(b)(ii)
- ITAA 1997 35-40(4)
- ITAA 1997 35-40(4)(a)
- ITAA 1997 35-40(4)(b)
- ITAA 1997 35-45
- ITAA 1997 35-45(1)
- ITAA 1997 35-45(2)
- ITAA 1997 35-45(3)(a)
- ITAA 1997 35-45(3)(b)(i)
- ITAA 1997 35-45(3)(b)(ii)
- ITAA 1997 35-45(4)
- ITAA 1997 35-50
- ITAA 1997 35-55
- ITAA 1997 35-55(1)
- ITAA 1997 35-55(1)(a)
- ITAA 1997 35-55(1)(b)
- ITAA 1997 35-55(2)
- ITAA 1997 Division 36
- ITAA 1997 36-10
- ITAA 1997 Div 40
- ITAA 1997 42-345(3)
- ITAA 1997 70-45(1)
- 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
- Brooks & Anor v. FC of T [2000] FCA 721
- Calkin v. CIR [1984] 1 NZLR 440
- 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 Youth Affairs v. Barrett & Anor (1998) 52 ALD 499; (1998) 82 FLR 524
- Watson v. DC of T [2008] FCA 1173; 2008 ATC 20-042
- Whitfords Beach Pty Ltd v. FC of T 83 ATC 4277; (1983) 14 ATR 247

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