


# ***TR 2007/6A1 - Addendum - Income tax: non-commercial business losses: Commissioner's discretion***

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## Addendum

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### Taxation Ruling

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

This Addendum amends Taxation Ruling TR 2007/6 to reflect changes to section 35-55 of the *Income Tax Assessment Act 1997* as a result of *Tax Laws Amendment (2009 Budget Measures No. 2) Act 2009* which introduced an income requirement.

**TR 2007/6 is amended as follows:**

**1. Paragraph 4 heading**

Omit 'limb'; substitute 'limbs'.

**2. Paragraph 4**

Omit 'paragraph 35-55(1)(b), known as the lead time limb'; substitute 'paragraphs 35-55(1)(b) and (c), known as the lead time limbs'.

**3. Paragraph 6**

Insert after the paragraph:

6A. However, in addition, for the 2009-2010 and later income years, the 'income requirement' in subsection 35-10(2E)<sup>2A</sup> applies. This change prevents certain high income individuals from claiming losses from their business activities, even though the activity may satisfy one or more of the tests. A new lead time limb in paragraph 35-55(1)(c) has also been introduced, to address cases where such individuals have started to carry on a business activity with a lead time.

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<sup>2A</sup> See paragraph 29A of this Ruling concerning subsection 35-10(2E).

#### 4. Paragraph 13

Insert after the paragraph:

13A. For those individuals who do not satisfy the income requirement in subsection 35-10(2E) special circumstances are those which have materially affected the business activity, causing it to make a loss. For these individuals the Commissioner's discretion in paragraph 35-55(1)(a) may be exercised for the income year(s) in question where:

- but for the special circumstances, the business activity would have made a tax profit; and
- the activity passes at least one of the four tests or, but for the special circumstances, would have passed at least one of the four tests.

#### 5. Paragraph 16

Omit the paragraph including heading; substitute:

**The lead time limbs in paragraphs 35-55(1)(b) and (c)**

***For the 2008-09 and earlier income years***

16. For these income years there is no income requirement. The Commissioner may exercise the discretion in paragraph 35-55(1)(b) for a business activity that has started to be carried on, where, for the income year(s) in question:

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

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

***For the 2009-10 and later income years – income requirement satisfied***

16A. The Commissioner may, on application, for an individual who satisfies subsection 35-10(2E) exercise the discretion in paragraph 35-55(1)(b) for a business activity that has started to be carried on, where, for the income year(s) in question:

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

***For the 2009-10 and later income years – income requirement not satisfied***

16B. The Commissioner may, on application, for an individual who does not satisfy subsection 35-10(2E) exercise the discretion in paragraph 35-55(1)(c) for a business activity that has started to be carried on, where, for the income year(s) in question:

- ‘because of its nature’, it has not, or will not produce a tax profit; and
- there is an objective expectation, based on evidence from independent sources (if available) that, within a period that is commercially viable for the industry concerned, the activity will produce a ‘tax profit’.

**6. Paragraph 17**

After ‘failure to satisfy one of the four tests’; insert ‘(subparagraph 35-55(1)(b)(i)) or produce a tax profit (subparagraph 35-55(1)(c)(i))’.

## 7. Paragraphs 18 and 19

Omit the paragraphs; substitute:

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

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

## 8. Paragraph 23

Omit 'subparagraph 35-55(1)(b)(ii)'; substitute 'subparagraphs 35-55(1)(b)(ii) and (c)(ii)'.

## 9. Paragraph 24

Omit the paragraphs including heading; substitute:

### **Interaction between the limbs**

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

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

**10. Paragraph 26**

After 'the activity will satisfy a test'; insert '(or produce a tax profit)'.

**11. Paragraph 27**

After 'expected to satisfy a test'; insert '(or produce a tax profit)'.

**12. Paragraph 29**

Omit the paragraph; substitute:

29. Subsection 35-55(1) provides, with effect from the 2009-10 and later income years, as follows:

**Commissioner's discretion**

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

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

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

- (b) for an applicant who carries on the business activity who satisfies subsection 35-10(2E) (income requirement) for the most recent income year ending before the application is made – the business activity has started to be carried on and, for the excluded years:

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

- (ii) there is an objective expectation, based on evidence from independent sources (where available) that, within a period that is commercially viable for the industry concerned, the activity will either meet one of those tests or will produce assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsections 35-10(2) and (2C)); or
- (c) for an applicant who carries on the business activity who does not satisfy subsection 35-10(2E) (income requirement) for the most recent income year ending before the application is made – the business activity has started to be carried on and, for the excluded years:
  - (i) because of its nature, it has not produced, or will not produce, assessable income greater than the deductions attributable to it; and
  - (ii) there is an objective expectation, based on evidence from independent sources (where available) that, within a period that is commercially viable for the industry concerned, the activity will produce assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsections 35-10(2) and (2C)).

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

29A. For the 2009-10 and later income years the income requirement was introduced to limit those who can rely on the four objective tests. Subsection 35-10(2E) (the income requirement), provides as follows:

You satisfy this subsection for an income year if the sum of the following is less than \$250,000:

- (a) your taxable income for that year;
- (b) your reportable fringe benefits total for that year;
- (c) your reportable superannuation contributions for that year;

- (d) your total net investment losses for that year.

For the purposes of paragraph (a), when working out your taxable income, disregard any excess mentioned in subsection (2) for any business activity for that year that you could otherwise deduct under this Act for that year.

29B. Also applying from the 2009-10 income year in relation to subsection 35-55(1), are the following major changes:

- (a) the need to make an application to the Commissioner in order for any limb of the discretion to be exercised. Such applications need to be in the '\*approved form' (see subsection 35-55(3)); and
- (b) the introduction of new paragraph 35-55(1)(c) to cater for those individuals who do not satisfy the income requirement, but who have commenced to carry on a business activity with a lead time.

### 13. Paragraph 30

- (a) Omit 'both' from the heading; substitute 'all'.
- (b) After 'Explanatory Memorandum to the New Business Tax System (Integrity Measures) Bill 2000 (the EM)'; insert footnote:

<sup>7A</sup> All future Explanatory Memorandum references in this Ruling are to the EM unless otherwise stated.

### 14. Paragraphs 33 and 34

Omit the paragraphs; substitute:

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

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

34. All three limbs in subsection 35-55(1) therefore can be said to have the common object of preventing unfairness or injustice in cases where the business activity cannot satisfy any one of the four tests, or produce a tax profit, for reasons outside the control of the person operating it.

## 15. Paragraph 37

(a) Omit 'Section 35-10 achieves'; substitute 'For income years up to and including the 2008-09 income year section 35-10 achieved'.

(b) Insert after the paragraph:

37A. From the 2009-10 income year satisfaction of any of the four tests will no longer automatically prevent the loss deferral rule in subsection 35-10(2) applying to a loss made from a business activity carried on by an individual who does not satisfy subsection 35-10(2E) (the income requirement).

## 16. Paragraphs 38 and 39

Omit all occurrences of 'paragraphs 35-55(1)(a) and 35-55(1)(b)'; substitute 'paragraphs 35-55(1)(a), 35-55(1)(b) and 35-55(1)(c)'

## 17. Paragraph 41

(a) After 'In regard to this limb'; insert ', for those who satisfy the income requirement,'.

(b) Insert after the paragraph:

41A. For most individuals who do not satisfy the income requirement it is expected that the business activity will meet one of the four objective tests.

41B. Access to the special circumstances limb is not limited to those individuals who satisfy the income requirement. Individuals who do not meet the income requirement, but who can demonstrate their business is commercial, and has been affected by special circumstances, may also be considered under the special circumstances limb, as explained at paragraph 41D of the Ruling.

41C. For a business activity to be regarded as 'commercial' for the purposes of Division 35 four objective tests are provided, at least one of which must be satisfied. There are no other tests in Division 35. As a result those tests are relevant to determining whether or not individuals who do not meet the income requirement are conducting a business activity that is 'commercial' for the purposes of Division 35.

41D. For individuals who do not satisfy the income requirement, the factors that must be satisfied before deciding whether to exercise the special circumstances limb of the discretion for an income year are that:

- the business activity is affected by special circumstances such that it is unable to produce a tax profit; and

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

**18. Paragraph 47**

(a) After 'In the context of Division 35'; insert ', where the income requirement is satisfied,'.

(b) After 'unreasonable for the loss deferral rule to apply'; insert footnote:

<sup>8A</sup> Paragraph 2.22 of the Explanatory Memorandum to Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009 makes it clear that the existing rules continue to apply to taxpayers who satisfy the income requirement.

**19. Paragraph 50**

Insert after the paragraph:

50A. Where the business activity is carried on by an individual who does not satisfy the income requirement and this activity would have made a loss even if it had not been affected by special circumstances, it is also unlikely that it would be considered unreasonable for the loss deferral rules to apply and therefore the Commissioner is unlikely to exercise the discretion (Refer to Example 7A at paragraph 129A of this Ruling).

**20. Paragraph 51**

After 'would therefore have failed to satisfy a test'; insert 'or produce a tax profit'.

**21. Paragraph 52**

After 'such that it cannot satisfy any of the tests'; insert 'or produce a tax profit'.

**22. Paragraph 65**

Omit 'The note to paragraph 35-55(1)(a)'; substitute 'Subject to the comments in paragraphs 66A and 66B of this Ruling the note to paragraph 35-55(1)(a)'.

## 23. Paragraph 66

Insert after the paragraph:

66A. The introduction of the income requirement means there will now be cases where satisfaction of a test will no longer automatically provide a reason for not applying the loss deferral rules. However, as explained in paragraphs 41A to 41D of this Ruling, this does not mean this is necessarily irrelevant to the exercise of the special circumstances limb in such cases.

66B. The note to paragraph 35-55(1)(a), as indicated in paragraph 62 of this Ruling is not an operative provision. It does not prevent paragraph 35-55(1)(a) applying to those individuals who do not satisfy the income requirement.

## 24. Paragraph 67

(a) Omit from the heading 'limb'; substitute 'limbs'.

(b) Insert after the paragraph:

67A. For an individual who does not satisfy the income requirement, paragraph 35-55(1)(c), describes the situation where the Commissioner may exercise a discretion not to apply the loss deferral rule in subsection 35-10(2) if a tax profit is not produced because of the nature of the business activity.

## 25. Paragraph 68

Omit 'Paragraph 35-55(1)(b) applies'; substitute 'Paragraphs 35-55(1)(b) and (c) apply'.

## 26. Paragraph 69

(a) Omit from second dot point 'subsection 35-10(2)'; substitute 'subsections 35-10(2) and (2C)'

(b) Insert after the paragraph:

69A. In regard to paragraph 35-55(1)(c) there are also two factors to consider. They are:

- whether because of its nature, the business activity has not produced, or will not produce, assessable income greater than the deductions attributable to it; and
- whether there is an objective expectation, based on evidence from independent sources (where available) that, within a period that is commercially viable for the industry concerned, the activity will produce assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsection 35-10(2) and (2C)).

#### **27. Paragraph 70**

After 'The first factor'; insert 'in paragraph 35-55(1)(b)'.

#### **28. Paragraph 73**

Insert after the paragraph:

73A. Because the tests are not automatically relevant if the income requirement is not met, the first factor in paragraph 35-55(1)(c) considers whether it is 'because of its nature' that the activity has not produced, or will not produce, a tax profit.

#### **29. Paragraph 74**

Omit the paragraph; substitute:

74. The note under paragraph 35-55(1)(c) states:

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

#### **30. Paragraph 78**

Omit 'subparagraph 35-55(1)(b)(i)'; substitute 'subparagraphs 35-55(1)(b)(i) and (c)(i)'.

## 31. Paragraph 80

Omit the paragraph; substitute:

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

## 32. Paragraph 83

(a) Omit 'Paragraph 35-55(1)(b)'; substitute 'Paragraphs 35-55(1)(b) and (c)'.

(b) Insert footnote after quote:

<sup>10A</sup> The note in paragraph 35-55(1)(b) was repealed and replaced by a similar note inserted after paragraph 35-55(1)(c), applicable in relation to the 2009-10 and later income years.

## 33. Paragraph 88

Insert at end of paragraph:

Subparagraph 35-55(1)(c)(ii) requires that there is an objective expectation that, within a period that is commercially viable for the industry concerned, the activity will produce a tax profit.

## 34. Paragraph 96

Insert at end of paragraph:

As noted already, the question posed by subparagraph 35-55(1)(c)(ii) only concerns the time by which the business activity is objectively expected to make a tax profit.

## 35. Paragraph 97

Omit 'subparagraph 35-55(1)(b)(ii)'; substitute 'subparagraphs 35-55(1)(b)(ii) and (c)(ii)'.

**36. Paragraph 99**

Omit all occurrences of 'paragraph 35-55(1)(b)'; substitute 'paragraphs 35-55(1)(b) and (c)'.

**37. Paragraph 101**

Omit 'paragraph 35-55(1)(b) is'; substitute 'paragraphs 35-55(1)(b) and (c) are'.

**38. Paragraph 102**

Omit 'paragraph 35-55(1)(b)'; substitute 'paragraphs 35-55(1)(b) and (c)'.

**39. Paragraph 108**

Insert after the paragraph:

108A. From the 2009-10 income year the fact that a business activity has satisfied one of the four tests no longer automatically means that the loss deferral does not apply, where the activity is carried on by an individual who does not satisfy the income requirement in subsection 35-10(2E). However, as explained in paragraphs 41A to 41D of this Ruling, this factor may remain relevant to the exercise of the special circumstances limb in such cases. This does not amount to an acceptance of the above alternative view to situations of this type.

**40. Paragraph 109**

(a) Omit 'comes within either paragraph (a) or (b) of the subsection, what impact the circumstances referred to in either paragraph'; substitute 'comes within either paragraph (a),(b) or (c) of the subsection, and what impact the circumstances referred to in the relevant paragraph'.

(b) Omit 'proposed' in final sentence.

## 41. Paragraph 129

Insert after the paragraph:

### **Example 7A**<sup>18A</sup>

129A. Alister carries on a business of breeding cattle for sale, and has done so for the past 20 years. In prior years this business activity has been very profitable. However, in the 2010 income year it was affected by drought, which caused Alister to spend much more than anticipated on fertilizer and seed to maintain the condition of his pastures. The drought also affected the average sale price per head Alister could obtain for his cattle. A large loss was made from the business for the 2010 income year.

129B. Alister did not meet the income requirement (subsection 35-10(2)(E)) for the 2010 income year. Therefore, the fact that his business activity satisfied both the assessable income and profits tests for this year does not automatically mean that the loss deferral rule in subsection 35-10(2) does not apply. This is due to the change in paragraph 35-10(1)(a), and the introduction of subsection 35-10(2E) (the income requirement). He applies for the Commissioner to exercise the discretion under the special circumstances limb in paragraph 35-55(1)(a), and decide that the loss deferral rule not apply.

129C. Alister's application shows that special circumstances outside of his control, in the form of the drought, caused his business activity to make the loss in question, where, but for those circumstances a profit would have been made.

129D. The Commissioner notes the inherent profitability of the business, as borne out by its strong past performance in this respect. He concludes that, while the factors in paragraph 35-10(1)(a) are not directly to be applied, the fact that the business continues to satisfy the assessable income test and the profits test points towards it being 'commercial' in the sense indicated by the scheme of Division 35. The Commissioner concludes that it would be unreasonable in these circumstances for the loss to be deferred, and exercises the special circumstances limb of the discretion.

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<sup>18A</sup> Refer to Explanation, paragraph 50A of this Ruling.

129E. If the facts were that the business had not made a profit in recent times, and moreover, was not reasonably expected to do so in the future, the mere fact that, for example, the business satisfied the real property test, or the other assets test, would not, in itself, indicate that it was unreasonable for losses from the business to be deferred. This would be so, even if the business activity was affected by special circumstances to some extent, but not to the extent that these circumstances caused what would otherwise be a profitable activity to be one which made a loss.

#### **42. Paragraph 184**

Omit:

The 'lead time limb'	4
The lead time limb in paragraph 35-55(1)(b)	16
Common object of both limbs	30

Insert:

The 'lead time limbs'	4
The lead time limbs in paragraphs 35-55(1)(b) and (c)	16
<i>For the 2008-09 and earlier income years</i>	16
<i>For the 2009-10 and later income years – income requirement satisfied</i>	16A
<i>For the 2009-10 and later income years – income requirement not satisfied</i>	16B
Common objective of all limbs	30
<i>Example 7A</i>	129A

#### **43. Legislative references**

Insert:

- ITAA 1997 35-10(2E)
- ITAA 1997 35-55(1)(c)
- ITAA 1997 35-55(1)(c)(i)
- ITAA 1997 35-55(1)(c)(ii)
- ITAA 1997 35-55(3)
- Tax Laws Amendment (2009 Budget Measures No. 2) Act 2009

#### **44. Other references:**

Insert:

- Explanatory Memorandum to the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009

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

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**Commissioner of Taxation**

27 April 2011

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ATO references

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