7

SPECIFIC EQUITY CONCERNS

Assessing the need for an alternative minimum company tax

Recommendation

7.1 Alternative minimum company tax not necessary

That on the basis the reforms recommended by the Review are implemented, an alternative minimum company tax is judged unnecessary to achieve equity in the Australian taxation system.

Background

A minimum company tax involves establishing a second tax system for companies so that they pay the greater of the amount of tax calculated in accordance with this system and the ordinary tax system. When compared with the ordinary tax system, a minimum company tax involves a lower rate of tax applied to a broader base. The base is broadened by, effectively, adding back certain deductions allowed to the taxpayer in calculating ordinary tax.

A small number of countries have a minimum company tax. In the USA a minimum company tax is calculated at 20 per cent of a tax base reconstructured from the ordinary tax base. The minimum company tax in India is determined by applying the usual tax rate to 30 per cent of the company's reported profit after adjustments for a number of specified tax preferences. In Ontario the minimum company tax is 4 per cent of a tax base derived from the taxpayer's reported profit after adjustments for matters such as foreign income and dividends. Canada, Columbia, Pakistan and Venezuela have a minimum company tax based on one or more of net assets, gross assets, capital and gross turnover.

A minimum company tax may be used to restrict access to tax preferences that are allowable under the ordinary tax system. In an Australian context, a minimum company tax would have the effect of overriding access to features of the taxation system such as:

- the carry-forward of tax losses;
- accelerated depreciation;
- concessional treatment of leases;
- immediate write-off of expenses incurred in forestry establishment;
- specific primary producer provisions;
- indexation of capital gains;
- investments in Australian films;

- avoidance of double taxation on foreign earnings; and
- the research and development concession.

The USA has operated a minimum tax since 1969. It applies to both companies and individual taxpayers. The Senate Finance Committee of the United States Congress, in its report on the Tax Reform Act of 1986, in supporting the retention of a minimum company tax in the US tax system:

> … believed that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability. The ability of highly profitable corporations to pay little or no tax undermines respect for the entire tax system and thus, for the incentive provisions themselves. In addition, even aside from public perceptions, the committee believes that it is inherently unfair for highly profitable corporations to pay little or no tax due to their ability to utilize various tax preferences. In particular, both the perception and reality of unfairness have been harmed by instances in which major companies have paid no taxes in years when they reported substantial earnings, and may even have paid substantial dividends to shareholders.

Fundamental reform a preferred alternative

The United States Treasury noted in a 1984 report to the President, *Tax Reform for Fairness, Simplicity and Economic Growth*, that minimum taxes 'reflect an attempt to maintain the equity and neutrality of a tax system that is riddled with special preferences. The corporate minimum tax would be necessary only if the underlying tax preferences were retained. Because the … comprehensive tax reform package repeals almost all special preferences directly, eventual repeal of the corporate minimum tax would be possible.'

The Review has proposed various measures which, taken together, will reduce substantially the capacity for companies to reduce their nominal tax liabilities, and therefore their effective tax rate, by taking advantage of tax preferences. Principal among these are the reforms proposed for:

- the taxation of wasting assets (particularly the abolition of accelerated depreciation for all but small businesses);
- the 'freezing' of indexation for capital gains;
- the accrual of payments associated with the taxation of leases and rights;
- the tax consolidation of corporate groups;
- taxing inter-entity distributions; and

- value shifting and loss duplication measures outside consolidated groups.

An appreciation of the full range of measures can be obtained from the revenue estimate tables in Section 24.

These measures will improve the efficiency of the ordinary tax system and reduce variations in effective tax rates across projects and between taxpayers. In that regard, a minimum company tax would not achieve the efficiency gains that are available through the repeal of tax preferences. The measures proposed by the Review will result in investment in a more efficient economy with greater aggregate output.

Business compliance costs

A minimum company tax necessarily involves additional complexity and uncertainty in the tax system, to the extent that it requires taxpayers to undertake additional calculations and record keeping to fulfil their minimum company tax obligations.

These additional compliance costs must be incurred by all companies to determine if they are liable to minimum company tax, not only those who are ultimately liable to the tax. The compliance burden of the minimum company tax is particularly severe for small business. The US Internal Revenue Service has estimated that the average time taken by a taxpayer to complete and lodge a minimum company tax form is in the order of 48 hours (including record keeping obligations).

Furthermore, a 1995 study by the US General Accounting Office indicated that from 1987 to 1991:

- only 0.7 to 1.5 per cent of companies paid minimum company tax in any given year. For example, in 1990, about 32,000 companies paid minimum company tax while some 2.1 million companies were obliged to undertake the calculations required to determine if they were liable; and
- companies with assets exceeding US$1,000 million comprised less than 3 per cent of minimum company tax taxpayers and contributed about 75 per cent of minimum company tax revenue.

An attempt has since been made to address compliance costs in the USA by exempting from potential minimum company tax liability companies that do not have significant annual turnover. The Review is concerned to reduce compliance costs for all businesses. In particular, in relation to small businesses, taxpayers with an annual turnover of less than $1 million will be able to elect into a simplified tax system, including a streamlined pooling arrangement for writing off most depreciable assets.

The minimum company tax and tax preferences

The tax base used to calculate a taxpayer's liability for minimum company tax would not have regard to a number of preferences and design features found in the ordinary tax system.

In general terms, the minimum company tax base would involve reversing selected tax preferences to apply the lower minimum company tax rate to a broader tax base.

A taxpayer could be liable to pay the same amount of tax under both the ordinary tax system and the minimum company tax system. Any further use of tax preferences would continue to reduce the taxpayer's liability for tax under the ordinary tax system. However, by design, the tax preference would not affect its income under the minimum company tax system, and its liability for minimum company tax would not change. Consequently, any reduction in the taxpayer's liability under the ordinary tax system would be nullified by an unchanged liability for minimum company tax. A minimum company tax would therefore limit, in an arbitrary manner, a company's capacity to access a range of tax preferences included in the ordinary tax system by design, such as the R&D concessional deduction.

As noted, the Review has recommended a wide range of targeted structural measures that will eliminate many tax preferences. The remaining tax preferences will be retained in the taxation law as a result of deliberate decisions.

The Review considers that it would not be consistent with the policy rationale for these measures to blunt their intended effects though a broad brush measure such as a minimum company tax. If measures such as these are to be removed from the tax system then this should be achieved directly and transparently.

Perceptions behind the minimum company tax

A minimum company tax is a response to perceived inequity in the ordinary tax system. The perception arises because the published financial reports of some companies indicate that they pay little or no tax despite having high levels of reported profit. This outcome is relied on to support the conclusions that there are substantial deviations between the statutory and effective tax rates borne by some companies, and that reported profits should be used as a minimum company tax base.

However, these conclusions are based on a misunderstanding of the differences between a company's taxable income and its reported profit.

A reconciliation between the operating profits and taxable income for 28 Australian public companies in aggregate is presented in Table 7.1. The Table indicates the general nature of the differences between operating profit and taxable income. The magnitude of the aggregate differences between profit and taxable income is not so large as to suggest that a minimum company tax is necessary to maintain equity in the entity taxation system.

Table 7.1 **1998 results for 28 Australian public companies (summary of accounting data)**

	$m	$m
Operating profits before tax		8,650
Add:		
Non-deductible depreciation	527	
Non-allowable expenditure	395	
Quarantined foreign losses	214	
Non-deductible interest (RPS)	186	
Increase in provisions	101	
Amortisation of goodwill/intangibles	94	
Attributable foreign income	54	1,571
		10,221
Less:		
Write-down of assets	619	
Non-assessable gains	592	
Inter-company dividends	497	
Prior year losses brought forward	318	
Exempt and other non-assessable income	287	
Development and investment allowances	206	
Tax differential on non-Australian income	162	
R&D deductions (additional 25%)	125	
Net timing differences	45	
Other	369	3,220
Taxable income		**7,001**

Source: BCA/TCA

Differences between taxable income and reported profits

In addition to specific tax preferences, significant differences between the amounts recorded for financial reporting and taxation purposes entail:

- the inclusion in reported profits of dividends that have already been taxed in another entity;
- the inclusion in reported profits of foreign source income that has already been taxed in the place that it was earned;
- the carry-forward of losses for tax purposes;
- the effects of equity accounting; and

- the effect of different recognition policies applied for financial reporting and taxation purposes. The Review has recommended a number of changes to the taxation law that will reduce these potential differences between reported profit and taxable income, which currently include:
  - an item of expenditure may be classified as being on the taxpayer's revenue account for taxation purposes, and result in an immediate deduction, or as an asset for financial reporting purposes, requiring depreciation over a longer period;
  - an asset may have different values for financial reporting and taxation purposes, resulting in different amounts being allowed for depreciation;
  - different depreciation methods may be used for financial reporting and taxation purposes;
  - a financial arrangement might be classified as debt for tax purposes, so that the financing costs are deductible as interest, and as equity for financial reporting purposes, so that the same costs are treated as a dividend without reducing reported profit; and
  - income arising from a financial transaction may be measured on an accruals basis for taxation purposes, and marked to market for financial reporting purposes.

The use of equity accounting for financial reporting purposes requires companies to count towards their accounting profits income earned by entities over which they have a significant influence, even though the entity has not yet distributed the profits to the company. This will cause the company's reported profit to exceed its taxable income, because the dividends will only be counted towards taxable income when they are actually paid. To the extent that they are retained by the controlled entity, the reported profits will never be included in the company's taxable income. Equity accounting could result in some companies not having the capacity to satisfy their liability for minimum company tax if taxable income was assessed on accounting profits.

Reported profits as the minimum company tax base

The use of reported profit as the minimum company tax base has been criticised because:

- it would involve significant compliance costs for the many small proprietary companies that are not required by the Corporations Law to prepare financial statements;
- it would involve an abdication of the Parliament's responsibility for taxation matters to those responsible for setting accounting standards, in relation to the minimum company tax base;
- it is subject to variations in financial reporting practices and policies between companies;

- the accounting standards do not apply in the same way in different industries — for example in relation to the valuation of assets by insurers;
- the accounting standards are insufficiently comprehensive in some areas — for example in relation to financial transactions; and
- the accounting standards do not require that transactions be measured on an arm's length basis, thus allowing profit shifting through practices such as transfer pricing.

When applied to the minimum company tax, these features of reported profit have the potential to increase the inefficiency of the tax system across projects and between companies.

Concerns have also been expressed that a minimum company tax based on reported profits would provide an incentive for companies to manage their reported profits in order to avoid a potential tax liability. For example, companies might revalue assets in order to increase their depreciation expense or to record a devaluation directly against profits. In addition to generating compliance costs, these responses to a minimum company tax decrease the overall quality of financial reporting and reduce the efficiency of the capital markets with adverse consequences for the economy as a whole.

The US minimum company tax originally included a component based on the taxpayer's reported profit. However, concerns that this would result in earnings management by taxpayers led to this component being replaced with a statutory proxy for reported profit.

Minimum company tax and fairness

A minimum company tax seeks fairness within the tax system through a compromise between eliminating some or all tax incentives or not allowing them to be used to 'excess' — in the sense of the gap between effective and nominal tax rates.

The principle that a tax system should be equitable is primarily directed at its application to individuals. This is because the burden of company taxes ultimately falls to individual shareholders, as well as customers and workers, rather than the company on which they are directly imposed. In order to assess whether a business tax system promotes fairness or equity within the overall tax system it is therefore necessary to look through the business tax system to consider how the system's final tax burden is distributed among individuals.

Individuals ultimately pay tax on the economic income of companies when they receive it as dividends or as capital gains on the realisation of equity interests.

The USA operates a classical company tax system under which companies and individuals pay tax on dividends received by them without the benefit of franking credits. Individual shareholders do not therefore benefit from taxes paid at the company level.

However, under Australia's imputation system, tax paid by companies represents an advance on the tax burden finally satisfied by individuals through their personal taxation obligations. The fairness of the business tax system will be promoted by measures improving the integrity of the dividend imputation system, including the introduction of refundable imputation credits as proposed by the Government and recommended by the Review.

Minimum company tax and anti-avoidance

Companies that would be required to pay at least a minimum company tax would have no incentive to engage in avoidance practices that would take their tax liability below the minimum company tax. A minimum company tax could therefore have an incidental effect of reducing the incentive for companies to engage in tax avoidance practices, and therefore to devote fewer resources to these activities. One response to this argument is that a minimum company tax would merely change the avoidance focus from the ordinary tax base to the minimum company tax base.

Conclusion

For the reasons outlined above the Review does not recommend the introduction of a minimum company tax system on the basis that its recommendations for fundamental reform of the business tax system are adopted.

Addressing the alienation of personal services income

Recommendation
7.2 Payments in respect of personal services

That where a company, trust or partnership (the 'interposed entity') is, or is to be, interposed between a person or entity requiring services (the 'service requirer') and the individual who performs or is responsible for performing the services (the 'service provider'), payments received by the interposed entity in respect of the services be treated for income tax purposes as the income of the service provider where:

(i) the interposed entity receives 80 per cent or more of its receipts in respect of personal services, either directly or indirectly, from one service requirer, or associate of that service requirer, during the year of income; or

(ii) the services are provided to the service requirer in an employee-like manner as determined by a range of specific criteria; or

(iii) the interposed entity is unable to obtain from the Commissioner of Taxation a decision that the 80 per cent/one service requirer test in paragraph (i) should not apply.

Alienation of income

It is a fundamental principle of most tax systems that income derived from the personal exertion of an individual — payments in respect of personal services — cannot be alienated. Some countries including the US, UK and Canada have legislative rules to ensure this outcome. Others however, including Australia, rely on common law rules (and in our case, on the general anti-avoidance rule in Part IVA) to the same end on a case-by-case approach.

Where payments in respect of personal services are made to an individual through an interposed entity, tax may be avoided by income alienation. The payments are diverted to the interposed entity, which is then used as a vehicle to share with related parties what is income of the individual. The creation of these structures for providing personal services also gives rise to a perception that a greater range of so-called business deductions are available which would not normally be allowable to an individual working as an employee. Concerns regarding these practices were raised in *A Platform for Consultation* (pages 57-58).

Need for equity in taxing income from personal services

These practices raise significant issues of equity and pose a growing threat to the income tax base. The use of such arrangements to reduce the tax liabilities of individuals means that people in substantially the same financial and work situation would be paying significantly different levels of taxation.

It is clearly inequitable that some taxpayers should be reducing their tax liability by using interposed entities to alienate income while other taxpayers also deriving personal services income, including ordinary wage and salary earners, pay the correct amount of tax. In addition to the tax consequences, income alienation can result in highly remunerated individuals being able to reduce their taxable income to a level that entitles them and members of their families to a range of income-tested government payments. Alienation can also enable these individuals to avoid a range of other obligations such as higher education contribution charges, Medicare levy and superannuation surcharges and child support payments.

The Review believes that remuneration in respect of the personal services of the individual who carries out the services should be taxed consistently with the manner that would apply if an employee carried out the services. This approach is consistent with Policy Design Principle 12 contained in the Charter of Business Taxation (see Recommendation 1.3) whereby economic transactions having the same economic substance should be taxed similarly, irrespective of their legal form.

Interposed entities

The use of interposed entities to alienate payments in respect of personal services is increasing along with the tendency to engage dependent contractors rather than employees. These practices are generally, though not necessarily, driven by and lead to taxation consequences. As indicated above these consequences are inequitable and pose a significant risk to tax revenue particularly where income splitting opportunities arise and the possibility of claiming an increased range of alleged business taxation deductions is opened up.

Figure 7.1 Labour market trends (20 years)

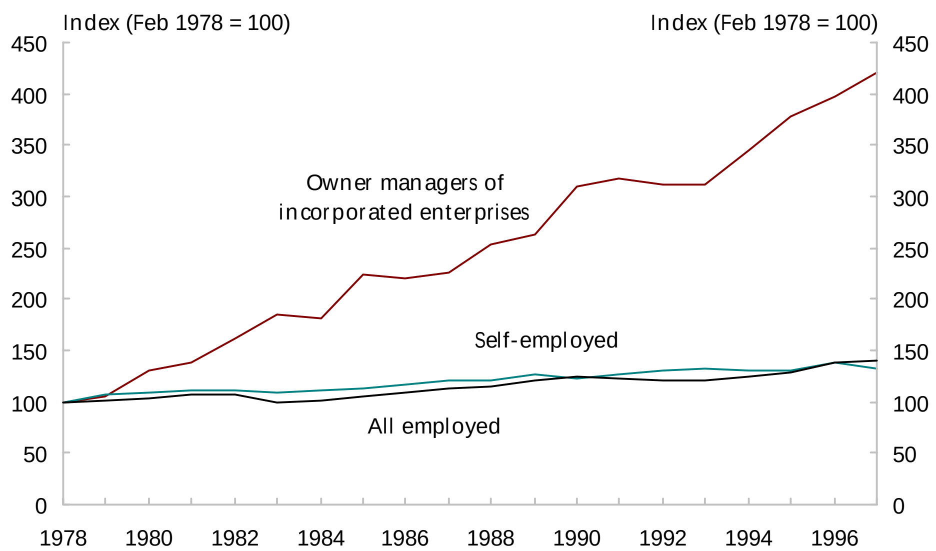

Figure 7.1, taken from the Australian Bureau of Statistics — Labour Force Survey — July 1997, demonstrates an increase of 320 per cent in owner managers of incorporated enterprises over the past 20 years. That is, the number of owner managers of incorporated enterprises more than quadrupled between February 1978 and February 1997 increasing from 110,700 to 465,900. However, it should be recognised that not all owner managers of incorporated enterprises will necessarily be providing services in an

employee-like manner. The findings of a recent national project conducted by the ATO are consistent with the Labour Force Survey.

The differential between the company rate of tax and the top marginal personal rate of tax makes corporate interposition attractive and this will be accentuated by the proposed reduction in the company tax rate to further Australia's international competitiveness. The progressive personal tax rates make income splitting between individuals a sought after outcome.

A systemic approach to these issues is therefore necessary. The recommended approach is directed towards cases where income should be correctly attributed for taxation purposes to an individual who carries out personal services in a manner broadly similar to the way those services would be carried out if that person was an employee of the person or entity who required the services.

Recommended by the Review is an approach designed solely to address the taxation implications resulting from the commercial arrangements under which labour (including professional and creative activities) may be engaged. The approach does not impinge, and should not be seen as impinging, in any way on any commercial or contractual obligation that may be present between any or all parties concerned with the arrangement, nor as preventing similar arrangements being entered into in the future. Most importantly, the approach recommended does not, of itself, under any circumstances and for taxation or any other purpose make the service provider a common law employee.

Where an individual provides personal services through an interposed entity or a chain of interposed entities, however structured, and one of the interposed entities contracts with the end user of those services ('service requirer'), the income derived from the contract ('payment in respect of personal services') is often split with members of the family of the individual performing the services ('service provider') thereby reducing the overall amount of tax payable.

Payments in respect of personal services include amounts that are wholly or predominantly for the labour or skill of an individual who performs that labour or exercises that skill including those rendered to provide a specific result or outcome. Personal services also include the performance of professional and creative activities.

Example 7.1 Alienation of payments in respect of personal services

An example of such an arrangement is where the services of a technical expert are engaged by a large firm through a family company owned by the expert and the expert's spouse. Among other conditions, the contract for those services stipulates what services are to be provided, how and when they would be provided and a regular rate of remuneration that is to be paid for these services. These conditions are similar to those under which employees of the same firm were engaged to perform the same services. The family company claims a range of so-called business expenses as tax deductions. It further seeks to share its 'income' with a number of parties each of whom can thus take advantage of the tax-free threshold and lower rates of personal tax. The company pays tax on its taxable income at the company tax rate. Traditional employees of the same firm receive only the tax deductions for work-related expenses they are entitled to as employees, they may apply only one tax free threshold and may pay a higher rate of personal tax.

Case law in Australia supports the view that, for income tax purposes, the income in these cases is properly that of the individual performing the services. However, no specific provisions in the taxation law deal with the taxation consequences of such arrangements. The current approach generally requires that the general anti-avoidance rule be applied to the facts of each individual arrangement on a case-by-case basis and that the Commissioner of Taxation determine that the purpose of entering into an arrangement was to gain a tax benefit.

Particularly when assessed against the growth trend evident in Figure 7.1, the resource requirements to ensure compliance with the current law are labour intensive and inefficient. A more systemic solution is therefore essential to address the inconsistent and inequitable treatment, and the increasing risk to the revenue, resulting from the alienation of payments through interposed entities in respect of an individual's personal services.

Providing a legislative basis for dealing with people supplying personal services in an employee-like situation will address these issues.

Source of payment

Analysis by the ATO shows that in a large number of arrangements where personal services are being provided through an interposed entity, only one service requirer or one labour hire firm is involved during the course of the year of income.

Where there is only one service requirer or associate of that service requirer for 80 per cent or more of the payments in respect of personal services received by an interposed entity during a year of income, all amounts received in respect of personal services will be treated for income tax purposes as the income of the individual who controls the entity and performed the actual services that are the subject of the contract. This approach is broadly based upon an aspect of the payroll tax arrangements that apply in some States.

Employee-like manner

The Victorian payroll tax arrangements, along with those that operate in other States and Territories, provide a model for framing the criteria to be considered in determining if payments in respect of personal services relate to services undertaken in an employee-like manner.

A range of criteria concerning the service requirer, the interposed entity and the service provider along with details of the manner in which the services are performed would need to be taken into account.

These criteria include:

- the manner in which the services are being carried out having regard to the level of control exercised by the service requirer in relation to matters such as the time of work and actual hours of work required and where the services are to be performed;
- whether the same services are also contracted to the public at large in the year of income;
- the use by the interposed entity of substantial income producing assets as the predominant source of earning income, with the provision of personal services being incidental;
- whether incidental services are provided in conjunction with the sale of trading stock;
- the extent of the infrastructure provided by the interposed entity;
- whether more than one person is contracted to, and actually provides the services to the service requirer; and
- the degree of any entrepreneurial risk in the way that services are provided.

The responses to these criteria will determine if it can reasonably be concluded that the services are being provided in an employee-like manner. The Commissioner of Taxation will issue a detailed Ruling to provide guidance on the operation of these criteria.

Safeguard

A safeguard arrangement will allow a service provider, who has received 80 per cent or more of payments for personal services from one service requirer or associate of that service requirer, to seek from the Commissioner of

Taxation a decision that the 80 per cent/one service requirer rule should not apply.

Such a request will be considered on the facts of the particular case. However, an application will not be successful if the interposed entity has been consistently receiving payments from one service requirer, and it cannot be demonstrated that the interposed entity is conducting an independent trade or business.

Implications of recommendation

This recommendation will also ensure that, for income tax purposes, payments in respect of personal services will be treated as the income of the individual who performed the services rather than any company, trust or partnership interposed between the individual and the service requirer. The amount payable by the service requirer to the interposed entity will in effect be treated as though it passed through the interposed entity intact to the individual service provider. This will ensure that income in respect of personal services derived in an employee-like way is treated in the same way for income tax purposes as income actually derived by an employee.

The recommendation will also preclude a taxation advantage arising from:

- the splitting of payments in respect of personal services through the payment of wages, trust distributions or dividends, prior to the attribution of the income to the individual who performed the services; and
- in the case of a company, the deferral of tax through the retention of profits within the company.

This approach will not impact on genuine business undertakings, which provide services to the public generally. It will not affect the capacity of business to continue to engage third parties to perform services — nor will it imply that the service provider was an employee of the service requirer.

But it will address income taxation inequities such as where two individuals are performing identical services in the same workplace but one seeks to split income through interposing an entity while the other is simply an employee who is taxed at normal marginal rates on such income. Alienation cases that are not employment-like will continue to be considered under the general principles of the taxation law, including the general anti-avoidance rule.

Recommendation
7.3 Limiting deductions

That where:

- **in accordance with Recommendation 7.2, payments in respect of personal services are treated for income tax purposes as received by the individual who performs the services, or**

- **payments are made directly to an individual engaged as a dependent contractor in similar circumstances,**

the availability of taxation deductions for related expenses be limited to those that would be allowable if the individual:

(i) were employed by the service requirer to whom the services have been provided; and

(ii) incurred the expenditure in relation to that activity.

Overclaiming deductions

There is a perception that an increased range of income tax deductions become available to an individual who operates through an interposed entity or who holds himself or herself out to be carrying on business. These alleged deductions would not otherwise be allowable to an individual in their capacity as an employee of the service requirer (or employer).

The Review does not see such use of a particular commercial or contractual arrangement as creating entitlement to any additional income tax deductions. Recommended changes will make it clear that deductions in addition to those that would be available in an employee/employer situation will not be recognised for income tax purposes. This will address the present situation where, as noted, the ATO must deal with this issue on a case-by-case basis.

This recommendation will put beyond doubt that where personal services are provided by an individual — contracting either as an individual or through an interposed company, trust or partnership — deductions allowable against the income derived will be limited to the normal work related expenditure of an employee in similar circumstances.

Expenditures that will be deductible in respect of the personal services income are those that would normally be deductible if the expenditure was incurred by the individual in the capacity of a common law employee of the party requiring the services.

Recommendation
7.4 Costs of maintaining the entity structure

That expenditure in respect of the maintenance of the interposed entity structure:

(i) be recognised against any income, other than amounts in respect of personal services, in the calculation of the taxable income of the interposed entity; and

(ii) to the extent not recognised at the interposed entity level, be recognised in the calculation of the taxable income of the service provider.

Current commercial practice often means that business undertakings require each of their future operatives (including current employees) to form an entity and provide services through that entity if they are to continue to perform work for that business. There are certain expenses incurred in maintaining that entity and in equity, where these would otherwise qualify as an income tax deduction, they should be allowed as income tax deductions. These expenses will include ASIC fees and charges, government fees and charges, tax agent fees and accountancy fees.

Where an interposed entity is in receipt of amounts of income as well as amounts in respect of personal services of the service provider that pass through it, the cost of maintaining the entity structure will be recognised in the calculation of the taxable income of the interposed entity. Where the other income of the interposed entity is not sufficient to absorb all the costs of maintaining the entity, the unabsorbed amount will be recognised in the calculation of the taxable income of the individual who performed the services.

This will ensure that the costs of maintaining the entity are recognised in either the calculation of the taxable income of the interposed entity or the individual service provider in the year of expenditure.

Deferring losses from non-commercial activities

Recommendation

7.5 Non-commercial activities

Activity tests enabling loss offset

(a) That as a means of ensuring more equitable and certain taxation treatment, a loss arising in a year of income from an activity conducted or carried out by an individual taxpayer not be offset against other income of that taxpayer in that year unless the particular activity satisfies at least one of the following tests:

(i) the loss arose in relation to the rental of real property;

(ii) the particular activity from which the loss arose had an annual turnover of greater than $20,000;

(iii) assets, not being assets that are primarily used for private purposes, have a value:

- **that, in respect of real property, exceeds $500,000; or**
- **that, in respect of all other assets, excluding passenger motor vehicles, exceeds $100,000;**

and were used on an ongoing basis in the particular activity;

(iv) the particular activity resulted in taxable income in three out of the last seven years; or

(v) it would be unreasonable for the loss from the activity not to be offset against other income for that year because:

- **the activity was affected by circumstances outside the control of the taxpayer, including drought, flood, bushfires or other natural disasters; or**
- **an activity with a significant commercial purpose or character has been commenced.**

Non-commercial losses deferred

(b) That if, in accordance with paragraph (a), a loss is unable to be offset against other income in the year in which it arose, the loss be deferred until a future year where:

(i) income from the same or a like activity is available; or

(ii) at least one of the tests in paragraph (a) is satisfied — at which time a deferred loss or deferred losses will be able to be offset against other income.

There is a significant revenue leakage from unprofitable activities carried out by individual taxpayers, either acting alone or in partnership with another individual. Concerns regarding these practices were raised in *A Platform for Consultation* (pages 57-58). Many of these activities are no more than hobbies and/or lifestyle choices but even those that have business like characteristics (according to existing law) are often unlikely to ever make a profit and do not have a significant commercial purpose or character. They continue in a net loss position year after year, offsetting so-called business losses against other income, notably salary and wages. On average they make little or no contribution to the revenue raising task but gain a significant tax advantage.

In recent years the Australian Taxation Office has sought to minimise the loss to revenue associated with non-commercial activities. The turnover of entities and their diverse nature have meant that the number of taxpayers involved has remained about constant, with a persisting cost to revenue. The law in relation to carrying on a business is very difficult and resource intensive to administer and must be done on a case-by-case basis. The need to apply the existing law on that basis does not permit the efficient and effective use of resources and creates uncertainty.

A systemic solution that better deals with losses arising from such non-commercial activities is warranted.

A number of tests will be available for application to each separate activity that gives rise to a loss in a year of income. For example, if a taxpayer has a primary production activity and a manufacturing activity, each activity will need to be considered separately against the tests. These tests have been modelled on comparable provisions in other countries and designed so as not to disadvantage genuine business activities.

Satisfying none of the tests does not mean that the activity is not a business. The tests simply determine the taxation treatment for the net loss from that activity.

Losses from an activity that satisfies any one of the specified following tests will be able to be offset against other income of the individual.

Income from rental of real property

Where income is from the rental of real property any net income will be included in taxable income and any loss arising from the activity may be offset against other income.

Turnover greater than $20,000

Where the annual turnover of the activity is greater than $20,000, any net income will be included in taxable income and any loss sustained by the activity may be offset against other income.

The setting of the turnover threshold at $20,000 will ensure that taxpayers with a genuine business activity will not be unduly inconvenienced by the turnover test. Setting the turnover figure at this level will also help ensure turnover figures are not artificially inflated to meet the test.

Where an activity has commenced or ceased part way through an income year, the turnover figure will be pro rated. The pro rata figure will establish how much turnover the activity could have generated if it had operated for the full income year.

Assets used in the activity

Where real property assets in excess of $500,000, or other assets — excluding passenger motor vehicles — in excess of $100,000, are employed in the activity any net income will be included in taxable income and any loss sustained by the activity may be offset against other income.

The asset tests recognise that where a taxpayer has made a significant investment in assets that are employed in an activity, this activity should not be subject to the loss deferral rules. For the purposes of this test assets may be taken into account at either their cost or market value.

Assets which will be included are those which are actually employed on an ongoing basis in the activity. These assets will include real property, trading stock, plant and equipment, and improvements such as sheds and other structures. Passenger motor vehicles will not be included for the purpose of the asset tests. Assets employed for private purposes will not be considered for the purposes of the asset tests. For example, the value of a private residence and associated fencing on a farming property will not be included in the value of assets for the purposes of the real property asset test. Where an asset is employed for both business and domestic or private purposes, the value of that asset will be apportioned between uses.

Assets that are leased and employed in the activity will be included for the purposes of the assets test. For example, if land is leased under a 99-year Crown lease, the value of this land will be included for asset test purposes. Likewise, where a taxpayer is leasing plant or equipment which is actually employed on an ongoing basis in the activity, the value of that plant or equipment will be included for the purposes of the asset test. The value of assets that are leased or hired on a short time basis for a specific task will not be taken into consideration. For example, a large item of earth moving equipment hired on a one-off basis for the construction of a dam will not be considered.

Where more than one activity using the same asset is carried on, the value of the asset must be apportioned between activities. An asset cannot in effect be double counted by being applied to two activities.

Taxable income in three out of seven years

Where a profit for taxation purposes has resulted from the activity in three out of the last seven years (including years that precede the introduction of this measure), the losses (including held over losses) from the activity can be offset against other income.

Example 7.2 demonstrates the practical application of this test.

Safeguard

Where special circumstances can be demonstrated that would warrant the recognition of — or make it unreasonable not to recognise — losses in the year they arose, the Commissioner of Taxation will have authority to recognise the losses in that year. An example of where this authority would be exercised is where the activity is affected by circumstances outside the control of the taxpayer — such as prolonged drought, flood, bushfire or other natural disasters.

Start-up expenditure, particularly in relation to an activity with a long lead time, will also be considered under the safeguarding arrangement. In determining whether it would be unreasonable for a loss from a particular start-up activity to be held over, a significant commercial purpose or character will need to be demonstrated for the activity.

A number of indicators may support the demonstration of a significant commercial purpose or character. In particular, the current size and scale of the activity, the repetition and regularity of activity and profit indicators would be major factors. Evidence from an appropriate independent source — such as a government agency, an industry body or professional association or from a similar successful activity — about the nature and extent of investment required to establish a viable and profitable activity would also go to that demonstration.

Example 7.2 Taxable income in three out of seven years

Assumptions:

- Activity is not the rental of real property.
- Activity does not meet 'turnover test' or 'asset tests' in any year.
- Profit or loss in each year is from the same or a like activity.

Year	Taxable profit or loss from activity		Other taxable income	Test for profit in three out of the last seven years	Taxable income	Cumulative losses held over
1	Profit	$5,000	$40,000	Profit from activity to be returned.	$45,000	Nil
2	Profit	$5,000	$45,000	Profit from activity to be returned.	$50,000	Nil
3	Loss	$10,000	$50,000	Deferring of loss rule will apply. Loss from year 3 to be held over.	$50,000	$10,000
4	Loss	$8,000	$55,000	Deferring of loss rule will apply. Loss from year 4 to be held over.	$55,000	$18,000
5	Loss	$6,000	$60,000	Deferring of loss rule will apply. Loss from year 5 to be held over.	$60,000	$24,000
6	Profit	$5,000	$65,000	Profit in years 1, 2 and 6. Test for profits in 3 out of the last 7 years met. All held over losses to be offset against year 6 income.	$46,000	Nil
7	Loss	$12,000	$70,000	Profit in years 1,2 and 6. Test for profits in 3 out of the last 7 years met. Deferral of loss rules will not apply. $12,000 loss can be offset against year 7 income.	$58,000	Nil
8	Profit	$2,000	$75,000	Profit from activity to be returned.	$77,000	Nil
9	Loss	$15,000	$80,000	Profit in years 6 and 8. Test for profits in 3 out of last 7 years not met. Deferral of loss rule will apply. Loss from year 9 to be held over.	$80,000	$15,000
10	Profit	$3,000	$85,000	Profit from activity to be returned. Profit in years 6, 8 and 10. Test for profits in 3 out of the last 7 years met. Loss held over from year 9 can be offset against year 10 income.	$73,000	Nil

Losses to be deferred

Where none of the tests can be met in respect of an activity, and the circumstances are such that the safeguarding arrangement cannot be invoked, the losses from the activity will be held over for an indefinite period. Such losses will be available to be offset against net income from the same or a like business activity in a later year. A like business activity will be an activity that is similar to the activity from which the earlier loss arose but not necessarily an activity the same as the previous activity; for example, if the activity was converted from sheep grazing to cattle grazing.

As a result, such deferred losses will not be denied, but rather held over to be offset when the activity or a like activity proves to be profitable.

Where in any year an activity is able to satisfy at least one of the tests, losses from the activity or a like activity in an earlier year that have been deferred may be offset against taxable income of that year.