bO2™

Corporate Essentials

NON COMMERCIAL LOSSES

ISSUE	125

b02.com.au

Contents

HOBBIES 2
PROFIT UNLIKELY 3
COMMENCEMENT 3
COMMERCIALITY TESTS 3
1. The assessable income test 3
2. The profits test 4
3. The real property test 5
4. The other assets test 5
PARTNERSHIPS AND THE FOUR TESTS 6
1. Assessable income test 6
2. Profits test 6
3. Real property test 6
4. Other assets test 6
ADJUSTED TAXABLE INCOME TEST 6
QUARANTINED LOSSES 7
EXCEPTIONS 7
CASE STUDY – OFFSETTING DEFERRED LOSSES 8
CONCLUSION 8

NON COMMERCIAL LOSSES

Sole traders or individuals in a partnership engaging in business activities separate from their primary income source need to be across the non-commercial loss rules. Put simply, non-commercial losses refer to the financial losses incurred from business activities that lack a significant commercial purpose or character.

While the rules mean that you may not be able to offset any losses made against your other income immediately, the legislation puts tests in place that determine when and how you can offset or defer your losses.

HOBBIES

To be clear, the non-commercial loss rules do not apply to individuals carrying on a hobby (distinct from a business).

The ATO favours "indicia" – individual criteria to assess whether an activity is a hobby or a business. Although no single criterion is conclusive, you will have a fairly clear idea if there are enough ticks on the checklist. These criteria include the following.

- What is the reason for the activity? Is it commercial or recreational?
- Is making a profit the intention or purpose of the activity?
- How often do you undertake the activity? Is it occasional or regular?
- Is the activity informal and unstructured? Or is it planned and organised like a business?
- What is the size and scale of the activity?
- Is there a significant amount of capital invested?
- Are there loans involved?

By contrast, a non-commercial business – for the purposes of these rules – refers to a business activity that is not your primary source of income and lacks a significant commercial purpose. Note that investments that generate passive income aren't considered a business activity either, or you won't be allowed to offset any loss.

The ATO opines, "If it is unlikely ever to make a profit and doesn't have a significant commercial purpose or character, you can't offset the loss against your other income." As stated, under the non-commercial loss rules, if you can't deduct the loss in the current financial year, the ATO may allow you to defer your loss for use later when you eventually profit.

The following table summarises the main indicators of carrying on a business.

Indicators which suggest a business is being carried on	Indicators which suggest a business is not being carried on
A significant commercial activity.	Not a significant commercial activity.
The purpose and intention of the taxpayer in engaging in the activity.	The taxpayer has no purpose or intention to carry on a business activity.
An intention to make a profit from the activity.	No intention to make a profit from the activity.
The activity is or will be profitable.	The activity is inherently unprofitable.
Repetition and regularity of activity.	Little repetition or regularity of activity.
Activity is carried on in a similar manner to that of the ordinary trade.	An activity carried on in an ad hoc manner.
An activity is organised and carried out businesslike and systematically - records are kept.	An activity not organised or carried on in the same manner as the regular ordinary business activity - records are not kept.
Reasonable size and scale.	Small size and scale.
Not a hobby, recreation or sporting activity.	A hobby, recreation or sporting activity.
A business plan exists.	There is no business plan.
Commercial sales of the product.	Sale of products to relatives and friends.
the taxpayer has knowledge or skill	taxpayer lacks knowledge or skill

PROFIT UNLIKELY

Even if your activity has business-like characteristics, if an individual's activities are unlikely to make a profit and do not have a significant commercial purpose or character, you can't offset this non-commercial business loss against your other income. In such a case, you may be able to defer the loss until you make a profit from the business activity, irrespective of whether it has an Australian or foreign source.

> **EXAMPLE**
>
> Bob is a sole trader who has a business operating machinery. His primary business income is helping others plough and prepare their land for growing crops.
>
> Bob acquired a 5-acre block of land close to his residence with the intention that, in his spare time, he would upgrade the property from its present run-down condition and develop it into a small pumpkin farm to harvest and sell pumpkins.
>
> The money he spent on developing the small pumpkin farm exceeded the income from the pumpkins, as the pumpkins were not ready for sale yet. Bob has made a non-commercial loss but will need to determine if he can offset or defer the loss.

COMMENCEMENT

In addition to being in business, you usually need to have commenced the business activity. Broadly, business is considered 'commenced' if you have:

- decided to commence the business activity.
- acquired the minimum commercial level of business assets to allow that business activity to be carried on and
- commenced business operations.

> **EXAMPLE**
>
> Following the earlier example, in the first year, Bob built a shed, repaired fences and cleared a part of the block. In the second year, he planted pumpkin seeds on a commercial scale.
>
> In the first year, the venture didn't have the significant purpose or character of a business venture, as the activities were done in preparation.
>
> In the second year, with the planting of the pumpkin seeds, the activities constitute the commencing of business operations.

COMMERCIALITY TESTS

Having established that a business is being carried on, the focus then goes on passing at least one of the four commerciality tests and having an adjusted taxable income (ATI) of less than $250,000 in the year the loss was made. Exceptions to the rule may be available in primary production or professional arts businesses (see later). Alternatively, the Commissioner may exercise discretion to allow the loss deduction (see later). This may happen, for instance, where the activity is impacted by something outside the taxpayer's control or where an activity has been started, and it is expected that it will meet one of the tests or generate taxable income within a commercially viable period.

Suppose none of the four conditions are met, and the Commissioner does not exercise discretion. In that case, the business losses will be quarantined and carried forward for a deduction against future income from the same source.

To summarise, taxpayers can only offset their business losses from other sources of income such as salary and investment income where:

- The taxpayer's ATI is less than $250,000, and
- One of the four commerciality tests is satisfied (profits test, assessable income test, real property asset test, other asset test (see later), or
- One of the exceptions for primary production or professional arts businesses applies (set later), or the Commissioner has exercised his discretion to allow the loss to be deducted.

> **TIP:** Any excess deductions from the non-commercial business activity must be excluded when calculating the taxpayer's ATI.
>
> The NCL rules only apply to individuals, including those individuals in a partnership.

1. The assessable income test

Under this test, you must demonstrate that the assessable income derived from the business activity is $20,000 or more for the relevant financial year.

For those carrying on a business in partnership with other individuals, there is a requirement to determine the proportion of assessable income attributable to each partner for this test. A taxpayer may include that part of the partnership's assessable income attributable to other individual partners. To be clear, if a taxpayer is in a partnership and all other partners are individuals, the

assessable income of the whole partnership must be $20,000 or more. This test is based on assessable income for the entire year. In the case of where a business activity commences or ceases during the income year, the taxpayer is entitled to make a reasonable estimate of what the assessable income would have been for the entire year. Where there are seasonal variations, the taxpayer may use an estimate rather than on a pro-rata basis.

EXAMPLE

In year 1, an individual taxpayer makes a loss of $10,000. The income derived from the business activity was $15,000.

In year 2, the taxpayer earns an assessable income of $40,000 from the same business activity, resulting in a net profit of $5 500. The taxpayer derived other taxable income of $15,000.

Applying the assessable income test, the taxpayer cannot claim any deduction for the loss incurred in year 1. The loss of $10,000 in that year is deferred.

In year 2, this test is satisfied as the assessable income is above $20,000. Therefore, $5,500 of the carry-forward loss is deductible against the business activity income, and the balance (i.e., $4,000) is allowed as a deduction against the taxpayer's other taxable income.

EXAMPLE – REASONABLE ESTIMATE

In October 2023, Slaide started operating a shirt manufacturing business called Sonny's Shirts. Slaide's income from Sonny's Shirts was $16,000 for the year. However, the business did not operate for the whole income year.

To work out his assessable income for the year, Slaide reasonably estimates his income from Sonny's Shirts if the business had operated for the whole income year.

Slaide considers relevant factors of the business activity, such as the number of orders and seasonal demand, and works out the reasonable estimate of his assessable income is $22,000.

Slaide's reasonable estimate of assessable income is greater than $20,000, so he passes the assessable income test and can claim the losses in the current year.

2. The profits test

Under this test, you must have earned a profit in three of the past five income years (including the current income year in which the loss occurs). Unlike the assessable income test (see earlier), there is no minimum dollar threshold.

Taxable income applicable from the business activity is the difference between the assessable income derived from the activity and the sum of deductions allowed in that income year.

Note that special rules apply to partners. They must aggregate their share of income and any deductions from the business activities conducted in the partnership with any income and deductions applicable in their own hands.

EXAMPLE

Income Year	1	2	3	4
Business Activity	$5,000	$5,000	($6,000)	$4,000
Loss Deferred	Nil	Nil	Nil	($6,000)
Current Year Result	$5,000	$5,000	($6,000)	($2,000)
Other Taxable Income	$40,000	$30,000	$20,000	$35,000
Loss for Current Year (Quar-antined)	Nil	Nil	($6,000)	Nil
Taxable Income	$45,000	$35,000	$20,000	$33,000

Under this test, you would not qualify for a deduction in year 3 because you have not had three profitable years during the past five years. Consequently, the non-commercial loss is deferred. In year 4, however, this test is now satisfied because you can demonstrate a profit in three of the past four years.

EXAMPLE

Nguyen bought an orange orchard from Steve as a going concern on 1 July 2017. At the end of the 2018 financial year, Nguyen's business produced a $7,500 tax loss. The business records show that in the previous years, the orchard made tax profits and losses:

- 2017 - $17,500 profit
- 2016 - $15,000 profit
- 2015 - $4,000 loss
- 2014 - $16,000 profit.

Nguyen needs to include the 2018 financial year when examining the profits test. From 2014 to 2018, three years have produced a tax profit. Nguyen meets the profits test; hence, he can offset his losses against other taxable income.

The profits test allows you to offset the losses from your non-commercial business against your other income, even if your business incurs losses in the current year. This test recognises the overall profitability of your business activity, providing you with greater flexibility in utilising your losses to reduce your taxable income.

3. The real property test

You will satisfy this test if the value of the real property used continuously in business activity is $500,000 or more at the end of the relevant income year. Importantly, when valuing the property, the value to be used is the greater of **(a)** the market value or **(b)** the CGT reduced cost base.

Only the real property (including any fixtures, whether depreciable or not) used mainly in the business activity is counted.

Real property includes:

1. Land.
2. structures, such as buildings, fixed to the land.
3. interests in that property, such as a lease of that property.

Real property, for this test, does **not** include:

- a dwelling and adjacent land that is used mainly for private purposes.
- fixtures owned by you as a tenant.

If a business ceases during an income year, the value of the real property is to be calculated when the business ceases.

Fixtures are included under the other assets test (see later).

EXAMPLE

You have a five-hectare property used partly for private purposes and partly for storing car bodies used for spare parts for your newly established business. The property's total market value is $800,000, of which $450,000 relates to the private dwelling and adjacent land used in association with the private dwelling. The taxpayer owns or uses No other real property in the business.

You would not satisfy the real property test.

4. The other assets test

This test deals with assets used continuously in carrying on the business activity, excluding real property (which is dealt with under the real property test – see earlier). The other assets test is satisfied where the value of those assets is $100,000 or more. Assets included under the real property test cannot be used when evaluating compliance with this test.

Assets included under this test are:

- An asset for which a capital allowance deduction is available
- An item of trading stock
- An asset leased from another entity, and
- Trademarks, patents, copyright etc.

TIP: Assets allocated to an SBE pool cannot be included under this test because they are not deductible under Division 40.

Commissioner's discretion

Suppose you fail to satisfy any of the four tests and would be denied a deduction for your business losses. In that case, the ATO Commissioner cannot allow the losses to be deducted nonetheless. For that discretion to be exercised, at least one of the following conditions must be met:

- There were special circumstances outside your control, e.g., natural disasters (such as drought, bushfire, floods), power plant shutdowns, oil spills, government restrictions on land use or illness of key personnel or
- The nature of the business activity is such that there is a lead time between the activity commencing and the production of assessable income (e.g., grape growing,

plantations, etc.), and there is an expectation within a period reasonable for the particular industry, you will satisfy one of the four tests or be profitable, or

- Where your ATI exceeds $250,000 but can independently demonstrate that the business is genuinely commercial and will produce profits within a commercially viable period.

> **TIP:** Normal economic or market fluctuations do not constitute special circumstances for the Commissioner to exercise discretion.

Review of discretion

Where the Commissioner makes a ruling about whether to exercise his discretion, and the taxpayer disagrees, you can object to the AAT or the Federal Court.

PARTNERSHIPS AND THE FOUR TESTS

If you are a partner in a partnership, you – as an individual – may offset your share of a partnership loss against your other income, subject to the non-commercial loss rules. The same four commercial tests and the ATI test apply to individual partners, but there are some nuances:

1. Assessable income test

Just like for a sole trader, the partnership's assessable income from a particular business activity must be at least 20,000 – but then there are possible adjustments at the partner level.

You can add assessable income for an individual partner if the partner earns income from the same business activity outside the partnership.

And you have to subtract assessable income if one of the partners is a company or trust. In other words, if you have partnership members that are companies or trusts, you must exclude their share of the assessable income.

ATO EXAMPLE

Jarli is in business in partnership with Ross and a company. The partnership earned $22,000 assessable income last year from the business activity.

$4,000 of that income went to the company and $9,000 to each individual in the partnership. Therefore, the partnership income would not be sufficient to allow Jarli to pass the income test ($22,000 − $4,000 = $18,000).

However, Jarli has an interest in the business activity outside the partnership. He received $3,500 in assessable income from this non-partnership interest, so the total assessable income he can count for the purposes of this test is $21,500 ($3,500 + $9,000 + $9,000). He also meets the income requirement and can deduct a loss.

Ross cannot consider the non-partnership assessable income earned by Jarli for this test. Ross does not satisfy the assessable income test.

2. Profits test

The profits test is per partner based on their tax return. There is no adding or subtracting.

Whatever each partner shows as a profit or loss for a particular business activity in their tax return goes into the profits test. If there is a profit of at least 1 cent in three of the past five years, you passed the profits test.

3. Real property test

For the real property test, you start with the whole partnership. The partnership's real property must be at least AUD 500,000 – just like for sole traders.

But then you deduct any shares attributable to corporate partners. In other words, if you have partnership members that are companies or trusts, you must exclude the value of any real property attributable to them.

And then, for each partner, you can include property they own in their name if the partnership business uses this property. That is a big IF. You can only add property in individual names if the business uses that property. If not, it doesn't get added.

4. Other assets test

As for sole traders, the value of other assets the partnership owns must be at least $100,000.

But just like the real property test, you then subtract and add. You subtract the relevant share attributable to corporate partners, companies or trusts. And you add any share owned by partners in individual names but used for business purposes.

Thus, the same logic as in the real property test.

If you fail all of the above tests, subject to the Commissioner's discretion, you cannot offset your losses against your other income. As a result, your losses will be deferred to future years until you can satisfy the tests.

ADJUSTED TAXABLE INCOME TEST

As noted, even if you pass at least one of the four tests, to apply your losses in the current year, you must have adjusted taxable income (ATI) of less than $250,000.

A person's ATI is the sum of the following amounts:

- taxable income (excluding any assessable First home super saver released amount)
- adjusted fringe benefits total, which is the sum of

  - o reportable fringe benefits amounts received from employers exempt from fringe benefits tax under section 57A of the *Fringe Benefits Tax Assessment Act 1986* multiplied by 0.53 and
  - o reportable fringe benefits amount from employers not exempt from fringe benefits tax under section 57A of the *Fringe Benefits Tax Assessment Act 1986*
- reportable employer superannuation contributions
- deductible personal superannuation contributions
- certain tax-free government pensions or benefits received by the person.
- target foreign income (income and specific other amounts from sources outside Australia not included in your taxable income or received as a fringe benefit)
- net financial investment loss (the amount by which the person's deductions attributable to financial investments exceeded their total financial investment income)
- net rental property loss (the amount by which the person's deductions attributable to rental property exceeded their rental property income)

less

- any child support payments the person provided to another person.

TIP: Because ATI uses 'taxable income' rather than 'assessable income', the typical tax planning strategy of bringing forward deductible expenses into the current financial year will not work to get you under the $250,000. Likewise, salary sacrificing to superannuation or making a deductible superannuation contribution will not work as both are included in the above tests as "reportable superannuation contributions" and "deductible personal superannuation contributions", respectively.

However, strategies that may be available to reduce your current year ATI include:

- deferring any expected capital gain until the following financial year, usually by delaying the sale until the following financial year
- deferring sending out year-end invoices if you are nearing the $250,000 threshold.

QUARANTINED LOSSES

Losses are quarantined (unable to be used in the current year) where none of the four commercial loss tests is met, or the $250,00 income test is not met and can be deferred for use in a later financial year.

If a business activity profits the following year, the deferred losses can be utilised against the profit.

The deferred loss can also be utilised for other income in the following year if:

- The $250,000 income requirement and the business pass one of the four tests in that year or
- The Commissioner has exercised his discretion.

There is no time limit for deferring the losses.

That is, the loss can be deferred indefinitely until one of the following applies:

- There is a profit from the business activity, in which case the deferred loss can be offset to the extent of the profit from the business activity.
- The income requirement is met, and one of the four tests is satisfied.

EXCEPTIONS

There are three exceptions from needing to satisfy the $250,000 income tests and at least one of the four commercial tests:

1. Individuals engaged in a primary production business activity, provided your other income is less than $40,000 in the relevant financial year
2. Individuals engaged in a professional arts business, provided your other income is less than $40,000 in the relevant financial year or
3. The Commissioner exercises his discretion.

If the business activity meets these exceptions, the deferred loss can be offset against income from other sources. If the deferred loss can be utilised in the current year, the current year's losses plus the deferred losses from earlier years can be offset against other income in the current year.

CASE STUDY – OFFSETTING DEFERRED LOSSES

Martin has a full-time job but also owns a mobile pie van at various weekend sporting grounds. His net figures from the pie van activity are:

Year	$	Allowable deductions (2)	Net (1) – (2)	Deferred deduction from previous year	Deferred deduction for current year
1	$10,000	$11,000	($1,000)	$0	$1,000
2	$14,000	$15,500	($1,500)	$1,000	$2,500
3	$18,000	$17,000	$1,000	$2,500	$1,500
4	$20,000	$22,000	($2,000)	$1,500	$0

In the first year, Martin loses $1,000 but cannot offset this against his other income because he doesn't meet any of the four commercial tests.

In the second year, Martin made a loss of $1,500. He cannot offset this loss because none of the four commercial tests are met. He now has a $2,500 deferred loss to carry forward ($1,500 is added to the $1,000 loss from the first year).

In the third year, Martin makes a profit of $1,000. He can offset that $1,000 against the deferred loss. Martin now has a deferred $1,500 ($2,500 less $1,000).

His losses will continue to be deferred until either:

- Martin satisfies at least one of the four commercial tests and meets the $250,000 income requirements or
- The Commissioner exercises his discretion to allow the loss.

In year 4, Martin meets the income requirement as he has an assessable income of $20,000. Martin can deduct the $1,500 deferred loss and the $2,000 loss for year 4 against his other income for that year.

Non-commercial losses can be utilised in any order. Each deferred loss is included in calculating any loss from the business activity for the following year. Thus, the order is not relevant.

CONCLUSION

Understanding and navigating the non-commercial loss rules is crucial for individuals (including individuals in partnerships) involved in business activities that are not their primary source of income. By comprehending the assessable income, profits, real property, and assets tests, individuals can determine their eligibility to offset or defer their business losses against their other income.

ANOTHER ESSENTIAL TAX SMART AUSTRALIA RESOURCE • CLARITY • CONVENIENCE • CONFIDENCE •
bO2

TSA Unit Trust
t/as bo2 Corporate Essentials Pty Ltd

ABN 70 377 440 020
ACN 119 058 310

Level 9, Wyndham Building,
1 Corporate Court, Bundall, Qld 4217

T 1300 55 55 33
E info@bo2.com.au

www.bo2.com.au

DISCLAIMER

The information expressed in this publication are only intended as a guide. Therefore, the information presented neither consider any personal circumstances nor replace personal advice. bO2 Corporate Essentials Pty Ltd does not accept any liability which may arise because of a loss for acting on information contained in this publication.

Copyright © 2023

This publication has been prepared by TSA Unit Trust T/as bO2 Corporate Essentials Pty Ltd. No part of this document can be reproduced without permission.