

Chapter 3

Views on the bill

3.1 The proposed amendments do not require significant legislative change to achieve the Government's policy intent. However, there will be considerable administrative impacts for taxpayers who exceed the \$250,000 income test.

3.2 In submissions received and evidence taken at the public hearing held on 9 November, five areas were consistently identified as areas of concern:

- (a) The \$250,000 threshold;
- (b) The Commissioner's discretion;
- (c) The retrospectivity of the proposed changes;
- (d) The impact on rural communities; and
- (e) The accuracy of the revenue projections.

The \$250,000 threshold

3.3 The introduction of the \$250,000 income test to Division 35 is the key element of this measure.

3.4 By introducing this threshold the government will limit access to tax deductions for non-commercial losses from a small sector of the community who could be regarded as high wealth individuals. (Treasury have advised that 'there are 11,000 taxpayers that will be affected by this measure'.¹)

3.5 The new test, which will be contained in Division 35 in new paragraph 35-10(2E) provides that:

(2E) 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.

3.6 Where the test is not met, the taxpayer will be required to quarantine any excess losses from their business activity and carry them forward to be offset against

1 Mr Christopher Leggett, Senior Adviser, Personal and Retirement Income Division, Department of the Treasury, *Proof Committee Hansard*, 9 November 2009, p. 38.

assessable income of the activity in the future. They do not lose access to claiming these losses as deductions in future years.

Submissions tended to criticise the apparent arbitrary nature of the threshold amount of \$250,000. The Tax Institute of Australia, in noting that the \$250,000 threshold would probably only affect a small percentage of taxpayers, raised the possibility of complexity in situations where a taxpayer moves in and out of (over and under) the threshold.² This would suggest that averaging a taxpayer's adjusted taxable income over the preceding three years would provide more certainty to affected taxpayers. However it would add some complexity.

3.7 The National Farmers' Federation commented:

...an ongoing issue that the National Farmers' Federation has had with taxation related thresholds: the fact that there is no discussion either way of having any kind of indexation around that threshold. Sure, \$250,000 may seem like a high income now, but will it be in 10 years time? ...

If you are going to implement an arbitrary threshold ...you get into a situation where the threshold do not change and what might initially have been deemed to be an appropriate level becomes obsolete very quickly. All we are saying is that there are concerns about taking a threshold approach at any time. You have to think about that carefully to make sure you get those settings right. But, even if you do go down that path, you have to make sure they are relevant over time and that you do not have to go through a legislative process again to change them to make them more relevant.³

3.8 When questioned as to how this threshold amount was determined, the Treasury advised that it was a policy choice of government. They have since provided further information detailing that in the 2009-10 income year an estimated 130,000 taxpayers will have an adjusted taxable income of \$250,000 or more and that modelling suggests 8.5% (11,000) of those taxpayers would otherwise have claimed non-commercial losses against non-farm income in 2009-10.⁴

3.9 Treasury also noted that 'wherever one seeks to place a threshold in the tax transfer system and in any other arrangement where government decides to provide benefits or impose costs on people, there will always be arguments about the appropriateness of the fixed line in the sand that government chooses.'⁵

2 Ms Joan Roberts, President, Taxation Institute of Australia, *Proof Committee Hansard*, 9 November 2009, p. 10.

3 Mr Charles McElhone, Manager, Economics and Trade, National Farmers' Federation, *Proof Committee Hansard*, 9 November 2009, pp 15 and 17.

4 The Department of the Treasury, answer to question on notice, 9 November 2009 (received 13 November 2009).

5 Mr Michael Willcock, General Manager, Personal and Retirement Income Division, Department of the Treasury, *Proof Committee Hansard*, 9 November 2009, p.40.

3.10 It is noted that although the seeming arbitrary nature of the threshold was criticised, no alternative approach to determining an appropriate income threshold was put forward. However, it was suggested that an alternative to the \$250,000 threshold would be the removal of the real property test, one of the four existing tests within Division 35.

We do have a solution ... a reasonably simple solution—that is, remove the \$500,000 real property test rather than introduce this arbitrary \$250,000 income test. The real property test is one of the existing four tests of the non-commercial loss provisions and is, in our view, the one that would be passed by, if you like, your Collins Street farmer or the individual that the government is looking to target in these proposed changes. So our No. 1 solution is to remove that \$500,000 test.⁶

3.11 In fact, the Treasury noted that this test is one that can be circumvented by high wealth individuals and that financial modelling associated with the removal of the test had not been undertaken:

Mr Willcock- ...Turning to the measure announced in this year's budget, the government is concerned that the current non-commercial losses rules are becoming less effective at identifying those business activities that are commercial in nature. This is because of the capacity for high-income individuals in particular to arrange their affairs to meet one of the four tests and use what is in reality a non-commercial business activity to reduce the tax payable on their other income. This could occur where the value of real property used in carrying on a business is greater than \$500,000—this would be the case for many hobby farms—or the plant and equipment is valued at more than \$100,000. High-income earners have the financial means to more readily meet these financial thresholds in the existing tax laws.⁷

CHAIR—Have you, as part of your consultation, had a look at other proposals—say, to remove the real property limit?

Mr Leggett—I guess the government considered a number of measures to address the problems that were identified. I assume that that was probably one of the issues—whether or not any particular test is more problematic than the others. I think everybody acknowledges that the real property test is perhaps one of the worst offenders in being circumvented, but that does not mean the other ones are not being circumvented as well. I guess there was a view that there was a need to protect smaller taxpayers from these changes. There was a focus on the upper end rather than changes across the board.

CHAIR—So you did not do any analysis of whether that would have produced the same result as the current proposal?

6 Mr Adam Tims, Thoroughbred Breeders Australia, *Proof Committee Hansard*, 9 November 2009, p. 26.

7 Mr Michael Willcock, Department of the Treasury, *Proof Committee Hansard*, 9 November 2009, p. 37.

Mr Leggett—On a monetary basis?

CHAIR—Yes.

Mr Leggett—Not that I am aware of, no.⁸

3.12 Alternatively, the government might look to increase and then index the threshold amount to ensure that it remains relevant into the future.⁹

The Commissioner's discretion

3.13 In circumstances where a taxpayer's adjusted taxable income is greater than \$250,000 the default position under the proposed changes will require that excess losses be quarantined and carried forward to be offset against assessable income generated by the activity in future years. However, taxpayers in this situation will have the opportunity to seek relief from the non-commercial loss rules by requesting that the Commissioner exercise the discretion of section 35-55 of the ITAA 1997.

3.14 The bill sets out at item 11 of Schedule 2, that the Commissioner's discretion will be amended to address situations where taxpayers exceed the \$250,000 income test:

11 At the end of subsection 35-55(1)

Add:

; 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.

8 Mr Michael Willcock, Department of the Treasury, *Proof Committee Hansard*, 9 November 2009, p. 38.

9 Mr Charles McElhone, National Farmers' Federation, *Proof Committee Hansard*, 9 November 2009, p15; Captain Kerry Dwyer (retired), Board Director, Australian Alpaca Association Ltd, *Proof Committee Hansard*, 9 November 2009, p. 22.

3.15 It is this requirement to provide objective evidence from independent sources that has caused considerable concern and uncertainty:

It will undoubtedly cause many taxpayers to go out and seek that advice, and I am sure that seeking that advice will come at a price. It not only imposes on taxpayers that headline cost of having to go out and seek that independent expert advice to justify the viability or otherwise of their particular business activity; it also imposes non-cash compliance costs, particularly in terms of the uncertainty that might be created for certain taxpayers, not knowing their tax position and what the commissioner may rule in respect of the exercising of discretion—which, in turn, could have consequential impacts on the taxpayer’s ability to predetermine their tax liability and be able to fund that liability on time, giving rise to debts and collection action down the track. So the potential consequences from a compliance perspective could be significant if these proposed changes are implemented in the fashion that is proposed at this point.¹⁰

...When you have a position where the commissioner is put in the position of exercising discretion with minimal skills themselves in the particular industries and no guidance as to how they are assessing these businesses, you are going to get to situations where more likely than not that discretion will not be exercised. It will be exercised, but in a negative sense.¹¹

What comes back to us is that there will be commissioner’s discretion but no-one is sure how that will work. ...you can take some comfort that there will be a process that you can go through to make sure your special circumstances are taken into account, but there is no guarantee that they will be.¹²

Senator BUSHBY—Are you talking about the lack of certainty about the prospect of this legislation or the lack of certainty as to how the ATO or the tax commissioner may deal with an application for an exemption?

Mr Tims—I think it is probably more about how the ATO commissioner will deal with an application.¹³

3.16 A number of witnesses advised that they take the view that the obligation the discretion imposes on the Commissioner is onerous and fraught with risk as it requires the taxpayer to expend money sourcing independent advice before presenting that advice to the Commissioner for his consideration and ultimate decision as to whether

10 Mr Yasser El-Ansary, Tax counsel, Institute of Chartered Accountants, *Proof Committee Hansard*, 9 November 2009, p. 9.

11 Mr Peter Murray, National Councillor, Tax Institute of Australia, *Proof Committee Hansard*, p. 13.

12 Mr Charles McElhone, Manager, Economics and Trade, National Farmers' Federation, *Proof Committee Hansard*, 9 November 2009, p. 17.

13 Mr Adam Tims, Thoroughbred Breeders Australia, *Proof Committee Hansard*, 9 November 2009, p. 34.

or not the business arrangements into which they have entered are commercial despite not being an expert on the industries involved.¹⁴

Retrospectivity of the proposed changes

3.17 In their joint media release on 12 May 2009 when announcing the measure, the Treasurer and Assistant Treasurer detailed that the proposed changes would apply from 1 July 2009, the current income year.¹⁵

3.18 The Institute of Chartered Accountants commented on this feature of the proposed changes noting that:

... introducing these proposed new laws from 1 July 2009 for the 2009-10 income year will mean that certain taxpayers who have taken positions based on the law as it stood prior to the budget announcement this year may potentially be disadvantaged in an adverse way by virtue of the fact that they are claiming what are referred to as division 40 and 43 capital allowance deductions on an ongoing basis because they are depreciation non-cash items that are deducted on a cyclical program over the effective life of an asset. The taxpayers who are claiming division 40 and 43 capital allowance deductions will find themselves ... in a position where they are generating tax losses and therefore are not able to satisfy the non-commercial loss rural tests and therefore be denied access to their losses simply by virtue of them claiming depreciation deductions. I think that is a significant issue which should not be dismissed or underestimated.

... The other point, on a related issue to that, is that for those taxpayers who have generated losses before the commencement of the 1 July 2009 changes and who will now potentially be subject to the changed taxation laws that apply in this area, they may be disadvantaged in adverse way as well by virtue of in effect the goalposts having been shifted on them from 1 July 2009. I think it would be appropriate for those taxpayers in those situations who have generated losses before the commencement of this current income year to be also given some transitional relief...¹⁶

3.19 The committee, through the Chair, sought clarification from Treasury in respect of the Commissioner's discretion:

CHAIR—A theme that was coming through in a number of submissions here today was the uncertainty and the desirability of the tax commissioner making rulings on the basis that people could not make investment without some more certainty about what the tax commissioner would decide. There

14 Mr Yasser El-Ansary, Institute of Chartered Accountants, *Proof Committee Hansard*, 9 November 2009, p. 3; Ms Roberts and Mr Murray, Tax Institute Australia, *Proof Committee Hansard*, 9 November 2009, p. 12.

15 Media release 67, 12 May 2009.

16 Mr Yasser El-Ansary, Tax counsel, Institute of Chartered Accountants, *Proof Committee Hansard*, 9 November 2009, pp 8 – 9.

was a view that perhaps people would not be able even to apply until July 2010.

Mr Leggett—That is not true. You can apply for the exercise of the commissioner's discretion at any time. It can be before you make the investment or after you make the investment. If you are profitable in the first couple of years even though the viability period has not happened, and you later become unprofitable, you can apply at that time as well. There is no limitation as to when you ask the commissioner for the exercise of that discretion.

Of course, until the law is enacted he cannot exercise his discretion, but his discretions have been exercised under the existing law and are being grandfathered into the new system, so people could apply for the exercise now. In effect, like managed investment schemes, the commissioner exercises discretion always in advance of the scheme being started. So he exercises his discretion in regard to the product rulings.¹⁷

3.20 It is suggested that these features of the amendments, ie the honouring of decisions made by the Commissioner to exercise his discretion under the existing provisions and the ability of taxpayers to seek a ruling at any time in the process of establishing their business activity will provide adequate protection to taxpayers and enable them to make decisions.

The impact on rural communities

3.21 Some witnesses suggested that the bill would have the effect of leading to hobby farms being abandoned with a subsequent loss of employment in rural areas:

...the losses being incurred by high-income earners are providing a vital injection of funds to rural and regional communities through things such as the wages being paid to farm managers, to contract suppliers and other equipment purchased from local rural trading shops. The NFF believes that the proposal to impose an income threshold to the non-commercial loss rules will act to reduce expenditure by these high-income individuals in regional Australia...¹⁸

...our farming business spends a considerable amount of money each year in our local community, through farm contractors and local businesses delivering products and services ... in all likelihood many working/farming families like ours will be forced to re-evaluate our businesses and take this expenditure out of the local community.¹⁹

17 Mr Chris Leggett, Department of the Treasury, *Proof Committee Hansard*, 9 November 2009, p. 38.

18 Mr Charles McElhone, National Farmers' Federation, *Proof Committee Hansard*, 9 November 2009, pp 14-15.

19 Ballycastle Pastoral Company, *Submission 6*, p 3.

3.22 However, such concerns appear misplaced. Firstly, they ignore the protection in the discretion provisions for 'serious' farming operations. As Treasury point out:

...as to the extent that the businesses are legitimate and genuine, they are unlikely to be affected by this measure because they will get the commissioner to exercise his discretion.²⁰

3.23 Secondly, the measures only affect people on high incomes who may well be able to organise their affairs to cope with some additional taxation. The measures may also encourage adjustment to the business plan to improve the profitability of their farms.

3.24 Finally, even if the measures do lead to some hobby farmers leaving, the farms may be sold, either to existing farmers who may very well operate them more efficiently, or to new farmers who may have found themselves priced out of the farming industry by the hobby farmers. There would therefore be no reason to expect any significant adverse 'multiplier' effects on rural communities.

The revenue projections

3.25 In announcing these proposed changes the Government has forecast ongoing revenue gains – expecting that over the forward estimates \$700 million will be collected.²¹

3.26 These forecasts were identified by a number of submissions as being higher than they would have expected given the potential flow-on effects of the movement of investment dollars from rural areas to other tax effective investment vehicles.

3.27 The Committee sought to clarify the extent to which revenue forecasts had factored in second and third round impacts. In response, the Treasury replied:

...the secondary impacts are not normally costed for the reason that it is just too difficult to come up with those sorts of figures. We do not know whether money will be reinvested in other areas or whether people will drop out of the particular industry concerned, so it is normally too difficult to calculate flow-on effects.²²

3.28 Senator Bushby sought to further clarify the extent to which the revenue from tightening up on deductions for losses on hobby farms would be offset by increased losses of revenue from greater use of other tax shelters:

I tested this this morning with other witnesses and they thought this was true—including the tax institute and chartered accountants. By making this change you will make investing in these types of enterprises less attractive

20 Mr Chris Leggett, Department of the Treasury, *Proof Committee Hansard*, 9 November 2009, p 41.

21 Budget 2009-10, p. 20.

22 Mr Leggett, Department of the Treasury, *Proof Committee Hansard*, 9 November 2009, p 41.

in terms of tax minimisation for some of the people who will be affected than other forms of investment which might also have tax minimisation benefit. I asked them whether they thought it would be significant or marginal. They said that ... it would be real and there would be a move from people, when they receive their tax advice, into areas other than this. I am interested in knowing whether any consideration of that likely impact was taken into account in the \$700 million.²³

3.29 The Treasury confirmed that although their estimates included an assumption that people would move into different investment types, they were not in a position to provide further detail and took on notice a request to provide more information around the exact costing method.²⁴

Conclusion and recommendation

3.30 The Committee supports the intention of tightening the non-commercial losses regime of Division 35.

Recommendation 1

3.31 The Committee recommends the Senate pass the bill.

Senator Annette Hurley

Chair

23 *Proof Committee Hansard*, 9 November 2009, p. 45.

24 *Proof Committee Hansard*, 9 November 2009, p. 45.

