



23 July 2013

Mr Jason McNamara  
Executive Director  
Office of Best Practice Regulation  
Department of Finance and Deregulation  
John Gorton Building  
King Edward Terrace  
PARKES ACT 2600

Dear Mr McNamara 

### **Post-implementation Review – non-commercial loss provisions**

I am writing to the Office of Best Practice Regulation (OBPR) regarding the Australian Government requirement to undertake a Post-implementation Review (PIR) for the proposal Improving fairness and integrity in the tax system – tightening access to non-commercial business losses.

This measure formed part of a package of measures in the 2009-10 Budget to improve fairness and integrity in the tax system and ensured that excess deductions from unprofitable business activities cannot be used to reduce salary and wage income of high income earners. In developing the policy, The Treasury self-assessed the proposal as having a minor impact on business and/or the not-for-profit sector, in accordance with the Best Practice Regulation requirements that applied at the time. However, as a RIS exemption for this proposal was provided by the then Prime Minister as part of a broader package of reforms, a PIR is required. As the impacts of this policy have not been significant, The Treasury offers you the following assessment as our PIR.

#### *Problem*

The non-commercial loss (NCL) rules were first introduced in 2000, following recommendations of the Review of Business Taxation. The reforms were aimed at improving the integrity, fairness and equity of the tax system by addressing the opportunity for individuals to avoid tax by carrying on unprofitable business activities and claiming deductions for losses arising from those activities against other incomes.

The NCL rules mean that losses from a non-commercial business would be quarantined to the business activity and could not be offset against other income. Rather, the losses are carried over and offset against future income from the business activity. However, there are exemptions that allow a taxpayer to apply the losses to their other income, if they satisfy at least one of four objective tests, or if the Commissioner of Taxation exercises a discretion.

Concerns had been raised that the existing exceptions operated in a discriminatory way as high income individuals were more able to satisfy the objective tests and use these to avoid the intent of the rules.

#### *Objectives*

The Government's objective was to further improve fairness and integrity of the tax system and target tax concessions to low and middle income taxpayers.

### *Impact analysis*

The measure tightens the application of the NCL rules in relation to high income earners. Individuals with an adjusted taxable income of over \$250,000 will no longer be able to offset deductions from non-commercial activities against their salary or other income, but will instead have excess deductions quarantined to the loss-making business activity.

The income test is aimed at business activities conducted by high-income taxpayers that are unlikely to be genuinely commercial and are more likely to constitute lifestyle choices or hobbies. However, taxpayers will be able to apply to the Commissioner of Taxation for relief from the rules if they have their business independently assessed as genuinely commercial or there are exceptional circumstances.

It was estimated that there would be around 11,000 high-income individual taxpayers who would have the income and losses that the measure would apply to. It is difficult to evaluate the actual impact of the measure because of subsequent policy changes and economic conditions.

Further, the measure has little impact on businesses as it does not affect the business activities or the regulation of those activities; it only relates to how any losses occurring are treated for tax purposes when distributed to individuals.

There may be some compliance cost impacts for taxpayers, as part of their normal tax return process, as they undertake a review of their tax arrangements as a result of the closing of the tax concession. There may also be some cost impacts if taxpayers seek a Commissioner's discretion. It was expected that there would be minimal applications for discretion. There were less than 200 applications for rulings in relation to NCL in 2010, less than 500 applications in 2011 and less than 400 in 2012.

There may also be a low compliance cost impact for tax agents in learning the new rules. However, the change was relatively simple and therefore would be a small part of a tax agent's regular process of updating their knowledge of recent law changes. The ATO provided guidance following the legislative change, which included a non-commercial loss home page, a specific guide to non-commercial losses and a new evidentiary checklist for these private ruling requests.

There would be little impact on taxpayers who operate commercial businesses, as they can apply to the Commissioner to exercise a discretion to allow the losses to be offset against other income. The measure also addresses the impact of the current NCL rules on other businesses operating commercially in the industry. Before this measure, many high-income taxpayers could operate at a loss and write this off against other income. Removing the ability of high-income taxpayers to offset losses will place them on a more equal footing with other businesses that are operating commercially, and ensure that the resources in the Australian economy are allocated more efficiently.

There may be a small impact in some industries as a result of high-income taxpayers changing their investment choices as a result of the removal of the tax concession. However, this is likely to be minor as losses from genuine commercial activities will still be able to be offset against income from other sources. High-income taxpayers will invest for reasons beyond tax concessions and other investors are able to step in should high-income taxpayers pursue other investments. As the Senate Standing Committee on Economics noted in its review of the legislation, with regard to the impact on rural communities:

- the Commissioner's discretion provides protection for "serious farming operations",
- the measure is limited to high-income earners who are able to organise their affairs to manage some additional taxation and in fact may encourage adjustments to business plans to improve the profitability of farms, and

- where some hobby farms may be sold, this would be to existing farmers who could operate them more efficiently or to new farmers who had been priced out of the industry by hobby farmers.<sup>1</sup>

Therefore, it was anticipated there would be a low impact on the business and/or not-for-profit sector and this reflects the experience to date.

#### *Consultation*

Consultation was undertaken following the Budget announcement. An exposure draft of the legislation was released on 26 June 2009 and seventeen submissions were received, including from key stakeholders such as the National Farmers Federation, the National Association of Forest Industries, Thoroughbred Breeders Australia, CPA Australia, the Institute of Chartered Accountants Australia and the Taxation Institute of Australia. Ten representations were also received outside the consultation process that were taken into consideration in finalising the measure.

Changes were made following consultation to minimise uncertainty for taxpayers (transitional provisions will ensure that all previous discretions granted by the Commissioner will continue to apply) and simplify the process of applying to the Commissioner for the exercise of a discretion.

The Senate Standing Committee on Economics also undertook consultation in its consideration of the legislation and six submissions were received in relation to the NCL rules. The Committee supported the intention of tightening the NCL rules and recommended that the Senate pass the Bill.

This consultation confirms our view that the measure would have a low impact on business and/or the not-for-profit sector.

#### *Conclusion*

On the basis of the impact analysis above it is considered the measure is meeting its objectives and having only a minor impact on the business/NFP sectors.

#### *Publication*

The Treasury understands that this letter fulfils the Australian Government Best Practice Regulation requirements for a PIR, and as such will be published on the OBPR website.

If you have any queries about this advice, please contact Michelle Dowdell on 6263 3071, or [michelle.dowdell@treasury.gov.au](mailto:michelle.dowdell@treasury.gov.au).

Yours sincerely



Rob Heferen  
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Revenue Group

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<sup>1</sup> Senate Economics Legislation Committee Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009 & Income Tax (TFN Withholding Tax (ESS)) Bill 2009, November 2009, page 14