

Media Release

Budget attack on “hobby farms” – is it THAT bad?

The recently announced 2009 Budget contains many tax changes aimed at generating desperately needed revenue for a Government forced to run huge deficits for the next 5 plus years.

Regrettably, these tax changes have industries such as breeding and racing firmly in its sights as one of the measures is aimed at making it more difficult (but not impossible) for individual high-income earners, with adjusted taxable income (ATI) of **over \$250,000**, to *immediately* claim tax losses from their activities.

For the record, ATI is not just taxable income and is the sum of the following amounts:

- taxable income;
- the value of any adjusted fringe benefits,
- target foreign income (including tax exempt foreign employment income),
- net rental property loss; and
- tax free pension or benefit.

These changes are aimed at attacking activities that are supposedly “hobbies or lifestyle choices” and, in that regard, closing a tax loophole that allows a small number (circa 11,000) of predominantly high income earning individuals claiming losses to minimize taxation. They are proposed to start on **1 July 2009**.

Current “Non-Commercial Loss” (NCL) rules

Under the proposals, the Government will make it more difficult for high-income earners (i.e. ATI over \$250,000) to claim losses from their activities (such as breeding) by tightening the existing NCL rules.

Under the existing NCL rules, a sole trader or individual partner who incurs a tax loss from a business activity cannot deduct the loss against their other income (if any) unless one of **four** certain tests ('the NCL tests') is satisfied. These tests are briefly summarised as follows:

- *Assessable income test* - the business activity produces assessable income of at least \$20,000 for the income year;
- *Profits test* - the business activity has produced a taxable income in 3 out of the last 5 income years (including the current income year);

• *Real property test* - the value of real property (i.e. land and buildings) used in the business activity is at least \$500,000; or

• *Other assets test* - the value of certain other assets (e.g., trading stock and depreciating assets - *excluding* cars, motorcycles and similar vehicles) used in the business activity is at least \$100,000.

New NCL rules proposed – loss is “quarantined”

The new NCL rules proposed will ensure losses from unprofitable business activities cannot be used to reduce salary, wage and other income of high income earners by tightening the application of the NCL rules. Taxpayers with an ATI of **over \$250,000** will instead have losses quarantined to the business activity, i.e. they can only be applied if the activity makes a profit into the future.

Thankfully, the existing rules (as noted above) will continue to apply to taxpayers with an ATI of \$250,000 or less.

The office of Assistant Treasurer, Chris Bowen MP, issued this example of how the new proposed rules will operate.

Example:

Ted is an executive in a large multinational company. Ted's salary is \$290,000 for the 2009-10 income year. Ted also has a hobby farm, which runs at a loss each year. In the 2009-10 year, the hobby farm makes a loss of \$40,000.

Under the *current* law, Ted passes the non-commercial losses real property test and therefore can claim his business losses.

Ted's taxable income has therefore been reduced to \$250,000 [$\$290,000 - \$40,000$] from \$290,000. This provides an unfair tax saving of \$18,600.

Under the *proposed* changes, Ted's adjusted taxable income (ignoring his business losses) is \$290,000.

Ted does not lose the deductions – but he can only use them to offset future income from the hobby farm.

Over \$250,000 earners – claiming losses still possible under “relief” rules

There is still hope for the \$250,000 plus earners - they can apply to the ATO, via a private ruling, for "special relief" to claim the loss *immediately*, i.e. it is not quarantined.

These "relief" measures are also part of the current NCL rules and available for taxpayers who do not meet any of the 4 tests. Refer below, from the current ATO NCL fact sheet, for further details regarding these “relief” measures, where it states that the ATO can exercise its discretion to allow the loss in *either* of the following two circumstances:

- The business was (or will be) affected by **special circumstances** beyond the control of the operators of the business (e.g., a fire, flood, drought, diseases affecting livestock or crops, a pest plague or a hailstorm), and the business would have passed one of the above tests if it were not for those special circumstances; or
- The business, because of its **nature**, is not expected to become commercially viable until some time after it has commenced. Horse Breeding very much fits into this category. Part of the ruling application has to be a viability report from an acknowledged industry expert - it must indicate commercial viability. A business plan is also recommended.

Carrazzo Comments

- ❑ Many high-income earners (i.e. ATI over \$250,000) will now be forced to seek private rulings from the ATO to be able to claim business losses, resulting in an increase in compliance costs;
- ❑ Taxpayers running breeding or racing activities with recurring losses will most likely never receive the benefit of these losses under the new “quarantining” rule;
- ❑ The new proposals do not relate to companies or trusts;
- ❑ It has not been made clear in the Budget papers or the Bowen release as to what happens to a quarantined loss (e.g. Ted’s \$40,000 loss above) where the taxpayer falls under \$250,000 ATI in subsequent years. Is it available to be claimed where that taxpayer meets the general NCL tests? We suspect so, but await clarification of this; and
- ❑ It is disappointing that Treasury considers that a high income earner trying to generate another income stream via a legitimate business activity leads to the ready inference that the activity is a “hobby”. Enjoying a business activity should not make it any less taxable.

You are welcome to contact me if you wish me to clarify or expand upon any of the matters raised in this article.

End of release.

DISCLAIMER

Any reader intending to apply the information in this article to practical circumstances should independently verify their interpretation and the information's applicability to their particular circumstances with an accountant specialising in this area.

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