

NEWSFLASH BOOKLET

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DIVISION 35 – OFFSETTING BUSINESS LOSSES AGAINST OTHER INCOME

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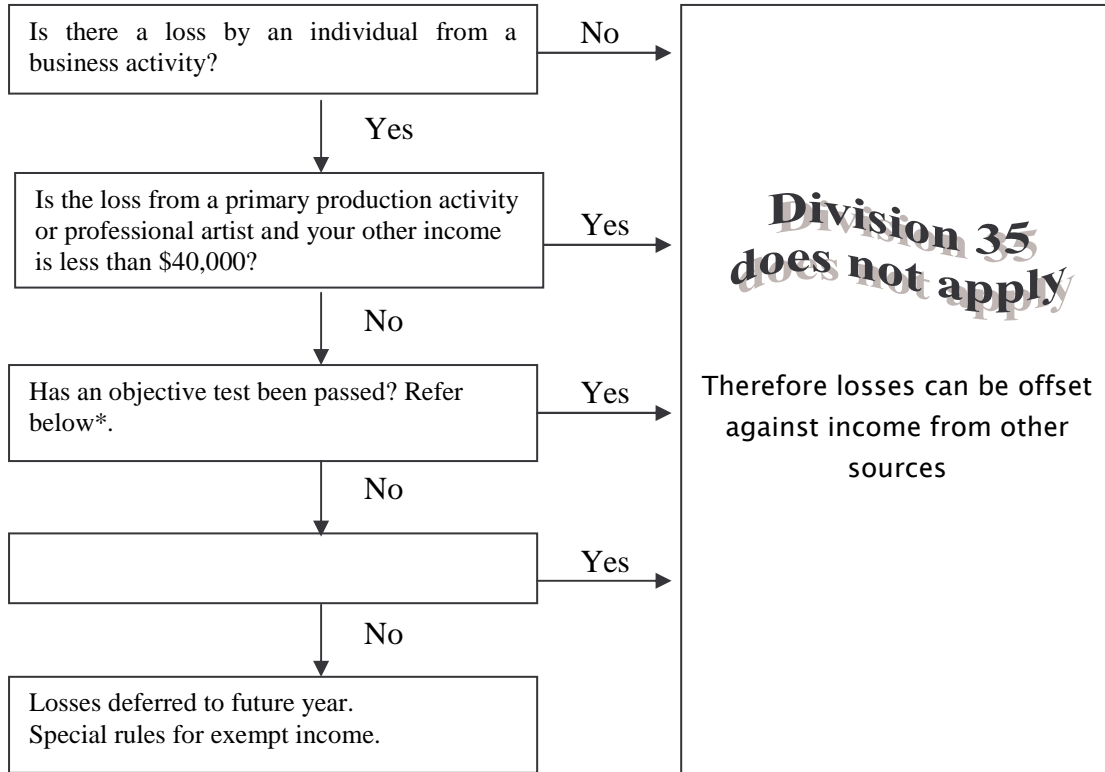
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Does Div 35 Apply – Flow chart

A bill has been introduced to Parliament that limits the circumstances where a taxpayer can offset business losses against his or her other income. Note this applies only to business losses, not passive income such as negatively geared rental property. This could apply to you if you receive a share of a loss from a partnership or operate a business at a loss. If caught by these provisions the losses can be held over to claim against future profits from the same business. Note this bill is currently before Parliament so there may be changes.

The following flow chart summaries the provisions.

For an income year:



*Objective Test:

To pass the objective test one of the following must be satisfied.

- 1) Turnover from the business activity is at least \$20,000.
- 2) The business has produced a taxable profit in at least 3 of the last 5 years including the current year. Note this is a profit before deducting any carried forward losses from previous years.
- 3) The value of real property used in carrying on the business is at least \$500,000.
- 4) The value of other assets used in carrying on a business is at least \$100,000.

Deferred losses and separate net income

The amount of a person's separate income determines how much spouse rebate their partner is entitled to. Just because a deduction for a loss is deferred by Division 35 it is not prevented from reducing the separate net income calculation. Of course this can't be counted twice so when these losses are claimed in a later year they will not reduce the separate net income for that year.

Wage earners with businesses on the side

Wage earners who have a business on the side that operates in a partnership or as a sole trader have to watch out for division 35 which prohibits them from offsetting the business losses against their wages income unless at least one of the division's requirements are met. There is an opportunity here to organise your affairs to meet these requirements before the end of the financial year.

High income earners such as doctors working in hospitals and building up a farm on the side should consider utilising the salary sacrifice provisions to make the farm run at a profit yet not increase their

taxable income. They should ask their employer to pay the businesses expenses and reduce their wages accordingly. The otherwise deductible rule would mean their employer would not be subject to FBT on any expenses it pays for the business. As the doctor's wage has been reduced by the amount of the expenses his or her taxable income will also be reduced. These expenses would no longer be claimed against the business so the business would operate at a profit and not be caught by Division 35. The doctors taxable income would be exactly the same as if the expenses had not been sacrificed and the business loss had been allowed just as it was in the good old days. This arrangement should not be packaged as part of your exempt portion if you work for a public hospital.

Commentary on the legislation

From other articles in Newsflash you are probably well aware that Division 35 prevents business losses being claimed unless one of the following points are met but there is opportunity in the detail:

a) If the loss is primary production and the total gross assessable non primary production income is less than \$40,000 the loss maybe offset against other income. This concession also applies to a professional arts business. Note the \$40,000 does not include capital gains or fringe benefits. If the other income is from a partnership it is only your share of the net profit of the partnership that is added to your assessable income if the partners are natural persons. This makes forming a partnership a very attractive option even if APSI requires you to return the net profit as 100% yours. If you were a sole trader your assessable income would be the total sales of the business before deductions rather than the net profit in the case of a partnership. If you are a wage earner, a partnership will not solve your problem therefore salary sacrificing may be the solution if you are just over the \$40,000 limit. But note fringe benefits are effectively taxed at the 48.5% rate. If your income is \$40,000 each extra dollar is taxed at 31.5% until you reach 50,000 when it is taxed at 43.5% until \$60,000 where it is taxed at 48.5%. So you need to consider the cost of the effective tax rate against the potential gain of offsetting the losses. There may also be benefits of salary sacrificing a vehicle and taking advantage of the formula method if the car does higher than average kilometres

b) The assessable income from the business activity is at least \$20,000. The assessable income is sales plus the increase in stock i.e. closing stock less opening stock. Therefore if you purchase more trading stock you will increase the closing stock and therefore increase the assessable income. Note the trading stock has to be on hand for it to be included in closing stock (Section 70-15 ITAA97). So you cannot just order it and bring it into account as a creditor. References Section 35-30 and 70-40 to 70-45. Buying and selling will also increase assessable income so there are plenty of ideas to work with here. There is also a concession for the first year of trading. If a "reasonable estimate" would conclude that had you been trading for the full year you would have made \$20,000 worth of sales plus closing stock (no opening stock in first year) then you are considered to have turned over the \$20,000. This also applies to the last year of trading but in that year there will be opening stock.

c) The business has produced a taxable profit in at least 3 of the last 5 years including the current year. Note this is a profit before deducting any carried forward losses from previous years.

d) The value of real property used in carrying on the business is at least \$500,000.

or

e) The value of other assets used in carrying on a business is at least \$100,000.

Non commercial losses (Div 35)

Division 35 prevents business losses being claimed against other income unless certain conditions are met but there is opportunity in the detail with some of these conditions, for example:

a) If the loss is primary production and the total gross assessable non primary production income is less than \$40,000 the loss maybe offset against other income. This concession also applies to a professional arts business. Note the \$40,000 does not include capital gains. If the other income is from a partnership, it is only your share of the net profit of the partnership that is added to your assessable income if the partners are natural persons. This makes forming a partnership a very attractive option even if APSI requires you to return the net profit as 100% yours because if you were a sole trader your assessable income would be the total sales of the business before deductions. If you are a wage earner, a partnership will not solve your problem therefore salary sacrificing may be the solution if you are just over the \$40,000 limit, but mainly

exempt benefits or confessionally treated car benefits. Otherwise the FBT payable at 17% more than your marginal tax rate would erode the advantages of being able to offset the losses.

b) Losses can also be offset against other income if the assessable income from the business activity is at least \$20,000. The assessable income is sales plus the increase in stock i.e. closing stock less opening stock. Therefore if you purchase more trading stock you will increase the closing stock and therefore increase the assessable income. Note the trading stock has to be on hand for it to be included in closing stock. So you cannot just order it and bring it into account as a creditor. Buying and selling will also increase assessable income so there are plenty of ideas to work with here. There is also a concession for the first year of trading. If a "reasonable estimate" would conclude that had you been trading for the full year you would have made \$20,000 worth of sales plus closing stock (no opening stock in first year) then you are considered to have turned over the \$20,000. This also applies to the last year of trading but in that year there will be opening stock.

c) Salary package the expenses relating to the non commercial business. As they are otherwise deductible your employer will not have to pay FBT. This should make the non-commercial business actually profitable but you will have less wages income.

Saving Tax on Your Investment Property – The Book

“Every investment property tax-related question you’ve ever wondered about is answered here and – perhaps more importantly – the ones you didn’t think to ask but should have! For property investors who want to refine their strategy for maximum gain, this resourceful handbook will make a great constant companion.” Eynas Brodie, Editor, Australian Property Investor magazine.

It’s finally finished! Combining Noel Whittaker’s easy reading style with Julia Hartman’s mind numbing attention to detail was a major challenge which ran way over schedule but it is finished, printed, and will be in the book stores soon. If you want a copy straight away you can purchase it online by going to: www.bantacs.com.au/property.php. The cost is \$29.95 plus \$5.95 postage – tax deductible of course!

Ask BAN TACS

For \$39.95 you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. If the answer may be questioned by your Accountant we will include references to support our conclusion. Just go to www.bantacs.com.au and look for the AskBantacs link on the right of the home page.

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Year End Tax Strategies

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Claiming a Motor Vehicle
Division 35
FBT for PBIs
Miners
Real Estate Agent
Selling a Business
Subcontractors
Wage Earners

Disclaimer: Please note in many cases the legislation referred to above has only just passed through parliament. The full effect is not clear yet but it is already necessary to make you aware of the ramifications despite the limited commentary available. On the other side of the coin by the time you read this information it may be out of date. The information is presented in summary form and intended only to draw your attention to issues you should further discuss with your accountant. Please do not act on this information without further consultation. We disclaim any responsibility for actions taken on the above without further advice as to your particular circumstances.