



## DIVISION 35 – OFFSETTING BUSINESS LOSSES AGAINST OTHER INCOME

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# Important

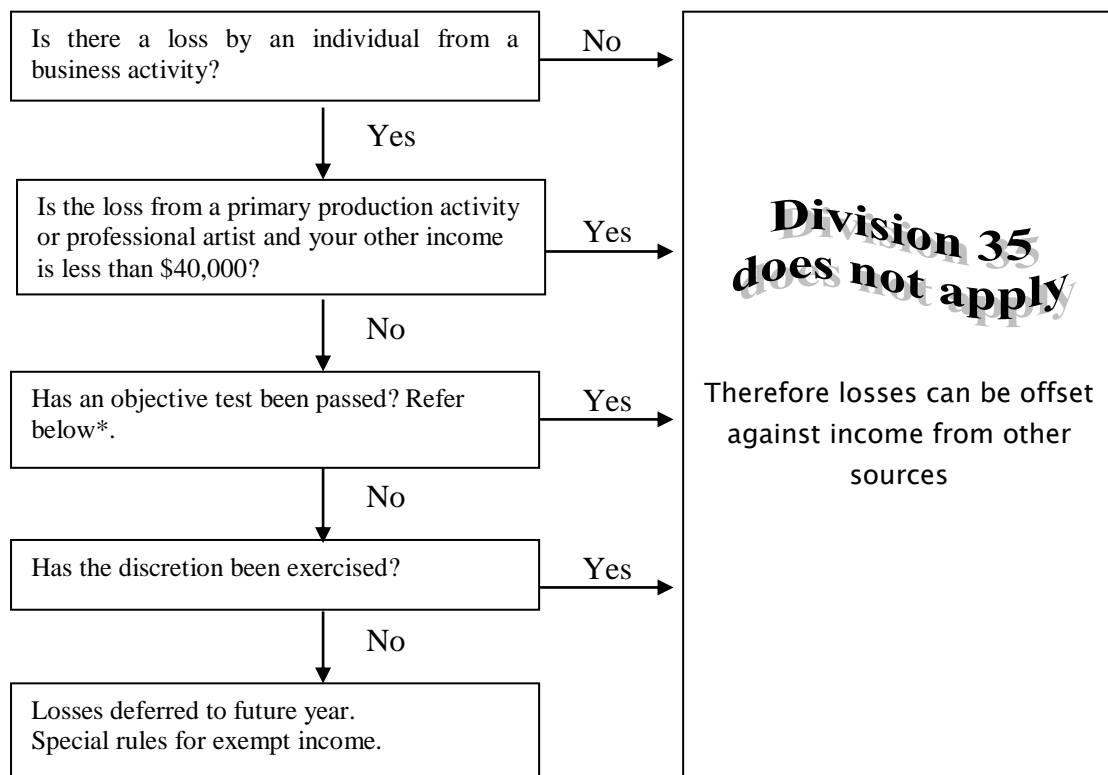
This booklet is simply a collection of Newsflash articles relevant to Div 35. The articles are transferred from Newsflash into this booklet so it is best read from the back page forwards to ensure you are reading the latest article on the topic first. Note that the information contained in this booklet is not updated regularly so it is important that you seek professional advice before acting on it.

## 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.

## 2009 Budget Update

This is the hobby farm issue that has been bandied around the restrictions on offsetting losses from a business against other income. There are many exceptions. The budget announced that people with other income exceeding \$250,000 will not be entitled to these exceptions. The only concession being that they can apply to the ATO in exceptional circumstances or if the business has been independently assessed as commercially viable but due to the nature of its activities is currently experiencing a temporary loss.

### Non Commercial Losses When Income Over \$250,000

When your adjusted taxable income (ATI) is over \$250,000 you cannot offset a loss from a business against your other income unless the ATO exercises its discretion. Discretion will generally only apply when it is normal for a business in your industry to have long lead times or you have experienced exceptional circumstances.

People with an ATI between \$249,999 and \$40,000 can only offset losses from a business against their other income if they pass one of the following tests:

- 5) Turnover from the business activity is at least \$20,000.
- 6) 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.
- 7) The value of real property used in carrying on the business is at least \$500,000.
- 8) The value of other assets used in carrying on a business is at least \$100,000.

People who's ATI is under \$40,000 who are primary producers or artists can offset their losses without having to pass one of the above tests though in that low tax bracket they would probably prefer to defer them. If your business is not in one of these industries but your ATI is under \$40,000 you cannot offset the losses unless you pass the tests listed above.

There is much more detail about this subject in our Division 35, Non Commercial Losses booklet.

Probably the easiest way of getting around these restrictions is to salary sacrifice the business expenses until it no longer makes a loss. This is done by your employer reimbursing you for the expenses. As these expenses are otherwise deductible your employer will not have to pay FBT or report it on your PAYG Summary. This approach has been accepted by the ATO, reference minutes of FBT sub-committee meeting 19-8-04. But rumour has it that they are considering changing their policy. It is probable that the law will

have to be changed to affect this change of policy and usually when an accepted practice is outlawed the changes are not retrospective. Nevertheless, if you are an employer offering this benefit it maybe the time to apply for a private ruling. If you are an employee you do not have to worry as it is your employer who will suffer the consequences.

If you have an ATI of more than \$250,000, want to offset non commercial losses and can pass one of the tests listed above, such as a turnover in excess of \$20,000 then consider deferring income every second year instead. Once your taxable income exceeds \$180,000 you are going to be subject to the maximum tax rate on every extra dollar. If say you earn \$300,000pa consider deferring \$51,000 of your income every second year so that your income in one year is \$249,999 and the other year \$351,000. No matter which year it is going to be taxed in the maximum tax bracket and in future years that bracket will be lower anyway. In the year that you do not qualify to offset your non commercial losses, they are simply carried forward until you do, so every second year you get to claim both years with no tax bracket disadvantage unless those losses exceed \$70,000. The only down side is the time value of waiting an extra year for your refund.

## Ask BAN TACS

For \$79.95 at Ask BAN TACS, [www.bantacs.com.au/ask-bantacs.php](http://www.bantacs.com.au/ask-bantacs.php), you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. We will include ATO references to support our conclusion. There is also a notice board where some askbantac users have generously allowed their question and answer to be published. Lots of good real life information.

## More Information

Please make sure you continue to keep your knowledge up to date by [subscribe to our Newsflash reminder](#). There are many other booklets available on our web site <http://www.bantacs.com.au/booklets.php> in fact the whole web site is full of useful information so also have a look around under topics.

## How to Make Sure Your Next Property Is a Good Investment

- Do you really know how much the property is going to cost you to hold?
- What name should the property be purchased in?
- Will this property fit your investment strategy and goals?
- What does the contract say about GST?
- How does the price compare with similar sales in the area?
- If it is negatively geared, how much capital growth is required before you breakeven?
- Do you know what records you need to keep and how?
- Are your financing arrangements maximising your tax deductions?
- What happens if interest rates rise?

.....and the list goes on!

To ensure you don't make a costly mistake with your next purchase make sure you see a BAN TACS Accountant before you sign

**Disclaimer:** The information is presented in summary form and could be out of date before you read it. It is only 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.

