

RUNNING A SMALL BUSINESS AT A LOSS?



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Why do you need to understand the Non Commercial Loss Regime?

We often have clients who run a small business at a loss and expect a large tax refund by offsetting this loss against their salary and wage income. Unfortunately the ATO have rules in place to limit this.

The Non-Commercial Loss Regime was introduced in July 2000 to stop people claiming their "hobby" as a tax deduction. Whilst this is reasonable in some cases, it does catch legitimate businesses as well.

To claim your business loss as a tax deduction without special consideration, your assessable income from other sources must be under \$250,000 and you must meet one of the following tests:

- ⇒ **Assessable Business Income** of at least \$20,000.
- ⇒ Your business has made a **profit** for tax purposes in three out of the last five years (including the current year).
- ⇒ You use **Real Property** of at least \$500,000 in your business.
- ⇒ You continually use "**other assets**" in the business (other than real property, cars, motor bikes and similar vehicles) valued at \$100,000 or more.

What is included in Assessable Income?

- ⇒ Normal business income
- ⇒ Profit on sale of depreciable assets
- ⇒ Capital gains relating to your business
- ⇒ Fuel tax credits received by your business

What is "Real Property"?

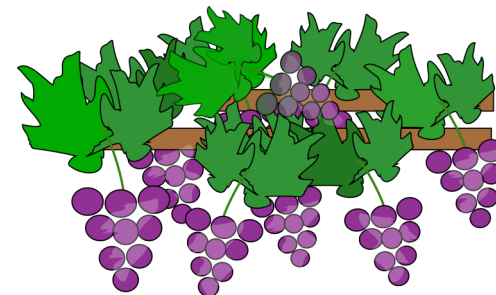
For this test, "Real Property" includes:

- ✓ Land
- ✓ Buildings and other structures fixed to the land
- ✓ A lease interest on that property

But does not include:

- ✗ Dwelling and adjacent land used mainly for private purposes
- ✗ Fixtures owned by you as a tenant

Your business doesn't need to own the land to pass this test. You just need to use that land on a continuing basis. A rented property could pass this test but not if it is for a short-term basis, for a one-off task or intermittent use only .



Primary Producer or Professional Arts?

A concession is available for primary producers and professional arts businesses. If your assessable income from all other sources is less than \$40,000 you can claim a tax deduction even if you don't meet the usual four tests.

If your income is over \$40,000 your loss will be deferred unless you can meet one of the four tests.

What Happens if I fail the Tests?

If you do not pass a test due to special circumstances which are outside your control, we can apply to the Commissioner to exercise his discretion to allow you to claim the losses.

We regularly provide this service for forestry, vineyard and fruit tree clients as there is an accepted delay in income production due to the need for the plants to mature.

If the Commissioner does not exercise his discretion, your loss will be “deferred”.

What Does Deferral Mean?

If you cannot claim your loss that year, it is carried forward and may be claimed in future years when you meet one of the tests.

- ⇒ Deferred losses are carried forward indefinitely. There is no time limit you need to meet to claim them.
- ⇒ If you make a profit from your business, you can offset your loss to reduce this to nil.
- ⇒ If you meet one of the tests for your business, you can claim your deferred loss in that year.
- ⇒ If you earn any “exempt” income, this will reduce your carried forward deferred loss.

Non-commercial loss rules are very complicated. Why not contact us on 4990 3775 or email enquiries@palfreyman.com.au to discuss your individual circumstances?

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Need an Example?

Chris and Jan started a small cattle business on their property at Quorrobolong in July 2018.

They have 30 head of cattle but only made sales of \$15,000 during the year. Due to interest on their mortgage and minor plant and equipment purchases, they made a loss on the business for 2019 of \$30,000. As they are a 50:50 partnership, this loss is split \$15,000 each.

The land value of their property is less than \$500,000 and they do not require many other assets to be used in the business.

The cattle business is not their only source of income. Jan's other income is \$20,000 but Chris earns \$150,000 in wage income.

Chris & Jan's cattle business has not passed any of the tests for non-commercial losses as:

- ✗ Assessable income (cattle sales) were less than \$20,000.
- ✗ The business has not made a profit in 3 out of the last 5 years.
- ✗ The value of “Real Property” (ie. land, buildings and fixtures) used was less than \$500,000.
- ✗ The “Other Assets” of the business are valued at less than \$100,000.

As cattle is a form of primary production, the ATO will allow Jan to claim a tax deduction for her share of the loss as her other income was less than \$20,000. However, Chris will need to defer his \$15,000 share of the loss ($\$30,000 \times 50\%$ share).

Chris' \$15,000 deferred loss is carried forward indefinitely until such time as the business meets one of the non-commercial loss tests.

In 2020, the cattle sales increased to \$25,000 but the business still made a small loss of \$20,000. The value of the real property was still under \$500,000 and no major additional equipment was purchased.

As the assessable income of the cattle business is over \$20,000 the business now meets the non-commercial loss tests. This means that:

- ⇒ Chris can claim a tax deduction for his 50% share of the current year loss (\$10,000) as well as any losses deferred in the past.
- ⇒ Chris' total tax deduction is \$25,000 - being his 50% share of the 2019 loss (\$15,000) and 2020 loss (\$10,000).
- ⇒ This accumulated loss can be offset against Chris' other income & should result in a good tax refund.
- ⇒ Jan is also entitled to claim her 2020 loss against her other income but does not receive any benefit from prior year as she already claimed it under the primary production concession test.