The Tax Status of Hobbies and Other Loss-Making Activities in New Zealand

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ABSTRACT

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A feature of New Zealand’s income tax regime is that it imposes tax on a “gross-global” basis which was clarified with the enactment of revised core provisions in 1994. A consequence imposing income tax on a “gross” basis is that whether a receipt is liable to income tax is done so in isolation without any consideration as to whether there is a resultant net income or loss produced. The “global” basis of imposing income tax means that any such losses can be offset against any other income the taxpayer has from other sources.

For several decades the Commissioner of Inland Revenue regularly reviewed tax losses reported by taxpayers with the aim of denying offset of those losses against other income where there was little prospect of the taxpayer’s activity becoming profitable. However, after the decision of the 1985 Court of Appeal in Grieve v. CIR 6 NZTC 61,682 and the enactment of revised core provisions in 1994, his scope for doing so is not as broad as was prior to these events.

This paper examines the issue of whether an offset should be allowed for losses arising from activities which have poor prospects of future profitability. In particular arguments can be made for clarifying the tax status of hobby or recreational activities which are not primarily carried on with the objective of earning income but may produce gross income from time to time. A further advantage of having a specific provision to deal with these activities is that is a prescribed treatment could be offered for any past losses should that hobby metamorphose into a profitable business. Another area would be where such a rule could be applied is in the area of rental property where excessive outgoings may be incurred by a taxpayer relative to its rental generation capacity, which will ultimately be recovered by the property’s disposal at a capital gain. Consideration of the recent reforms to “mixed-use” assets will also be made as well as the non-commercial loss rules in the Australian tax regime.
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I. INTRODUCTION
Several decades ago the New Zealand Commissioner of Inland Revenue directed considerable attention to reviewing tax losses returned by taxpayers with the aim of denying offset of those losses against other income if the activity giving rise to the loss was not in the nature of a business. From the 1970s until the mid-1980s he had some success at the Taxation Review Authority achieving this objective by arguing loss offsets were only permissible if the second limb of general deduction section was satisfied, something only possible if the taxpayer was carrying on a business. If no business was in existence, a loss offset was subsequently denied by applying the apportionment clause in the first limb of the general deduction rule to reduce the amount of deductible expenditure so that it was equivalent the amount of gross revenue received leaving a break-even net result.

By the mid-1980s these grounds for denying loss offsets became questionable after several decisions from the New Zealand courts starting with Grieve v. CIR in 1983, Pacific Rendezvous v. CIR in 1986 and others. Any doubt that he could continue with this line of argument to deny loss offsets finally disappeared with the enactment of revised core provisions in the Income Tax Act of 1994, which explicitly incorporated a “gross/global” basis of imposing income tax for resident taxpayers in New Zealand. As a consequence of these changes, it has become much clearer that taxpayers could offset losses derived from unprofitable activities against other sources of income whether or not the loss-making activity was in the nature of a business.

With this background in mind, it would seem that taxpayers are advantaged by the current legislative framework compared to how they may have been treated under earlier income tax statutes. For some taxpayers this undoubtedly will be true especially when compared to the

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1 Equivalent to section DA 1(1)(b) Income Tax Act (ITA) 2007.
2 Equivalent to section DA 1(1)(a) ITA 2007.
3 As the burden of proof is upon the taxpayer to show the CIR’s assessment is wrong, most taxpayers were unable to advance a more appropriate method of apportionment that was superior to that adopted by the CIR here.
4 6 NZTC 61,682.
5 8 NZTC 5,146.
CIR’s earlier successes in the 1970s. What this paper will do is to advance arguments that despite these revised core provisions, under current income tax legislation certain matters remain unclear surrounding the tax treatment of loss making activities which do not necessarily favour taxpayers. Similarly, arguments will be advanced that in other respects the current framework is in some ways too liberal in its treatment of losses and that there are good policy reasons why some losses which can currently be offset against other income should probably not be so. Finally examination will made of rules adopted in Australia over ten years ago to deal with losses incurred by “non-commercial” businesses and of new rules to be introduced in New Zealand to deal with the calculation of income derived from the use of certain assets where they have also been used privately within the same income year.

II. HOW DO LOSSES ARISE FOR TAX PURPOSES IN NEW ZEALAND?

Background to the Core Provisions

Income tax in New Zealand for resident taxpayers is imposed on a “gross-global” basis which was explicitly adopted with the enactment of the core provisions in Part B of the 1994 Income Tax Act. Earlier income tax legislation had been somewhat ambiguous on this point where the term “assessable income” had been used in both a gross and net sense within the same statute without any distinction being made between gross and net concepts. The problems associated with this ambiguity were first raised in Grieve v. CIR\(^6\) but in the end proved not pivotal to the outcome in this case and attracted little comment from the Court of Appeal. The issue was later raised by the Consultative Committee on the Reform of the Taxation of Income from Capital in their discussion paper on the core provisions of the 1976 Income Tax Act. Their final recommendations later formed the basis for the new core provisions included in the 1994 Income Tax Act and carried over to the current 2007 Act.\(^7\)

The new core provisions incorporated into the 1994 (and carried over to the 2004 and 2007 Income Tax Acts) made it explicit for the first time that income tax is imposed in New Zealand on a “gross-global” basis. The term “gross” means that liability to income tax arises when a gross receipt is deemed to be income irrespective of whether there is net income or a loss produced from it after allowable deductions. The second term “global” means that income from all sources is aggregated together and taxed using the same tax rate scale. The

\(^6\) Ibid at 61.685-6.

“global” approach also means that any losses from any one source or activity can be offset against any income the taxpayer has from other sources, the opposite of what is found with a schedular system of income tax whereby losses are quarantined within separate categories.

**Determination and Treatment of Losses**

Under the revised core provisions enacted in 1994, a loss arises in an aggregate context where the total income from all sources derived in an income year is less than the total allowable deductions for that year. The core provisions in Part B of Income Tax Act 2007 do not require taxpayers to separately determine net income from each source of income (or transaction) for an income year, however, taxpayers are required to calculate the individual net returns from each source of income due to the filing requirements imposed under the Tax Administration Act (TAA) 1994.

Section 33 of the TAA 1994 requires taxpayers to file annual returns of income on the “prescribed form” issued by the CIR. The relevant forms for filing returns of annual income (being the IR3, IR4, IR6 or IR7 forms) issued by the CIR require taxpayers to provide information about the net income from each category of income. For example, the IR3 form for individual taxpayers requires them to disclose the net income or loss from the renting of real estate (arguably when earned outside the context of a business activity) and to file a separate form (IR3R) for each rental property detailing the income and expenditure for that property. The effect of the filing requirement is that the CIR will be alerted to any loss making activities carried on by a taxpayer for which an offset is claimed.

Another implication of the requirement to file an annual return of income on the prescribed forms also requires taxpayers to consider whether any transaction they have been a party to within an income year has given rise to a receipt or benefit which is assessable to income tax. The decision of the Court of Appeal in *CIR v. Glover*\(^8\) confirmed and the revised core provisions enacted subsequently in the 1994 and succeeding Income Tax Acts require a taxpayer to return any gross receipt of income irrespective of whether a net loss is produced.

Due to adoption of the global basis of imposing income tax, once a loss has been incurred a taxpayer is able to directly offset that loss against any other income within the same income

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8 7 NZTC 5,097 (HC); 10 NZTC 5,012 (CA).
year. If all the losses are not fully offset within the same income year, the remainder can be carried forward indefinitely by individuals (until death) or by companies provided a certain level (49%) of shareholder continuity is maintained.\footnote{Hybrids such as limited partnerships and look-through companies allow limited partners and shareholders respectively to offset their share of losses against other sources of income up to the amount of capital they have at risk in the partnership or company. Otherwise losses have to be carried forward by the entity to be offset against future income.}

**Should Losses From Loss-Making Activities Be Recognised For Income Tax Purposes?**
Parliament enacted the current core provisions in 1994 after careful consideration of recommendations from a consultative committee of tax experts and submissions from the public.\footnote{Consultative Committee on the Reform of the Taxation of Income from Capital (Valabh Committee), *Discussion paper on the core provisions of the Income Tax Act 1976*, *ibid* and *Final Report of the Consultative Committee on the Taxation of Income from Capital*, Wellington, October 1992.} The core provision reflect an underlying policy choice to tax all types of income on the same basis (making no distinction between income from capital or labour) thereby promoting tax neutrality, an objective underpinning many of the tax reforms enacted in New Zealand since 1984. It is also effectively a rejection of the policies behind two measures in the 1982 Budget, the first of which was designed to quarantine tax losses from certain passive activities (rental losses and farming losses)\footnote{Section 188A Income Tax Act 1976.} and the second to tax capital gains from the disposition of rental properties which had been financed interest-bearing borrowed money.\footnote{Section 129 Income Tax Act 1976. Under this provision, interest deductions claimed in respect of acquisition of properties for income producing purposes were clawed back to the extent that the property was sold at a capital gain within 10 years of acquisition. It can also be viewed as an indirect measure to recoup rental loss deductions but only to the extent that the losses arose due to deductions for interest. Both of these measures were subsequently recognised as not being particularly robust due to weakness in the drafting of these sections.}

The author believes that there are good reasons for allowing offsets of losses against other sources of income in some situations, while in other instances there are grounds for arguing that offsets should not be permitted but instead the losses should be quarantined and carried forward. Essentially for reasons of fairness, equity and revenue integrity not all losses incurred by a taxpayer should necessarily be recognised for income tax purposes.

The main arguments that can be made in support of loss offsets are:

- Income tax should be imposed on what is considered to be economic income - hence all losses and gains from whatever source should be aggregated.
Some activities are long term in nature and it may require several years to pass before profits start to emerge. It is therefore appropriate to recognise these losses as incurred as later profits will be subject to tax. It is also possible to argue that with activities that are long-term in nature, tax losses incurred in the commencement of the activity are a merely creation of income tax law because income tax is assessed annually.

Transaction Symmetry. If a transaction produces a net profit which is subject to income tax, then if a transaction of the same type produces a loss it is only appropriate to recognise that loss. This line of argument expressly underpins the treatment of tax losses under the present core provisions because the gateway to tax recognition of a transaction is whether the gross receipt from a transaction is assessable income, not whether a net gain or loss is produced. The symmetry argument had been successfully advanced by taxpayers prior to the enactment of the current core provisions in Inglis v. CIR\textsuperscript{13} where shares bought for a speculative purpose but subsequently disposed of at a substantial loss, were held to be on revenue account and therefore the loss was deductible for income tax purposes.

On the other hand there are situations where it can be argued that loss offsets are not justified. A case can be made for not recognising losses for tax purposes where they arise from an activity or transaction that was not entered into with a primary objective of earning taxable income. For example:

- An activity carried essentially for private purposes or enjoyment (i.e. a hobby) but there is some incidental income received which is used to offset the costs of carrying on this activity. Because the boundary to income tax under the core provisions is whether a gross receipt is taxable, it provides a platform for taxpayers to assert the hobby was really a type of business subsequently leading to offset of losses from the activity. However, in essence the activity is a private one and to allow offset of the losses incurred effectively provides a subsidy for what is really a taxpayer’s private hobby or recreation.

- An activity carried out to produce a gain but not one that is subject to income tax. Here the activity does have a economic focus as its main objective, it is just that the gain enjoyed is not subject to income tax. A good example of this case exists in New Zealand with rental properties. As New Zealand does not comprehensively tax all

\textsuperscript{13} (1992) 14 NZTC 9,180.
capital gains taxpayers may be prepared to acquire rental properties with the expectation of incurring losses, if the property can be sold at a non-taxable capital gain.

The second case above is slightly different to the others because it involves the renting of land. All amounts received from the renting of land are taxable under section CC 1 of the ITA 2007 and whether or not the rental venture could be regarded as type of business is irrelevant to the taxation of rents received. This same issue also underpins the new mixed-use asset rules which will be introduced from 1 April 2013 where land has been used for both private and rental purposes during an income year.

The tax treatment of rental properties has attracted considerable attention in the last decade usually in the context of whether this tax treatment is contributing to poor housing affordability. A comprehensive capital gains tax has sometimes been advocated as a solution to this problem although Australia has suffered similar housing affordability issues even with a comprehensive capital gains tax. The argument to tax capital gains does address the symmetry issue where rental losses are incurred which are compensated by a capital gain at a later date.

The real problem with this argument is that with a realisation based capital gains taxation regime, a full offset of losses from rental activities against other sources of activities will still provide a tax advantage because of a:

- Timing advantage from immediate offset of losses while the capital gain is only taxed when realised which may be decades later;
- Tax preferences applying to capital gains such as partial taxation of the gain, indexation, or a lower rate of tax than that applying to ordinary income.

A more appropriate treatment of rental losses would be quarantine them even in the presence of a capital gains tax as it would be a better solution to the mismatch between rental losses and capital gain taxation.
Does the current ITA contain adequate provisions to deal with these loss offsets?

The first step to the recognition of a loss for income purposes is determining whether a sum received by a taxpayer is income. The relevant sections most likely to apply are:

- CB 1 - income from a business
- CB 3 - profitmaking schemes or undertaking
- CB 4 - sale of property acquired for purpose of disposal
- CB 5 - dealing businesses
- CC 1 - rental of land
- CC 3 to CC 9 & CD 1 - interest, dividends, royalties all being income from capital

Of the above list, two apply when a receipt is derived in the context of a business (CB 1 and CB 5). Another two (CB 3 and CB 4) apply only if necessary conditions are met such as the presence of speculative purpose at time of acquisition of a piece of property or the existence of a profitmaking scheme or undertaking. The remaining provisions (such as CC 1 and others) bring to tax all receipts that merely fall within the relevant definition of that income type without any further qualification as to whether a business exists.

Turning to the case of section CB 1, if a taxpayer contends that an activity carried on for personal objectives is a really business for income tax purposes, it can be usually argued that the activity is not a business and hence any receipts from that activity are not income under CB 1. Therefore with robust monitoring of what constitutes a business for income tax purposes, it appears that this would be adequate to prevent the subsequent recognition and offset of losses against other income from what are essentially non-business activities.

A “business” is defined in section YA 1 of the ITA as “including any profession, trade, manufacture or undertaking carried on for profit”. It is an inclusive definition rather than an exhaustive one, leaving the courts to develop the definition further using common law principles. The leading New Zealand authority on this issue is of course Grieve v. CIR\textsuperscript{14} where the Court of Appeal upheld that a business was some activity carried on by a taxpayer with the intention of making a profit. The objective test of whether the activity under review was capable of eventually becoming profitable at some later stage advanced in earlier cases.

\textsuperscript{14} Ibid.
such as *CIR v. Harley*\textsuperscript{15} being merely one factor to be taken into account in determining the genuineness of a taxpayer’s intention. Thus whether an activity is a business hinges on whether the taxpayer carries on the activity primarily for profit or instead for some other reason. Such a classification is more easily applied in the context of an activity which produces losses. Presumably if the activity is not a business, a taxpayer is prepared to continue to incur losses carrying on that activity because of the personal benefits enjoyed, while if it was a business one would expect a taxpayer to modify or restructure their activity in light of the losses incurred with the objective of becoming profitable in a later income year.

The existence of a profitmaking intention as the deciding factor as to whether a business exists or not becomes more problematic when an activity produces a net profit occasionally. Can it be argued that a profitmaking hobby is not a business if a taxpayer enjoys net profits from the activity over several income years? At this point there must be grounds for arguing that the taxpayer’s intention has changed and that it has shifted to one of making profits and hence a business. The author finds it difficult to accept that the Commissioner would be prepared to allow a taxpayer to carrying on an activity over a number of years which produce net profits and not to regard it as business activity.

But what about the transition point? Can a point be identified where a hobby metamorphoses into a business? The Taxation review Authority has been prepared to do so in some cases, but in the context where the derivation of net losses resulted in the taxpayer restructuring their activity into an economic venture.\textsuperscript{16}

The problem is the status of the losses incurred while the activity was still regarded as a hobby. These have been treated by the TRA as preparatory to the commencement of a business and hence non-deductible and capital in nature.\textsuperscript{17} This is not necessarily the fairest treatment but one that is currently sustainable in the framework of the current ITA. It does leave the risk that the taxpayer suffers the double jeopardy of non-deductible losses but later taxable profits.

\textsuperscript{15} [1971] NZLR 482.

\textsuperscript{16} Refer TRA Case E24 (1981) 5 NZTC 59,133.

\textsuperscript{17} Refer to case in above footnote.
Reliance on the definition of what a business is for tax purposes to appropriately handle loss making activities may seem a big ask of what can be a complex decision. It also exposes taxpayers to uncertainty and the double jeopardy of taxable profits but non-deductible losses. There is also the problem that whether an activity can be considered a business often requires several years’ trading to have passed before an appropriate decision can be made. The fact that income tax is assessed annually easily does not accommodate that type of longer-term consideration.

What about loss making activities than potentially fall within the scope of other sections? Some hobbies could fall within the scope of section CB 4 if they involving collecting and trading in property such as stamps, old coins, antiques etc. If the hobby is one of merely expanding the collection of the taxpayer then it is unlikely any income will be received that will require consideration as to the income tax status of it. Where the collecting hobby involves both acquisition and disposal of items in the collection, the dispositions become more problematic as they could potentially fall within section CB 4. Difficult arguments could arise as to the purpose of acquisition of items in the collection - was it merely for the pleasure associated with ownership or it to expand the overall value of size of the collection through skilful purchasing and trading of items? The latter would seem to suggest that section CD 4 would apply. But once any disposal is held to fall within section CB 4, any expenses incurred are deductible and therefore any loss is recognised for tax purposes. There is also the possibility that section CB 3 could apply to a hobby activity, but the qualification that the profitmaking objective required to exist for this section to apply must be a profit of an income nature (rather than a capital or non-taxable gain) must limit its potential application to hobby type activities.

A case can be made that the current New Zealand ITA 2007 is not sufficiently robust to deal with loss making activities where offset of those losses is not justified. Division 35 of the Australian Income Tax Assessment Act (ITAA) 2007 contains special rules for dealing with losses from non-commercial business activities which provides a relevant comparison. These rules establish several brightline tests for quarantining losses from non-commercial activities which are in the nature of business. The rules are administratively more appropriate for dealing with activities that may span over several income years or longer but have to be assessed for income tax on an annual basis. The rules also address the problems arising from trying to prevent recognition and offset of losses from a loss-making activity by subjectively
reviewing whether they are in the nature of a business or a hobby. The Australian rules introduce objective tests based on the results obtained rather than a subjective assessment of a taxpayer’s intention.

III. AUSTRALIAN NON-COMMERCIAL LOSS RULES

The Australian non-commercial loss rules were introduced from 1 July 2000. They were enacted in Division 35 of the ITAA 1997 as a result of a recommendation from the Ralph Committee’s report Review of Business Taxation: A Tax System Redesigned. The Ralph Committee was concerned about considerable revenue loss from taxpayers’ claiming losses from activities which were “often unlikely to ever be profitable”. In section 35-5 the objective of the rules is given as improving the integrity of the taxation system by “preventing losses from non-commercial activities that are carried on as a business by individuals (alone or in partnership) from being offset against other income”. There is a second objective of preventing deductions for pre-business and post-business capital expenditure in relation to non-commercial activities being deductible unless certain exceptions apply.

It is interesting that the term “non-commercial” is used in the context of business activities implying that there can be such a thing as a non-commercial business. Since the key characteristic of a business is an activity which a taxpayer carries on with the intention of making a profit, this term may appear to some inherently contradictory. In Taxation Ruling 2001/14 it is noted by way of a footnote that the term “non-commercial business activity” refers to an activity that Division 35 potentially applies to rather than meaning the activity “has been pre-judged as being non-commercial in any ordinary sense of that term”.

The Australian non-commercial loss rules apply only to activities that would be considered a business (as opposed to a hobby). In section 35-5(2) it made clear that the rules do not apply to activities that do not constitute the carrying on of a business such as the renting of property or income from passive investments as well as activities of a hobby or personal nature. The rules address the same key issue that the definition of business for income tax purposes on its own may not be sufficient on its own to prevent losses being recognised from activities which

19 Footnote 1, TR 2001/14.
are inherently uneconomic and not carried on with commercial objectives. They are objective in that they employ a number of brightline tests upon which loss offsets are either disallowed (quarantined) or permitted to be offset. Where a loss is not able to be offset under these tests, a taxpayer can request the FCT to exercise a statutory discretion to allow offsets based if they can meet certain qualitative tests in respect of their loss making activity.

The rules also have another advantage in that they provide a framework for treating losses not qualifying for an offset to be carried forward to a later income year. This addresses the weakness with the current New Zealand treatment of marginal business activities where a loss making activity may be classified as hobby but if it develops into a profitable business those earlier losses are still not recognised. This is particularly desirable as the uncertainty as to whether an activity is a commercially viable business may only be resolved in later income years once a pattern of trading has emerged.

**What is a business under Australian income tax law?**

For income tax purposes a business is defined in subsection 995-1(1) of the ITAA 1997 as including “any profession, trade, employment, vocation or calling but does not include occupation as an employee”. There is no reference to a profit-making intention as found in the New Zealand definition but interestingly it specifically excludes the activities of an employee from being a business, a point not made in the New Zealand definition but would be the case anyway in New Zealand under common law.

Like the New Zealand definition of a business, the Australian definition is an inclusive one rather than an exhaustive one, and the view of the ATO in Taxation Ruling 97/11 is that the definition merely states what activities might constitute a business but does not provide “any guidance for determining whether the nature, extent and manner of undertaking those activities amount to the carrying on of a business” which is left to case law. Among the additional factors that have been considered by Australian courts in determining whether an activity is a business, include whether a taxpayer has a purpose of profit when engaging in the activity and the prospect of future profit from it. Similarly as in New Zealand, activities which amount to a hobby or personal pursuit are not considered a business and are left
outside the tax net, with any amounts received not being subject to tax and any expenditure incurred being non-deductible.

**How do the rules operate?**

Once it has been established that a business exists, any losses incurred from that activity suffered by individuals either as sole traders or as members of a partnership are potentially subject to the non-commercial loss rules in Division 35 of the Income Tax Assessment Act (ITAA) 1997. The rules do not apply to companies. Nor do the rules apply to losses derived from share transactions or the renting of property, or to losses derived from hobby activities which are left outside the income tax net. Apart from these rules tax losses in Australia are, in general subject, to similar treatment as is accorded in New Zealand although the ability to carry forward company tax losses are subject to either a shareholder continuity or a line of business test rather than solely a shareholder continuity test as in New Zealand.

For these individuals to offset a business loss, they have to meet both an “income requirement” test and a “business test”. 21 Until 1 July 2009 taxpayers had to only satisfy the “business test” but the additional requirement to meet the “income requirement” test was introduced from that date to reduce revenue loss from high income individuals with loss-making activities. The two tests apply as follows:

1. The *income requirement* is met when the aggregate of the following items is below $250,000 for an income year:
   - Taxable income (ignoring any business losses falling within this Division);
   - Reportable fringe benefits amounts;
   - Reportable superannuation contributions; and
   - Total net investment losses.

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21 Note the term “business test” is used here as it appears in the rules and does not refer to a test for an existence of a business as discussed earlier in this paper.

22 Section 35-10(2E).

23 The top marginal tax rate for individuals applies when their taxable income exceeds $180,000. The $250,000 appears to have been set above the taxable income threshold of $180,000 to ensure that the losses the taxpayer is seeking to offset will attract relief at the top marginal tax rate (being 45%). (For incomes between $80,000 and $180,000 the marginal tax rate is 37% significantly lower than the top marginal rate.)
(2) The business test\textsuperscript{24} is met if the loss-making business activity meets any one of the following thresholds:

- The business has assessable (gross) income of at least $20,000 in the current income year;\textsuperscript{25} or
- The business had a net profit for tax purposes in three out of the past five income years (including the current income year);\textsuperscript{26} or
- The value of real property, or of an interest in real property used in the business on a continuing basis was at least $500,000;\textsuperscript{27} or
- The value of other assets (excluding real property, motor vehicles) used on a continuing basis in the business was at least $100,000.\textsuperscript{28}

If a taxpayer is carrying on a business involving “primary production” or a “professional arts business”\textsuperscript{29} they can offset a loss from these businesses in the same income year if their other assessable (gross) income is less than $40,000. In addition, they do not need to meet any one of the four business tests above in respect of these two types of activity.\textsuperscript{30}

If both the “income requirement” test and the “business test” are met in any income year, the business loss can be offset against the taxpayer’s other sources of assessable income. If a loss offset is denied because either one or both of these tests are not met, two possible outcomes arise:

- The loss ineligible for an offset can be carried forward to a future income year for potential offset in that and later income years; or
- The taxpayer can alternatively request the FCT to exercise his discretion to allow an offset of a business loss if the taxpayer fails to meet the income requirement test or business test.

\textsuperscript{24} Section 35-10(1)(a).  
\textsuperscript{25} Defined in section 35-30.  
\textsuperscript{26} Defined in section 35-35.  
\textsuperscript{27} Defined in section 35-40.  
\textsuperscript{28} Defined in section 35-45.  
\textsuperscript{29} Defined as a business carried on as “the author of a literary, dramatic, musical or artistic work, or a performing artist or production associate”.  
\textsuperscript{30} There is a second dispensation from the rules is if the business loss arises solely from deductions arising from the small business and general business tax break. This “tax break” was introduced in 2008 as a type of investment incentives (heavily weighted toward smaller businesses) which provided a deduction in addition to depreciation for assets purchased in 2009. Allowing loss offsets for losses arising from this incentive is consistent with the policy objective of this temporary incentive.
The FCT can exercise a discretion conferred upon him under section 35-55 and allow a loss offset if it is “unreasonable to apply” the business test because it has not been met due to one of the following situations:

- Special circumstances arose outside the taxpayer’s control such as drought, bushfire or some other natural disaster; 31 or
- For taxpayer who has met the “income requirement” and just started the business in question, they have not meet any one of the four “business tests” because of its nature there is a lead time before it can pass one of these tests and, there is objective evidence that within a period that is commercially viable for the industry concerned, the activity will be able to meet one of these tests or become profitable.

If a taxpayer did not meet the “income requirement test” but can meet one of the “business tests”, the FCT can also exercise his discretion to allow a loss offset if the taxpayer can satisfy him that the loss arose due to its nature which means there is a lead time before it can become profitable and there is objective evidence that, within a period that is commercially viable for the industry concerned, the activity will be able to become profitable in the future.

The Australian uncommercial loss rules are complex but their objectives are reasonably clear. The rules are designed to enforce a boundary at which offset of losses from non-commercial activities against other income is denied unless the activity is a genuine business evidenced by one of the following grounds:

- size (based on either on gross sales or assets employed); or
- a history of earlier profitability in some of the previous 5 years; or
- specific evidence related to the activity under review that the activity has prospects of becoming profitable at a later stage which is consistent for the industry type.

The “income requirement” test means that any loss offset by a high income earner can only be obtained by FCT discretion meaning that their loss making businesses will attract more attention from the ATO than would loss-making businesses carried on by lower income earners. High income earners enjoy greater benefits from any loss offset due to their higher marginal tax rates. The rules do, however, provide safeguards against persons suffering

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31 Section 35-55(1)(a). Under 35-55(2) where a loss offset was denied because the business activity did not actually commence, the taxpayer can similarly apply to the FCT to exercise this discretion if the business did not commence for the same reasons.
hardships from losses incurred from genuine business activities provided objective evidence is provided that the venture has some prospect of future profitability.

IV. NEW ZEALAND MIXED USE ASSET RULES
The New Zealand IRD had for a number of years been concerned about taxpayers reporting losses from the renting or business use of certain assets which had been used both privately and to earn income within the same income year. The key issue with these assets was whether the ownership costs attributable to the period that the assets were being used neither privately nor for production of income could be deducted against income received or instead be treated as a private expense.

It had been accepted that provided the asset was not being used privately and was merely available for income earning purposes, the ownership costs for these non-use periods could be deductible for tax purposes. Inevitably this treatment has lead to taxpayers reporting tax losses which are unlikely to ever decrease and in effect other taxpayers are subsidising the ownership of assets primarily acquired for private purposes. The incidental business or rental use is usually seasonal and arranged to help defray the private costs of ownership. Additionally because of seasonal factors there may be limited opportunities to earn income from these assets even if there was no private use during the year.

Given this background, the New Zealand Government announced in its 2011 Budget that special rules would be introduced to deal with certain “mixed-use” assets. These are assets that are owned primarily for private purposes (such as holiday homes, boats, aircraft) but where there is some incidental leasing (or business use) of the assets when not needed privately. Under section CC 1 ITA 2007 all amounts received from the leasing of land (and any improvements upon) are income which obliges a taxpayer to return such income irrespective of the circumstances surrounding their receipt such as whether it was a business activity.

The mixed use asset rules will impose a more balanced allocation of ownership costs deductible for income tax purposes. In addition, the rules will exempt from tax leasing on non-commercial terms or between family members.
The mixed use asset rules will impose an apportionment rule to the ownership costs of certain assets if they are used by a taxpayer both privately and for income producing purposes and the asset has also been unused for either purpose for at least 62 days (or 62 working days if only used on working days) in an income year. The assets to which the rules apply will be all land (and improvements erected upon it) and any other asset with a cost of more than $50,000 to the taxpayer. Motor vehicles are specifically excluded from the rules as are any other assets subject to apportionment on a space basis.

Private use will be specifically defined to include all use by the owner and persons associated with them irrespective of whether a market rental is charged. The one exception will be if the asset requires expert or specialist knowledge in order for it to be used and the person uses it in that capacity directly or indirectly to derive income which is at market value. Any renting at below market rates will be treated as private use.

Certain expenditure will remain deductible and not fall within the scope of the apportionment rule. This will apply where:

- The particular expenditure is incurred to produce income and cannot reasonably be expected to derive any private benefit (e.g. advertising of a holiday home to rent); or
- A reasonable amount incurred to meet a regulatory requirement so that the asset can be rental out (e.g. cost of a mandatory marine survey necessary to charter out a boat).

However, repairs and maintenance expenditure will not qualify for this exception and will remain subject to the apportionment rule.

The basic apportionment rule will apply to expenditure which is neither wholly private nor eligible to be deducted in full. It will apply as follows:

\[
\text{Expenditure} \times \frac{\text{Income Earning Days}}{\text{Income Earning Days} + \text{Private Days}}
\]

Thus costs associated with owning an asset during the periods it is unused is allocated proportionately according to the proportions of income and private use only rather than attributing all these ownership costs to the income producing period which is currently the case.
There are special rules proposed that will apply to interest costs incurred by close companies. These special rules are necessary because under section DB 7 all interest expense incurred by a company is otherwise deductible. Under these rules, any debt owed by a company is first attributed to the mixed-use asset first only if the debt exceeds the asset’s cost is it attributed to other assets owned by the company. There are further provisions where a chain of companies exist which hold the shares in the company owing the mixed-use assets. This is to close a loophole that would otherwise exist if the interest expense was charged higher up the company chain. This anti-avoidance provision also extends to interest incurred by an individual shareholder to buy shares in a close company which owns the mixed-use assets.

**Loss Quarantining After Expense Apportionment**

In addition to apportioning the ownership costs based on the earlier formula, the mixed-use asset rules further quarantine any net losses derived after the application of the expense apportionment rule where the amount of market rate rentals is below a deminimis threshold. When this provision applies, any net losses incurred from renting the mixed-use asset have to be carried forward to future income years until the asset produces a net profit.

This loss quarantining provision applies when a person:

- incurs expenditure which is subject to the mixed-use asset apportionment rule; and
- the amount of income derived from the use of the asset (disregarding any income derived from associated persons) is less than 2% of:
  - its latest rating value or its cost on acquisition for land property; or
  - for other property is cost to the taxpayer.

There is an exception to this provision where the income earned from the use of the asset in a business activity and the amount of income cannot be separately attribute to the use of the asset. This exception will not apply however if the asset is also used to produce income which can be attributed to its use and rental use is at least 80% of its total business and rental use.

**Deminimis Income Exemption Option**

If the amount of income produced by a mixed-use asset is less than $1,000 in an income year, a taxpayer may elect for that income to be exempt. This option is also extended to taxpayers
who suffer loss quarantining. In both cases any interest expense must be apportioned for the amount incurred in deriving what is now exempt income. Presumably this exemption is offered on compliance cost grounds.

**Analysis of the Rules**

The effect of the mixed-use asset rules will be to reduce deductions claimed against income derived from mixed-use assets, leading to reduced tax losses or emergence of taxable income. In addition they will be able to relieve taxpayers from returning income from renting mixed use assets (which would otherwise have to be returned because it fell within section CC 1 of the ITA 2007) where they have been rented to associated persons or to non-associated persons at rentals below prevailing market rates.

**V. CONCLUSIONS**

There are considerable incentives for a New Zealand taxpayer with hobbies that produce incidental income to assert it is a business activity to gain the advantage of a loss offset against other income. In addition investment in rental property is also incentivised given that rental losses can be offset against other income but any capital gain upon disposal of the property is not subject to tax.

The New Zealand ITA 2007 contains limited provisions to deal with loss-making activities returned by taxpayers which have poor prospects of becoming profitable. While there can be grounds for disputing whether the taxpayer’s venture constitutes a business for tax purposes, in the case of rental property there is no such scope, as all amounts received from the rental of land are taxable irrespective of the context in which they were derived.

On grounds of both equity and efficiency it does not seem desirable that taxpayers can offset losses from activities where there is a marginal prospect of future profitability nor from renting property where the losses incurred will be balanced by a non-taxable capital gain. The Australian non-commercial loss rules provide an interesting solution to dealing with loss-making businesses although they do not apply to rental property or passive investments. The Australian rules employ several brightline tests the main criteria underpinning them being that the venture under review is of a certain size, implying that from a policy perspective the un-commercial activities not eligible for loss-offsets will those that are small scales ones (possibly undertaken on a part-time basis). Beyond the brightline tests, taxpayers can still
obtain loss offsets if they can satisfy the FCT that there venture is being carried on in manner similar to other business in the same industry type and that there is an objective prospect of profit in the future. In some way, these rules enforce a prospect of profit test that had to be also satisfied for a business to exist in New Zealand prior to the Court of Appeal decision in Grieve v. CIR.

Interestingly the Australian non-commercial loss rules do not apply to the renting of real estate. Disposal of rental properties is subject to a capital gains tax in Australia which for individuals makes 50% of the gain is subject to ordinary income tax. Rental losses have previously been quarantined in Australia but full loss offsets were subsequently restored later, a popular move in Australia but one conceptually debatable.

Another advantage of the Australian rules is that quarantined losses are still recognised for tax purposes it is just that they have to be carried forward. This enables preservation of the losses should the activity under review develop into a successful business.