

## **Board of Taxation**

### **Post-implementation Review of Non-commercial Losses (Division 35)**

#### **The Special Circumstances of Artists**

“The contribution of the artistic community to Australian life, when measured in cultural and social terms, is immense. Yet much of the value of this contribution is not reflected in the market prices that artists command when selling work - whether they are seeking to sell their labour (actors, dancers, musicians, community cultural development workers) or the works their labour produces (writers, visual artists, craft practitioners, composers). As a result the economic return to artists remains stubbornly low, and is not a true measure of their contribution to Australian society.”<sup>1</sup>

#### **1 Introduction**

- 1.1 The Australia Council welcomes the opportunity to respond to the invitation by the Board of Taxation to make a submission to assist in the Board's assessment of the quality and effectiveness of the non-commercial losses provisions in Division 35 of the *Income Tax Assessment Act 1997* (the Act).
- 1.2 In preparing this submission, the Australia Council has consulted with a variety of arts sector organisations. The following peak arts bodies wish to express their support for, and agreement with, this submission:
  - The Artists Foundation of Western Australia
  - The Arts Law Centre of Australia
  - The Australian Dance Council (Ausdance)
  - The Australian Major Performing Arts Group
  - The Australian National Playwrights' Centre
  - The Australian Society of Authors
  - The Music Council of Australia
  - The National Association for the Visual Arts
  - Playworks Inc.
  - Youth Performing Arts Australia
- 1.3 Division 35 is of particular relevance to Australia's professional arts community, as the majority of artists operate in a freelance or self-employed capacity. Furthermore, it is not unusual for Australian artists to work two to three jobs—their art, a related arts job such as teaching, and non-arts jobs (eg, telemarketing, taxi driving) as most artists are unable to make a living from their profession.

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<sup>1</sup> From the concluding pages (at page 79) Australia Council report *Don't Give Up Your Day Job* prepared by Professor David Throsby and Virginia Hollister, Division of Economic and Financial Studies, Macquarie University, Sydney, 2003 (**Throsby Report**).

- 1.4 A recent economic study of professional artists in Australia<sup>2</sup> revealed that there are about 45,000 professional artists. In 2000-01 the mean income for artists from creative work was just over \$17,000, while the mean income for artists from all sources (i.e. not just creative sources) was \$37,000.<sup>3</sup> Government support is an important part of an artist's income, with 25 per cent of artists receiving some form of government support between 1996 and 2001.
- 1.5 The tax system also plays an important role in providing support to the arts industry. Measures such as the tax averaging provisions (Division 405) and the current exemption contained in Division 35 (i.e. the \$40,000 cap) recognise the particular economic circumstances of professional artists. This submission addresses the effects of Division 35 on Australia's professional artists (writers, visual artists, craft practitioners, musicians, actors, dancers, choreographers, composers and film-makers) and the extent to which Division 35 achieves fair and equitable treatment of this taxpayer group.

## 2 Outline of Submissions

- 2.1 The Board has identified that it will evaluate the quality and effectiveness of Division 35 by reference to whether the division:
- gives effect to the Government's policy intent, with compliance and administrative costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
  - is expressed in a clear, simple, comprehensible and workable manner;
  - avoids unintended consequences of a substantive nature;
  - takes account of actual taxpayer circumstances and commercial practices;
  - is consistent with other tax legislation; and
  - provides certainty.
- 2.2 Our primary submission is that all professional artists should be exempted from the operation of Division 35 because the division does not adequately take into account the actual circumstances of individual artists and the commercial practices of the arts industry generally. We expand below on our primary submission by reference to the criteria identified by the Board of Taxation for their post-implementation review of Division 35.
- 2.3 We note that our primary submission is consistent with the recommendations made in 2002 by the Report of the Contemporary Visual Arts and Craft Inquiry, chaired by Rupert Myer (the **Myer Report**)<sup>4</sup>. This report was commissioned in 2001 by the then Federal Minister for the Arts and the Centenary of Federation, the Hon. Peter McGauran MP. The brief of the inquiry was to scope the contemporary visual arts and craft sector, examine its cultural and economic contribution, and make recommendations on key issues impacting upon the future sustainability, development and promotion of the sector as whole<sup>5</sup>.

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<sup>2</sup> The Throsby Report, *ibid*.

<sup>3</sup> However, the Throsby Report notes that mean figures are not necessarily the most accurate measure of the "typical" artist's income, due to the impact of outliers (i.e. the few artists who earn very large incomes). Accordingly, later in this submission we refer to the median income of artists in Australia.

<sup>4</sup> The full text of the Myer Report is available at [http://www.dcita.gov.au/download/0,2118,4\\_111224,00.pdf](http://www.dcita.gov.au/download/0,2118,4_111224,00.pdf)

<sup>5</sup> Myer Report, "Executive Summary" at page 4.

Recommendation 2.2 of the Myer Report was that “the Commonwealth remove the \$40,000 limit on secondary income of artists, and the exemption from the non-commercial losses provision [i.e. Division 35] be extended to all visual artists and craft practitioners carrying on a legitimate arts business activity”.

- 2.4 By way of background, we note that a binding public ruling is currently due for release by the ATO and should be finalised in the first half of 2004 - “carrying on business as a professional artist”. The ruling is designed to provide guidance to the ATO and arts practitioners on when an artist will be regarded as “carrying on a business” for tax law purposes.

### **3 The nature of an artists’ business**

- 3.1 There is no issue that a person can carry on business as an artist. However, the nature of an artist’s business differs significantly from many other businesses. Therefore, from a policy perspective, an understanding of the nature of a professional arts business is essential to avoid unintended discrimination against this sector.
- 3.2 We have provided with this submission a copy of the Throsby Report<sup>6</sup>, which clearly conveys the financial plight of artists in Australia. Of most relevance to this submission are the following facts which are verified by the Throsby Report (all page references are to the Throsby Report unless otherwise indicated):
- (a) financial reward is often not the prime motivator for artists (see page 6 Myer Report, Executive Summary), rather an artist will often be driven by creativity and the pursuit of artistic vision (page 12);
  - (b) 63% of artists work more than one job; in other words, the majority of artists have to rely on other sources of income to sustain themselves and their arts work (page 37);
  - (c) three-quarters of artists conduct their art work on a freelance / self-employed basis (page 38);
  - (d) as a result of the need to work multiple jobs, on average artists spend only about half of their time on creative work in their own or another artform (page 39); half of all artists spend less than 20 hours per week at creative work due to time and economic constraints (page 40);
  - (e) almost 80% of artists would like to be able to spend more time on their arts work (page 41); indeed almost 4 out of 5 artists surveyed cited economic factors or time constraints as the major factor inhibiting their further professional development (page 36);
  - (f) the majority of artists currently earn less than \$20,000 from their arts practice and less than \$40,000 from other sources (page 45);
  - (g) 15% of the artists surveyed had to wait more than 3 years before receiving *any* income from their arts practice (page 34); and
  - (h) many artists do not confine their work to a single artform, but cross over into other artforms (page 26).

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<sup>6</sup> See footnote 1.

- 3.3 Subsequent to the release of the Throsby Report, the Australia Council commissioned Virginia Hollister to perform some additional calculations based upon the data compiled for the Throsby Report. Her analysis revealed that 13% of the artists surveyed for the Throsby Report earned more than \$40,000 in 2000 - 2001 from sources other than their professional arts practice. Using Throsby's figure of 45,000 professional artists in Australia, this equates to around 5,850 artists. As discussed below, the effect of Division 35 is to *preclude* these artists from claiming business losses from their arts practice.
- 4 The application of Division 35 to the arts industry does not give effect to the government's policy intent**
- 4.1 Division 35 was introduced in response to the perceived inadequacy of the existing law to distinguish between activities which were more properly characterised as a hobby or lifestyle choice and activities which "genuinely" amounted to the carrying on of a business.<sup>7</sup> The object of Division 35 is to prevent losses of individuals from "non-commercial" business activities being offset against other assessable income in the year in which the loss is incurred. In short, Division 35 was an added safeguard designed to overcome the resource-intensive enquiry required to determine whether a taxpayer was carrying on a business.
- 4.2 The ATO recognises that an artist will be regarded as carrying on a business even though they do not make a profit in a particular year of income, provided they organise their affairs in a systematic way and they meet the other criteria of a business established by case law.
- 4.3 We submit that the policy intent of Division 35, in the context of artists, must be met at the threshold inquiry of whether or not the taxpayer is actually carrying on a business at all. If a taxpayer is able to demonstrate that they are carrying on a professional arts business, then there is no need for the additional hurdle represented by Division 35 to apply to the deductibility of losses generated by that arts business.
- 4.4 We acknowledge that at the time Division 35 was enacted, the application of the existing law to the question of whether or not an artist would be regarded as carrying on a business was uncertain. However, the arts community, following close interaction with the ATO over the last **7 years**, has now developed a draft ruling on this topic. In this context we note that Recommendation 2.1 of the Myer Report was that "The Australian Taxation Office make a public ruling on what constitutes carrying on an arts business."
- 4.5 In the draft public ruling the ATO and the arts community have sought an outcome that recognises and accommodates the distinctive characteristics of the arts industry so as to achieve *substantive* equality with other taxpayers, while preventing any such equalizing measures from becoming the subject of tax abuse. The draft public ruling applies each of the common law business indicators that have been developed by the English and Australian courts to the special circumstances of an artist. Through extensive consultation across a variety of sectors of the arts industry, the draft ruling seeks to ensure that artists reading the ruling will find a document that demonstrates an understanding of the special circumstances of their industry.
- 4.6 The draft public ruling was carefully tailored to address how the classic business indicators of profit-motive or overall "commerciality" could be applied to artists. It

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<sup>7</sup> See the Second Reading Speech in support of *A New Business Tax System (Integrity Measures) Bill 2000* delivered by the Treasurer (Mr Peter Costello) at page 1.

emphasises the importance of the impression created by the arts activity as a whole, taking into account *all of the relevant common law business indicators*. The ruling seeks to demonstrate to both the ATO and taxpayers how an artist may demonstrate sufficient professionalism, commitment and conformance with industry norms to segregate themselves from even a very enthusiastic hobbyist.

- 4.7 The limited exemption for artists contained within Division 35 (i.e. that professional artists can deduct business losses as long as their “assessable income from other sources” is less than \$40,000) does not provide an answer. In addition to the reasons outlined below<sup>8</sup>, it is simply illogical to measure the commerciality of an artist’s business by reference to the amount of income that an artist may generate from other sources wholly unrelated to that arts business.
- 4.8 We submit that the draft public ruling will be a far more rational and effective method of achieving the policy imperatives behind Division 35 in the context of artists than the actual terms of Division 35 (including the \$40,000 exemption) could ever hope to be.
- 4.9 Parliament *never intended* Division 35 to act as a disincentive for taxpayers to engage in different kinds of businesses. As case law has made clear over time, it is not the intention of the tax acts or those who administer them to tell the taxpayer in what kind of business s/he should engage.<sup>9</sup>

## **5 The \$40,000 exemption for professional artists - section 35-10(4)**

- 5.1 Section 35-10(4) provides that the deferral of business losses will not apply to a business activity for an income year if the activity is a professional arts business and the taxpayer’s assessable income for that year (except any net capital gain) from other sources that do not relate to that activity is less than \$40,000.
- 5.2 This exemption was introduced as a welcome but “last minute” amendment to Division 35 immediately prior to its introduction, as a direct response to concerns raised before the Senate Estimates Committee about the impact of Division 35 on the arts sector.<sup>10</sup> It mirrored the exemption provided to primary producers.
- 5.3 However, we submit that it is now clear that this form of exemption for artists does not meet the government’s policy intent for the following reasons:
- (a) If a professional artist earns more than \$40,000 of “assessable income from other sources”, they are unlikely to be excluded from the operation of Division 35 (and therefore unable to claim their deductions in the relevant year) because:
    - (i) an arts business is inherently unlikely to meet any of the following four “commerciality” tests contained in Division 35, ie:
      - (A) assessable income test (section 35-30);
      - (B) profits test (section 35-35);
      - (C) real property test (section 35-40);

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<sup>8</sup> See section 5 of this Submission.

<sup>9</sup> See *Tweddle v FCT* (1942) 180 CLR 1 at 7.

<sup>10</sup> See Hansard for Monday 19 June 2000, “Economics Legislation Committee”.

(D) other assets test (section 35-45); and

- (ii) the Commissioner is unlikely to be able to exercise his discretion under section 35-55,

with the result that the artist will be unable to claim deductions from their arts business against other sources of income.

- (b) There is confusion about the categories of income that are taken into account in determining whether the \$40,000 exemption threshold in section 35-10(4) has been exceeded. The precise issue is whether the phrase “assessable income from other sources that do not relate to that [professional arts] activity” includes or excludes income earned by a professional artist from other arts-related positions such as an arts lecturer or curator. A person’s standing as a professional artist generally underlies (or indeed is a prerequisite to) such appointments. The ATO’s current view is that a professional practising artist who earns more than \$40,000 a year as (say) an arts lecturer will **not** qualify for the exemption under section 35-10(4).<sup>11</sup> However, the width of the expression “relate to” in section 35-10(4) suggests the ATO is wrong. We submit that any income earned which has a relationship to the artist’s professional practice should *not* be taken into account in determining whether the \$40,000 threshold has been reached.
- (c) In any event, it is simply illogical to test the “commerciality” of an arts business by reference to the amount of assessable income the taxpayer generates from sources wholly unrelated to that arts business.

5.4 As discussed in section 6 below, artists are unlikely to come within any of the four general exclusions in Division 35 or within the Commissioner’s discretion. As a result, they must either bring themselves within the \$40,000 exemption or defer any losses generated by their arts business until such time as they can meet one of the four general exclusions. **This has the unintended consequence of providing an artist with a strong incentive to ensure that their “assessable income from other sources” in any given year does not exceed \$40,000.** Further, as there is no indexation of deferred tax losses, the longer an artist is unable to realise the losses that have been generated by their arts activity, the greater the financial burden on the artist and therefore the stronger the financial disincentive to practice their art, or the stronger the incentive to bring their assessable income from other sources below the \$40,000 threshold.

5.5 Recent empirical data shows that the greatest source of subsidisation of art in Australia comes not from the government, private corporations or wealthy arts patrons. Rather, it is individual artists themselves that effectively subsidise the cultural life of Australia by earning income from non-arts sources, which they then use to support their arts activities.<sup>12</sup> The existence of the \$40,000 cap in the current limited exemption for arts businesses contained in section 35-10(4) has the unintended and perverse consequence of discouraging artists from continuing to subsidise their arts practice at the same high levels that *some* artists have been able to achieve in the past.

5.6 If the limited exemption for artists contained in section 35-10(4) were but one of a number of ways in which a taxpayer could realistically expect to overcome the operation

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<sup>11</sup> See ID 2003/88 and ID 2003/89 for instances of where the ATO has taken this view of the operation of Division 35.

<sup>12</sup> See the Throsby Report generally and Chapter 8 in particular. See also the Myer Report, “Chairman’s Preamble” at page 3.

of Division 35 (as is clearly the case with primary producers who currently enjoy the same exemption in section 35-10(4) as artists), then the scope of the exemption would naturally be less important. However, for most artists the only way in which the operation of Division 35 can be avoided is through the statutory exemption in section 35-10(4). Accordingly, it is only through a complete (that is, uncapped) exemption from Division 35 for taxpayers who are carrying on a professional arts business that substantive equality with taxpayers in other kinds of businesses can be achieved.

**6 Division 35 has an unintended and substantively disproportionate effect on the arts industry and does not adequately take into account the actual circumstances of individual artists and the commercial practices of the arts industry generally**

- 6.1 The statutory tests contained within Division 35, which are designed to distinguish “truly commercial” businesses from those that are more akin to a hobby or lifestyle choice, are inherently more difficult to meet for a taxpayer who is carrying on a professional arts business.
- 6.2 The nature of a professional arts business is such that the vast majority of taxpayers will never be able to bring themselves within the four corners of any of the “traditional commerciality” tests and nor will they be able to attract the “safeguard” of the tightly bounded discretion of the Commissioner contained in section 35-55. We submit that this is not because these taxpayers are trying to “rort” the tax system or that their commitment to their art is anything less than genuine. Rather, it is the distinctive characteristics of being a professional artist that means Division 35 has a differential impact on this particular industry sector.

*The assessable income test (section 35-30)*

- 6.3 The Throsby Report examined the different kinds of income generated by artists, dividing that income into three categories: income from the artist’s primary creative activity; income from other arts-related sources; and non-arts related income. Taking the average across the 8 identified categories of artists, the Throsby Report found that the median income from artists’ primary creative activity was \$7,300. Even when this figure is combined with income from other arts-related activities, the average median figure only increases to \$15,700. The actual breakdown of median income levels across the 8 different art groups is as follows<sup>13</sup>:

Category of artist	Median Creative Income (\$)	Total Arts-Related Income (\$)
Writers	4,800	11,700
Visual Artists	3,100	9,200
Craft Practitioners	8,200	14,300
Actors	10,500	18,400
Dancers	12,900	23,600
Musicians	10,500	20,000
Composers	4,200	19,200
Community cultural	3,400	16,500

<sup>13</sup> This table is drawn from data presented on page 45 of the Throsby Report.

development workers		
<b>All Artists</b>	<b>7,300</b>	<b>15,700</b>

- 6.4 From this data it is clear that most taxpayers carrying on a professional arts business are unlikely to meet the \$20,000 assessable income test contained in section 35-30.
- 6.5 Further, a test based on the income generated by the arts activity in any given year does not take into account the fact that an artist will often have sold their art for far less than it ultimately becomes worth, with the result that the actual artist cannot meet the \$20,000 assessable income test in any given year, even though in later years *art dealers* selling that artist's work may have no problem in meeting such a test.

*The profits test (section 35-35)*

- 6.6 Even if the taxpayer is commercially successful in their arts business, it will often be difficult to sustain profitability to meet the profits test in section 35-35, which requires the professional arts business to have made an actual profit in 3 out of the prior 5 years.
- 6.7 It is well recognised that significant fluctuations can occur in the incomes attributable to the business activities of a professional artist (for example, see the income averaging provisions in Division 405 of the ITAA 1997). Therefore, it will often be difficult for an artist to demonstrate the consistent pattern of profit required by the "profits test" in section 35-35.
- 6.8 The Throsby Report found that most artists earn income from non arts-related sources in order to subsidize the cost of their arts practice and sustain their livelihood.<sup>14</sup> Indeed, 63% of artists work at more than one job.<sup>15</sup> This requirement to source income outside of their artistic activity, means that the income generated from their arts business will necessarily fluctuate - not least because the time spent working outside their arts business reduces the amount of time left to the taxpayer to produce their artwork. Almost 4 out of 5 artists surveyed for the Throsby Report nominated economic factors or time constraints as the most important factor inhibiting their professional development.<sup>16</sup>
- 6.9 Even without the need to work outside of the arts industry to generate income, the artistic process invariably takes time. The "profits test" discriminates unfairly against taxpayers engaged in a professional arts business as it fails to take account the factors that tend to dictate against any consistent picture of past profitability, even for a commercially successful artist.

*The real property test (section 35-40)*

- 6.10 It is rare for an artist to own *any* real property which they utilise on a continuing basis in their arts activity in a given income year, let alone real property with a value of at least \$500,000 so as to meet the real property test in section 35-40.

<sup>14</sup> See generally Chapter 8 of the Throsby Report.

<sup>15</sup> Throsby Report, page 37.

<sup>16</sup> Throsby Report, page 36.



*The “other assets” test (section 35-45)*

- 6.11 Similarly, an artist is unlikely to meet the “other assets” test in section 35-45 which requires nominated assets (including trading stock) used in their business on a continuing basis to have a value of at least \$100,000.
- 6.12 The arts sector is unique in the variability that may exist between the value of the assets that are required to produce a piece of art and the potential value of that finished artwork. In some cases the value of the assets used to produce the art will be literally negligible, whereas the value of the finished artwork may be quite substantial.
- 6.13 Many artists, due to the nature of the particular kind of art they practice, do not accumulate a stock of finished artwork that can then be brought to account as “trading stock” at the end of each income year for the purposes of satisfying this test. For example, performing artists will not usually have any output that could be regarded as trading stock.
- 6.14 There may be a substantial lapse of time between when an item of art is produced and the time in which it may become valuable (in many cases, this may only occur after the artist has built up an established reputation as an artist, or even after the artist’s death). Further, by the time an item of art becomes valuable, it is likely to have long since passed out of the ownership of the artist who originally created it.
- 6.15 For both the real property test (section 35-40) and “other assets” test (section 35-45), the taxpayer is required to demonstrate that the relevant assets are used on a *continuing basis* in carrying on the business activity before they can be counted towards the respective thresholds. It is not uncommon for artists to continually produce unique pieces of art, in each case possibly utilising different assets suited to the particular items of art under development. Indeed, the value of an artist’s work may be directly impacted by the perceived originality of each piece of artwork. Division 35 presupposes a type of business activity that employs the same assets on a continuous basis. It does not accommodate the regular application of artistic skills across a series of unique pieces of artwork, which may involve only ad hoc use of assets as required by each item of art.

*The Commissioner’s discretion (section 35-55)*

- 6.16 The “safeguard” of the Commissioner’s discretion to excuse a taxpayer from the operation of Division 35 appears to be primarily focused on taxpayers engaged in a primary production business and fails to take into account the actual circumstances of individual artists and the commercial practices of the arts industry generally.
- 6.17 The Commissioner’s discretion in section 35-55 is a bounded one - it may only be exercised in 2 limited situations, which make up the 2 limbs of the discretion set out in sub-sections (a) and (b) of that section. Neither (a) nor (b) is likely to be easily satisfied in the case of a professional arts business.

*The first limb of the Commissioner’s discretion under section 35-55*

- 6.18 The Commissioner may exercise his discretion not to apply the usual rule in Division 35 where the business activity in any given year has been affected by “special circumstances” outside the control of the taxpayer, “including drought, flood, bushfire or some other natural disaster”. A note to this sub-section states that this first limb is intended to provide for a case where a business activity *would have* satisfied one of the

tests (i.e. would not have been caught by Division 35) were it not for the special circumstances.<sup>17</sup>

- 6.19 The breadth of this first limb is severely constrained by both the nature of the examples that are given as well as the interpretative note that accompanies this sub-section. All the given examples of “special circumstances” are most likely to apply to primary production activities, being the kind of business most vulnerable to natural disasters. Paragraph 70 of TR 2001/14 reinforces this emphasis on primary production activities by listing the following further examples of the kinds of natural disasters with which the section is concerned: earthquakes; diseases affecting livestock or crops; pest plagues; and hailstorms. It is difficult to see how “special circumstances” might ever apply to a professional arts business, except perhaps due to the illness of an individual artist.
- 6.20 TR 2001/14 makes clear that generally ordinary economic or market fluctuations that might reasonably be predicted to affect the taxpayer’s business activity would not be regarded by the Commissioner as “special circumstances”.<sup>18</sup> However this presupposes that the taxpayer is in an industry where market forces can be predicted. Where the ordinary or normal commercial experience of a particular industry sector is characterised by extreme unpredictability, it is doubtful whether the Commissioner could or would ever regard “special circumstances” as attracting the exercise of this first limb of his discretion under section 35-55.
- 6.21 The interpretative note to this first limb is also significant, as it states that Parliament’s intention is that the Commissioner’s discretion is only to be exercised both if “special circumstances” in the nature of a natural disaster have occurred and *but for this special circumstance*, the business would satisfy one of the other tests contained in other parts of Division 35. It is difficult to read this note as including the exemptions within its ambit, as it is hard to see how the “special circumstances” would also affect the non arts-related income of the taxpayer so as to *increase* that non arts-related income and thus push the taxpayer out of the exemption. Accordingly, the only logical interpretation is that the interpretative note means that the taxpayer should be regarded as likely to have met one of the four “commerciality” tests in Division 35, but for the “special circumstances” of the natural disaster type incident that has befallen the taxpayer. Given that the most likely external factor influencing the profitability of an arts business in any given year will be the fluctuating public interest in a particular artist’s work, we submit it is unlikely that artists would be able to attract the operation of this first limb of the Commissioner’s discretion.

*The second limb of the Commissioner’s discretion under section 35-55*

- 6.22 The second limb of the Commissioner’s discretion is also highly unlikely to apply to a professional arts business. In section 35-55(b) the Commissioner may exercise his discretion where two elements are satisfied in relation to a business that has clearly commenced:
- (a) in a given income year the business because of its nature will not satisfy one of the four commerciality tests; and

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<sup>17</sup> We note that in ID 2002/701 the Commissioner has stated that a reasonable expectation of profit is not the decisive factor in applying this first limb of his discretion. Rather, what will be decisive is whether the “special circumstances” stopped the activity from meeting one of the four commerciality tests in Division 35.

<sup>18</sup> See paragraph 73 of TR 2001/14.

- (b) there is an *objective expectation based on evidence from independent sources (if possible)*<sup>19</sup> that within a period that is commercially viable for the particular industry in issue, the activity will either meet one of the commerciality tests or become profitable.
- 6.23 The interpretative note to this second limb of the Commissioner’s discretion again reveals a focus on primary production activities - the example given is an activity involving the planting of hardwood trees for harvest, where many years would pass before the activity could reasonably be expected to produce income. We submit that a professional arts business, *because of its nature*, will rarely attract the Commissioner’s discretion under this second limb of section 35-55.
- 6.24 A large part of the process of preparing the draft public ruling on whether an artist will be carrying on a business from a tax law perspective involved the ATO and artists grappling with the concepts of “commercial viability” or *reasonable* expectation of profit. Given the vulnerability of artists to the volatility of public opinion and taste, it is often extremely difficult for an artist to say that they have a realistic expectation that their arts practice *will become* profitable in the future. Demand for artistic output is very difficult to gauge or predict. Further, not all artists are producing their artwork with a pre-existing market in mind. Many artists are engaged in market creation and vanguard forms of artistic expression. Therefore, in the context of determining whether a particular artist is carrying on a business, an artist will usually only be able to assert that they have taken all reasonable steps to try and make their business commercially viable, rather than the further step of asserting that they have a realistic and reasonable expectation of future profit within any particular timeframe.
- 6.25 The routes to commercial viability for an artist are also not simple, or necessarily easy to demonstrate via evidence from objective sources. For certain kinds of artists, the route to commercial viability may primarily involve reputation building, in the hope of attracting a wider audience and/or public or private commissions for their work. For performing artists, a substantial amount of time may need to be devoted to practising their craft so as to sustain the level of professionalism necessary to attract income in their field. In short, there is no “one size fits all” roadmap for commercial success as an artist; talent and hard work compete equally with timing and sheer luck. Again, it is difficult to mesh this reality of the nature of a professional arts business with the parameters established by Division 35.
- 7 Unintended uncertainty and disproportionate administrative burden**
- 7.1 The application of Division 35 to taxpayers carrying on business as professional artists generates substantial uncertainty, which in turn creates a disproportionate administrative burden on this discrete subset of taxpayers.
- 7.2 The Throsby Report shows that many artists engage in arts-related activities to generate income in addition to income from their primary artistic activities. The reality of the artistic life is that for economic as well as creative reasons, artists will often ply their artistic skills across a range of endeavours. If an artist needs to work outside their

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<sup>19</sup> In the recent case of *FCT v Eskandari* [2004] FCA 8, Justice Stone recognised that the application of this “objective expectation” test may be difficult in certain industries, due to their innovative or under-developed nature. In such circumstances Justice Stone noted that the burden on the taxpayer to convince the Commissioner to exercise his discretion will be more difficult than in more traditional or established industries (see para 46 of the decision).

primary creative field, they tend to seek out work in arts-related areas.<sup>20</sup> The application of Division 35 to a taxpayer's multifarious artistic activities is uncertain. This uncertainty creates a disproportionate administrative burden on professional artists as they seek to comply with Division 35. For example:

- (a) If an artist is regarded as carrying on several separate business activities in the arts sector, when will those activities be regarded as being "of a similar kind" and thus able to be grouped together for the purposes of Division 35? If an artist is able to group their various arts activities under s35-10(3), they may have a greater chance of meeting one of the commerciality tests in Division 35. However if the artist is unable to group their activities in this way, then the chances of meeting one of the commerciality tests become even more remote. The Commissioner has explained in TR 2001/14 that the question of whether several business activities can be grouped together as businesses "of a similar kind" for the purposes of Division 35 is a question of fact and degree. However the examples given in the Ruling do not offer much guidance as to how these questions of fact and degree might be answered in the context of a taxpayer carrying on several different business activities in the arts sector<sup>21</sup>.
- (b) When will income be appropriately regarded as derived from "other sources" that do not relate to the taxpayer's professional arts business for the purpose of either:
  - (i) assessing the income generated by the taxpayer's arts business (relevant to the assessable income test in s35-30); **or**
  - (ii) applying the \$40,000 exemption in s35-10(4)?

Especially as most artists chose to work as much as possible in "arts-related" fields, when does arts-related work cross the divide between assessable income "related to" a professional arts business and assessable income from "other sources that do not relate to that activity"?

- (c) Where a taxpayer is working in multiple arts-related areas, when will an arts-related expense be properly referable to a taxpayer's professional arts business as opposed to the taxpayer's "assessable income from other sources"? If the expense cannot be allocated to the taxpayer's professional arts business, may it nonetheless have a sufficient connection to the derivation of the "other sources" income, so as to be deductible on that basis? What if the expense is partly referable to an activity that is regarded as a discrete "professional arts business" and partly referable to activities which (although arts-related) are not part of that business? Most importantly, how is a professional artist to predict the correct tax treatment of expenses at the time they are contemplating incurring those expenses?
- (d) A further concern for artists arises from the fact that, once a business loss from their arts activity is caught within Division 35, then that loss will be deferred until such time as that same business activity or a business activity of a similar kind generates a profit that can absorb the deferred loss. This means that if an artist is to be regarded as carrying on a number of discrete businesses that are not able to be grouped as business activities "of a similar kind", then losses generated by one

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<sup>20</sup> Throsby Report, page 37.

<sup>21</sup> For example, only 1 of the 16 "Examples" given in TR 2001/14 touches on the arts industry. That one instance is found in Example 14, which makes limited mention of arts activity not amounting to the carrying on of a business. By contrast, many of the examples relate to the business of primary production.

arts business activity cannot be off-set against losses generated by other arts business activities that are regarded as separate. Therefore, if a taxpayer is regarded as having ceased to carry on one particular business activity (perhaps because they have finished a particular kind of artistic endeavour) then any losses generated by that activity, which have been deferred by the rule in Division 35, may be permanently lost to the taxpayer.

- 7.3 As these examples show, it is difficult to fit the reality of being a professional artist into the structures dictated by Division 35. This uncertainty means that many professional artists will be unable to predict the application of the division to their business activities without professional assistance. Even with professional advice, the application of Division 35 to taxpayers who engage in multiple arts-related activities is by no means clear.<sup>22</sup>

## **8 Division 35 is inconsistent with other tax legislation concerning artists**

### *Division 405 (the “averaging” provisions)*

- 8.1 Division 35 is inconsistent with the recognition in Division 405 that significant fluctuations can occur in the professional incomes of artists. The averaging provisions contained in Division 405 are designed to lessen the impact of these fluctuations when artists (and other “Special Professionals”) return “above average income” from their professional arts business. Division 405 is premised on the fact that artists (and other “Special Professionals”) are different. The difference between special professionals and other taxpayers means that different, tailored rules are required to achieve substantive equality between taxpayers. By contrast, a significant flaw in Division 35 is that it fails to adequately take account of substantive differences between different kinds of taxpayers and therefore has the effect of unfairly discriminating against taxpayers carrying on professional arts businesses.
- 8.2 The benefit of the averaging provisions contained in Division 405 is available to artists (assuming no issue of residency arises) once they have an income year in which their taxable professional income is more than \$2,500 (known as “professional year 1”). The Division allows the taxpayer to work out their average taxable professional income for the past 4 years and then to apply a concessional rate of tax<sup>23</sup> to any above average taxable professional income that they may generate in a given income year.
- 8.3 There are stark differences between the commerciality tests in Division 35 and the requirements for attracting the concessional treatment in Division 405. In particular, we note the differences in the threshold assessable income test in section 35-30 (\$20,000) and the threshold taxable professional income in section 405-10 (\$2,500). We also note that Division 405 only requires an artist to make taxable professional income in one year (professional year 1) in order to attract the benefit of the averaging provisions, whereas section 35-35 requires the taxpayer to make a profit in 3 out of the past 5 income years to avoid the operation of Division 35.
- 8.4 The discrepancies between these two sections of the ITAA 1997 are not sufficiently answered by the exemption in Division 35 for professional arts businesses where the taxpayer has kept their assessable income from other sources below \$40,000. The blunt

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<sup>22</sup> On this point see also the discussion at paragraph 5.3(b) above and the Interpretative Decisions cited at footnote 11.

<sup>23</sup> A concessional rate of tax will only apply to any “above average professional income” if without the averaging provisions 2 marginal tax rates would otherwise apply to that “above average professional income”.

exemption in section 35-10(4) is in no way tailored to the specific characteristics of a professional arts business.

## **9 Conclusion**

9.1 We submit that the continued application of Division 35 to professional artists will not deliver the policy intent of the original legislation, which was to improve the integrity of the tax system by preventing revenue-leakage from non-commercial business activities. The development of a binding public ruling on the issue of when an artist will be carrying on a business for tax law purposes has rendered Division 35 otiose in its application to artists. In light of this public ruling, the limited exemption from Division 35 for artists contained in section 35-10(4) is undesirable and inadequate because:

- (a) it creates perverse incentives for taxpayers to limit the amount of their non arts-related income to under \$40,000, thus depriving the public of the benefit of individual artists themselves subsidising the creation of their art from other sources of income and possibly also creating an incentive for artists to shift from self-reliance (and self-subsidisation) to limited public forms of subsistence and subsidy;
- (b) it is illogical to measure the “commerciality” of an arts business by reference to the assessable income of the taxpayer from other sources that have no relation to that business;
- (c) it unfairly discriminates against artists as a discrete sub-set of taxpayers, because the very nature of an arts business is such that the taxpayer will be highly unlikely to meet any of the four “commerciality tests” in Division 35 or to attract the exercise of the Commissioner’s limited discretion in section 35-55, with the net effect of discrimination in substance against this particular kind of business activity; and
- (d) its application generates substantial uncertainty, which in turn places an unfair and disproportionate administrative burden on professional artists.

9.2 Accordingly, we submit that the quality and effectiveness of Division 35 would be enhanced by removing any limitation on the deductibility of losses generated by a professional arts business from its scope. This position is consistent with the Myer Report recommendation that artists be granted an exemption from the non-commercial loss provisions in Division 35.