Share trader or share investor: drawing the line — Devi and FCT

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Introduction
The question of whether a business exists for income tax purposes is a perennial issue that ends up at the Administrative Appeals Tribunal (AAT) and occasionally the courts, notwithstanding the longstanding principles of what constitutes a business are well-established. This analysis revisits and clarifies the longstanding principles of what constitutes a business and examines the recent AAT case, Devi and Commissioner of Taxation (Taxation) (Devi and FCT). Somewhat controversially in Devi and FCT, a child care worker and day share trader was denied share trading losses despite a significant scale of activities and profit-making intention.

Carrying on a business
For income tax purposes, a loss from a business is generally deductible to an individual unless the loss limitation rules, such as the non-commercial loss rules in Div 35 of the Income Tax Assessment Act 1997 (Cth) (ITAA 1997) apply, whereas a loss from investing or from a hobby or pastime would be on capital account producing a capital loss that can only be applied against later capital gains. Further, a business accounts for the purchase and sale of shares as inventory under the trading stock rules in Div 30.

A “business” is defined under the ITAA 1997 to include “any profession, trade, employment, vocation or calling, but does not include occupation as an employee”. This definition is merely inclusive and does not provide much guidance for determining whether a particular activity constitutes a business. In Martin v Federal Commissioner of Taxation, Webb J set out the following test as to what constitutes the carrying on of a business. The test is both subjective and objective; it is made by regarding the nature and extent of the activities under review, as well as the purpose of the individual engaging in them, and, as counsel for the taxpayer put it, the determination is eventually based on the large or general impression gained.

In Ferguson v Federal Commissioner of Taxation (Ferguson), the Full Federal Court provided the leading principles as to whether a taxpayer is carrying on a business. Bowen CJ and Franki J in their joint judgment identified the following relevant factors:

There are many elements to be considered. The nature of the activities, particularly whether they have the purpose of profit-making, may be important. However, an immediate purpose of profit-making in a particular income year does not appear to be essential. Certainly it may be held a person is carrying on business notwithstanding his profit is small or even where he is making a loss. Repetition and regularity of the activities is also important. However, every business has to begin, and even isolated activities may in the circumstances be held to be the commencement of carrying on business. Again, organization of activities in a business-like manner, the keeping of books, records and the use of system may all serve to indicate that a business is being carried on. The fact that, concurrently with the activities in question, the taxpayer carries on the practice of a profession or another business, does not preclude a finding that his additional activities constitute the carrying on of a business. The volume of his operations and the amount of capital employed by him may be significant. However, if what he is doing is more properly described as the pursuit of a hobby or recreation or an addiction to a sport, he will not be held to be carrying on a business, even though his operations are fairly substantial.

There is no definitive approach as to what constitutes a business and while the above factors are not exhaustive, they have frequently been cited by the Federal and High Courts. Ascertaining whether a business exists is the result of a process of weighing up a number of relevant factors. The weighing up of factors is problematic for taxpayers with small-scale activities that have elements of some combination of business, passive income and lifestyle characteristics. The vagueness of this classification has given rise to a plethora of cases on business activity and a number of taxation rulings from the Australian Taxation Office (ATO). The ATO appears to mainly rely on Taxation Ruling TR 97/11 to determine whether a business (either primary or non-primary production) is being carried on. TR 97/11 sets out similar relevant indicators to Ferguson, although TR 97/11 takes a more restrictive approach asking “is the activity of the same kind and carried on in a [similar way to] that … of [the] ordinary trading in [that] line of business?” This may hinder new businesses, risk-taking and innovation in existing businesses.

Devi and FCT
The recent case Devi and FCT concerned whether the taxpayer carried on a business of share trading in the 2010/11 income year. The taxpayer held university
qualifications in education and worked as a casual childcare worker for 25–30 hours per week earning $40,000 in 2010–11. During the year, she had purchased shares at a cost of $379,630.87 in 71 trades and sold shares for $215,019.76 in 37 sales, using a margin loan facility. The total loss for the year from share trading was $20,000. Most of the trades were in the first 6 months of the year, with 10 transactions totalling about $70,000 being made in the second half of the income tax year.

In concluding that a business was not being carried on, the AAT adopted the principles established in AAT Case 6297; AAT Case X8619 (AAT Case 6297) which are more restrictive than the factors outlined above in Ferguson, stating:19

A particularly helpful summary of factors in the context of examining share trading activities was suggested by Deputy President Todd in AAT Case 6297 (1990) 21 ATR 3747 at 3755–6, as follows:

In deciding this issue the case law has established the following factors as generally relevant considerations:

(a) the nature of the activities and whether they have the purpose of profit-making;
(b) the complexity and magnitude of the undertaking;
(c) an intention to engage in trade regularly, routinely or systematically;
(d) operating in a business-like manner and the degree of sophistication involved;
(e) whether any profit/loss is regarded as arising from a discernible pattern of trading;
(f) the volume of the taxpayer’s operations and the amount of capital employed by him;

and more particularly in respect of share traders:

(a) repetition and regularity in the buying and selling of shares;
(b) turnover;
(c) whether the taxpayer is operating to a plan, setting budgets and targets, keeping records;
(d) maintenance of an office;
(e) accounting for the share transactions on a gross receipts basis;
(f) whether the taxpayer is engaged in another full-time profession.

The AAT Case 6297 factors above fall outside the factors in Ferguson, adopting a higher threshold requirement for a business activity. Ferguson does not specifically take into account:

• the complexity and magnitude of the undertaking;
• the degree of sophistication involved;
• maintenance of an office;
• accounting for the share transactions on a gross receipts basis; and
• whether the taxpayer is engaged in another full-time profession.

Rather, Ferguson notes that being engaged in another full-time profession does not preclude conducting a business!20

In Devi and FCT, the AAT weighed up the relevant factors, stating:21

In this case, the factors which favour Ms Devi carrying on business as a share trader are as follows:

• the turnover was substantial, particularly having regard to Ms Devi’s wages; and
• Ms Devi maintained a home office for the purpose of undertaking the share transactions.

The factors which do not favour Ms Devi carrying on business are as follows:

• the share transactions were not regularly and systematically carried out throughout the 2011 income year — there were only 10 share transactions in the second half of the income year;
• the activities were very basic and lacked sophistication to constitute a share trading business;
• there was no demonstrated pattern of trading although I accept there was a business plan even before the written document was later produced; and
• she had no skills or experience or interest in shares.

Notwithstanding a clear profit motive that the share trading and capital employed were of a significant scale and the sophistication of a margin loan facility, the AAT found that a business did not exist. The AAT found the activities were basic and lacking sophistication and the applicant had no skills or experience or interest in shares.22 The AAT thus appears to adopt a narrower view of a business activity as evident in the AAT Case 6297 principles.

The AAT found that there was a lack of regular and systematic trade, as the applicant’s oral evidence exposed her lack of knowledge about the share transactions that she claimed to have “personally extensively researched”.23 The taxpayer’s methods of research of reading financial newspapers was not business-like as needed to constitute a share trading business.24 Although there was substantial capital involved, the relevant factors mainly weighed against the taxpayer.25 While there was a profit-making intention, this is also consistent with the motive of a share investor.

Undoubtedly, the inconsistency in evidence from the taxpayer weakened her case. In response to the Commissioner’s request for information, she stated in a signed letter that she usually spent 5 to 10 hours on research and share trading per week, but this changed in her Case Statement stating that she spent 15 to 25 hours per week.26 Also, the taxpayer’s business plan was not contemporaneous and only provided for the purposes of the hearing.27

The AAT weighed up all of the relevant factors and concluded that the taxpayer was not in business as a share trader, stating:28
Having regard to the evidence and to all of the factors set out above, Ms Devi was not carrying on business as a share trader. Her activities were very basic and lacked sophistication to constitute a share trading business particularly as there was no demonstrated pattern of trading.

Conclusion
Notwithstanding the inconsistency in evidence, the AAT’s finding is somewhat surprising as seen by the story highlighted by the Australian Financial Review. The scale of the activities was significant and she had a clear profit intention. It would appear a different conclusion may have been reached if the evidence was better presented and the relevant factors outlined by the full Federal Court in Ferguson applied rather than the more restrictive views in AAT Case 6297 and ATO ruling TR 97/11.

Each case that considers whether a taxpayer is carrying on a business is based on the facts of the particular case. Taxpayers and practitioners need to be very cautious in determining share trading business status and in presenting evidence to the AAT. The relevant factors in Ferguson must be argued and applied rather than the non-binding views of TR 97/11 and AAT Case 6297.

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Footnotes
2. Devi and Commissioner of Taxation (Taxation) (Devi and FCT) [2016] AATA 67.
5. ITAA 1997, s 995–1(1).
8. Above n 7 at 474.
10. Ferguson v Federal Commissioner of Taxation, above n 1 at 311.
17. TR 97/11, above n 1, paras 63 to 67.
18. AAT Case 6297; AAT Case X86 (1990) 21 ATR 3747.
19. Above n 2, at [20].
21. Above n 2, at [44]–[45].
22. Above n 2, at [47].
23. Above n 2, at [15].
24. Above n 2, at [15]–[16].
25. Above n 2, at [44]–[46].
26. Above n 2, at [16].
27. Above n 2, at [14].
28. Above n 2, at [47].