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What happens when a pension fund makes losses for tax purposes? Can they be carried forward (and used in the future) or are they lost? And does it really matter – since pension funds don't pay tax anyway?

Introduction

Not surprisingly, many superannuation funds have made losses on their investments in recent years.

Where these are realised (ie, the assets are actually sold), many funds will have a capital loss.

Other funds make losses simply because they are able to claim tax deductions that exceed their income – we generally refer to these as income losses.

In this edition of Heffron Super News we highlight some interesting outcomes of the tax rules governing losses in self managed superannuation funds. In particular, we explore some traps that arise in funds that are paying pensions.

Our tips to avoid them are simple and very easy to implement for either advisers or accountants – often at great benefit to the client.

The principles

Perhaps the first important principle to establish is that capital and income losses are generally treated differently for tax purposes and the same applies in superannuation funds.

Capital losses

Regardless of the tax entity, capital losses can generally only be offset against capital gains. In other words, a superannuation fund cannot escape paying tax on its concessional contributions or interest income just because it has a made a capital loss. The loss will only reduce or remove the tax it pays on capital gains.

When the losses made in any particular year exceed the capital gains, the taxpayer might have a capital loss to carry forward. Normally, the taxpayer just keeps a record of the amount of the loss and uses it progressively over time as it realises capital gains in the future.

Income losses

Income losses are normally carried forward too. A key difference, however, is that income losses can be offset against any future income, regardless of whether or not that income comes from a capital gain, concessional contributions, dividends, rent etc.

But what about pension funds?

So how does this work in a vehicle which isn't paying much (or even any) tax at all when it makes the loss – such as a superannuation fund paying pensions? Like most superannuation questions, the answer starts with "it depends".

Two approaches for capital losses

The treatment of capital losses in superannuation funds (including self managed superannuation funds) paying pensions depends on whether the fund is "segregated" or "unsegregated".

SMSF practitioners will be familiar with these terms – generally speaking a "segregated" fund is a fund where specific assets have been set aside to underpin one or more pensions while an

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"unsegregated" fund is one where there are both pension and non-pension balances and the fund's assets are shared or pooled between them.

In a ***"segregated"*** fund, once a pension starts[1] capital gains and losses realised on the assets set aside for the pension(s) are simply *ignored* [s 118-320 ITAA 1997]. They don't even appear on the fund's tax return. (Note, that gains and losses on any other assets that the fund has – for example, assets set aside to underpin accumulation balances – are still taxed in the usual way, it is only the gains and losses on pension assets that are ignored.)

While that means that no tax is paid on the capital gains, it also means that any losses realised on the pension assets once the pension starts *cannot* be carried forward. In effect, they are simply lost. Whether or not this is a problem is discussed further below.

In an ***"unsegregated"*** fund, both the gains and losses are added up and the losses are offset against the gains.

Where applicable (ie, where a gain has arisen on an asset that was held for more than 12 months), a 1/3rd discount is applied to the net amount in the usual way. The end result (if it's positive) is included in the Fund's assessable income and ultimately reduced to reflect the fund's "exempt current pension income" (ie, if the fund is 40% in pension phase, 40% of this end amount will not be taxed).

Where the net amount is negative – ie, the fund has a capital loss, the **full amount of the capital loss is carried forward**.

Importantly this capital loss can also be carried forward indefinitely.

A practical example

To compare the two methods, let's assume we have two funds that are ***almost*** identical.

Both have earned $50,000 in capital gains (some eligible for the discount and some not) but have also realised capital losses of $80,000.

They have no other investment income, there are no expenses (purely for illustrative purposes) and concessional contributions were made to each fund.

The difference between the two funds is:

- Fund A is segregated – the whole fund was in pension phase until right at the end of the year when the concessional contributions were received. They were held in a separate bank account and hence the fund remained "segregated" throughout the year;
- Fund B is unsegregated – almost all of it is in pension phase but a tiny amount was still accumulating during the year (and of course the contributions were received late in the year and added to this accumulation balance). In fact, this amount is so small that the actuarial certificate obtained by the Fund's accountants shows that the Fund's investment income is 99% tax exempt.

Both funds have obviously made a capital loss ($30,000) but only Fund B can carry that loss forward to the next year.

Fund A would only be able to carry a capital loss forward if it also had other (non pension) assets and these had generated losses too – those losses alone (excluding the $30,000 loss on the segregated assets) could be carried forward.

And the next year?

Let's say that the following year, both Funds generate $50,000 in capital gains (and no other investment income is earned nor expenses incurred). Neither Fund is entitled to any CGT discount

[1] Note that any capital losses realised before the pension commenced can be carried forward to a later income year [s 102-15(3) ITAA 1997].

because the assets sold were held for less than 12 months.

In Fund A, those gains were achieved partly on the segregated pension assets ($40,000) and partly on some accumulation assets (new non-concessional contributions) - $10,000.

In Fund B, the actuarial certificate % for exempt income is now 80% (this fund has also received new non-concessional contributions and the accumulation balance has therefore grown).

Again, the funds are therefore almost identical, but Fund A is segregated while Fund B is not.

Tax in Fund A will be simply $1,500 (15% x $10,000 gains made on the *accumulation* assets).

In Fund B, however, the process will be different.

Firstly, this year's capital gains ($50,000) will be reduced by the carried forward capital losses ($30,000), leaving a net $20,000.

As the actuarial certificate indicates that 80% of the Fund's investment income is tax exempt, only 20% of this amount ($4,000) will be subject to tax.

Tax of only $600 will be paid.

What about losses realised before the pension started?

Starting a pension (either on a segregated or unsegregated basis) does not mean that capital losses made in the past (and carried forward to date) are written off.

Rather, these "pre-pension" losses are carried forward but again, there are significant differences in outcome between segregated and unsegregated funds.

Normally, carried forward losses are "used up" by capital gains in subsequent years.

However, bear in mind that capital gains and losses on segregated pension assets are completely disregarded.

This means that a fund which (say) realises a very large loss and then (the following year) converts entirely to pension phase will effectively freeze that capital loss and carry it forward indefinitely – the gains on the segregated assets in future years will not affect it [s 102-15(3) ITAA 1997].

Alternatively, a fund may be segregated by virtue of the fact that the trustee maintains separate pools of assets for accumulation and pension liabilities.

In this case, the gains on the "accumulation" side of the portfolio will use up the carried forward losses but not the gains on the "pension" side.

In contrast, "pre-pension" carried forward losses might well be used up far more quickly in an unsegregated fund.

Following the same process as outlined earlier for Fund B – all of the fund's gains are offset against the capital losses. In effect, this may well see the fund "using up" some of its carried forward losses on capital gains that were substantially tax free anyway.

Let's consider two new funds – C and D which both have carried forward losses of $20,000 before they start any pensions. They are almost identical except that:

- Fund C converts entirely to pension phase (and is therefore segregated). During the year, it achieves capital gains of $30,000; but
- Fund D leaves a very small amount in accumulation phase. In fact, the amount is so small that the fund's actuarial % is 100% but it is nonetheless not segregated. It too realised capital gains of $30,000.

At the end of the first year of providing pensions, neither fund has actually paid any tax. However:

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- Fund C still has carried forward capital losses of $20,000 (the $30,000 gains are completely ignored and do not "use up" the carried forward loss); but
- Fund D no longer has any carried forward capital losses – the full $30,000 gain is effectively offset against the carried forward loss amount.

Having your cake…

In the ideal world, then, funds would be **unsegregated** (or not even providing pensions at all) **at the time any substantial capital losses were realised.**

This enables the losses to be carried forward.

There are two main barriers to ensuring that a fund is unsegregated in a year when a capital loss is realised.

Firstly, some funds choose to segregate their assets for a range of valid reasons which extend well beyond issues such as carrying forward capital losses. (We have discussed some of these below.)

Secondly, however, is tax avoidance. When the current rules on tax exemptions for pension funds were first introduced (at the time – via changes to the Income Tax Assessment Act 1936), the Explanatory Memorandum to the relevant Bill indicated that routinely swapping assets between the "pension" and "accumulation" portfolios in a segregated fund ran the risk of exposing the trustee to Part IVA of that Act (the provisions dealing with tax avoidance).

The same is potentially true of an arrangement under which a fund "segregates" one year but not the next – and regularly changes between the two. (Remember also that segregation is only legally effective if done in advance – it cannot be retrospectively applied.)

Hence we would not advocate regular changes to the basket of assets that have been specifically identified as pension assets in a genuinely segregated fund.

However, one "segregation" scenario that often arises almost by accident in practice is where a fund is considered segregated simply because it is entirely in pension phase. While there may be several members / balances and the assets are not segregated between them, the fact that all members are entirely in pension phase means that the fund is considered segregated for tax purposes.

This is relatively easy to change without fundamentally altering the way the fund operates – simply roll back a small amount to "accumulation" phase OR accept new contributions into the fund's normal bank account (rather than creating a separate account to maintain the segregation).

This is essentially the position applicable to Fund B – recall that it was almost entirely in pension phase but for a small accumulation balance held throughout the year. That balance could be so small that the fund's investment income is still virtually 100% tax exempt (in accordance with the actuarial certificate) but it nonetheless means that the Fund is "unsegregated".

… And eating it

In the ideal world, funds would be **segregated in the years after a capital loss had been carried forward** (because this ensures the losses are used up as slowly as possible).

Remember, however, that a return to complete segregation could be as simple as paying out a small accumulation balance as a lump sum early in the year or converting it to a pension. At that point, the gains achieved within the fund no longer act to reduce the losses carried forward.

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Does it actually matter?

It might not.

The reason the carried forward capital losses were useful in, say, our Fund B example above was that the fund had taxable gains which arose in a future year.

If instead, Fund B had:

- Converted the accumulation balance to pension phase at the end of the year (from which point all of the fund's assets would be "segregated";
- From that point, remained entirely in pension phase; and
- the member had gradually drawn out the entire balance and no capital gains had been made on death

there would have been no value at all in being able to carry forward these losses.

However, there are a range of circumstances under which pension funds revert to paying tax. For example:

- The pensioner dies (leaving no reversionary pensioner) and the balance is paid out as a lump sum to his or her dependants or estate. At that point, substantial capital gains may well be realised;
- As was the case in the examples above, the fund receives additional contributions which remain in accumulation phase (and these generate capital gains);
- The pensioner decides to "roll back" some or all of the pension account to accumulation phase and more of the fund's investment income becomes "taxable"; or
- The recommendation of the Henry Review to tax pension funds at 7.5% (rather than nil%) is introduced.

Under these circumstances some carried forward capital losses would be very handy!

What the discussion above highlights is that there are some rules of thumb. All other things being equal, maximum benefit is derived from capital losses (ie, they can be carried forward most effectively) if:

- The fund **is not** segregated when the losses are actually realised (as this allows the fund to carry the loss forward in the first place); but
- The fund **is** segregated afterwards (as this minimises the rate at which the loss is used up).

An aside - pooling v segregating

Funds that are genuinely segregated may be operating that way for reasons that are considered more important than optimising the carried forward losses. For example:

- A large gain is expected on one particular asset and the fund is only partly in pension phase – segregation will clearly help to minimise the tax on that gain over the long term, even if it does mean that smaller capital losses incurred along the way cannot be carried forward;
- Two members (one in pension phase and one not) may have different investment strategies.

This could well override the points discussed here. Funds will not necessarily have their segregation policy driven by the need to maximise their use of carried forward losses but all other things being equal, it would certainly be a consideration.

What about Income losses?

Unlike the treatment of capital losses, the treatment of income losses between the two types of pension fund (segregated and unsegregated) is exactly the same.

In both cases, income losses can be carried forward.

Unfortunately, however, their value is diminished by the fact that they are effectively "used up" by the Fund's "exempt current pension income" (ie the part of the

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fund's investment income (including capital gains) that is not taxed because it is providing pensions).

In other words, the fund uses up its carried forward income losses just as quickly as it would if it was not in pension phase.

Conclusion

Many pension funds will never pay material amounts of tax (on capital gains or other income) again.

However, there are obviously some circumstances where tax re-emerges – either due to unforseen circumstances (death or legislative change) or because the fund is not entirely in pension phase.

For that reason, funds realising very large capital losses may like to consider ensuring they remain "unsegregated" so that they can carry forward that loss.

Afterall, the next most useful expression in superannuation work (after "It depends") is "you just never know".

On a separate note..

Business real property receives a range of concessions in superannuation law – in particular, it can be leased to a related party without being classified as an in-house asset.

However, it is worth noting that to receive this concession, the business real property must be "subject to a lease or to a lease arrangement enforceable by legal proceedings" [SIS s71(1)(g)].

In many contexts, a contract can be entered into verbally and be legally binding. However, arrangements relating to property must generally be in writing.

In NSW for example, Conveyancing Act 1919 requires that instruments which create rights in relation to land must be in writing. In fact, the Real Property Act 1900 (covering most land that is business real property) requires that leases which operate for more than three years must not only be in writing but must also be registered.

On that basis, we would generally recommend that any business real property which is leased to a related party is covered by a written lease agreement (albeit that lease agreement may well be a rolling 1 year agreement to avoid the need for registration!)