Smart Money DIY super

Expert view

Capital loss reverberations

John Wasiliev

Market volatility has do-it-yourself superannuation investors again contemplating the prospect and implications of entering retirement with accumulated capital losses.

One question is whether such losses can offset tax that may be charged on a super death benefit.

The issue is topical, as the Australian Taxation Office has recently confirmed its view that on the death of a member, a pension-paying super fund loses its major tax concession. It loses the right to treat investment earnings, from which a pension was being paid, as tax-exempt.

As a consequence, if investments are sold to pay a death benefit, profitable investments will become taxable at the fund level.

Checking if a DIY fund is in a net capital loss or gain position before starting a pension can be can done by seeing whether any provisions have been made for either a future income tax benefit or a deferred tax liability.

A fund has a future tax benefit if it finished a year in an overall capital loss position. There were many funds in this position for the two financial years following 2008, says Craig Fishburn of Superannuation Auditors.

Under the process of "tax effect accounting", a capital loss is considered to be a benefit because any loss can be carried forward and used at a future date to offset future gains.

In the case of a deferred tax liability, if you sold assets before retirement there would be tax to pay that would reduce an overall superannuation benefit.

If a fund has such a liability, this amount is subtracted, in its financial statement, from the total fund assets for a bottom line that shows how much is available to members as retirement savings.

Although there is a long way to go before 2011-12 can be written off as a losing year, any trustees who lost patience and sold shares at a capital loss during the recent market turmoil will very likely have added to capital losses their fund has carried forward from similar sales in recent years.

Senior associate of DBA Lawyers, Bryce Figot, says that whether these capital losses will have any future value will be influenced by a number of factors.

The major one is whether all or part of the fund is in the accumulation phase. The other factor is any future capital gains earned by fund investments. A DIY fund can be partly in accumulation phase, where one member is taking a pension and the other is still saving, or where members have a pension, such as a transition to retirement income stream, as well as an account still accepting contributions. Under super rules, contributions cannot be made directly into accounts that are paying pensions. They must be kept quite separate.

Bryce Figot. Photo Arsineh Houspian

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If a fund has a mix of pension and accumulation accounts and assets are not segregated to their respective accounts, carried forward capital losses can be chewed up by capital gains, Figot says.

The same applies when a fund is totally in accumulation mode. If it earns a net capital gain in a future financial year and has capital losses from previous years, the losses will reduce the gain in the order they were made, with the oldest losses deducted first. So any carried-forward losses should always be the most recent.

As far as the scope to carry losses forward to use against gains on the sale of investments to pay out a death benefit, Figot gives the example of a fund with accumulated capital losses of $200,000 and two members, one taking a pension.

In such a case the fund will most likely establish its right to claim exempt tax treatment for pension accounts by getting an actuary to calculate the proportion of fund earnings entitled to this concession. That is, the assets are segregated.

Although it could, as an alternative, establish a separate portfolio of investments for the pension account, Fishburn says, fewer than 2000 of the estimated 150,000 funds with pensions will segregate a pension in this manner.

They will rather choose the actuarial certificate approach that will, however, mean that any capital gains the fund earns will be taxable.

Figot says that, if the fund earns a capital gain of $30,000 in the following financial year, this will be offset against the $200,000 of carried-forward losses. It will leave a $170,000 carried-forward capital loss position.

Should the fund make a capital loss in future years, this will be added to the carried-forward loss.

A major change will occur if a second member starts a pension, resulting in the entire fund now being committed to paying pensions to members.

If financial market fortunes turn and the fund earns $100,000 of capital gains, these gains will be completely disregarded, Figot says. Similarly, if the fund has another bad year in which losses prevail, they will be disregarded if all investments are committed to paying pensions.

Having all the fund in pension mode means carried-forward losses won't be eroded by pension investment activity. They will remain as offsets against any capital gains on profitable investments sold to pay a death benefit.

At a glance

How to avoid retirement ruin.

The problem

Q: Two retirees have the same capital, draw the same income from their funds and earn the same average return, but one runs out of money much earlier than the other. **How can that be?**

A: It's simple. Markets might return, say, 7 per cent on average over a lengthy period but that doesn't mean they return 7 per cent year in, year out. **Some years, the returns will be double-digit and other years there will be losses.**

A few years ago, Canada-based academics Moshe Milevsky and Thomas Salisbury examined two **$100,000** portfolios with the same average return over 20 years.

The first portfolio suffered poor returns in its first three years, while the second achieved the kinds of gains generated in a bull market.

Fund A earned an eye-popping **38%** in year four – to make up for the bad first 3 years – while **Fund B** lost **14%** that same year. **But it was too late.**

The unlucky owner of the first portfolio ran out of capital after 16 years, while the second retiree still had close to **$105,000** left after 21 years.

The solution

- Save more than you think you might need in retirement to create a buffer.
- Always have two to three years' cash available to pay living expenses in retirement to avoid selling other assets in falling markets.

SOURCE: FINANCIAL REVIEW

Investment tips

Protection – with a catch

Sulieman Ravell of fundsfocus.com.au explains how an increasingly popular investment with do-it-yourself superannuation funds really works.

What are self-funding instalment warrants?
These securities are usually issued over an individual share, such as Telstra, and listed on the sharemarket.

It's best to think of them as an investment in shares that offers protection against capital losses, as well as the benefits of dividends and franking credits.

Investors normally pay some money (typically 20 per cent to 50 per cent of the value of the warrant) upfront, plus the interest for the first year. However, in some cases you only need to pay the interest.

The product also involves a loan for the outstanding amount and a put option to protect the loan against any decline in the value of the underlying shares.

The idea is that the investor won't need to pay any more for the life of the warrant – dividends paid each year should pay off the loan.

There are a number of differences between products and it is safe to say, no two are exactly the same.

Providers try to differentiate products from their competitors.

What interest rate is charged?
This is not as simple as it sounds, as most providers wrap up the cost of the put option into interest costs.

Is all my investment protected against loss?
Some issuers protect against 50 per cent of losses, others 100 per cent.

Do providers ever use a stop loss instead of a put option to provide capital protection?
RBS uses stop losses, saving investors the cost of the put option, but if the underlying share falls to the stop loss, you are sold out and won't benefit from a recovery.

Is potential capital growth from the products capped?
Some providers do this to reduce the interest costs on the loan, or to enhance the yield. For example, Instreet Telstra warrants pay an estimated yield of 23 per cent.

Are there any quirks to grasp?
If a share price falls below the designated level of protection, you need the share price to recover to that level before you benefit from any increase in the share price.

How easy is it to sell a self-funding instalment warrant?
The majority are listed on the Australian Stock Exchange. But although issuers are required to create a market, this is a grey area and the spread between the buy and sell price can be significant.