

Tax Brief

27 August 2009

Proposed Loss Transfer Regime for Superannuation Funds

In December 2008, Senator Nick Sherry, then Minister for Superannuation and Corporate Law, announced that the Government would introduce a temporary tax measure to assist in the consolidation of superannuation funds. The apparent goal behind the measure is to allow the industry to merge into fewer, more efficient, larger and presumably more stable funds by removing some of the tax impediments to consolidation. The announcement proposed an optional loss transfer system for any net capital losses that resulted from the CGT events that would be triggered by the merger of an existing fund into an APRA-regulated fund. This Tax Brief examines the many refinements to that proposal that occurred during the last eight months culminating, earlier this month, with the release by Treasury of Exposure Draft legislation.

1. Key stages

The December 2008 proposal was substantially refined and developed as a result of industry consultations in the eight months since it was announced. Major milestones in the consultation process included:

- the release by Treasury of a Discussion Paper in January 2009 elaborating some aspects of the proposal;
- a further Press Release by the Minister in May 2009 announcing the Government's decision to accept various modifications to the December proposal; and
- the release of the Exposure Draft legislation and an Explanatory Memorandum in August 2009.

The measure evolved in various ways at each stage in this process so that now the proposal:

- is no longer limited simply to the transfer of capital losses, it extends to revenue losses as well;
- is no longer limited to losses realised as a result of the process of merging the two entities, it extends to losses already realised by the transferring fund which it is carrying forward from prior years and would be lost if the fund ceased to exist;

- has been expanded to include transfers involving pooled superannuation trusts (PSTs) and the complying superannuation fund business of life insurance companies, as well as transfers between superannuation funds. The measure was not extended to approved deposit funds or the deferred annuity business of life insurance companies;
- has been extended by one year so that it is available until 30 June 2011; and
- is now an optional loss transfer system and an asset roll-over regime.

In its current form, the Exposure Draft legislation proposes more than the loss transfer mechanism that was set out in the original December 2008 Press Release. The Exposure Draft legislation refers rather curiously to the system as a 'loss roll-over.' In fact, the draft legislation now contains both:

- a loss transfer system (which operates in broadly the same way as the familiar revenue and capital loss transfer systems that existed in the income tax legislation prior to the consolidation system); and
- an asset cost base roll-over regime.

This Tax Brief will distinguish the 'loss transfer' aspect and the 'asset roll-over' dimension, where appropriate.

2. The current proposal

The operative provisions in the draft legislation provide that the trustee of a complying superannuation fund or PST, or a life insurance company, can accept the transfer of various kinds of losses where certain conditions are met.

The measure applies to net losses. That is, gains – and the tax liability on gains – are not transferred under this regime. Further, any gains realised in the course of the merger are applied against losses in the usual way, but if a net capital gain or revenue gain remains after the losses have been exhausted, the transferor fund is taxable on the net gain.

Impact. The loss transfer is optional. Where the relevant conditions are met, and the parties elect, the receiving entity is taken to have incurred a loss equal to the amount transferred to it. The entity which made the loss is taken not to have incurred it.

Conditions relevant to the transferor. The legislation sets out a number of conditions that must be met by the entity which is transferring the loss. Most importantly, the transferor must be either a complying superannuation fund, PST or life insurance company dealing with assets used to support its complying superannuation business. It must cease to hold all of its CGT assets (a requirement which is modified in the case of life companies and PSTs) within the course of a single income year. At this stage it seems intended that the assets of the terminating fund must be transferred to an appropriate entity (subject to the retention of some assets to meet expected debts) – they cannot simply be sold at a loss on market and the proceeds

paid to the surviving fund, and it seems that all of the assets must go to the one entity – a terminating fund cannot be split between several entities. The transferor fund must cease to have any members as a result of these transactions.

Conditions relevant to the transferee. The legislation sets out a number of conditions that must be met by the entity which is receiving the loss (and the assets). The transferee must be a complying superannuation fund (though not a small superannuation fund), PST or life insurance company holding the assets to support its complying superannuation business. It is this condition which ensures that the transferee is an entity regulated by APRA.

Types of losses. The regime permits the transfer of:

- a net capital loss carried forward from a previous year;
- a net capital loss incurred in the current year;
- a tax loss suffered in an earlier income year; and
- a tax loss incurred in the current year.

Alternative all-asset tax cost base rollover. The asset rollover described so far operates for assets transferred to the continuing entity on an asset-by-asset basis and is available only for assets on which a loss would otherwise be realised.

However, a separate mechanism proposed in the draft legislation permits the effect of a transfer of all capital assets if a net capital loss would be made by the transferor for the year of transfer. A separate election is available for all revenue assets transferred where the transferor would otherwise make a tax loss for the year of transfer.

Special rules exist where the transferred asset is a financial arrangement subject to the recently-enacted TOFA regime and its cost is restated by the receiving entity, for example under the TOFA fair value or financial reports methods.

Sunset clause. The proposed amendments are only accessible if the transfer is effected between 24 December 2008 and 30 June 2011, and then only if completed in a single income year.

3. Some issues and comments

There are a number of technical requirements in the rules which are already creating headaches, and it seems quite likely that there will have to be further modifications. For example, there are undoubtedly things of value within funds that are not capable of being assigned under property law – how are they dealt with? There are ongoing administrative and compliance tasks – who is to perform those if the fund must cease to exist? How does one manage the times and dates if the transferring and receiving funds have different income years? There is a requirement that the assets being transferred to the receiving entity are 'identical' to the assets held by the transferring fund just before the first transfer occurs. How can this test be

met when the winding up of the first fund is being staged over a year, and assets are still entering the fund after the first assets start to leave? The requirement that losses relate to assets held for certain members may prove difficult where the assets of a PST, for example, are currently held to meet the claims of more than one unitholder, and some unitholders are not departing. There are some technical difficulties surrounding the ability of a PST or life company to transfer prior year capital and revenue losses, even though the policy appears to be allow such transfers. Finally, there seems to be no logic to the sunset clause; scrip for scrip rollover for shareholders and unitholders now exists as a permanent feature of the tax landscape. The issue in this context is not conceptually different, yet a sunset clause means that this arrangement will cease in 2011.

4. Next steps

The legislation exists at present in Exposure Draft form. A formal Bill to enact these measures is expected in Parliament shortly and – it is important to note – may differ from the proposals outlined in this Tax Brief.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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