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Technically Speaking: Understanding the Transfer Balance Cap series – TBC Credits arising from LRBAs and Notional Earnings

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Overview

We began this Understanding the Transfer Balance Cap series by laying some foundational groundwork to establish a better understanding of the Transfer Balance Cap (TBC) regime, before progressing to explore some of the more common TBC events, and the TBC impacts following the death of a fund member.

In our first two bulletins we covered several common TBC events that give rise to a Transfer Balance Account (TBA) credit including:

- Commencing a pension
- Death benefit pensions – including modified TBC rules for minors.

In this bulletin we will turn our focus toward two more events that give rise to a transfer balance credit. That is, credits arising due to:

- Certain LRBA repayments, and
- Notional Earnings that arise once an individual exceeds their TBC.

LRBA repayments

Broadly, a credit will arise in an SMSF member's TBA where an LRBA, that is supporting assets held in the retirement phase, has amounts of principal and interest repaid from funds held in the accumulation phase.

However, such a credit will only arise where the LRBA was entered into on or after 1 July 2017 – this includes arrangements that are refinanced on or after 1 July 2017 that ***do not*** meet the criteria listed below.

Where an LRBA was entered into before 1 July 2017 but is (or has been) refinanced on or after 1 July 2017, the refinanced LRBA will be exempted from this treatment if:

- the refinanced LRBA is secured by the same asset as the original LRBA, and
- the amount borrowed under the refinanced LRBA at the time it is/was entered into is equal to or less than the outstanding balance of the borrowing under the original LRBA.

NOTE

Note: Contracts that were entered into prior to 1 July 2017 but that completed after that time are also excluded.

When will the credit arise?

A TBA credit will arise where an LRBA repayment results in an increase in the value of an individuals' superannuation interests that are in the retirement phase.

That is, an individual will receive a TBA credit where a payment in respect of an LRBA, where that LRBA is supporting superannuation interests held in retirement phase, is made from assets that support superannuation interests that are not in retirement phase – as this increases the overall value of an individual's superannuation interests supporting income streams in retirement phase.

Analogous with commencing an income stream with accumulation phase money, or adding more money into the pension phase, this ensures that an individual's TBA captures the shift of value that occurs where liabilities arising from an LRBA, which is in retirement phase, are paid using accumulation assets.

The credit to the individuals' TBA arises at the time the relevant LRBA payment is made and is equal to the amount of the increase in the value of the superannuation interest supporting the retirement phase income stream. As such, the amount to be credited is determined by reference to the amount that is repaid on the LRBA.

Example 1:

Tony, age 67, is the only member of the Golf King SMSF.

He has an account-based pension which was valued at $1.2 Million on 30 June 2024. He also has a small accumulation interest to which his employer makes SG contributions.

The primary asset supporting his account-based pension is a residential property, which is held under an LRBA – with an outstanding loan balance of $400,000.

In June 2024, the Golf King SMSF trustees used monies accumulated from Tony's SG contributions (i.e. money from Tony's accumulation interest) to make a $20,000 payment towards the LRBA.

By effectively satisfying a pension phase liability, this payment had the overall effect of increasing the value of Tony's retirement phase interest by $20,000.

As a result, in June 2024, a credit of $20,000 will arise in Tony's TBA.

Example 2:

Melania, age 65, is the only member of her SMSF. Her superannuation interests are valued at $1.5 million.

She has an account-based pension which is backed by a property with a net value of $1,300,000 (the property has a significant outstanding liability under an LRBA).

Melania's SMSF makes monthly repayments of $10,000. Half of each repayment is made using the rental income generated from the property. The other half of each repayment is made using cash that supports Melania's accumulation interest.

Example 2 – continued:

At the time of each repayment, Melania receives a transfer balance credit of $5,000, representing the increase in value of the superannuation interest that supports her retirement phase pension.

The repayments that are sourced from the rental income that the SMSF receives do not give rise to a transfer balance credit.

There may be scenarios where assets are segregated to support the retirement phase interests of more than one member. In these cases, it will be necessary to apportion the credit across the different members' interests on a fair and reasonable basis.

In LCR 2016/9: Superannuation reform – Transfer balance cap, the ATO indicates that one acceptable methodology is for the respective proportions to be based on a value of the member's retirement phase superannuation interests as at 30 June of the immediate prior financial year – provided there have been no significant changes in value between that date and the date of determining the amount of the credit.

Example 3: Adapted from LCR 2016/9

Ram and Madhu are the only members of an SMSF which has allocated specific assets to support the superannuation income streams payable by the SMSF. They both have account-based pensions and accumulation interests.

On 30 June 2024, Ram's retirement phase interest is valued at $400,000 and Madhu's retirement phase interest is valued at $600,000.

The SMSF entered into an LRBA on 1 August 2024 to acquire an asset that solely supports the account-based pensions of both Ram and Madhu. The fund makes a monthly repayment of $10,000 from accumulation interests of both Ram and Madhu towards the borrowing under the LRBA on 1 September 2024. There have been no significant changes in value of the members' superannuation interests in the retirement phase prior to the repayment.

The transfer balance credits that arise in Ram and Madhu's transfer balance account on 1 September 2024, is apportioned in a fair and reasonable manner in accordance with the proportion of their retirement phase interests in the SMSF. This is calculated as follows:

Ram's transfer balance credit:

$400,000 / ($400,000 + $600,000) * $10,000 = $4,000

Madhu's transfer balance credit:

$600,000 / ($400,000 + $600,000) * $10,000 = $6,000

When will a LRBA repayment not result in a TBA credit?

As outlined earlier, a transfer balance credit will only arise where a payment, in respect of an LRBA supporting a retirement phase superannuation income stream, is sourced from assets that do not support retirement phase superannuation income streams.

Therefore, where a repayment in respect of an LRBA supporting a retirement phase superannuation income stream is sourced from assets supporting the retirement phase interest, the payment will not affect the value of the interest.

As such, where loan repayments are made from retirement phase assets, the reduction of the outstanding LRBA loan will not trigger any further adjustments to the TBC.

Example 4:

James, age 65, is the only member of his SMSF.

His entire superannuation benefits are held in an account-based pension which is backed, in part, by a property. The property was purchased using an LRBA.

James' SMSF uses rental income from the property and its other cash deposits to repay the LRBA over time.

As the repayments are sourced from assets that support James' retirement phase interests, the repayments do not increase the value of James' superannuation interest supporting his account-based pension and James does not receive a transfer balance credit.

Practical considerations and observations

Given the above TBC assessment of impacted LRBA repayments, there are a number of important considerations and observations, including but not limited to:

1. Trustees will need to be able to identify the source of any loan repayments in respect of an LRBA that is supporting a retirement phase superannuation income stream.

Along with the fact that superannuation funds are required to report TBA events quarterly, the burden of compliance in reporting these events must be considered.

2. Where a fund has identified specific assets, that are subject to a LRBA, as supporting retirement phase pensions, trustees should ensure that sufficient cash holdings are also available, in the retirement phase, to service loan repayments.

3. Where a fund operates on an unsegregated basis, loan repayments on an outstanding LRBA will typically not trigger an additional credit to a member's TBA. This is because the repayments are already occurring on a proportional basis across both retirement and accumulation phase interests.

4. Fund trustees considering the refinancing of an existing LRBA, that was first established before 1 July 2017, should ensure that the refinancing does not result in the new loan being subjected to these rules.

TIP

It's worth noting that the above treatment of LRBA's for TBC purposes is entirely different to the treatment of LRBA's for Total Superannuation Balance (TSB) purposes. For TSB purposes, an 'LRBA amount' will be added to an individual's TSB where the LRBA is between the fund and an associate of the fund, or the member has met a condition of release with a nil cashing restriction.

Notional earnings

Where an individual's transfer balance account exceeds their personal transfer balance cap, an excess transfer balance occurs. Of course, the two main consequences of this are that, typically:

1. The individual must commute (either fully or partially) their retirement income stream to eliminate the excess, including any notional earnings, and
2. Excess transfer balance tax will be imposed on the notional earnings.

NOTE

Note: Where a member's only income stream is a capped defined benefit income stream (CDBIS), this income stream alone cannot directly cause an excess transfer balance in the traditional sense as it is subject to special rules under the transfer balance cap (TBC) regime. However, if a person has *other* retirement phase income streams in addition to a CDBIS, the combined value of these may cause an excess transfer balance if it surpasses the TBC. In this scenario, it's the additional income stream(s) that contribute to the excess, not the CDBIS alone – and it is this income stream that will need to be commuted to eliminate the excess transfer balance. It is beyond the intended scope of this bulletin to provide a more detailed discussion of the rules that apply to a CDBIS.

Determining an individual's notional earnings, or more specifically their 'excess transfer balance earnings', is important because an individual who exceeds their transfer balance cap continues to benefit from tax-free earnings on the excess capital while they remain over the cap.

As such, it is these earnings, along with the excess capital, that must be removed from the retirement phase. It is also these earnings that will be subject to excess transfer balance tax.

Importantly, in the context of this bulletin, these notional earning amounts are credited to the individual's transfer balance account on a daily basis, further compounding the size of their excess transfer balance, until the day that the excess transfer balance is removed.

However, unlike most other transfer balance events, these 'earnings' are not reported to the ATO by a superannuation fund. Rather, due to the difficulty in determining actual earnings derived on the excess portion of a member's superannuation holdings, 'notional earnings' are calculated by the ATO (and credited to an individual's TBA) on a daily basis.

The rate at which notional earnings accrue is based on the general interest charge (GIC). The annual GIC rate, for the October – December 2024 quarter is 11.38%. The daily rate is worked out as follows:

$$\frac{\text{(90-day bank accepted bill yield + 7 percentage points)}}{\text{The number of days in the year}}$$

NOTE

Note: The '90-day bank accepted bill yield + 7 percentage points' is the legislative basis for calculating the GIC. The GIC rates can be found here.

The amount of notional earnings credited to an individual's TBA compounds daily, until the earlier of the day:

- the breach of the transfer balance cap is rectified, or
- the ATO issues an excess determination.

Generally, an individual can rectify the breach of their transfer balance cap by commuting the excess amount, including the 'notional earnings' and either:

- leaving the amount in their accumulation interest, or
- withdrawing the amount as a lump sum.

Therefore, timely action to rectify the breach of an individual's excess transfer balance cap will minimise the amount of notional earnings credited to their TBA.

Planning point: Unlike contribution cap breaches, a member can proactively commute an account-based pension to prevent excess transfer balance earnings from accumulating and does not need to wait for the Commissioner to issue a determination.

NOTE

Note: Death benefit income streams cannot be rolled back into the accumulation phase and can only be cashed out.

Should an individual fail to proactively rectify their excess, the ATO will issue them with an excess transfer balance determination.

From the date an excess transfer balance determination is issued, no further notional earnings are credited to that individual's transfer balance account.

That is, the excess transfer balance determination will state the crystallised reduction amount which is the individual's excess transfer balance (i.e. the excess amount plus the notional earnings on this amount calculated to the date of the determination). It is this amount that will need to be debited from the individual's transfer balance account to rectify the breach of their transfer balance cap.

NOTE

Note: While excess transfer balance earnings that accrue after the ATO has issued a determination are no longer credited to a member's transfer balance account, the member remains liable for excess transfer balance tax on these notional earnings until the excess is subsequently commuted.

A more detailed discussion on dealing with an excess transfer balance, what happens following an excess determination being received, and the administrative processes, will be covered in a future Technically Speaking bulletin edition.

Example 5:

Genevieve commenced an account-based pension from her SMSF in 2020.

Following the death of her husband George, she also commenced a death benefit pension on 1 October 2023.

The commencement of this death benefit pension causes her to exceed her TBC by $400,000.

On 1 December 2023, Genevieve sees her financial adviser, who identifies the excess and calculates her notional earnings.

They arrange for an immediate commutation of $407,523 (i.e. the $400,000 excess, plus 61 days of notional earnings) from her account-based pension back into the accumulation phase to rectify the breach.

The GIC rate used to calculate notional earnings for Genevieve is the October – December 2023 quarter rate which was 11.15% (or 0.03054794% daily).

Analysis

For each day that Genevieve's TBA exceeded her personal TBC, an amount just over $120 was credited to her TBA – resulting in her excess continuing to grow (on a compounding daily basis).

Due to Genevieve's swift action in rectifying the breach, the Commissioner does not issue a determination.

Despite this, Genevieve is still required to pay 15% tax on the $7,523 of notional earnings.

Practical considerations and observations

1. Individuals should consider rectifying a breach of their transfer balance cap as soon as possible, and ensure that any associated commutation is promptly reported to the ATO. Doing so will reduce the amount of notional earnings that will be subject to tax.

2. If a member rectifies their excess before the ATO issues a determination they will need to calculate the 'notional earnings' amount that needs to be commuted. In LCR 2016/9, the ATO advises that when determining the amount to commute, individuals should consider not only the original excess transfer balance, but also the notional earnings and the time required to action the commutation.

If the excess is commuted before a determination has been issued, the member can expect the ATO to issue an excess transfer balance earnings assessment only.

3. If a commutation occurs after the ATO has issued an excess transfer balance determination, it is only the amount stated in that determination that needs to be commuted. There is no need to calculate notional earnings.

4. A member's 'notional earnings' will be subject to Excess Transfer Balance tax, regardless of whether they accrue before or after the ATO issued a determination. The tax rate applicable to these notional earnings is 15% for the first breach and 30% for any subsequent breaches.

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