

FACT SHEET

Income Streaming to Beneficiaries of Discretionary Trusts

What is Income Streaming?

If your family group includes a discretionary trust, an effective tax strategy has often involved streaming particular types of trust income to particular beneficiaries with a view to minimising overall exposure to income tax. This would be done by taking beneficiaries' individual circumstances into account when making resolutions to distribute, such as capital or revenue losses available to the beneficiary or an ability to access certain tax concessions. A trustee may, for example, resolve to distribute to a corporate beneficiary to take advantage of the capped company tax rate, however the resolution may relate to non-capital gains income only given companies are not entitled to the general CGT discount concession.

Up until the famous *Bamford* case, income streaming as it relates to discretionary trusts was condoned as an acceptable practice by the ATO, as evidenced by a dedicated tax ruling. However, since this pivotal case the ATO has issued an opinion citing the *Bamford* decision does not support income streaming by discretionary trusts.

What does this mean for Income Streaming?

As a result, legislation has since been passed to allow discretionary trusts to stream capital gains and franked dividends provided certain conditions are met. In order for a trustee to stream capital gains and franked dividends generally:

- The trust deed must contain a complying streaming clause which permits the trustee to stream capital gains and franked dividends. That is, trustees do not automatically have the power to stream – the trust deed must empower the trustee to stream

- The nominated beneficiaries must be “specifically entitled” to the streamed capital gains and / or franked dividend income

If a trust deed does not contain an adequate streaming clause, it can be amended accordingly however it must be amended in the year that the streaming is to occur. That is, the amendment cannot apply retrospectively. In most cases, the required amendment will not trigger a resettlement of the trust, however this should be assessed on a case-by-case basis.

What is “Specific Entitlement”?

Specific entitlement differs from present entitlement purely on the basis that specific entitlement refers to particular classes of income. A beneficiary's specific entitlement to the streamed capital gains or franked dividend will be determined with reference to the share of the economic (cash) gain the trustee resolves to stream to said beneficiary. The economic gain in relation to a capital gains or franked distribution transaction is referred to as the “Net Financial Benefit” and the share received by the beneficiary is his / her “Share of Net Financial Benefit”. These terms are explained in further detail below.

A beneficiary's taxable entitlement will be determined with reference to the percentage of net financial benefit received in accordance with the following formula:

$$\frac{\text{Taxable Income in Income Class} \times \text{Share of NFB}}{\text{Net Financial Benefit (NFB)}}$$

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Share of Net Financial Benefit

The term "Net Financial Benefit" is defined according to economic concepts and will generally refer to the net income derived in relation to the class of income, being gross income net of any applicable losses or directly related expenses. In the case of:

- Capital Gains, it will be calculated as the proceeds received on disposal of the capital asset less costs incurred in acquiring the asset, less any capital losses
- Franked Dividends, it will be calculated as the value of the total cash dividends received less any directly related expenses such as interest paid

Tax concepts such as CGT concessions and franking credits are irrelevant to the determination of Net Financial Benefit. "Share of Net Financial Benefit" simply means the share of total Net Financial Benefit the trustee resolves to stream to the particular beneficiary.

What Conditions must be satisfied in order to Stream Income?

In order for a beneficiary to be specifically entitled to streamed capital gains or franked dividends:

- There must be a positive Net Financial Benefit in relation to the capital gains and / or franked dividends being streamed. That is, you cannot stream a loss
- The share of Net Financial Benefit the trustee resolves to stream to a beneficiary must be referable to the transactions giving rise to the capital gains or franked dividends derived by the trust. In the case of streamed capital gains, the amount must be referable to the share of residual

sale proceeds of the capital asset(s), and in the case of streamed franked dividends, the share of the cash dividends received net of direct expenses)

- The beneficiary must receive, or be reasonably expected to receive, the share of the Net Financial Benefit
- The resolution to stream must be made within the 2 months following the end of the income year in the case of capital gains, and by the end of the financial year in relation to franked dividends

If there is a chain of trusts, the requirements for specific entitlement must be met at each level in the chain.

Specific Entitlement Resolutions

Income streaming can be done at a transactional level, or done with reference to the total capital gains or franked dividends received across the income year. For instance, if a discretionary trust disposes of 2 capital assets during the year resulting in capital gains, the trustee can resolve:

- To make Beneficiary A specifically entitled to the gain from the sale of the first asset, and Beneficiary B specifically entitled to the gain from the sale of the second asset, or
- To make Beneficiary A and Beneficiary B specifically entitled to a percentage of the total capital gains derived during the year

If making resolutions at a transactional level, the resolution must clearly state which transactions any capital losses will be netted against. Finally, the resolution must clearly refer to capital gains or franked dividend income generally, or the individual transactions making up the income

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class balances. It is not enough to resolve that a percentage of trust income will be distributed to Beneficiary A, even if the income is 100% capital gains or franked dividends.

If this pooling approach is used, the specific entitlement resolutions should refer to "Franked Distributions" income as opposed to "Franked Dividends" income.

Pooling approach for "Franked Distributions"

Where a trustee is empowered to stream franked dividends, it does have the option to pool all dividends and other types of franked income (such as trust distributions) into one class of income for streaming purposes. The total pooled income is referred to as "Franked Distributions" and is then streamed on a percentage basis. This draws in trust distributions that may be partially franked as well as unfranked dividends. Apart from the administrative advantage, pooling allows the effects of negatively geared shareholdings to be offset against positively geared shareholdings, therefore removes the exposure to non-streamable negative net financial benefits.

Can Franking Credits be streamed separately?

When streaming franked dividends, the franking credit entitlement will follow the entitlement to the actual franked dividends whether the entitlement is determined at a transactional level or at the income class total level. That is, franking credits cannot be separately streamed.

What about remaining Trust Income?

Any other income that is not distributed under specific entitlement resolutions is distributed under the existing present entitlements basis.

What Next? The developments in legislation and case law impacting trusts create significant changes for trustees of trusts to digest. If you are the trustee of a trust potentially impacted by these changes, contact your manager or partner at Enspira Financial to discuss the following action items that trustees should undertake:

- If you wish to have the power to stream capital gains and / or franked dividends, have your trust deed reviewed to ensure an adequate streaming clause is in place. A deed amendment may be required however any trust resettlement issues should be resolved first
- Ensure trust records adequately identify which expenses relate directly to either capital gains or franked dividends, and which capital gains any capital losses are to be netted against
- Re-consider streaming of other types of income (i.e: types other than capital gains or franked dividends) if this has been a practice in the past. This may be disallowed by the ATO
- Ensure specific resolutions:
 - For streaming franked dividends are done by the end of the year, and for streaming capital gains are done within two months following year-end. In the case of the latter, check that the trust deed permits the making of a resolution after year-end
 - Refer specifically to capital gains, franked dividends or franked distributions. Where resolutions are made at a transactional level, ensure the resolution clearly states which transactions capital losses are being applied against
- If there is a chain of trusts, ensure the requirements for specific entitlement are met at each level in the chain
- Review the trust deed for any conditions or clauses that may hinder any of the above, or specify conditions that must be met before distributions can be made

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