

Abstract: Anyone whose estate plan includes one or more trusts should review them before filing an income tax return. And those who have already filed should look carefully at how their trusts were affected. This article explains that trusts can be subject to the highest tax rates and suggests three ways to soften the blow.

Are income taxes taking a bite out of your trusts?

If your estate plan includes one or more trusts, review them before you file your tax return. Or, if you've already filed it, look carefully at how your trusts were affected. Income taxes often take an unexpected bite out of these asset-protection vehicles.

3 ways to soften the blow

For trusts, there are income thresholds that may trigger the top income tax rate of 37%, the top long-term capital gains rate of 20%, and the net investment income tax of 3.8%. Here are three ways to soften the blow:

1. Use grantor trusts. An intentionally defective grantor trust (IDGT) is designed so that you, the grantor, are treated as the trust's owner for income tax purposes — even though your contributions to the trust are considered “completed gifts” for estate- and gift-tax purposes.

The trust's income is taxed to you, so the trust itself avoids taxation. This allows trust assets to grow tax-free, leaving more for your beneficiaries. And it reduces the size of your estate. Further, as the owner, you can sell assets to the trust or engage in other transactions without tax consequences.

Keep in mind that, if your personal income exceeds the applicable thresholds for your filing status, using an IDGT won't avoid the tax rates described above. Still, the other benefits of these trusts make them attractive.

2. Change your investment strategy. Despite the advantages of grantor trusts, nongrantor trusts are sometimes desirable or necessary. At some point, for example, you may decide to convert a grantor trust to a nongrantor trust to relieve yourself of the burden of paying the trust's taxes. Also, grantor trusts become nongrantor trusts after the grantor's death.

One strategy for easing the tax burden on nongrantor trusts is for the trustee to shift investments into tax-exempt or tax-deferred investments.

3. Distribute income. Generally, nongrantor trusts are subject to tax only to the extent they accumulate taxable income. When a trust makes distributions to a beneficiary, it passes along ordinary income (and, in some cases, capital gains), which are taxed at the beneficiary's marginal rate.

Thus, one strategy for minimizing taxes on trust income is to distribute the income (assuming the trust isn't already required to distribute income) to beneficiaries in lower tax brackets. The trustee might also consider distributing appreciated assets, rather than cash, to take advantage of a beneficiary's lower capital gains rate. Of course, doing so may conflict with a trust's purposes.

Opportunities to reduce

If you're concerned about income taxes on your trusts, contact us. We can review your estate plan to assess the tax exposure of your trusts, as well as to uncover opportunities to reduce your family's tax burden.

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