Capital gains may be trapped inside your trusts

Many families today are attempting to reduce their tax bills by distributing trust income to beneficiaries in lower tax brackets. But it's not always possible to distribute capital gains. If long-term gains remain "trapped" inside a trust, they'll be taxed at rates as high as 23.8%. However, there may be steps you can take to liberate capital gains from a trust and shift the income to your beneficiaries.

Income taxes in the spotlight

Historically, estate planning strategies focused on minimizing estate taxes. But today, a generous gift and estate tax exemption ($5.45 million in 2016) combined with soaring income tax rates has shifted the emphasis to income tax planning. Taxpayers in the highest tax bracket are now subject to a 39.6% marginal tax rate on their ordinary income and a 20% capital gains tax rate.

In addition, taxpayers whose modified adjusted gross income ("MAGI") tops $200,000 ($250,000 for joint filers) are subject to a 3.8% tax on their net investment income ("NII"), which includes dividends, taxable interest and capital gains. The tax applies to the *lesser* of (1) your net investment income, or (2) the amount by which your MAGI exceeds the threshold.

The impact of higher income taxes on nongrantor trusts is particularly harsh because the top tax rates, as well as the NII tax, kick in when income exceeds only $12,400. Once a trust's income reaches that threshold, its ordinary income is taxed at 39.6% and capital gains are taxed at 20%. Furthermore, the trust is subject to NII tax on the lesser of (1) its undistributed net investment income, or (2) the amount by which its adjusted gross income exceeds the $12,400 threshold.

Removing capital gains

One strategy for reducing taxes on nongrantor trusts is to distribute their income to the beneficiaries. Generally, trusts are subject to tax only on their undistributed income, while income distributed to a beneficiary is taxed at the *beneficiary's* marginal rate. Trust accounting rules limit these distributions to distributable net income ("DNI"), which typically includes dividends and interest but *excludes* capital gains. As a result, capital gains ordinarily are taxed at the trust level.

Depending on applicable state law and the terms of the trust document, however, it may be possible to include capital gains in distributable net income, either by amending the trust or through an exercise of trustee discretion.

Review your trusts

If your trusts are paying capital gains taxes at the highest rates, talk to tax advisor about whether you can include capital gains in DNI and have them taxed at the beneficiary level. The move could be a wise financial strategy.

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