

Obama Attack On "Trust Fund Loophole" Could Increase Tax Advantage Of Trusts

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For those who like their tax rhetoric served with a side order of irony, here's a tasty one: In his State of The Union Address tonight President Obama will propose closing what the White House has dubbed the "trust fund loophole." But the loophole Obama is aiming at has nothing to do with trusts and closing it could actually increase the tax appeal of trusts.

Okay, I get that "trust fund baby" is shorthand for someone with inherited wealth who doesn't need to work ---the Paris Hilton type. And it's true that the Obama proposal is aimed at rich heirs. Still, it seems less aptly named than the Obama Administration's earlier [attempt to impose a minimum income tax on the rich](#), which carried the surname of [Berkshire Hathaway](#) billionaire [Warren Buffett](#), who famously complained he was taxed at a lower rate than his secretary.

What follows is insanely complicated, but then so are the U.S. tax system and the techniques the rich use to cut their tax bills. Start with the proposed change. Obama's "trust fund loophole" closer

would eliminate the current “step-up” in the tax [basis](#) of appreciated assets at death. Say you bought \$10,000 of [Apple Inc.](#) shares in 2009 that are now worth \$50,000. If you sell the shares today you have a \$40,000 long term capital gain (\$50,000 minus your \$10,000 tax basis or cost) that is taxable at a top rate of 23.8%. (In a related proposal, [Obama wants to raise that rate to 28%](#) for couples with income above \$500,000.) But if you drop dead today before clicking the sell button on your computer, your heirs will get to step up the basis of those Apple shares to their \$50,000 market value at your demise. They can sell the shares immediately and not owe any capital gains tax, or sell them later and pay tax only on any gain beyond \$50,000. That \$40,000 of profit that accrued before your death never gets taxed.

Obama would not only eliminate this step-up, but also [make death a taxable event](#)---meaning if you left the Apple shares to anyone other than charity or a spouse, all the gain which took place before your death would be taxable at your death, and the shares (if not sold then) would take the current market value as their new basis. (This is also known as “mark-to-market.”) The Obama proposal would also tax any unrealized gain when you gifted the shares to anyone other than charity or a spouse.

Currently, if you give appreciated shares away while you’re alive, they don’t get a step-up in basis, but there’s also no capital gains tax due until the recipient actually sells the shares.

Now, for that trust fund business. It’s true that step-up primarily benefits the wealthy. According [to a CBO analysis](#), 21% of all savings from step up go to the top 1% (measured by income) and another 28% of savings go to those who fall in the 96% to 99% income distribution. And very big dollars are being saved here. Congress’ Joint Tax Committee [estimates](#) that step-up will cost

the Treasury \$175 billion during the five years from 2014 through 2018, making it one of the most expensive individual tax breaks in the code. Moreover, middle class and upper middle folks hold a growing share of their wealth in retirement accounts, which don't get any advantage from step-up. And to further spare the middle class, Obama's proposal would exempt gains of up to \$250,000 per person/\$500,000 per couple on a primary residence and \$100,000 per person/\$200,000 per couple of other capital gain. (Len Burman, director of the Tax [Policy Center](#), makes the policy case for eliminating step-up [here](#).)

But the reality is, that step-up, in combination with the current estate tax law, makes it *less* tax advantageous for some families to set up trusts and getting rid of step up would increase the tax advantage to using trusts. Deep breath here. Ok, please read on. Thanks to the [fiscal cliff tax deal](#) passed by Congress on January 1, 2013, a hefty [\\$5.43 million per person, or \\$10.86 million per couple](#), can be passed on free of estate or gift tax, and that number is rising each year with inflation. In addition, a newish "portability" provision allows any exemption the first spouse to die doesn't use to be transferred to the surviving one (usually the woman), meaning the widow can leave as much as \$10.86 million to the kids or other heirs estate tax free---and without using the sort of bypass trust couples used to need to preserve the estate tax exemption of the first to die.

In fact, because of step-up, if an affluent couple is likely to have less than \$10 million on the death of the second spouse, putting assets into a bypass trust after the death of the first spouse can increase their family's total tax bill---particularly if they live [in one of the 31 states without a state death tax](#). That's because with a bypass trust, at the death of the first spouse an amount up to his

exemption goes into a trust for the kids. The surviving spouse has access to the earnings (and in some cases principal) of the trust, but the assets in the trust aren't hers outright and bypass her estate when she dies---meaning they don't get a second step-up when she dies. As Deborah L. Jacobs, author of *Estate Planning Smarts*, explained in *Forbes* a year ago, with step-up, even some families likely to have taxable estates have been better off keeping assets, like art, whose gains are taxed at a top federal rate of 31.8%. out of trusts. This is particularly true if they live in a state like California, which has no estate tax, but taxes capital gains at a hefty 13.3%. (Curious if your state has an estate tax? See *Where Not To Die In 2015*.)

So what would happen if step-up were eliminated---admittedly an unlikely prospect with Republicans in control of Congress? (Their price for eliminating step-up would be doing away with the estate tax too—a tradeoff that existed briefly in 2010 as a result of President George W. Bush's tax cuts.) Without step-up, there would, for example, be an even greater tax advantage to putting assets that are likely to explode in value---such as founders' stock in a hot start-up—into an irrevocable trust for children or grandchildren. Facebook co-founders Mark Zuckerberg and Dustin Moskovitz, put company stock in such trusts in 2008, before they had kids or were even married, allowing them to shift hundreds of millions of wealth to heirs without paying gift or estate taxes. Without step-up, such trusts would be even more appealing, for donors of every age, since there would be no loss of step-up to offset the estate and gift tax savings. Even better, once the stock was in an irrevocable trust, the death of the donor wouldn't be a taxable event forcing the payment of gains taxes. In states that allow “dynasty” trusts, points out New York estate lawyer Bruce D. Steiner, “you could keep the trusts going forever

and not have to mark to market (and pay capital gains tax) each time someone dies, so trusts would be more useful and we'd have more trusts.”

Instead of a “trust fund loophole” closer, maybe Obama should package the elimination of step-up as a jobs plan for lawyers? They [do need one](#), after all.

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