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Ask a trust officer:
The "trust fund loophole"

DEAR TRUST OFFICER:

How does the "trust fund loophole" work? President Obama said, in his State of the Union address, that he wants to close this loophole. Is this something I should look into before the loophole is closed?

—LOOKING FOR ADVANTAGES

DEAR LOOKING:

Oddly, the "trust fund loophole" has nothing to do with trusts, as such. It is a tax break that accrues primarily to the wealthy, and perhaps this sound-bite name came about because the wealthy are commonly associated with having trusts.

The target of the President's proposal is a long-standing tax rule under which the basis of property is "stepped-up" to fair market value at death. In effect, the capital gains tax on appreciation of an asset is forgiven. Heirs who sell inherited property shortly after receiving it are likely to owe little or no capital gains tax on it.

One alternative to this approach is something called "carryover basis." When one makes a gift of an appreciated asset, there is no step-up, the tax basis carries over to the donee. There was an attempt to apply this rule in the context of estate taxes in 1976. However, carryover basis at death was found to be administratively unworkable, and it was repealed before being fully implemented.

The President has proposed a different solution. He wants to make death a realization moment for capital gains. A capital gains tax would be imposed as if the owner had sold all of his property just before death, subject to an exemption for the first $200,000 of gain. A similar rule would apply to gifts of appreciated assets.

This proposal is important because the exemption from the federal estate tax is now $5.43 million, or $10.86 million for married couples. That means for the vast majority of families, the most important tax that would come up during estate planning would be the capital gains tax. However, the proposal is not likely to prove popular in the Republican-controlled Congress.

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