



# estate planning BULLETIN

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### Should the “trust fund loophole” be closed?

Oddly, the “trust fund loophole” mentioned in materials released before President Obama’s State of the Union speech has nothing to do with trusts, as such. It is a tax break that accrues primarily to the wealthy, and perhaps the sound-bite name came about because the wealthy are commonly associated with having trusts.

The target of the President’s proposal is the 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.

This particular “loophole” is not of recent vintage, it dates to the creation of the modern income tax in 1913. Basis was not defined in the tax code until the Revenue Act of 1921, which provided that basis was fair market value on the date of acquisition. In 1934 any ambiguity about the date of acquisition of an inheritance was resolved in favor of fair market value at death.

One alternative to forgiving the capital gains tax on a lifetime of capital appreciation is “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 to transfers at death in 1976. However, carryover basis at death was found to be administratively unworkable, and after repeated postponements it was repealed before being fully implemented.

The President proposed a different resolution for taxing built-in gains. 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 \$100,000 of gain. A similar rule would apply to gifts of appreciated assets. Married couples would have a \$200,000 exemption, and a special rule would apply to personal residences. The first \$250,000 of gain on a home (\$500,000 for married couples) would also avoid being taxed at death. For the sake of simplicity, an exemption would also apply to tangible personal property other than expensive art and collectibles.

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. Although

the proposal is not likely to prove popular in the Republican-controlled Congress, it is likely to become a talking point for tax reform plans of the Democrats in the future.

### **Bright future for 529 plans**

The President also called for an end to the tax freedom for distributions from 529 plans for college expenses. The President's essentially proposed going back to the pre-2001 rules for these programs, which allowed for tax-deferred growth but full income taxes on all withdrawals. The new rules would only have applied to future contributions. The justification for the change was that the tax benefits of 529 plans have been flowing disproportionately to higher-income taxpayers, given that they have the highest marginal tax rates.

After a bipartisan outcry, the President backed off of the proposal, his spokesman saying that it had become a "distraction." The House responded by voting to expand somewhat the benefits of 529 plans. By a vote of 401 – 20, H.R. 529 was approved, which would:

- Modernize 529 plans by adding computers to the list of qualified expenses;
- Allows funds to be re-deposited without taxes or penalties if student withdraws early for medical reasons and obtains a refund from the school; and
- Removes unnecessary paperwork burdens that date back to before withdrawals from 529 plans became tax-free.

The Obama administration has not threatened to veto the bill, although it continues to call for additional changes that may target more benefits to lower-income families.

### **Proposals**

Among the early proposals for changing the income tax system are:

- H. R. 186, the *Farmers Against Crippling Tax Act*, would repeal the federal estate tax gift taxes;
- H. R. 144, the *Alternative Maximum Tax Act*, would limit the total burden of federal, state and local taxes, including sales and excise taxes, to 50% of adjusted gross income; and
- S. 155 and H. R. 25, the *Fair Tax Act of 2015*, would replace the income, payroll, and transfer taxes with a national sales tax administered by the states.

As interesting as these may sound, they do not appear likely to gain traction in Congress this year.

### **The "lost" e-mails are found**

Last year IRS Commissioner John Koskinen testified before Congress that the e-mails of Lois Lerner were not recoverable. The e-mails were needed for the Congressional inquiry into the targeting of conservative groups by the IRS. Koskinen stated that back-up tapes of the e-mails were routinely recycled as a cost-saving measure.

The search for the lost e-mails was turned over to the Treasury Inspector

General for Tax Administration (TIGTA). At a February 26 hearing, two TIGTA representatives reported that they had found the “missing” e-mails on backup tapes located at the IRS’ computing center in Martinsburg, West Virginia. The IT people in Martinsburg reported that they were never asked about the tapes by the IRS officials previously charged with finding the e-mails. The basis for Koskinen’s earlier testimony is now unclear.

Some 80,000 Lois Lerner e-mails were found, of which about 60% were duplicates. An investigation is underway as to which of the 32,774 unique e-mails have already been supplied to Congressional oversight committees. Republicans were upset by the ever-changing story of the e-mails. Both committee Chair Jason Chaffetz, R-Utah, and committee member Trey Gowdy, R-S.C., asked if criminal statutes may have been violated. TIGTA Deputy Inspector General for Investigations, Timothy P. Camus, replied that “there is potential criminal activity.”

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