

# TAXATION OF SAME SEX COUPLES A VOYAGE THROUGH THE LOOKING GLASS

**PRESENTED**

**BY**

**PROFESSOR DAVID L. RICE, ESQ.,**

**Beverly Hills Bar Association**

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# BRIEF SUMMARY OF CALIFORNIA DOMESTIC PARTNERSHIP LAW

- ◆ Since 1999 California has granted certain civil and property rights to domestic partners who register their partnership by filing a statement of Domestic Partnership.
- ◆ On September 19, 2003, the California Domestic Partner Rights and Responsibilities Act was enacted, effective January 1, 2005.
- ◆ On September 29, 2006 Senate Bill 1827 was enacted, effective January 1, 2007 which provided that earned income of Domestic Partners was to be treated as community income for both property law and state income tax purposes.
- ◆ Domestic Partners have the right to enter into agreements akin to premarital agreements which can avoid the application of community property laws.

# FRANCHISE TAX BOARD TAX RETURN FILING REQUIREMENTS

- ◆ Beginning on January 1, 2007, Registered Domestic Partnerships (“RDPs”) must file their tax returns as if they are married. They may file a Joint Return or Married Filing Separately.
- ◆ If the couple entered into a same-sex legal union in another state, other than a marriage, and that union has been determined to be substantially equivalent to a California registered domestic partnership, they are required to file a California income tax return using either the married/RDP filing jointly or married/RDP filing separately filing status.

# STATES RECOGNIZING SAME SEX COUPLE UNIONS

- ◆ THERE ARE 15 STATES PLUS DC THAT RECOGNIZE SOME FORM OF SAME SEX COUPLE UNIONS.
  - ◆ MARRIAGE – California; Connecticut; Washington D.C., Iowa, Massachusetts, New Hampshire, New York, Minnesota, Rhode Island and Vermont.
  - ◆ Civil Union – Colorado, Delaware, Hawaii, Illinois, New Jersey, and **Rhode Island**.
  - ◆ Domestic Partnerships – California (Expanded to Community Property on 1/1/2005), Nevada, Oregon and Washington (expanded to Community Property on 6/12/2008)

# Differences between Marriage and Civil Unions

- ◆ A civil union is a legal status created initially by the State of Vermont in 2000 and then adopted by other states. It provides legal protection at the state law level, but omits any protection at the Federal level.
- ◆ Portability – Marriages are deemed respected in every state, but it is unclear how civil unions will be respected.
- ◆ Ending a Civil Union – Must be a resident of a state that respects Civil Unions.
- ◆ Federal Benefits – None, including family leave, right to sponsor spouse for immigration, Social Security survivor benefits.

# Civil Union Distinctions (continued)

- ◆ Taxes and Benefits for the Family – Filing of joint returns; means tested programs such as Medicaid, pension protections, insurance protections.
- ◆ Filling out forms – For Federal purposes they are not a single family unit – but see below.
- ◆ Separate and Unequal – Second-Class Status – but see below.
- ◆ However, in a recent *letter* the Office of Chief Counsel held that if a civil union was treated by state law (in this case, Illinois) as the same as a marriage, then it would be treated as a marriage for Federal purposes.

# FEDERAL TAX LAW

- ◆ Federal Defense of Marriage Act
  - ◆ Passed in 1996
  - ◆ In determining the meaning of any Act of Congress, or any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word “marriage” means only a legal union between one man and one woman as husband and wife, and the word “spouse” refers only to a person of the opposite sex who is a husband or a wife.”

# President Obama Will Not Support DOMA

- ◆ On February 23, 2011 President Obama stated that he would no longer support DOMA as he believed it was a violation of the Equal Protection Clause under the Constitution.
- ◆ The Department of Justice on the same date sent a letter to the Honorable John A. Boehner, Speaker of the House, confirming that the Department of Justice would no longer defend DOMA based upon a denial of Equal Protection.



# 1<sup>st</sup> and 2<sup>nd</sup> Federal Court of Appeals Rules DOMA Unconstitutional

- ◆ In *Gill vs. OPM*, a 3 Judge panel in the 1st Circuit Court of Appeals in Boston in May of 2012 held that Section 3 of DOMA unconstitutional under the equal protection clause by denying federal benefits to legally married same sex couples. The court did not address whether other states have to recognize the same sex marriages.

# 1<sup>st</sup> and 2<sup>nd</sup> Federal Court of Appeals Rules DOMA Unconstitutional

- ◆ The Second Circuit has in October of 2012 in *Windsor v. USA*, striking down Section 3 of the Defense of Marriage Act (DOMA) as unconstitutional.
- ◆ Edith Windsor is an 83-year-old widow who lost her wife in 2009 and was subsequently stuck with more than \$363,000 in estate taxes -- money she would not have had to pay if she were in a heterosexual marriage. She challenged Section 3 of DOMA, which limits federal recognition of marriage only to opposite-sex marriages.

# DOMA RULED UNCONSTITUTIONAL

- ◆ **ON June 26, 2013, the Supreme Court in *United States v. Windsor*, 570 U.S. \_\_\_ (2013) (Docket No. 12-307) held that restricting U.S. federal interpretation of “marriage” and “spouse” to apply only to heterosexual unions, by Section 3 of DOMA, is unconstitutional under the Due Process Clause of the Fifth Amendment.**

# DOMA RULED UNCONSTITUTIONAL

- ◆ The Majority in a 5-4 decision held:
- ◆ DOMA's principal effect is to identify a subset of state-sanctioned marriages and make them unequal. The principal purpose is to impose inequality, not for other reasons like governmental efficiency... By this dynamic DOMA undermines both the public and private significance of state-sanctioned same-sex marriages; for it tells those couples, and all the world, that their otherwise valid marriages are unworthy of federal recognition. This places same-sex couples in an unstable position of being in a second-tier marriage. The differentiation demeans the couple, whose moral and sexual choices the Constitution protects, ... and whose relationship the State has sought to dignify. And it humiliates tens of thousands of children now being raised by same-sex couples. The law in question makes it even more difficult for the children to understand the integrity and closeness of their own family and its concord with other families in their community and in their daily lives. Under DOMA, same-sex married couples have their lives burdened, by reason of government decree, in visible and public ways. By its great reach, DOMA touches many aspects of married and family life, from the mundane to the profound. It prevents same-sex married couples from obtaining government healthcare benefits they would otherwise receive. ... It deprives them of the Bankruptcy Code's special protections for domestic-support obligations. ... It forces them to follow a complicated procedure to file their state and federal taxes jointly. ... It prohibits them from being buried together in veterans' cemeteries.

# DOMA RULED UNCONSTITUTIONAL

- ◆ For certain married couples, DOMA's unequal effects are even more serious. The federal penal code makes it a crime to "assaul[t], kidna[p], or murde[r] ... a member of the immediate family" of "a United States official, a United States judge, [or] a Federal law enforcement officer," ... with the intent to influence or retaliate against that official.... Although a "spouse" qualifies as a member of the officer's "immediate family," ... DOMA makes this protection inapplicable to same-sex spouses.

# DOMA RULED UNCONSTITUTIONAL

- ◆ The federal statute is invalid, for no legitimate purpose overcomes the purpose and effect to disparage and to injure those whom the State, by its marriage laws, sought to protect in personhood and dignity. By seeking to displace this protection and treating those persons as living in marriages less respected than others, the federal statute is in violation of the Fifth Amendment

# PROPOSITION 8

- ◆ *In Hollingsworth v. Perry (formerly Perry v. Brown and Perry V. Schwarzeneger)* 570 U.S. \_\_\_\_ (2013), the Supreme Court held that the official sponsors of California Proposition 8, a 2008 ballot initiative, did not have Article II standing to appeal an adverse decision when public officials refused to do so.
- ◆ Proposition 8 which had barred same sex marriages by an amendment to the California Constitution was immediately challenged after its passage in Federal Court by two same sex couples that wanted to get married.

# Proposition 8

- ◆ The U.S. District Court ruled that Proposition 8 violated the due process and equal protection clauses of the Fourteenth Amendment because there was no rational basis for refusing marriage licenses to same-sex couples.
- ◆ State of California did **not** appeal, but the proponents of Proposition 8 did. After asking the California Supreme Court whether they had standing and lost they appeal to the District Court and the Ninth Circuit, which again found that they lacked standing. They appealed to the Supreme Court and the Court found that they lacked legal standing under Article III of the U.S. Constitution and instructed the Ninth Circuit to dismiss the appeal.



# Proposition 8

- ◆ By dismissing the action, it left the original ruling of the District Court overturning Proposition 8 as the final ruling in the case.
- ◆ Following the Supreme Court's decision, on June 28, 2013, the Ninth Circuit panel dissolved its stay banning same sex marriages. The very same day the Plaintiffs in the case were married.

# Proposition 8

- ◆ On July 12, 2013 the proponents filed a petition with the California Supreme Court challenging the scope of the District Court's injunction and requested that all same sex marriages be halted. On July 15<sup>th</sup>, the Court denied the request and requested all sides to file their arguments. The case is still pending.

# What is the IRS Response to DOMA now?

- ◆ On June 27, 2013, the IRS issued a statement indicating that the agency “will be working with the Department of Treasury and Department of Justice, and ...will move swiftly to provide revised guidance in the near future.”
- ◆ Key issues:
  - ◆ Who is married for Federal Purposes?
  - ◆ There are over 1000 benefits that married couples are entitled to – how is the government going to deal with these benefits?
  - ◆ What are the tax planning opportunities?
  - ◆ Will RDP’s be deemed married?

# Who is Married Under Federal Law?

- ◆ What marriages count for federal purposes?
  - ◆ Should the federal government look to the place where the marriage occurred or where they are currently domiciled?
- ◆ Suppose a California couple gets married and moves to Georgia. Assume the California same sex marriage was valid, but Georgia does not recognize same sex couple marriages? Can the couple file a joint return? Can the couple divorce in Georgia? If the State tax return piggybacks on the Federal return and the State will not let the couple file a joint return, then what?

# Who is Married Under Federal Law?

- ◆ If Social Security is used as a guide, then if you are legally married in one State, you should be legally married for Federal purposes in all States.
- ◆ Social security laws provide that if you are legally married in your state of domicile at the time you apply for benefits, then you are sufficiently married to receive spousal benefits. If you later move to a state that does not recognize your marriage, there is nothing that will strip you of those spousal benefits.
- ◆ Will the IRS follow Rev Rul. 58-66? In that ruling it held that if a couple is married under common law of one state, and they

# Who is Married Under Federal Law

- ◆ Move to another state that does not recognize common law marriage, for federal purposes they will still be deemed married.

# Who is Married Under Federal Law?

- ◆ In *Cozen O’Conner, P.C., v. Jennifer J. Tobits, et. al.* Case 2:11-cv-0045-CDJ (USDC Pennsylvania, July 29, 2013), the court held the Winsor case requires a recognition of a valid Canadian same-sex marriage for purposes of benefits distribution pursuant to ERISA.
- ◆ Sarah Farley began working at the Cozen O’Connor law firm and participated in a Profit Sharing Plan (the Plan”). In 2006 Ms. Farley married Jean Tobits in Toronto, Canada, as authorized under Canadian law. Shortly after the marriage Farley died of cancer.

# Who is Married Under Federal Law

- ◆ Both the parents of Ms. Farley and her spouse applied for the Pre-Retirement Survivor Annuity after Ms. Farley's death. In response the Company applied for an interpleader. The Court held that the plan is subject to ERISA and that as a result of Windsor, the spouse is the person who is entitled to benefits. The court specifically held that Ms. Tobits was Ms. Farley's spouse, notwithstanding the fact that the State only recognizes Civil Unions and not marriages of same sex couples. The Court also held that ERISA preempted state law entirely and did not need to look to state law to define "spouse", which was denied in the plan. The plan participant died in 2010 – note the retroactive application of Windsor



# Who is Married Under Federal Law?

- ◆ On July 22, 2013 a Federal District Court in Ohio held in the the case of *James Obergefell, et. al. vs. John Kaisch*, Case 1:13-cv-00501-TSB (D.C. Ohio July 22, 2013) that the State of Ohio must recognize a valid marriage in another state with respect to same sex couples even if Ohio itself doesn't permit same sex marriages.
- ◆ Plaintiffs James Obergefell and John Arthur are male Cincinnati residents who had resided together for 20 years. Mr. Arthur was dying of ALS. Plaintiff's rented a plane, flew to Maryland and were married on the tarmac. They then flew back to Cincinnati.<sup>25</sup>

# Who is Married Under Federal Law

- ◆ The Ohio laws and Constitution expressly prohibit same sex marriages. Nonetheless the Court found that the law under Windsor violated the Equal Protection Clause and thus must fall. In addition they noted that Ohio, with the exception of same sex marriages, will recognize a valid marriage in another State even if it would not have been recognized had it occurred in Ohio. Ohio does not authorize marriages between first cousins. However, it will recognize those marriages if the marriage was performed in a jurisdiction where it is legal, such as Michigan or Georgia.

# Who is Married Under Federal Law

- ◆ The Plaintiffs in this case had wanted a Court order declaring the law forbidding recognition of legal same sex marriages from other states and requiring the Registrar of Ohio death certificates to declare Mr. Arthur as “married” and to record James Obergefell as his “surviving spouse” at the time of Mr. Arthur’s death. The Court determined that Plaintiff would be irreparably harmed and as “Scalia” predicted, would nullify State’s laws banning same sex marriages.

# Tax Implications Arising from Windsor

- ◆ As a result of the Supreme Court striking down DOMA, the tax practitioner should be aware to advise his clients of the following:
  - ◆ The couple may want to consider filing amended returns or protective refund claims. Will this be mandatory?
    - ◆ Costs involved and chance of audit.
  - ◆ Capital gains of one party can offset capital losses of other party.
  - ◆ Related party rule transactions are now in effect.
  - ◆ For those who had a schedule C and split income, it may be worth amending return to recover excess self-employment tax.

# Who is Not Married for Federal Purposes

- ◆ Windsor did NOT address whether domestic partnerships or civil unions are to be treated as spouses. Indeed if the IRS follows its prior policy of only recognizing marriages in those states where the civil union or domestic partnership is treated as a marriage, then in most instances, the taxpayers in question should err on the conservative side.
- ◆ In speaking with the Office of Chief Counsel, California Domestic Partnerships are not the same as a marriage under California law.

# Tax Implications Arising From Windsor

- ◆ Residents of same sex marriage states need to take the following steps:
  - ◆ If there is an ERISA plan in effect, determine who needs to revise the plan to show their spouse. There are also spousal rights under COBRA, HIPPA and FMLA.
  - ◆ Any imputation of additional taxes on the value of health benefits should stop.
  - ◆ You may want to send out a notice of the consequences of Windsor to your employees.
  - ◆ This applies to marriages and although in certain cases the IRS will deem a Civil Union to be a marriage, it may not be the same for other federal benefits.

# Tax Implications Arising From Windsor

- ◆ Employers who had previously “grossed up” employees to cover the costs of coverage for same-sex spouses should review their policies to adjust for changes in the federal tax treatment. In essence employers are no longer required to continue to withhold federal income tax and pay FICA taxes on the imputed amount. Employers may want to file protective claims for refunds pending IRS guidance. Remember the SOL is only 3 years

# Tax Implication Arising From Windsor

- ◆ Tax-free health coverage.
- ◆ Unlimited Marital deduction
- ◆ Use of the deceased spouse's unused exclusion by the surviving spouse.
- ◆ Use of favorable rule for IRA distributions.
- ◆ 1041 applies
- ◆ Alimony deductible
- ◆ Innocent Spouse now applicable.
- ◆ Although Windsor gave the taxpayer retroactive effect, it is unclear how the IRS will deal with the retroactivity in other areas of the tax law.



# Tax Implications Arising From Windsor

- ◆ The federal law definition of spouse will affect the following areas:
  - ◆ Spousal consent to payments to non-spouse beneficiary. Applies to 401(k) plans and all other tax qualified retirement plans.
  - ◆ Spousal right to a qualified joint and survivor annuity from a money purchase pension or a defined benefit plan. Does not apply to a 401(k) plan unless the plan offers a joint option.
  - ◆ Spousal consent to early payment of plan benefits. Look at the design of the plan.

# Tax Implications Arising From Windsor

- ◆ Somewhat more favorable rules for tax-free rollovers of plan distributions.
- ◆ Division of participant retirement benefits in a divorce or legal separation pursuant to a Qualified Domestic Relations Order (“QDRO”).
- ◆ Cobra coverage.
- ◆ Working fringe benefits
- ◆ Cafeteria Plan.
- ◆ Employee discounts
- ◆ No additional cost services

# Tax Implications Arising From Windsor

- ◆ Adoption assistance
- ◆ Dependent Care Assistance
- ◆ Tuition benefits provided by a University.
- ◆ On premises gym facilities.
- ◆ Retirement planning services.

# *POE V. SEABORN*

## 282 U.S. 101 (1930)

- ◆ State law determines property rights. See David L. Rice, *Protecting the Innocent*, Los Angeles Lawyer, Volume 28, No. 1 (March 2005).
- ◆ The Supreme Court was faced with the issue of whether community property belongs to the person who earned it or whether both parties have an undivided interest in the property. The case arose from the State of Washington which is a community property State. See also *U.S. v. Malcolm* 282 US 792 (1931).
- ◆ The Court held that the husband and wife were entitled to file separate returns, each reporting  $\frac{1}{2}$  of the income earned by the other spouse.
- ◆ Congress remedied this by allowing for the filing of joint returns.
- ◆ Joint Returns do not apply to same sex couples. Even if DOMA is ruled unconstitutional by the Court of Appeals, same sex couples will not be spouses if the state they reside in doesn't recognize marriage. In other words those states that only recognize civil unions and registered domestic partnerships still will not be deemed a "spouse" under the Code.

# Community Property Laws

- ◆ Community property is a marital property regime that originated in civil law jurisdictions and is now found in common law jurisdictions. It was inherited from Mexico's ganancial community system, which itself was inherited from Spanish law as well as French law. Not surprisingly most community property states are in the West.
- ◆ Law of Domicile determines whether community property laws apply.

# Community Property (continued)

- ◆ There are nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. In addition, Puerto Rico allows property to be owned as community property as does several Indian jurisdictions.
- ◆ Alaska is an opt-in community property state; property is separate property unless both parties agree to make it community property through a written agreement. It should be pointed out that IRS Publication form 555 dealing with community property does not apply to an election under Alaskan laws.

# Community Property (continued)

- ◆ The community property laws vary among the various states.
  - ◆ In general all property acquired during marriage, with the exception of inheritances and gifts are deemed community property, absent a prenuptial or post nuptial agreement. In essence property acquired during marriage is presumed to be community.
  - ◆ Property acquired prior to marriage, or by inheritance or gift is separate property. If separate property is sold or exchanged it remains separate property. For example, if stock is deemed separate property, than any shares acquired by reason of a stock split would remain separate property. In Idaho, Louisiana, Texas and Wisconsin, income from most separate property is deemed to be community property.

# Quasi- Community Property

Quasi-Community Property. If a couple acquires property in a non-community property state, the property may be deemed quasi-community property after moving to a community property state. Quasi community property is property acquired during marriage in a state that is not governed by community property, and later treated by the courts as community property due to a new domicile of the couple. Although state laws do vary, quasi-community property is treated as community property for divorce and inheritance purposes.



# Transmutation of Separate Property to Community Property

- ◆ Separate property can be transmuted to community property. In some states this can be as easily as commingling assets, while other states require a writing to do so.
- ◆ Community property can also be transmuted to separate property by way of a pre or post nuptial agreement, absent a fraudulent conveyance.

# OFFICE OF CHIEF COUNSEL

## MEMORANDUM 200608038

### 2/24/06

- ◆ Initially, the IRS ruled that regardless of the community property rules, Domestic Partners are not allowed to split any income earned by the other partner.
- ◆ Chief Counsel's office specifically held that the *Seaborn* case was not applicable to Domestic Partners as those cases always dealt with spouses and Domestic Partners are not married as defined by California law.

# OFFICE OF CHIEF COUNSEL MEMORANDUM 200608038 CONTINUED

- ◆ Although California granted community property rights to RDPs, for tax purposes, the California's tax laws provided that the person who earned the income would be taxed upon it.
- ◆ This led a number of commentators to question whether the granting of community property rights would be subject to either an estate or income tax.
- ◆ The IRS adopted California's same methodology for federal purposes and many commentators criticized the IRS for not following *Seaborn*, which provided that community property income should be equally divided between the parties.

# OFFICE OF CHIEF COUNSEL MEMORANDUM 200608038 CONTINUED

- ◆ The IRS's logic was totally flawed.
  - ◆ Since *Seaborn*, the Supreme Court enunciated two principles of federal income tax: (1) Ownership determines liability and (2) state law determines ownership.
  - ◆ The IRS totally disregarded *Seaborn* as the ruling implied that *Seaborn* only applied exclusively to heterosexual married couples, even though courts have previously held that these principles apply to other relationships. See *Teschner v. Commr*, 38 T.C. 1003 (1962) where the court held that lottery winnings could be split between a father and his daughter.

# CHIEF COUNSEL ADVICE

201021050

5/5/10

- ◆ In 2007, California amended the Domestic Partnership Act to provide that earned income is deemed to be community property.
- ◆ This Advice Memorandum (which is not binding law – See 26 U.S.C 6110(k)(3)) held that for years beginning after December 31, 2006, each partner of a Domestic Partnership must report one-half of the community income, whether it be compensation or income from community property.
- ◆ For tax years beginning before January 1, 2010, the domestic partners may, but are not required to file amended returns.

# CHIEF COUNSEL ADVICE

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5/5/10

- ◆ Although the IRS was finally beginning to follow the principles set forth in *Seaborn*, the reason it established for doing so was seriously flawed.
  - ◆ California had changed the tax laws to provide that partner in an RDP must report  $\frac{1}{2}$  of the community income.
  - ◆ Although California had indeed taxed earned income differently, that should have never affected the principles laid down in *Seaborn* that community income is owned  $\frac{1}{2}$  by each of the partners and thus should be reported by the partners as such on their Federal Income Tax Returns.

# CHIEF COUNSEL ADVICE

201021050

5/5/10

- ◆ *Seaborn* requires that all couples be treated equally for tax purposes and those with community property should be permitted to split their combined income in half for reporting income for federal tax purposes.

# IRS Publication 555

- ◆ IRS Publication 555 was published for registered domestic partners (RDPs) who are domiciled in Nevada, Washington, or California, or for individuals in California, who for state law purposes, are married to an individual of the same sex.
  - ◆ California RDPs attained these rights as of January 1, 2007.
  - ◆ Nevada RDPs attained them as of October 1, 2009.
  - ◆ Washington RDPs attained them as of June 12, 2008.
  - ◆ For RDPs prior to 2010, they can amend them providing the SOL is still open by each partner reporting  $\frac{1}{2}$  of the community income.



# Publication 555

- ◆ RDPs and individuals who are same sex couples and married under California law are not married for federal tax purposes. They can only file using single status or head of household, if they qualify.
- ◆ This publication was published in response to the IRS's view that RDPs who own community property must report their fair share of income and deductions on each of their separate tax returns.

# PRIVATE LETTER RULING

## 201021048

- ◆ Issue 1: Whether a taxpayer must report on his individual tax federal tax return one-half of the combined income that Taxpayer and Domestic Partner earn from the performance of personal services and one-half of the combined income derived from their community property assets?
- ◆ Yes. In 2007 California had extended full community property treatment to RDPs. Consequently, Taxpayer, a registered domestic partner in California, must report  $\frac{1}{2}$  of the community income whether received in the form of compensation for personal services or income from property on his federal tax return.

# PRIVATE LETTER RULING

## 201021048

- ◆ Issue 2: Whether Taxpayer is entitled to  $\frac{1}{2}$  of the credits for income tax withholding from the wages of Taxpayer and Domestic Partner?
- ◆ Because Taxpayer is the recipient of  $\frac{1}{2}$  of the community income, Taxpayer is entitled to  $\frac{1}{2}$  of the amount allowed as a credit against the income tax imposed on the income.

# PRIVATE LETTER RULING

## 201021048

- ◆ Whether the requirements under California law, effective January 1, 2007, to treat, for state property law and income tax purposes, Taxpayer's earnings as community property, and thus half of Taxpayer's earnings as vested in his or her partner, results in a transfer of property by Taxpayer to his partner for federal gift tax purposes?
- ◆ The requirements under California law to treat the Taxpayer's earnings as community property, and thus half of Taxpayer's earnings as vested in his or her partner, does not result in a transfer of property by Taxpayer to his partner for federal gift tax purposes, but by operation of law.

# Reporting of Community Income for Federal Purposes

- ◆ How do RDPs or Same Sex Couples report gross income?
- ◆ Both same sex couples and RDPS must each report  $\frac{1}{2}$  of the couple's community income plus all of their separate income.

# Reporting of Community Income for Federal Purposes

- ◆ Identifying Income

- ◆ Wages, earnings and profits – must be evenly split. Note on the Q&A published 9/16/2011, the IRS requires that each partner file a schedule C (or Schedule C-EZ) by reporting  $\frac{1}{2}$  of the income, deductions and net earnings. In addition, each RDP owes self-employment tax on  $\frac{1}{2}$  of the net earnings of the business.

# REPORTING OF COMMUNITY INCOME FOR FEDERAL PURPOSES

- ◆ The IRS's rationale is that IRC Section 1402(a)(5) only prohibits spouses from treating net earnings as community income for these purposes and not RDPs.
- ◆ However, it is the partner or spouse who earns the income. If the IRS wants to impose a self-employment tax it is in essence taxing the RDP or marriage as a partnership, which clearly it isn't, as the IRS defines a partnership as two or more individuals who enter into an agreement to make a profit.
- ◆ Clearly, this requires an immediate Congressional fix, as this was not the intent of Congress.

# Reporting of Community Income (continued)

- ◆ Dividends, interest and Rents. If these are items of CP under state law, they must be divided evenly. If SP, reported by the party who owns the property.
- ◆ Alimony received.  $\frac{1}{2}$  taxable by each RDP.
- ◆ Gains and losses – Based upon how the property is treated for state law purposes.
- ◆ Withdrawals from IRAs and Coverdell Education Accounts – Treated as separate property based on the name on the account.
- ◆ Pensions – Based upon the respective periods of participation while married or while an RDP.



# Reporting of Community Income for Federal Purposes

- ◆ Lump sum distributions – If you qualify (must have been born prior to January 2, 1936), it is treated as SP.
- ◆ Civil Service Retirement – CP laws apply to annuities payable under the Civil Service Retirement Act., to the extent it was earned while the CP laws applied. If both CP and SP, must allocate.
- ◆ Military retirement Pay – Look to state law for characterization.
- ◆ Partnership income – if active income, then it is CP. If passive, then look to the character of the underlying partnership interest.

# Reporting of Community Income for Federal Purposes

- ◆ Tax Exempt Income – If CP, generally retains its status. For example, on the foreign income exclusion, must remain out of the U.S. for 330 days during any 12 month consecutive period. If this is CP, it is still treated as CP to the RPD (or spouse) even if they don't qualify for the exemption.
- ◆ Income from Separate Property. Property is treated as separate if domiciled in the following states: Washington, Nevada, Arizona, California and New Mexico. Treated as community income in Idaho, Louisiana, Wisconsin and Texas.

# Reporting of Community Income for Federal Purposes

- ◆ Social Security – Up for grabs.
  - ◆ Arguable that it is CP, since it was received during marriage. Moreover, in *Fleming vs. U.S.*, 363 U.S. 603, the Supreme Court held that the right to receive social security benefits does not constitute property. Hence, any payments made into the system should not confer any property rights, albeit, SP or CP.

# Reporting of Community Income (continued)

- ◆ Social Security (continued)

- ◆ It is also possible to contend that they are SP based on the following:

- ◆ The IRS punts and states that the taxpayer should look to state law. There virtually is almost no state law in this area. For divorce purposes, California has ruled that Social Security is not community property. See *Marriage of Hillerman*, 109 Cal. App. 3d 334 (1980). However, that might be solely based upon the argument that those monies were not received during marriage and there is no vested rights to those monies at any point in time.
- ◆ Although the Court has not considered whether State law may pre-empt Federal Law on social security, it has held that most federal benefits with anti-alienation provisions are SP. See *Mansel vs. Mansel*, 490 U.S. 581 (1989) and *McCarty vs. McCarty*, 453 U.S. 210 (1981). Social Security has anti-alienation provisions and most state cases involving dissolution of marriages has held that said benefits are SP. See: <http://www.divorcesupport.com/divorce/Classification-of-Social-Security-as-Marital-3150.html>.

# Exemptions for Same Sex Couples

## ◆ Dependency Deductions

- ◆ An RDP can be a dependent of his or her partner providing that the requirements of Sections 151 and 152 are met. Most will fail due to the gross income test, as the dependent's taxable income must be less than the exemption amount (\$3650 for 2010). If they are governed by CP, then note the splitting of income requirement. Also the RDP must provide more than  $\frac{1}{2}$  of the support of the other RDP. If an RDP is not a dependent, certain tax benefits, such as health insurance for the nonworking RDP are subject to tax.
- ◆ Child dependency exemptions – Can be divided up between the parents. If no parent is involved, then the person taking the deduction must have a higher adjusted gross income than the parent.

# Reporting of CP Deductions

- ◆ Deductions

- ◆ Business and Investment – If CP, each RDP or spouse reports  $\frac{1}{2}$ . If SP, then reported by the spouse who earned it or owns it as SP.
- ◆ Alimony Paid. If paid from community funds it should be divided evenly based on *Seaborn*; however, if it is not the obligation of the other RDP, what is the basis for taking it? Publication 555 doesn't address this, probably because an RDP or same sex spouse would not be entitled to a deduction for alimony paid to his or her former RDP or same sex spouse. But what if the RDP or spouse was formerly married to an opposite sex partner? Also see *Commissioner v. Newcombe*, 203 F.2d 128 (1953) where the court held that the husband's payment of alimony out of community funds should take the same approach as in *Seaborn* and split the deduction evenly.

# Reporting of CP Deductions

- ◆ IRA Deduction – Deductible by the person making it without regard to CP laws.
- ◆ Personal Expenditures – If paid from SP, deductible by the RDP or spouse who paid it; otherwise it has to be split under the CP rules.
- ◆ Itemized deductions. Since an RDP or a same sex couple is not deemed to be a spouse under the IRC, unlike married opposite sex couples, one party may itemize and the other party take a standard deduction.

# Electing Head of Household Status

- ◆ In order to claim Head of Household status, the person claiming it must be unmarried, provide more than  $\frac{1}{2}$  of the costs of maintaining the household and the household must be the principal abode of the dependent for more than half of the taxable year. If each RPD or same sex spouse pays  $\frac{1}{2}$  the costs of the household from community funds, each partner is considered to have incurred half the cost and neither can qualify as Head of Household. However, if one of the partners pays more than half by contributing separate funds, that partner may qualify for Head of Household status.



# Electing Head of Household (continued)

- ◆ Note that a dependent is a qualifying child as defined under IRC Section 152 which is a child of the taxpayer or a descendant of such child, or a brother or sister, or stepbrother or stepsister or a descendant of any such relative. If the RDP with the separate property is not the parent of the child, then that RDP may not qualify for head of household status due to the relationship test as the child is the qualifying child of the parent RDP and the qualifying child always takes precedence over a qualifying relative.

# Various Tax Credits

- ◆ Are CP laws taken into account in determining earned income for purposes of the dependent care credit, the refundable portion of the child tax credit, the earned income credit and the making working pay credit?
- ◆ No. The federal laws governing these credits specifically provide that earned income is computed without regard to CP laws in determining the earned income amounts for the aforementioned credits. However, the CP laws are taken into effect in determining AGI or modified AGI amounts for such credits.
- ◆ But CP laws are taken into account in determining AGI or MAGI for purposes of determining these credits.

# Adoption Credits

- ◆ Must be incurred or paid in connection with a qualified adoption. Maximum amount that can be deducted is \$12,970 per child in 2013. If two RDPS each pay the expenses they will need to split the \$12,970 in any manner they can agree.
- ◆ If an RDP or same sex spouse adopts the child of his or her partner or spouse, then he or she is entitled to the adoption credit. The limitation in section 36C(d)(1)(C) does not apply to adoptions by RDPs because RDPS or each spouse in a same sex marriage are not spouses as defined by federal law.

# Division of Tax Withholding and Estimated Payments

- ◆ Each RDP is entitled to  $\frac{1}{2}$  of the withholding shown on the W-2.
- ◆ However, when it comes to each estimated payment, an RDP or same sex spouse is only entitled to the credit he or she paid.

# Section 66 and 469

- ◆ Section 66 does not apply to RDPs or same sex couples.
- ◆ IRC Section 469(i)(5) does not apply for RDPs or same sex couples. Thus, you cannot add the hours worked by either your partner or spouse to your hours for purposes of meeting the 500 hour test with respect to determining whether you have an active versus passive activity.

# Preparation of 1040

- ◆ RDPs should report wages, other income items and deductions according to the instructions to Form 1040. In addition, RDPs should attach the Allocation Worksheet in Table 2 of Publication 555 to their separate returns showing how the partners computed the income, deductions and federal income tax withholding that each reported. Each partner should write the social security number of the other partner in the “Notes” section of the worksheet. If no worksheet is attached, then the other partner’s W-2 or 1099-R must be attached and should show by notation the division of income and withholding.
  - ◆ How do you E-File with the Allocation Worksheet for 2010 and earlier years?
  - ◆ Mark on top of return “Pursuant to CCA 201021050”
  - ◆ Include Power of Attorney
  - ◆ If filing a joint return on basis DOMA is unconstitutional attach IRS form 8275.
  - ◆ If filing a separate return, you may want to preserve your clients’ rights by footnoting the fact that the taxpayer is legally married under the State of \_\_\_\_\_ and is hereby electing to preserve the right to file a joint return should DOMA be stricken as unconstitutional.
  - ◆ File a protective claim for refund.

# WHAT ARE THE TAX CONSEQUENCES OF A PROPERTY DIVISION WITH RESPECT TO A RDP?

- ◆ Internal Revenue Code 1041 is inapplicable to RDPs and the pre-Davis rules apply.
- ◆ In *Davis vs. U.S.*, 370 U.S. 365 (1962) pursuant to a property settlement agreement executed prior to divorce, a Delaware taxpayer transferred to his wife shares of stock having at the time a market value of \$ 82,250, the taxpayer's cost basis for the stock being \$ 74,775.37. He also paid \$ 5,000 for tax advice in relation to the property settlement, one-half of which went to his wife's attorney. The question presented to the court was whether the transaction was taxable to the husband. The Supreme Court affirmed the lower courts rulings and held that the Taxpayer's use of separate property to satisfy the wife's release of all marital rights against his estate was a taxable event to the extent that the taxpayer used appreciated property to make an equalizing payment. The wife's release of rights was equal to the value of the property received and hence, not tax.

# WHAT ARE THE TAX CONSEQUENCES OF A PROPERTY DIVISION WITH RESPECT TO A RDP?

- ◆ Because of the disparity between separate and community property states, Congress enacted IRC Section 1041 which provides that property divisions between spouses are tax free. But a Domestic Partner is not a spouse, hence 1041 does not apply.
- ◆ The attorney's fees were not deductible, but as a side note they may in part be capitalized and added to basis. See also Rev. Rul. 67-221, 1967 2 C.B. 63.
- ◆ Do not use separate property to make an equalizing payment for community property as it may very well constitute a taxable transaction.



# WHAT ARE THE TAX CONSEQUENCES OF A PROPERTY DIVISION WITH RESPECT TO A RDP?

- ◆ Under Revenue Ruling 68-379, 1968-2 C.B. 414, the release of support rights by a spouse constitutes consideration in money or money's worth and thus there would only be a gift to the extent the value of property exceeded those rights. Hence, to the extent it is reasonable, classify property transfers as a release of support rights. However, be aware that the IRS may assert that the payments constitute compensation. But doesn't State law give RDP and same sex couples similar rights to property on dissolution?

# Gift vs. Compensation

- ◆ The taxpayer has the burden of proving that the IRS is wrong.
- ◆ Gifts vs. Compensation: To be considered a gift by the transferor, it must be the result of a disinterested and detached generosity, motivated by love, affection, charity or the like, with the donor's intent being most critical. On the other hand, it will be deemed compensation if there is any moral or legal duty attached with the payment. In other words was the payment made for an economic benefit flowing to the payor?

# Gifts vs. Compensation

- ◆ Case examples:

- ◆ In *Starks v. Commissioner*, T.C. Memo 1966-134, a 55 year old man gave his girlfriend who was 24, a home, money, jewelry and had her living expenses paid for. The IRS assessed tax claiming it was for services rendered. The boyfriend contended that the payments were made to ensure companionship and the Court held that the payments were deemed gifts.
- ◆ In *Reis v. Commissioner*, T.C. Memo 1974-287, the taxpayer was a nightclub dancer and her male friend was quite a bit older than her. During the ensuing 5 years she would meet her new boyfriend at the nightclub every Tuesday and on every Wednesday they would get together in the afternoon for a few hours. He paid her living expenses, provided her with an apartment and a living allowance of \$200 a week. The tax court held that it was a gift notwithstanding her statement that she “earned every penny”.

# Gifts vs. Compensation

- ◆ Case examples (continued)

- ◆ In *Green v. Commissioner*, T.C. Memo 1987-503, the girlfriend sued the estate contending that her boyfriend had promised to leave her everything when he died. She convinced the Court that she indeed had performed her part of the bargain and that the decedent had reneged on his part. The Court differentiated the other cases on the basis that based on the lawsuit, Green had a compensatory arrangement with the decedent.
- ◆ In *Jones v. Commissioner*, T.C. Memo 1977-329, the Court held that when the girlfriend testified that the boyfriend “was getting his moneys worth”, it was taxable as compensation. The Court went further and held that the boyfriend did not make payments out of affection and detached and disinterested generosity...” as required by *Duberstein v. Commissioner*, 363 U.S. 278, 285 (1960).
- ◆ Finally, in *Austin v. Commissioner*, T.C. Memo 1985-22, the court held that some of the monies paid were for compensation and others were gifts. The Court found that all gifts made during the boyfriend’s life were gifts, but gifts made at death due to a lawsuit were for compensation.

# Example 1-2

- ◆ Fred and Jeff have filed for a RDP 5 years ago. Assume that they have \$500,000 in community property and they agreed to divide in half. Further assume that Fred agrees to pay Jeff support of \$3,000 a month for 2 years. What are the tax consequences? See Rev. Rul. 76-83, 1976-1 C.B. 213; Rev. Rul. 81-292, 1981-2 C.B. 158; Patricia A. Hughes, *Tax Effects of Equitable Distribution Property Transfers*, *The Tax Lawyer*, 35 Tax Law 199.
- ◆ Suppose instead Fred just pays Jeff \$300,000. What are the potential tax consequences? See *Violet A. Reynolds v. Commissioner of Internal Revenue*, T.C. Memo 1999-62; *Gould v. Gould*, 245 U.S. 151 (1917); but the FTB and the IRS have informally said that they will take the position it is taxable under *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). But what about Rev. Rul. 1968-379, 1968-2 C.B. 414 where the IRS held that the giving up of support rights in a legal separation in exchange for property is a nontaxable event.

# Example 3

- ◆ Assume that Mary and Jane own a house as community property and the equity in the property is \$200,000. Assume further that there are no other community assets. What are the tax consequences if Mary buys Jane out with her separate property? What happens if the parties refinance the property and Mary gives Jane the \$200,000? See IRC Section 121.

# Qualified Pension Plans

- ◆ Qualified Pension Plans, such as Pension and Profit sharing plans, 401Ks, etc., are governed by ERISA and under California law to the extent that treating a Domestic Partner as a spouse would otherwise disqualify the plan, the rights of the RDP under California will not be respected. In general, these plans are divided in a marriage through the use of a Qualified Domestic Relation Order (“QDRO”). However, a Domestic Partner is not deemed a spouse under the IRC and hence a QDRO will not work. For Federal purposes the Domestic Partner does not have any rights to obtain the benefits or be named as a beneficiary of these types of plans. Note that some state government programs such as 403(b) plans may be exempt from ERISA.

# IRA'S, ROTH IRA'S, COVELL SAVINGS ACCOUNTS

- ◆ An RDP will not be treated as a spouse where such treatment would result in a tax-favored account, such as a Individual Retirement Account (IRA), Roth IRA, Coverdell Education Savings Account (ESA), Archer Medical Savings Account (MSA), or IRC Section 529 plan (Qualified Tuition Program), no longer are being qualified as a tax-favored account for federal purposes.



# IRA'S, ROTH IRAS, COVERELL SAVINGS ACCOUNTS

- ◆ For example, under federal law, the beneficiary of a Coverdell ESA may transfer the remaining balance in an ESA to a new beneficiary. This new beneficiary must be “a member of the family,” which is defined broadly to include the following relatives of the original beneficiary: spouse, child, brother, sister, stepbrother, stepsister, stepfather, stepmother, etc because federal law does not recognize an RDP as a spouse, the transfer of the balance in an ESA to a taxpayer’s RDP or an RDP’s child would result in the Coverdell ESA no longer being treated as a qualified tax-favored account for federal income tax purposes Instead, the change in beneficiary would be considered a non-qualified distribution from the tax-favored account subject to additional tax of 10% for federal tax purposes and 2.5 % for California, **Therefore, for California purposes, an RDP would not be treated as a spouse for purposes of changing the beneficiary of a Coverdell ESA.**

# IRA'S, ROTH IRAS, COVELL SAVINGS ACCOUNTS

- ◆ In the event of a distribution from an IRA, Roth IRA, or other tax-favored account, because federal law does not recognize RDPs, a taxpayer whose RDP or RDP's child receives distributions from the taxpayer's IRA, Roth IRA, or other tax-favored account, may incur additional tax penalties for federal income tax purposes, but not for California income tax purposes. Federal law could impose a 10% penalty while the 2.5% penalty under the California Revenue and Taxation Code would be waived.

# COMMUNITY PROPERTY RIGHTS IN PENSION PLANS – THE TAX QUAGMIRE

- ◆ Earnings during partnership are community property by definition, and there is no statutory exception for federally-sponsored retirement benefits.
- ◆ QDROS cannot be used.
- ◆ If the plan is an ERISA plan then it cannot be transferred due to anti-alienation clauses.
- ◆ However, the law still is not clear whether federal pre-emption applies to ownership. In other words the law is clear that the benefits must be paid to the beneficiary of the plan, but query whether the same sex partner or spouse can bring an action in state court to assert her or his community property rights. See *Alcorn v. Appleton*, 708 S.E.2d 390 (Ga. 2011). The husband died prior to the finalization of the divorce and the wife was paid the proceeds from the retirement plan notwithstanding the fact that the daughter had been named the beneficiary. The Court allowed the daughter to bring suit to recover the benefits because State law recognized the rights of the daughter.

# COMMUNITY PROPERTY RIGHTS IN PENSION PLANS – THE TAX QUAGMIRE

## ◆ GILLMORE RIGHTS

- ◆ Once pension benefits vest, a court cannot, over the objection of the non-employee spouse, defer receipt of his or her rights to community benefits until the spouse actually retires. *Marriage of Gilmore* (1981) 29 Cal. 3d 418, 424-425.
- ◆ However, be aware of the holding in *Commission v. Dunkin*, (2007) 500 F. 3d 1065, which could potentially lead to double taxation. In *Dunkin*, the husband worked for the Los Angeles Police Department for 27 years and was entitled to a pension for life. The earnings in the pension were community income and were vested. As part of the division of community property the wife was awarded part of the pension. Note that the court could have computed the present value of the pension rights and awarded the wife a distribution of other community property, but in the case in question the court didn't do that. The Court did enter a QDRO order for a division of benefits after the husband retired. The wife demanded her share immediately, and the husband paid to the wife out of his salary her share of the monthly pension benefit which was just a little over \$2000 a month. The 9<sup>th</sup> Circuit in a split decision held that the wages of the husband were his separate property which he was using to satisfy his obligation to his wife and hence taxable to him. Since it was not alimony, he was not otherwise entitled to a deduction. Query – Will the husband at least get to add any payments to basis in his pension plan?

# IS MARRIAGE AN INCOME TAX DISASTER?

- ◆ Loss of Dependency Deduction
- ◆ Sale of Home - IRC 121 Exemption
- ◆ Related Party Issues - Planning opportunities – Federal Only– But note Economic Substance Doctrine
- ◆ Interest Deduction on Homes
- ◆ Various Tax Credits
- ◆ Splitting of Income
- ◆ No “Innocent Spouse” or “Abandoned Spouse” or IRC Section 66 Defenses
- ◆ Federal – No Joint Return

# Alimony

- ◆ For Federal purposes, alimony is not deductible for the payor nor is it includible in the income of the payee with respect to RDPs.
- ◆ With DOMA being in question, the language in the Property Settlement Agreement should be drafted very carefully.
  - ◆ “Both Parties to the Agreement understand and agree that the tax consequences of an alimony payment under Federal law are unclear and are likely to be denied treatment under IRC Section 71, which provides for deductibility by the payor and includible in the income of the payee. Because the tax consequences are potentially burdensome to both parties, it is agreed that support will be adjusted as follows to take into account any tax consequences: \_\_\_\_\_.”
  - ◆ One possibility might be to share the tax burden.

# Example 4 - 7

- ◆ What if the Domestic Partner files a schedule C and fails to pay any estimated tax? Note that estimated payments cannot be split.
- ◆ Suppose Mary is a tax deadbeat and has not filed for 6 years. Mary and Jane want to enter into a RDP. What advice should you give them?
- ◆ Assume Mary and Jane have been an RDP since 2005 filing separate returns for federal purposes. Jane is under audit for having invested in a tax shelter in 2008 and the IRS is proposing to assess her for taxes in the amount of \$150,000 and a listed transaction penalty in the amount of \$100,000. Assume they each filed separate returns but Jane has no separate or community property but Mary has just sold a book for a \$1.5M that she wrote during the last two years. What can the parties do, if anything?
- ◆ Would your answer change if Mary had inherited the \$1.5M from her mother?

# Example 8 - 10

- ◆ Suppose Fred and Jeff decide in 2010 to amend their returns back to 2007 for Federal purposes and each split the income from each other. Shortly thereafter Jeff is audited and is assessed an additional \$50,000 in income for 2007. What can Fred do to protect himself?
- ◆ Suppose Fred and Jeff entered into a RDP in 2005. Further assume that Fred is the bread winner for the family and Jeff is the stay at home domestic partner. Fred has always claimed Jeff as a dependent since 2005. Can he do so in 2010 and if not, what are the consequences?
- ◆ Suppose Fred and Jeff are now on extension and pursuant to the recent Chief Counsel's Memorandum are going to split income. Assume that Jeff is self employed and has filed estimated tax payments. If Fred is suppose to include  $\frac{1}{2}$  of Jeff's income, he will still owe an additional \$25,000 in tax. What should you advise them about penalties?



# ESTATE PLANNING ISSUES AND TECHNIQUES

- ◆ A. Conflict of Interest Issues and Lack of Attorney Client Privilege
- ◆ Types of Agreements to Set Forth the Understanding of Partners
  - ◆ Cohabitation Agreements
  - ◆ Pre and Post Nuptial/Relationship Agreements
  - ◆ Domestic Partnership Agreements
  - ◆ Joint Ownership

# ESTATE PLANNING TOOLS

- ◆ Advanced Health Care Directive/Hippa Release
- ◆ Wills
- ◆ Revocable Living Trusts
- ◆ Durable Powers of Attorney

# TITLE HOLDING TO PROPERTY

- ◆ Community Property
- ◆ Joint Tenancy
- ◆ Pay on Death Accounts and Totten Trusts
- ◆ Revocable Trust

# ADVANCED ESTATE PLANNING TECHNIQUES

- ◆ Charitable Trusts
- ◆ Grantor Retained Income Trusts
- ◆ Qualified Personal Residence Trusts
- ◆ Life Insurance Trust
- ◆ Fractional Discounts - LLC

# MISCELLANEOUS ESTATE PLANNING ISSUES

- ◆ Estate and Generation Skipping Taxes
- ◆ Gift Taxes and Form 709
- ◆ Property Taxes
- ◆ Medical Issues
- ◆ Miscellaneous Issues to Consider Before Registering as a Domestic Partnership

# TAXATION OF DOMESTIC PARTNERS

David L. Rice, J.D., L.L.M.  
Professor of Accounting,  
California State Polytechnic University, Pomona  
David Lee Rice, A.P.L.C.  
2780 Skypark Drive, Suite 475  
Torrance, California 90505  
(Telephone) 310-517-8600 (Fax) 310-517-8606

[www.lawrice.com](http://www.lawrice.com)