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Tax Issues for the Non-traditional Couple

By Terrence Benshoof and Raiford D. Palmer

This article attempts to summarize, for the family law and estate planning practitioner, key federal income, gift and estate tax issues faced by unmarried opposite-sex couples, as well as married same-sex couples. This article refers to these couples

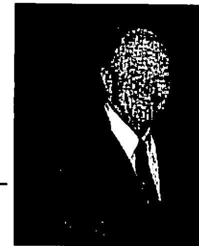
"The key concept for NTC partners is that under current law, in all cases, if required to file an income tax return, they must (each) file a single return and cannot file jointly."

as "nontraditional couples" or "NTCs." The parties to an NTC are referred to as "partners" for clarity. This article should not be considered a comprehensive review on this topic, but rather a review and a handy guide for the major issues facing these couples.

United States tax law began very early in the nation's history, with a patchwork quilt of taxes for various transactions. The first federal income tax was instituted in 1913 with a 1% tax on income at the lowest bracket and with the highest bracket at 7%. The Internal Revenue Code was first passed as a unified code in 1939.[1]

Federal law presently treats all unmarried people, as well as married same-sex couples, in the same manner for tax purposes. The Defense of Marriage Act, (the "Act") was enacted on September 21, 1996.[2] The Act applies to any statute or regulation promulgated by Congress or the United States government, including the Internal Revenue Code (the "Code"). The Act specifically rules out same-sex relationships as "married" for purposes of the Code, including those sanctioned by local law.[3] The Code, as modified by the Act, therefore permits only opposite-sex married couples (and certain common law married couples) to take joint-filing or double deduction tax positions.

Given current law, what are the key tax issues facing the NTC during a relationship, when the relationship dissolves, or at death of one of the parties? A thorough and complete examination of the Code, regulations and case law would require much more detail than this article allows. However, a review of major provisions is useful for the family law practitioner and estate planner. The following explains common tax issues for the NTC.



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PARTNERS MUST FILE AS SINGLE PERSONS

The key concept for NTC partners is that under current law, in all cases, if required to file an income tax return, they must each file a single return and cannot file jointly. Even if the partners are married pursuant to local or state law, the Code requires they file as individuals. They may not file married – neither jointly nor married filing separately. However, unlike the traditional married couple, each can take a full standard deduction. If applicable, each NTC party could take itemized deductions, without the limitations of the "married filing separately" status. Also, the "floors" for medical, casualty, and miscellaneous deductions are based on each individual's adjusted gross income, not on that of the combined level of the partners.

STANDARD DEDUCTION

Assuming partners want to take the standard deduction, if each NTC partner files a return, each is entitled to the $5,450 standard deduction, which is half of the $10,900 standard deduction

currently allowed to married joint filers.[4]

DEPENDENCY EXEMPTIONS

One advantage of the NTC is the personal exemption, currently $3,500.00 for each taxpayer.[5] Both partners may claim the full personal exemption if one is not claimed as the dependent of the other.[6] The exemptions phase out for single filers at $159,950 of adjusted gross income (AGI), and for married-joint filers at $239,950, so there are some benefits accruing to the NTC.[7]

The NTC taxpayer may be able to claim the other partner as a dependent, member of household. The applicable test is whether the dependent is a "qualifying relative"- a non-child[8], with a gross income under $3,500.00[9], who receives over half his or her support from the tax-payer during the calendar year, and whose principal abode is the taxpayer's home.[10] To qualify, the dependent partner must have gross income below $3,500.00 and the taxpayer partner must provide more than half of the dependent partner's total support during the calendar year. If the income and support tests are not met, both parties would have to file single returns. In that case, each partner could claim a full standard deduction.[11]

There are several caveats. If the relationship violates state or local law (e.g. living with a partner who is already married to someone else) a dependent exemption cannot be claimed.[12] Similarly, there is no dependency exemption allowed if local law makes cohabitation illegal.[13] A dependency exemption is not allowed for a common-law spouse if the state requirements for that status are not met.[14] But the dependency exemption is allowed where there is no violation.[15] In a private-letter ruling, the IRS specifically determined that a dependency exemption will be allowed for same-sex relationships, whether partners or children, as long as the tests of IRC §152 are met.[16]

DEDUCTIONS

Since NTC are treated as single individuals, they cannot combine deductions like a married opposite-sex couple. They also cannot claim deductions for expenses paid by their partner. Married couples filing jointly may combine itemized deductions. They also may offset income due to investment or business losses of the other spouse, a benefit unavailable to NTCs. The rules concerning division of dependency deduction claims would likely apply for any children who might be claimed as dependents. Either partner who provides over half the support of the dependent child could claim the deduction, or it might be alternately claimed by the partners from year to year.

HEALTH AND LIFE INSURANCE BENEFITS

Since NTCs are unmarried in terms of Code treatment, health insurance benefits paid by one partner's employer to the other in excess of the cost of the premiums under a domestic partner benefit plan are taxable income to the employee.[17] In addition, premiums for the recipient partner are paid by the employee partner with after-tax dollars. There is a similar problem with employer-provided life insurance – if the employee partner obtains group life insurance coverage for the other partner, the cost of the coverage is taxable income for the employee. In contrast, for opposite-sex married couples, only life insurance premiums for policies provided to spouses above the first $50,000.00 are generally taxable as income.[18]

TRANSFERS OF PROPERTY BETWEEN PARTNERS

The right of married spouses to transfer property between themselves tax-free[19] does not extend to NTCs. That is, a traditionally married spouse may transfer title of a home to the other spouse, or add that person onto title, with no taxable effect during the marriage. This is not so for partners in an NTC, however. For example, if one of the partners adds the other to the title to real estate, to secure a refinance for example, they will likely trigger tax liability, as the recipient has now gained an interest in the other's asset. Even a joint purchase with uneven contributions to jointly owned property may trigger tax liability.[20] For example, if one partner pays $200,000, and the other pays $300,000 for a jointly-owned $500,000 home, the IRS will likely find that the partner paying $200,000 received a $50,000 gift.

TRANSFERS OF PROPERTY INCIDENT TO DIVORCE/ PARTNER BREAK-UP

Opposite-sex married couples currently have a significant advantage over NTCs in the event of divorce: property transfers related to the divorce are generally tax free.[21] The Supreme Court decided that lump-sum or periodic payment divisions of marital property were not taxable events under the Code.[22] But, of course, there cannot be marital property without a marriage. Because the Code does not recognize same-sex marriages, in the event of a breakup the NTC couple does not enjoy the benefit of similar tax-free property transfers. Therefore, should an NTC break up, even incident to a local- or state-sanctioned divorce,

transfers of property from one former NTC partner to the other can incur tax liability, just as if they were complete strangers.

SALE OF RESIDENCE

For an opposite-sex married couple, the Code generally provides for a tax-free transfer between spouses if the transfer is "incident to a divorce."[23] In fact, if the opposite-sex marriage were annulled or voided, the provisions of §1041(a) would still apply. For the NTC, there are, nonetheless, still some tax protections available in the event of a break-up. NTC co-owners of a residence may still utilize some exclusion from income per the Code.[24] The rules allowing a $250,000 exclusion on the sale of a principal residence apply, without regard to marital status.[25] The sale of vacant land adjacent to a principal residence is included for this purpose.[26] Also, the exclusion rules are generally applicable to co-owners.[27] There is even a safe-harbor provision, which provides for exclusion from gain on a short-term sale of a principal residence, which should logically also apply to NTCs, subject only to the reduced exclusion rules formula.[28]

PASSIVE ACTIVITY LOSSES

Passive activity losses ("PAL") are losses from business activities in which the taxpayer did not actively participate during the tax year, or losses from rental activity regardless of participation by the taxpayer.[29] The NTC has an advantage here, because each partner may deduct up to $25,000 in PAL (for example, losses related to real estate rentals) while the married joint filers are limited to the $25,000 combined PAL deduction.[30]

GIFTS

A traditional married couple, except in the case of gifts to a non-U.S. citizen spouse, have unlimited gift exemptions with respect to each other.[31] The scope is even broader for the estate tax, as the couple needs only to be validly married.[32] For the NTC, the options for inter-partner planning are consequently much more limited.

"However, the last thirty years have seen dramatic change in the social fabric of the United States."

With respect to gifts, each taxpayer is allowed to give $13,000.00 tax-free annually, as of 2009.[33] NTC partners do not have the benefit of the gift-splitting (doubling) provisions allowed to traditionally married couples,[34] so each would need to make a separate maximum gift from their own assets, unlike the single-earner traditional married couple. Also, transfers of property between NTC partners for less than fair market value would be considered gifts subject to the $13,000 exclusion.[35]

Interestingly, health care expenses paid by one partner for another appear to be considered as "gifts" by the Code.[36]

ESTATE TAX

The estate tax provides for taxation of property transferred to heirs incident to death. Again, the Act impacts the tax treatment for gifts and estate taxes related to NTCs, making knowledge of these issues important for estate and tax planning.

For estate tax purposes, the NTC is denied marital deductions, due to the prohibitions in the Act. As a result, a major tax avoidance device is lost to the NTC. In the event of death, each NTC partner is allowed the individual $3,500,000 estate tax exclusion for 2009, but does not receive the unlimited exclusion allowed to a traditional married couple.[37] (The estate tax will be repealed entirely in 2010, and unless Congress extends or modifies the Code, it will revert to a $1,000,000 individual exemption limit in 2011). Therefore, transfers of property upon death to an NTC partner will be subject to the estate tax, should the transferred property exceed this exempt amount. In 2011, assuming Congress takes no action regarding estate taxes, the $1,000,000 limit will affect a substantially higher number of NTC partners.

A word of caution – the gift tax exclusion lifetime limit is $1,000,000,[38] and the exclusion reduces the available estate tax exclusion amount at the time of death. This can be a serious problem for an NTC couple if one partner transfers substantial assets to the other during life, especially when one considers the many ways the less financially advantaged partner can receive "gifts" via transfers of real estate, below fair market transfers of property, receipt of health benefits, and so on.

To some extent, these difficulties can be overcome by judicious planning in the form of gifting and through the use of irrevocable trusts. But these methods are not without pitfalls, since a complete gift, whether outright or to an irrevocable trust, while having the effect of reducing the taxable estate, can only be tax-advantageous if done over a period of years, and cannot be pulled back in the event of the break-up of the relationship.

CONCLUSION

At present, federal law, and therefore the Internal Revenue Code, does not recognize same-sex marriages despite any potential state or local legal recognition. As such, any relationship not legally recognized locally or by state law (such as "common law" married couples living in a non-common law marriage state), or same-sex married couples, are treated as single persons for federal tax purposes. While there are methods available within the current Internal Revenue Code to minimize the tax burden of the non-traditional couple, and there are even some provisions which work to the NTC's advantage, overall the Code still favors the traditional opposite-sex married couple. Careful estate and tax planning can help minimize the effects of this situation.■

[1] 26 USC 1 *et seq.*
[2] 28 USC 1738(c).
[3] *Mueller v. Commissioner*, 90 AFTR 2d 2002-5309, 39 Fed. Appx. 437 (7th Cir. 2002), IRS Letter Rul. 200108010.
[4] IRS Publication 501 (2008), 22-24.
[5] IRC § 151(d); IRS Publication 501 (2008), 10.
[6] IRC § 151(d)(2); IRS Publication 501 (2008), 10.
[7] IRC § 151(d)(3); IRS Publication 501 (2008), 21.
[8] IRC § 152(a)(9).
[9] IRC § 151.
[10] IRS Publication 501 (2008), 15-20. *See also* Domestic Partner Dependency Chart, Figure 1.
[11] IRC § 63(c)(2)(D).
[12] IRS Publication 501 (2008), 16.
[13] IRS Publication 501 (2008), 16. IRC § 152(b)(5). See also *Ensminger, Nevitt*, 1977 T.C.M. 1977-224, *aff'd.* 45 AFTR 2d 80-373, 610 F. 2d 189 (4th Cir. 1979).
[14] *Jim Nicholas*, 1991 T.C.M. ¶91393, 1991-393.
[15] *In re Mary Shackleford*, 45 AFTR 2d 80-1074, 80-1 USTC ¶9276 (Bk. Ct. Mo. 1980).
[16] IRS Letter Rul. 9850011.
[17] IRC § 61(a)(1).
[18] IRC § 79(a)(1).
[19] IRC § 1041(a)(1), IRS Publication 17 (2008), 100.
[20] IRC § 2512.
[21] IRC § 1041(a)(2),
[22] *United States v. Davis*, 370 U.S. 65 (1962), and *Lester v. Commissioner*, 366 U.S. 299 (1961).
[23] IRC § 1041(a)(2).
[24] IRC § 121(a).
[25] IRC § 121(b)(1).
[26] Treas. Reg. § 1.121-1(b)(3)(i).
[27] Treas. Reg. § 1.121-3(f)(3).
[28] Treas. Reg. § 1.121-3(e)(4), Ex.6; IRC §121(c)(1)(B)(i).
[29] IRC § 469, IRS Publication 925 (2007); See also IRS Instructions for Form 8582 (2008), 1.
[30] IRC § 469, IRS Publication 925 (2007); IRS Instructions for Form 8582 (2008).
[31] IRC § 2523. IRS Publication 950 (2008).
[32] IRC § 2056(a).
[33] IRC § 2503(b).
[34] IRC § 2013(a).
[35] IRS Pub. 950 (2008), 5-6.
[36] IRC § 2503(e)(2).
[37] 26 USC 2001, as amended by EGTRRA, the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. Law 107-16.
[38] EGTRRA, Pub. Law. 107-16, § 521(b).

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