6-1-2011

Planning for Same-Sex Couples in 2011

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Santa Clara University School of Law

Legal Studies Research Papers Series

Accepted Paper No. 14-11, June 2011

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A. Overview Of Recognition Versus Non-Recognition States

1. *States That Recognize Same-Sex Marriage.* Five states and the District of Columbia currently recognize same-sex marriages celebrated within their borders. California recognizes some same-sex marriages celebrated within its borders.

   a. Massachusetts—*see Goodridge v. Department of Public Health*, 798 N.E.2d 941 (Mass. 2003)

   b. Connecticut—*Kerrigan v. Comm'r of Public Health*, 957 A.2d 407 (Conn. 2008).

   c. Iowa—*Varnum v. Brien*, 763 N.W.2d 862 (Iowa 2009).

   d. New Hampshire—by statute.

   e. Vermont—by statute.

f. District of Columbia—by statute.

g. California—Approximately 18,000 same-sex couples were married in California between June 16, 2008, and midnight of November 4, 2008 (the date of the general election that passed Proposition 8 stating that "Only marriage between a man and a woman is valid or recognized in California."). California has also passed a statute, S.B. 54, that recognizes all valid marriages from other states post-November 4, 2008, as entitled to the same rights, privileges, and responsibilities of marriage, but not the name "marriage."

2. *States That Recognize Valid Foreign Same-Sex Marriages*

a. New York—Valid foreign marriages are recognized for most purposes, although not for state income tax purposes. There is no direct authority that covers recognition for state estate tax purposes.

b. New Jersey—Marriages have been recognized for purposes of divorce, but not for other purposes.

c. Maryland—The Attorney General issued an opinion in 2010 that valid out-of-state same-sex marriages should be recognized under Maryland law.

d. New Mexico—The Attorney General issued a recent opinion that New Mexico would recognize valid out-of-state same-sex marriages.

e. California—California recognizes valid out-of-state same-sex marriages that pre-date Proposition 8, November 4 (midnight), 2008.

3. *States That Recognize Spousal Equivalency*

a. New Jersey—civil unions.

b. California—registered domestic partnerships (includes rights to community property).

c. Oregon—domestic partnerships.

d. Washington—domestic partnerships (includes community property).

e. Nevada—domestic partnerships (includes community property).

f. Illinois—civil unions (effective June 1, 2011).

g. Hawaii—civil unions (effective January 1, 2012).

4. *States That Recognize Status, But Only Provide A Handful Of Rights And Obligations*

Hawaii	Reciprocal Beneficiaries Couples must opt for either civil union or reciprocal beneficiary	Created by legislature in 1997 in response to marriage case litigation Available for any two people who cannot marry and not just same-sex couples (for example, sisters can register) Limited rights, but does include inheritance and ability to own property as tenants by the entirety
Maine	Domestic Partnerships	Limited rights Enacted in 2004
Maryland	Domestic Partnerships	Limited rights (medical and taxation) Enacted in 2008 (effective 7/1/2008)
District of Columbia	Domestic Partnerships	First enacted in 1992, but not funded 2002—health benefits for government employees enacted Additional medical, inheritance, and similar rights have been added, most recently in 2008, bringing the status closer to full parity with marriage Status is retained even though DC now recognizes marriages
Colorado	Designated Beneficiary	Creates a central registry where a person can indicate a beneficiary (including different beneficiaries) for various types of rights
Wisconsin	Domestic Partnerships	Limited rights

5. *State Constitutional Amendments Banning Same-Sex Marriage*. Many states have adopted constitutional amendments regarding same-sex marriage. Some of these amendments (such as California's) ban only same-sex marriage; others (such as Georgia's) ban any sort of relations between same-sex couples.

    a. Hawaii was the first state to adopt a constitutional amendment. It was adopted in the midst of the state litigation over the right to marry. The amendment does not ban same-sex marriage. Rather, it leaves the definition up to the legislature.

    b. The chart below indicates how many states are restricted by constitutional amendments.

States that do not currently recognize marriage and are free to adopt marriage by legislative act (no constitution prohibition)	States that have constitutional amendments prohibiting marriage equality	States that have constitutional amendments prohibiting any recognition (for example, prohibiting RDPs and civil unions as well as marriage)
Delaware	Alaska	Alabama
Hawaii*	Arizona	Arkansas
Illinois	California	Florida
Indiana	Colorado	Georgia
Maine	Mississippi	Idaho
Maryland	Missouri	Kansas
Minnesota	Montana	Kentucky
New Jersey	Nevada	Louisiana
New Mexico	Oregon	Michigan
New York	Tennessee	Nebraska
North Carolina		North Dakota
Pennsylvania		Ohio
Rhode Island		Oklahoma
Washington		South Carolina
West Virginia		South Dakota
Wyoming		Texas
		Utah
*Hawaii has a constitutional provision but it does not ban marriage. It says that the legislature shall define marriage.		Virginia Wisconsin

B. Overview Of Types Of Problems That Arise Under Existing Law

1. *Non-Recognition States*. Most states do not recognize the status of same-sex couples no matter how committed they are. As a result, tax law treats such partners as strangers. This is not a true reflection of the reality of their lives. Applying tax rules that do not recognize the reality of the couple's property sharing and support for each creates both benefits and detriments. (For example, a two-earner couple,

filing as single or as single and head of household, avoids the marriage tax penalty, but is burdened by the estate and gift tax rules.)

2. *DOMA*. Under the Defense of Marriage Act, none of the Internal Revenue Code provisions that specifically reference "spouses" or "marriage" can be applied to same-sex couples. That puts all same-sex couples, even those recognized as married, in a disfavored position with respect to the following issues:

a. *No Marital Deduction For Gift Tax Purposes*

i. When one partner supports the other, the support may constitute a taxable gift, unless it qualifies as medical or educational payments under Internal Revenue Code §2503(e). (Unless otherwise indicated, all section references are to the Code.) Payment of support in states where the couple's status is recognized under state law and where state law imposes an obligation of support should not be treated as taxable gifts. This difference in tax treatment depending on state family law creates geographical inequities and bad tax policy.

ii. Partners often acquire the principal residence together and do not always contribute equally to the purchase price. To the extent that one partner contributes more than $26,000 of separate funds to the cost of a jointly owned residence (50/50 ownership), that partner is making a taxable gift. The gift tax can be avoided by careful planning and by drafting documents that make ownership in the jointly owned property proportionate to contributions. The need for extra legal work, however, imposes a burden on such couples. And, often, couples are not advised of the gift tax issues at the time of purchase or of adding a partner to the title.

b. *No Marital Deduction For Estate Tax Purposes*

i. Spouses can accumulate property jointly during their relationship without fear that upon an untimely death of the first spouse, the second spouse will have to liquidate some of their estate holdings to pay an estate tax. As a result of the unlimited marital deduction, the combined estate is not taxed until the death of the second spouse, thereby creating something like a tax on wealth when it passes to the next generation. For same-sex couples, a tax will be levied at the death of the first partner to the extent that partner's share of the estate exceeds the exemption amount ($5 million as of 2011).

ii. With proper estate planning, a same-sex couple can utilize bypass trusts to avoid a second estate tax at the death of the second partner. In such cases, the tax on the couple will similarly be levied only once at their generation.

iii. However, unlike with spouses, the tax will be levied at the death of the first to die, rather than at the death of the second to die. Although the $5 million exemption makes this a limited problem for other than the very wealthy, consider a wealthy same-sex married couple whose principal residence is the main asset and is valued at more than $10 million. Even after the exemption, the tax due on the home alone will be 35 percent of $5 million, or $1,750,000. That may seem a high price to pay to stay in the family home.

c. *Section 1041 Only Applies To Spouses And Ex-Spouses*

i. Section 1041 makes transfers incident to divorce non-taxable for spouses. But under DOMA, this section will not apply to same-sex spouses or similar couples. As a result, couples will be subjected to the same income tax rules that faced spouses before the passage of section 1041. If the pre-1041 rules are applied consistently, same-sex couples in community property states may be able to split their community estate free of income tax and gift tax (discussed in more detail below). Tax-free divisions may also be available for couples in non-community property states as long as their property divisions are basically equal divisions of property that was jointly owned during the relationship. But for couples in which one partner was the breadwinner and the other stayed home to take care of the children, a taxable event is likely in non-community property states (discussed in more detail below). Again, this creates a geographical inequity that seems inconsistent with a uniform tax rule throughout the country.

d. *Sections 71 And 215 (Alimony And Child Support) Only Apply To Spouses*

i. The first statutory provisions regarding taxation of support payments made incident to divorce were enacted in the 1940s. They have evolved over time into the current versions of sections 71 and 215. But these statutes, by their terms, only apply to spouses and ex-spouses. Under DOMA, they cannot apply to same-sex couples, even those who are married and getting a divorce under state law. For couples who are divorcing in states where their relationships are recognized, there is a strong argument that the payment of alimony has no tax effect on either party. That is, it should not be taxable to the recipient or deductible by the payor. That is the rule that was in effect before the statutory changes in the 1940s. See *Gould v. Gould*, 245 U.S. 151 (1917), discussed in D.1.b below.

ii. No independent rules outside of section 71 deal with taxation of child support, although everyone assumes that such payments are not income if paid to the custodial parent. The principal in *Gould* supports this result for state-imposed obligations of support. But in non-recognition states, where the paying partner is not recognized as a legal parent, the transfer could either be considered income to the party who receives it or a gift under section 102. In the worst possible world, such payments could be considered income to the recipient and a possible taxable gift by the payor. (Note: The test for what is a gift under the income tax is different from the test for what is a gift under the gift tax. See Part D below.)

3. *Other IRC Issues*. Another set of problems arises because the Internal Revenue Code has been amended over time to deal with issues faced by married couples. No amendments have been made to take into account the existence of unmarried same-sex couples who have virtually the same rights and responsibilities as spouses. In addition to those who are married, but not recognized as such because

of DOMA, such couples include registered domestic partners (RDPs) in California, Oregon, Washington, Nevada, Hawaii, and Illinois who have basically the same rights and obligations as spouses, and parties to a civil union in New Jersey and Illinois, who similarly are spousal equivalents. A number of other states recognize registered couples, but provide them with only a handful of rights and obligations (for example, Maryland, Maine, Wisconsin, Colorado, and the District of Columbia, where same-sex couples can also opt for marriage, and Hawaii, where same-sex couples can opt for either civil unions or reciprocal beneficiary status). The Code and the interpretive regulations and rulings of the IRS simply do not address a number of the issues that are raised by these state-recognition-of-status laws. Here are some examples:

a. Section 2040 provides a special rule (discussed in C.1.b.iii below) for estate inclusion of property held as "joint tenancy with right of survivorship by the decedent and any other person, or as tenants by the entirety by the decedent and spouse." Does this rule apply to property held as "community property with right of survivorship"? Does it apply to property held as tenants by the entirety with a non-spouse?

b. Spousal gifting that created a tenancy by the entirety (TBE) used to be covered by section 2515, but that section has been repealed. This leaves no guidance for how to value a TBE interest that is gifted in states where unmarried couples (or same-sex spouses) can create TBE interests. Because TBE properties are not unilaterally severable, the valuation formula is different from that applied to joint tenancy with right of survivorship.

c. The IRS has recently recognized that the community income of RDPs in California is owned 50/50, and under the principles of *Poe v. Seaborn*, 282 U.S. 101 (1930) (discussed in C.1.d below), each partner (or spouse) is required to report 50 percent of any such income. Decades ago, we learned of a problem that arose for certain community property spouses who filed separate returns (married filing separately) and failed to report the required 50 percent of income earned or acquired by the other spouse. Had these spouses filed jointly, they would have been able to satisfy the statutory provisions for innocent spouse and been relieved of the liability for tax on income that they neither knew about nor benefitted from. But, having filed separately, this innocent spouse provision was not available to them. Nor was the United States Supreme Court willing to cease applying the basic principle of *Poe v. Seaborn* in such cases. See *United States v. Mitchell*, 403 U.S. 190 (1971). Thus, Ms. Mitchell was liable for taxes on 50 percent of the community income that her husband had hidden from her. Congress responded by enacting section 66 to provide relief similar to the innocent spouse provisions to persons in the position that Ms. Mitchell found herself in. That statute, however, only applies to spouses. As a result, an innocent RDP (or same-sex spouse) might be in the same position as Ms. Mitchell.

C. Acquisition And Ownership Of Property During The Relationship

1. *Title To Property*. If a couple wants to own real estate jointly, there are a number of different ways to accomplish that. Each of the forms of ownership listed below creates its own unique tax issues. Many of these issues apply to ownership of personalty as well as realty. Joint bank accounts, however, have their own rules and thus do not generally raise any of the gift tax or similar issues discussed below. For gift tax purposes, joint bank accounts are treated as revocable gifts. Thus, creating a joint account does not result in a completed gift for gift tax purposes. But if one partner withdraws more than that partner contributed, there may be a completed gift at that time. It depends on the intent of the parties and the state law rights in the depositor to demand his or her money back. In any event, keeping track of these transfers is in many situations virtually impossible.

   a. *Tenancy In Common.* In a tenancy in common, the partners (or spouses) each own an undivided interest in the whole. They can own these interests in any proportion. Often couples wish to own property in proportion to their contributions to the purchase price. If they do this, no taxable gift occurs upon formation of the tenancy in common. If one person is already the owner and wishes to sell an undivided interest to his or her partner, there may be taxable gain. If the sale is of a principal residence that qualifies under section 121 for nonrecognition of gain, up to $250,000 of gain can be excluded. Note, however, that this is a single exclusion of $250,000 for this seller on this residence. If $100,000 of the gain is excluded, upon a later sale the original owner can exclude only an additional $150,000. The partner who buys in, however, will still have a $250,000 maximum exclusion amount on this residence. Other tax points:

      i. If the sale is of property other than a principal residence, the gain may be deferred if the sale is structured as an installment sale. Interest should be stated on the installment note to avoid imputed interest and the section 7872 rules.

      ii. If one partner gifts an undivided interest to the other partner, the transaction is a taxable gift. (Note: The IRS is reviewing deed records in California to identify transfers that look like they may be unreported taxable gifts.)

      iii. The value of the gift should be reduced by a fractional share discount—for example, a 50 percent interest in Blackacre is worth less than 50 percent of the full market value of Blackacre because it is difficult to market undivided interests in property. *See*, *e.g.*, *LeFrak v. Comm'r*, 1993 WL 470956 (U.S. Tax Ct. Nov. 16, 1993) (20 percent discount); *Ludwick v. Comm'r*, 2010 WL 1850223 (U.S. Tax Ct. May 10, 2010)(30 percent discount rejected; approximately 15 percent deemed reasonable under facts; good discussion of method of determining discount).

      iv. If a gift tax return is filed, the statute of limitations should begin as long as there is a sufficiently thorough appraisal.

v. *Gifts Spread Over Several Years*. Some transferors split gifts of land into fractional shares that will qualify for the $13,000 per year annual exclusion. In planning for these annual gifts, it would be good to make the first two transfers in December and January so that you can rely on the same appraisal. It is still advisable to get a statement from the appraiser that nothing has changed to affect the value during the one- or two-week period between the two transfers, but you will not have to pay for two full appraisals in this case.

vi. Upon the death of the first partner, the estate will include the undivided interest owned by the decedent. But again, a fractional share discount ought to be allowed.

vii. If the co-tenants additionally restrict the marketability of the property by agreeing to waive their right to partition while either of them is alive, it may be possible to obtain additional discounts for lack of marketability. There is a valid non-tax reason for entering into such agreements, especially if the property in question is the principal residence and each partner wants assurance that the property will not be sold without consent during his or her life.

viii. For transfer tax purposes, the valuation of the transferred property is not based on what the transferor owned or what the transferee receives. Instead, it is based on the property itself, while in transit, and the test is what a willing buyer would pay on the open market. See *Shepherd v. Comm'r*, 283 F.3d 1258, 1262 (11th Cir. 2002), which explains the issue as follows:

> This "in transit" valuation has been described as analyzing "the moment of truth, when the ownership of the [donor] ends and the ownership of the [donees] begins." *United States v. Land,* 303 F.2d 170, 172 (5th Cir.1962). "Brief as is the instant [of transfer], the court must pinpoint its valuation at this instant." *Id*. *See also Estate of Bright v. United States,* 658 F.2d 999, 1002 (5th Cir.1981) (en banc) (noting valuation for estate tax purposes "to be made at the time of the transfer").

b. *Joint Tenancy With Right of Survivorship (JTWROS).* As with co-tenancies, if the partners hold interests in the joint tenancy that are equal to their contributions, there is no gift upon formation of the JTWROS. Because some states still follow the common law rule, based on the doctrine of the four unities (time, title, possession, and interest), joint tenants may be required to own the property 50/50 (unity of interest). There is also some risk that any side agreement that says otherwise might be viewed as a severance of the joint tenancy, although the modern rule would require an intent to sever.

i. *The Unequal Contribution/Unequal Ownership Problem*

(1) Some states still follow the common law rule.

(2) Some states—California, for example—require "equal shares" or "equal interests" by statute. *See* Cal. Civ. Code §683; N. M. Stat. Ann. §47-1-36; Utah Code Ann. §57-1-5.

(3) The modern trend is toward rejecting the "four unities" as a fixed requirement and instead relying more strongly on intent of the parties. See *In re Estate of Johnson*, 739 N.W.2d 493 (Iowa 2007); R.H. Helmholz, *Realism & Formalism in the Severance of Joint Tenancies*, 77 Neb. L. Rev. 1 (1998). Although the issue more often arises in the context of whether there is an unintentional unilateral severance, the Iowa Court quite clearly stated "we see no reason to distinguish our [intent-based] approach based on whether the joint tenancy is sought to be created, severed, or terminated." *Johnson,* supra, 739 N.W.2d at 497–498.

(4) Despite this modern trend, I would not state in the deed that the joint tenancy is held other than 50/50. Instead, I would draft a side agreement between the parties that does the following: (1) reaffirms the intent to hold the property as joint tenants; (2) provides that if the tenancy is severed into a tenancy in common the shares will be in accord with contributions; and (3) provides that if the joint tenancy is sold while the two joint tenants are alive, the sale shall be deemed a severance and the proceeds from the sale shall be distributed in accord with contributions.

ii. *Gift Tax Upon Formation*. If the interests are not taken in accord with contributions (for example, if there is no side agreement to account for unequal contributions), the creation of the joint tenancy will be treated as a transfer subject to the gift tax. Because of the unilateral right to sever, each joint tenant is considered vested with a 50 percent undivided interest. To the extent that one tenant did not contribute 50 percent of the purchase price, the other tenant will be deemed to have made a gift.

(1) The gift should be valued with a fractional share discount. If the transfer creates a taxable gift, a valuation expert should be consulted to help set the value of the gifted portion. As with gifts of tenancy in common interests, the same considerations apply regarding splitting the gift over several years and providing annual appraisals.

iii. *Estate Tax At Death*. One huge problem with JTWROS is the rule under section 2040 that 100 percent of the fair market value of the property will be included in the estate of the first to die unless the surviving joint tenant can prove original contribution to the acquisition of the property.

(1) *No Fractional Share Discount*. Because section 2040 is a special rule requiring full inclusion of the property's value in the estate, arguments regarding fractional interest discounts are inapplicable. Compare *Estate of Williams v. Comm'r*, 75 T.C.M. (CCH) 1758 (1998) (allowing a fractional discount in valuing, for estate tax purposes, an undivided half interest held as tenants in common) with *Estate of Young v. Comm'r*, 110 T.C. 297 (1998) (no fractional discount allowed for joint tenancy property included in estate under section 2040). Thus, even if the survivor can prove 50 percent contribution, the property will be valued for estate tax purposes at a higher value than if it had been held by the owners as tenants in common.

(2) *Contribution Of Survivor Must Originate With Survivor*. What if Partner A had given Partner B cash and B had used the cash to purchase her part of the home? If B can prove her contribution to the purchase price, can she reduce the amount of the value included in A's estate under section 2040? The answer is no, because B must not only prove her contribution, but must also prove that the contribution came from her and is not traceable to a gift of cash from A. *See Goldsborough v. Comm'r*, 70 T.C. 1077 (1978), *aff'd per curiam*, 49 A.F.T.R.2d (RIA) 1469 (4th Cir. 1982) (mother transferred land outright to daughters; years later they sold land and invested proceeds in stock held jointly with mother; at mother's death, IRS argued that full value of jointly owned stock was subject to estate tax because the daughters' contribution could be traced to the original gift from mother; Tax Court held that the portion of the value of the jointly owned stock traceable to the original gift of land from mother to daughters was included in mother's estate, but not the portion traceable to the capital gain on the land that accrued while the daughters held the property in their own names).

(3) *Adequate Records.* What sort of evidence can be offered to overcome the presumption that the first to die contributed everything? The regulations don't say and there are very few cases. Assume that A and B made equal contributions to the purchase of the home. Even if they have accurate records of who contributed how much to the down payment, they will still need to show equal contribution to the mortgage payments. However, exact records on individual contributions may not be necessary. Proof that each owner had sufficient funds available to contribute equally and reliance on the *Cohan* rule—*Cohan v. Comm'r of Internal Revenue*, 39 F.2d 540 (2nd Cir. 1930) (estimation of expenses okay for deduction purposes)—should suffice. *See Estate of Fratini v. Comm'r*, 1998 WL 525500 (U.S. Tax Ct. Aug 24, 1998). *See also Concordia v. Comm'r*, 2002 WL 1964737 (U.S. Tax Ct. Aug. 26, 2002) (commissioner challenged allegation of contribution by survivor, but court ruled in favor of survivor on the basis of survivor's testimony, which was corroborated and uncontradicted).

(4) *Additional Evidence*. As additional protection against the application of section 2040, I suggest that both joint tenants sign an affidavit explaining how the full purchase price of the property is being paid equally by both of them. The section 2040 presumption is rebuttable and once any evidence is submitted by the survivor, the burden will shift to the IRS to prove otherwise. I have talked to IRS personnel about this and they state that they will not rely on any such affidavits, but instead will seek records. That is understandable. The affidavit is not intended to replace records, only to supplement available records that may be incomplete.

(5) *Risk Of Audit*. A 1999 survey of IRS estate tax attorney auditors listed non-spousal joint tenancies high on the list of possible hot topics subject to audit. Because of this viewpoint, it is probably wise to attach to the estate tax return some evidence of equal contribution. It might help avoid an audit.

c. *Tenancy By The Entirety (TBE)* (Massachusetts, Hawaii, Oregon, Vermont, Illinois). Tenancy by the entirety is a common law form of joint ownership limited to spouses. It usually is available only for realty. Hawaii, Oregon, and Illinois all authorize this form of ownership for registered partners. In Massachusetts and Vermont, same-sex spouses can own property on the same basis as opposite-sex spouses. The attributes of a tenancy by the entirety are the same as a joint tenancy with right of survivorship except that there is no unilateral severance. Key points:

i. Since the TBE cannot be unilaterally severed, it enjoys a certain amount of protection from creditors. In Hawaii and Vermont, for example, property held as tenants by the entirety is basically exempt from creditors' claims. In Hawaii, even if spouses (or reciprocal beneficiaries) convey the property away to a third party, their creditors cannot reach the property. *See Sawada v. Endo*, 561 P.2d 1291 (Haw. 1977). Creditors can attach entireties property in Massachusetts and Oregon, but they cannot destroy the nondebtor spouse's survival rights. If the nondebtor spouse survives, the creditor takes nothing.

ii. Computing the value of the gift for gift tax purposes is complicated by the fact that there is no unilateral severance for estates held as TBE. A JTWROS is valued on the basis of two equal 50 percent undivided interests (the same as a tenancy in common) because unilateral severance empowers each tenant to convert the JTWROS into a tenancy in common. When a TBE is created, however, the value of each tenant is the sum of two different interests in the property: (1) the value of the joint life estate, and (2) the value of the contingent remainder. If the tenants' ages are far apart, the value of the two interests will vary more greatly. Valuation of TBE gifts used to be covered by the regulations under section 2515 (covering gift tax rules for the creation of tenancies by the entirety between spouses). But section 2515 has been repealed now that there is a 100 percent marital deduction. One might assume that the valuation rules in these regulations would nonetheless apply to the creation of nonmarital tenancies by the entireties. However, there is no statute or regulation directly on point, probably because the Treasury and IRS have never acknowledged that same-sex couples can hold property as tenants by the entirety. If claiming that tenants' interests should be treated as though they were equal in value, one might cite to the fact that the disclaimer regulations were amended in 1997 to treat a TBE as passing a 50 percent interest in the property at the death of the first spouse. *See* Treas. Reg. §25.2518-2(c)(4).

iii. See also Treas. Reg. §25.2515-2, which is still on the books and gives example of how to value such gifted interests.

iv. But valuation depended on life expectancy "factors" in Treas. Reg. §25.2515-5 (now repealed).

v. Presumably, one would consult joint life actuarial tables to compute.

vi. Existing caselaw on valuation of the interest for purposes other than gift tax (for example, amount of property subject to tax lien) are in conflict. *See Pletz v. U.S.*, 221 F.3d 1114 (9th Cir. 2000) (joint life actuarial tables used); *U.S. v. Goddard*, 735 F. Supp. 2d 820 (E.D. Tenn. 2010) (50 percent of fair market value used).

vii. Estate taxation of tenancies by the entireties is probably covered by section 2040, although it is worth noting that the statutory language in section 2040 refers only to "tenants by the entirety *by the decedent and spouse*" (emphasis added). If DOMA continues to prevent spousal recognition for same-sex couples in other Code provisions, it is arguable that it should prevent section 2040 from applying to same-sex tenants by the entirety. It is probably worth noting that the IRS has tended to take a literal approach toward DOMA, taking the position that any statute with the word "spouse" in it cannot apply to same-sex couples. [See, for example, instructions in IRS Publication 555 dealing with community property issues and pointing out the instances in which statutory rules that mention spouse are simply not available for Registered Domestic Partners or same-sex spouses.] In the case of section 2040, however, it would be in the interest of the federal fisc to include all same-sex couples who hold property as tenants by the entirety. I support construing any statute that describes rules based on spousal property rights as rules that should be applied to all couples who have the same property rights, but it is not clear that the IRS would adopt that position in any case, and thus it is reasonable to argue that section 2040 does not apply to same sex couples who hold a tenancy by the entirety. If section 2040 does not apply, one might argue that there is nothing included in the estate because at the moment of death, the decedent does not own anything. I don't think this is a more-likely-than-not outcome, however.

viii. If section 2040 does apply, all the points made previously with respect to JTWROS property are applicable.

d. *Community Property*. Same-sex (and opposite-sex) registered domestic partners in California, Washington, and Nevada can hold property as community property on the same basis as spouses. In California and Nevada, property may also be held as community property with right of survivorship. In Washington, spouses or registered partners who own property as JTWROS are presumed to own the property as community property, except that the survivorship feature of joint tenancy is retained. *See* Wash. Rev. Code Ann. §64.28.040. This is a roundabout way of creating community property with right of survivorship. As long as the property is classified as community property under state law (even if title is held as JTWROS), the IRS will treat the property as community property. *See* Rev. Rul. 87-98, 1987-2 C.B. 206.

i. Generally, for tax purposes, when community property is acquired during the marriage through the efforts of one of the spouses, the property is viewed as initially vested 50 percent in each spouse. The tax consequences that flow from this analysis assume that there is no transfer from one spouse to the other, even though all of the community income may be earned by that one spouse. *See Poe v. Seaborn*, 282 U.S. 101 (1930) (Washington community property law); *United States v. Malcolm*, 282 U.S. 792 (1931) (*Seaborn* rule extended to California community property). Additionally, since all community income is vested equally in the spouses the moment it comes into existence, *Poe v. Seaborn*, rather than *Lucas v. Earl*, 281 U.S. 111 (1930), applies to impose income tax liability on each spouse or partner for half of the community income.

ii. Several tax scholars, including this author, argued that the *Seaborn* rule should have applied to California RDPs as of January 1, 2005, the first instance in which the community property rules of any state were extended to RDPs. See Cain, *Relitigating Seaborn, Taxing the Community Income of California Registered Domestic Partners*, 111 Tax Notes 561 (2006). Initially, the IRS disagreed. See CCA 200608038, holding that earned community income from personal services must be taxed to the earner.

iii. The IRS has now reversed course. See CCA 201021050 and PLR 201021048, holding that all community income should be split 50/50 for income tax reporting and that the creation of community property, even if attributable to the earnings of one partner, is not a transfer for gift tax purposes. The 2010 CCA, however, takes the position that the original position stated in the 2006 CCA was correct at the time and that the law changed in 2007 because that was the first year that California authorized RDPs to report 50 percent of personal service community income as belonging to each partner for state income tax purposes.

iv. *Critique Of IRS Position On The 2007 Effective Date For Applying Seaborn*: The community property regime was extended fully to RDPs as of January 1, 2005. That is the same date that RDPs began to be treated as spousal equivalents for most additional state law purposes. But for state income tax purposes, there were two special rules applicable in 2005 that were later repealed as of 2007. First, RDPs were not allowed to file joint returns. They were required to file state tax returns on the same basis as federal tax returns, which necessarily required them to file as single. Furthermore, worried that two couples filing singly and splitting all community income might pay a lower tax bill, a provision was included in AB 205 (the Domestic Partner Act) that provided that "[e]arned income may not be treated as community property for state income tax purposes." Cal. Fam. Code §297.5(g)—repealed as of 2007. The California legislature did not say that wages were not community or did not belong equally to both RDPs. All it said was that even though this is community property, you cannot treat it as community and thus split it for purposes of state income tax law. This approach is not unlike federal legislative enactments that reverse the rule of *Seaborn* in limited circumstances, such as section 66 (innocent spouse) and section 879(a) (nonresident aliens). But without any limitation for federal income tax rules, the property law rule of the state should be the rule that allocates the income—and as of 2005, that rule in California allocated community income of RDPs 50/50 for all purposes other than state income tax law.

v. The IRS reluctance to recognize the full strength of the community property interests and the application of *Seaborn* to all such state-created property rights raises transfer tax issues for community property that can be traced to unequal earnings before 2007. Even if the IRS wishes to stick with the 2007 start date for income tax purposes, it would be helpful to clarify the transfer tax issues with respect to pre-2007 community property.

vi. There are many unanswered questions about how RDPs are supposed to comply with the new reporting requirements under the 2010 CCA. Tax return preparers are worried about unjustified audits because they are forced to report on single returns, which provide no indication or special lines for splitting community income. In addition, although withholding taxes are to be allocated 50/50 on the final return, the IRS (unofficial) position to date is that estimated payments, even if made out of community funds, can only be allocated to the person whose earnings produced the estimated tax liability. Unless changes are made, it is unlikely that RDPs in these three states (California, Washington, and Nevada) will be able to e-file. The IRS is proposing some changes, planned to take effect in mid-February 2011. These changes would make it possible to e-file, and to receive any refunds due, but many such returns are likely to be caught by automatic computer audits that are run toward the end of 2011. This is because there is no e-file box to check to show the other partner's Social Security Number, and splitting withholding on vastly different income levels is likely to trigger a computer-generated inquiry about the return. As a result, many professional return preparers are not planning to e-file this season for their community property RDPs.

vii. Unanswered questions for planners (as opposed to return preparers) include the following:

(1) *Estate Tax Consequences*. Neither the PLR nor the CCA addresses any estate tax issues. Presumably, if there is no gift tax upon formation, at death the community estate will be split 50/50, and thus only half will be included in the estate of the first to die.

(2) Although there will be a double step-up in basis for California income tax purposes, that rule cannot be applied at the federal level. It is a matter of statutory law and the statute uses the word "spouse." As long as DOMA is on the books, section 1014 is probably not available for same-sex spouses. There is an argument that the "word" spouse in the statute is descriptive, not normative, and thus the provision should apply to any couple subject to a state community property regime, but it seems unlikely that the IRS will adopt this approach to statutory construction. Washington and Nevada do not have a state income tax, so the benefit of the stepped-up basis under state law is currently only available in California.

(3) Will community property with right of survivorship be covered by section 2040 even though it is not specifically mentioned in that provision? On the one hand, the survivorship feature suggests a similarity to JTWROS (and thus section 2040 ought to apply), but on the other hand, since this is community property, by definition it already belongs to both partners and there should be no reason to require proof of original contribution (and thus section 2040 ought not to apply). Different considerations, however, might apply to property that has been transmuted from separate to community.

(4) In community property states, spouses and RDPs can agree to change the character of their property. To be effective, these agreements must follow the requirements of state statutes. Transmuting property from one type to another can create taxable gifts. Although there is some old law on these issues involving husbands and wives, there is nothing very recent because the 100 percent marital deduction enacted in 1981 made this question irrelevant for opposite-sex spouses.

(A) Agreements entered into before registration can convert property to be acquired in the future from community to separate. Such agreements do not constitute a current transfer of property and do not create taxable gifts at the time they are signed, but query whether they create taxable gifts at the time the conversion occurs.

(B) Agreements that future earnings will be treated as separate rather than community have been recognized for income tax purposes to tax only the earner. *See Van Dyke v. Comm'r*, 120 F.2d 945 (9th Cir. 1941).

(C) What will the gift tax effect of such agreements be? For example, in the year that A's $100K salary, which but for the agreement with RDP B would have been community, vests in A as separate property, has B made a gift of $50K to A? I can find no authority, but to be consistent with the reasoning in the *Van Dyke* case, supra, there should be no taxable gift. Under state law, the agreement has successfully converted community property into separate *ab initio*, and so it belongs to A the moment it comes into existence as income and there is no transfer from B to A.

(D) Agreements that future separate income from separate property will be community will create a taxable gift at the time the income arises and the income will be taxed to the owner of the separate property. This fact situation raises a typical assignment of income issue—an attempt to assign income from the property without transferring the underlying income-producing property. As a result, the income still belongs to the separate owner for income tax purposes and the transfer by agreement is a gift. *See* Rev. Rul. 77-359, 1977-2 C.B. 24. *See also* PLR 8109032 (under a 1980 Louisiana statute, royalty income on separate mineral interest was classified as separate property; the law allowed spouses to agree to continue treating such income as community property, as it had been treated under pre-1980 law; IRS ruled that any such agreement would be a transmutation from separate to community and thus would create a taxable gift). The gift is complete when the agreement is signed. However, no gift tax is incurred until the value of the gift can be ascertained, that is, at the time the royalty income is earned. *See* Rev. Rul. 69-346, 1969-1 C.B. 227.

(E) Transmutation of community property to separate property after registration would not create a taxable gift if the property were divided equally between the two partners. They would merely be receiving what they already owned albeit free of the community regime. *See Comm'r v. Mills*, 183 F.2d 32 (9th Cir. 1950). But a transmutation of community property into the separate property of one partner should be treated as a taxable gift since it serves to transfer a 50 percent interest of one partner to the other. *See* Rev. Rul. 75-551, 1975-2 C.B. 378 (ruling that equal divisions are not taxable and implying that unequal divisions would be).

(F) Transmutation of separate property of one partner into community property after registration can create a taxable gift. Such an agreement would "transfer" vested property rights from one partner to the other. *See Damner v. Comm'r*, 3 T.C. 638 (1944).

(G) Applying these general principles, there should be no gift tax consequences if partners convert a JTWROS or tenancy in common into community property, provided that the joint tenancy or tenancy in common was owned 50/50 and had been acquired with the partners' joint funds. RDPs in California should consider owning all joint property as community property because under California income tax rules, the property will receive a double step-up in basis at death. On the other hand, since this is transmuted from separate into community, it may be more difficult to argue that section 2040 does not apply.

e. *Partnership.* Regardless of state property law and whether or not the state recognizes same-sex couples, any unmarried couple can form a partnership. As a general rule, the partnership has to have some profit-making potential. Merely owning a home together and sharing living expenses is not enough to form a partnership for tax purposes. *See* Treas. Reg. §301.7701-1(a)(2).

i. However, if the parties own property that they manage or if they run a business together and that business includes assets, forming a partnership (or an LLC) to own the properties may create some tax advantages. Not only will the entity provide a vehicle for joint management of the property (assuming joint management is desired), the transfer into the entity of assets that would otherwise be owned outright creates a significant devaluation in the value of the transferor's estate. This is because assets that are subject to the typical restrictions found in partnership agreements are worth much less than even the discounted value of an undivided interest as a tenant in common. One simply cannot sell a 50 percent limited partnership interest for anything close to 50 percent of the value of the assets in the partnership. Because of the steep valuation discounts available (sometimes close to 50 percent), family limited partnerships (or LLCs) have become prime estate planning gimmicks.

ii. There has been much litigation in the past few years over the role of family limited liability enterprises (FLLEs) in estate planning. For a good discussion of the key cases, see Walter D. Schwidetzky, *Family Limited Partnerships: The Beat Goes On*, 60 Tax Law. 277 (2007).

iii. Example: Wealthy Partner (WP) owns several rental properties with a value in excess of $8 million. Less Wealthy Partner (LWP) has some cash or other liquid assets and is good at keeping the books on the rental properties. They form a limited partnership by contributing cash and the properties to the entity and receiving interests that are proportionate to their contributions. LWP has a 1 percent general partnership interest and WP has a 99 percent limited partnership interest. The assets in the partnership are the $8 million worth of real estate and approximately $80,000 in cash. The 99 percent limited partnership interest in WP's hands is instantly worth substantially less than $8 million due to discounts for lack of marketability and lack of control. If WP wishes to make lifetime gifts of the limited partnership interests, they will be valued at the discounted value.

If WP holds onto the interest until death and then transfers the interest to LWP, it will be valued at the discounted value. Discounts of 35 percent are typical. See 60 Tax Lawyer at 278. In this situation, merely creating the partnership could reduce the estate of WP by almost $3 million.

iv. As long as there is a business purpose for the creation of the entity, the arrangement should be respected for gift and estate tax purposes. However, abusive use of these arrangements has created some troubling precedent, especially if the partnership assets do not consist of property that needs management, such as marketable securities. Also, FLPs or FLLEs that are created shortly before death are at high risk of audit.

v. Most litigated cases involve partnerships formed by parents as a vehicle for passing wealth to the next generation, but there is nothing to prevent the arguments made by the IRS in those cases from being applied to a partnership created by a same-sex couple. There are two potential risks if the entity is not formed correctly and if the only motive for creating the entity is to reduce taxes.

(1) *The Section 2036 Problem*. Section 2036 has been successfully applied by the IRS to erase the estate tax savings potential of these arrangements if under the arrangement the transferor (usually the parent) has retained the right to income or enjoyment of the property. When successful, the IRS has been able to show that there was an understanding among the parties (parents and children) that the transferor could withdraw assets from the partnership if needed or continue to live in the home (when that was transferred to the partnership). One key fact in the cases that find section 2036 applicable is the fact that the parent did not retain sufficient assets to support him- or herself, in which case naturally the partnership assets would be expected to be available as needed. *See*, *e.g.*, *Estate of Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 382 F.3d 367 (3d Cir. 2004); *Estate of Bigelow v. Comm'r*, 503 F.3d 955 (9th Cir. 2007).

(A) If section 2036 is applicable, the transfer of the assets will be ignored and the value of the assets (rather than the discounted value of the partnership interest) will be included in the estate at death. Of course, section 2036 does not apply to a transfer that qualifies as a "bona fide sale for an adequate and full consideration." These transfers at the creation of the partnership interest are not gifts. They are transfers in exchange for a partnership interest. Though the IRS has argued that a transfer of assets for a partnership interest that is discounted for lack of marketability and control can never be a bona fide sale for adequate consideration, the courts have not been willing to adopt such a *per se* rule. Nor have they been willing to adopt the taxpayer argument that the receipt of a proportionate partnership interest is, in every case, adequate and full consideration. The Tax Court and at least three courts of appeal have stated that, in addition to the proportionate interest, the transfer into the partnership must create some intangible benefit such as a "genuine pooling of assets" and not just a change in form of ownership. See, especially, *Estate of Bigelow*, 503 F.3d at 969. Bills have been regularly introduced in Congress to repeal the valuation and lack-of-control discounts for any transfer of nonbusiness assets. But none of these provisions made it into the most recent tax law, which re-established the estate tax with a $5 million exemption level.

(2) *Indirect Taxable Gifts.* Form must be followed carefully. In our example, WP must clearly transfer assets to the partnership well before gifting any interest in the partnership to LWP. Also, the assets must be transferred in exchange for the partnership interest, and an appropriate capital account must be created. If WP gifts property to the partnership, she is indirectly benefitting LWP and the IRS will classify the transfer of assets as an indirect taxable gift of assets to LWP. Since the gift is of "assets" rather than of a partnership interest, no discounts would be available. *See Shepherd v. Comm'r*, 283 F.3d 1258 (11th Cir. 2002). If the transfer of assets and the gift of the partnership interest occur too close in time, the IRS may argue that under the step transaction doctrine, the effect is really an indirect gift of assets rather than of partnership interest. If the gift is characterized as a gift of assets, the extra valuation discounts will be lost (although a smaller fractional share discount should still be available as WP is indirectly transferring an undivided interest in the property). The IRS has lost a series of recent cases in which it pushed the step transaction doctrine. *See*, *e.g.*, *Gross v. Comm'r*, 2008 WL 4388277 (U.S. Tax Ct. Sept. 29, 2008), and cases cited therein.

f. *Revocable Trust—Advantages.* Putting property in a revocable trust creates a number of advantages.

i. Avoiding probate. Because the trust holds title to the property there is no need for the property to go through probate.

ii. Unlike the creation of a joint tenancy or tenancy in common, there is no taxable gift upon transfer to a revocable trust.

iii. Flexibility. Trusts are generally easier to amend than wills.

iv. Avoids the simultaneous death problem of joint tenancies. If one joint tenant survives the other for a short period of time, the surviving joint tenant will wind up with all of the property, which may then pass to that survivor's heirs or beneficiaries to the exclusion of the family of the first joint tenant.

v. If the partners serve as co-trustees, or are named as successor trustees, the trust serves as a vehicle to manage property during disability.

vi. Privacy. Most trusts are not a matter of public record.

vii. Protection against will contests. Although a revocable trust can be challenged on grounds of undue influence, duress, or fraud, the fact that the trust arrangement was a completed transfer of property at the time it was created and funded makes it a bit more difficult to challenge. If a challenge seems imminent, it probably makes sense to use a trust department or some other independent trustee.

g. *Revocable Trust—Tax Issues*

i. No completed gift upon formation even though the transferor's partner is named as a beneficiary. However, if distributions from the trust are made to the partner rather than to the transferor, that payment could trigger gift tax liability if it exceeds the annual exclusion ($13,000 in 2011) and if the transferor has exceeded the $1 million lifetime exclusion. Payments in discharge of a legal obligation of support of the partner should not create taxable gifts.

ii. Transferor continues to report income and deductions. No fiduciary return needs to be filed for a grantor trust.

iii. At the transferor's death, 100 percent of the trust assets are included in the estate for estate tax purposes.

iv. If the trust is funded with community property, the trust document should provide that the property remains community property even though it is held in trust. For California RDPs this will protect the double step up in basis at the death of the first partner. This benefit is only available for *state* income tax purposes.

h. *Irrevocable Trusts*

i. *QPRTs And GRITs*. A Qualified Personal Residence Trust and a Grantor Retained Income Trust are two ways to transfer property from one partner to another at a gift tax savings. Example: Partner A transfers in trust a $4 million vacation home to Partner B but retains a beneficial interest in the trust for 10 years. The value of the gift is discounted to account for the fact that the transfer is of a future interest, which is worth less than $4 million. The transfer also freezes the value of the property for transfer tax purposes. If the transferor survives the 10-year term, the asset will not be included in the estate. If the transferor fails to survive, the vacation home will be taxed at date of death value, which is the same result as not making the transfer in the first place. If the asset escapes estate tax it will not receive a step up in basis at death. (Note: For opposite-sex married couples the only type of GRIT allowed is a QPRT.)

ii. *GRATs And GRUTs*. Grantor Retained Annuity Trusts and Grantor Retained Unitrusts are arrangements similar to GRITs, although the transferor might provide for the retained interest in these sorts of trusts that is much larger over a shorter period of time—for example, a transfer of $100,000 worth of stock with a three-year retained interest of $30,000 a year, or 30 percent of the stock per year. This works well if the stock is expected to appreciate rapidly over the next three years. The gift will be discounted to present value of the $10,000 (or 10 percent) remainder interest for gift tax purposes, and at the end of the three-year term, if the stock has appreciated, the donee will benefit from ownership of the appreciated value at no gift tax cost. If the stock were to double in value, the donee would have $20,000 in value for the cost of a gift tax on less than $10,000.

iii. *ILIT (Irrevocable Life Insurance Trust)*. Life insurance is a good way to plan for paying estate taxes when the wealthy partner dies. Since there is no marital deduction, the estate tax cannot be avoided if the estate exceeds the credit shelter amount ($5 million as of 2011). As long as someone other than the insured is the owner of the policy, the proceeds will not be included in the taxable estate. One option is for the partners to own policies on each other's lives (assuming you have two taxable estates). But when a partner dies, the value of the policy *owned* by that partner (cash surrender value) will be included in the estate of that partner. You also have to worry about where the policy goes at that partner's death. Does it go back to the insured? If so, you will not avoid inclusion in the insured's estate. For some clients this is not really an issue if the policy is a term policy (virtually no value) and the only reason for taking out the insurance was to cover estate taxes on the first to die. But if the intent is to keep the policy in force, it would be better to have the policy owned by an irrevocable trust. Trusts don't die. If the insured is funding the trust to pay for the premiums, there may be taxable gift issues since the transfer to the trust is not a present interest. The best way to avoid the current gift tax is to create a Crummey power—a right of withdrawal—in the other partner. The right to withdraw a sum from the trust creates a present interest and will qualify for the $13,000 annual exclusion.

iv. *IDGTs.* The point of an intentionally defective grantor trust is for the transferor to retain a power over the trust to make it a grantor trust, but not a power that would include the trust in the transferor's estate. One possibility is to retain a nonfiduciary power to substitute assets. This makes the trust a grantor trust under section 675(4)(C). But the power does not cause the trust assets to be included in the grantor's estate. *See* Rev. Rul. 2008-2, 2008-1 C.B. 796. The full value of the trust assets is gifted to the partner as a beneficiary of the trust, including the trust income. But the grantor pays the income tax on the trust income. And payment of tax on income that is distributed to the partner is not an additional gift to the partner because the income is treated as income of the grantor under the grantor trust rules.

v. *CRATs And CRUTs*. These are charitable remainder trusts (CRTs). In a charitable remainder annuity trust (CRAT), the retained income interest is expressed in terms of a fixed amount or annuity. A charitable remainder unitrust (CRUT) expresses the income as a fixed percentage of the value of the trust assets, valued annually. Because the return will increase as the value of the assets increases, the CRUT is used as a vehicle to keep up with inflation. There are restrictions on the size of the retained income interest to ensure that the remainder interest to charity will not be eradicated by contingent withdrawals for named beneficiaries, etc. CRTs can be set up during the donor's lifetime if an income tax deduction is desirable, or they can be created at death with the income interest assigned to the partner. The trust will produce a charitable deduction to the estate, which is of interest to couples who do not have access to a marital deduction.

D. Specific Tax Issues For Same-Sex Married Couples, Registered Domestic Partners, And Parties To A Civil Union: More Detailed Discussion

1. *Income Tax Issues*

a. *Property Divisions At "Divorce."* Divisions of property at "divorce" may be taxable under *U.S. v. Davis*, 370 U.S. 65 (1962). Section 1041 of the IRC provides that spousal transfers, during marriage or incident to divorce, are not taxable. By its terms the provision only applies to spouses and not to RDPs. Under DOMA, the provision only applies to opposite-sex spouses. Before the enactment of section 1041 in 1984, transfers of appreciated property at divorce often created taxable exchanges under the reasoning of *U.S. v. Davis* (holding Mr. Davis taxable on the gain recognized when he transferred appreciated stock in exchange for Mrs. Davis's release of her marital rights). Between 1962 and 1984, however, a number of courts ruled that property divisions incident to divorce were not *always* taxable. To avoid tax under the *Davis* rule, the spouses both had to have ownership interests in the marital property. This ownership was easy to establish for community property spouses. Early, pre-*Davis* case law had established that equal divisions of community property at divorce were not taxable events. *See Walz v. Comm'r*, 32 B.T.A. 718 (1935). *See also Carrieres v. Comm'r*, 64 T.C. 959 (1975), *acq. in result*, 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977) (nontaxable division of community property, but gain recognized to extent separate property was exchanged for community interest); Rev. Rul. 76-83, 1976-1 C.B. 213 (citing additional cases in accord). In common law property states, wives who were not on the deed were sometimes found to have a sufficient equitable interest in the marital property to apply the tax rules applicable to community property spouses. *See Imel v. United States*, 375 F. Supp. 1102 (D. Colo. 1973), *aff'd*, 523 F.2d 853 (10th Cir. 1975) (split of marital property under equitable division rules is a nontaxable division of jointly owned property provided wife has sufficiently vested interest); *Collins v. Comm'r*, 412 F.2d 211 (10th Cir. 1969) (applying Oklahoma law and holding division of marital property non-taxable after U.S. Supreme Court remanded for decision in keeping with property rights announced by Oklahoma Supreme Court). In a related case, it was determined that when the wife later sold the stock she had a gain calculated on the stock's carryover basis. *But see U.S. v. Wallace*, 439 F.2d 757 (8th Cir. 1971), *cert. denied*, 404 U.S. 831 (1971) (applying Iowa law and finding wife was not sufficiently vested in property; husband recognized gain under the *Davis* rule).

i. Ultimately the IRS agreed with the courts. *See* Rev. Rul. 81-292, 1981-2 C.B. 158 ("An approximately equal division of the total value of jointly owned property in a state that is not a community property state, under a divorce settlement agreement that provides for transferring some assets in their entirety to one spouse or the other, is a non-taxable division and does not result in the realization of gain or loss.") The legal argument is that there is *no realization* when two partners make an equal division of their jointly owned property. The same argument can be used to support non-realization in property divisions between same-sex spouses and registered domestic partners.

ii. *See also* GCM 37716. This is an internal memorandum from the Chief Counsel, IRS, addressing the questions finally resolved in Revenue Ruling 81-292. The memo offers its rationale for treating married couples differently from unrelated individuals. *Observation*: Unmarried cohabitants at "divorce" are more similar to married couples than to unrelated individuals. *See especially* footnote 2 of GCM 37716 (making the distinction between property divisions incident to the dissolution of a relationship and ad hoc property divisions between unrelated individuals).

iii. Conclusion: Even though section 1041 cannot apply to same-sex spouses or partners, a property division is not necessarily a taxable event under *U.S. v. Davis*, supra. The transfer of appreciated property can be characterized as a tax-free division of jointly owned property if there are sufficiently vested ownership interests for both spouses. This characterization is not limited to community property states. Couples in equitable division states may be able to rely on pre-§1041 cases from common law states provided that the partners can be characterized as co-owners. In some cases, even though title was held in the name of the husband, the wife's interests were found to be sufficiently vested to avoid the *U.S. v. Davis* characterization. Cases include *Imel*, supra (Colorado law); *Collins*, supra (Oklahoma law); and *McIntosh v. Comm'r*, 85 T.C. 31 (1985) (Montana law). But if the state's equitable division statutes give the judge too much discretion in dividing the property, the spouses will not be considered co-owners. *See Wiles v. Comm'r, 499 F.2d 255* (10th Cir.), *cert. denied,* 419 U.S. 996 (1974) (Kansas law). Instead, the transferor will be treated the same as Mr. Davis and taxed on any appreciation in the property transferred.

iv. Revenue Ruling 81-292 concluded as follows:

> An approximately equal division of the total value of jointly owned property in a state that is not a community property state, under a divorce settlement agreement that provides for transferring some assets in their entirety to one spouse or the other, is a non-taxable division and does not result in the realization of gain or loss.

That is, the ruling itself was not limited to community property. This ruling has never been revoked.

v. Although DOMA prevents direct application of this ruling (because it mentions spouses), the reasoning in the ruling seems correct and stands for the principle that when a couple is dissolving a relationship and distributing out the jointly owned property, the fact that the distributions are not pro rata does not affect the underlying tax characterization as a non-realization event.

vi. *See also Reynolds v. Comm'r,* 1999 WL 109618 (U.S. Tax Ct. Mar. 4, 1999) (cash payments in settlement of cohabitant's claim to property acquired during the relationship; IRS argued payment for services, taxpayer argued excludable gifts under section 102; court held that the payments were for property and did not exceed claimant's basis). The court held that the non-titled partner had an equitable interest in the property, which she was exchanging for cash. Under this characterization of the transaction, had the partners merely divided the property equally, presumably the transaction would have been a non-taxable division of property. Instead, because she received cash payments, the transaction was treated as a sale. The court held that she recognized no gain because there was no evidence that her basis in the property interest was less than the amount realized.

vii. U.S. v. Davis, supra, focused only on the income tax consequences to Mr. Davis. Some years later, the IRS issued a revenue ruling that covers spouses such as Mrs. Davis. Rev. Rul. 67-221, 1967-2 C.B. 63, held that when a wife receives property at divorce in exchange for her dower rights, she has no income and takes a basis equal to fair market value. (See also footnote 7 in the *Davis* case, noting that the IRS administrative practice was to treat the wife's receipt of property at divorce as nontaxable.) The ruling contains no rationale or justification for the conclusion it reaches, but it is commonly understood to be the right result under the "in lieu of" theory. Similarly, if a same-sex spouse or partner receives cash or property at "divorce" in exchange for marital rights like support and dower, the receipt of the cash or property should not be taxable income since it is "in lieu of" items the partner would have been entitled to enjoy tax free.

viii. Query whether a *Davis*-type transfer is subject to tax under the gift tax rules. Just because it is *not* a gift under the income tax rules does not mean that it is also *not* a gift under the gift tax rules. The definitions of "gift" under the two taxes are different. For income tax, the transferor's motive is key. For the gift tax, the rule is that the transfer is a gift unless the transferor received "adequate consideration in money or money's worth." Section 2516 answers the gift question for spouses by providing that if the transfer is made in settlement of support rights or marital or property rights, there is adequate consideration. With DOMA on the books, this provision probably cannot apply to same-sex couples. If the statute merely codifies existing "common law" of taxation, however, one can argue that a similar rule applies to registered or married same-sex partners. At least to the extent that the transfer is in settlement of support rights, there is a strong argument that there is no taxable gift. Satisfaction of support obligations, as long as those obligations are imposed by state law, should not constitute a taxable gift. See D.2.g below.

b. *Alimony Or Support Payments*. Alimony payments will not be covered by sections 71 and 215. These provisions allow spouses to shift the income tax burden on alimony payments by including the payment in the income of the payee spouse and awarding a deduction to the payor spouse. At the federal level, the only way to shift the tax burden on alimony payments is to comply with sections 71 and 215, which are explicitly available only to spouses. At the state level (California, Massachusetts, and similar states), alimony income can be shifted on the state income tax return.

i. It is not clear how alimony payments between same-sex spouses and partners will be taxed at the federal level. One possibility is to rely on *Gould v. Gould*, 245 U.S. 151 (1917), for the proposition that the payments are not income to the recipient. It has been informally suggested that *Gould* is no longer good law because it was decided at a time when income was thought to consist only of salary and rentals and similar recurring items. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), is thought to have changed this notion of income for good. However, *Gould* can also be characterized as a case in which the payment was received in lieu of ongoing spousal support, which is itself nontaxable. The "in lieu of" doctrine supports the notion that damages received "in lieu of" something that would have been excluded from income should similarly be excluded from income. *See Lyeth v. Hoey*, 305 U.S. 188 (1938) (damages received in settlement of will contest suit held nontaxable because they were received in lieu of a bequest or inheritance that would have been nontaxable under section 102).

ii. See also GCM 37571, 1978 WL 43529, holding that support payments included in an ex-wife's income under section 71 continue to be included under section 61 when they are made beyond the period that the ex-husband was legally responsible. One interpretation of this GCM could be that support payments are taxable to the recipient, either under section 71 or section 61. However, the IRS specifically rejected that broad rule in the GCM, and reaffirmed the basic principle in *Gould*, stating:

> If payments are made by the husband in satisfaction of a valid support obligation, we believe the holding of *Gould v. Gould* would bar the includibility of these payments in the wife's gross income, unless they were specifically included in her income under section 71. While Congress, by enacting section 71 and its predecessor, section 22(k) of the 1939 Code, intended to overrule the holding of *Gould* in the circumstances described in those sections, it showed no intention of rendering this holding inapplicable to a situation which was not so specifically described. Moreover, contemporary decisions have recognized the continued viability of *Gould* in situations not covered under section 71. See, e.g. *Taylor v Comm'r*, 55 T.C. 1134, 1138 (1971).

In other words, the payments in the GCM were not alimony because the husband was no longer under an obligation to continue the support payments. They were more like a windfall and thus taxable under section 61. If they had been true alimony, they would have been excluded under *Gould*.

2. *Estate And Gift Tax Issues*

a. *No Marital Deduction*. There is no marital deduction for same-sex couples. Thus, there is no way to avoid the federal estate tax at the death of the first to die. For wealthy same-sex couples, the only possible estate tax saving is to avoid the tax on the death of the second partner by creating a bypass trust.

i. Note: As a general rule, this means that formula funding clauses used to fund marital share and bypass/credit shelter trusts for married couples have no meaning for same-sex couples. As a result, you cannot use standard forms to draft residuary trusts for same-sex couples. There is no point in limiting the funding of a credit shelter trust to the exemption amount because the excess will not qualify for a marital deduction. It might make more sense to put 100 percent in the credit shelter trust.

ii. On the other hand, a funding formula tied to the unused GST exemption to fund a bypass trust that qualifies as GST exempt would make sense. The question is what to do with the rest of the property. If the aim is to avoid taxes upon the second death and the survivor has property of his or her own equal to the exemption amount, everything should be in a bypass trust. If taxes are not a major concern and the desire is to provide as much as possible to the surviving partner, an outright gift or a gift in trust with a general power of appointment or right to revoke may make sense.

b. *Potential Problem With Use Of Disclaimer Trusts*. One planning opportunity for spouses is to leave the estate outright to the surviving spouse, but if he or she disclaims, in whole or in part, to direct that the disclaimed property will fund a bypass trust that benefits the surviving spouse during lifetime but is not taxed at the surviving spouse's death. The allows the couple to do some postmortem estate planning by deciding whether it is better for the surviving spouse to take outright and utilize the marital deduction or for the surviving spouse to save taxes at her or his subsequent death, in effect by electing to take under the bypass trust and forgo the marital deduction.

i. Same-sex couples who want the same flexibility—that is, for the survivor to be able to decide whether to take outright or in trust for tax savings at the second death (there is no marital deduction to enter the equation here)—run into a problem with the language in section 2518. Section 2518(b)(4) provides that to be a qualified disclaimer, the property must pass either to the spouse of the decedent or to a person other than the person making the disclaimer. Even though the property passes under the terms of the decedent's will to a bypass trust, and through no direction on behalf of the disclaiming partner, the fact that the disclaimant has an interest in the bypass trust means that the requirements of subsection (b)(4) are not met.

c. *Contingent Marital Deduction Planning*. If the primary estate plan is to avoid taxes upon the death of the second partner, everything should be left in a bypass trust. At this point, however, the planner should ask: What if DOMA is repealed by the time this couple dies and their relationship is recognized by the IRS? If the plan has left everything in a bypass trust, that transfer likely will not qualify for the marital deduction that would otherwise be available. Solution: Use the normal funding clauses to fund a credit-shelter trust (the trust can also be GST exempt) and leave everything else to a separate bypass trust that can qualify as a QTIP—that is, all income must be paid to the survivor and no one else can have an interest in the trust assets during the survivor's lifetime. That means there can be no special powers to appoint corpus or income to anyone other than surviving spouse. Then, if the marital deduction is available, the QTIP election can be made for that trust. You might also provide that if the QTIP election is not made, the assets will instead pass to the credit shelter trust. *See Est. of Clayton v. Comm'r*, 976 F.2d 1486 (5th Cir. 1992).

i. Some planners are considering naming a trust protector and giving the trust protector the power to rewrite any provisions in the trust that may need to be rewritten to qualify a trust for the marital deduction. Under this approach, you could create a discretionary income bypass trust and charge the trust protector with dividing the trust into a discretionary bypass trust and a marital deduction trust by amending the terms that apply to the marital deduction trust so that it will meet IRC requirements (for example, mandatory income payout and no power to appoint to anyone other than spouse/partner). Issues include:

(1) Who will be the trust protector? The attorney who drafts the estate plan?

(2) What is the potential liability of the trust protector?

d. *Same Sex Couples In Recognition States With Decoupled Estate Taxes*. A number of states that recognize same-sex couples (married or domestic partners or civil unions) have separate state estate taxes that are decoupled from the federal estate tax, meaning their exemption amounts are lower than the $5 million federal exemption. New Jersey, for example, has an estate tax with a $675,000 exemption. (See also Connecticut, Massachusetts, Washington, and other states.) Same-sex couples subject to possible estate taxes in these states ought to at least consider marital deduction planning to avoid the state estate taxes.

e. *Life Insurance*. If the couple has significant estate tax liability and insufficient liquidity, life insurance is the best way to meet the liability. It may be worth checking with life insurance professionals to see if purchasing a first-to-die policy would save on the overall cost of life insurance since the liability arises on the death of the first to die.

i. It is also important to keep the life insurance policy out of the estate of the first to die. If the policy covers both partners, neither of them should be the owner of the policy. Instead, the policy should be owned by an irrevocable life insurance trust. The estate can then borrow the funds from the trust to pay the estate taxes when the life insurance pays out.

ii. One other point about life insurance: Often one partner will own a simple term policy on the life of the other partner. In California, Washington, and Nevada, if the policy is to be owned by the uninsured partner, the premium payments should come from the uninsured partner's separate property to avoid having the policy classified as community property. If the policy is a community asset, 50 percent of the proceeds would be included in the estate of the insured. If there is no separate property, community property should be transmuted into separate property for this purpose.

iii. If a partner has significant life insurance through an employer insurance plan, it is worth checking with the employer to see if it is possible to transfer ownership to someone other than the employee. Many people assume that such transfers are not possible with respect to group plans, but that is not necessarily true. And in the community property states of California, Washington, and Nevada, any such group insurance is likely to be community property so that only half goes into the estate of the insured if he or she is the first to die.

f. *Use Of Joint Trusts.* In some states, planners regularly use inter vivos revocable trusts to avoid probate. To wholly avoid probate, that means all assets (or as many as possible) must be transferred into the trusts. For same-sex couples who have pooled all their assets, a question often arises whether to use separate trusts or a single joint trust. Use of a joint trust raises possible gift tax issues. If the joint trust is drafted correctly, A can contribute A's separate property to the trust and B can contribute B's separate property to the trust. If any of this property is income-producing, the income should be allocated out to the owner of the underlying property to avoid potential gifts between A and B. Both A and B should have an independent power to revoke the joint trust, and upon revocation A's property should vest in A and B's property should vest in B. At the death of the first partner, that partner's share of the trust should be included in his or her estate. The survivor's share should remain subject to a power to revoke—that is, it should *not* become irrevocable—to avoid any possible lifetime gift to the ultimate beneficiaries under the trust. At this point, the question becomes: what is the benefit of having a joint trust?

i. If the assets have to be kept segregated to avoid unintentional gifts from one partner to the other, there really is no gain from having a single trust as opposed to two separate trusts. Husbands and wives do not have to worry about unintentional gifts between spouses because they generally qualify for the 100 percent marital deduction. In any event, many estate planners, even for husbands and wives, believe that separate trusts are safer and easier to manage. It is clear whose property is whose. I concur in the advice that use of separate rather than joint trusts is preferable.

ii. But what about couples in California, Washington, and Nevada who own community property? California attorneys in particular use revocable trusts to avoid probate. Even those who advise separate trusts for each partner are reconsidering whether a single joint trust for community property should be used. If the property is 100 percent pure community—that is, it was community when acquired and has not been transmuted from separate to community—the two partners are equally vested in the property and all the income from the property. I do not think there is a risk if the trust contains only pure community property.

iii. Thus, for clients in these three community property states who want to use revocable inter vivos trusts as part of their estate plans, the solution would be to have each partner create a separate trust for separate property and have both create a third, joint trust for community property.

iv. Then, at the death of the first partner, the assets in the separate trust would be included in his or her estate, as would 50 percent of the assets in the joint trust. Where should the assets go at the death of the first partner? That depends on the estate plan. If taxes are not a concern and the desire is to benefit the surviving partner, at the death of the first partner the joint trust becomes a survivor's trust for the benefit of the surviving partner. The assets in the joint trust should continue in that trust with full right of the surviving partner to revoke and use all assets as he or she may request. And the assets in the separate trust should pass to the survivor's trust. For joint estates under $5 million (assuming the $5 million exemption continues), this plan is simple and causes no tax disadvantages.

v. For couples bumping up against the estate tax exemption amount, upon death of the first partner, that partner's share of the joint trust and separate property trust should be subject to a disposition provision that gives an amount to the survivor that, when added to his or her own property at that time, does not exceed $5 million. The remainder should be included in a bypass trust for the benefit of the survivor for life and then for the children or whoever the intended beneficiaries are after the death of the second partner.

vi. Practice Point: Do not combine community and separate property in a single trust. The tax consequences of doing this for partners who cannot rely on the marital deduction are unknown. Although it is possible to draft in detail to allocate ownership of the property between the two partners for purposes of revocation and transfer at death, it is probably simpler to put the property into separate trusts. And community and separate property need to be separately identified for purposes of basis step-up at death under state income tax law (California's, for example).

g. *Payments Of Support And The Gift Tax.* When one taxpayer supports another out of the goodness of his or her heart, any amount in excess of $13,000 per year can be classified as a taxable gift to the person who is being supported. The general rule is that support payments that are not required under state law constitute taxable gifts. *See, e.g.*, Rev. Rul. 54-343, 1954-2 C.B. 318 (father's payments of hospital bills and living expenses of son and son's family held as taxable gifts); Rev. Rul. 82-98, 1982-1 C.B. 141 (parent support of adult disabled child held as taxable gifts). *See* Robert G. Popovich, *Support Your Family, but Leave Out Uncle Sam: A Call for Federal Gift Tax Reform*, 55 Md. L. Rev. 343 (1996); *but see* Patricia A. Cain, *Same-Sex Couples and the Federal Tax Laws*, 1 Law & Sexuality 97 (1991) (arguing that support payments by one partner for the joint consumption of both partners should not be viewed as taxable gifts because they are not *transfers* of property and such payments do not constitute the sort of estate-depleting transfers that the gift tax was intended to cover). Now that the gift tax has been retained despite potential repeal of the estate tax, the new justification for the gift tax is to protect against income-shifting gifts. Joint consumption does not shift income and so, similarly, such payments are not the sort of transactions that the gift tax is intended to cover.

i. On the other hand, when support obligations are imposed by state law, as they are for same-sex married couples and RDPs and parties to a civil union, there should be no taxable gift to the extent that payments during the relationship (or at "divorce") can reasonably be characterized as support payments.

(1) There is no clear rule in the gift tax regulations saying that payments in satisfaction of legal obligations of support are not taxable gifts. Such a regulation was proposed under the 1954 Code, but never adopted.

(2) Transfers in satisfaction of a legal obligation of support do not constitute taxable gifts because they are made in exchange for consideration in money or money's worth. *See* Rev. Rul. 68-379, 1968-2 C.B. 414 (H transfers property to W incident to a legal separation in exchange for her release of her support rights; to the extent the property was for the release of support rights, it did not constitute a taxable gift).

(3) As early as 1946, the IRS took the position that a release of support rights constituted valuable consideration in money or money's worth, and thus the receipt of a sum in exchange for such a release would not be a taxable gift. *See* E.T. 19, 1946-2 C.B. 166. This E.T. was superseded by subsequent revenue rulings taking exactly the same position. *See* Rev. Rul. 60-160, 1960-1 C.B. 374, Rev. Rul. 68-379, 1968-2 C.B. 414. The position taken in these revenue rulings was required by the United States Supreme Court opinion in *Harris v. Comm'r*, 340 U.S. 106 (1950). That case, although it covered transfers between spouses, is still good law.

(4) Before *Harris*, there was an ongoing debate between the IRS and the Tax Court over whether transfers incident to divorce could ever be taxable gifts. The Tax Court took the position that they could not, even if the transfer was for property rights (for example, dower) as well as for support. The IRS, by contrast, continued to insist that property divisions might be subject to gift tax even though transfers for support were never subject to the gift tax. After the *Harris* decision, the Tax Court concluded that the IRS position was correct. *See McMurtry v. Comm'r*, 203 F.2d 659 (1st Cir. 1953). The key point, however, is that both the IRS and the courts have consistently taken the position that transfers in exchange for a release of *support* rights can never be subject to the gift tax.

ii. What constitutes support?

(1) Food, clothing, and shelter.

(2) Something beyond the basic necessities. See *Hill v. Comm'r*, 88 F.2d 941, 945 (8th Cir 1937) (husband created trust to support wife and contribute to the maintenance of the home as long as they lived together; the question was whether the income from the trust was taxable to the husband because it discharged his legal obligation to support the wife; the court held that the income was taxable to the husband. The cost of maintaining the home was $50,000 a year. This amount was above bare necessities, but the court said: "The maintenance, operation, and upkeep of a dwelling as a home for a man and his wife connote something more than the mere food and shelter for the two spouses alone. It includes a place to which friends and the children and other relatives of the man and his wife may come and visit and be socially entertained from time to time. So much inexorable custom would seem to dictate").

(3) There is very little law on the question of where support ends and a taxable gift begins. *See* David Beck and Sheldon V. Ekman, *When Does Support End and Taxable Gift Begin?* 23 N.Y.U. Ann. Inst. on Fed. Tax'n 1181 (1965).

(4) There is more law on what constitutes support for purposes of the dependency exemption. Query whether the tests should be the same or at least similar.

(A) Items of support are not limited to necessities. *McKay v. Comm'r*, 34 T.C. 1080 (1960) (singing and drama lessons for minor child).

(B) Support can include transfers of capital items like televisions and automobiles. *See* Rev. Rul. 77-282, 1977-2 C.B. 52.

(C) Support may include charitable contributions made by the dependent or spouse. *See* Rev. Rul. 58-67, 1958-1 C.B. 62.

(D) Support includes expenses for entertainment. *See Muracca v. Comm'r*, 1984 WL 14489 (U.S. Tax Ct. Apr. 30, 1984) (tickets to hockey games and country club expenses).