TAXATION OF DOMESTIC PARTNERS

by Robin L. Klomparens

DISCUSSION

I. BACKGROUND

This proposed topic is submitted on behalf of the Estate and Gift Tax Committee of the Taxation Section of the State Bar of California.

A. Summary of Proposed Topic

AB 205, as amended by AB 2580, the Domestic Partner Rights and Responsibilities Act ("Act"), was a complicated but landmark piece of legislation. This California state law, which took effect on January 1, 2005, expanded domestic partner rights to include most, but not all, rights of married couples. The legislation provided rights but also imposed responsibilities. Family Code Section 297.5(a) gives community property rights. It states: "Registered domestic partners shall have the same rights, protections and benefits and shall be subject to the same responsibilities, obligations and duties under law . . . ."[1] The Act unfortunately raised legal uncertainty, however, on the interplay between state community property rights and state and federal income, gift and estate tax laws. It also caused many other tax issues to rise to the surface.

SB 1827, signed by the Governor on September 30, 2006, revised two provisions in state tax law. Family Code Section 297.5(g). California law now permits domestic partners to file joint returns and actually requires them to file as married filing separately if they do not file jointly. It also removed the provision of prior law that earned income would not be treated as community income. Thus, the conflicts with federal tax law continue and remain today. Now, it is crystal clear under California law that all income, whether earned or unearned, is treated as community income, split equally between the partners, absent a written agreement executed by both partners overriding the treatment.

While multiple income, estate and gift tax issues exist, three areas will be the focus. The first deals with the treatment and classification of earned and unearned income. The second deals with the tax treatment of division of property on dissolution of the domestic partner union as IRC Section 1041 does not apply. The third deals with estate and gift tax treatment, including clarification of alimony payments received by a domestic partner.

II. CURRENT LAW AND REASON FOR PROPOSED CHANGE

Because of the disparity between state community property rights and federal law as they relate to domestic partners, uncertainty exists as to how a domestic partner should report both earned and unearned

income. California law states that this income is the community property of the partners and shall be reported by the partners on a state income tax return under the "married rules". Whereas, the Internal Revenue Service ("IRS") and the Treasury indicate the earning partner is taxed on the income on a separate federal income tax return (Chief Counsel Adviser No. 200608038 and Defense of Marriage Act, 1 U.S.C. 7). Secondly, on the termination of a domestic partner relationship, since Section 1041[2] does not apply, income tax treatment will depend on which state has jurisdiction over the property of the partner. In essence, the tax consequences will hinge on state law property rights in the state where the division of property occurs. Prior to Section 1041, divorcing spouses faced this problem and Section 1041 was enacted specifically to provide clarity and uniformity between states. Finally, there are complications that the author raises with gifts and other transfers including the treatment of alimony.

A. Property Rights and Income

Under prior law, effective for tax year 2005 only, in filing California state income tax returns, domestic partners had to use the same status used in filing federal income tax returns. Federal law does not consider domestic partners to be married. Defense of Marriage Act, 1 U.S.C. 7, provides:

> In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word `marriage' means only a legal union between one man and one woman as husband and wife, and the word `spouse' refers only to a person of the opposite sex who is a husband or a wife.

Thus, for 2005, domestic partners had to file individual federal and state income tax returns. For 2007 and later years, they will continue to file individual federal returns even though they will file either a joint state return or married filing separate return in California.

Under California Family Code Section 297.5(a), domestic partners are granted the same property rights as spouses, including community property rights. Although community income is deemed community property for all state law purposes, its character for federal income tax purposes is unclear.

In 1930, the United States Supreme Court decided the case of *Poe v. Seaborn*, 282 U.S. 101. This case held that in Washington State community income is equally earned by each spouse so that half of the community income should be reported on each spouse's separate income tax return (joint income tax returns were not possible prior to 1942). The principles of *Seaborn* were extended to California community property the next year in *United States v. Malcolm*, 282 U.S. 792 (1931). The Treasury Department and the Internal Revenue Service were asked to apply the principles of *Seaborn* and *Malcom* to registered domestic partners. The first request, in November 2004, was for a public ruling. The second request, in April 2005, was for a private ruling.

For 15 months the federal government was silent on this issue. Then on February 24, 2006, an internal memo to the Service Centers was issued as Chief Counsel Advice, No. 200608038 ("Memo"). This Memo

concludes an individual who is a registered domestic partner in California must report all of his or her income earned from the performance of his or her personal services on his or her own individual return. The Memo quoted in its factual statement former Family Code Section 297.5(g), which states as follows: "Notwithstanding this section, in filing state income tax returns, domestic partners should use the same filing status as is used on their federal income tax returns, or that would have been used had they filed federal income tax returns. Earned income may not be treated as community property for state income tax purposes." The Service, however, states that it did not rely on that provision in its analysis.

The Memo relied heavily on *Lucas v. Earl*, 281 U.S. 111 (1930) which states a taxpayer may not shift the tax burden of his or her earned income to another by contractually assigning all or a portion of it to someone else. In *Lucas* the Supreme Court held that all of the husband's earnings are to be taxed to husband even though husband and wife had previously entered into an agreement under which all earnings of husband and wife "shall be treated and considered and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship."

The Memo concluded that *Seaborn*, decided the same year as *Lucas*, did not apply to California registered domestic partners. The Memo states that the case law relating to income splitting in community property states has always arisen solely in the context of spouses. The Memo further states that the IRS does not believe that *Seaborn* and its progeny apply to the application of a state's community property law outside the context of a married husband and wife. In its view, the rights afforded domestic partners under the Act are not "made in incident of marriage by the inveterate policy of the state." Therefore, they do not extend *Seaborn* to registered domestic partners. The Memo concludes that an individual who is a registered domestic partner in California must report all of his or her income earned from the performance of his or her personal services, notwithstanding the enactment of California law.

This Memo caused a further dilemma for tax practitioners, including accountants, other return preparers and tax lawyers. This dilemma continues today. While the IRS and Treasury acknowledge that both spouses and domestic partners have the same community property rights, they are taxing them differently. This in essence causes a dichotomy between state property laws and federal income tax laws when dealing with domestic partners.

Staff at the Treasury Department and the IRS in Washington D.C. working on this issue, indicate that the revisions of the Family Code and Revenue and Taxation Code by S.B. 1827 will not affect their Memo. However, one must bear in mind that the Memo is only an internal memo and none of these issues have yet been brought before a court, as they are virtually certain to be. Certainly, SB 1827 will likely strengthen, not weaken, a domestic partner's argument that earned and unearned income should be treated as community property for federal income tax purposes as well, and be allocated 50/50 to each partner's return.

One of the movements in Washington is to legislatively override *Seaborn*. This legislation would in effect prevent, even spouses in community property states, from splitting income. It would mandate that the spouse who controls the income reports that income on his or her separate return. While this may be seen as a solution, it raises concerns from a liability perspective. IRS expects the non-reporting domestic partner to

maintain liability under community property principles, thus he or she would be obligated to pay any tax deficiency. This is inconsistent, since, if community property principles are not applied, the nonreporting partner should bear no liability.

There remains uncertainty as to how IRS will deal with the consequences of the Memo. For example, is the Service taking the position that community income is earned equally by both partners and taxed, by the Memo's special rule, to only one? This could be a problem under *Hoeper v. Tax Commission*, 284 U.S. 206, 52 S.Ct. 120, 76 L.Ed. 248 (1931) which suggests it is unconstitutional to tax one person's income to another.

Or is the Service taking the position that the salary paid to a domestic partner initially is that partner's income and then half of it is transferred to the other partner? If so, is this a reportable gift? Or, is it section 61 income to the receiving partner? And, if both partners work, are the transfers netted, or is each transfer viewed separately as a gift or income?

The author believes that no clarity exists. Currently, many domestic partners split income and report income 50/50 to each domestic partner's return since this is what California law provides. Additionally, the Memo issued by the Service specifically states that it cannot be relied on. Therefore, legislation on the issues raised herein would seem appropriate. This would allow clarity and remove potential and inconsistent positions.

B. Terminating Relationships and Division of Property

Internal Revenue Code Section 1041 prohibits recognizing any gain on property transfers between spouses either during or after marriage if the transfer was incident to divorce. Since that provision only applies to a "spouse" or "former spouse," it currently does not apply to domestic partners. This could result in a taxable transaction if the community property is not divided equally or when separate property is used in dividing community property. This is particularly problematic when living in a non-community property state or when dealing with non-community property or quasi-community property in equalizing a division.

If Section 1041 is not applicable, then one will have to utilize Davis and its progeny. (*United States v. Davis* (1962) 370 U.S. 65) Taxation will then turn on the state property rights in the state of residency and the characterization of the property rights of the property being divided. In a community property state, if there is an equal division of community property, no gain will result. Thus, in California the tax consequences will be minimized. However, in many other states or if dividing non-community property (even in California), then gain could likely result.

In *United States v. Davis* (1962) 370 U.S. 65, Mr. Davis transferred appreciated property to his former wife pursuant to a property settlement agreement executed prior to divorce in a non-community property state. The Supreme Court held that a transfer of appreciated property to a spouse or former spouse in satisfaction of the transferee spouse's support rights or other marital claims and property rights results in the recognition of gain to the transferor spouse. Under Section 1001(a), the transferor spouse recognizes gain or loss on the difference between fair market value and his or her adjusted basis. The spouse receiving the

property receives the basis in the asset transfer equal to its fair market value on the date of transfer and realizes no gain. (Rev. Ruling 67-221, 1967-2 C.B. 63) The nature of the property in the hands of the transferor determines whether the gain or loss was ordinary or capital. The rationale of Davis was that the transferee spouse exchanged inchoate marital rights under state law, the value of which was deemed to be equal to the value of the property transferred by the transferor spouse.

The biggest problem with the *Davis* decision was that the tax result in property settlements differed among the various jurisdictions as it hinged on the particular state's classification of property rights. (See *Lenz v. Lenz* (1982) 117 Misc. 2d 78, 457 N.Y.S. 2d 401, mod., remanded, 103 App. Div. 2d 822, 478 N.Y.S. 2d 56 (1984).) States which were non-community property states followed the *Davis* result. In community property states where there is an equal division of property, or a partition of jointly-held property, the *Davis* result did not apply. (Revenue Ruling 74-347, 1947-2 C.B. 26) This is because in a community property state, the husband and wife have equal interests in community property and there is no realization when the community property is equally divided between them. Additionally, in a community property state, each asset does not have to be split in half, as the assets can be distributed non prorata so that each party ends up with approximately half. (*Waltz v. Com'r*. (1939) 32 B.T.A. 718 and Rev. Ruling 76-83, 1967-1 C.B. 218)

If non-community property is used in a division of community property, however, the division is partly taxable to the person who receives the non-community property, even in a community property state. (*Carrieres v. Com'r.* (1975) 64 P.C. 959, affirmed 552 F.2d 1350 9th Cir. 1977) Likewise, if the division is unequal, gain will also result in a community property state. (*Siewert v. Com'r.* (1979) 72 P.C. 326) In essence, if non-community property is used in a community property state to equalize division, then in that instance gain is recognized up to the non-community property amount. To calculate this amount one looks at, for instance, husband's assets received. If a portion of the property exchanged is separate property, one must calculate the separate property portion compared to the entire amount received to arrive at a fraction. Once that fraction is obtained, it is multiplied by unrealized gain on the property transferred to the wife. Hence, gain will result in this case even in a community property state.

Additionally, there can be further disparity between the non-community property states depending on their classification of property rights. In equitable distribution states, the law has been all over the board. In effect, courts have tried to interpret the way in which the state law characterized the party's interests. The states which found co-ownership, avoided the Davis result. Yet, if the party's interests were not so classified, the Davis result applied. (See *Imei v. U.S.* 375 F.Supp. 1102 (D Colo 1974)., aff'd. 523 F.2d 853 (10th Cir. 1975); and *Cook v. Com'r.* 80 T.C. 513 (1983); *Siewert v. Com'r.* ,72 T.C. 336 (1979).

In essence, the inapplicability of Section 1041 to domestic partners, will cause disparate treatment between various states.[3] This treatment will hinge on whether they reside in a community property or non-community property state. It will further hinge on whether the property rights in the non-community states are more similar to a community property state or other. In effect, one will have to analyze division based on the Davis line of case law. Theoretically, section 1041 will apply to domestic partners with respect to their state income tax liabilities.

The author raises this issue as the legislative branch of the government previously believed, the disparate treatment on division of property between spouses, between states, was problematic. Thus, Section 1041 was enacted to provide uniformity in a property division regardless of the state where the parties resided or property was located. In fact, it is virtually impossible except under extremely limited circumstances to cause gain recognition in such a division. In California, division is not as problematic as taxation will only occur when noncommunity property or quasi-community property is utilized to equalize the division. In other states, however, depending on the characterization of state property rights, taxation will occur. Thus, when property is divided between domestic partners, disparate tax treatment will exist, depending on the state in which the domestic partners reside and the property jurisdiction.[4] Therefore, legislation is needed to prevent such inequities.

C. Gifts and Other Transfers

There are a myriad of gift and estate tax provisions that come into play between domestic partners. This is primarily due to the fact that no marital deduction is available to domestic partners, as once again, under the Defense of Marriage Act cited above, they are not treated as married for purposes of spousal provisions throughout the Internal Revenue Code. The author discusses the various provisions that will come into play in the transfer tax arena.

Under Internal Revenue code Section 2523, gifts between spouses are not subject to gift tax. This does not apply to domestic partners. Gifts would actually include transmutation of separate property to community property between domestic partners. Thus, gift tax would be triggered on the amount of the transfer, less the annual $12,000 gift exclusion and lifetime gift exclusion of $1,000,000 allowed per individual. While the treatment may be appropriate, this could happen accidentally as domestic partners often transfer property back and forth, unknowingly, or change the character of property from separate to community, potentially triggering transfer tax. While many domestic partners are aware of the transfer tax implications on death, they are unaware of the implication of life time transfers, particularly recharacterizations.

On death, partners are ineligible for the unlimited marital deduction for transfers to a surviving partner. They are also ineligible for the step-up in basis for the survivor's share of community property (Section 1014). One partner may transfer up to the unified credit amount to his or her partner upon death, which is currently $2,000,000. As federal law does not recognize community property between partners, transfers between partners either during life or upon death may be deemed gifts of separate property even if the surviving partners own community property interest.

With joint tenancy transfers, there are similar problems. Once again, partners are ineligible for the unlimited marital deduction for the transfer to the surviving partner. Therefore, under the Internal Revenue Code, the IRS may attempt to argue that the joint tenancy property was owned one-hundred percent (100%) by the first joint tenant to die. This puts the burden on the surviving joint tenant to trace the books and records to prove contribution. This is because the Internal Revenue Code requires joint tenancy property to be taxed in proportion to contribution. Once again, many domestic partners are unaware that such records need to be kept.

Generation-skipping transfer ("GST") tax laws may also come into play. If the surviving partner is less than 37-1/2 years younger than the deceased partner, GST tax will arise on any such property transferred over the exclusion amount, which currently is equal to the unified credit amount of $2,000,000. Gifts to a niece or nephew or to a partner's children or grandchildren may trigger GST tax as well. Thus, taxpayers and practitioners need to be aware of the interplay of these rules.

Because of complications with the gift and estate tax laws, it is important for domestic partners to be aware of what is available. Partners can utilize a $12,000 per year annual gift tax exclusion under IRC § 2503(b)(1). Additionally, medical and educational expenses of a partner are exempt if they are paid directly to the provider such as directly to a university or hospital under IRC § 2503(b). Transfers on death up to $2,000,000 in 2006, increasing to $3,500,000 in 2009, unlimited in 2010 and back down to $1,000,000 in 2011 can be utilized. Gifts are excluded only up to $1,000,000, however.

Because of the unavailability of the marital deduction, bypass trusts can be utilized so that any property passing to the domestic partner is taxed at the first death but then excluded from the surviving domestic partner's estate on his or her death. These trusts are obviously irrevocable and must contain the ascertainable standard, allowing the survivor to access principal on health, education, support or maintenance or, alternatively, they can allow unlimited access to principal if an independent trustee is appointed. The survivor can be given a limited power of appointment if the deceased domestic partner wants to permit the surviving domestic partner to change the beneficiaries.

Last but not least, spousal support paid to a domestic partner also raises transfer tax issues. Spousal support paid by one former domestic partner to another is currently not deductible. Is the nondeductible support taxable to the recipient for income tax purposes? Because of the 1917 Supreme Court case of *Gould v. Gould*, 245 U.S. 151 (1917) which suggests that support is not taxable to the recipient (a result changed by Section 71), such payments may be gifts. Alternatively, since the definition of income has broadened since *Gould*, this support may simply be income to the recipient and not a gift at all.

The author believes that while most of the provisions in the transfer tax arena may not apply to a domestic partner, the majority of domestic partners and lawyers practicing in this area are unaware of the implications of the various transfer tax sections. As explained herein, it is very common for domestic partners to make multiple transfers of property between each other and/or to change the characterization of the property. These transactions arguably cause gift tax implications. Hence, it may be appropriate for guidance or legislation to be issued as to the tax treatment of transactions such as the recharacterization of separate property to community.[5] Additionally, since the Service's position appears to be that there is no community property between domestic partners, California requires property to be treated as such, what are the tax implications of accumulation of community property between partners in a community property state? Finally, practitioners and taxpayers are struggling with the treatment of spousal support, particularly to the recipient.

III. PROPOSED ACTION

In summary, the author poses the following issues that practitioners and taxpayers are facing:

(1) Tax treatment of earned and unearned income and on a transfer of half of the income to the other partner in a community property state due to the state's classification of property rights as community. Is this a gift or income to the receiving partner? And, are these transfers netted or are each of them viewed separately as a gift or income?

(2) There is an issue as to the division of property in a community versus non-community state. More specifically, does Davis apply to division of community property between domestic partners in a community property state?

(3) Whether the transfers between domestic partners during life are subject to gift tax and estate tax on death. While in many instances transfer tax implications seem obvious, many domestic partners, family law lawyers, and others in the accounting or tax profession are not aware of the transfer tax implications.

(4) Issues pertaining to the accumulation of community property and conversion of separate property to community and the taxation of these conversions.

(5) Finally, issues involving whether spousal support paid to the recipient causes gift tax or is merely income to the recipient.

IV. CONCLUSION

While the Act gives many rights to domestic partners, it has created havoc on taxpayers attempting to comply with federal tax law, due to the classification of property rights in California versus the federal government's treatment of those property rights. While the tax issues are too numerous to discuss, the author has focused on three primary areas.

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[1] A registered domestic partner is defined as two adults who have chosen to share one another's lives in an intimate and committed relationship of mutual caring. To be recognized in California they must file a Declaration of Domestic Partnership with the Secretary of State and meet certain criteria. Persons of opposite sex may register only if one of the partners is over age 62.

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[3] This is also a problem in civil union states such as Connecticut, Vermont and New Jersey.

[4] Utilizing the Service's analysis in its memo, which does not recognize community property rights between domestic partners, do they agree that Davis avoids imposition of tax on division of community property co-owned by domestic partners in a community property state? For example, a home is purchased with community earnings, the source of which is from one partner. On divorce, if that house is divided 50/50, does Davis apply for federal tax purposes, since IRS may treat those earnings and the source of purchase as belonging solely to the earning partner?

[5] Also, what is the characterization if property is transferred back and forth multiple times. Query: Is this a gift subject to gift tax on each transfer?