PLANNING FOR EVERYDAY LIFE
Estate Planning for Nontraditional Couples, OSB, CLE, July 29, 2004

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I. GIFT TAX ISSUES

A. Transfers of Assets

Like most relationships, nontraditional couples feel like they are "equal" partners in the relationship. They often want their assets to reflect this equality. Transfers of property between partners, adding a partner on title, and designating a partner as a beneficiary are commonplace. In each case where a transfer of an interest in property has occurred, the gift tax consequences should be analyzed.

1. Gift Tax – State. Oregon does not have a gift tax. The taxability of transfers of property between partners is governed by federal law.

> **NOTE: Because federal law controls this issue, the Defense of Marriage Act (DOMA) will prevent same-sex marriage partners from being recognized as "spouses" in this context.[1] Consequently, the gift tax analysis for same-sex marriage couples will be the same as with other unmarried partners.**

2. Gift Tax – Federal. Internal Revenue Code §§2501 and 2511 work together to impose a tax on the gratuitous transfer of property by gift. The application of the federal gift tax statutes to transfers of property is broad. Section 2511 states that the gift tax shall be imposed to any transfer of property "in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible..." Direct gifts are usually obvious; the gift tax traps for most unmarried partners come up in the context of indirect gifts, which are discussed in detail below.

3. When Does a Gift Occur? In general, a gift occurs when the donor transfers property by surrendering all dominion and control of the property and receives no adequate consideration in money or money's worth in exchange for the transfer.

a. **Exceptions.** The following transfers are not taxable gifts:

(1) Transfers between spouses (as defined by federal law-DOMA) (§ 2523).

[1] Defense of Marriage Act, H.R. 3396, §3 provides that for purposes of federal laws, marriage is defined to be a "legal union between one man and one woman."

(2) Transfers to a tax-exempt organization (§2522).

(3) Transfers of a present interest in property within the annual exclusion. ($11,000 in 2004.) (§2503(b).)

(4) Transfers qualifying under §2503(e). Payment of another person's tuition and/or medical expenses if paid directly to the institution providing the services.

b. **Application of the Unified Credit (§2505).** There is a mandatory application of the donor's unified credit against the value of the donor's taxable gifts for the year. Beginning in 2004, the unified credit for gift tax purposes is limited to $345,800 (which shelters $1,000,000 of value). The practical effect of this is that a donor will not have to pay any gift tax until he/she has transferred more than $1,000,000 in taxable gifts during life. Of course, the use of the unified credit against taxable gifts will impact the amount of property that can be sheltered from the estate tax at the donor's death.

c. **Gift Tax Returns and Gift Tax Liability.** If the donor has made a transfer of property that: (i) is in excess of the annual exclusion, (ii) is to a person or entity that is not the donor's spouse, and (iii) is not excluded under the provisions of §2503(e), the donor is required to file a gift tax return for the year that the gift is made.

(1) **Due Date.** The due date of the return is April 15th of the year following the year of gift (§6075(b)). Failure to file the return will subject the donor to penalties unless reasonable cause can be shown (§7508). If a taxpayer is granted an extension of time to file the income tax return, there is a corresponding extension of time to file the gift tax return (§6075(b)).

(2) **Period of Assessment.** If a gift tax return is filed for a year, the usual limitation period within which additional tax can be assessed is three years from the date that the return is filed. However, if a gift of a value in excess of 25 percent of the total gifts stated on the return, the three-year period is extended to six years. Finally, if no return or a fraudulent return is filed, there is no limitation; the tax can be assessed at any time (§6501).

(3) **Donee Liability.** While, normally, the liability for the gift tax falls on the donor (§2502(c)), there is substantial authority that shifts the liability for payment of the gift taxes to the donee if the donor fails to pay. *See Bauer v. Commissioner*.[2] *Bauer* has been

[2] 145 F.2d 338 (3rd Cir. 1944).

cited favorably as recently as 2002[3] and stands for the following somewhat surprising propositions:

(i) If the donor fails to pay the gift tax, the donee is personally liable for the gift tax to the extent of his/her gift.

(ii) The reason for the donor's failure to pay is immaterial; the IRS doesn't even have to make an effort to first collect from the donor.

(iii) Even recipients of tax-free gifts (e.g., a gift within the annual exclusion) can be held liable for the gift tax due on transfers to other beneficiaries.

B. Indirect Gifts

Below are indirect gifting scenarios that frequently arise in the context of transfers between unmarried partners.

1. Adding Partner to Title of Real Estate. Often, unmarried partners have a strong desire to ensure that the title to their personal residence reflects both parties. If one partner was the original owner of the house, or if one partner provided all of the consideration for the purchase of the house, transferring title to both partners will trigger a gift.

a. **Tenants in Common.** A conversion of separate ownership into ownership with partner as tenants in common constitutes a gift of one-half of the donor's equity in the property.[4]

b. **Joint Tenancy.** If one person (donor) provides all the consideration for the purchase of property and thereafter has it transferred to himself and another as joint tenants with rights of survivorship, there is a gift equal to one-half of the donor's equity in the property.[5]

2. Adding Partner as Joint Owner of Bank/Investment Accounts. If the property transferred to joint ownership is a bank account (or any similar property that could be retrieved in its entirety by the donor), there is not a completed gift because the donor retains the right to withdraw all of the assets before the partner can receive any benefit. The gift occurs only when and if the donee actually withdraws funds from the account.[6]

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[3] *U.S. v. Botefuhr*, 309 F.3d 1263 (10th Cir. 2002)

[4] *Commissioner v. Proctor*, 142 F.2d 824 (4th Cir.), *cert. denied* 323 U.S. 756 (1944); Rev. Rul. 86-41, 1986-1 C.B. 300; Rev. Rul 65-144, 1965-1 CB 442.

[5] Treas. Reg. §25.2511-1(h)(5)

3. Designating Partner as Beneficiary. Generally, naming the partner as a beneficiary on a life insurance policy, annuity, retirement plan, or other contract will not constitute a gift, because the donor has not relinquished enough control and would still have the authority to change the designation. However, an irrevocable designation of the partner as a beneficiary or the later relinquishment of the right to change the partner as the existing beneficiary will trigger a gift.[7]

4. Providing Support for Partner. This is likely to be the most controversial of the situations and an area that is bereft of legal analysis. In general, the gift tax has never been applied to the transfer of property to satisfy a support obligation for a spouse or dependent children. Indeed, in an early proposed Regulation, the Treasury stated, "current expenditures by an individual on behalf of his spouse or minor child in satisfaction of his legal obligation to provide for their support are not taxable gifts."[8] Although this statement did not appear in the final version of the Regulations, the principal has continued to hold true in the context of traditional support obligations. (*But see* the holding of *Commissioner v. Greene,*[9] discussed below).

a. ***Commissioner v. Greene.***[10] While it may seem evident that a strong argument could be made that the existence of a support obligation should be determined by local law (and thereby create some wiggle room, at least in the case of same-sex marriage partners), the Ninth Circuit has explicitly rejected this proposition. In the case, California had explicit statutes that provided for the support of adult children in specific circumstances. Further, these were court-sanctioned transfers of property to the adult children based on these support statutes.

The Ninth Circuit ruled that despite the fact that the duty to support existed under state law, the transfers of property to the taxpayer's adult children nonetheless constituted taxable gifts under federal law, stating in part:

> "[A]s we have often had occasion to point out, the revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to state control or limitation unless the language or necessary implication of the section involved makes its

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[6] Treas. Reg. §25.2511-1(h)(4).

[7] Treas. Reg. §25.2511-1(h)(8)

[8] Prop. Treas. Reg. §25.2511-1(f)(1).

[9] 119 F.2d 383 (9th Cir.), *cert. denied,* 314 US 641 (1941).

[10] *Id.*

application dependent on state law."

QUERY: What happens in the case of a divorce between same-sex partners when there is a court-ordered division of assets? Section 2516 exempts transfers of assets incident to divorce between a "husband and wife" (DOMA would support this application to only heterosexual couples). An extension of the conclusion in *Green* would seem to suggest that these transfers could be subject to gift tax.

b. ***Dickman v. Commissioner.***[11] In discussing the parameters of the gift tax consequences of an interest-free intra-familial loan, Justice Powell, writing for the majority of the Supreme Court, stated:

> "Our laws require parents to provide their minor offspring with the necessities and conveniences of life... Generally, the legal obligation of support terminates when the offspring reach majority. Nonetheless, it is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional family matters. When the government levies a tax on routine neighborly or familial gifts, there will be time enough to deal with such a case."

c. **Some Approaches.**

(1) Take a cue from Justice Powell's views in *Dickman* and do nothing – understanding that likelihood of audit is very low and these types of subtle payments of expenses difficult to prove.

However, beyond the potential gift tax exposures, partners should be aware of the potential income tax exposure – payment could be characterized as payment for services. If amount is characterized as payment for domestic or child-care services, the receiving partner has income and self-employment tax and nondeductible personal expense to the deemed paying partner.

(2) More cautious partners may want to track expenses paid on behalf of the partner or at a minimum, make a reasonable estimate of the annual amount to evaluate the potential gift or income tax exposure (estimate is most common).

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[11] 465 U.S. 330 (1984)

(3) After expenses are estimated, partners should evaluate individual circumstances. A portion may be allocated for a child but not in excess of more than one-half of the support for other partner to retain dependency exemption; amount for living could be arguably reduced if nonpaying partner does not own residence, taking position benefit is only for a portion of residence. If over $11,000, file the gift tax return and trigger the statute of limitations.

C. Case Study

1. Facts. Janet (38 years old) and Jackie (36 years old) have been together for five years. Janet owns her own nursery business, and Jackie is a self-employed graphic artist who mostly works out of the home so she can take care of her seven-year-old son. (Son is not Janet's biological child, and Janet has not legally adopted son.) They have the following assets:

a. **Janet:**

(1) **Nursery:** $1,500,000 (expected to grow substantially over the next few years).

(2) **Residence:** $300,000 (mortgage of $250,000).

(3) **Retirement Plan:** $50,000 (Jackie is the beneficiary).

(4) **Investments:** $10,000.

b. **Jackie:**

(1) **Investments:** $25,000 (an inheritance she received from her father's estate).

Janet and Jackie are interested in learning whether there are any tax/financial benefits to them if Janet were to adopt Jackie's son. They would also like to put the house and Janet's investment account into their joint names and want to know whether there are any negative tax consequences. Finally, Janet wants to know about any potential benefits to her hiring Jackie as an employee of her nursery business.

a. **Adoption of Jackie's Son:**

(1) Child tax benefits shifted to Janet to offset income.

(2) Covered under business's health insurance.

(3) Preferences for guardian/conservator.

(4) Would same-sex marriage change the analysis?

b. **House:**

(1) Gift tax issue:

(i) Essentially gifting one-half of the equity in house to Jackie ($25,000), a gift above the annual exclusion.

(ii) Triggers need for gift tax return.

(iii) No difference if married because gift tax is federal (DOMA).

(2) Due-on-sale clause of mortgage.

(3) Liability exposure.

c. **Other Gifting Issues:**

(1) Unmarried couples or same-sex married couples are likely making many indirect gifts to each other throughout the year:

(i) One partner is the substantial breadwinner.

(ii) Both live in house.

(2) Reporting issues – the reality and practicality is that couples are not reporting these indirect gifts:

(i) Gets picked up on audit of Jackie's return.

(ii) Arguments that the "sharing of money and assets" are not gifts.

(iii) Potential protection by filing gift tax return – closes the audit year.

d. **Business:**

(1) Transfer value to Jackie.

(2) Unmarried transfer third-party value (no related-party issue).

(3) Participate in 401(k).

2. Discussion.

a. **Putting Jackie on Title to House.** Janet and Jackie's desire to put Jackie on title to the house as a joint tenant will trigger a gift. The value of the gift will be equal to one-half of the value of Janet's equity in the house, or $25,000. Because the value of the gift is over $11,000, Janet and Jackie should file a gift tax return. There should be no tax due; the value of the gift ($14,000 after deduction for the annual exclusion) will simply reduce the value of Janet's unified credit against gift taxes.

NOTE: Because of DOMA, this analysis would be the same whether or not Janet and Jackie were married in Oregon.

b. **Putting Jackie on Title to Investment Account.** There would be no taxable gift upon the conversion to a joint account because Janet has not parted with enough dominion and control (she could withdraw the assets) to render the gift complete. However, if Jackie were to withdraw money from the account, the gift would be complete to the extent of the money withdrawn.

c. **Providing Support for Jackie; Payment of Miscellaneous Expenses.** In our case study, Janet is the primary income earner, supplementing living expenses for Jackie and her son. Assuming $60,000 in after-tax income for Janet and $20,000 income for Jackie and approximately $24,000 mortgage payments paid by Jackie, including taxes. The remainder of their income is combined. An analysis of the amounts paid in benefit for Jackie is as follows:

	Janet	Jackie
After Tax Income	$60,000	$20,000
Expenses:		
Mortgage Payments	24,000	0
Living Expenses	26,000	0
Living Expenses: Jackie/Son	0	20,000
Savings/Luxury	10,000	0
Total Expenses	$60,000	$20,000

(1) In the example, Janet pays $50,000 for combined household expenses. If we take a conservative assumption of one-half of all expenses, $35,000 (24,000+26,000+20,000/2) for Jackie and her son, less $20,000, contributed by Jackie, the total for Jackie and her son that is supplemented by Janet is $15,000. After allocating a reasonable amount of the $15,000 to the son, Janet

is below the $11,000 gift tax exclusion.

(2) The dependency exemption for the son should be considered in the analysis. The person providing over one-half of the support is entitled to dependency exemption. Dependency exemptions are matched by service. If Janet is taking exemption, for nonadopted child, very difficult to meet support test with service.

(3) If we changed our facts so that Jackie did not work and stayed at home to manage the household and care for Janet's child, annual gift tax returns would support noncompensatory supplement, as income from self-employment for domestic services is taxable at 15.3 percent, without exemptions.

II. INCOME TAX AND OTHER ISSUES

A. Income Tax Consequences

There is conflicting discussion on the income tax impact for couples as unmarried versus married. Couples used in examples showing a lower combined liability if married are generally in the $80,000 or lower combined income range and not itemizing deductions.

Wealthier unmarried couples, when both partners have reasonable income, and those itemizing deductions, frequently have a lower combined income tax liability than if they were married filing a joint return.

Some of the income tax advantages lowering combined tax liabilities for unmarried couples are as follows:

1. Flexibility in allocating itemized deductions, where non-contributing partner takes standard deduction.

2. The $25,000 ceiling on rental losses is fully phased out at $150,000 in gross income for married filing a joint return and unmarried couples filing.

3. Married individuals receive a $45,000 exemption for alternative minimum tax, where unmarried individuals receive $33,750 each. This is more relevant in high-tax states such as Oregon.

4. The annual ceiling for capital losses is $3,000 for married couples and $3,000 each for unmarried partners. Unmarried partners have opportunity to gift loss assets to spread deduction.

5. Federal tax rates are lower for unmarried couples when both partners have

taxable income in excess of around $60,000.

B. Other Planning Opportunities for Business Owners

Unmarried couples have the same opportunities through employing the other partner in their business as married couples. Additionally, unmarried couples are treated as unrelated parties for income tax purposes, and therefore transactions between the business and nonowner partners are not as visible and not subject to related-party limitations for married couples:

1. Additional retirement funding may be available through employing a spouse or partner in a business as a common planning opportunity for married and unmarried couples. The spouse or partner must work in the business and compensation must be reasonable.

2. Unmarried couples can use employment through their partner's business to qualify for nontaxable fringe benefits such as medical insurance, assuming work is performed at reasonable salary. If Jackie is on Janet's medical insurance, premiums paid by company are taxable for federal purposes. In our case study, Jackie could qualify for nontaxable medical insurance for herself and her son through employment. Janet would have taxable income if she covered Jackie's son and the son is not a dependent.

3. Janet could also consider a gift or sale of part of the business at arm's-length price. If services are not a significant factor in business, this could shift income to Jackie to limit supplement gifting and shift appreciation to Jackie.

C. Availability of Dependency Exemptions for Unmarried Couples

To claim a dependency exemption for a partner or partner's child, five tests must be met. The relevant tests for our case are: (1) dependent must have less than $3,050 of gross income; (2) over half of the dependent's support must be furnished by taxpayer; (3) if not a relative of the taxpayer, person must live in taxpayer's home for the entire year.

1. Dependency exemptions are usually matched by the service with Social Security records. Taking the position of a dependency exemption for a nonadopted child, partner, or even adopted child will likely trigger a notice disallowing the exemption, putting the taxpayer in the position of proving the five tests.

2. In Oregon, Janet could take the position of a dependency exemption for Jackie and/or Jackie's son. Janet would be at the burden of proving to the service that she is entitled to the exemption.

3. If Janet adopts Jackie's son, the five tests may be easier and may be limited to providing the service with adoption documentation.

4. Adopted status also allows head of household rates.

D. 2004 Tax Return Filing Status for Same-Sex Married Couples, Including Federally Taxable Employer Medical Insurance Premiums

The Internal Revenue Service's position is: "The marital status of individual as determined under state law is recognized in administration of the federal income tax laws," Rev. Rul. 58-66, 1958-1 C.B. 60.

In 1996, Congress passed the Defense of Marriage Act (DOMA). Under DOMA, "marriage," as used in any federal statute, means only a legal union between one man and one woman as husband and wife:

1. With DOMA enacted by the legislature, the IRS has no authority to ignore it until successfully challenged in court.

2. Federal returns may be challenged for same-sex married couples filing jointly for 2004.

3. Married same-sex couples should be aware that they can file amended returns for refunds, generally within three years of filing their 2004 returns, if judicial interpretations change the IRS's position on DOMA.

Same-sex couples married in Oregon and Oregon residents married in other states may be allowed to file 2004 returns as married filing jointly, pending the outcome of lawsuits challenging the validity of these licenses.

E. Relationship LLCs

Relationship LLCs are being used as a vehicle by unmarried couples to obtain some of the tax advantages available to married couples.

Relationship LLCs are partnerships – nontaxable entities where couples contribute real property and or businesses in exchange for ownership in the LLC and a share of the LLC's taxable income and deductions.

Services are offering these LLCs online. In the extreme example, couples contribute their income-generating business and real property, including personal residences, in an attempt to equalize income and asset ownership:

1. The formation of the LLC or partnership followed by contribution of assets is generally not a taxable transaction for income tax purposes under Section 721.

   If the value of an LLC member's capital contribution is in excess of the capital

interest in the LLC received, an excess contribution may constitute an indirect gift under Reg. 25.2511-1(h). *See also Shepherd v. Comr.*, 283 F.3d 1258 (11th Cir. 2002).

2. Further issues with Relationship LLCs as a vehicle for shifting income and asset ownership are:

    a. Section 121 exclusion of gain on sale of residence may not be available for time period residence held by partnership. *See* PLR 200119014.

    b. Other sections of the code may limit the ability for couples to shift business income from services through a Relationship LLC, including Section 482, permitting the IRS to reallocate income to prevent evasion of taxes, and the partnership anti-abuse regulations at Reg. 1.701-2, authorizing the IRS to recharacterize a transaction involving a partnership if the principal purpose of the arrangement is to reduce the partners' aggregate income tax liability.

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