

FEDERAL TAX IMPLICATIONS OF AB205
THE CALIFORNIA DOMESTIC PARTNER RIGHTS
AND RESPONSIBILITIES ACT OF 2003

M. Jean Johnston, JD, LLM
Johnston|Childress, LLP
220 Montgomery Street, 15th Floor
San Francisco, CA 94104

D. Chris Kollaja, CPA
A.L. Nella & Co.
1390 Market Street, Suite 1004
San Francisco, CA 94102

On September 9th of 2003, Then-Governor Gray Davis signed into law Assembly Bill 205, the California Domestic Partner Rights and Responsibilities Act of 2003 (“AB205” or the “Act”). This act, which became effective on January 1, 2005, attempts to extend to registered domestic partners the rights and duties of marriage.¹ In particular, the Act provides that all registered, former and surviving “domestic partners shall have the same rights, protections, and benefits, and shall be subject to the same responsibilities, obligations, and duties under law, whether they derive from statutes, administrative regulations, courts’ rules, government policies, common law, or any other provisions or sources of law, as are granted to and imposed upon spouses.” *AB205 Section 4 amending Family Code Section 297.5(a)-(c)*.

The stated legislative intent of AB205 was “to help California move closer to fulfilling the promises of inalienable rights, liberty and equality contained in Sections 1 and 7 of Article 1 of the California Constitution by providing all caring and committed couples, regardless of their gender or sexual orientation, the opportunity to obtain essential rights, protections, and benefits and to assume corresponding responsibilities, obligations, and duties and to further the State’s interest in promoting stable and lasting family relationships...” *AB205 Section 1*. The Act appears on its face to create a form of legally sanctioned “marriage” for gay and lesbian couples, granting certain protections previously afforded only to heterosexual couples. The Act does not grant gay and lesbian couples the right to marry, but rather creates a separate and far from equal institution. This inequality is distinctly manifest in the area of federal taxation resulting in disparate treatment between similarly situated registered domestic partners (hereinafter registered domestic partners are “Partner(s)” and the institution is the “Partnership”) and married heterosexual couples (hereinafter “spouse(s)”).

In its proposed form, the Act provided that Partners could file joint tax returns and be taxed in the same manner as spouses for California state income tax purposes. However, the Franchise Tax Board determined that the State would lose tax revenue if Partners were allowed to file joint returns. Then- Governor Gray Davis indicated that he would not sign the legislation if any separate part thereof had a negative revenue impact to the State. As a result, the Senate version of the legislation not only deleted this provision but added language that specifically precluded equal tax treatment for Partners.

¹ A clarification of the Act made the rights and duties retroactively effective as of the domestic partners’ registration date. See AB2580.

Section 4 of AB205 added a new Section 297.5 to the Family Code which provides in pertinent part the following:

“(e) To the extent that provisions of California law adopt, refer to, or rely upon, provisions of federal law in a way that otherwise would cause registered domestic partners to be treated differently than spouses, registered domestic partners shall be treated by California law as if federal law recognized a domestic partnership in the same manner as California law.

(g) Notwithstanding this section, in filing their state income tax returns, domestic partners shall 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.”

These two sections will have significant tax implications for Partners and have and most likely will continue to engender great uncertainty for tax planning and tax compliance. The purpose of this paper is to inform practitioners, in very general terms, of these implications and uncertainties. The authors are not advocating that particular filing positions be taken or that the various arguments presented herein are unassailable. We are simply attempting to alert practitioners to the possibilities and probabilities of the tax consequences of AB205. This is an area in which there is a great deal of uncertainty. It will be necessary for the Internal Revenue Service to issue rulings, which may be followed or attacked depending upon the consequences to a particular taxpayer thus opening the door to, although most likely not the floodgates of, litigation.² The practitioner is cautioned to search for any new IRS rulings before advising clients.

Before discussing the consequences of these two provisions, it is important to outline what AB205 does offer Partners in order to examine the tax treatment of these newly found rights and duties. The Senate Rules Committee in its report on a draft of AB205 (8/27/03 *Senate Floor Analysis*) highlighted certain rights and obligations created by the legislation, including:

- “1. The right to financial support during and after the relationship has terminated.
2. Joint ownership of property (similar to community property), and equitable division upon the partnership’s dissolution or legal separation.
3. Custody, support and visitation of children of both partners born before or after the registration of the partnership or adopted after the registration of the partnership.

² It is our understanding that the Service had not prioritized its review of the tax implications. However, the Service has now begun to review the Act and is expected to issue some form of guidance, although the Service’s rulings only reflect the Service’s interpretation and may not be dispositive of the issues.

4. The right to make anatomical gifts, consent to autopsy, and make funeral arrangements for a deceased partner, and for a deceased partner to be buried in family cemeteries.
5. The right to benefits, such as family care and medical leave, medical, dental, life and disability insurance, pension and death benefits for surviving partners of firefighters and police officers.
6. The mutual responsibility for debts to third parties incurred during the partnership.
7. Protection from discrimination in housing and employment, and entitlements to benefits accorded spouses of employees or applicants.
8. The right to exercise the “marital communication” privilege, as provided by the California Evidence Code.
9. The right to receive government-provided or government-regulated benefits, such as worker’s compensation, public assistance, and the transfer of licenses upon death of a domestic partner.
10. The ability to apply for an absentee ballot for a partner.
11. The ability to make legal claims that are dependent on family status, such as claims against victims’ compensation funds.
12. The fiduciary nature of the partner’s duties towards one another.
13. Other rights and responsibilities derived from case law, government regulation, or policy.”

Under the Act, registered domestic partners will be subject to the jurisdiction of the Superior Court to resolve issues related to the termination of a Partnership, including child custody, support and division of property. The termination of a Partnership will involve procedures similar to a divorce for a married couple.

While the Act does confer significant benefits for Partners, there are many spousal benefits not extended to Partners. In addition to the “not for tax purposes” of subsections 4(e) and 4(g) cited above, the Act perpetuates current separate and unequal treatment for Partners in Section 4(j) which provides that the Act does not modify or amend the State’s Constitution or any statute that was adopted by initiative. An example of a statute adopted by initiative is “Proposition 13” and its reassessment exclusion for real property transfers between spouses.³ More significantly, the Act further provides it “does not amend or modify federal law or the benefits, protections, and responsibilities provided by those laws.” *AB205 Section 4(k)*.

The broad and sweeping language of AB205, while granting rights and imposing obligations, also has significant and most likely unintended tax implications for Partners.

³ In all California counties except for San Francisco, there is no blanket equivalent exemption from reassessment for transfers between domestic partners as there is for spouses. Domestic partners must rely upon certain confusing and ambiguous exemptions created in the Probate Code and by the State Board of Equalization. See AB 2216 and SBE Rules 462.240 and 462.040.

For example, the Act applies community property law and analysis to Partnerships, but does not address how this community property is created for tax purposes. The Act creates joint liability for debts incurred by either Partner during the Partnership, however, the Act does not clarify which Partner is entitled to allowable deductions for community debts and expenses, or how relief of indebtedness income for forgiven debts is allocated between Partners. The Act creates obligations of support during and after the Partnership and mandates division of property upon dissolution in the same manner as property division incident to divorce, but there is no tax relief to the payer of alimony and no exclusion of taxable gain on the division of property pursuant to a dissolution. The Act does not address whether California will still collect its estate/gift “pick up” tax in situations where the federal tax is attributable because in whole, or in part, no marital deduction was allowed to Partners for intervivos or testamentary transfers.⁴

As is evident, the Act does and does not do many things; further, because of the need for clean up legislation and the likelihood of judicial challenge and interpretation, there is much uncertainty as to how the Act’s provisions will be applied. Nevertheless, as the drafters stated, the intent is “to move closer” to providing gay and lesbian couples equal rights under the law and this legislation is a giant step in that direction. Unfortunately, it is also a giant step into a quagmire of federal and state tax implications, and as will be evident herein, there are many questions for which there are uncertain answers.

Filing Status for Federal and State Income Tax Returns

Partners will be required to file as “single” for both federal and California purposes. Partners will not be allowed to file joint federal or state returns. A Partner may be able to qualify for the preferential “head of household” filing status if the Partner supports a qualified dependant. *IRC §2(b)*. A domestic partner is not a qualified dependant for head of household purposes. See below.

The Act specifically provides that federal law controls a Partner’s filing status. For federal purposes, the determination of filing status as “married,” “single,” or “head of household” is determined under the Internal Revenue Code. However, the Code does not define marriage. Internal Revenue Code §6013 authorizes the filing of joint returns for “husband and wife:” “[A] husband and wife may make a single return jointly...” This section refers only tangentially to marriage, e.g., “an individual who is legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.” *IRC §6013(d)(2)*.

The Internal Revenue Code incorporates concepts of relationships such as “marriage” and “parent and child” but does not specifically define these terms.⁵ Traditionally, the determination of whether a couple is married has been the province of state law. See *Penoyer v Neff (1878) 95 US 714*. However, it is anticipated that the

⁴ Although the credit for state estate taxes was eliminated in 2005, and thus there is currently no California estate tax. This provision of the Internal Revenue Code is scheduled to sunset in 2011 unless extended and will again become applicable in 2011.

⁵ See *Cain supra*.

Defense of Marriage Act (“DOMA”) will be used to define “married” for federal income tax purposes rather than looking to state law to expand the definition to include domestic partners.⁶ Whether intended, subsections 4(g) and 4(k) of AB205 as enacted avoid conflict with federal law, at least in the area of filing status.⁷

A Partner may be able to qualify for the preferential “head of household” filing status if the Partner supports a qualified dependant. *IRC §2(b)*. A domestic partner is not a qualified dependant. (A partner may be a dependant for exemption purposes.) Such qualified dependants include children, step- children, parents, grandparents, siblings and certain in-laws. Therefore it appears that even though a Partner may not be a dependant for head of household purposes, the supporting Partner’s in-laws or step-children may be qualified dependants, allowing that Partner to claim head of household status because the Act creates relationships for Partners such as parent-child, in-laws and step-children. Presumably, the Service would allow state law to define relationships that are not otherwise defined in the Code.⁸ However, it is possible that the Service will assert DOMA to preclude those relationships usually confirmed only to spouses through marriage. See *Cain, id at 396-398 in respect to relationships created by Vermont Civil Union Statutes*.

A taxpayer’s filing status determines the tax rate applicable to the taxpayer. Partners may pay different amounts of tax than similarly situated spouses because of the filing status each couple is allowed to use. The tax consequences of precluding Partners from filing joint returns must be determined on a case by case basis because a taxpayer’s filing status may be determinative of certain tax adjustments, deductions and credits allowed to the taxpayer. Generally, however, if only one Partner has income, then the Partners will pay more total tax than spouses who are allowed to file jointly. If both Partners have income, then they may save taxes by being able to file separately as single taxpayers, whereas spouses who file separately must use the higher tax rates applicable to “married filing separately.”⁹

⁶ DOMA provides that “[i]n determining the meaning of any Act of Congress, or of any ruling, regulation or interpretation of the various administration 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.” *IUSC §7*. Previously, the IRS has asserted that a “domestic partner” is not a “spouse” for federal income tax purposes in the context of the taxability of health insurance coverage for non-working domestic partners and defining dependants. *PLR 9850011 and PLR 200339001*. Professor Cain states in reference to Vermont civil unions that, “[a]s a technical matter, parties to a civil union are not married. Thus, they cannot file joint returns. Even if they were married, DOMA would prevent their marriage from being recognized for purposes of federal tax law.” *Cain id at 390-391*.

⁷ The working draft of a Massachusetts Technical Information Release states “[f]ederal law does not recognize same sex civil marriage, and same sex spouses will remain individual filers for federal tax purposes.” (TIR 04-17) July 7, 2004.

⁸ Prior to the Act the California State Board of Equalization allowed head of household status to a taxpayer who supported her domestic partner’s child applying the concept of “intentional parenthood.” *In re Appeal of Helmi A. Hisserick (Nov. 1, 2001) No 99A-0341 CA ST BD EQ*.

⁹ If spouse Jane has taxable income of \$200,000 and files jointly with her spouse John who has no income, their federal tax liability, using 2005 projected rates, would be \$46,591. If Jane and John are each treated as having \$100,000 of taxable income each have tax liability of \$23,512 and a combined federal liability of

Community Property and Taxable Income

The determination of a taxpayer's taxable income takes into consideration the taxpayer's gross income, adjustments to that income, then deductions and exemptions against the adjusted gross income. All of the same procedural rules that applied pre-AB205 will apply to 2004 tax years. Furthermore, the Partner's filing status will remain the same, and the Partner's tax rates will depend on that status. However, because of the community property system the substantive rules of determining a Partner's gross income, adjustments, deductions and exemption will change.

AB205's application of the community property system for Partners provides the central premise for the analysis of its tax ramifications. Until the enactment of AB205, the concept of community property existed only between a husband and wife. Property rights between domestic partners were based on contractual relationships, either explicitly memorialized by written agreement or implied by "Marvin" type agreements. *See Marvin v. Marvin (1976) 18 C3 550*. The distinction between property rights created by contract versus those created by statute is important in analyzing the taxability of the transfers of wealth between partners. *Marvin* rights are contractual rights. Therefore, the tax implications of *Marvin* transactions and those based on written agreement are based upon theories of contractual consideration.¹⁰ Obligations of support and ownership of property founded in statute are usually not subject to tax analysis upon theories of contractual consideration.

The Senate Rules Committee in its report stated: "[t]his bill repeals the current provisions dealing with joint property of the domestic partnership and instead confers the same rights and obligations on domestic partners, former domestic partners, and surviving domestic partners, that current law confers on married couples. The current provision requires the partners' property to be apportioned according to any agreement the partners may have had prior to the acquisition of the property. This bill does away with the need to enter into such agreements, and treats such property the same as property of married couples is treated."

The community property system is based upon the concept that a husband and wife form a partnership to which each partner contributes labor, effort and skill. The product of this labor, effort and skill belongs to the partnership/marriage and hence to each of the partners/spouses. In general, all property acquired by either husband or wife during a marriage is community property, except that which is acquired by gift, devise or

\$47,024. If Partner Tom has \$200,000 in taxable income and his Partner Tim has no income, Tom's tax liability filing as single would be \$52,998. If, however, Tom and Tim were both treated as having \$100,000 of taxable income the each would owe \$22,506 in federal tax for a combined tax of \$45,012. Based on these generalized calculations, Tom and Tim potentially could pay less tax than Jane and John if Tom's income is taxable to both Tom and Tim using the true community property paradigm. This is the result of the so-called "marriage penalty." California income tax rates do not create a marriage penalty because there is not a separate rate for married filing separately.

¹⁰For example, providing for a *Marvin* partner's support may be a taxable event, it could be a taxable gift to the extent that the amount of support exceeds the value of the supported *Marvin* partner's non-meretricious sexual services and income to the supported partner to the extent of such services.

descent (or otherwise provided by agreement or federal law).¹¹ Each spouse has an undivided one-half interest in all income and property acquired by either spouse during the marriage. *Family Code §751 and §760*. All property acquired during marriage is presumed to be community property and titling property in the name of one spouse does not overcome the presumption of community property. Both husband and wife have a present vested, equal, undivided interest in all community property. *Bishop v Comm* (9th Cir 1945) 152 F2d 389, PLR 8016050. For community property purposes, it is irrelevant which spouse actually earned or acquired the income or property, the asset belongs to the community and both spouses are equal participants in and owners of the community.

If the community property system is applied in the same manner to Partners as it is to spouses, then it would follow that any property acquired during the Partnership is community property, except that which is acquired by gift, devise or descent (or otherwise provided by agreement or federal law). For example, it would appear that earnings of a Partner belongs to the Partnership, and hence equally to the Partners regardless of which Partner earned the income. Property acquired with such earnings would therefore be community property.

Typically, community assets are created by the earned income of the spouses. For federal income tax purposes, this community earned income is split between the spouses. *Reg. §1.66-1(a), Poe v Seaborn* (1930) 282 US 101. If a spouse elects to file a separate income tax return, one-half of all community income is included on that return, regardless of whether that spouse is the actual wage earner, and one-half would be included on the other spouse's separate return.¹² However, because most spouses file a joint return, this split is irrelevant for income tax purposes. *See IRC §6013*. Partners however are not allowed to file a joint return. Therefore, applying a pre IRC §6013 analysis, each Partner would presumably be required to report one-half of the community income on his or her single filing status return.¹³ However, the Act clearly states that for Partners, "earned income may not be treated as community property for state income tax purposes." This language is susceptible to at least two very distinct interpretations, each having very different consequences. One interpretation is that for federal tax purposes income is split, but not for state tax purposes. Another interpretation is that earned

¹¹ California recognizes the right of spouses to enter into marital agreements respecting their property rights. Spouses can agree that earned income is the separate property of the earning spouse. *Helvering v Hickman* (9th Cir 1934) 70 F2d 985. Furthermore, in some circumstances, federal law preempts community property law. For example, pensions, IRAs, and other funded plans subject to ERISA are governed by ERISA and are not subject to state community property law with regard to joint and survivor benefits. *See Boggs v Boggs* (1997) 520 US 833 with regard to ERISA. Also see *Bowlden v Bowlden* (1989) 118 Idaho 15, 794 P 2d 1145 with regard to Social Security. However, state law may create spousal rights in this otherwise preempted property.

¹² Jane has a salary of \$100,000 and her husband John has a salary of \$200,000. If Jane and John file separate returns, each would report income of \$150,000 or one-half of the community total of \$300,000.

¹³ In many situations, this could be a preferable result to filing jointly because each Partner would be able to enjoy the benefit of graduated tax rates. See Footnote 9.

income is, for federal and state tax purposes, reportable only to the earning partner and is not split.¹⁴

The Act clearly creates community property for the Partners. With limited exceptions, federal law looks to state law for the determination of property rights. *Malcolm v US* (1931) 282 US 792. Both federal case law and the Code clearly provide that community income is reportable equally by spouses as the members of the community. *Poe v. Seaborn* (1930) 282 US 101 and IRC 66(d)(2).

The argument in support of the income split interpretation is that state property law will determine ownership of property and earned income is community property for state property law purposes. The phrase “for state income tax purposes” only controls reporting of earned income for California purposes, not for federal purposes. Federal law looks to state *property* law not state *tax* law to determine the nature of earned income for federal income tax purposes.¹⁵

If this is the accepted position (and the authors believe that it should be), then it would logically follow that each Partner would report one-half of the community income on his or her separate return as is appropriate for married couples who file separately. (The primary difference being the filing status of “married filing separately” as opposed to “single.”) This follows the historical premise of the community property system which finds a form of marital partnership within which the spousal partners share income. This system avoids gifts or disallowed assignments of income in the creation of the community interest.

Although the split income approach is probably the legally correct analysis in light of *Poe v Seaborn*, it is arguable that the Service will not accept this position, citing perhaps legislative intent, ambiguity, and DOMA.¹⁶ It may be argued that historically, by statute or ruling, community property has always been an incident of marriage, therefore without the accepted relationship of marriage, the property interest created under state law will be ignored for federal purposes.¹⁷

¹⁴ Unearned income derived from community property should be reportable to both Partners whether the split or separate interpretation is applied to earned income. Even if the earned income was originally separate property for income tax purposes, any investment of this property will be community property by operation of law. Therefore, as with any transmutation of separate property to community property, the income or capital so derived will be community income.

¹⁵ “State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.” *Morgan v. Comm* (1940) 309 US 78,80. (This decision concerns a general power of appointment created under state law.)

¹⁶ It is clear that, for California filing purposes, earned income is not split between the Partners. As a result, a Partner will still be required to file two income tax returns, a federal Form 1040 and a State Form 540. However, the Form 1040 will report split income (*see IRS Publication 555*), while the state Form 540 will report a recalculated hypothetical federal adjusted gross income instead of the Form 1040 amount. Thus preparing State income tax returns for Partners will be much more complicated than for other taxpayers.

¹⁷ See *Comm v Greene* (1941 9th Cir) 119 Fd 2d 383 wherein the federal court ignored a California court order regarding a statutory obligation of support created under California law thus finding a taxable gift for federal tax purposes. The *Green* court cited *US v Pelzer* (1940) 312 US 399 “we have often had occasion to point out, the revenue laws are contrived in light of their general purpose to establish a nation-wide

Another possible interpretation of the statement that “earned income may not be treated as community property for state income tax purposes” is that for both federal and state income tax purposes earned income is not community property. It has been asserted that this interpretation is in line with legislative intent to avoid conflicts with tax laws. If this interpretation is adopted, then this exclusionary action by the legislature, whether taken to avoid conflict or as a politically motivated concession, raises the following perplexing tax issue: If earned income is not community property for income tax purposes and the Partners cannot file a joint return, then it follows that the earning Partner would report all such income on his or her single/separate return. This implies for tax purposes that such income is the separate property of the earning partner. Therefore, for tax purposes, how does the property acquired by separate taxable income become community property? Or is the income still community property but only taxed to one Partner? If this interpretation controls there is the potential for presumable unintended gift tax consequences.

Spousal community property income is deemed earned by both spouses for federal income tax purposes, therefore there is no transfer of property, assignment of income or gift between the spouses upon the creation of the community. However, the transmutation of one spouse’s separate property into community property is a gift for federal gift tax purposes. *See IRC §2511*. Nevertheless, the spousal transfer is excluded for gift tax purposes because of the unlimited marital deduction. *IRC §2523*. If a Partner’s earned income is treated as separate property for both federal and state income tax purposes, is the property interest received by a non-earning domestic Partner a gift for federal gift tax purposes?

A transfer of property is almost always income or a gift, except perhaps if the transfer is in satisfaction of a statutory obligation of support or if the transferee already owns the property. However, assuming that the Partner’s earned income is separate property, then presumably, for example, a federal taxable gift may occur each time one Partner receives a paycheck because the other Partner has a community property interest in that paycheck. If both Partners receive employment income, are there cross gifts, or are the two gifts netted and only the excess of the higher salary is deemed transferred to the lower wage earner? Furthermore, is the non-earning Partner’s interest in the paycheck equal to the net earnings after taxes or to the pre-tax earnings? These questions have yet to be resolved.

If a Partner’s earned income is treated as community property for federal tax purposes, then there should be no gift on the creation of the community. Under *Poe v*

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 application dependent on state law.” Furthermore, it could be argued, for example, that *IRC §66* applies specifically to spouses and therefore, read in that context, directs that the definition of state community property rights only controls in the context of community property between spouses. While the *Green* opinion is distinguishable on other grounds and counter analyses can be made, it is beyond the scope of this paper to entertain a full legal analysis regarding this or any other argument related to the tax consequences of the Act. The purpose in citing a case such as *Greene* is to caution the practitioner that there is no certainty that the Service or courts will apply *Poe v Seaborn* in this situation. Hopefully, there soon will be some guidance in this respect.

Seaborn, supra, the earned income is community property for federal tax purposes, therefore, there is no transfer between Partners. (This may not be true for pre-2005 earned income that has been retroactively transmuted by statute into community property.) However, even if earned income is not treated as community property for federal income tax purposes there are other arguments against treating the creation of the community as a gift.

One potential argument in support of non-gift treatment is that the non-earning spouse has a statutory interest in the earned income, therefore, there is no gift because the transfer is only of property that by statute belongs to the non-earning spouse. However, there is still the fundamental transmutation problem, i.e. separate earnings to community property.

Another potential argument against an imputed gift is that the Act imposes the legal obligation of support between the Partners and the discharge of the obligation is not a taxable event for gift tax purposes. Federal law provided that “[C]urrent expenditures by an individual on behalf of his spouse or minor child in satisfaction of his legal obligation to provide for support are not taxable gifts.” *See Prop. Reg § 25.2511-1(f)(1) under the 1954 Code since superceded*. Although this language is not found in the current law, its meaning is likely implied, therefore, under the current Internal Revenue Code, a parent’s or spouse’s discharge of a legal monetary support obligation is not a taxable transaction. It is not certain that the Service or courts will extend this principal to Partners. Even so, an issue may arise concerning the extent of the support obligation for tax purposes. There is the potential for a gratuitous transfer for amounts transferred in excess of the true support obligation. In other words, when does an obligation become an indulgence? This issue does not arise for spouses because of the unlimited marital deduction. It may be an issue for Partners.

Another possible interpretation of the Act is that there is no vested interest in the earned income. That is, earned income and the products thereof are only taken into consideration when the community is dissolved, so that a Partner is protected in the event of divorce or death. While this interpretation has been advanced, it is beyond the scope of this chapter to analyze the drafters’ intent. However, if this interpretation is adopted, then the tax analysis would shift to the implications upon vesting of an interest during the relationship, i.e. when property is acquired in both names, or upon death or divorce.

Income Tax Adjustments, Deductions, Exemptions and Credits

As almost anyone who has filed an income tax return is aware, taxes are not solely dependant upon what one makes but also upon what one spends. The legislature values certain expenditures over others, and those that are truly valued are allowed as either adjustments to income, itemized deductions or tax credits. The preferential tax treatment for certain expenditures is used to encourage such expenditures.

Adjustments to income are deductions that are allowed directly against gross income. These so-called “above the line” deductions are used to determine a taxpayer’s adjusted gross income and include expenditures for IRAs and other qualified plans,

student loan interest, self-employment tax, moving expenses, self employed health insurance, alimony, etc. *See IRC §62*. Adjustments to income are personal in nature. Except for limited situations, a taxpayer cannot take an above the line deduction for expenditures made for a spouse or dependant or paid on his or her behalf by another. Yet as discussed above in reference to income, the ability of spouses to file a joint return makes the identity of the payer and source of funds irrelevant. For Partners, on the other hand, the identity of the payer and source of funds may be a complicated issue.

The Act presents the following threshold question: Can a Partner take a deduction for 100% of an adjustment item paid with community funds, and if so, has a gift been made by the other Partner? For example, Partner Joe is self-employed and contributes \$30,000 to his profit sharing plan. The contribution is made from his self-employment income which pursuant to the Act is community property. Has his Partner, John, made a gift of \$15,000 to Joe? Has John made a completed gift if John has a community property interest in Joe's plan? If John has not made a gift, can Joe take the full deduction?

The inability to file a joint return will cause Partners to be treated differently than spouses in the allowance of other adjustment items. For example, a non-earning spouse can borrow the earning spouse's income to qualify for an IRA deduction.¹⁸ A Partner cannot take a deduction for tuition payments or student loan interest for his or her Partner even if paid with community funds. (Query: does the expense become deductible if it is a community debt?) The ability to take a deduction is most significant when one Partner has little income to be otherwise offset by the deduction. In effect, the Partners may lose the benefit of the deductions because they are not allowed to file a joint return.

One of the most glaring inequalities between Partners and spouses is the ability of a former spouse to deduct alimony paid. *See IRC §215*. As will be discussed below, Partners are not eligible for this adjustment item

Individuals are generally granted certain itemized deductions in computing their taxable income. Depending upon the complexity of the individual's income tax situation, itemized deductions generally include medical expenditures, home mortgage interest, property taxes, charitable deductions, state income taxes, and miscellaneous deductions. Generally, itemized deductions are deductible by the person who both enjoys the personal benefit and incurs the economic cost of the expense.

With the prospect of community property rights for Partners and the obligations imposed by the Act, the issue arises as to which taxpayer Partner is allowed to deduct certain community expenditures. As stated above, expenses that are personal to the taxpayer, such as personal income taxes, medical expenses, and miscellaneous deductions, are usually only deductible by the taxpayer incurring the expense. Generally,

¹⁸ An advantage to Partners however is that one Partner's income level and participation in a qualified plan will not be imputed to the other Partner and possibly limit that Partner's contribution.

no deduction is allowed if one taxpayer pays a deductible expense of another except if the other is a dependent or spouse.¹⁹

The creation of community property rights and obligations for Partners raises the question of how deductions for community expenses are allocated between the Partners. If a married couple's expenses are paid with community funds, each spouse is entitled to report one-half of the deductions. If spouses file separately, one-half of such deductions are reported on each respective return. *IRS Publication 555*. Furthermore, in order for a spouse to take a full deduction for a separate property expense the spouse must establish that payment was made with separate and not community property. *E.W. Clemens v Comm (1947) 8 TC 121*. If spouses file a joint return, this categorization becomes irrelevant. Because Partners cannot file joint returns, the categorization becomes very important. Tracing the source of payment becomes a complicated issue for Partners.²⁰

A particular tracing problem can arise involving real property. For example, Partner owns a home as separate property but pays the mortgage with community funds. Does the owner Partner get a 100% deduction for interest paid, or only a 50% deduction? If only a 50% deduction, can the non-owner Partner take the deduction if he, or his property, is not obligated on the debt? No deduction is allowed for a taxpayer's payment of property expenses unless the taxpayer owns the property or has an interest in the real property. *Brock v Comm (1982) 44 TCM 128, 145*; *Brooks v Comm (1992) 63 TCM 1973*. A taxpayer is allowed, however, to deduct interest and property expenses where the taxpayer has a beneficial or equitable interest in the property. *Conroy v Comm (1958) 17 TCM 21, 25*. Does the payment of expenses and principal with community funds attributable to a Partner's separate property create a beneficial or equitable interest in the property for the other Partner?

For federal income tax purposes, a taxpayer obtains a beneficial interest when the taxpayer takes possession, and assumes the burdens and benefits of ownership. *Riordan v Comm (1978) 37 TCM 839, 841-42*. For example, Partner Joan owned her principal residence when she registered as a domestic partner with Karen. Subsequently, Joan pays from her checking account, as she has always done, the interest and real estate taxes for the principal residence (which is now occupied by both domestic partners). However, Joan's checking account now holds community property income. Because these

¹⁹ While spouses can benefit from all expenses paid for by each other, this is not true for expenditures on behalf of other dependants. Such deductions are limited to medical expenses. *Williams v Comm (1960) 19 TCM 106, 113*. For example, daughter could pay her father's hospital bills, but unless father is daughter's dependant, she cannot take the deduction for the expenses she paid. Furthermore, if daughter made the payment directly to the hospital, father cannot take the deduction. However, if daughter gifts funds to father and he makes the payment, the father could take the deduction. However, daughter may then have made a taxable gift to father.

²⁰ Partner Sue incurs a \$20,000 hospital bill, it is clear that Partner Jill cannot take the deduction even if she paid the bill, unless Sue is a dependant. However, if Sue pays the bill from their community property, Sue has paid only \$10,000 of the bill and Jill the other half. Therefore, Sue is probably only allowed a deduction of \$10,000 unless there is a deemed gift of \$10,000 from Jill to Sue. Furthermore, if Sue does not have sufficient income to take advantage of the deduction, the tax benefit of the expenditure would be lost to the Partnership. Of course if Sue and Jill could file a joint return, the source of funds and the spouse benefited would be irrelevant for tax purposes.

payments are from community property, is a beneficial interest being created by Karen? If Karen does have a beneficial interest, is she entitled to a portion of the deduction? Even if Karen does not have a beneficial interest, can Joan take the full deduction because one-half of the expenses have been paid with Karen's share of the community property? Is Karen deemed to be paying rent to Joan?

Co-ownership of real property presents additional complications for Partners. If Partners acquire property during the Partnership with community funds and title is held equally as either tenants-in-common or joint tenants, it would appear that the income and deductions related to the property for federal income tax purposes would be evenly divided between the Partners. It would be assumed that the income derived from the property is 50/50 community income, and expenses paid from community income would also be equally split. However if property is acquired as tenants-in-common during the Partnership other than ratably between the Partners, or acquired with part community/part separate funds, there are resulting complications. For example, Partner John and Partner Ray take title 70% to John and 30% to Ray. The expenses for the property are paid from a joint account into which both deposit their paychecks. Because the income is subject to community property rules and presumably owned equally by Partners, it follows that the related deductions would be equally deducted. However, the underlying ownership indicates that the property may be part separate property and part community property. If this is the case, the difficulty lies in the right of reimbursement for tenants in common under California law. Under federal tax rules, a co-owner is only allowed to deduct his or her ownership percentage of property expenses because of the right of reimbursement, regardless of whether he or she provided all the funds for the expenses. *James v Comm* (1995) 70 TCM 1420.

Resolving these issues will require careful planning. A cautious approach is to establish separate accounts to insure that a Partner pays the expenses he or she expects to deduct from his or her separate funds and to memorialize any agreements between the Partners regarding characterization and source of funds. Unfortunately, this tax reality approach may not be acceptable to Partners who want to focus on the relationship realities and need for joint accounts. If this is the case, then it is recommended that Partners at least take a uniform and consistent approach to allocating expenses.

The deductibility of state income taxes paid presents possibly the most complicated issues related to itemized deductions. As discussed above, the Act provides community property rights in the earned income of the Partners. However, the Act specifically states that earned income is not community property for state income tax purposes. Accordingly, each Partner would separately report his or her income (regardless of community property character) and would be subject to state tax on that income. A conflict occurs however, if community property funds are used to pay the expenses that would otherwise be deductible by the earning party. For example, state tax is imposed on only the earning Partner, usually in the form of withholding. Is only the earning Partner's share of the community reduced by the taxes withheld or paid, or has the tax been partially paid by the non-earning Partner? If taxes are paid by the non-earning partner, are the state taxes paid still deductible by the earning partner? Or are they deductible, but a deemed gift by the non-earning Partner to the earning Partner? The

non-earning Partner has no liability to the state for state taxes, therefore he or she should not be entitled to any deduction for state taxes paid.

In addition to adjustments and deductions, each taxpayer is entitled to a personal exemption. In 2005, this exemption is \$3,200.²¹ In addition to the personal exemption that a taxpayer Partner can claim, the Partner may also be able to claim an exemption for his or her Partner if the Partner qualifies as a dependant under IRC §152. (A married taxpayer can receive a personal exemption for his or her spouse without requiring that spouse to qualify as a dependant.) A dependant may also include in-laws and step-children. However, unlike qualifying as a dependant for head of household status, a dependant may qualify for exemption status without the requisite “familial relationship.”²² Therefore, as long as the other qualifications of IRC §152 are met, the individuals that a taxpayer supports may qualify as dependants.

The member of household test is important if the Service does not accept that relationships such as step-child and in-law are created by the Act. For example, unlike a married step-parent whose relationship is recognized in many federal statutes, from a tax perspective, a step-parent’s Partner has no relationship with the stepchild and therefore cannot qualify for head of household status. *See IRC §2(b)*. A step-parent Partner may at least claim the other Partner’s child as a dependant for exemption purposes, provided the step-parent Partner provides over half the child’s support and the child is a member of the household. *IRC §152(a)(9)*.

The community property aspects of the Act could potentially have unexpected tax effects for Partners who have children. Prior to AB205, if both Partners were legal parents, one Partner could treat the child as a dependant and take advantage of the head of household filing status as long as that Partner provided more than 50% of the child’s support and paid more than 50% of the expenses for the child’s home.²³ However, if all such expenses are charged equally to the community and are paid from community funds, how does one Partner pay more than 50%?²⁴ A possible solution is to create separate property for one Partner to pay a portion of the child’s expenses. This would involve creating a separate account to hold separate property and insure that a portion of the expenses are paid therefrom. However, in relation to the home, we are again confronted with the issue of separate property contributed to the community and the related tax issues.

²¹ The amount of exemption allowed is reduced for AGI over \$214,050 for joint returns, \$178,350 for head of household, \$142,700 for single.

²² IRC §152(a) and 152(b) provide dependant status for a “person (other than the taxpayer’s spouse) who, during the taxpayer’s entire year, lives in the taxpayer’s home and is a member of the taxpayer’s household...”

²³ Head of household is a filing status that allows a single taxpayer to use married filing jointly tax rates. *IRC §1(b)*. Claiming someone as a dependant allows the taxpayer to take an exemption for that person. *IRC §151*. There is no tax benefit for an exemption once a taxpayer reaches a certain income level. There is almost always a tax benefit for the preferential head of household status.

²⁴ Spouses filing separate returns who support dependants with community funds are allowed to allocate the dependants between them. *See IRS Publication 555 “Community Property and Federal Income Tax.”* However, it is likely that DOMA would preclude Partners from doing the same.

Partners may have certain tax advantages over spouses in qualifying for certain tax credits and tax benefits. The availability of earned income credits, child care credits, and employer sponsor child care benefits exclusions are limited by the earned income of the spouses. For example, if one spouse has no earned income, then the married couple does not qualify for the child care credit. *IRC* §24. A Partner's earned income, or lack thereof, should not affect the eligibility of the other Partner for the credit. Adoption credits are another area where Partners may enjoy greater tax benefits than spouses. Adoption credits are limited to \$10,000 per eligible child. A married couple and a single taxpayer are entitled to the same \$10,000 credit. *IRC* §23. Each Partner, however, should be entitled to a \$10,000 credit thus resulting in a \$20,000 credit for the Partnership. Also, no credit is available for spouses for step-parent adoptions. There are no rules precluding the credit for adopting a child of a Partner.

Divorce and Separations

In addition to the property rights and obligations created during the Partnership, the Act creates rights and obligations for Partners upon the termination of the Partnership. These rights and obligations are the same as those for divorcing spouses and include the division of Partnership assets and obligations, and the potential payment of Partnership and/or child support to an ex-Partner. As with spouses, these rights and obligations have tax implications. However, the tax implications for terminating Partners are quite different from those for divorcing spouses.

Under *IRC* §71, §215 and §1041, spouses who divorce or separate are afforded special tax treatment to ameliorate the economic upheaval that can result from divorce or separation. Sections 71 and 215 provide that alimony paid can be deducted by the payor and is taxable to the recipient. This allows the parties to allocate the tax burden in a manner that can reduce the overall tax liability of the ex-spouses. Section 1041 allows for a tax free transfer of property between spouses incident to divorce, thus avoiding potential capital gains on the disposition of property. The Internal Revenue Code specifically grants the benefits of these tax provisions to "spouses," therefore, the IRS would likely assert DOMA to deny these same benefits to Partners terminating a Partnership. Therefore, the federal tax ramifications for terminating Partners may be subject to a completely different analysis than for spouses.

Prior to the passage of the Act, the tax ramifications of transactions between domestic partners were subject to analysis based upon principals of contract law and/or gift tax law. Such "palimony" or *Marvin* type support payments and property divisions are generally viewed as payments or transfers pursuant to a contract because there was no statutory basis for the underlying obligations as there is for marriage. Therefore, the tax treatment for such transactions is dependant on the nature and extent of consideration received. For example, a payment in consideration of a domestic partner's services rendered would be income to that partner. To the extent that there is not adequate consideration for a transfer made, there is a potential for a transfer to be treated as a gift. A "support" payment made to an ex-domestic partner would not be deductible by the payor, and could be taxable to the payee or could be deemed a gift to the payee. *See IRC* §61 and §2511. If a domestic partner transfers appreciated property to an ex-partner to

satisfy a “contractual” obligation, there could be taxable gain to the transferor. Property transfers between domestic partners could trigger income tax and/or gift tax to the transferor, and income tax to the transferee, on the same transaction.

Tax advisors struggle with determining the appropriate tax treatment for transfers of property and ongoing support obligations between non-registered domestic partners. This struggle continues under the Act for Partners.

AB205 established that a terminating Partner may be obligated to make support payments to an ex-Partner. These support payments are substantially the same as spousal support provided for an ex-spouse. However, the federal tax treatment for ex-Partners as compared to ex-spouses is substantially different. Given a literal reading of the Internal Revenue Code in conjunction with DOMA, it is fairly certain that an ex-Partner will not be able to deduct support paid from his or her federal adjusted gross income. An ex-spouse is allowed to do so if the support paid is qualified “alimony” under IRC §215. However, IRC §215 is applicable only to payments made to a “spouse” *IRC §215(b) (incorporating the definition of alimony under IRC §71(b)(1))*, and a Partner is not a spouse. However, there is uncertainty as to whether the recipient ex-Partner must also include the support received in gross income pursuant to IRC §61. A payee ex-spouse usually will not have includible income under IRC §61 because IRC §71(b) allows an exclusion if the payment does not qualify for deductibility under IRC §215.

Internal Revenue Code Section 61 provides that for federal income tax purposes, gross income means all income from any source derived, unless the income is specifically otherwise excluded by another provision in the Code. Income generally includes any accession to wealth other than by gratuitous transfer. Alimony or separate maintenance payments are specifically included in income under IRC §61(a)(10). Therefore, to avoid inclusion, support payments received by a Partner must be otherwise excluded by the Code, be a gratuitous transfer, or fall within a recognized judicial exception to inclusion in gross income.

There is no specific provision in the Code that excludes the receipt of Partnership support payments from gross income. There is such a provision for spouses. Internal Revenue Code Section 71(b)(1)(B) provides an exception to IRC §61(a)(10). Pursuant to IRC §71(a), the recipient spouse must include alimony payments in gross income, however, alimony will not be taxable to the recipient if the divorce instrument provides that the payments are non-taxable to the payee and non-deductible by the payor under IRC §215. *IRC §71(b)(1)(B)*. The ex-spouses can elect to treat alimony payments as non-qualifying under IRC §215 and therefore not includible under IRC §71 and IRC §61(a)(10). *Reg. §1.71-1T(a) Q&A-2*. As a result, the payment is ignored for tax purposes. (It is arguable that a payment is excludible under IRC §71 only if it meets the IRC §71(b) requirements, not simply because it fails to qualify under IRC §215. Therefore, even though it may fail IRC §71 and not be deductible under IRC §215, it could still be includible under IRC §61.) Partners could argue that their support payments should be treated as non-qualifying IRC §215 payments, because otherwise, the result would be double taxation, once to the payor Partner and then to the payee Partner.

Nevertheless, IRC §71 and §215 are not applicable to Partners, only IRC §61 is applicable.

Support payments would not be income to the Partner if they are deemed a gift by the payor Partner. However, for income tax purposes, there must be donative intent by the donor if the transfer of wealth is to be treated as a gift. *Comm v. Duberstein (1960) 363 US 278*. It is highly unlikely that most payors of alimony or support are doing so from a level of unfettered generosity required to establish donative intent. Therefore, a finding of the requisite donative intent to preclude inclusion as a gift is unlikely, except possibly in a situation in which the amount of support agreed to far exceeds the legal obligation that could be imposed. For example, if the maximum amount that a court could impose as support is \$10,000 per month, yet the parties agree to \$50,000 per month, the Service may assert that the additional \$40,000 is a gift.

Although the inclusion of support payments as income is not specifically precluded by the Code, and most likely is not a gift for income tax purposes, there are other potential arguments against inclusion. “Alimony” is defined in the Code as payments received by a “spouse.” A Partner is not a spouse. Therefore, the Partnership support payments should not be treated as “alimony” income as defined under IRC §61(a)(10) or §71(a). Therefore, the tax analysis of the payment must move from the marriage paradigm. However, the non-registered domestic partner contract/gift paradigm would also be inapplicable. Unlike a *Marvin* payment, which is based on a contract, the support payments pursuant to the Act are based on a relationship and obligations created by state law. In *Gould v. Gould (1917) 245 US 151, 153-154*, the Supreme Court found that alimony paid to the wife was not includible in her income because the payment was created by the relationship and not by contract. In a predecessor statute to IRC §61, “alimony” was not a specifically designated item of income, and the Court concluded that it was not income under that act. The Gould court citing *Audubon v Shufeldt (1901) 181 US 575* found that the payment of support is just an extension of the legal and moral obligation of support during marriage. The court also stated that unless the Code explicitly included these types of payment in income, they were otherwise not income. Internal Revenue Code §61 now specifically includes “alimony” as income, but arguably it does so as an exception to the general concept that the payment of obligations based on relationship and imposed by state law, such as support between spouses, between Partners, and parent to child, do not create taxable events.

Another argument that a Partner may assert is also based on the concept that Partnership support is not to be treated like “alimony” as defined by the Code. If the transfer is not alimony subject to IRC §71 and §215, then the transfer should be analyzed as a transfer of property in the nature of a property settlement in which the payee has released inchoate Partnership rights in exchange for property, e.g. periodic payments. Under established case law and IRS rulings, such payments are not taxable to the recipient. *US v Davis (1962) 370 US 25*.²⁵

²⁵ In *US v Davis*, a pre IRC §1041 case, the court found that a taxpayer had taxable gain when he transferred appreciated property to his ex-spouse. The court did not find taxable income to the taxpayer wife who received property in exchange for her marital rights. See also *Rev Rule 67-221, 1967-2 CB 63*. If

The termination of a Partnership may involve the division of co-owned property, exchange of separate property, and/or transfer of property for the release of rights. These transactions could trigger taxes for Partners.

Partners will not be able to take advantage of IRC §1041 which provides, subject to a few exceptions, that no gain or loss is recognized on a transfer of property to a spouse incident to a divorce. For the most part, this is a non-elective provision which is beneficial to spouses. Prior to the enactment of IRC §1041, the transfer of property in satisfaction of a marital obligation was a taxable event. Therefore, if appreciated property was used to satisfy the obligation, the transferor would recognize gain to the extent of the property's fair market value over the transferor's adjusted basis in the property. See *US v Davis supra*.

It is interesting to note in *Davis* that the recipient spouse did not have income on the receipt of the appreciated property or gain on the transfer of her rights. It was arguable that the wife gave up something of value, e.g. her marital rights, and therefore she should have gain on her transfer. However, it would be difficult to establish the value of these inchoate rights. This may have led the IRS to rule that as to the wife, the transfer was a non-taxable event because the value of the rights relinquished equaled the value of property received. See *Rev. Rule 67-221, 1967-2 CB 63, California Family Law Practice and Procedure 1st ed Matthew Bender Chapter 27 §27.101[4]*. This may provide the basis for an argument that if a Partner receives a support payment that it should be non-taxable as a release of rights.

As stated above, IRC §1041 will not apply to Partners, therefore, it is likely that a *Davis* analysis will be applied. However, not all divisions or transfers of property between Partners will be taxable. This determination will have to be made on a case by case basis considering the character, value and basis of each asset transferred.

Under generally accepted case law, prior to the enactment of Section 1041, the equitable division of community property or property jointly owned by spouses did not trigger gain or loss. This could be in the form of an equal partition of each asset or a non *pro rata* division of assets based upon equal or near equal net values. *Walz v Comm (1935) 32 BTA 718, Rev Rul 76-83 1976-1 CB 213. US v Davis supra*. General Counsel Memorandum 37,716 October 5, 1978 states that the mere equal division of community property is not a taxable event.

Partners should be cautioned before placing too much reliance on the holdings and rulings regarding equitable division of community property. Before the concept of equitable division is applicable, the IRS and courts must accept that Partnership community property is to be treated the same as spousal community property both as to the nature of acquisitions and vesting. As previously discussed, the creation of community property may not be recognized for federal purposes if the Service or courts determine that *Poe v Seaborn* applies only in the context of marriage or that the Act

husband transfers stock to wife worth \$1 million with a basis of \$100,000, in exchange for a release of her other marital rights, he would have a taxable gain of \$900,000, but for the non-recognition provided by §1041.

should be interpreted as creating unvested rights in property because of the language “earned income is not community property” for California income tax purposes. If Partnership community property is not recognized for federal purposes, then its transfer will be treated as deemed sales between unrelated parties that can trigger gain. *See IRC §1001*. Community property created retroactively under AB2580 may be particularly problematic. This property was not community at the time of its acquisition, therefore, by analogy, may be likened to quasi-community property in that state law gives each spouse a one-half interest in the property at death or divorce, but for federal tax purposes, it is still separate property.

Unequal divisions or transfers of separate property will trigger gain or loss even if equitable division is applicable to Partners. But for IRC §1041, spouses would recognize gain or loss on the transfer of separate property or to the extent of an unequal division of community property. *Carrieres v Comm (1975) 64 TC 959 aff per curiam (1977) 552 F2nd 135*. This should hold true for Partners. Thus, Partners should consider issues such as built-in gain or loss when dividing assets.

In certain circumstances, there are advantages to Partners in not qualifying for the special rules of transfers incident to divorce. For example, if ex-husband buys ex-wife out of the marital residence, this is a non-taxable transaction. Therefore, even if husband pays more to wife than her tax basis, wife has no gain, but husband takes wife’s basis rather than his cost basis. Therefore, there is a potential for built-in gain. *See IRC §1041*. However, if an ex-Partner buys out an ex-Partner’s appreciated share of the residence, selling Partner may use his or her \$250,000 exclusion to reduce or eliminate the gain and buyer ex-Partner gets a cost basis in the acquired interest. *See IRC §121*.

Terminating Partners must also contemplate the tax ramifications of the division of certain community assets such as retirement benefits, deferred compensation plans, other nonqualified plans and stock options. The disposition of these assets can have significant tax implications in the absence of the tax protection afforded to married couples by federal statute such as IRC §72, §402 and §408.

For example, the early distributions from qualified plans are subject to a 10% penalty tax. An exception to this penalty is made for distributions to a spouse, ex-spouse, child or other dependant pursuant to a QDRO (qualified domestic relations order). A distribution to a spouse or ex-spouse may also be eligible for rollover treatment by the recipient spouse, thus avoiding current inclusion of income. Unless a Partner or ex-Partner qualifies as a dependant, which is unlikely, there will be a 10% penalty on early distributions to the Partner. Furthermore, the distribution must be currently taken into income. If a transfer is to a spouse, then the spouse is taxed on the income. However, if there is a transfer to a non-spouse, i.e. a Partner, the transfer is treated like an assignment of income and is taxable to the participant Partner.

Partners are also cautioned regarding the division and transfer of deferred compensation and certain stock options. For example, the transfer of incentive stock options will likely be deemed a disqualifying disposition under IRC §422. Furthermore, the transfer of an interest in a deferred compensation plan would be treated as an

assignment of income. If so, the proceeds are taxed to the participant, and then possibly again to the payee.

Related Party Rules

Prior to the passage of the Act, Partners could engage in transactions that were otherwise limited to related party rules under IRC §267 and related sections. For the most part, these rules did not apply to Partners. As a result, there were excellent opportunities for tax planning that were not available to married couples. With the passage of AB205 and DOMA at the federal level, these rules should not be affected. However, these rules do not preclude the IRS from scrutinizing the transactions for gifting or compensation related issues.

Gift and Estate Tax Issues

Currently, the gift and estate tax ramifications of the Act for Partners are even less certain than the income tax ramifications. All gratuitous transfers of property made during life and at death are subject to federal gift and estate taxes. Excepted from taxability are gifts that qualify for the annual exclusion pursuant to IRC §2503, or are nominal in nature, made to a qualified charitable organization, or made to a spouse. *IRC §2056 and §2523*. The so-called “unlimited marital deduction” allows married persons to make gifts to each other during lifetime or at death without incurring any gift or estate tax liability if the transfer is done in a qualified manner. *IRC §2056 and §2523*. It does not matter whether the gift is of \$10,000 or \$10,000,000. Currently, a surviving spouse will also receive a step-up in basis for all property, community or separate, received from a deceased spouse. *IRC §1041*. Furthermore, the surviving spouse will receive a step-up in basis on his or her share of the community property held with a deceased spouse. As a result, the surviving spouse receives all marital property free from transfer tax and possibly free from income tax on a subsequent sale of otherwise appreciated property.

Partners enjoy no such benefits. There is no unlimited marital deduction between Partners. (Although California should allow a surviving Partner to receive a step-up in basis on his or her half of community property.) Transfers between Partners are treated as transfers between unrelated third parties except in limited situations. Furthermore, the creation of community property in and of itself may have unintended tax consequences for Partners. Because of the inapplicability of the unlimited marital deduction, Partners who desire to avoid, or at least reduce, gift and estate taxes may need to utilize certain estate planning strategies. These strategies include annual gifting, payments for educational and medical needs, use of life insurance and the creation of irrevocable trusts. While these strategies do not afford Partners anything equal to the unlimited marital deduction, they can help to lessen the impact of gift and estate taxes.

Partners are advised to use caution if they plan to make inter vivos or testamentary gifts to their Partner's children, grandchildren, nieces, nephews, etc. and even a younger Partner if there is a very large age difference as they may unwittingly expose these transfers to the Generation Skipping Transfer Tax (“GSTT”). *IRC §§2601-2664*. The GSTT is a flat rate tax imposed on non-exempt generation skipping transfers. This tax is

in addition to the regular estate or gift tax. (There is currently a \$1.5 million exemption for generation skipping transfers. *IRC §§2631-2632.*)

A Generation Skipping Transfer is a transfer to a “skip person.” *IRC §2611.* A skip person is an individual assigned to a generation more than one below the donor. *IRC §2613.* Generations are assigned based upon either a familial relationship or age. For example, a grandchild is a skip person, as is a grandniece or grandnephew. If there is no familial relationship, then a skip person is anyone more than 37 ½ years younger than the transferor. In effect, a generation is created every 37 ½ years.

For GSTT purposes, a spouse’s step-relatives and in-laws are considered family for generation assignment purposes. Prior to the Act, a Partner’s step-relatives were not considered family and a Partner had to look to age for the generation assignment of a donee. For example, Partner Dan’s niece is not a skip person as to Dan, but if Dan’s Partner Joe is 37 ½ years older than the niece, she will be a skip person to Joe and any taxable gifts from Joe to step-niece will use part of Joe’s GSTT exemption or be subject to GSTT.

Under the Act, it is unclear whether step and in-law relationships will be recognized for GSTT purposes. As discussed in Section 15.3 above, the Act creates relationships such as “step-child” and “in-law.” Usually, federal law recognizes relationships created under state law unless such recognition is specifically precluded by federal law. DOMA specifically precludes the recognition of a Partner as a spouse for federal purposes, however, DOMA does not specifically preclude the creation of other relationships that are created because of the status of a Partner as a spouse under state law.

Conclusion

At this time, there are more questions regarding AB205 than answers, and some of these questions will not be resolved without IRS interpretations and judicial rulings. While we have been very critical of AB205 from a tax perspective, it is not our intent to denigrate the efforts of those who drafted and supported this landmark legislation. However, taxes are important, and not simply in an economic sense. All individuals, directly or indirectly, are taxed from the cradle to the grave and sometimes beyond. A stated purpose of taxation is to support government. An insidious purpose of taxation is the attempt to control, manipulate, promote, reward and/or punish certain behaviors. The marital relationship between a man and a woman is a dominant tenet of our culture. Accordingly, our laws, tax and otherwise, have been tailored to encourage and favor this relationship. Unless the Internal Revenue Code is amended to treat domestic partners and spouses equally, civil unions and marriages will not be comparable institutions, thereby relegating gays and lesbians to second class citizenry, marginalizing gay and lesbian relationships, and thus also perpetuating government sanctioned discrimination.