Planning for Non-Traditional Couples: Part II - Common Tax Planning Obstacles and Opportunities

This is the second in a Four-Part series that addresses planning for same-sex couples and unmarried couples of the opposite sex. In Part One, we reviewed general Federal and State laws and how they restrict planning for non-traditional couples. In Part Two, we will review common tax planning obstacles and opportunities unique to this market segment. In Part Three, we will review common estate and gift tax planning issues. In Part Four, we'll look at more advanced estate planning strategies that may be used with non-traditional couples including how life insurance can play a critical role in this process.

Real Property Tax Issues

A. Exclusion of Gain on Sale of Residence

When a principal residence is sold, a portion of the gain from the sale may be excluded from the seller's gross income*. For a single taxpayer, the maximum exclusion is $250,000. For a married couple filing a joint income tax return, the maximum exclusion is $500,000.
(*Internal Revenue Code Section 121)

For a married couple filing a joint return, if only one spouse owns the property, the other spouse is deemed to have owned it for purposes of meeting the two-year ownership requirement. Thus, to be entitled to the $500,000 maximum exclusion:

1. Both spouses must use the residence as their principal residence for two years during the five years prior to the sale;
2. One spouse must own the residence for at least two years during the five years prior to the sale; and,
3. Neither spouse must have used the exclusion in the prior two years.

Example 1 - Rebecca purchased a home in 2004 for $200,000. Her boyfriend, Mitch, moved into the residence in June, 2007. Rebecca and Mitch were married in October, 2008. In August, 2009, Rebecca sold the home for $500,000. During the five years prior to the sale, Rebecca owned the home and used it

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as her principal residence. Mitch used the home as his personal residence for two years prior to the sale. Mitch was deemed to have owned the home for two years because his wife, Rebecca, owned the home for two years. As a result, they both qualified for the exclusion, and the gain of $300,000 was covered by the use of both of their exclusions so there were no taxes on the gain from the sale.

These rules seem simple enough. However, upon further examination, they actually present certain planning limitations for same-sex couples, even same-sex couples that have been legally married in their jurisdiction. These limitations also apply to non-married opposite-sex couples.

Example 2 - Sharon purchased a home in Massachusetts in 2004 for $200,000. Her partner, Leah, moved into the home in June, 2007. Sharon and Leah were legally married in Massachusetts in October, 2008. Sharon sold the home in August, 2009 for $500,000. During the five years prior to the sale, Sharon owned the home and used it as her principal residence. Leah used the home as her principal residence for two years prior to the sale. However, since Sharon and Leah were not considered married for federal income tax purposes, Leah could not be treated as owning the home for two years, despite Sharon having met this requirement. Sharon was considered single for these purposes. As a result, only $250,000 of the $300,000 in gain was covered by the exclusion. Sharon had to pay taxes on $50,000 of gain.

B. Passive Loss Limitations

While rare, there are some income tax advantages for couples that are not recognized as married under federal law. One of these is the passive loss rules under IRC Section 469. Under Section 469, rental real estate losses up to $25,000 may be deducted in full against wages and portfolio income. In order to take maximum advantage of this deduction, a taxpayer's modified adjusted gross income must be less than $100,000. Additional qualifications for this deduction are that the taxpayer must actively participate in the investment, own at least 10 percent of the investment, and must not be a limited partner in the real estate. The $25,000 exemption begins to phase out at the rate of 50 cents for every dollar of modified adjusted gross income (MAGI) exceeding $100,000. Thus, when a taxpayer's MAGI exceeds $150,000, none of the $25,000 offset is allowed.

So, how does this deduction apply in the context of married versus non-traditional couples? First, note that there are no differences in the MAGI limitation as a result of marital status. The limit is $150,000 for an individual taxpayer or a married couple filing jointly. Thus, once a married couple's combined MAGI exceeds $150,000, they are unable to deduct any, otherwise qualifying, rental real estate losses. Conversely, each partner of a same-sex or unmarried couple may be able to claim the full $25,000 deduction, assuming each has MAGI of less than $100,000. Each partner is recognized as a single taxpayer for federal income tax purposes. Thus, if each partner has MAGI of less than $150,000, and they meet the active participation standards, they could, potentially, have a tax advantage over a married couple. Let's look at an example.

Example - Bret and Kim are a married couple who file a joint income tax return and have combined MAGI of $90,000 in 2009. This amount constitutes compensation income. In 2008, they purchased a 3-unit apartment building as rental property. Bret and Kim are each 50 percent owners, and both actively participate in the management of the building. They approve new tenants, decide on rental terms and approve capital and repair expenditures. In 2009, the property generated $60,000 of net losses in excess of rental income. As such, Bret and Kim may deduct up to $25,000 of the losses on their 2009 joint return to offset their compensation income. (If they filed separate returns, each would deduct $12,500 of the loss).

However, let's assume that Bret and Kim were instead a same-sex couple or unmarried domestic partners. Since they would be considered two single taxpayers for federal income tax purposes, each could deduct $25,000 of rental real estate losses against other ordinary income on their individual federal income tax return. This results in a combined deduction of $50,000 as opposed to a married couple filing jointly who would be limited to $25,000.

Employee Benefit Tax Issues
In the area of employee benefits, the tax treatment between married couples and non-traditional couples once again diverge. Let's review a few common issues in the context of employment.

A. Medical and Related Benefits
Although employers often include employees' spouses or domestic partners in medical and dental plans, since non-traditional couples are not recognized as spouses under federal law, the benefits provided to the employee's partner constitute taxable income to the employee. This is not the case for a couple recognized as married under federal law.

However, if the employee's partner can qualify as the employee's dependent, it may be possible to avoid the income taxes associated with the benefits. It may also be possible for the employee to pay the premiums for his or her partner/dependent on a pre-tax basis. Critical to this determination is how "dependent" is defined.

A "dependent" for these purposes is someone who resides in the employee's home as his or her principal residence, for the entire tax year AND receives more than one-half of her or his support for the calendar year from the employee. There are a number of rules related to how individuals may qualify as a dependent, but one that is significant to same-sex partners and domestic partners is the income test. This test states that a dependent's income must fall below $3,900[1] for 2013 in order to determine whether the individual is a "qualifying relative" for purposes of claiming the dependency exemption. This income limitation clearly places a significant obstacle for many non-traditional couples in order to exclude the value of medical and dental coverage benefits for an employee's partner from the employee's taxable income. Note also that this imputed income is NOT a deduction; it is considered an amount of non-cash compensation that will be taxed.

B. COBRA Premium Subsidy
The *Consolidated Omnibus Reconciliation Act of 1985* (COBRA) contains provisions giving certain former employees, retirees, spouses, former spouses and dependent children the right to continued health coverage on a temporary basis at group rates. However, coverage is available only when it is lost due to certain specific events, such as voluntary or involuntary termination of employment for reasons other than misconduct. Usually, group health coverage for COBRA participants is more expensive than health coverage for active employees. This is because employers usually pay part of the premium for active employees, while COBRA participants generally pay the entire premium themselves.

So, who qualifies for the COBRA subsidy? Any COBRA-*qualified beneficiary* associated with the covered employee who is covered immediately *before* the covered employee's employment was terminated. As you may have guessed, an eligible *qualified beneficiary* only includes an opposite-sex spouse or dependent child of the terminated employee. Thus, the same-sex spouse or domestic partner of a terminated employee would not meet the criteria for a qualified beneficiary. The result is no continued health coverage for the partner of an employee who may have been laid off, retired or otherwise qualified for COBRA coverage.

[1]Calculated based upon inflation-adjusted CPI amounts.

C. Social Security Benefits

Not surprisingly, same-sex spouses and domestic partners are ineligible for retirement, disability and survivor Social Security benefits. There are two reasons for this: first, non-traditional couples do not meet the definition of *wife* and *husband* under the Social Security Act; and second, the Defense of Marriage Act (DOMA) prevents the recognition of these benefits for non-traditional couples. Note also that if a child of a same-sex legally married couple or domestic partner is not the biological or legal (i.e., adopted) child of a deceased same-sex spouse or partner, the child will not qualify for Social Security dependent survivor benefits.

D. Qualified Domestic Relations Order (QDRO)

A qualified domestic relations order, or QDRO, is a court order that is included in a divorce decree that addresses qualified retirement plans. It specifically establishes an ex-spouse's legal right to receive a designated percentage of a participant's qualified plan account balance or benefit payments. The ex-spouse is commonly referred to as an "alternate payee." However, because DOMA prohibits the recognition of same-sex marriage, an employer is not required to comply with a QDRO from a state court where a same-sex marriage has been dissolved.

Property Transfers at a Gain Between Spouses/Domestic Partners

Under IRC Section 1041, transfers made between a wife and husband during marriage or incident to a divorce do not trigger the recognition of gain or loss. Thus, if a wife and husband sell property between themselves, no federal income tax consequences will result.

Example 1 - Jim and Fran are married. Prior to marrying Fran, Jim owned commercial property having a fair market value of $300,000 and an adjusted basis of $180,000 in 2009. Jim decided to sell the property to Fran for $300,000. Since Code Section 1041 applies to the transfer, Jim will not recognize $120,000 of gain from the sale, and Fran's basis in the property will be $180,000. Since same-sex couples and domestic partners do not meet the definition of marriage for federal tax purposes, this same treatment would not apply if Jim and Fran were unmarried or were of the same sex.

Example 2 - Katrina and Karen are a same-sex couple legally married in Massachusetts. Prior to getting married, Katrina owned commercial property with a fair market value of $300,000 and an adjusted basis of $180,000 in 2009. Katrina decides to sell the property to Karen for $300,000. Since IRC Section 1041 does not apply, Katrina must recognize $120,000 of gain on the sale, and Karen's basis in the property is $300,000.

Sale of Depreciable Property to "Related Parties"

While transfers between same-sex couples and domestic partners can trigger the recognition of gain or loss, non-traditional couples are not subject to other tax code provisions that disallow losses on sales between "related parties" (IRC Section 267). They would also not be subject to rules that recharacterize the tax treatment of the sale of depreciable property, normally treated as a capital gains transaction, to one that treats the gain as ordinary income because the sale is made to a related party (IRS Section 1239). This can present a significant planning opportunity for non-traditional couples.

The reason losses are not allowed on sales to related parties is to prevent a taxpayer from claiming a tax loss on property that may have temporarily declined in value merely by shifting ownership to a family member or a "related party". In essence, the taxpayer never relinquishes his or her investment in the asset if it is still held by a family member. Selling property to a *related party*, which includes members of the taxpayer's family (including brothers and sisters by whole and half blood, spouses, ancestors and lineal descendants), would NOT be considered a relinquishment of the investment in the property. Here is where a planning opportunity may exist for same-sex and domestic partners. Since they are not considered "married" for this purpose, and thus, not a "related party", this provides flexibility for one spouse/domestic partner to sell property at a loss to the other spouse/domestic partner.

Example 1 - Katrina and Karen are a same-sex couple legally married in Massachusetts. Prior to getting married, Katrina owned commercial property with a fair market value of $180,000 and an adjusted basis of $300,000 in 2009. Katrina decides to sell the property to Karen for $180,000. Since Karen and Katrina are not considered spouses for purposes of Code Sec. 267, Katrina can recognize $120,000 of loss on the sale.

Now that we've seen how losses are impacted by the related party rule, let's take a look at the *gain* side as it pertains to this rule and the sale of depreciable property. IRC Section 1239 may cause a sales transaction to be recharacterized from capital gains treatment to ordinary income treatment, when the seller and the purchaser are related parties. For this purpose, in addition to family members, *related parties* include:

- A corporation that an individual is deemed to control by owning more than 50 percent of the stock; or,
- A partnership in which the individual is deemed to own more than 50 percent of the partnership interests.

When determining an individual's ownership of stock and partnership interests, you must consider any stock or partnership interests that are owned by certain members of the individual's family. For example, any stock or partnership interest owned by an individual's brothers and sisters by whole or half blood, spouse, ancestors and lineal descendants are considered to be owned by that individual. This is commonly referred to as *family attribution*. However, the family attribution rules do not apply to same-sex spouses and domestic partners because they are not considered family members. As a result, non-traditional couples have a much greater chance of avoiding the recharacterization rules under IRC Section 1239. This means that the sale of depreciable property may receive capital gain treatment, rather than ordinary income treatment.

Example 2 - Connie and Harold are a married couple and live in a non-community property state. Together, they own all of the stock of Portersville, Inc., a C corporation. Connie owns 75 percent, and Harold owns 25 percent of Portersville shares. Harold also owns a depreciable office building that he had acquired prior to marrying Connie. In June of 2009, the office building had a fair market value of $300,000, with an adjusted basis of $180,000. At that time, Harold decided to sell the office building to Portersville, Inc. for $300,000. Although Harold only owns 25 percent of Portersville shares directly, he is deemed to own 100 percent of Portersville shares since he is also considered to own Connie's 75 percent interest as a result of the family attribution rules. Thus, when Harold sells the building to Porterville, Inc., the recharacterization rules under Code Sec. 1239 will be triggered, resulting in $120,000 of ordinary income, rather than $120,000 of capital gain on the sale.

Now, if Connie and Harold had been a same-sex or unmarried couple, Harold would be deemed to own only his 25 percent interest in Portersville, Inc. because the family attribution rules would not apply. Thus, when Harold sells the building to the corporation, this would trigger $120,000 of capital gain. Today, capital gains tax rates are lower than most ordinary income tax rates.

Finally, there are potential planning opportunities regarding corporate stock for non-traditional couples. Similar to the rules under IRC Section 1239, an individual will generally be treated as owning the stock of her or his spouse, children (including adopted children), grandparents and parents under Section 318. Again, however, since same-sex couples and domestic partners are not considered related parties for federal income tax purposes, the family attribution rules should not apply.

Example 3 - Carl and Philip each own 50 percent of stock in CP Corporation. Philip decides to redeem all his stock. Under IRC Section 302(b)(3), this transaction will be treated as the equivalent of a sale of a capital asset resulting in capital gain. However, if Carl and Philip were considered “spouses” for federal income tax purposes, the rules of attribution would apply, and Philip would be considered to own 100 percent of CP Corporation following the redemption. As a result, Philip would be considered to have received a dividend for any cash or property he received in exchange for the redeemed shares. However, if certain requirements are met, it may be possible for Philip to qualify for a waiver of the family attribution rules under IRC Section 302(c)(2).

We have covered a lot of planning pitfalls and opportunities in this article ranging from real estate transactions to employee benefit and property transfers between couples. While these topics are certainly not intended to be an all inclusive list, they do highlight some of the disparities in planning between non-traditional couples and heterosexual married couples. In Part III of this series, we will examine differences in gift and estate planning techniques for non-traditional couples and how they impact other planning opportunities.

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