

Tax Aspects of Marriage, Divorce and Domestic Partnerships

Michael C. Wetzel
Fitzwater Meyer, LLP
6400 SE Lake Road
Suite 440
Portland, OR 97222
(503) 786-8191
mwetzel@fitzwatermeyer.com

I. Overview

The tax aspects of marriage, divorce, and domestic partnerships in Oregon are governed primarily by four different, sometimes inconsistent, bodies of law. At the federal level, the tax laws are contained in the Internal Revenue Code, Title 26, United States Code. However, the Defense of Marriage Act (DOMA), P.L. 104-199 (1996), 1 USC 7, limits for federal purposes, including taxation, the definition of marriage to “a legal union between one man and one woman...”

Oregon’s relevant tax laws are found at ORS chapters 118 (inheritance tax), 305 (tax procedure), 314 and 316 (income tax). Oregon’s tax laws are largely (but not entirely) tied to the Internal Revenue Code and federal tax law concepts. In addition, the 2007 legislature passed and the Governor signed HB 2007, the Oregon Family Fairness Act (OFFA). The OFFA authorizes same sex couples to register as a domestic partnership. The OFFA contains a number of provisions specific to the tax laws. Section 9(8) provides that for purposes of administering Oregon’s tax laws, domestic partners, and their children, under the OFFA have the same rights and responsibilities as are granted or imposed on spouses of a marriage. Section 11 of the OFFA provides that ORS chapter 314 applies to domestic partners under the OFFA as if federal income tax law recognized a domestic partnership.

II. Property Transfers.

A. In General.

As a general rule, the sale or exchange of property will cause the taxpayer to recognize gain (or loss) to the extent the consideration received exceeds the adjusted basis of the property. 26 USC 1001. Under 26 USC 1041, no gain or loss is recognized for transfers of property between spouses, or

between former spouses if the transfer is incident to divorce. The transfer is treated for income tax purposes as a gift.

Because of DOMA, section 1041 will not apply for federal tax purposes to the transfer of property between domestic partners during the term of the domestic partnership or on its dissolution. Section 1041 will apply for Oregon income tax purposes under the OFFA. For federal purposes, the parties (and the IRS) have a number of options, including:

- 1) Treat the transfer as compensation: subjecting the recipient to ordinary income tax and self employment tax and subjecting the transferee to potential gain (probably not a favored result).
- 2) Treat the transfer as a sale or exchange: if the partners swap properties or interests in properties, each will recognize gain to the extent the fair market value of the property received exceeds the adjusted basis of the property transferred. This may be the preferred treatment in a dissolution context if the basis in property is close to the fair market value. Also, 26 USC 1031 may help defer gain in this context.
- 3) Treat the transfer as a gift. Gifts are excluded from gross income under 26 USC 102; however, gifts in excess of the annual exclusion amount (\$12,000 currently) have gift tax consequences under 26 USC 2501 et. seq.

The preferred tax treatment will depend on the specific facts of each case. Note also that section 1041 applies a non-recognition rule to losses as well as gains. In the case of a transfer of loss property, a domestic partner may actually fare better under federal tax law than state tax law. See also 26 USC 267, disallowing losses between related taxpayers, including "spouses."

B. Personal Residence.

Under 26 USC 121, any individual may exclude up to \$250,000 of gain from the sale of a personal residence if he or she owned and used the residence as his or her principal residence for at least two out of the five previous years. For a husband and wife filing a joint return, they may exclude up to \$500,000 if either meets the ownership requirement and both meet the use requirements. Again, because of DOMA, domestic partners may not take advantage of the provision for a husband and wife for federal income tax purposes. However, each domestic partner may take advantage of his or her \$250,000 exclusion, so long as both the ownership and use

requirements are met.

In the dissolution context, two special rules apply under section 121(d)(3):

- 1) A divorced spouse who still owns an interest in the residence is treated as using it as a principal residence during the time it is occupied by the former spouse (the “kicked out spouse rule”); and
- 2) A spouse who receives title in a section 1041 transfer can tack the ownership of the transferor (applies to both current spouses and divorcing spouses).

The benefits under section 121 provided to spouses will not apply to domestic partners for federal tax purposes, but will be available for Oregon income tax purposes.

C. Other Situations.

- 1) Redemption of Corporate Stock.

The taxation of corporate stock redemptions in the marriage and divorce context has long been a trap for the unwary. Because domestic partners are precluded from section 1041 treatment for federal tax purposes, either a redemption or a transfer to the other partner will be a taxable event under federal tax law. However, because of the danger of dividend treatment and the application of section 1041 for Oregon income tax purposes, care is still required in dealing with this issue in the domestic partnership arena.

- 2) Qualified Retirement Plans.

Under the federal tax law, and ERISA, rights under most qualified retirements and individual retirement accounts are subject to anti-alienation or anti-assignment provisions. A major exception exists for transfers pursuant to divorce. See 26 USC 408(d)(6) for IRAs and 26 USC 40(a)(13)(B) and 414(p), relating to qualified domestic relations orders (QDROs) for qualified plans. If a transfer does not meet the exception, the transferor will be subject to ordinary income on the amount transferred plus a 10% penalty.

Because the plans are drafted to comply with applicable federal requirements, the plan documents themselves will generally not allow a transfer or assignment of an interest in a plan to a domestic partner.

The OFFA recognizes this in sections 9(6) and 9(7).

3) Stock Options.

Stock options come in two forms for income tax purposes: incentive stock options (ISOs) (see 26 USC 421-424) and non-qualified stock options. ISOs are generally non-transferrable. See section 422(b). Stock received from the exercise of an ISO may be transferred incident to divorce. See 26 USC 424(c)(4). In the context of a domestic partnership, such a transfer of stock received from the exercise of an ISO within the waiting period would be a disqualifying disposition, which would cause the option to be treated as a non-qualified stock option for federal income tax purposes.

Non-qualified stock options are freely transferrable, unless restricted by the governing instrument. The IRS, in Rev. Rul. 2002-22, held that the transferee spouse will recognize the income from the exercise of a non-qualified stock option. Rev. Rul. 2002-22 relies primarily on section 1041; accordingly, its analysis would not apply to domestic partners. Instead, Rev. Rul. 2002-22 indicates that the IRS would apply the assignment of income doctrine and/or a sale or exchange analysis to the transfer of non-qualified stock options between domestic partners, causing income to be recognized by the transferor.

III. Support of Dependents.

The tax laws contain a number of favorable provisions for the support of a dependent child or other dependent. These include the dependent exemption, the child tax credit, the child and dependent care credit, the earned income credit and the Hope and Lifetime Learning Credits. To qualify as a dependent under 26 USC 152, a child must:

- 1) Be the taxpayer's natural or adopted child, stepchild, eligible foster child, sibling or descendant;
- 2) Reside with the taxpayer more than half the year;
- 3) Be under the age of 19 or 24, if a full time student, or permanently disabled;
- 4) The child cannot have provided more than half of his or her own support.

For purposes of claiming the dependent exemption, a taxpayer may claim another individual, who is not the taxpayer's child, as a qualifying relative if:

- 1) The individual is related to the taxpayer, including an individual, other than a spouse, who "has the same principal place of abode as the taxpayer and is a member of the taxpayer's household";
- 2) The individual's gross income is less than the exemption amount;
- 3) The taxpayer provides over half of the individual's support; and
- 4) The individual is not a qualifying child of the taxpayer or anyone else.
26 USC 152(d).

The taxpayer could also claim the Hope and Lifetime Learning Credits for such an individual.

In the divorce context, the custodial parent is entitled to claim a qualifying child unless the custodial parent signs an instrument releasing the right to the dependency exemption to the non-custodial parent. The preferable approach is to have the custodial parent sign an IRS form 8332. The release of the dependency credit also releases the child tax credit, but not the child care credit, earned income credit or head of household status.

The OFFA provides in sections 9(3) and 9(4) that the rights and responsibilities granted to a spouse or former spouse with respect to a child or either spouse shall be equivalent in the case of domestic partners. For Oregon income tax laws, a domestic partner should be able to claim stepchildren (i.e. the children of the other domestic partner) as dependents, relying on the definition of child in section 152(f)(1). However, for federal income tax purposes, the domestic partner would need to adopt the child or children of the other partner before he or she were able to claim the full tax benefits for supporting the child. A domestic partner may be able to claim the other partner as a dependent on his or her federal return if the other partner meets the definition of a qualifying relative.

IV. Spousal Support.

Qualifying spousal support, called alimony or separate maintenance under the tax code, is tax deductible to the payor under 26 USC 215, and includable in the payee's income under 26 USC 71(a). Alimony is defined as any payment in cash if:

- 1) The payment is received by (or on behalf of) a spouse under a divorce or separation instrument;
- 2) The applicable instrument does not identify the payment as not deductible to the payor and not includable in income of the payee (an opt-out provision);
- 3) For individuals who are divorced or legally separated under a decree of separate maintenance, they are not members of the same household when the payment is made; and
- 4) There is no liability to make any such payment after the death of the payee spouse. 26 USC 71(b).

Because alimony payments must be made to or for the benefit of a spouse to qualify under section 71(b), spousal support payments (or their equivalent) to former domestic partners will not be deductible by the payor or includable in the payee's gross income for federal tax purposes, at least not under section 71. However, such payments are likely to have some tax consequences, either as:

- 1) Compensation for past services, with income tax, self employment tax and possible withholding obligations;
- 2) Payment for the release or transfer of property rights. See Reynolds v. Com'r, T.C. Memo 1999-62 (1999). The recipient would recognize gain, possibly under the installment method, to the extent the payments exceed his or her adjusted basis in the property transferred. The payer would add the payments to his or her basis.
- 3) A gift.

Domestic partners should be able to receive alimony treatment for Oregon tax purposes.

V. Filing Status and Liability Relief.

A. Filing Status.

Married individuals or surviving spouses in the year of death may file a joint federal income tax return. 26 USC 6013 and 7703. For a married couple with widely unequal incomes, filing jointly will generally result in less overall tax. However, a married couple with two equal incomes, especially as high

earners, will generally pay more in taxes than if they were each filing as unmarried individuals. The married filing separately option does not alleviate the marriage penalty, and in fact many tax benefits are not available to married filing separately individuals, such as the educational tax credits, earned income credit, child care credit, credit for adoption expenses, the ability to elect to claim the standard deduction if the other spouse itemizes, and the student loan interest deduction.

For domestic partners, if they are both high earners, they will generally be better off tax-wise than similarly situated married individuals, since they will be able to file their federal return as unmarried individuals. Domestic partners with only one income earner will generally not fare as well tax wise. However, if the income earner qualifies as head of household, either because he or she provides more than half the support to a qualifying child or other person who is a dependent (including possibly the other domestic partner), then the tax treatment will be better than filing single though still not as advantageous as filing married.

For Oregon income tax purposes, domestic partners should be able to file joint returns if they so choose, notwithstanding ORS 316.367, which requires consistent filing of federal and state returns.

B. Liability Relief.

Under 26 USC 6013(d)(3), individuals filing a joint return have joint and several liability for all tax shown on the return and any additions to tax for that tax year. Nonetheless, under 26 USC 6015, a joint filer can obtain relief as an "innocent spouse" if he or she can show that (1) there was an understatement of tax attributable to the other filer, (2) the individual had no reason to know of the understatement, (3) it would be inequitable to hold the individual liable for the understatement, and (4) the individual timely requests relief. Section 6015(b). An individual may also seek to apportion the tax liability if he or she is no longer married to (or is legally separated from) or no longer living with the other filer (section 6015(c)) or he or she can seek equitable relief under all the facts and circumstances (section 6015(f)).

Because domestic partners will not be able to file joint federal returns, relief from joint liability will not be an issue at the federal level. Oregon allows joint filers to request equal division of joint tax liability if the individuals are no longer married (or are legally separated) under ORS 316.368. Oregon also allows innocent spouse relief when granted by the IRS, or if the IRS has not made a determination, under Department of Revenue rules that generally mirror section 6015. Domestic partners should be eligible for this type of relief

at the state level.

VI. Estate and Gift Tax.

The Internal Revenue Code imposes a tax on transfers made at death under 26 USC 2001 (the estate tax), and gifts made during life under 26 USC 2501 (the gift tax). An unlimited estate tax deduction exists under 26 USC 2056 for transfer to a surviving spouse so long as he or she is a U.S. citizen. A similar gift tax deduction exists under 26 USC 2523 for lifetime transfers to spouses who are U.S. citizens. A separate gift tax exclusion under 26 USC 2516 applies to certain property transfers between former spouse pursuant to a property settlement agreement.

Domestic partners will not be able to take advantage of the federal spousal deductions and exclusions. Accordingly, any lifetime transfer without consideration will potentially be subject to the gift tax, whether during the partnership or on its dissolution. If the transfer exceeds the \$12,000 exclusion, a gift return will need to be filed and some or all of the transferor's \$1,000,000 lifetime exclusion will be consumed. Transfers without consideration in excess of \$1,000,000 will result in gift tax payable.

Likewise, transfers to the partner at death will not qualify for the marital deduction. Transfers in excess of the exemption amount (currently \$2,000,000) will incur estate tax. Unfortunately, at the death of the surviving partner, the same assets may be subject to estate tax again if the value of the estate exceeds the exemption and credit shelter planning has not been done.

Oregon has a separate inheritance tax (but no gift tax). The Oregon inheritance tax exemption is \$1,000,000. Oregon also allows for a marital deduction and also a deduction for Oregon special marital property under ORS 118.013. Oregon domestic partners should be able to take advantage of the marital deductions to reduce or eliminate Oregon inheritance tax on the death of the first partner.