

January 24, 2011

Tax Considerations for Same - Sex Marriages

With same-sex marriages being allowed in certain states, couples will need to begin planning their finances and taxes very carefully. Federal law however does not recognize same-sex marriages. This provides same-sex couples with some administrative burdens at tax time, but also some tax planning opportunities as well.

In certain instances, same-sex couples will need to file as unmarried persons for federal tax purposes, and as married for state tax purposes. This means that same-sex couples will need to file either three or four tax returns: two single federal returns plus a joint state return; or two single federal returns plus two separate state returns.

If you are part of a same-sex couple, April 15th can be a daunting date. Tax matters that are simple for heterosexual couples can be quite complicated for gay and lesbian couples -- from filling out a federal tax return to determining whether a spouse's health insurance benefits are exempt from taxation. To make matters more difficult, some states recognize same-sex marriages or treat domestic partnerships as marriage-like for tax purposes. Others do not.

Here are the basics of how various states and the federal government treat gay and lesbian couples for tax purposes. But remember, since so many variables can affect your tax liability (such as the state you live in, how much money each spouse earns, how big your estate is likely to be upon death, and many other, this will make each case unique.

Non-Recognition States

If you live in a state that does not recognize same-sex marriages or treat civil unions or domestic partnerships as marriage-like for tax purposes, you and your partner file as single people on both state and federal returns.

Recognition States

It gets trickier if you live in a state that recognizes same-sex marriages or treats those in civil unions or domestic partnerships as spouses for tax purposes. Such states include California, Connecticut, the District of Columbia, Iowa, Maine, Maryland, Massachusetts, Nevada, New Hampshire, New Jersey, New York, Oregon, Washington State, and Vermont (there may be others -- the law changes rapidly). In those states, you must fill out your state tax return as a married couple and follow tax rules that apply to married couples.

But how do you fill out your state return as a married couple when it asks you to plug in numbers from your federal return, which you filed as singles? I advise couples to prepare a dummy federal return, filled out as if you were married, and then use those figures to plug into your state return. Once you are done, you toss the dummy return. This significantly

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increases the time and money that gay and lesbian couples must spend on preparing tax returns, because they must prepare three federal returns (two separate single returns and one dummy joint return).

Filing Status Options

Federal law does not recognize same-sex marriages under the Defense of Marriage Act. Even if a couple is legally married in California or Massachusetts, (See individual State Laws since some States have either accepted or repealed there laws concerning same-sex marriage.) or has entered into a registered domestic partnership or civil union, these couples cannot file as married persons on their federal tax returns. They will have to file individual tax returns. Their filing status can be either single, or possibly head of household if they support a qualifying person such as a child or parent. A domestic partner will not qualify for the head of household based solely on supporting his or her partner financially.

For certain state tax purposes, married couples will file as married in their state. Here the filing status options are to file jointly or separately. Since some tax opportunities have various limitations, state tax liabilities will likely be different than if the couple filed single returns. For example, there is a \$3,000 cap on net capital losses per year. If both spouses have capital losses, their state loss could be different than their federal losses. There is a wide range of dollar limits and phase out ranges that would need to be considered in optimizing a state tax return. As such, I recommend that married same-sex couples focus on managing their federal tax situation first.

The federal government does not recognize same-sex marriage, so married gay and lesbian couples must file as single people on their federal tax returns. Some experts recommend noting on your tax return that you are in fact married, but filed as single due to federal tax law. This might help in other contexts – such as applying for a joint mortgage -- where you want to show that you represent yourself as married.

If you and your spouse have a child, one of you can claim that child as a dependent on your federal tax return. You may also be eligible for the child tax credit (\$1,000 if your gross income does not exceed \$75,000). If you provide more than 50% of the child's support, you can file as head of household, which usually allows you to pay fewer taxes than if you filed as single. If a couple has two children, each might be able to claim one child as a dependent and file as head of household on their federal tax return. Check with a tax professional to understand your options.

It often makes sense for the higher-earning partner to file as head of household, but not always.

States operate according to their own rules. New York, for instance, says it recognizes same-sex marriage, but it does not allow married couples to file joint state returns.

If you live in a state that recognizes your union — whether you are married, registered domestic partners or part of a civil union — you will probably be required to file joint returns

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(or married/civil union/domestic partner filing separately). However each state varies, so be sure to evaluate which filing status will save you the most money.

In some instances you may be able claim your domestic partner as a dependent. If your partner is not currently employed, lives with you in your household, and you provide more than 50% of their support, you may be able to claim them as your dependent. You would then be entitled to an extra exemption deduction on your tax return. In addition, if your domestic partner qualifies as your dependent, any domestic partner health insurance coverage via your employer is not taxable to you. However, if you provide more than \$13,000 per year in support, this can trigger gift tax to you.

Since the federal government doesn't recognize same-sex marriage, same-sex couples who are living in states that do recognize their various legal unions must still file separate federal returns. That requires more record-keeping and planning than their heterosexual counterparts.

Some of the consequences are not all negative. By remaining unmarried, some same-sex couples will avoid the so-called marriage penalty. This occurs when a couple's combined income pushes them into a higher tax bracket than if they had remained single. Or, they may qualify for more tax deductions or credits that phase out as their income rises.

My suggestion to same-sex couple would be to view their financial situation as a household and not as individuals.

Be prepared to spend some extra time with you accountant strategizing. Although you are filing separately you are really leading very joint lives, there are many extra things you need to do.

State and Federal Tax Planning Suggestions for 2011

Strategies

If you have joint accounts, property or children, the question then becomes: Who should deduct what and what filing status should each partner take?

Generally speaking, the person who pays the expense gets the deduction, if you paid 60% of the mortgage payments, you could deduct that percentage of interest, while your partner could deduct the remaining 40%. However to take a deduction you need to have an ownership stake in the property.

Like any two people who are roommates that do not file a joint return, there is the question of who pays for certain things, and there is a need to document that.

Other Income & Expenses

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When it comes to jointly held accounts or property, you should call your bank or brokerage to get two copies of the forms that report any sort of miscellaneous income (including the 1099 form, which lists any income earned other than wages, salaries or tips: or the 1098 form, which lists mortgage interest paid). The banks usually send out only one form to the person whose Social Security number is listed first, which does not affect heterosexual couples filing jointly.

If you split the interest income collected on a joint savings account for tax purposes, you will want to attach a letter to each partner's tax return, along with a copy of the relevant form. The letter should state that the accounts are held jointly, and that you are splitting the interest, the dividends or whatever the item. The partner whose Social Security number does not appear on the tax form may be challenged by the Internal Revenue Service claiming they do not have filing records.

Health insurance benefits

Health insurance benefits will be tax-deductible for the employee, but not for a covered same-sex spouse. If both spouses work, it would make sense for each spouse to obtain coverage through their respective employers. If one spouse is not covered by a group plan, consider purchasing an individual policy instead of getting coverage through a group plan. This will preserve the tax-deductible status of the health insurance premiums at the federal level.

Claiming a Spouses Child to benefit Tax situations

It is very difficult claim a spouse's child as your own with out legally adopting the child to claim exemptions and possibly qualify for head of household filing status. If the other biological parent is deceased or gives up her parental right to the children, adoption may be possible, depending on your state law. Otherwise, the current tax law does not provide any dependent-related deductions (i.e. child tax credit, dependent care credit, education credits, dependent exemption, etc.) if the child is not a dependent of the taxpayer as defined by the Internal Revenue Code.

Income shifting

Consider shifting income to the spouse with the lower income. Investment income such as dividends, interest, and capital gains might be taxed at a lower rate. Each spouse will report his or her own wages, so income shifting really means deciding who will do the saving and investing.

Deduction Shifting

Consider shifting deductions to the spouse with the higher income. Mortgage interest, property taxes, and charity would yield greater tax savings for the spouse with the higher income. Some deductions cannot be shifted, such as IRA contributions, college tuition and medical expenses. Those deductions remain with the taxpayer and cannot be deducted by the other partner.

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Maintain separate bank accounts

To get a tax deduction, a person will need to prove that he paid for the expense. Paying for tax-deductible expenses out of a joint account could result in lost deductions if a return was audited and the taxpayer could not prove that he actually paid for the expense. To eliminate this audit scenario, the person who gets the deduction should pay expenses out of his or her own bank account.

Estate Tax and Gift Tax

Property that passes from one spouse to another is not subject to estate or gift taxes. Unfortunately, for couples the Internal Revenue Service considers to be unmarried, when one partner inherits property from the other, the unlimited marital deduction does not apply.

The takeaway: For unmarried or same-sex couples with assets beyond the exemption amount, efforts to minimize estate taxes become even more important than they are for other couples.

Inheriting an IRA or 401k

The rules for inherited retirement accounts are different for a spouse beneficiary than for a non-spouse beneficiary.

Specifically, as a non-spouse beneficiary, you have to begin taking required minimum distributions (RMDs) in the year following the death of the original account owner — no matter how old you are. (In contrast, spouse beneficiaries can simply roll the inherited IRA into their own IRA and treat it as if they were the original owner all along.)

Takeaway: Do not forget to take RMDs from an inherited IRA.

Early IRA Withdrawals

The rules for withdrawals from an IRA allow you to avoid the 10% penalty if you are using the money to purchase your first home only up to \$10,000.00, pay for higher education expenses or unreimbursed medical expenses that exceed 7.5% of your adjusted gross income. And, for most couples, the same exception applies if you are withdrawing money to pay for your spouse's medical or education expenses.

But again, because same-sex couples are not considered married, any IRA distributions used to pay for your partner's expenses will be subject to the 10% penalty (unless, of course, you meet some other exception).

Takeaway: If you need to withdraw money from an IRA to pay for such expenses, be sure to take it out of the right partner's IRA!

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Have a Will, and Name Your Beneficiaries

This last point is not exactly a tax consideration so much as a general estate planning consideration. In short, for same-sex or other unmarried couples, a will becomes absolutely essential — even more so than for heterosexual couples.

The reason is that (in most cases) if somebody dies without a will, his or her assets pass on to the closest relatives. Therefore, if your state does not consider you to be married, your partner could inherit nothing if you die without a will, as everything will pass to your blood relatives.

Similarly, be sure to name your partner as the beneficiary for your IRA or retirement plan at work if you want to ensure that he or she will inherit those assets when you pass on.

Beware the Gift Tax

Heterosexual married couples are exempt from almost all federal taxes that are levied on transfers of property or money between them. Not so for gay and lesbian couples, since their marriage is not recognized by the federal government. This means that same-sex couples must be aware of federal gift tax rules.

Gifts

While heterosexual couples can freely transfer money, property or expensive cars and gifts to one another without tax consequences, same-sex couples cannot: anything valued above \$13,000 per calendar year is considered a taxable gift. I recommend that clients keep a joint bank account to pay their joint expenses — and that each partner keep records of how much he or she contributed to the account.

If you did give your partner a gift valued at more than \$13,000 last year, you are required to file a gift tax return by April 15, and the amount will be counted against your \$1 million lifetime exemption. You should consult a professional for proper gift giving alternative.

The Unified Credit/Applicable Credit and Estate tax exempts 1 million and the credit amount is \$345,000. Be aware that the law changes rapidly each year. The Bush administration has increased on a sliding scale for the credits and exclusions. There was no Estate Tax in 2010 so if you died in 2010 you paid no federal estate taxes. Gifts between same-sex couples do not qualify for this exemption

Heterosexual married couples can arrange their affair any way they want without a tax burden, which generally does not happen for gay and lesbians couples.

It is recommended that same-sex couples open a joint bank account to pay joint expenses (i.e. rent, mortgage, utilities, groceries, etc.) The higher wage earner may contribute more money to the account than the lower-wage earner, as long as the higher-income partner uses that extra money to pay for his or her own expenditures. The lower-wage earner has to be careful not to withdraw more than \$13,000 to pay for his or her

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expenses. If one partner earns and spends significantly more, it's probably easier to simply use their own accounts and cards to pay for their own expenditures.

Planning for the Future -- Estate Taxes

The federal government imposes estate tax at your death only if your property is worth more than \$3.5 million. However, all property left to a heterosexual spouse is exempt from the tax, as long as the spouse is a U.S. citizen. Same-sex couples do not qualify for this exemption. If you leave a large estate to your same-sex spouse when you die, your spouse may have to pay a bundle in estate taxes. Be sure to talk to a tax professional about legal ways to avoid this

Taxes on Employment Benefits

When an employee, their heterosexual spouse, and their children receive health benefits through a job, the value of those benefits is exempt from tax by the federal government. However, if that employee is able to secure health benefits for a same-sex spouse or domestic partner, the federal government requires that the employee spouse report those benefits as taxable income.

A decision in May by the Internal Revenue Service that was hailed as a step toward equality for same-sex couples has instead become a headache for tens of thousands of gay and lesbian families in California.

Same-sex couples who are registered domestic partners — or who married during the brief legal window — are facing a new, more complicated tax status, one that has raised a litany of expensive concerns. Many of these families will now have to pay for professional help to file by April 15.

The issues involve an Internal Revenue Service decision that affects the three states with both community-property laws and same-sex marriage or registered domestic partnerships: California, Nevada and Washington.

Married heterosexual couples in those states have long had the option of filing their federal taxes separately and splitting their earned incomes (community property) on their tax returns. If one person makes more than the other, splitting can result in paying lower taxes by taking the higher earnings down a tax bracket or more.

After gay rights advocates fought for five years, the Internal Revenue Service decision let the same rules apply to legally partnered same-sex couples — an estimated 60,000 in California.

The omission is problematic. Employers send W-2 income reports directly to the Internal Revenue Service, so it could appear that some filers are cheating on their taxes or underreporting income and could face penalties.

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Sale of Principle Residence

The home sale exclusion allows each taxpayer to exclude up to \$250,000 in capital gains from taxation, provided you meet the Internal Revenue Service requirements that you each own the home and use it as your primary residence for at least two of the five years before selling the home. Second homes (i.e. for weekend or vacation use) do not qualify for the exclusion.

The following organizations contributed material for this overview: The Internal Revenue Service, GLAD – Gay & Lesbian Advocates & Defenders, New York Times article written January 14, 2011 – For Same-sex Couples, a Tax Victory that Doesn't Feel Like One, MSN Money – Giant Tax Headaches for gay couples, dated January 18, 2011, USA Today, Gay couples face tax complications, dated April 8, 2008, Nolo.com, Tax Issues for Same-sex Couples, Dated December 2010, Lambda Legal, dated March 25, 2010, Money Matters and the Examiner Newspaper, Md comptroller examining tax issues for same-sex couples.