# The Definitive Guide to Income Tax Planning for Same-Sex Couples

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**Following the Supreme Court's decision in *Windsor*, which opened the door to federal recognition of same-sex marriage, same-sex couples are faced with more choices about ordering their relationships to take advantage of tax planning opportunities.**

Marriage comes with many joys. Unfortunately, income tax ramifications are not often one of them. Married same-sex couples were first exposed to the federal income tax consequences of marriage for tax year 2013, following the Supreme Court's decision in *Windsor*, 111 AFTR2d 2013-2385, which ruled that the federal government must recognize legal same-sex marriages, and the IRS's issuance of Rev. Rul. 2013-17, 2013-38 IRB 201, which adopted a "place of celebration"[1] standard for recognizing all legal same-sex marriages for tax purposes irrespective of the couple's place of domicile.

Although income tax rules do not differentiate based on the gender composition of a married couple, the income tax rules may nonetheless affect same-sex couples differently than opposite-sex couples. Additionally, many same-sex couples, particularly those that have been together for a long time, will need to transition from an income tax system that disregarded their relationship to one that now treats–and taxes–their relationship as a single economic unit. As already noted, in most cases, the income tax results are not usually favorable, though this article certainly identifies the benefits of marriage for the income tax. The article also identifies the surprising and negative ramifications of marriage so that same-sex couples can be aware of these issues as they enter into their nuptials and enjoy the rights and expectations that arise with marriage.

## MARRIAGE VS. DOMESTIC PARTNERSHIP FOR PURPOSES OF THE INCOME TAX

Married taxpayers reach the highest marginal rates of income tax at well less than double the income of a single taxpayer. For 2014, single taxpayers paid the highest marginal rate of income tax of 39.6% on all income earned over $406,751. Married couples reached the 39.6% rate on all income collectively earned over $457,601—just 13% more than the income of a single taxpayer.

This counterintuitive result and inequity has long made marriage a non-neutral decision for income tax purposes: married couples will have a different tax bill than if the couple continued to pay as two single taxpayers. In many cases, these rates often result in a larger tax bill, creating what is commonly known as the "marriage penalty." (The rates do have the ability to create a marriage bonus, which is most often the case when one spouse had no or very little income.)

Same-sex couples in legal marriages were subject to the marriage penalty for the first time in 2013 as a result of the Supreme Court's decision in *Windsor*, which ruled that the federal government must recognize same-sex marriages. Subsequently, the IRS issued Rev. Rul. 2013-17, stating that it would recognize all legal same-sex marriages for tax purposes. Previously, legally married same-sex couples had to file federal tax returns as two single individuals because the Defense of Marriage Act[2] prohibited the federal government from recognizing same-sex marriages. Like all married couples, same-sex couples who are legally married will face a different tax bill as a result of their federal married filing status.

**Application of the Marriage Penalty to Same-Sex Couples in Marriage Alternatives.**

In Rev. Rul. 2013-17, the IRS ruled that couples in marriage alternatives are not considered married for purposes of federal tax law. For federal tax purposes, they are not taxed as a married couple; rather, they file tax returns as two single taxpayers and are not subject to the marriage penalty. Depending on state law, they may have a different filing status for state and local tax returns.[3]

**Impact of the Marriage Penalty on Same-Sex Couples.**

Although the long-term impact of the marriage penalty on same-sex couples is currently unknown (because same-sex couples first filed joint federal tax returns for calendar year 2013), there has been an abundant amount of research on the impact the marriage penalty has had on opposite-sex couples. Although not all of the current scholarship on the marriage penalty directly translates to same-sex couples,[4] one thing is clear: the marriage penalty makes marriage a non-neutral decision for income tax purposes. Below are three *potential* impacts of the marriage penalty on same-sex couples. The authors fully recognize that these are just their own hypotheses, and the long-term impact of the marriage penalty on same-sex couples of course remains to be seen.

1. *Marriage will be less neutral for male same-sex couples than couples of other gender compositions.* Based on data extracted from US Census Bureau American Community Survey (ACS), the average income of same-sex couples exceeds that of opposite-sex couples.[5] Additionally, according to data from 2012, women make only 77 cents for every dollar made by men.[6] Given that the marriage penalty increases alongside income, we can infer that, generally, more male same-sex couples will be negatively affected by the marriage penalty than female same-sex couples and opposite-sex couples. If it is true that a higher income tax bill affects the decision to marry, the income tax rates imposed on married couples make marriage less neutral—on a macro level—for male same-

> Same-sex couples may be particularly interested in the tax benefits for adoption expenses and medical expenses incurred for assisted-reproductive treatment and gender-confirming procedures.

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1 The IRS could have taken two approaches to recognizing same-sex marriages: "place of celebration" or "place of domicile." By adopting a "place of celebration" standard, the IRS ruled that it will recognize all legal same-sex marriages, including those of couples domiciled in a jurisdiction that does not recognize same-sex marriage. Alternatively, had the IRS adopted a "place of domicile" standard, it would have recognized fewer same-sex marriages. Under this latter standard, the IRS would recognize legal same-sex marriages of only couples domiciled in a jurisdiction that recognized the marriage. The distinction is illustrated by the following example. Assume a same-sex couple married in New York, where same-sex marriage is legal, but then took domicile in a state that does not perform or recognize same-sex marriage; because the IRS adopted a "place of celebration" standard, the couple's marriage is recognized for federal tax purposes; had the IRS adopted a "place of domicile" standard, the marriage would not be so recognized.

2 P. L. 104-199, 9/21/96 (effectively repealed in part by *Windsor*).

3 For example, couples registered as domestic partners in California file a joint tax return for state purposes, even though they are taxed as single taxpayers for federal income tax purposes. See California Taxation of Domestic Partners available at www.ftb.ca.gov/individuals/faq/dompart.shtml ("domestic partners who are registered with the California Secretary of State are required to file using the married filing joint or married filing separate filing status").

4 A significant portion of the scholarship on the marriage penalty to date has focused on the income disparity between men and women and a woman's return to the workforce after marrying. For an interesting academic discussion of the issue, see, McCaffery, "Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code," 40 UCLA L. Rev. 983 (1993).

5 Gates, "Same-sex and Different-sex Couples in the American Community Survey: 2005-2011" (The Williams Institute, UCLA School of Law, February 2013). The study concluded that same-sex couples had average income of $94,000 and opposite-sex couples had average income of $86,000. The study also found that in 2011 the average income of men in same-sex relationships was $47,000; the average income of women in same-sex relationships was $38,000.

6 See Women's Earnings and Income available at /www.catalyst.org/knowledge/womens-earnings-and-income#footnotel_dubwcwt Note that these figures focus only on the overall earnings of women compared with men and ignores, among other factors, differences in income between ever-married and never-married women.

sex couples than couples of other gender compositions.

2. *The marriage penalty will affect the work habits of the same-sex spouses.* Like opposite-sex couples, the marriage penalty could lead the lower-earning same-sex spouse to reduce or cease work-place participation in favor of leisure, child-raising, or home care because that spouse's income will effectively be taxed at a higher rate. Another possibility is the marginalization of both same-sex spouses with each one reducing work hours in response to the disincentive to work caused by the marriage penalty.
3. *Same-sex couples may choose marriage alternatives to avoid additional tax.* The income tax rates imposed on married couples create different tax bills for same-sex couples of equal incomes depending on whether their relationship is recognized as a marriage or marriage alternative. Civil union spouses and domestic partners file federal income tax returns as single individuals; thus, for these couples, marriage is tax neutral. However, marriage is not neutral for federal income tax purposes because the couple is no longer taxed as two single taxpayers, but is instead taxed on their joint income at the less preferential rates imposed on married couples. Accordingly, equal-income same-sex couples would pay different amounts of tax depending on the legal status conferred on their relationship. Generally speaking, marriage is more likely to provide a tax break to couples whose income is derived largely or entirely by one spouse; on the other hand, couples whose income is derived equally by both spouses—and particularly high-income couples—will likely see an increased tax bill. Paradoxically, the income tax rates imposed on married couples may create an unintended benefit of entering into a marriage alternative: avoidance of the marriage penalty.

**Limited Planning Opportunity—"Toggle" Marital Status.**

As discussed above, same-sex couples with the option to enter into a marriage or marriage alternative might choose the marriage alternative if the income tax weighed heavily in their decision. However, most same-sex couples will not easily have this choice because most jurisdictions that confer legal status on same-sex relationships—be it marriage or some alternative—do not give couples a choice between one or the other. Thus, a same-sex couple seeking legal status and avoidance of the marriage penalty might have to move to one of the shrinking number of states—soon to be zero?[7]—that provides only a marriage alternative (but not marriage) to same-sex couples. For many, that is probably too high a price to pay.

Interestingly, this strategy may be available in California, which allows same-sex couples to enter into domestic partnerships or marriages.[8] In California, the couple could enter into a domestic partnership and receive all the state-law benefits of marriage (and a lower federal tax bill); subsequently, the couple could marry to take advantage of federal tax benefits, such as the marital deduction from estate tax.[9] During the period of the domestic partnership, that couple would have to weigh the tax savings against relegating themselves into a lesser status and not enjoying the many federal benefits of marriage. Intuitively, this planning opportunity is likely of interest to only a handful of high-income taxpayers that place great value on saving income taxes.

## INCOME TAX FILINGS: FILE JOINTLY OR SEPARATELY?

The decision for a married couple to file jointly or separately does not differ between same- and opposite-sex couples. Married couples that file jointly pay income tax as one unit: all income and expenses are lumped together to compute one ultimate tax liability. Additionally, both spouses are jointly and severally liable for the return. On the other hand, married couples that file separately treat all their income and expenses separately, just like single individuals, and are liable only for their own return.

Married-filing-separate status is not an escape from the marriage penalty: the tax liability of married-filing-separate taxpayers is not computed using the more favorable rates paid by single taxpayers. The income tax rates of married individuals that file separately are exactly half the rates imposed on married couples filing jointly. The rates do not provide an advantage to filing separately. Deductions aside, the overall rate of tax paid by a married couple when each spouse has identical income will not differ if the couple files separately or jointly. When there is a disparity in income, it often makes sense to file jointly because the higher-earning spouse's income will reach the highest rates less quickly.

Rates aside, below are some common reasons the majority of married taxpayers file jointly:

1. *Deductions, Exemptions and Credits Not Available to Married-Filing-Separate Taxpayer.* The following are examples of deductions, exemptions, and credits, not available to either spouse when a married couple files a separate tax return:
   - Tuition and fees deduction (Section 222(d)(4)).
   - Student-loan interest deduction (Section 221(e)(2)).
   - Adoption credit (Section 23(f)(1)).

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- Exclusion of Social Security benefits (Section 86(c)(1)(C)(i)).
- Child and dependent care credit (Section 21(e)(2)).
- Earned income tax credit (Section 32(d)).

2. *Simplicity.* All things being equal (or nearly equal), married couples can save the time and expense of filing an extra return when they file jointly. Additionally, married-filing-separately taxpayers may need to jointly divide certain deductions, adding further complexity to such tax returns.
3. *Parallel-Form Requirement.* Married taxpayers that file separately must use the same method of claiming their deductions. Thus, one spouse could not take the standard deduction while the other spouse itemizes deductions.[10]

#### When to File Separately

The following are the most common reasons married couples file separately:

1. *Reimbursable Medical Expenses.* Under Section 213, medical expenses are reimbursable only to the extent they exceed 10% of the taxpayer's adjusted gross income. This threshold is temporarily reduced to 7.5% for taxpayer's ages 65 and older.[11] When spouses file jointly, this threshold is harder to reach because the government looks at the income of both spouses. Thus, if one spouse has significant medical expenses in a given year, it may make sense to file separately for that year. In such cases, the other spouse's income is disregarded for calculating the amount eligible for the deduction. The deductions for expenses incurred in connection with assisted-reproductive technology and gender-confirming procedures are addressed below.
2. *Impending Divorce.* Couples anticipating divorce may prefer to file separately to disconnect from each other and avoid contentious battles rgarding tax issues, namely splitting tax refunds. Also, as noted above, spouses are both liable for jointly filed returns, providing another reason divorcing spouses may prefer filing separately.
3. *Capital Gains Rate Preferences.* In 2013, Congress increased capital gains rates from 15 to 20% on joint taxpayers with combined income over the amount subject to tax at 39.6% (for 2014 status, $457,601).[12] When spouses file under a separate status, the threshold is reached at half the amount: $228,801 of income.[13] Thus, it may make sense to file separately when the lower-earning spouse has a significant amount of capital gain income. Doing so may prevent or limit the amount of capital gain income taxed at the 20% bracket. For example, assume that Al and Bill are married. In 2014, Al has $500,000 of taxable income. Bill's income consists entirely of $50,000 of long-term capital gain from the sale of stock. By filing separately, no part of Bill's $50,000 is taxed at 20%.
4. *Net Investment Income Tax (Section 1411).* The net investment income tax of 3.8% may be imposed on passive income when a taxpayer's total income exceeds a certain threshold. For married couples filing jointly, the threshold is $250,000; when married couples file separately, the threshold is $125,000.[14] Similar to the discussion above on minimizing taxes on capital gains, when the lower-earning spouse has income that would be subject to the net investment income tax, it may be possible to avoid the tax by filing separately. The threshold amounts for the net investment income tax are not indexed to inflation.

#### Immigration Issues

Section 6013(a)(1) provides that a married couple cannot file a joint return if at any point during the tax year one spouse is a nonresident alien. Under this rule, the US citizen or resident-alien spouse would file a return using the married-filing-separate status, not as a single taxpayer. Under Section 6013(g), however, the couple can elect to file under a married-filing-joint status. By making the election, the nonresident-alien spouse's worldwide income will be subject to US income tax and most tax-treaty benefits exempting certain US-source income from US taxation will not be available to offset the income tax liability of the nonresident-alien spouse.

### DEDUCTIONS, EXEMPTIONS AND CREDITS

The deductions, exemptions and credits available to married taxpayers do not turn on the couple's gender composition. That being said, same-sex couples may be particularly interested in the tax benefits for adoption expenses and medical expenses incurred for assisted-reproductive treatment and gender-confirming procedures. In fact, as explained below, recent case law has addressed the latter two subjects.

#### Adoption Credit

Section 23 allows taxpayers a credit of up to $13,190 for adoption expenses. The amount of the credit is indexed to inflation and increases yearly. Generally, taxpayers can claim a tax credit for all expenses incurred in adopting a child up to the maximum amount of the credit. Taxpayers who adopt a special-needs child can claim the maximum amount of the credit, even if their expenses fall short of this amount.[15] As mentioned previously, married taxpayers can claim the credit only if they file jointly.[16]

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7 On 1/16/15, the Supreme Court granted certiorari to four cases addressing the constitutionality of same-sex marriage. The Court's decision to grant certiorari likely stemmed from the Sixth Circuit's decision to uphold state-level marriage bans. This created a split among the Circuit Courts, all of which had previously struck down such bans as constitutional.

8 See California Family Code 297-297.5.

9 For a discussion on the federal estate tax benefits of marriage, see Weissbart, "Strategies to Minimize Estate and Gift Tax for Same-Sex Couples," 37 Estate Planning 33 (February 2010).

10 Section 63(c)(6); Publication 504.

11 Section 213(f).

12 Section 1(h)(1)(D).

13 Section 1(h)(1)(C)(ii)(I).

14 Section 1411(b).

15 Section 23(a)(3).

16 Section 23(f)(1).

Couples planning to marry should note that the adoption credit is not allowed when one spouse is adopting the child of the other spouse.[17] Thus, couples may wish to complete the adoption process prior to marriage.

### Assisted Reproductive Treatment (ART) and Procedures

The deductibility of expenses incurred for in vitro fertilization or other ART appears to turn on whether the taxpayer could reproduce without the medical care. In Ltr. Rul. 200318017, the IRS allowed a deduction under Section 213 for certain expenses incurred by a woman to obtain an egg donor. The woman incurred these costs after she unsuccessfully underwent treatment to conceive using her own eggs.[18] The IRS permitted deductions for the following expenses:

- Medical fees for egg donor.
- Fees for time and expenses of the egg donor.[19]
- Agency fee for finding the egg donor and arranging the transaction between donor and taxpayer.
- Legal fees for contract between the taxpayer and the egg donor.

However, the Tax Court reached the opposite result in Magdalin, TCM 2008-293, *aff'd* 105 AFTR2d 2010-242 (CA-1, 2009), denying the taxpayer's deductions for ART because the taxpayer could clearly reproduce without medical intervention. *Magdalin* involved a male taxpayer who previously conceived naturally with his ex-wife but now incurred expenses for ART to have another child.

It is worth noting that both decisions predate federal recognition of same-sex marriage. Although the Tax Court ruled that denying the deduction was not an issue of "constitutional dimensions" and that a taxpayer's "gender, marital status, and sexual orientation do not bear on whether he can deduct the expenses at issue," perhaps today the case would be decided differently, particularly if the same-sex couple in *Magdalin* was legally married. On one hand, a court could reason that the deduction should be permitted because married same-sex couples cannot conceive without ART, thus medical intervention is necessary. On the other hand, a court, citing *Magdalin*, could claim that such an argument is meritless because marriage does not change the couple's inability to conceive. Moreover, Section 213 is marriage neutral—indeed, it applies equally to single and married taxpayers of all genders; if Congress intended to give a tax break for the cost of ART to married same-sex couples because they cannot biologically reproduce together, it should do so by enacting new legislation.[20] Nonetheless, the recognition of same-sex marriage—and the inability for same-sex couples to conceive within their marriage—at least presents a new argument for deductibility under Section 213 (or the enactment of new legislation).

### Gender-Confirming Procedures

On 11/21/11, the IRS issued a notice of acquiescence[21] agreeing to accept the Tax Court's decision in *O'Donnabhain*, 134 TC 34 (2010), which ruled that a taxpayer could deduct expenses for hormone therapy and sex-reassignment surgery as medical expenses under Section 213(d)(1)(A). The Tax Court decision stemmed from the IRS's denial of the deduction on grounds that the taxpayer's treatment was entirely cosmetic.

## PRE- AND POST-TAX BENEFITS AND DRAWBACKS

For income tax purposes, aside from the rates, marriage comes with other benefits and drawbacks. As previously discussed, income taxes attempt to treat married couples as one unit. Accordingly, the rules allow spouses to make transfers to each other without recognizing gain or altering basis; on the other hand, the rules disallow losses and attribute one spouse's ownership interests or voting rights to the other. This section addresses several of these benefits and drawbacks.

The above issues will be particularly relevant to individuals in long-term relationships who are now marrying. These individuals are now transitioning from a tax system that did not legally recognize their relationships to one that may treat their spouses' assets as their own.

### Tax Benefits

The following points are tax benefits resulting from marriage.

**Non-recognition provision on transfers between spouses.** Section 1041 provides that no gain or loss is recognized on a transfer between spouses. Thus, spouses can sell or gift property to each other without any gain recognition. Section 1041 also provides for a carryover basis: the donee-spouse takes the basis of the donor-spouse in the transferred property.[22] The rule also extends to transfers between former spouses, but only if the transfer was related to the cessation of the marriage.[23] The income tax ramifications of divorce are discussed in greater detail below.

The above rule (along with Section 267) also prohibits recognizing losses on transfers between spouses. Although this part of the rule is not taxpayer friendly, Section 1041 provides a silver lining that is not available when Section 267 disallows a loss between other related parties, i.e., siblings. When Section 267 disallows a loss, the buyer takes a cost basis in the property under Section 1012. Thus, the transferor has "lost" the loss forever.[24] As noted above, under Section 1041, the buyer-spouse takes the seller-spouse's basis, i.e., a carryover basis, thus preserving the loss should the buyer subsequently sell the prop-

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17 Section 23(d)(1)(A).

18 The Letter Ruling does not address the tax deductibility of these expenses.

19 In Perez, 144 TC No. 4, the Tax Court ruled that fees received by egg donors constitute taxable income. Previously, egg donors claimed that their compensation was excluded from gross income under Section 104(a)(2). This decision has no impact on a same-sex couple's ability to deduct the expense.

20 The IRS could also issue new regulations resolving the issue pursuant to its general rulemaking authority (Section 7805(a)).

21 AOD 2011-33, IRB 2011-47.

22 Section 1041(b).

23 Section 1041(a)(2).

24 Section 267(d) provides a possible benefit to the transferee upon subsequent sale of the property at a gain. The rule provides that gain is recognized only to the extent it exceeds the loss disallowed to the transferor.

erty to an unrelated person. Section 267(g) provides that Section 1041 trumps the application of Section 267(a).

**Double Exclusion of Gain from Sale of Real Property.** Section 121 excludes up to $250,000 of gain from the sale of real property provided the taxpayer used the property as a primary residence for two years (in the aggregate) of the five-year period ending on the date of the sale of the property. However, the exclusion is doubled to $500,000 provided the taxpayer files a joint return with his or her spouse and *either spouse* meets the above-discussed ownership requirement.[25] However, both spouses must meet the two-year use requirement and neither spouse may have sold a property to which the exclusion under Section 121 applied within two years of the date of the closing.[26]

**Spousal IRA Rollovers.** The surviving spouse who is the sole beneficiary of a decedent's IRA has a choice unavailable to other beneficiaries: to treat the IRA as his or her own.[27] The designation is simply made by "the surviving spouse redesignating the account as an account in the name of the surviving spouse as IRA owner rather than as beneficiary."[28] Thus, the surviving spouse can be treated as the owner of the plans and would not be required to take any withdrawals until April 1 of the year after he or she reaches $70^1/_2$.[29] Any withdrawals would be based on the surviving spouse's life expectancy.[30]

**IRA Contributions.** For 2015, single taxpayers can contribute a maximum of $5,500 to an IRA or Roth IRA (if income limitations permit) for the calendar year.[31] However, married taxpayers filing a joint federal return may collectively contribute double that amount ($11,000) per year, irrespective of which spouse earned the income, and the contributions can be made to the IRA of either spouse.[32] The increased contribution limit is most significant for couples when one spouse does not earn sufficient income to contribute to an IRA; the rules for married couples effectively allow the other spouse to double his or her contribution. Before same-sex couples could file federal tax returns jointly, each member of the couple could contribute only up to the amount allowed for a single taxpayer.[33]

**Pension Benefits.** On 4/4/14, the IRS issued Notice 2014-19, 2014-17 IRB 979, to address the impact of *Windsor* and Rev. Rul. 2013-17 on the application of the qualified retirement plan rules to same-sex married couples. In the Notice, the IRS clarified the date on which retirement plans must operate in accordance with *Windsor* by recognizing a same-sex spouse as the legal spouse of a participant. Although all retirement plans must now recognize married same-sex spouses, the date in which the plan was first required to do so turned on the domicile of the same-sex married couple.

For same-sex married couples domiciled in a jurisdiction that recognized the marriage, retirement plans had to recognize same-sex spouses as of the date of the *Windsor* decision (6/26/13). The recognition date for same-sex married couples living in a jurisdiction that did not recognize same-sex marriage is 9/16/13, the date the IRS issued Rev. Rul. 2013-17. The basis for this distinction is that the IRS first adopted a rule to recognize same-sex marriages based on the "place of celebration" in the Revenue Ruling.[34] That being said, the Notice permits and provides a procedure for plan sponsors to amend plans to recognize same-sex spouses on an earlier date, including dates prior to *Windsor*.

## Tax Drawbacks

The following points are tax drawbacks resulting from marriage.

**Nonrecognition of Losses:** Section 267(a)(1) (and Section 1041 discussed above) does not permit an individual to recognize a loss on property sold to his or her spouse. Comparatively, an unmarried person—including individuals in civil unions or domestic partnerships—could recognize a loss on the sale of property to his or her partner. The ability for the one partner to recognize a loss while the property remains available for his or her use (because it is owned by his or her partner) creates enormous tax-planning opportunities.[35] Particularly if the property is transferred back at a later date, taxpayers should be wary of the IRS calling this a pre-arranged transaction.[36]

**Automatic Grantor Trust Status.** Section 672(e)(1)(B) provides that a grantor shall be treated as holding any interest held by an individual who became the spouse of the grantor for the period after the individual becomes the grantor's spouse. With respect to same-sex couples, a grantor could create a trust that names his or her unmarried partner as trustee without being deemed the owner of the trust for income tax purposes. If the couple subsequently married, the grantor would be automatically treated as the owner of the trust and would be forced to include all of the trust's income and deductions on his or her personal tax return from the date of the marriage.

**Attribution Rules.** The Code is filled with attribution rules that deem an individual the owner of certain property held by his or her spouse. These

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25 Section 121(b)(2)(A)(i).

26 Sections 121(b)(2)(A)(ii) and (iii).

27 Sections 402(c)(9) and 408(d)(3)(C)(ii); Reg. 1.408-8, Q&A 5(a).

28 Reg. 1.408-8, Q&A 5(b).

29 Section 401(a)(9)(C).

30 Regs. 1.401(a)(9)-5, A-5(b), A-5(c)(2).

31 According to IRS Publication 590A, the most that can be contributed to a traditional IRA generally is the smaller of the following amounts: $5,500 or the IRA owner's taxable compensation for the year.

32 When one or both spouses is age 50 or older, they can contribute an additional $1,000 or $2,000, respectively (IRS Publication 590A).

33 Provided the lower-earning member of the non-married couple had earned income above the IRA contribution limit for the tax year, the higher-earning member of the couple could have made an annual exclusion gift of the IRA contribution amount to the lower-earning member of the couple without any negative income or gift tax consequences to either of them.

34 See note 1 *supra*.

35 For a discussion on this issue, see Cain, "DOMA and the Internal Revenue Code," 84 Chi.-Kent L. Rev. 481, 501, 515 (2009).

36 See, e.g., Section 7701(o).

rules arise in virtually every area of the income tax. The policy reason for these rules is that the Code–for better or worse–views married couples as a single economic unit and related in a way that makes treating them as dealing at arm's length unwise for tax purposes. Despite the sensibility of these rules, attribution does not generally favor the taxpayer. The following are a handful of common spousal attribution rules that may have income tax consequences to long-term couples who are now marrying:

- *Tax treatment of redemption of stock:* Under Section 318(a)(1)(A)(i), an individual is treated as owning the stock owned by his or her spouse. When stock is redeemed, if the redemption is considered "substantially disproportionate" or a "complete termination," the character of the income will be capital gain; if not, the character of the income will be dividend income.[37] Thus, same-sex couples who are both shareholders in corporations may wish to examine the impact of marriage on subsequent redemption of the stock, particularly when one spouse remains a shareholder. In today's world, although the income tax rates on capital gains and qualified dividends are the same, it is still better for the character of the income to be treated as capital gain because gain is recognized only to the extent the amount realized on the redemption exceeds the taxpayer's basis in the stock and any available capital losses can be used to offset the gain.
- *Controlled foreign corporations:* Under Section 957, a foreign company owned more than 50% by U.S. persons is treated as a controlled foreign corporation (CFC). If a CFC has what is known as "Subpart F income," the U.S. shareholders will be taxed on their pro rata share of the corporation's Subpart F income, even if the corporation does not make a distribution to the shareholders. In contrast, if a corporation is not a CFC, a shareholder is not generally subject to taxation until the earnings and profits are repatriated into the United States as a dividend. Under Section 958(b), the attribution rules in Section 318(a) (with certain modifications) apply to determine whether an entity is a CFC. Thus, marriage can turn an entity into a CFC and create a huge yearly tax bill that could have otherwise been deferred.
- *Private foundation disqualified person rules:* Section 4946 defines a spouse of a substantial contributor or foundation manager as a disqualified person of the private foundation.[38] Thus, by marrying, spouses automatically become disqualified persons of the private foundation. It is bad to be a disqualified person of a private foundation because he or she becomes subject to, among other restrictions, the self-dealing rules of Section 4941, which can impose excise taxes on disqualified persons for certain transactions, i.e., leases, even though the transactions are at arm's length.[39]

## AMENDING PAST INCOME TAX RETURNS

On 9/16/13, the IRS ruled in Rev. Rul. 2013-17 that it will recognize all legal same-sex marriages for federal tax purposes. Thus, married same-sex couples must file a tax return using a married-filing-jointly or separately status for tax year 2013. Additionally, married same-sex couples who filed their 2012 return on or after 9/16/13 (because it was filed late or on extension) must also file using a married-filing-jointly or separately status.

Rev. Rul. 2013-17 also provides that taxpayers can rely on the ruling to amend tax returns up to the applicable period of limitations. Under Section 6511(a), a taxpayer generally may file a claim for refund from the later of three years from the date the return was filed or two years from the date the tax was paid. Taxpayers are not under any obligation to amend a tax return. Thus, same-sex couples who were married for tax years in which they may be able to amend their return should determine whether doing so will result in any tax savings.

## INCOME TAX PLANNING IN STATES WHERE SAME-SEX MARRIAGE IS NOT RECOGNIZED

Married same-sex couples that reside in a state that does not recognize their marriage have to file as two single taxpayers for state income tax purposes even though they file as a married couple for federal tax purposes. This disparity creates a problem for preparing state income tax returns as the content is generally based on the federal tax return.[40] Where this problem exists, states have developed three different solutions to address the issue:

- *The allocation approach.* Married same-sex couples allocate income on their federal tax return to two state tax returns as single taxpayers using a state-provided schedule. This has been the approach favored by Ohio and North Dakota.
- *The dummy federal return approach:* Married same-sex couples complete two pro forma "dummy" federal tax returns as single taxpayers. These tax returns are not filed with the federal government; rather, they are used solely for the purpose of preparing two state tax returns as single taxpayers. This has been the approach favored by Georgia, Kentucky, Louisiana, Michigan, and Nebraska.
- *The ratio approach:* Alabama was alone in providing a ratio that

NOTES

37 Sections 302(b)(2) and (3).

38 Sections 4946(a)(1)(D) and (d).

39 See, however, Reg. 53.4941(d)-1(b) (exempting certain established transactions from constituting self-dealing).

40 Arkansas, Mississippi, and Tennessee are the only remaining states instructing the filing of single returns on the state level, even if filing married returns on the federal level. South Dakota and Texas do not have state income taxes and therefore no state level return is filed.

married same-sex couples use to apportion their income onto two state tax returns as single taxpayers. Same-sex marriage began in Alabama on 2/9/15.

Given the ever-growing number of states that recognize same-sex marriage, this conundrum may become irrelevant in the near future.[41] Nonetheless, until same-sex marriage is recognized across the country, which is scheduled to be addressed by the Supreme Court, married same-sex couples that reside in a state that does not recognize their marriage should be aware of this complexity.

## INCOME TAX RAMIFICATIONS OF DIVORCE

Whether a married couple must file as a married taxpayer or two single taxpayers is determined based on their marital status on the last day of the tax year.[42] If a spouse dies during the tax year, the determination is based on the marital status at the time of the spouse's death.[43] Thus, said differently, a married couple will be treated as two single taxpayers for the entire tax year only if they have obtained a final decree of divorce or separate maintenance by the last day of the tax year.[44]

State law determines marital status and the date of its termination. Thus, same-sex couples in marriage alternatives, such as civil unions and domestic partnerships, are not considered married for federal tax purposes.[45]

Once a couple has divorced, Section 1041 no longer applies to any transfers of property between the spouses, unless those transfers are "incident to divorce." Thus, subsequent transfers between divorced spouses that are not "incident to divorce" will constitute recognition events based on general principles of the taxation of property transactions.[46]

Section 1041(c) and the accompanying regulations provide both two bright-line rules and a facts-and-circumstances analysis to determine whether a transfer is "incident to divorce." All transfers that occur within one year of the date the marriage ends–as defined under state law–will continue to be treated as non-recognition events under Section 1041. This is true even if the transfer has nothing to do with the divorce, including when one former spouse transfers property acquired after the cessation of the marriage but within the one-year period following the cessation of the marriage. Transfers are also "incident to divorce" if the transfer is (1) pursuant to a divorce or separation agreement and (2) occurs within six years of the date the marriage ceases (as defined under state law).[47] If both prongs are not met, Section 1041 will still apply provided the taxpayer can show facts and circumstances proving "that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage."[48]

Divorce can also raise the following issues with dividing deductions and expenses:

- *Exemption for dependent children.* Section 152(c)(4)(B) provides that the parent with whom the child resided for the longest time is entitled to the exemption. If the child spent an equal amount of time with both parents, the statute assigns the exemption to the parent with a higher adjusted gross income. Divorced parents are free to deviate from these rules by filing Form 8332, which assigns the exemption to one of the parents.[49]
- *Income and deductions.* Generally, in the year of divorce, each spouse will report his or her wages and income and deductions on separately owned assets. Income and deductions on jointly owned assets are typically split. Couples usually address this in a divorce settlement.
- *Deduction and gross income for alimony.* Section 71(a) provides that gross income includes alimony payments. Similarly, the individual paying the alimony is entitled to a deduction for the payment. Alimony is an "above the line deduction," i.e. it is deductible whether or not the payor itemizes deductions. Generally, only cash payments qualify as alimony.[50] If the payor-spouse agrees not to take a deduction, the payee-spouse does not need to include the alimony in his or her gross income; this must be done in a divorce decree.[51] Note that child support payments do not constitute gross income to the child or custodial parent nor are the payments deductible by the payor.

## CONCLUSION

The income tax ramifications of marriage may surprise same-sex couples, particularly those that have been in relationships long before marriage was even possible for them. The joys of a wonderful marriage are great. At the very least, awareness of the income tax ramifications discussed in this article will eliminate any unfortunate surprises that might otherwise take away from one of life's greatest joys.

NOTES

41 As of 2/9/15, the following states/jurisdictions have legalized same-sex marriage: Alabama, Alaska, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Minnesota, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.

42 Section 7703(a)(1).

43 *Id.*

44 Sections 7703(a)(2), 6013(d)(2).

45 See Rev. Rul. 2013-17.

46 See generally, Sections 61(a)(3) and 1001.

47 See Temp. Reg. 1.1041-1T(b), Q-6.

48 *Id.*

49 Section 152(e).

50 Sections 71(b)(1) and 215(b).

51 Temp. Reg. 1.71-1T(b), Q-8.