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And You Thought Marriage Was Taxing…

Tax Implications of New Jersey's New Civil Unions

by Gary R. Botwinick

On Dec. 21, 2006, the New Jersey Civil Union Act was signed into law, and became effective on Feb. 19, 2007. The act was the Legislature's response to the Supreme Court's decision in *Lewis v. Harris*,[1] which held that "committed same-sex couples must be afforded, on equal terms, the same rights and benefits enjoyed by married opposite-sex couples." The intent of the act was to place same-sex couples on exactly the same footing as opposite-sex couples. And, in fact, the act does an excellent job in that regard with respect to New Jersey taxation. However, with respect to federal taxation, the act runs headfirst into the Federal Defense of Marriage Act (DOMA).[2]

DOMA provides that "[i]n determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife."[3] Consequently, those certain tax benefits (and burdens) afforded to married couples under the Internal Revenue Code, will not apply to civil unions.

In advising parties prior to entering into a New Jersey civil union, or representing an individual terminating a civil union, it is incumbent upon the attorney to understand the tax impact of both events. Family law attorneys are quite familiar with the tax aspects of a traditional divorce (*e.g.* alimony, child support, equitable distribution). Now they must become familiar with the effect transactions will have before, during *and after* the termination of a civil union. While space will not permit a thorough discussion of all of the tax implications of civil unions in comparison to marriages, this article is intended to focus on those issues that are most important to family law attorneys.

FEDERAL AND STATE INCOME TAX ISSUES: ENTERING INTO AND TERMINATING A CIVIL UNION

The refusal to recognize a civil union as a marriage under federal law creates significant problems with respect to income taxation.

Filing Status

Because DOMA specifically excludes same-sex partners (even if joined in a civil union) from the definition of "married" under the Internal Revenue Code, civil union couples are prohibited from claiming married filing status on a federal income tax return. Thus, they will be required to file using the single status.

Though the act specifically provides that, with respect to any New Jersey state tax laws, members of a civil union are treated in the same manner as married spouses,[4] New Jersey law generally provides that a taxpayer's filing status for New Jersey income tax purposes will follow the filing status of the taxpayer for federal income taxes.[5] So, are members of a civil union required to file New Jersey income tax returns claiming a single filing status, or are they permitted to deviate from the requirement of consistency?

The New Jersey Division of Taxation has recently indicated that civil union couples will be able to file using a joint filing status for New Jersey income tax purposes. Incidentally, this may be beneficial for federal tax purposes. Through a quirk of the federal income tax system, married couples with approximately equal income are subject to a "marriage penalty," which results in a higher tax than if the spouses were each entitled to file singly and the tax obligations were aggregated. DOMA, in effect, gives civil union couples a *bonus* for federal tax purposes.

Gain on Sale of Principal Residence

Section 121(b) of the Internal Revenue Code provides an exclusion for certain sales of a principal residence. Individuals owning and using a residence for two out of the five years preceding a sale, are able to exclude $250,000 of the gain on the sale from taxation. Married taxpayers filing a joint return can exclude up to $500,000 of gain from taxation, even if only one spouse meets the ownership test.

At first blush, this does not appear to be a problem for civil union couples, because they would each be able to exclude $250,000 on their single returns, thus getting the benefit of the full $500,000 exemption (2 x $250,000). But what if only one of the civil union spouses meets the ownership test? If they were permitted to file a joint return, this issue would be irrelevant. Additionally, the Internal Revenue Code provides that the ownership and use rules are relaxed if a sale occurs as a result of "unforeseen circumstances."[6]

The IRS has issued regulations

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that provide certain "safe harbors," which are presumed to be "unforeseen circumstances," including "a divorce or legal separation under a decree of divorce or separate maintenance."[7] Would a dissolution of a civil union qualify under the safe harbor? Though DOMA does not define divorce or legal separation, it is likely that an interpretation of DOMA would lead to the conclusion that such a dissolution would not satisfy the safe harbor. This could result in the recognition of significant taxable gain to a spouse in a civil union that would not have been imposed in a marriage, as defined in DOMA.

Alimony

In a divorce, the tax implications of alimony payments are clear. The Internal Revenue Code provides that "gross income includes amounts received as alimony or separate maintenance payments," and "there shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during such individuals tax years.[8] In other words, the payee-spouse must include the alimony in taxable income, and the payor-spouse gets a corresponding deduction. But would this be the result if the payments are made as a result of a termination of a civil union?

Because DOMA limits the definition of a "spouse" to someone of the opposite sex, and only payments from a spouse can be considered "alimony or separate maintenance payments" under the Internal Revenue Code, such payments would not meet the requirements of 26 U.S.C. 71, and would not qualify as "alimony." Thus, the payor-spouse would be denied a deduction. But what about the payee-spouse?

It is unclear how the payee-spouse would be treated. There is no provision in the Internal Revenue Code to exclude these payments from the general definition of "gross income," as there is with respect to alimony payments.[9] Because the payment is unlikely to be viewed as having been given with "detached and disinterested generosity,"[10] it will not qualify as a gift exempt from income taxation.[11] So if it is not specifically exempted from the definition of "income," and it is not a "gift," then the likely result is that the IRS would take the position that the payment is includable in the payee-spouse's income. Thus, there is no deduction to the payor and inclusion in the payee's income—*double taxation*.

Property Transfers Between Civil Union Couples

Transfers of property between spouses or former spouses, if incident to a divorce, are exempt from federal income tax consequences to both the transferor and transferee-spouse.[12] The transferee takes a carryover basis from the transferor—in other words, the transferee assumes the transferor's basis. Consequently, neither spouse recognizes any gain or loss on the division of assets in a divorce, regardless of who may be the transferor or transferee.

DOMA, however, prohibits the application of Section 1041 with respect to transfers between civil union couples. Generally, this should not result in taxable income to the recipient-spouse in a civil union that is not being dissolved, because the transaction will typically qualify as a gift, and, therefore, be exempt from income taxation and gain recognition (but see below for gift tax treatment). However, if the transfer is incident to a dissolution of a civil union, the result is likely quite different, since such a transfer would not be considered a gift (*i.e.*, no detached and disinterested generosity).

In the case of a dissolution (since 26 U.S.C. 1041 does not apply), the tax consequences are likely to be governed by the holding of *United States v. Davis,*[13] which was decided before the enactment of 26 U.S.C. 1041. In *Davis*, the Court found that a transfer of appreciated property to an ex-spouse resulted in the recognition of taxable gain to the transferor-spouse. The transferee-spouse would take a stepped-up basis, as the built-in gain already would have been taxed. Interestingly, the Court also held that the receipt of property by the transferee-spouse did not result in income, as the property was received in exchange for a surrender of marital rights.

Thus, in a civil union dissolution, the transferor-spouse may have gain recognition if appreciated property is transferred. But would the transferee-spouse have income, or would the surrender of civil union partner rights be sufficient to avoid such an imposition? It is unlikely that the logic in *Davis* is any different when a civil union partner is, under state law, surrendering certain civil union rights. It is possible that the IRS could take the position that DOMA prevents such a result, though it is unlikely that such a position would be successful. Similarly, the IRS could take a position that there should be a capital gain on the exchange of the surrendered civil union rights for the transferred property. The Court, in *Davis*, however, did not make that determination.[14] Consequently, the transferor-spouse will likely have a taxable event, but the transferee-spouse probably will not.

Retirement Plans

In a divorce, qualified retirement benefits and individual retirement accounts (IRAs) are customarily divided between the spouses. Through the use of a qualified domestic relations order (QDRO), the division of the accounts does not result in a taxable event to either the transferor-spouse or the transferee-spouse. DOMA, however, prohibits the use of a QDRO with respect to civil union partners, as a QDRO must relate to child support, alimony or marital property rights of a spouse, former spouse, child or other dependent of the participant in the plan.[15] Thus, an actual division of a qualified retirement plan may be a practical impossibility, and if not impossible, then, at a minimum, extremely expensive from a tax perspective (*e.g.*, imposition of income taxes on distributions and a potential 10 percent penalty).

Gift and Estate Tax Issues

Contrary to popular belief, the federal estate tax is not dead, and

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the federal gift tax is even livelier. The current federal estate tax exemption is $2,000,000 (and is scheduled to increase to $3,500,000 in 2009) and the lifetime gift tax exemption is $1,000,000 (and is not scheduled to increase). The gift tax annual exclusion amount is currently $12,000. Of course, the federal estate and gift tax regime still provides for an unlimited marital deduction for transfers between U.S. citizen spouses (as defined in DOMA). That means that transfers between U.S. citizen spouses, no matter how large, and regardless of whether they occur during or after death, will not be subject to either federal estate or gift taxes.

New Jersey, with the adoption of the act, now treats civil union couples the same as married couples for New Jersey estate taxes and inheritance taxes. This means that testamentary transfers between civil union partners will be exempt from the imposition of New Jersey estate and inheritance taxes. Likewise, transfers prior to dissolution of a civil union will not be subject to New Jersey taxes.

Unfortunately, as in the area of federal income taxes, DOMA rears its ugly head in the area of gratuitous transfers between civil union partners.

Support Paid by One Partner to the Other

As in most traditional marriages, members of a civil union will typically pool their resources, and use them for the support of the family. Married couples usually do not worry about gift tax consequences from such an arrangement because of the unlimited marital deduction. But how will these arrangements be treated for federal gift tax purposes?

Clearly, DOMA prevents such transfers from qualifying for the marital deduction. Thus, it would appear that these transfers will be subject to federal gift taxation to the extent that the transfer exceeds the $12,000 annual exclusion. But if the transfer is in satisfaction of a statutory obligation of support, the transfer would be neither income to the recipient nor a gift from the payor. This is akin to the support a parent provides to a child. For example, if a parent pays $30,000 per year in aggregate expenses to support a child, is the amount in excess of $12,000 considered a taxable gift? Generally, these expenses are not considered taxable gifts.[16] If the amount paid or transferred exceeds the reasonable requirements for support, the excess may be a gift.[17]

Civil union spouses are required to support each other in the same manner a husband and wife are required to support each other.[18] So it is arguable that payments to or for the benefit of a civil union partner are not considered gifts. But what if the payment is beyond the level of support required to be given? There are no reported cases on this issue yet, but it is an interesting question.

Joint Property

Spouses in a traditional marriage typically own their marital residence in joint names. The source of the downpayment and the future mortgage payments are generally ignored for gift tax purposes because of the unlimited marital gift tax deduction. Consider the following hypothetical examples:

1. The husband (who is a starving artist) and the wife (who is a successful surgeon) buy a $1,000,000 home in joint names. The wife provides the downpayment of $200,000 from her own premarital assets, and all of the mortgage payments and other expenses related to the residence are paid by her from her earnings. *There are no gift tax consequences either during or upon the termination of the marriage as a result of the unlimited marital deduction.*
2. Assume the same facts as in hypothetical 1, except that the parties are John (artist) and Mark (surgeon), and they are partners in a New Jersey civil union. Upon taking title to the home in joint names, because there is no marital deduction, the IRS is likely to take the position that a gift of half the equity has been made from Mark to John. Moreover, every time Mark makes a payment toward the mortgage, he is enhancing the value of John's interest in the property, thus it is a taxable gift.[19]

This same logic would apply to joint bank accounts. However, the gift would occur only as the money is withdrawn by or for the benefit of the non-contributing partner.[20]

Are there gift tax consequences upon the dissolution of the civil union? In a divorce in a marriage, the division of marital assets does not typically result in the imposition of gift taxes because of the exemption set forth in 26 U.S.C. 2523 (the "marital deduction" if the transfers occur while the spouses are still married to each other) and the provisions of 26 U.S.C. 2516 (pursuant to a written separation agreement, where there is a final divorce within three years thereafter). But in the case of a dissolution of a civil union, there is no marital deduction and, because of DOMA, the treatment under Section 2516 is not available.

All is not lost. Prior to 1981, the marital deduction for gifts between spouses was limited. Prior to 1954, Section 2516 of the Internal Revenue Code did not exist. Section 2516 was, in fact, enacted in response to the U.S. Supreme Court's decision in *Harris v. Comm.,*[21] which held that a transfer of property, pursuant to a decree of divorce, was a transfer for adequate and full consideration in money or money's worth and was not subject to the gift tax. After the *Harris* decision, there was significant confusion regarding whether or not any certain division was pursuant to a decree, and whether the fact that a division may not have been pursuant to a decree was enough to result in the imposition of a gift tax. Most courts held that a gift had occurred unless the terms of the

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property settlement agreement had been incorporated into the Court's decree. In some cases, however, it was sufficient if the agreement itself provided that it would become effective upon entry of the decree. When Section 2516 was enacted in 1954, the issue was put to rest.

Since DOMA precludes the application of Sections 2516 and 2523 to civil union dissolutions, it is likely that the Supreme Court's holding in *Harris* would apply. Thus, if the transfer is pursuant to a decree of divorce (including where a property settlement agreement is incorporated into a divorce decree), then it is unlikely that the IRS would be successful in asserting that the transfer is a taxable gift. Of course, we will not know until such a case is ultimately litigated.

Federal Estate Taxation

As stated above, there is no federal marital deduction for testamentary transfers to a surviving civil union partner. For federal estate tax purposes, it would appear that such transfers are taxable. In many cases where the estates are rather large, this may be an important issue to consider before entering into a civil union, despite the fact that the federal estate tax is scheduled to be repealed in full in 2010[22] and currently has a high[23] exemption that is increasing.[24] Can a claim made by the surviving civil union spouse against the estate of the deceased spouse result in a substitute deduction in lieu of the marital deduction?

Upon the enactment of the act, the provisions of N.J.S.A. 3B:8-1 *et seq.,* specifically, the "elective share," applied equally to civil union and married couples. In other words, civil union spouses have the same elective share rights as married spouses. Pursuant to 26 U.S.C. 2053(a)(3), "claims" against a decedent's estate are deductible to the extent the claim is allowable under the applicable law of the jurisdiction under which the estate is being administered.

If a deceased civil union spouse leaves nothing to his or her surviving spouse, and the surviving spouse makes a claim for the elective share, is that a claim that the estate would be able to deduct for federal estate taxes under Section 2053(a)(3)? In order to be deductible, the claim must represent a personal obligation of the decedent, *existing at the time of his or her death,* whether or not then matured.[25] Is a claim for an elective share a claim that was existing at the time of the decedent's death?

In *Essex v. U.S.,*[26] the Court held that a claim for a widow's allowance, authorized as a claim against the estate under Nebraska law, was not deductible under Section 2053(a)(3). The IRS also may contest the surviving civil union spouse's claim on the grounds that the claim is not for an interest *in* the estate as opposed to a claim *against* the estate.[27]

Prior to entering into a civil union, would it make a difference if the parties entered into a prenuptial agreement providing that the parties will provide certain benefits to each other in the event of a death of one of the parties or a divorce? New Jersey law provides that civil union couples could enter into enforceable prenuptial agreements in the same manner as spouses in a so-called traditional marriage. Is that sufficient to make a deductible claim under Section 2053(a)(3)? The author has been unable to find any cases addressing this interesting question, but in counseling a party entering into a civil union, it may be worth considering.

CONCLUSION

The enactment of New Jersey's Civil Union Act creates an interesting playing field for various issues. Obviously, tax issues are among the most important considerations for family law attorneys counseling clients. This article could not possibly address all of the issues certain to arise. Many of the issues raised here will only be developed over the course of many years of litigation. It the meantime, it should be a very interesting ride. ■

ENDNOTES

1. 188 N.J. 415 (2006).
2. Pub. L. No. 104-199, 110 Stat. 2419 (Sept. 21, 1996).
3. 1 U.S.C. 7 (2007).
4. N.J.S.A. 37:1-32(n), 37:1-33.
5. *See* N.J.S.A. 54A:2-1.
6. 26 U.S.C. 121(c)(2).
7. Treas. Reg. 1.121-3(e)(2)(iii)(D).
8. 26 U.S.C. 71(a) and 215(a).
9. *See* 26 U.S.C. 61(a) (which defined "gross income" for tax purposes) and 26 U.S.C. 71 (excluding alimony from the definition of gross income).
10. The general test for determining when a transfer is a gift for tax purpose.
11. *See Commissioner v. Duberstein*, 363 U.S. 278 (1960).
12. 26 U.S.C. 1041.
13. 370 U.S. 65 (1962).
14. *See also* Rev. Rul. 67-221, 1967-2 C.B. 63 (Under the terms of a divorce decree, the husband transferred his interest in an apartment building to his former wife in consideration for and in discharge of her dower rights. The marital rights the former wife relinquished are equal in value to the value of the property she agreed to accept in exchange for those rights. *Held:* there is no gain or loss to the wife on the transfer and the basis of the property to the wife is its fair market value on the date of the transfer).
15. 26 U.S.C. 414(p).
16. *See Hooker v. Comm.,* 10 T.C. 388 (1948), *aff'd,* 174 F. 2d 863 (5th Cir., 1949).
17. *See* N.J.S.A. 37:1-31.
18. *See Rosenthal v. Comm.,* 205 F.2d 505 (2nd Cir. 1953).
19. *See* Treas. Reg. 25.2511-1(h)(5).
20. *See* Treas. Reg. 25.2511-1(h)(4).
21. 340 U.S. 106 (1950).
22. A likelihood that the author sees as extremely remote.
23. $2,000,000.
24. $3,500,000 in 2009.
25. *See* Treas. Reg. 20.2053-4.
26. 33 AFTR2d 74-1478 (D. Neb.).
27. *See Lindsey v. U.S.,* 167 F. Supp. 136 (D. Mary. 1958).

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