

Tax and Estate Planning for Nontraditional Families: Gay, Lesbian and Unmarried Heterosexuals

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Agenda

- Retirement plans and miscellaneous items
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Background – Spousal Discrimination

- State and federal laws have default statutes that give spouses rights but not unmarried partners, such as rights under:
 - state intestacy statutes
 - Social security survivor benefits
 - To handle funeral arrangements
- According to a 2004 letter from an Associate General Counsel of the GAO to Senator Bill Frist dated January 23, 2004, as of January 31, 2003 there were 1,138 federal statutory provisions under the United States Code where marital status was a factor in determining eligibility for rights, benefits and privileges.
- Generally, unmarried partners do not have a unique set of laws geared to their status as do married couples
- However, there are techniques available to unmarried couples that are not available to married couples

Background – Disposition of Assets at Death

- In the absence of a will, a person's estate will pass according to the intestacy statute of the state where the decedent was domiciled
- Generally an intestacy statute will provide that if the decedent died survived by a spouse and children, property will be distributed to the decedent's spouse and children in some manner and if there is no spouse or children, to various blood relatives depending upon their relationship to the decedent.
- Who is a "spouse" is determined by state law
- For purposes of federal law, the 1996 Defense of Marriage Act (DOMA) (1 U.S.C. §7 and 28 U.S.C. §1738C) defines "marriage" exclusively as a "legal union between one man and one woman". It defines "spouse" as "a person of the opposite sex who is a husband or a wife."

Background – Disposition of Assets at Death

- Unmarried couples do not have the same protections and benefits as a married heterosexual couple
- Examples – unmarried couples:
 - No intestate share
 - No statutory elective share
 - No community property share in community property states
 - Can hold property as joint tenants but not as tenant by the entirety
 - No spousal right in ERISA pension plan
 - Can't claim a common law marriage (in states which permit common law marriage)
 - Partner does not have statutory authority to administer estate
 - No state divorce laws governing disposition of property – dissolution may be decided under contract law rather than family law
 - Can't bring wrongful death claim or receive workman's compensation if partner dies in work-related injury
 - Separation of unmarried couples or same-sex partners does not automatically revoke provisions in estate planning documents e.g. a disposition to a partner, naming the partner as an executor, trustee, attorney-in-fact under a durable power of attorney, agent under a health care proxy, beneficiary of retirement plan benefits or life insurance

Background – Differing State Laws

- States allowing same-sex marriages: MA, CT, IA, VT, NH, NY, DC
- States allowing civil unions: DE, HI (effective 1/1/12), IL, MD, NH (all civil unions automatically convert to marriages on 1/1/2011), NJ, RI
- States allowing domestic partnerships: OR, WA
- States allowing domestic partnership reciprocal benefits: NV, ME, WI, CO, MD, HI, CA and DC
- Some states have some sort of same-sex partnership legislation pending: HI, MD, NJ, PA, MN
- Common law marriages are recognized in 11 states and DC and other states recognize common law marriages lawfully entered into in other states.
 - IA, DC and NH recognize same-sex and common law marriage, so that a same-sex common law marriage is possible

Background – State v. Federal Law

- DOMA allows states to refuse to allow full faith and credit to other state's laws or judicial proceedings for same-sex marriages, civil unions and domestic partnerships
 - Generally, full faith and credit must be given by one state to the laws and judicial proceedings of another state
 - Limited exception: full faith and credit doesn't apply where the strongly held public policy of a state would be violated.
 - Thus, DOMA allows states to refuse to grant full faith and credit to same-sex marriages even if it was lawful in the state where the marriage occurred
- 41 states currently have DOMA type statutes that prohibit the recognition of same-sex marriages performed in other jurisdictions or have legislation banning same-sex marriages.
- MD, NM, MA, NY, RI and DC recognize same-sex marriages that are valid in the state in which they took place
- DOMA also prohibits the recognition of same sex relationships for any federal purposes e.g. tax purposes.

Transfer Tax – Estate Tax

- No federal estate tax marital deduction
 - Pay estate taxes once by leaving assets in trust (LE/SPOA) instead of outright to partner
 - Provides good asset management vehicle if partner becomes disabled or dies without his/her own estate plan – Jim Morrison story
 - Avoids complications with durable power of attorney and guardianship petitions
- Assets over estate tax exemption subject to estate tax at death of partner
- Increases need for life insurance at the death of first partner

Transfer Tax – Gift Tax

- No federal gift tax marital deduction
 - Transfers between partners are taxable gifts subject to the annual exclusion, the lifetime exemption and the Med/Ed exclusion
 - Payment of living expenses by one partner may be a taxable gift to the other partner subject to the annual exclusion, the lifetime exemption and the Med/Ed exclusion
 - The \$5,000,000 lifetime gift exemption, available until the end of 2012, gives partners a tremendous opportunity to make lifetime, tax-free gifts to the other partner.
- No gift-splitting
 - While the annual exclusion gifts can be made, the partner cannot double the amount of the gift by gift-splitting

Transfer Tax – Gift Tax

- §2516 transfers incident to a “divorce” of the partner, tax-free for married heterosexuals, is not available to partners.
 - For married opposite sex couples, §2516, which allows for transfer of property and payments between ex-spouses pursuant to a written settlement of marital property rights, or for the support of minor children of the marriage, are deemed for adequate consideration i.e. not a gift
 - §2516 requirement: parties must divorce within the 3 year period that begins one year before the agreement is executed and ends two years after agreement is executed. The actual transfer of property can happen at any time.
- Transferring title of assets into joint tenancy (except for joint bank accounts and other investment accounts) may result in a taxable gift

Transfer Tax – Generation Skipping Tax

- The \$5,000,000 lifetime generation skipping tax exemption, available until the end of 2012, gives partners a tremendous opportunity to make lifetime, gift free of the generation skipping tax
- Lifetime generation assignment is based on family relationships for relatives but is based on the relative ages for non-family members i.e. partners (see diagram)
 - Result: unmarried couples unable to transfer assets to “trophy” much younger partner and avoid generation skipping transfer tax
 - GST regs in effect make it impossible to adopt partner to avoid GSTT
 - Must be descendent of parent or the adoptive parent (or the adoptive parent's spouse or former spouse) and be under 18 at the time of adoption
- No GST gift-splitting available
- Can't use deceased partner's GST exemption on death of second partner via a reverse QTIP election

	<u>Family Relationship</u>	<u>Non-Family Relationship</u>
1 st generation	Parent/Transferor	Transferor
2 nd generation – non-skip person	Child	12 ½ to 37 ½ years younger than G1
3 rd generation – skip person	Grandchild	25 years younger than G2

Income Tax

- Income Tax Returns
 - Federal filing status – separate, perhaps head of household
 - State filing status: depends on state and whether it allows marriages, civil unions or domestic partnerships
- Mortgage interest deduction – each partner can use the \$1 million acquisition indebtedness limit
- Each partner can exclude up to \$250,000 of gain on the sale of a principal residence assuming other requirements are met (note: each partner must meet the ownership and use requirements)
- Dissolution/divorce - §1041 not applicable to dissolution of same-sex marriage i.e. gain or loss must be recognized on transfer of appreciated property at the termination of the relationship
- Maintenance/alimony – §71 and §215 do not apply to partners – alimony is ordinary income to the recipient and non-deductible by the payor.
 - It may also be a gift

Income Tax

- Benefits – FMV (including the employee's pre-tax contribution) of employer provided health insurance coverage for partner or dependents of the partner of the employee is treated as imputed income of the employee.
 - Increased income increases employee's social security and employer's payroll taxes.
 - Same coverage for married opposite sex couples is excluded from the employee's gross income.
- Disallowance of losses on the sale or exchange of property to a related party under §267 does not apply to loss on sale or exchange of property to a partner.
 - Note the purchase price become the buyer's basis
- Stock redemptions – where unrelated partners own stock in a closely held business, the stock attribution rules under §318 do not apply.
 - Thus, it may be easier to qualify a stock redemption for capital gain treatment rather than as ordinary income under §302(b).

Adult Adoption – Estate Planning Reasons

- Reasons:
 - Establish a family relationship for purposes of entitlements and other benefits e.g. social security, health insurance, survivor benefits, dependency exemption, head of household status)
 - To establish a legal heir and secure inheritance rights e.g. to enable the adopted person to inherit as a child under state intestacy statute
 - To have the adoptee within the class of beneficiaries entitled to take under pre-established estate planning documents e.g. to take as "issue" under a trust established by the partner's ancestors.
 - To prevent having a disposition to a partner under a will from being challenged – it is more difficult to successfully challenge an adoption than a will
- Not all states permit adult adoption and some that do limit the adoption to those under the age of 18 or younger than the person adopting them.
- Caution: consider the possibility of prosecution for incest

Adult Adoption – Estate Planning Reasons

- §2031A special valuation rules – property must pass to “member of the decedent’s family” and continue to be used by a “member of the decedent’s family” which includes adopted children
- §6166 election to pay estate tax on qualified business in installments
 - Allows payment of estate tax attributable to a closely held business in installments over a maximum 14 year period
 - Requirement: At least 35% of the decedent’s adjusted gross estate must consist of an interest in a closely held business that was an active trade or business in which the decedent or a member of his family (including an adoptee) holds a minimum percentage ownership interest

Estate Planning Techniques – Life Insurance

- Provides liquidity for the deceased partner’s estate
- Provides surviving partner with funds to buy out a business partner
- Provides funds necessary to support the surviving partner
- Allows the insured to retain the inter vivos power to cancel the policy or alter the beneficiary designation

Estate Planning Techniques – Outright Gift

- Great opportunity before the end of 2010 to gift up to \$5 million free of gift tax
- In addition, if donor lives for 3 years after making a taxable gift, any gift tax paid is not pulled back into the gross estate
- Lifetime gifts, computed on a tax-exclusive basis (the amount of the gift tax is not included in the tax base), are taxed more favorable than subjecting the asset to estate tax, which is calculated on a tax-inclusive basis (the amount of the estate tax is included in the tax base).

Estate Planning Techniques – Advantage under Chapter 14

- Unmarried partners are not considered family members within the definition of Chapter 14
- As a result, certain techniques that are of limited use or not available to married partners under Chapter 14 are available to unmarried couples
- Thus, it is not necessary to use a grantor retained annuity trust (GRAT) or a qualified personal residence trust (QPRT)
- Instead, unrelated parties can still use split-interest purchases, establish a common law grantor retained income trust (GRIT) and some of the restrictions applicable to related parties regarding QPRTs do not apply

Estate Planning Techniques – GRIT

- GRIT is an irrevocable trust in which the grantor retains an income interest for a term of years with the remainder interest passing to individuals
- GRIT allows the grantor partner to retain an income stream during the retained term and pass the remainder interest at a reduced transfer tax value to the partner at the expiration of the term
- For this technique to succeed, the grantor must survive the retained term - if the grantor dies during the term, the assets of the GRIT will be included in his estate for estate tax purposes

Estate Planning Techniques – QPRT

- Way a qualified personal residence (QPRT) works:
 - Person transfers residence to QPRT and retains right to live in house for a term of years, say 15 years
 - Value of the gift is the value of the remainder interest
 - At end of term, remainder interest passes to remaindermen, e.g. children or partner
 - Concern: owner wants to continue to live in house
 - It is ok for the grantor to continue to live in the residence after the expiration of the retained term as long as the remaindermen agrees and the grantor pays fair rental value.
 - However, Reg. 25.2702-5(c)(9) prohibits the grantor or the grantor's spouse from buying the residence from the QPRT
 - If the partner establishes a QPRT for the benefit of an unrelated person, they are not subject to the sale prohibitions otherwise applicable to QPRTs
 - Thus, the grantor can purchase the house from the QPRT just prior to the expiration of the grantor's retained term so that cash or other assets pass to the remaindermen instead of the residence.
 - Since the QPRT is structured as a wholly grantor trust, there is no gain or loss to the grantor
 - If the grantor holds the residence until death, the residence will get a step-up in basis

Estate Planning Techniques – Split-Interest Purchases

- Way a split-interest purchase works:
 - Two people (the same-sex couple) purchase property
 - One person contributes an amount equal to the actuarial value of his life interest or the actuarial value of a term of years and the other person contributes an amount equal to the value of the remainder interest following the termination of the life or term interest.
 - If the joint purchasers are “applicable family members,” the person acquiring the term interest is treated as acquiring the entire property and then transferring the remainder interest to the other purchaser, and the retained interest is valued at zero (unless the retained interest is a “qualified interest.”) i.e. the person acquiring the term interest is treated as making a gift of the entire value of the property to the remaindermen.
 - If the joint purchasers are not “applicable family members,” the valuation rules of §2702 do not apply and all appreciation is shifted to the remaindermen.

Charitable Planning – Charitable Remainder Trust (CRT)

- An inter vivos CRT created by one partner for the benefit of the other partner may give rise to gift tax consequences upon formation
 - Gift can be avoided if the grantor establishes a CRT for the grantor's life, followed by the life of the partner, with the grantor retaining the right to terminate the survivorship interest.
 - Alternatively, build into the CRT document that if the relationship between the two partners ends, so does the partner's interest in the CRT.
 - A CRT created by one partner for the benefit of the other partner can give rise to gift and estate tax because the marital deduction is not available.

Charitable Planning – Charitable Lead Trust (CLT)

- When a CLT is established for the life of one or more individuals the life of a partner cannot be used as the measuring life for the charitable term.
 - Under Reg. 1.170A-6(c)(2)(i) and (ii) each remainder beneficiary must be a lineal descendant or spouse of a descendant
 - There must be less than a 15% probability that persons who are not lineal descendants of the measuring individuals will receive any portion of the trust corpus.

Charitable Planning – Charitable Gift Annuity (CGA)

- If an unmarried couple are the beneficiaries of a CGA and appreciated property is used to fund the annuity, the taxable gain must be fully recognized by the donor in the year the annuity is created.
 - However, if the donor is the sole or initial annuitant, the gain may be prorated over the donor's life expectancy calculated at the time payments begin. Reg. 1.1011-(2)(a)(4).
- If an annuity is created by one partner and payable to the other partner, there will be gift tax consequences upon formation
 - If the annuity is paid first to the donor and then to the partner, or if the partner is an annuitant of a deferred payment gift annuity, the gift tax annual exclusion is not available because the gift is the gift of a future interest

Retirement Benefits – Non-spouse Rollover

- PPA of 2006 allows non-spouse designated beneficiary to directly rollover qualified retirement plan benefits via a plan to plan transfer to an “inherited IRA” i.e. an IRA opened after the participant’s death in the name of the deceased participant payable to the beneficiary. §402(c)(11)(A).

Retirement Benefits – QJSA and QPSA

- Due to DOMA, qualified plans are not required to provide a qualified joint and survivor annuity (QJSA) or a qualified pre-retirement annuity (QPSA) to the same-sex partner of the plan participant.
 - Employers are free to provide such benefits for same-sex couples
 - A QJSA or QPSA is required to be made when the participant is married.

Retirement Benefits – QDRO

- ERISA recognizes the rights of a spouse (among other persons) to receive all or part of a participant's interest in a retirement plan but not a partner.
- Thus, there is no federal protection for a qualified domestic relations order (QDRO) – a QDRO is an order issued by a state court in a domestic relations proceeding dividing retirement plan benefits held by an employee pursuant to a marital dissolution
- An ERISA plan must follow a state court domestic relations order that qualifies as a QDRO
 - it is not likely that a partner will be able to enforce a QDRO.
- ERISA plans are not bound by state court orders that conflict with ERISA

Retirement Benefits – COBRA

- COBRA requires most employers to offer certain former employees, retirees, spouses and dependent children the right to temporary continuation of health coverage in the event their coverage ends due to certain events such as divorce, job termination or reduction in work hours.
- DOMA prevents same-sex partners from being treated as a spouse under COBRA i.e. COBRA benefits do not apply to a surviving or divorced domestic partner or that partner's dependents

Retirement Benefits – FSA

- Flexible spending accounts (FSA) allow employees to use pre-tax dollars to pay for medical and dental as well as dependent care expenses for themselves, spouses or qualifying dependents
- Medical expenses of a non-dependent partner are not eligible for tax-free reimbursement from a FSA

Retirement Benefits – Family Medical Leave Act (FMLA)

- The Family Medical Leave Act mandates that certain employers grant employees up to 12 weeks of unpaid leave during any 12 month period to care for parents, children or spouses in the event of a serious health condition or for the birth or adoption of a child
- Due to DOMA, an employee is likely to be ineligible for leave under the FMLA to care for a domestic partner

Conclusion

- State and Federal law inconsistencies will continue to exist until DOMA is repealed and state laws adopt uniform laws
- Clients in these relationships need to identify areas of concern (e.g. tax benefits, federal entitlements, etc.) and develop a solution
- Most importantly, draft documents to accomplish their objective and not leave these matters to state or federal default statutes
- Unmarried couples need a comprehensive estate plan as no default structure exists as it does for married couples.