Stocks and (Marriage) Bonds

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Following the California Supreme Court's decision in In re Marriage Cases, attention has shifted from whether same-sex couples in California would be able to marry, to the practical economic aspects of their marital partnership. Specifically, such couples will now need to concern themselves with the challenges of joint asset ownership, estate planning and income tax planning. Despite the very real social and psychological significance that marriage can offer same-sex couples, such couples should not assume that the legal rights and responsibilities arising from the legal recognition of their relationship do not come with a price tag. Income, gift and estate tax issues lurk where couples least expect. While state property and family laws may treat married same-sex couples the same as married heterosexual couples, the federal tax laws do not, and instead treat the couples as unrelated, with potentially devastating tax consequences. Care and attention must be given to merging assets, where desired, dividing jointly owned assets, creating sound basic estate plans, transferring assets using strategies that offer tax-free or leveraged opportunities, and providing for dissolution of the marriage by way of prenuptial agreements. When care and attention is paid to such matters, transfer taxes otherwise payable may be minimized or at least deferred, offering significant wealth preservation opportunities since such transfer taxes can be at the rate of almost 50 percent. Despite the generic name of this landmark court ruling, the application of the tax laws to specific couples is as varied and personal as the couples who pursued this ruling. Couples should consider these issues carefully in light of their own circumstances with the assistance of experienced advisers.

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Because transfers of assets between same-sex spouses pre and post marriage, or even transfers of certain assets into the joint names of the same-sex spouses, are not protected by the federal gift tax marital deduction (which, for most heterosexual spouses, makes it possible to make tax-free transfers of assets between them regardless of value), tax-free transfers from one same-sex spouse to the other are limited to $12,000 per calendar year. Larger transfers are taxable, although $1 million will be sheltered by the federal gift tax lifetime exemption; gifts in excess of $1 million and annual exclusions are subject to federal gift tax, which is paid by the donor, not the recipient of the gift, at a current maximum rate of 45 percent. Keep in mind that payment of expenses incurred by the other spouse will count toward the use of the $12,000 annual amount. Gifting can shift the appreciation on such assets from and after the date of the gift to the recipient, thereby reducing estate taxes. Joint ownership of assets created in prior years may have resulted in an unintended taxable gift. Taking title to a home jointly if the spouses did not contribute equally to the acquisition and improvement costs can result in a taxable gift from the spouse who made the larger contribution. Similarly, disjointing jointly held property should be done only after carefully considering the tax consequences because in many cases such transfers are taxable gifts, potentially doubling the tax exposure.

For couples wishing to shift ownership of assets, leveraged gifting techniques can minimize federal gift taxes. A couple can shift only a portion of future appreciation on certain assets from one spouse to the other, or can reduce the value of the asset transferred by retaining the right to enjoy the property for a period of years. Such techniques can significantly decrease the amount treated as having been transferred, thereby leveraging the $1 million gift tax exemption. In addition, there are a number of planning techniques not available to related parties under the federal tax law. Because married same-sex couples are not treated as related by the IRS, they can make offensive use of these techniques, which cannot be used by married heterosexual taxpayers. These include interest free loans.

Even if the couple makes no change in current asset ownership, the couple's basic estate plan to distribute their assets at death should be reviewed to consider trust planning. Assets in excess of the federal estate tax exemption (currently $2 million less taxable gifts made during life) will be taxed at the first spouse's death. If assets are left outright to the surviving spouse, and total asset values at the second death exceed the surviving spouse's exemption, those assets will be taxed again before the ultimate beneficiaries receive them. Conversely, if trust planning is used, it may be possible to eliminate estate tax at the surviving spouse's death.

Retirement plans are governed by ERISA, a federal law that requires the spouse to be the beneficiary of most retirement plans (although interestingly, not IRAs), unless the spouse consents to permit a different beneficiary to be named. ERISA does not currently apply to same-sex couples. Having a "designated beneficiary" can reduce the minimum required distributions from qualified plans, thereby permitting the plan balances to accumulate on a tax-deferred basis. The recently enacted Pension Protection Act does one very positive thing by permitting a same-sex spouse who inherits a retirement account to roll over the death benefit from a qualified plan and withdraw payments over the longer of the plan participant's life expectancy (even though deceased), or the beneficiary's life expectancy, assuming the plan participant survived his or her required beginning date.

Income tax rules also differ for same-sex couples. Because same-sex couples must still file tax returns singly for federal income tax purposes, it will be important to consider who has or should have legal ownership of real property, and, therefore, the obligation to pay certain deductible expenses, such as real estate taxes. The person who has the legal obligation to pay such an expense and makes the payment may take the deduction for income tax purposes; if a non-owner of the property makes the payment, no deduction is allowed, and the payment instead will be treated as a gift from the person making the payment to the person having the obligation to make the payment, resulting in a potential double loss.

If one spouse has significant capital losses, or the potential for generating losses by selling an asset before year end, and the other spouse has assets that can be sold at a gain, such couples should consider whether it makes sense to transfer assets from one spouse to the other, even in excess of the $12,000 annual gift tax exclusion amount, in order for one spouse to be able to match gains and losses for income tax purposes.

Couples should consider whether it is more expensive to have family health insurance coverage through one employer, or individual coverage through each spouse's employer. If family coverage is provided, the cost of the coverage for the non-employee spouse will be treated for federal income tax purposes as taxable income to the employed spouse; the cost of coverage for the employed spouse is not taxable.

Because same-sex couples must file separately for federal income tax purposes, charitable contributions may provide greater income tax benefits to one spouse versus the other. The spouse who intends to take a charitable deduction should make the contribution.

It may be more advantageous for one spouse to claim children as dependents, and it may be possible to claim the spouse as a dependent as well. Legal recognition of the marriage is not required to claim someone as a dependent, but the taxpayer must supply more than half of the support for the calendar year and the dependent's principal residence must be the same as the taxpayer's principal residence.

Couples who marry also should consider whether they wish to rely on state law to fix their rights and obligations in the event of divorce and death, or whether they wish to fix those rights themselves by entering into a prenuptial agreement. Whether the agreement will be enforceable if the couple moves to another state is not certain, but an out-of-state court could enforce it as a contract. Now the bad news — for heterosexual married couples, federal income and gift tax rules provide that property settlements incident to divorce are tax-free for both parties, and there is clear direction about the taxability of alimony to the recipient and deductibility to the payer. For same-sex couples, these tax rules are not applicable, and could produce either taxable income to the recipient of a property settlement, or gift tax to the payer. Not only is there a difference in the identity of the taxpayer, but the tax rate may differ significantly. There is no clear law currently, so careful attention must be paid to the desired net-after-tax result to both parties. California's community property laws add an additional potential wrinkle because absent an agreement to opt out of the application of community property, rights vest and accrue during the marriage, not just upon divorce. Because taxation is not clear, there is all the more reason for couples with substantial income and/or assets to consider premarital tax planning by prenuptial agreement.

Despite the significant federal tax benefits that are not available to same-sex couples, whether married or not, there are very real planning opportunities available that can provide immediate and long term tax benefits, but timing is critical because much of the planning is not available after the fact to remedy a tax problem.

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