X. BASIC TAX AND ESTATE PLANNING FOR SAME-SEX COUPLES*

[This outline is not intended as tax advice. To the extent that this document concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.]

[Introductory comment: One of the main problems for same sex couples is that the IRS has not issued any rulings or other clear guidance about how transactions will be treated for tax purposes. In the absence of any authority, my intent in this outline is to make the best pro-taxpayer arguments possible for claiming tax advantageous positions for the taxpayer. I make no claim that these arguments will win in court, but I believe they are all based on the best authority available and are consistent with tax policy principles of taxing individuals accurately on their individual income.]

I. Acquisition and Ownership of Property During the Relationship.

A. Title to Property.
If a couple wants to own the real estate jointly, there are a number of different ways to accomplish that. Each of the forms of ownership listed below create their own unique tax issues. Many of these issues apply to ownership of personalty as well as realty.

Joint bank accounts, however, have their own rules and thus do not generally raise any of the gift or similar issues discussed below. For gift tax purposes, joint bank accounts are treated as revocable gifts. Thus, creating a joint account does not result in a completed gift for gift tax purposes.

1. Tenancy in Common
   In a Tenancy in Common, the partners (or spouses) each own an undivided interest in the whole. They can own these interests in any proportion. Often couples wish to own property in proportion to their contributions to the purchase price. If they do this, then no taxable gift occurs upon formation of the Tenancy in Common. If one person is already

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the owner and wishes to sell an undivided interest to her partner, there may be taxable gain. If the sale is of a principal residence that qualifies under §121 for nonrecognition of gain, then up to $250,000 of gain can be excluded. Note however that this is a single exclusion of $250,000 for this seller on this residence. If $100,000 of the gain is excluded, then upon a later sale, the original owner can exclude only an additional $150,000. The partner who buys in, however, will still have a $250,000 maximum exclusion amount on this residence. Other tax points:

- If the sale if of property other than a principal residence, then the gain may be deferred if the sale is structured as an installment sale. Interest should be stated on the installment note to avoid imputed interest and the §7872 rules.
- If one partner gifts an undivided interest to the other partner, the transaction is a taxable gift.
- The value of the gift should be reduced by a fractional share discount, i.e., a 50% interest in Blackacre is worth less than 50% of the full market value of Blackacre because it is difficult to market undivided interests in property. See, e.g., Lefrak v. Commissioner, T.C. Memo 1993-526 (20% discount).
- Upon death of the first partner, the estate will include the undivided interest owned by the decedent. But again, a fractional share discount ought to be allowed.
- If the co-tenants additionally restrict the marketability of the property by agreeing to waive their right to partition while either of them is alive, it may be possible to obtain additional discounts for lack of marketability. There is a valid non-tax reason for entering into such agreements, especially if the property in question is the principal residence and each partner wants assurance that the property will not be sold without consent during his or her life.
- For transfer tax purposes, the valuation of the transferred property is not based on what the transferor owned or what the transferee receives. Instead it is based on the property itself, while in transit, and the test is what a willing buyer would pay on the open market. See Shepherd v. Commissioner, 283 F.3d 1258 (11th Circuit 2002), which explains the issue as follows:
  “This “in transit” valuation has been described as analyzing “the moment of truth, when the ownership of the [donor] ends and the ownership of the [donees] begins.” United States v. Land, 303 F.2d 170, 172 (5th Cir.1962).
  “Brief as is the instant [of transfer], the court must pinpoint its valuation at this instant.” Id. See also Estate of Bright v. United States, 658 F.2d 999, 1002 (5th Cir.1981) (en banc) (noting valuation for estate tax purposes “to be made at the time of the transfer”).

2. Joint Tenancy with Right of Survivorship (JTWOS)
As with co-tenancies, if the partners hold interests in the Joint Tenancy that are equal to their contributions, there is no gift upon formation of the JTWROS. Because some states still follow the common law rule, based on the doctrine of the four unities (time, title, possession, and interest), joint tenants may be required to own the property 50/50 (unity of interest). There is also some risk that any side agreement that says otherwise, might be viewed as a severance of the joint tenancy.
- The unequal contribution/unequal ownership problem.
Some states still follow the common law rule.


The modern trend is toward rejecting the “four unities” as a fixed requirement and instead relying more strongly on intent of the parties. See In re Estate of Johnson, 739 N.W.2d 493 (Iowa 2007); R.H. Helmholz, Realism & Formalism in the Severance of Joint Tenancies, 77 Neb. L. Rev. 1 (1998). While the issue more often arises in the context of whether there is an unintentional unilateral severance, the Iowa Court quite clearly stated “…we see no reason to distinguish our [intent-based] approach based on whether the joint tenancy is sought to be created, severed, or terminated.” 793 N.W.2d at 497-498.

Despite this modern trend, I would not state in the deed that the joint tenancy is held other than 50/50. Instead I would draft a side agreement between the parties which does the following: (1) reaffirms the intent to hold the property as joint tenants, (2) provides that if the tenancy is severed into a tenancy in common the shares will be in accord with contributions, and (3) provides that if the joint tenancy is sold while the two joint tenants are alive, the sale shall be deemed a severance and the proceeds from the sale shall be distributed in accord with contributions.

- **Gift tax upon formation.**
  
  If the interests are not taken in accord with contributions (i.e., if there is no side agreement to account for unequal contributions), the creation of the joint tenancy will be treated as a transfer subject to the gift tax. Because of the unilateral right to sever, each joint tenant is considered vested with a 50% undivided interest. To the extent one tenant did not contribute 50% of the purchase price, the other tenant will be deemed to have made a gift.

  The gift should be valued with a fractional share discount. If the transfer creates a taxable gift, a valuation expert should be consulted to help set the value of the gifted portion.

- **Estate Tax at death.**
  
  One huge problem with JTWROS is the rule under §2040 that 100% of the fair market value of the property will be included in the estate of the first to die unless the surviving joint tenant can prove original contribution to the acquisition of the property.

  - **No fractional share discount.** Because Section 2040 is a special rule requiring full inclusion of the property's value in the estate, arguments regarding fractional interest discounts are inapplicable. Compare Ellie B. Williams v. Com'r, 75 T.C.M. 1758 (1998)(allowing a fractional discount in valuing, for estate tax purposes, the value of an undivided half interest held as tenants in common) with Estate of Young v. Com'r, 110 T.C. 297 (1998)(No fractional discount allowed for joint tenancy property included in estate under Section 2040). Thus, even if the survivor can prove 50% contribution, the property...
will be valued for estate tax purposes at a higher value than it would have been valued if held as tenants in common.

- **Contribution of survivor must originate with survivor.** What if Partner A had given Partner B cash and B had used the cash to purchase part of the home? If B can prove her contribution to the purchase price, can she reduce the amount of the value included in A's estate under Section 2040? The answer is no, because B must not only prove her contribution, but must also prove that the contribution came from her and is not traceable to a gift of cash from A. See *Goldsborough v. Commissioner*, 70 T.C. 1077 (1978), aff'd, per curiam, 49 A.F.T.R.2d 1469 (4th Cir. 1982) (mother transferred land outright to daughters; years later they sold land and invested proceeds in stock held jointly with mother; at mother's death, IRS argued that full value of jointly owned stock was subject to estate tax because the daughters' contribution could be traced to the original gift from mother; Tax Court held that the portion of the value of the jointly owned stock traceable to the original gift of land from mother to daughters was included in mother's estate, but not the portion traceable to the capital gain on the land which accrued while the daughters held the property in their own names.)

- **Adequate records.** What sort of evidence can be offered to overcome the presumption that the first to die contributed everything? The regulations don't say and there are very few cases. Assume that A and B made equal contributions to the purchase of the home. Even if they have accurate records of who contributed how much to the down payment, they will still need to show equal contribution to the mortgage payments. However, exact records on individual contributions may not be necessary. Proof that each had sufficient funds available to contribute equally and reliance on the Cohan rule (estimation of expenses okay for deduction purposes) should suffice. See *Estate of Fratini v. C.I.R.*, T.C. Memo. 1998-308, 1998 WL 525500, T.C.M. (RIA) 98,308 (Aug 24, 1998). See also *Concordia v. Commissioner*, T.C. Memo 2002-216 (commissioner challenged allegation of contribution by survivor, but court ruled in favor of survivor on the basis of survivor's testimony, which was corroborated and uncontradicted).

- **Additional evidence.** As additional protection against the application of Section 2040, I suggest that both joint tenants sign an affidavit explaining how the full purchase price of the property is being paid equally by both of them. The §2040 presumption is rebuttable and once any evidence is submitted by the survivor, the burden will then shift to the IRS to prove otherwise.

- **Risk of audit.** A 1999 survey of IRS estate tax attorney auditors listed non-spousal joint tenancies high on the list of possible hot topics subject to audit. Because of this viewpoint, it is probably wise to attach to the estate tax return some evidence of equal contribution. It might help avoid an audit.
3. Tenancy by the Entirety (T by E)(Massachusetts, Hawaii, Oregon, Vermont)

Tenancy by the Entirety is a common law form of joint ownership limited to spouses. It usually is available only for realty. Hawaii, Oregon and Vermont all authorize this form of ownership for registered partners. In Massachusetts, same-sex spouses can own property on the same basis as opposite sex spouses. The attributes of a tenancy by the entirety are the same as a joint tenancy with right of survivorship except that there is no unilateral severance.

Key points:

• Since the T by E cannot be unilaterally severed, it enjoys a certain amount of protection from creditors. In Hawaii and Vermont, for example, property held as tenants by the entirety is basically exempt from creditors’ claims. In Hawaii, even if spouses (or reciprocal beneficiaries) convey the property away to a third party, their creditors cannot reach the property. See Sawada v. Endo, 561 P.2d 1291 (Haw. 1977). Creditors can attach entireties property in Massachusetts and Oregon, but they cannot destroy the nondebtor spouse’s survival rights. If the nondebtor spouse survives, the creditor takes nothing.

• Computing the value of the gift for gift tax purposes is complicated by the fact that there is no unilateral severance for estates held as T by E. A JTWROS is valued on the basis of two equal 50% undivided interests (i.e., the same as a tenancy in common) because unilateral severance empowers each tenant to convert the JTWROS into a Tenancy in Common. When a T by E is created, however, the value of each tenant is the sum of two different interests in the property: (1) the value of the joint life estate, and (2) the value of the contingent remainder. If the tenants’ ages are far apart, the value of the two interests will vary more greatly. Valuation of Tenancy by the Entirety gifts used to be covered by the regulations under Section 2515 (covering gift tax rules for the creation of tenancies by the entirety between spouses). But Section 2515 has been repealed now that there is a 100% marital deduction. One might assume that the valuation rules in these regulations would nonetheless apply to the creation of nonmarital tenancies by the entireties. However, there is no statute or regulation directly on point, probably because the Treasury and IRS have never acknowledged that same-sex couples can hold property as Tenants by the Entirety. If one wants to claim that tenants’ interests should be treated as though they were equal in value, one might cite to the fact that the disclaimer regulations were amended in 1997 to treat a T by E as passing a 50% interest in the property at the death of the first spouse. See Treas. Regs. §25.2518-2(c)(4).

• Estate taxation of Tenancies by the Entireties is probably covered by Section 2040 although it is worth noting that the statutory language in Section 2040 refers only to “tenants by the entirety by the decedent and spouse.” (emphasis added) If DOMA continues to prevent spousal recognition for same-sex couples in other code provisions then it is arguable that it should prevent Section 2040 from applying to same-sex tenants by the entirety. If §2040 does not apply, one might argue that there is nothing included in the estate because at the moment of death, the decedent does not own anything.

• If Section 2040 does apply, then all the points made previously with respect to JTWROS property are applicable.