TAXWATCH

Singular tax status

Same-sex couples face complex decisions when doing their taxes

By Eva Rosenberg, MarketWatch
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LOS ANGELES (MarketWatch) - "Judge Clark Brown diagnosed with Same Sex Attraction Disorder. Sues religious rehab center for failing to cure him."

That was the story line for a recent episode of the television show "Boston Legal," with the judge played by actor Henry Gibson.

In the course of the trial's closing argument and final scene with William Shatner, James Spader's character touches on most of the issues affecting same-sex couples, except one: The tax implications of same-sex marriage, civil unions or domestic partnerships. And, oh, they are fraught with danger -- and expense.

More than a million people in the U.S. are part of a same-sex couple (that were willing to say so in the official Census forms), according to 2000 Census data, as analyzed by GayDemographics.org. About 21% live in states that presently have marriage, civil union or domestic partnership laws on the books.

California's recently-expanded domestic partnership law gives the largest population of gay couples in the country access to a sort of matrimonial tax recognition, according to GayDemographics.org.

On May 16, 2004, Massachusetts became the only state with legal same-sex marriage. A same-sex couple files a joint tax return in that state, just as any heterosexual couple would. But complications arise when it's time to prepare the IRS tax return, says Shari Levitan, an attorney and partner in Holland & Knight's Boston office. The federal government doesn't recognize same-sex couples, so they must each file as single.

Seems simple enough, doesn't it? Think again. That couple must have three tax returns prepared for them, says Debra Neiman, a certified financial planner in Arlington, Mass., and author of "Money without Matrimony."

The couple must file: 1) one joint IRS tax return, because the Massachusetts joint return is based on the Form 1040 -- this "dummy" return is sent to the Massachusetts Department of Revenue to back up the numbers used by the couple, and 2) two individual federal tax returns, prepared as single filers, to send to the IRS.

This couple will have to pay for three tax returns. But sometimes costs go even higher, with tax prep for same-sex couples running double the price of two single returns. Neiman deplores the extra cost, but there is so much extra time involved, there's no way to avoid it, she said.

Why the extra time?

Levitan and Neiman explain that completing these returns is not like pushing a button. You have to devote time to separating income from joint assets, such as bank accounts, businesses and securities sales. You must split up expenses, such as medical insurance, mortgages, property taxes and business expenses. And then there are the children. How do you go about equitably splitting a child? You need the wisdom of Solomon not to alienate and anger one or the other partner. Often, the child is related by blood to the partner who is not producing the income.

This creates problems with the dependency exemption, earned income credit, child care credit, student loan deduction and more. The Massachusetts Department of Revenue site details some special provisions that apply to same-sex couples. Visit the Web site.

California more complex than most

In California, where the first same-sex tax returns will be filed in 2008, Lynn Freer, president of Spidell Publishing, Inc., in Anaheim, Calif., is pushing for legislation to get the California Franchise Tax Board to allow registered domestic partners (RDP) to file the same joint tax returns that other married couples file.

Under present law, when RDPs file jointly in California, they have to make several adjustments to their joint return based on two federal single returns. Freer says some of the rules are still unclear. For instance:

- Federal rental losses are limited to $25,000 per joint tax return, or on a single tax return. Will California use the combined $50,000 ($25,000 x 2) loss on the RDP return? Or just the federal joint limit of $25,000?
- What if one person has a capital loss of $100,000, but the other has a capital gain of $100,000? Will they be allowed to net the losses, or will they pay tax on the gain, but not benefit from the loss?
- If one owns a home for two years and then they sell it, will California grant them each a $250,000 exclusion from gain? Or just the one owner that the IRS would allow?

And so it goes. In all other states that allow joint tax returns, same-sex couples follow the same rules as heterosexual couples within the state.

The combination of elements from the two single returns will generally result in higher joint taxable income on the California Form 540 than the couple would have paid using a "dummy" federal joint return. For anyone -- even a tax professional -- to prepare the California version of the RDP joint return, he will need a specialized checklist of line items to change, combine, or eliminate. No other state has made joint filing this complicated.

Across state lines

If you got married in Massachusetts and moved to California, will California recognize your marriage for tax purposes? No. California hasn't legalized same-sex marriage.

However, if you have a registered domestic partnership in another state, California will honor that relationship and allow you to file jointly. Couples married in Massachusetts would have to register as domestic partners in California to have the same privilege.

States with domestic partnerships and civil unions have reciprocity with each other. But if you move, it's worth checking the state laws to find out whether you may file a joint return.

Investments are another concern when moving. If you have income from investments - such as real estate property, partnerships, or S corporations, etc. -- located in a state that doesn't recognize your marital status, you may find yourself filing a joint return in your state, separate returns for federal purposes, and separate returns in the other state, too.

Are there tax advantages to filing jointly?

Logically, if one member of the couple works and the other doesn't, it would drop their combined incomes into a lower tax bracket. Right? Well, when it comes to state tax rates, they hit the highest brackets pretty quickly. So, except perhaps in New Jersey and Vermont, you're in the top bracket long before you reach the federal poverty levels, as you can see in the table.

Individual income tax rates for states with same-sex tax laws

State	**Effective date**	**Type of union**	**Joint tax return**	**Highest tax rate; income level at which it applies** (Tax rate source: Tax Foundation)
California	1/1/2007	Domestic partner	X	9.3%, greater than $43,467
Connecticut	4/20/2005	Civil unions	X	5%, greater than $10,000
District of Columbia	2002	Domestic partner	X	9%, greater than $30,000
Hawaii	7/8/1997	Reciprocal beneficiary		8.25%, greater than $40,000
Maine	7/30/2004	Domestic partner	X	8.5%, greater than $18,250
Massachusetts	5/16/2004	Marriage	X	5.3%, flat rate
New Jersey	2/19/2007	Civil unions/RDP	X	8.97%, greater than $500,000
Vermont	12/20/1999	Civil unions	X	9.5%, greater than $336,500

So, the decision to file jointly wouldn't be based on the savings from lower tax brackets. But when one partner works and brings home the proverbial bacon, and the other owns the home and has all the mortgage and property-tax deductions, suddenly, by filing jointly, you can itemize your deductions for state purposes.

For the IRS, if the income producer pays the mortgage and property taxes, but isn't named on the mortgage, you've just lost the entire mortgage deduction. Why? The person who made the payments isn't entitled to the deductions, and the partner who is entitled to the deductions didn't make the payments. So no one gets to deduct the mortgage interest for IRS purposes.

Without some extensive planning now, at the beginning of the year, on how to pass along funds to each other, how to gift money or property to one another, what legal documents, promissory notes and liens you must file, same-sex couples may find themselves facing a tax coma at the end of the year.

Divorce disasters

As if divorce weren't already bad enough, just wait until you see same-sex couples deal with dissolving civil unions, registered domestic partnerships, or getting divorced in Massachusetts. Conventional couples may split the home and other assets without any tax consequences. Same sex couples? Let's look at a pretend couple - Jack and Jim.

Jim originally bought the home. Jack partnered with him. In the split, the court gave Jack half the house. This may work fine for the state. But, as Lynn Freer notes, to the IRS this is either a gift (which may involve gift taxes being due) or compensation for services rendered (which would be taxable to Jack).

Let's look at alimony. Jim is ordered to pay Jack $2,000 per month in support. So, the state lets Jim deduct $24,000, but the IRS won't, as they weren't married for federal purposes. To the IRS this is a gift, or further payment for services rendered.

What about Jack? It's unclear whether he picks this up on his federal return as alimony income, other income, self-employment income or something else.

And, Debra Neiman, the certified financial planner, brings up QDROs - qualified domestic relations orders -- that allow a couple to split up pensions without early withdrawal penalties or immediate tax assessments. When it comes to same-sex couples, they won't qualify for the special treatment provided by the tax code.

When judges deal with these dissolutions, Shari Levitan says they have neither the experience nor the responsibility to ensure there is an equitable tax split. It's up to the lawyers to prepare their cases with the help of tax and financial professionals who understand all the implications.

Julie and Hillary Goodrich, one of the couples in Massachusetts whose landmark case is responsible for gay marriage, separated amicably in July 2006, according to an article at GayWired.com. No divorce is on the horizon. Perhaps their advisers looked at the potential tax nightmare that a divorce would cause and decided to wait this one out.

Many experts agree that when it comes to taxes, getting married or registered poses too many challenges. Suzanne Durbin, a senior adviser at GV Financial Advisors Inc., in Atlanta, Ga., says same-sex couples who don't get married or registered enjoy distinct advantages. Her strategy works for couples who plan to stay together for the long-term, where one is wealthy and the other is not. Durbin takes full advantage of the limits of the gift tax and estate tax laws.

For instance, usually when someone passes a share of a home or business property to a spouse or child, the appraiser discounts the value of the asset - that is, sets it lower than fair market value -- because only part of the property is transferred. The IRS tends to insist on very conservative discounts when the transfer is between family members. But since a same-sex couple isn't married in the eyes of the IRS, the discounts on the valuations may be more aggressive. As far as the IRS is concerned, these are transfers to unrelated parties, so there's no need to look so closely. As a result, more property can be transferred to your spouse without triggering tax consequences.

Same-sex couples face so many tax complications, you could fill a book with them. In fact, it's so complex that income tax software producers don't write software to handle the computations. So, tax professionals must make the adjustments by hand.

We've barely tickled the surface of the inequities in the income tax, estate and inheritance laws. Lynn Freer predicts that as tax and divorce cases involving same-sex couples hit the courts over the next few years, the legislation will evolve to define tax guidelines for couples that don't qualify for marriage in the eyes of Uncle Sam.

In the meantime, consider bringing your romantic impulses under control, and resist the urge to register ... unless it's to get medical coverage, to be able to visit your partner in the hospital room, or to give a do-not-resuscitate order.

Or simply to be treated with dignity in your own community.

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