

**Horizons Foundation
Planning for “Unmarried Couples”
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Comparing the Tax Implications for Unmarried Couples (UC) and Registered Domestic Partners (RDP)

Sharing of income/splitting of income

- UC—Separate income. All earned income is taxable to the person who earns it. All unearned income (investment income) is taxable to the person who owns the property. For jointly owned income, each owner is subject to tax to the extent of ownership.
- RDP—Community property income. All earned income is taxable for California income tax purposes to the person who earns it. All earned income for federal income tax purposes **might** be taxable equally to both RDPs or it **might** be taxable to the one who earns it. All unearned income (investment income) for both federal and California income tax purposes **might** be taxable to both equally or it **might** be taxable to the owner(s). (California community property law provides that income from separate property is community property income.)

Sharing of deductions

- UC—Generally, itemized deductions are deductible only by the person who incurs both the personal benefit and the economic cost of the expense or is the owner of property causing the expenditure. Also, no deduction is allowed if one taxpayer pays a deductible expense of another taxpayer which the payer has no legal or contractual obligation to pay.
- RDP—With the application of community property rules for RDPs, there is uncertainty as to who gets the deduction and how much. Under the Act, there is an obligation of support between the RDPs; does this rise to the level of a deductible status when one RDP pays for medical services for another RDP? Is this an indirect gift between them? And regardless of who pays for the medical services, since the funds used to pay for the expense are likely community property funds, is only half deductible? Typically, this problem does not arise for married individuals since they have a right either to file jointly or separately and rules for allocating income and deductions are set out by *IRS Publication 555*. Another problem is the deduction for state income tax. Under the RDP act all obligations incurred during the relationship are considered the obligations of both RDPs. However, under AB 205, earned income is not community property income for

tax purposes only. If community funds are used to pay state income taxes (such as, the payment of taxes through payroll withholding) who gets the deduction? Since state income tax is only imposed upon the earning RDP, the obligation for state income might not be a community property debt, but if community property funds are used to pay the tax, who gets the deduction? In a worst-case scenario, the person from whom the state taxes are withheld could be deemed entitled to deduct only half the withheld amount, while the other RDP would not be entitled to deduct the other half because the tax is not that person's obligation.

Filing Status and Exemptions

- UC—Taxpayers who are couples but are not RDPs, are considered single taxpayers for federal and state income tax purposes. Either biological or adopted children can be claimed by only one of the parents. Effective for 2005, new rules go into effect for dependents. For children of taxpayers, there are tie-breaking rules in the case of joint parents. Under the tie-breaking rules, the child is claimed by the parent (1) with whom the child resided the longest period of time during the taxable year, or (2) if the child resides with both parents for the same amount of time during the year, the parent with the highest Adjusted Gross Income. The support test for children is no longer used. Head of household status is claimed only by that person who qualifies to claim the exemption for the dependent and who provides more than one-half the cost of maintaining the home which is the principal residence of the dependent.
- RDP—Same as UC. With community property rules, the demonstration of providing more than one-half the cost of maintaining the home is probably easier.

Divorce or Separation

- UC—Payments for support due to a separation agreement are likely to be taxable to the recipient and non-deductible by the payer, since the language of IRC §71(b) specifies payments by a spouse. Maintaining ownerships in properties jointly owned is non-taxable. However, transactions re-arranging ownership percentages or exchanging property interests are likely to be subject to tax. (The exclusion of gain from the sale of a principal residence may be available. Also, for certain investment property, a tax deferred exchange may be available.) Gift tax is unlikely to be asserted since there is a lack of donative intent. Child support is likely to be non-taxable to the recipient.
- RDP—The tax results are similar. The provisions under federal law that allow alimony to be taxable to the recipient and deductible to the payor are not available to RDPs. Furthermore, the rule allowing the tax-free transfer of property, including rollovers of retirement plans, is not allowed for RDPs. Before the passage of AB 205, we understood that California community property rules allow both spouses immediate vesting of ownership in retirement plans with full management and control. This is not considered a gift for federal tax purposes. Now with the passage of AB 205 and the entitlement or RDPs to community property interests in each other's retirement plans, does the federal law also exempt the immediate vesting of ownership from gift tax? Also, with the passage of AB 2580 allowing for the retroactive treatment of community property to the date of registration, could the IRS assert a gift of all property transformed from separate

property to community property by this act? What is the effect settlement agreements have upon splitting of retirement plans upon termination of the domestic partner relationship?

Income and Deductions relating to joint ownership of property

- UC—Mortgage interest and real property taxes are deductible if the payor is subject to the obligation or has an interest in the property. Under California law, co-owners of property have a right to have each co-owner pay his or her share of ownership expense or be reimbursed if an owner pays more than his or her share. Although there is case law allowing unreimbursed individuals to claim the amount paid, best practices suggest that a co-ownership agreement should exist between the co-owners. If the co-owners commingle money, the presumption is that these deductions are equally shared. This presumption could be defeated by the showing of the facts.
- RDP—For community property real estate, interest and taxes are likely shared equally since the funds to pay them are likely community property. For separate property, under California law, income from separate property is separate income, under the Texas rule, this income is community property. Tracing of ownership is important.