

# Tax Implications of California Domestic Partnerships

Peter James Lingane, EA, CFP®

Peter is licensed as a tax professional by the federal government and as a planning professional by the Certified Financial Planner Board of Standards. His firm, *Financial Security by Design* in Lafayette, California, emphasizes retirement and tax issues of interest to maturing adults. Peter can be contacted via [www.lingane.com](http://www.lingane.com).

Summary. Unearned community income, and deductions or credits related to community income or property, are shared equally between the partners for both California and federal income tax purposes while wages and other earned income are reported separately for each partner. Registered domestic partners do not file married filing joint or separate income tax returns even if they are married to each other. There is generally a double step-up in basis upon death for both California and federal purposes, but for different reasons. Equalization of ownership will generally have gift and/or income tax implications. Adequate disclosure is imperative.

Introduction. There is more than one type of “domestic partnership” in California. This article addresses state registration. City, county or employer registration does not convey the same benefits or responsibilities.

Same-sex couples, and older heterosexual couples, who are registered as California domestic partners on or after January 1, 2005, generally have the same rights and responsibilities as are granted to or imposed upon married couples<sup>1</sup>. These rights include community property rights.

California Income Tax Returns. The Franchise Tax Board has rules for allocating income and deductions between the separate returns of married couples<sup>2</sup>.

- Split earned income, and any taxes withheld, on this income equally;
- Split unearned income from community assets, and any taxes withheld on this income, equally;

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<sup>1</sup> CA Fam §297.5. (a) Registered domestic partners shall have the same rights, protections, and benefits, and shall be subject to the same responsibilities, obligations, and duties under law, whether they derive from statutes, administrative regulations, court rules, government policies, common law, or any other provisions or sources of law, as are granted to and imposed upon spouses.

The full statute, which adds important qualifications, is available at [www.leginfo.ca.gov](http://www.leginfo.ca.gov).

<sup>2</sup> FTB Publication 1051A “Guidelines for Filing Married Filing Separate Returns.”

- Split deductions and credits paid with community funds or related to community assets or income; and
- Allocate exemption credits, for dependents supported by community funds, between the taxpayers in any manner.

These rules are modified for domestic partnerships<sup>3</sup>. The separate California returns of registered domestic partners

- Do not split wages and other earned income. This is unchanged.
- Split unearned income from community assets. This is a change.
- Split deductions and credits paid with community funds or related to community assets or income. This is a change.

Previously, mortgage interest and real estate tax were only deductible by a partner if the property was owned or jointly owned by the partner, the partner was responsible or jointly responsible for payment and the payment was traceable to the partner.

- Allocate exemption credits for dependents supported by community funds in any manner. This is a change.

Federal Income Tax Returns. Community property is an ownership right. The courts, see most recently TC Memo 1998-340, determine property ownership under state law. I conclude that the federal government is required to honor the community property rights of California registered domestic partners unless there is a federal statute limiting these rights.

While there are situations in which the federal government neglects community property rights<sup>4</sup>, there is no general provision in the Code limiting community property rights to married couples and there is no specific limitation with respect to unearned income, credits or deductions.

The Defense of Marriage Act made two additions to the U.S. Code<sup>5</sup>. The first

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<sup>3</sup> CA Fam §297.5(g) Notwithstanding this section, in filing their state income tax returns, domestic partners shall use the same filing status as is used on their federal income tax returns, or that would have been used had they filed federal income tax returns. Earned income may not be treated as community property for state income tax purposes.

<sup>4</sup> §22 Credit for the Elderly and Disabled; §32 Earned Income Credit; §219 IRA deduction; §220 medical savings accounts, §§408, 402 and 457 which relate to IRAs and other retirement plans and §879 which modifies the treatment of community income of married nonresident aliens, for example.

<sup>5</sup> No State, territory, or possession of the United States, or Indian tribe, shall be required to give effect to any public act, record, or judicial proceeding of any other State, territory, possession, or tribe respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other State, territory, possession, or tribe, or a right or claim arising from such relationship. 28 USC §1738C.

In determining the meaning of any Act of Congress, or of any ruling, regulation or interpretation of the various administrative bureaus and agencies of the United States, the word 'marriage' means only a

does not appear to be relevant because the California Court of Appeal (Third District, Sacramento, April 4, 2005) said, in an unanimous decision, that “The numerous dissimilarities between the two types of unions disclose that the Legislature has not created a ‘same-sex marriage’ under the guise of another name.” Of course, this court does not have the final word.

The second addition does not appear to be relevant either because California says specifically that this statute does “not amend or modify federal laws or the benefits, protections, and responsibilities provided by those laws<sup>6</sup>.”

I conclude that neither the Code nor the Defense of Marriage Act limits the community property rights of California registered domestic partners. Consequently, income, deductions and credits are the same for federal and California income tax purposes.

Step-up in Basis Upon Death. Domestic partners receive a double step-up in the basis of community property on death for California but not necessarily for federal purposes.

Although the Internal Revenue Code limits the double step-up to marital property<sup>7</sup>, California neglects any federal provision which treats registered domestic partners differently from spouses<sup>8</sup>.

I’m assuming that real estate registered as community property with right of survivorship, or California’s similar title for financial assets, will be treated as joint tenancy property with respect to the federal step-up in basis. Because of the presumption that joint tenancy property receives a double step-up in basis on the death of an unmarried joint tenant<sup>9</sup>, there will likely be many situations in which the federal basis receives a double step-up.

The downside of a double step-up for unmarried joint tenants is that the entire value of the property is included in the decedent’s federal estate whereas only one half of the value of community property of a married person is included in the decedent’s estate.

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legal union between one man and one woman as husband and wife, and the word ‘spouse’ refers only to a person of the opposite sex who is a husband or a wife. 1 USC §7.

<sup>6</sup> CA Fam §297.5(k).

<sup>7</sup> §1014 Basis of property acquired from a decedent.

(b)(6) ... property which represents the surviving spouse's one-half share of community property held by the decedent **and the surviving spouse** (emphasis added) under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate ....

<sup>8</sup> CA Fam §297.5(e). To the extent that provisions of California law adopt, refer to, or rely upon, provisions of federal law in a way that otherwise would cause registered domestic partners to be treated differently than spouses, registered domestic partners shall be treated by California law as if federal law recognized a domestic partnership in the same manner as California law.

<sup>9</sup> IRC §2040.

Gift Tax Issues. Community income is not a gift from one domestic partner to another because the ownership rights of each partner are vested from the moment the income is earned.

Separate property can be converted to community property with a transmutation agreement. However, unlike married couples who generally enjoy an unlimited exemption for marital gifts, transmutions by registered domestic partners will have gift and/or income tax implications.

Transmuting equal interests in the same property should not be a gift since these properties were already equally owned. It would be prudent to file a gift tax return nonetheless in order to start the statute of limitations.

Transmuting unequal interests in the same property would be a gift subject to the usual gift and generation skipping tax exemption provisions.

Transmutation of separate property by one partner and the simultaneous transmutation of different separate property of equal value by the other partner would seem to be a taxable exchange. That is, a one half interest in property is being exchanged for a one half interest in other property.

There are complications for both married couples and domestic partners if community income or community labor is spent on separate property. If community income is used to pay the mortgage on separate property, or if a spouse/partner manages separate property – even if the property is his or her own business established long before the union - a community interest in the form of a loan or fractional interest is created in the separate property.

Your customers should be reminded that transmuting or converting separate property to community property means that the previously separate property is available to pay community debts. This is one of the responsibilities of a domestic partnership.

Filing Status. Registered domestic partners cannot be married, unless they are married to each other. The Defense of Marriage Act would appear to deny married domestic partners joint or separate filing status on their federal income tax returns. Neither a joint nor separate married status is permitted on the California return of a registered domestic partner because of the general rule that the filing status must be the same on both returns. This rule is reinforced by CA Fam §297.5(g).

It had been possible to claim head of household filing status on the basis that a low income partner was a dependent. However, the new uniform definition of “qualified child” limits this option to partners less than age 26.

California has an additional rule for unmarried or unregistered individuals seeking head of household status, namely that the high earning partner cannot claim head of household status on the basis of a child whose natural parent is a member of the household. This is not an issue for registered

domestic partners since a child of either is a child of both<sup>10</sup>.

The new uniform definition of child appears to lead to the same result and thus this federal-state inconsistency is eliminated.

Portability. The rights of California registered domestic partners probably won't be honored in other jurisdictions. Domestic partners who own property or who deal with financial institutions in other jurisdictions may therefore wish to consider a joint living trust. A living trust effectively extends California property rights to other jurisdictions and also provides a graceful, private and enforceable transition should either partner be unable to manage their own financial affairs.

Domestic partners should execute powers of attorney for health care and advance health directives since these documents are independent of marital status and are generally recognized by other jurisdictions.

Domestic partners with children should consider adopting the children of the other partner – if this is possible – to avoid potential problems in other jurisdictions.

Domestic partners should be named explicitly as the beneficiary of pensions, IRAs and insurance policies if the intention is for these assets to pass to the surviving partner. Domestic partners should honor all of California's community property formalities<sup>11</sup> when naming someone else as beneficiary.

These formalities should also be honored when making gifts.

Conflict of Interest. A spouse has a fiduciary responsibility to their spouse and yet there are times when it is unwise for a practitioner to represent both husband and wife. Engagement letters therefore commonly include language whereby spouses acknowledge and accept the potential for conflict.

A domestic partner has the same fiduciary responsibility to their partner and practitioners should take similar precautions with respect to potential conflicts of interest.

It is also wise to include both partners in privacy provisions, just as you should explicitly include both spouses, to be sure that these provisions are valid under federal law.

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<sup>10</sup> CA Fam §297.5(d). The rights and obligations of registered domestic partners with respect to a child of either of them shall be the same as those of spouses. The rights and obligations of former or surviving registered domestic partners with respect to a child of either of them shall be the same as those of former or surviving spouses.

<sup>11</sup> Chapter 4, *California Estate Planning*, Continuing Education of the Bar, California, February 2005.

Effective Date. The effective date for community property rights and responsibilities is the date of California registration<sup>12</sup>. Be aware, when applying this rule to partners registered before January 1, 2005, that a retroactive effective date is open to challenge on constitutional grounds.

*Caveat. This is uncharted territory and some of my conclusions are controversial. It remains to be seen whether my analysis will be challenged by the tax authorities and, if challenged, sustained in court.*

*It may be prudent to attach Form 8275 to the return explaining the rationale for the tax treatment chosen by taxpayer. The rules of practice for Enrolled Agents, as enunciated in the Treasury Department's Circular 230, require me to advise that this analysis is not intended to be used, and cannot be used, to avoid tax penalties or to promote, market or recommend any tax-related matter. However, you are free to make similar arguments after confirming this analysis with independent sources.*

*I am not competent to offer legal advice nor am I licensed to do so. It would be foolhardy to execute a transmutation agreement or a living trust or to retitle property without competent legal advice.*

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Addendum, January 2006. See also FEDERAL TAX IMPLICATIONS OF AB205, The California Domestic Partner Rights And Responsibilities Act Of 2003, by M. Jean Johnston, Esq. and D. Chris Kollaja, CPA. This article is available at [www.aclu.org/FilesPDFs/ca%20dp%20rights.pdf](http://www.aclu.org/FilesPDFs/ca%20dp%20rights.pdf).

Addendum, March 2006. A Chief Counsel Advice memorandum (CCA 200608038, February 24, 2006), concluded that an individual who is a registered domestic partner in California must report all of his or her earned income from performance of his or her personal services. Readers who remember my article in the December 2005 *EA Journal* will not have been surprised by this conclusion.

The legal standing of a Chief Counsel Advice memorandum is about the same as a brief submitted in a court proceedings. It is not the law and a memorandum cannot be cited in the case of another taxpayer.

The value of a Chief Counsel Advice memorandum is the window it provides on the Service's legal reasoning. Income splitting is forbidden because there is no case law addressing the splitting of community income in a nonmarital context. "We do not believe that the [Supreme Court decision] *Poe v. Seaborn*

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<sup>12</sup> CA Fam §297.5(m)(1).

decision applies to the application of a state's community property law outside the context of a husband and wife.”

This is a weak argument. I'd have argued that, in the absence of case law, the federal treatment should mirror the California statute which forbids the splitting of earned income.

The Chief Counsel might also have looked to the comments of Franchise Tax Board staff. These suggest that the legislative objective may have been to make no changes to the income taxation of registered domestic partners.

This bill would provide that “earned income” may not be treated as community property for state income tax purposes for a domestic partner. Since the term “earned income” does not encompass all types of income it could lead to confusion for taxpayers because forms of “unearned income,” such as pension income, would still be treated as community property for state income tax purposes. Domestic partners would be required to claim half of community income other than earned income on their separate returns (single filing status). It appears the intent of the author is to allow domestic partners to have the same community property privileges and burdens as those given to civil marriage partners, while eliminating any impact to the state's income tax revenue. To achieve this intent, department staff would suggest replacing the term “earned income” with the phrase “property or income of a domestic partner.”<sup>13</sup>

The legislature did not accept this staff recommendation. Was this an oversight, or a reaffirmation that domestic partners must split unearned income and deductions on their state tax returns?

I was pleased by the lack of any reference to the Defense of Marriage Act. I had expected this to be at the center of the IRS opposition although, as discussed in December, I don't think the Defense of Marriage Act is relevant.

This Chief Counsel Advice memorandum does not address the splitting of unearned income or deductions paid with community funds. I suspect that there is also no case law concerning these issues in the nonmarital context. Therefore, it is likely that the IRS would oppose the splitting of unearned income and deductions, if they were asked.

Informal discussions suggest that the allocation of unearned income and deductions are not priority audit issues for the Franchise Tax Board; the same is probably true of the IRS. There would appear to be little risk of challenge if registered domestic partners prepare their returns as I had suggested last December: report earned income individually and split unearned income and deductions.

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<sup>13</sup> AB205, August 21, 2003. Available at [www.ftb.ca.gov](http://www.ftb.ca.gov).