Note, TAXATION OF SAME-SEX MARRIAGE AND LIVE-INS

by
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Same-Sex Couples

It is the position of the Internal Revenue Service that same-sex couples, whether married where permitted or not, will not be allowed to file joint tax returns. Rather, they will be treated as persons who are "live-ins," whether in a heterosexual or same-sex relationship.

The IRS position as to same-sex couples is based upon *The Defense of Marriage Act*[1] which defines "marriage" for the purpose of administering federal law, including federal tax laws, as the "legal" union between one man and one woman as husband and wife. "It further defines "spouse" as a "person of the opposite sex who is a husband or wife."

The IRS position further states that:

> Because of the statue only married individuals under this definition could elect to file a joint tax return. Even though a state may recognize a union of two people of the same sex as a legal marriage for the purposes within that state's authority, that recognition has no effect for purposes of federal law. A taxpayer in such a relationship may not claim the status of a married person on the federal income tax return.
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> The law is clear on this issue, and we point out the federal definition of marriage when explaining 'filing status' in IRS Publications 17, "Your Federal Income Tax," and 501, "Exemptions, Standard Deduction, and Filing Information." In both publications, we introduce the subject of marital status with this paragraph: "In general, your filing status depends on whether you are considered unmarried or married. A mar-

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1 P.I. 104-199.

> riage means only a legal union between a man and a woman as husband and wife.[2]

Dependency Exemption

Only an individual who can be considered a dependent under IRC 152 can be claimed for exemption. Under IRC 152(a) an individual will be considered a dependent if he or she satisfies either the "qualifying child" or the "qualifying relative" requirement.

Payments or Transfers of Property: A Gift or Taxable Income?

There is a question of how to classify payments of support for a "live-in," or the transfer of funds or property to the person. Are they gifts, and thus subject to gift tax treatment, or are they considered compensation for services, hence taxable as ordinary income to the recipient and, if for business purposes, deductible to the payor?

Under *Commissioner v. Duberstein*,[3] the donor's intent is the "critical consideration" in distinguishing between gifts and income.

Professor Asimow has put the following proposition.[4]

> The tax consequences of support payments between cohabitants during their relationship remain unclear. It can be argued that these payments can be excluded by the recipients as gifts, but the IRS may be expected to contend that they are payments for services and thus taxable to the recipient (but not deductible to the payor).

The taxpayer has the burden of proving that the tax collector's determination is wrong.[5]

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2 IRS Letter to Public Advocate of the United States, Inc., June 14, 2004. http://www.publicadvocatesusa.org/news/article.php?article=121 (last visited May 6, 2009).

3 363 U.S. 278, 285 (1960).

4 Asimow, Tax Planning for Cohabitation and Marital Dissolution, Nov. 1991. (ALI-ABA).

5 Welch v. Helvering, 209 U.S. 111 (1933).

Gift to "Live-In"

To be considered a gift by the transferor it must proceed from a disinterested and detached generosity, motivated by affection, respect, admiration, charity or the like, with the most critical factor being the transferor's dominant intention. By contrast, a transfer of property is income if it is the result of "the constraining force of any moral or legal duty constitutes a reward for services rendered, or proceeds from the incentive of anticipated benefit of an economic nature."[6]

However, the court opined in *Pascarelli v. Commissioner*:[7]

> [W]hen a transfer is made without being motivated by a sense of generosity, but rather with the expectation of an economic benefit flowing to the transferor as a result, then no gift has been made, and the transferee realizes ordinary income to the extent of the excess of the value of what is transferred over the value of the consideration which is returned to the transferor. The mere absence of a legal or moral obligation to make a payment does not establish that such payment is a gift for tax purposes; in fact, such payment is not a gift if made in return for services rendered, or if made because of the incentive of anticipated economic benefit to the payor.

In *Pascarelli*, the court found that the funds transferred to Lillian were intended to be gifts. The parties had a 20-year live-in relationship and they lived in most respects as husband and wife, the court finding that Mr. De Angelis' dominant interest in Mrs. Pascarelli was personal and not one of employer/employee, notwithstanding the fact that she entertained for business purposes and bought most of his clothes, among other things. The court held that Mrs. Pascarelli did not perform services for Mr. De Angelis for purposes of obtaining compensation, but rather with the same spirit of cooperation that would motivate a wife to strive to help her husband in his business.[8]

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6 Commissioner v. Duberstein, 363 U.S. 278 (1960).

7 55 T.C. 1082, 90 (1971), aff'd *without opinion*, 485 F.2d 681 (3rd Cir. 1973).

8 The holding in Reynolds v. Commissioner, T.C. Memo 1999-62, was similar. However, when Violet gave up her claim to property acquired in Gregg's name during their 24-year relationship for a sum to her, the Tax Court observed that her sale of her interest in the property to Gregg was a taxable event to the extent the "selling price" exceeded her basis.

In *Starks v. Commissioner,*[9] Greta Starks was 24 and received substantial gifts of money for living expenses, a house (cash was given to her to put it in her name), furniture, an automobile, jewelry, fur coats and other clothing from a 55-year old married man. The IRS assessed all against her as income tax, alleging she received same "for services rendered." The donor testified that the purpose of the payments was "to insure the companionship of Greta Starks, more or less for a personal investment in the future on my part." The court held the payments were gifts for "companionship," not for services rendered.

In *Reis v. Commissioner*,[10] the taxpayer was a young female nightclub dancer who met an older man when he bought dinner and champagne for the performers in the show. The man paid each person at the table, other than the woman, $50 to leave the table so that he and she would be alone. The man gave the woman $1,200 for a mink stole and another $1,200 so that her sister could have an expensive coat too. Over the next 5 years, the woman saw the man "every Tuesday night at the [nightclub] and Wednesday afternoons from approximately 1:00 p.m. to 3:00 p.m. . . . at various places including. . .a girl friend's apartment and hotels where [he] was staying." He paid her living expenses, plus $200 a week, and he provided her with money for other things, such as investing, decorating her apartment, and buying a car. The Court held that none of the more than $100,000 that he gave her over the 5 years was taxable to her. The Court concluded that she received the money as a gift. The Court reached this conclusion notwithstanding the fact that the woman had stated that she "earned every penny" of the money.

Similarly, in *Libby v. Commissior*,[11] the Tax Court accorded gift treatment to thousands of dollars in cash and property that a young mistress received from her older paramour.[12]

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9 T.C. Memo 1966-134.

10 T.C. Memo 1974-287.

11 T.C. Memo 1969-184 (1969).

12 In response to assertions by the IRS that there was a lack of documentary evidence of the money given to Libby by her paramour, the Tax Court noted that "we are not too concerned because there is little likelihood that they were interested in 'keeping books on romance.'"

The Court in *United States v. Harris*[13] commented that "Duberstein provides no ready answer to the taxability of transfers of money to a mistress in the context of a long term relationship. The motivations of the parties in such cases will always be mixed. The relationship would not be long term were it not for some respect of affection. Yet, it may be equally clear that the relationship would not continue were it not for financial support or payments."[14]

Income to "Live-In"

When Lyna testified that James "was getting his money's worth," the court in *Jones v. Commissioner*,[15] held that the funds paid by James were for sexual relations and thus taxable as compensation. It was not a gift, the court saying,

> James did not give money to petitioner from feeling of "detached and disinterested generosity,. . .out of affection, respect, admiration, charity or like impulses" as required under the holding of *Commissioner v. Duberstein*. . .

Recovery by a long-time girlfriend against her deceased benefactor's estate, in spite of her characterization of her relationship as that of "an old-fashion traditional wife," was held as taxable income in *Green v. Commissioner*.[16] In her claim against her lover's estate, Ms. Green sought compensation for past services rendered. She proved that although she had performed what she promised, the decedent reneged on his promise to leave her "everything" when he died. The Court distinguished *Green* from *Pascarelli* because in the latter the transfers were found to be gifts, but in Green, based on the lawsuit, Ms. Green had a compensatory arrangement with the decedent. The Court did offer that the substantial legal expenses, pursuant to I.R.C. ¶212, in connection with the litigation against the estate, were deductible.[17]

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13 942 F.2d 1125 (7th Cir. 1991).

14 Id.

15 T.C. Memo 1977-329.

16 T.C. Memo 1987-503.

17 See also Blevins v. Commissioner, T.C. Memo 1955-211, where Thelma Blevins did not sustain her burden of showing that the monies she received were gifts. She testified that the funds were gifts in contemplation of marriage;

Gift and Income, Part of Each

The dichotomy in the foregoing cases was exemplified in *Austin v. Commissioner*.[18] During his lifetime Cathy's benefactor bought her a house and gave her money. She provided him, a married man in his late 60s, with companionship. After his death Cathy sued his estate for $7,000,000 but finally settled for $42,500. The settlement agreement recited that same was for services in connections with the man's individual business interests. Stating that:

> [I]n determining whether a transfer is a gift for purposes of section 102, the most critical consideration is the transferor's intent. For a transfer to constitute a gift in the statutory sense, it must proceed from a "detached and disinterested generosity,' . . . ' out of affection, respect, admiration, charity or like impulses.'" If, on the other hand, a transfer proceeds primarily from "the constraining force of any moral or legal duty," constitutes a reward for "services rendered," 'or proceeds from "the incentive of anticipated benefit' of an economic nature," the transfer is not a gift.[19]

The Court held that what was given in the man's lifetime were gifts; however the payment from the estate was compensation and was taxable income.[20]

Deductible by Payor

Whether or not a taxpayer could deduct payments to his or her companion, for whom he was the sole support, as he was for her son and her dog, all of whom lived with him was dealt with in *Bruce v. Commissioner*.[21] The girlfriend assisted in acquisition, management and sale of investment properties.

Noting in *Bruce* that the taxpayer did not pay self-employment tax on the claimed amount, nor did he execute withholding forms nor withhold employment taxes, the court observed:

> [T]he question is purely one of fact, and no one circumstance controls the ultimate resolution of the issue. Specifically, the taxpayer's failures to pay social security tax, and meet filing and reporting requirements imposed upon employers by the Internal Revenue Code is not deter-

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however, the man had a wife throughout all the taxable years and there was no indication the he or his wife were ever attempting a divorce.

18 T.C. Memo 1985-22.

19 *Id.*

20 *Id.*

21 T.C. Memo 1983-121.

> minative as to the question of whether payments in fact consider. Likewise, the fact that payments are made indirectly by paying household expense of the claimed employee, rather than being paid directly by cash or check, is not determinative.[22]

The court concluded in *Bruce* that payments for household expenses and those related to personal relationships with friends were not deductible compensation; and costs incurred in locating and assisting in acquisition of properties and expenses beyond "incidental repair" of real property were capital expenses.[23] Only portions of payments ordinary and necessary for management, conversation or maintenance of investment properties qualified for ordinary deduction.

Cohabitation Agreement

Julia Perles and Ruth J. Wilztum[24] have observed that:

> The best way to avoid any question of income taxes is to include in a cohabitation agreement a provision that neither party has any obligation to support the other, and that each party shall keep his or her own income separately. This does not preclude agreement as to how household expenses shall be paid.

Property Division

An equal division of jointly owned property would cause no tax consequence as each party would receive what each party owned. However, a transfer of separately (or unequally) owned property would have *Davis*[25] consequences—the transferor would be required to recognize a gain or loss and the transferee would have the then fair market value as a tax basis.

Gifts

If the gift is cash or property having a value of more than $12,000 (for 2008), a gift tax returns must be filed. If the donor has exceeded gifts of the applicable exclusion amount, a gift tax must be paid. For gifts made in 2008 the exclusion amount is $2,000,000 and $3,500,000 in 2009.

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22 *Id.*

23 *Id.*

24 *Negotiating a Cohabitation Agreement*: A Taxing Expense, ENCYCLOPEDIA OF MATRIMONIAL PRACTICE, 1964 (Prentice Hall 1991).

25 U.S. v. Davis, 370 U.S. 65 (1962).

Estate Taxes

"Live-ins" are not entitled to the marital deduction. It is therefore suggested that the idea of "a deathbed marriage" should not be overlooked if a substantial bequest is to be made to one's "honey," as a marriage at any time prior to death will qualify all amounts passing to the surviving spouse for the unlimited marital deduction.[26]

Retirement Funds/Death Benefits

Death benefits payable to a beneficiary who is a "live-in" will not qualify for the same favorable tax treatment for a recipient spouse. If the beneficiary was married, he or she could roll over the proceeds from the retirement plan and/or IRA into his or her own IRA and thus avoid a tax at that time of receipt. The "live-in" would have to report all the funds received as current income.

Filing Status

Cohabitants will no longer save on taxes if they do not marry. Furthermore, if a standard deduction is to be claimed, instead of iteming deductions, the "live-ins" have the same total deduction as the married.

Sale of Principal Residence

Unmarried taxpayers who jointly own their principal residence may each take up to a $250,000 exclusion from gain if they lived in and owned the home for 2 of the past 5 years, if no exclusion had previously been taken during the applicable period. The following is the example used by the Internal Revenue Service:[27]

> Example (1). Unmarried Taxpayers A and B own a house as joint owners, each owning a 50 percent interest in the house. They sell the house after owning and using it as their principal residence for 2 full years. The gain realized from the sale is $256,000. A and B are each eligible to exclude $128,000 of gain because the amount of realized gain allocable to each of then from the sales does not exceed each taxpayer's available limitation amount of $250,000.

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26 WREN, GABINET AND CARRAD, TAX ASPECTS OF MARITAL DISSOLUTION 323 (Callaghan & Co. 1987).

27 Treas. Reg. ¶1.21-2(a)(4).