

Just A Matter of Fairness: Tax Consequences of the Service's Revised Community Property Treatment of California Registered Domestic Partners (RDPs)

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A Brief History of Federal Tax Treatment of California RDPs

For Mr. Eric Rey, it was just a matter of fairness. “For the first time ever, I’m able to file federal taxes that, in a small way, acknowledges what’s going on in my relationship,” he exclaimed after the Service issued its historic rulings on May 28, 2010. It had been a long journey for Mr. Rey as he fought for—and ultimately won—the right to split community property income with his RDP for federal tax purposes. In 2005, when California amended its domestic partnership laws to extend community property rights to RDPs, he asked the Service for guidance on how the amendments affected the federal tax treatment. It responded with CCA 200608038, a highly criticized memorandum, which refused to recognize California’s community property treatment for federal tax purposes. Because the CCA left Mr. Rey and his RDP with more questions than answers, he tried again in 2007. At that time, the Service refused to offer any additional guidance.

Still not willing to give up, Mr. Rey felt hope with the enactment of new California RDP legislation and the election of President Barack Obama. On the same day that the Service declined to grant RDPs community property tax treatment for federal purposes in 2006, California State Senator Carole Migden introduced the State Income Tax Equity Act or “the final piece” of state legislation to make California RDPs equal to spouses. The bill would require RDPs to file their state income tax returns in the same manner as married couples and would apply California community property rules to RDPs exactly as those rules apply to heterosexual married couples. Despite contentious and heated debate on the floor of the California Assembly that had to be paused to allow tempers to cool, the legislature passed the bill. On September 30, 2006, Governor Schwarzenegger signed the bill into law.

After this final piece of the California tax equality puzzle was in place, Mr. Rey once again asked the Service for guidance on the federal income and gift

tax treatment of his RDP. On May 28, 2010, it responded with PLR 201021048, CCA 201021049, and CCA 201021050. These newly issued documents reversed the Service’s previous position and properly applied “the principle that federal law respects state law property characterizations,” and historically determined that “the federal tax treatment of community property should apply to California registered domestic partners.”

Application of the Revised Service Position on Income-Splitting for Community Property Income

Income Allocation and Filing Status
Under the revised rules, each RDP reports one-half of community property income that is earned by either RDP, but each continues to report the full amount of his or her separate income. The Service has suggested that California RDPs follow the advice given for married heterosexual taxpayers filing their tax returns separately to determine how state community property laws apply for

federal income tax reporting purposes. See Publication 555, *available at* www.irs.gov/pub/irs-pdf/p555.pdf, and California Franchise Tax Board Publication 737, *available at* www.ftb.ca.gov/forms/2009/09_737.pdf. These publications have not yet been updated to reflect the revised Service position.

The rules above apply to income allocation. They do not apply to filing status. Because neither RDPs nor same-sex married couples can file using the married filing jointly (or separately) federal filing status, RDPs and same-sex married couples must file separate federal income tax returns under the applicable filing status as either “unmarried/single” or “head of household.” Accordingly, the advice in Publication 555 that applies to the “married filing separately filing status” rather than community property law is not applicable to RDPs.

Because this new tax treatment changes the amount of income each RDP reports as gross income, it may cause unexpected, but related tax consequences. For example, an otherwise qualifying dependent may no longer qualify as such for federal income tax reporting. Notably, self-employment

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taxes on a sole-proprietorship's net income are the sole responsibility of the sole-proprietor and should not be allocated between RDPs. However, each RDP should report one-half of the deductions and federal income tax withholdings with respect to any split community property income for federal income tax purposes. As is the case for California married couples, California RDPs can enter into written agreements to opt out of community property treatment. Given the complexity of these and related issues, California RDPs and other same-sex couples should consult their tax attorneys about their particular situations and how they should best proceed to achieve their personal goals. Lambda Legal offers online publications that can assist couples confronted by these complex and often overwhelming issues (*available at www.lambdalegal.org/publications/take-the-power/*).

Electing Treatment for Prior Years
The Service will allow, but not require, California RDPs to amend their federal income tax returns filed for calendar years 2007, 2008 and 2009, to reflect community property income-splitting treatment, subject to any applicable statutes of limitations. The May 2010 guidance seems to indicate that community property income-splitting treatment is not required until calendar tax year 2011. Nevertheless, Lambda Legal has indicated that "Notwithstanding the language of the May 2010 IRS memorandum, however, as of November 2010, some IRS representatives have informally communicated that community property treatment will be *mandatory* for calendar year 2010 taxpayers." *The IRS Applies "Income-Splitting" Community Property Treatment to California's Registered Domestic Partners* (Q&A #12) (Oct. 20, 2010), *available at www.lambdalegal.org/publications/factsheets/fs_the-irs-applies-income-splitting-community-property.html*.

Federal Gift Tax Consequences

Community property income-splitting operates by law so there is no taxable transfer between the parties for federal gift tax purposes. However, if the parties agree by a qualifying agreement to convert certain property from community property to separate property or from separate property to community property, the conversion may result in a federal gift tax.

Effect on California Married Same-Sex Couples?

The CCAs and PLR issued in May 2010 refer only to California RDPs. Nevertheless, Lambda Legal stated that "the new IRS position *should* apply similarly to other situations in which community property rights exist under state law, specifically including that of married same-sex couples." *The IRS Applies "Income-Splitting" Community Property Treatment to California's Registered Domestic Partners, supra* (Q&A #14).

According to Lambda Legal, this should include any married same-sex couple residing in California who married (1) before November 5, 2008 in any country or state, including California, that permitted at the time of the marriage same-sex couples to marry; or (2) on or after November 5, 2008 outside of California in any country or state, such as Canada or Massachusetts, that permitted or permits, as the case may be, at the time of the marriage same-sex couples to marry. *Id.*

Effect on Same-Sex Couples Outside of California?

The Service should treat taxpayers in another state the same as it treats Californians if the other state applies its community property laws to same-sex couples in a manner similar to California's treatment of RDPs. As of November 2010, according to Lambda Legal, only the states of Washington and Nevada recognize and apply community property treatment to same-sex RDPs. *Id.* (Q&A #15). Therefore, these are the

only states that potentially qualify for the same federal tax treatment for their same-sex RDPs.

In Washington and Nevada the Service applies community property laws to heterosexual married couples living in these states for federal income tax purposes. While none of the May 2010 Service documents explicitly address taxpayers other than California RDPs, the principle underlying this treatment should be applied uniformly. There is no apparent basis to treat Washington or Nevada RDPs' community property income any differently than the community property income of heterosexual married couples in these states is treated. If the Service applies community property income-splitting treatment to these states' RDPs, the application should be retroactive to tax years after June 12, 2008 (Washington) and October 1, 2009 (Nevada) (the dates on which these states recognized community property ownership for their same-sex RDPs). Same-sex couples residing in Washington and Nevada, but who formed their legal relationships outside of their state of residence, must register under their respective states' laws as RDPs to be treated as such.

Conclusions

Mr. Eric Rey, together with his attorney, heroically pursued fair answers to his basic federal tax questions. After several years Mr. Rey and similarly situated California RDPs have received some federal tax guidance. Unfortunately, the federal tax guidance for California RDPs raises many more questions than it answers. Same-sex couples across the United States, including the 18,000 couples married in California before passage of anti-marriage equality amendments, face more uncertainty and complexity as compared to their similarly situated heterosexual counterparts. The Service has stated that its revised position on community property income for California RDPs is consistent with its treatment of heterosexual married

couples filing separate tax returns. This answer ignores the obvious and glaring fact that California RDPs, as well as any same-sex legally committed couple, cannot file jointly for federal income tax purposes. As a result, the comparison is incongruous, awkward, and confusing.

Nevertheless, as the 2011 tax season is upon us, California RDPs are facing complex and time sensitive tax planning issues including whether or not they should amend their 2007, 2008, and 2009 federal income tax returns to

incorporate income-splitting as well as whether they should enter into qualifying agreements to recharacterize community property and separate property income. These issues depend on a couple's particular facts and circumstances. Until the Service issues guidance on the community property income of California same-sex married couples as well as Washington and Nevada RDPs, it is unclear whether, when, and to what extent community property income-splitting applies to them. As a result,

these couples must continue to consult experienced tax professionals regarding these very complicated tax issues.

Albert Einstein said it best: "The hardest thing in the world to understand is the income tax." This is especially true when state law relationships are recognized selectively based upon the sexual orientation of the parties involved. We hope that uniform and just guidance is forthcoming. Some things should be just a matter of fairness. ■

GOVERNMENT SUBMISSIONS BOXSCORE

BOXSCORE

Since October 2010, the Section has coordinated the following government submissions, which can be viewed and downloaded free of charge from the Section's website at www.abanet.org/tax/pubpolicy.

Submissions and Comments on Government Regulations, Administrative Rulings, Blanket Authority, and ABA Policy*

TO	DATE	CODE SECTION	TITLE	COMMITTEE	CONTACT
Internal Revenue Service	1/10/2011	1471, 1472	Comments on Grandfathering Rules in the HIRE Act and Notice 2010-60	U.S. Activities of Foreigners and Tax Treaties	Michael Hirschfeld
Internal Revenue Service	1/5/2011	103, 141	Comments on Bond-Financed Grants	Tax Exempt Financing	Maxwell Solet
Pension Benefit Guaranty Corporation	12/22/2010	415, 436	Comments on PBGC Proposed Rule on Reportable Events	Employee Benefits	Harold Ashner, Eleanor Banister
Internal Revenue Service	12/7/2010	6662, 6694, 7525	Comments on Circular 230 Sections 10.2, 10.3, 10.4, 10.5, 10.6, 10.30 and 10.34	Standards of Tax Practice	Scott Michel, Charles Muller III
House Committee on Ways & Means, Senate Committee on Finance	12/1/2010	901, 1013, 1022, 2210, 2664	Request for Action on Pending Estate & GST Tax Legislation	Section of Taxation, Section of Real Property, Trust and Estate Law	Charles Egerton
Internal Revenue Service	11/15/2010	909	Comments on the Effective Date of Section 909	Foreign Activities of U.S. Taxpayers	Dirk Suringa
House Committee on Ways & Means, Senate Committee on Finance	11/12/2010	894, 1563, 7852, 7874	Letter Regarding the Treaty Override Provision in H.R. 847	U.S. Activities of Foreigners and Tax Treaties	Joan Arnold
Internal Revenue Service	11/9/2010	54AA, 148, 1273, 1274	Comments on Issue Price	Tax Exempt Financing	Winnie Tsien
House Committee on Ways & Means, Senate Committee on Finance	11/5/2010	n/a	Comments on Carried Interest Proposals in Senate Amendment 4386 to H.R. 4213	Partnerships & LLCs	Adam Cohen
Internal Revenue Service	10/22/2010	871	Comments on the Taxation of Dividend Equivalent	U.S. Activities of Foreigners and Tax Treaties	Matthew A. Stevens

*The technical comments and blanket authority submissions listed in this index represent the views of the ABA Section of Taxation. They have not been approved by the ABA Board of Governors or the ABA House of Delegates and should not be construed as representing the policy of the ABA.