New Jersey Law Journal

VOL. CLXXXIX– NO.1 – INDEX 48 JULY 2, 2007 ESTABLISHED 1878

Wealth Management

Post Civil-Union Planning

The tax and estate planning issues faced by the nontraditional family

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As a result of the recent New Jersey Supreme Court decision in *Lewis v. Harris*, 188 N.J. 415 (2006), New Jersey enacted the Civil Union Act. (P.L. 2006, Chapter 103, effective Feb. 17, 2007). While the CUA would have been unthinkable in the days of Ozzie and Harriet, New Jersey is now one of several states to enact similar legislation in recent years.

The CUA provides civil-union couples with all of the same "benefits, protections and responsibilities" as those of a traditional marriage. This includes all statutory, common-law and civil rights in areas such as property ownership, adoption, domestic relations, probate and inheritance, taxation, workers compensation, insurance benefits and family leave benefits, to name a few.

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However, the benefits and rights provided civil-union couples under the CUA apply only to matters governed by the laws of New Jersey. For federal income and estate tax purposes, civil unions are not recognized. For federal law purposes, the Defense of Marriage Act defines a marriage to be between one man and one woman, and "spouse" refers only to a person of the opposite sex. This dichotomy between the federal and New Jersey tax laws results in both advantages and disadvantages for civil-union couples.

Once Felix Unger and Oscar Madison finally come to realize that opposites do indeed attract, what are the tax and estate planning issues that will confront their nontraditional family?

While Felix and Oscar may jointly file their New Jersey income tax returns, each of them must file his federal income tax returns as an unmarried individual. Under some circumstances, most typically a two-income family, the couple may pay less income tax as a result of filing as unmarried individuals. The lower tax usually results from the avoidance of the higher tax brackets that could apply if the couple's income were combined on a joint return. This is because the range of the rate brackets for joint filers is less than double that of unmarried individuals for tax rates over 15 percent. For example, if each spouse in a civil union earned $100,000, then the couple would save $1,000 in taxes due to their ability to file as unmarried individuals. These savings increase as the couples' income increases to approximately $14,000 for couples each earning $350,000 per year.

Under other circumstances, however, such as when most of the couple's income is earned by one partner, filing as unmarried individuals increases the joint federal income tax liability as compared with a married couple filing jointly due to the progressive structure of income tax rates. The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 that mitigated the so-called marriage penalty for the 15 percent tax bracket and the standard deduction will sunset under the current law for tax years beginning after December 31, 2010. If these provisions are allowed to sunset, filing as unmarried individuals for two-income households will be favored.

What if Oscar were to enter the union with a dependent child from a previous relationship? Oscar, filing as an unmarried individual, would be entitled to the personal exemption if the statutory requirements were otherwise met. If Oscar had no taxable income, however, the benefit of the personal exemption

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would be lost to the couple because Felix would not qualify for the personal exemption on his own federal income tax return unless the demanding requirements of IRC Section 152(d) were met.

A number of issues also arise with respect to the couples' real property. The couple should pay close attention to how title to the family home is held. Where the couple owns the home as tenants in common, each should potentially qualify for the exclusion from capital gain recognition on the sale of the residence of up to $250,000 under IRC Section 121. If the residence were to be titled in the name of only one partner, however, only $250,000 of gain would be eligible for exclusion. This contrasts with the situation for a married couple, where up to $500,000 of gain may be excluded on the sale of a principal residence even if only one of the spouses has title to the property.

Couples not recognized as being married under federal law have several federal tax planning opportunities. IRC Section 1041 treats purported sales of property between spouses as gifts. This means that the buying spouse takes the property at the same tax basis as it had in the hands of the selling spouse. IRC Section 1041 does not apply, however, to the members of a civil union. Assume, for example, that one partner is in title to the family home, which has a very low tax basis. If the couple wishes to convert the principal residence into rental real estate, the partner who owns the property has the ability to sell the house to the other partner. If the built-in gain in the property is less than $250,000, then the result is no federal capital gains taxes by reason of the exclusion of gain under IRC Section 121 and an increase in basis for depreciation purposes. With respect to New Jersey taxes, the transfer would be exempt from any realty transfer taxes as an interspousal conveyance.

Another income tax planning opportunity for civil union couples involves capital assets with built-in losses. Because federal law does not recognize civil unions, those spouses are not subject to the limitations on losses for transactions between related parties under IRC Section 267. Thus, Felix can sell a depreciated asset to Oscar and recognize the loss currently, while the couple continues to own the investment.

For two-income households, issues may arise when determining the elections to make for health insurance. If both partners' employers offer insurance coverage, it might be cheaper for one of them to waive coverage and the other to elect a family plan. While the CUA requires that insurance companies do not discriminate against civil-union couples for any policy issued in New Jersey, the employer's contributions towards insurance premiums and/or the benefits received by the employee's spouse may be subject to federal income tax under IRC Sections 104 through 106.

Thus, if Felix waives coverage, a portion of the amount Oscar's employer pays towards the couple's health insurance and any benefits Felix receives may be subject to income tax. However, if Oscar pays the insurance premiums for the fair market value of the coverage for Felix, or if such amount is included in Oscar's gross income, PLR 9717018 states that any medical benefits (including reimbursements) provided to Felix under the health insurance plan are not includable in Oscar's gross income.

Because the federal tax laws do not recognize civil unions, they also cannot recognize their dissolution. Since neither IRC Section 1041 nor IRC Section 2516 apply to the dissolution of a civil union, in contrast with the divorce of a heterosexual couple, the division of a couple's property could result in a taxable gain or a gift tax.

The primary consequence of the failure of federal law to recognize civil unions for federal gift and estate tax purposes is that the marital deduction is not available to the partners in a civil union. While a married couple can usually defer federal estate tax liability on the couple's assets until the death of the surviving spouse, this may not be true for the members of a civil union.

The fact of a civil union does not, of course, affect the threshold at which an estate becomes subject to federal estate tax. This is currently $2 million, rising to $3.5 million in 2009. Where, however, only one of the partners is wealthy, the absence of an estate and gift tax marital deduction may mean that the partners cannot easily shift assets between them so that each can take full advantage of the estate tax threshold upon his death. As with any other donee, each partner can utilize the gift tax annual exclusion, currently $12,000, without having made a taxable gift.

While the CUA provides that the retitling of a residence from one partner into their joint names or the other's name is exempt from both New Jersey income tax and realty transfer taxes, such would result in a federal taxable gift and require the use of one partner's gift tax exemption or, if he has already made taxable gifts in excess of $1 million, a federal gift tax.

For estate tax purposes, the primary benefit of the failure of federal law to recognize civil unions is that transfers between civil union partners are not subject to the federal estate tax freeze rules of Chapter 14 because they are deemed unrelated for purposes of IRC Sections 2701 through 2704. This allows for the use of estate planning techniques that are not available to heterosexual spouses, including the grantor retained income trust, or GRIT. A GRIT is a trust where the grantor receives the trust's income for a fixed term of years, with the remainder passing to another beneficiary, such as the civil-union partner. However, where the trust invests in low-income-producing assets, both the original principal and any appreciation in such assets will pass to the civil-union partner at the end of the term. Thus the present value of the amount that passes to the civil-union partner might greatly exceed the amount of the taxable gift determined at the trust's inception under the assumption that income at the applicable federal rate would be paid to the grantor.

The GRIT technique could also be used for the couple's residence. While heterosexual couples may also make a gift of their home using the personal residence trust technique under IRC Section 2702, the statute and regulations impose

significant restrictions on the use of this technique, which civil union couples can avoid by utilizing the GRIT.

Where a taxpayer is greater than 37.5 years older than his partner, taxable gifts to the partner may be subject to generation-skipping taxes.

Finally, one issue that has not yet been resolved by the courts is whether the claim of a civil-union partner against a deceased partner's estate for either an elective share or under a prenuptial agreement is deductible by the estate for federal estate tax purposes. The argument for a deduction is stronger in the case of a prenuptial agreement because the spouse relinquished statutory rights upon entering into the agreement as consideration for the bequests. However, neither of these issues has been tried by the federal courts to date. ■