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## IN PRACTICE TAX LAW By PETER R. SPIRGEL

# How Taxing Is the Domestic Partnership Act?

Domestic partners do not receive the same tax treatment as spouses

New Jersey joined a growing number of states when it granted certain legal rights to gay and lesbian couples on July 11, 2004. Putting aside the social implications of this new legal status offered to gay and lesbian couples, the Domestic Partnership Act creates several beneficial tax planning opportunities that, prior to its enactment, were not available to same sex partners. However, it falls far short of granting domestic partners the same status as spouses for tax purposes. This notwithstanding, attorneys counseling clients who meet the definition of “domestic partners” under the act should become familiar with the tax implications of this newly-created legal status.

Under the act, a domestic partnership is generally defined as the relationship between two unmarried, unrelated, same sex individuals, over the age of 18, who file an Affidavit of Domestic Partnership and agree to be jointly responsible for each other’s basic living expenses. The definition of a domestic partner also includes heterosexual couples over the age of 62 if they meet the other requirements of the act.

At the onset, it should be recognized that the act does not impact federal tax

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liability. The Internal Revenue Code (IRC) does not grant domestic partners the tax status granted to husbands and wives. Interestingly, the attribution rules within the IRC, which generally attribute the activity of one spouse to the other, frequently foil tax-planning opportunities.

For example, IRC §267 generally disallows losses from the sale or exchange of property between “related taxpayers.” The term “related taxpayers” includes members of a family—further defined as brothers, sisters, spouse, ancestors and lineal descendants. See, IRC §267(c)(4). Attribution rules also exist among business partners and among certain stockholders in a corporation; however, the IRC does not contain any attribution rules for individuals having the status of a domestic partner under state law.

Accordingly, transactions between domestic partners can be structured to save federal income tax, where the same transaction between spouses would be ignored for federal tax purposes.

Unlike federal law, the act grants a domestic partner the tax status equivalent to a spouse for some, but not all, state taxes imposed on individuals. Of course, the legislature could have simply included in the definition of a “spouse,” a person meeting the statutory requirements of a domestic partner. This would have granted domestic partners the same tax benefits

afforded to married individuals. Instead, the act adopts a piecemeal approach by granting domestic partners only limited tax benefits which, when viewed as a whole, appear to obfuscate the legislative intent of recognizing these unions.

### New Jersey Gross Income Tax

The act applies to the 2004 tax year, but has little effect on the calculation of New Jersey gross income other than allowing a taxpayer to claim an additional \$1,000 personal exemption for a qualified domestic partner who does not file a separate return. Alternatively, if the taxpayer’s domestic partner qualifies as a “dependent” under IRC Section 152, the taxpayer can claim a \$1,500 state tax exemption. The act does not allow qualified domestic partners to file joint state income tax returns. Contrary to similarly situated spouses, the act does not allow an additional personal exemption for a domestic partner over the age of 65, or for a domestic partner who is blind or disabled.

### New Jersey Transfer Inheritance Tax

The act applies to decedents dying after July 10, 2004, and exempts from inheritance tax all transfers to qualified domestic partners. This exemption from tax includes the transfer of membership

or stock certificates in cooperative housing corporations and the value of any pension, annuity, retirement allowance or return of contribution.

#### **Pension Benefits**

Although the act does not impose transfer inheritance tax on the receipt of retirement and pension payments by a qualified domestic partner, domestic partners are not covered by the federal law which requires pension plans to provide survivor benefits known as "qualified joint and survivor annuities" (QJSA) and "qualified pre-retirement survivor annuities" (QPSA) to spouses. The federal law known as the Defense Of Marriage Act defines the term "spouse" as a person of the opposite sex. Accordingly, surviving spouse benefits under a private employer's pension plan would not automatically be payable to the decedent's domestic partner.

#### **Health Benefits**

The Act requires commercial health insurers to offer coverage to qualified domestic partners but does not require that employers include such coverage as a benefit, even in instances where the employer offers family coverage to its employees. To obtain health insurance coverage for domestic partners, submission of proof of domestic partner status under New Jersey law is usually required. Employers may want to amend their group health plans to require proof of certification pursuant to the procedures set forth in the act as a prerequisite to obtaining coverage. If an employer does provide subsidized health insurance coverage for domestic partners, the cost of

such coverage will be taxable to the employee unless the domestic partner qualifies as a dependent under the provisions of the IRC. Similar coverage for spouses and children provided by the employer is not taxable to the employee for federal income tax purposes.

#### **New Jersey Estate Tax**

The New Jersey Estate Tax is based on the federal estate tax credit for state death taxes that was allowable under the provisions of the IRC in effect on December 31, 2001, if the value of the decedent's estate exceeded \$675,000. The federal estate tax does not allow a deduction for property passing to a domestic partner. Accordingly, a decedent's estate passing entirely to his or her qualified domestic partner would be subject to the New Jersey estate tax if the value exceeded \$675,000.

A domestic partner is not granted the right under the act to elect against the will of the deceased domestic partner nor do the laws governing intestate succession apply to domestic partners. Accordingly, if one partner dies without a will, the other partner may inherit nothing at all, while a spouse who is disinherited would be able to elect against the will.

#### **Real Estate Transfer Tax**

Transfers of real property are generally subject to a realty transfer tax. New Jersey allows a complete exemption from this tax for transfers between spouses and for transfers between a parent and child. The act does not expand this exemption to include transfers between qualified domestic partners; however, transfers of

real property interests between domestic partners will qualify for an exemption from this transfer tax for transfers where the consideration is less than \$100.

#### **Medicaid Planning**

The act does not impact any state-administered federal program such as the Medicaid program. Accordingly, greater flexibility and opportunities exist when advising domestic partner clients seeking to insulate accumulated wealth from depletion by one partner's medical care expenses. Typically, all of a married couple's non exempt assets are considered when determining one spouse's eligibility for Medicaid benefits, and title to the marital assets is ignored. The healthy spouse is allowed to continue to live in the marital residence, but only retain a relatively small amount of other assets. Since domestic partners are not recognized as having the status of spouses under federal law, assets held by a Medicaid applicant's domestic partner are not counted in determining the applicant's eligibility for Medicaid benefits. As with all transfers to non spouses for less than full fair market value, transfers to a qualified domestic partner by a Medicaid applicant would still be subject to a 36-month look-back period (60 months for transfers to trusts) for purposes of determining any Medicaid ineligibility period.

In conclusion, the act does not equalize the tax treatment of qualified domestic partners to that of spouses. Despite the disparate treatment, attorneys counseling domestic partners should be familiar with the limited tax benefits available under this new legal status. ■