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Guest Article

Questions & Answers On Planning For Same-Sex Couples

By Jeffrey A. Baskies

More and more often, estate planners find themselves in a position to assist nontraditional families in facing the challenges associated with satisfying their estate planning goals. Representing same-sex couples can be very rewarding and valuable work. Here's one question and answer discussion from a hypothetical client conference.

Jim & Mike

Your clients, Jim and Mike, have been together more than 15 years. During the course of their relationship, Jim has acquired substantial assets (both earned and inherited) that have been pooled in common accounts with the less significant earnings of the other partner, Mike.

About 10 years ago, using his own funds, Jim purchased the couple's home in his name only. During the relationship, both partners have lived together in the house Jim owns, and they have pooled their resources for payment of bills and investments. Naturally, Jim contributed a higher percentage.

Assets traceable to Jim are presently more than $2 million, so there would be estate tax issues should he die tomorrow. Because of this, if possible, Jim would like to equalize their estates. Jim would also like for 50 percent of their common residence to belong to Mike.

Each wants the other to receive 100 percent of the estate of the first to die. On the death of the survivor, most of the assets should pass to their friends and family and the rest to charities they name.

Some Questions

1. Can Jim gift half the assets to Mike to equalize the estates?

2. Can Jim convey 50 percent of the house to Mike in exchange for his prior services in the management and upkeep of the home for all these years? If so, would that mean he'd receive taxable income he'd have to report? Or should Jim consider using a Qualified Personal Residence Trust ("QPRT") to transfer half the house?

3. How will any of this planning affect the basis of the property for capital gains tax purposes? Assume that the value of the marketable securities in their portfolio and the value of the home have increased dramatically in the past 10 years.

4. Are there any other ideas we should consider?

The Answers

In representing same-sex couples with their estate planning, lawyers are faced with several hurdles. Many of the problems they face are similar to those faced by unmarried male-female couples. However, same-sex couples do not currently have the ability to solve the tax problems by getting married.

While tax planning and spreadsheets may be comforting to estate planners, we need to recognize that the couple in our office also has emotional, non-monetary needs to address.

For example, for a same-sex couple (or an unmarried male-female couple), the issue of title to a residence often has very significant emotional aspects. Many couples want/need to have the residence in joint names even if doing so may be a taxable event. Sometimes the best planning for your clients (to meet their emotional needs) may conflict with traditional ideas of planning to minimize taxes. Thus, while putting a home into joint name will usually cause a taxable gift, it may be an emotional necessity for the couple.

Before delving into tax avoidance techniques, be sure you are comfortable with the emotional and non-tax aspects of their planning.

Now, from a tax perspective, unlike a married couple, any unmarried couple (same-sex or not) faces planning complications due to the lack of an unlimited marital deduction. Much standard estate planning - equalizing estates, credit shelter and marital trust formulas, and issues of joint accounts - does not apply to same-sex couples. They are limited in how much they can give one another each year by the annual gift tax exclusion, which is currently $11,000 per year. And they are limited in how much they can pass tax-free on the death of the first partner to the applicable exclusion amount, which is currently $1 million. Gifts in excess of $11,000 and estates in excess of $1 million will face taxes where married couples would not. So all of the planning must consider these points.

Another unique issue in addressing planning with same-sex couples is the fact that all of these legal matters need to be drawn out, discussed and documented. With married couples a great deal is presumed in the law - and thus doesn't need to be debated. Sometimes the fact that every little point needs to be put into some written agreement can act as a deterrent to actually completing any planning, as the process becomes over-whelming. Try to keep that in mind.

Next, I will try to address the questions in the order raised above:

1. Equalizing the estates

Generally, paying gift tax is less costly than paying estate tax, due to the different tax-inclusive vs. tax-exclusive nature of the taxes. But advising clients to make large gifts now (such as a gift to equalize the size of the estates), particularly gifts that incur tax, seems imprudent. Given the current status of the estate tax (exclusion going up, tax going away, tax maybe coming back, etc.), they would be wise not to incur large gift or income tax liability at the present time.

That doesn't mean they couldn't equalize (or at least partially equalize) the estates. For example, Jim could make a large gift (half the house, for example) to Mike and would not owe any tax. He'd use part of his applicable credit, but that's not necessarily bad. Thus, if putting the house in joint names is an important psychological step for the couple, and it can be accomplished with minimal tax impact, then I suggest going ahead with issuing a deed making the home joint. There is an additional benefit to gifting half the house. On the gift tax return (which should be filed before next April 15), Jim can claim a fractional interest discount in valuing the part gifted to Mike. While an appraiser can help set the level of discounting, it is common to see a 15-20 percent discount from the fractional market value of the whole house. For example, if the home is worth $500,000, the gift of one-half the home is arguably worth less than $250,000 since you don't own and control the half independently. The amount of diminution in value is based on the discount determined by an appraiser.

Other gifting is possible, but I am not sure if it is advisable. You need to advise Jim that, if he gifts fully half his assets to Mike, then he will have to report that on a gift tax return using up essentially his entire applicable credit. That may not be a problem today, but in the future Jim may regret doing such.

Another issue to consider is the impact of gifting on a potential dissolution of the relationship. If Jim makes completed gifts of assets to Mike (even if only for estate planning purposes), and if the couple later breaks up, those gifted assets are Mike's. This issue is difficult to address but vitally important.

An option may be making smaller annual gifts - under the $11,000 annual exclusion. That may allow a shifting of value without depleting Jim's full applicable exemption amount and only passing assets over time as the couple remains together.

2. Exchanging the house or using a QPRT

I wouldn't try to "exchange" half the house for "services."

First of all, if the Internal Revenue Service challenges that, you probably can't support the argument that there were services rendered of a value to warrant the transfer. At least that will be a difficult argument to make in good faith.

Second, if the argument succeeds, then Mike has to recognize the value received as income. So they wind up paying current income tax (at least a portion of which will probably be at the 35 percent bracket) today just to avoid possibly paying an estate tax 30-40 years from now (if they live that long and if there is an estate tax then). I am not sure that's a good trade.

While I am a fan of QPRTs, given the current interest rate environment and the size of this estate, I'd suggest not going through all that work - drafting documents, getting appraisals (and discount appraisals, which are not cheap), filing a Form 709, etc. It seems the fractional interest gift might be sufficient. Now if the size of the estate were more like $3-million-plus and/or if the clients were older, then the need to equalize the estates might be more pressing and the use of a QPRT might be more worthwhile.

3. Basis issues

Like all gifts, the basis in the hands of the recipient would be the same as the basis in the hands of the giver. So for any amounts gifted from Jim to Mike, Jim's basis will carry-over. Capital gains taxes are not triggered on transfer, but when Mike sells, he'll report any gain.

If the transfer of the house were for "consideration" that would have income and capital gains tax implications. As stated above, Mike would have to recognize income and pay tax immediately. But as that options seems inappropriate, I will assume that it is more likely Jim will gift half the house to Mike and thus Mike will assume Jim's basis.

4. Other options

- Basic Planning

In addition to the planning described above, you should also address with the clients their basic wills and possibly trusts. Many same-sex couples like to use revocable trusts as they avoid probate, thus achieving a degree of greater privacy and also help minimize challenges by disgruntled family members. While a "will contest" may not be entirely avoided, revocable trusts seem to have a better chance of withstanding challenge.

Also, same-sex couples especially need good health care decision planning. Durable powers of attorney, health care surrogates and living wills are vital. Without such, any hospital will turn to biological family members for health care directions.

- Life Insurance

Another option to consider is buying some cheap life insurance on Jim's life and putting it in Mike's name or in an Irrevocable Life Insurance Trust ("ILIT"). That tax-free death benefit would make up for the lost estate taxes, if any, on Jim's death. If they want to keep the proceeds out of both estates, then an ILIT can be prepared which will be the owner of the life insurance.

- Beware Joint Titling of Assets

Remember, an unmarried couple cannot just "pool" assets into joint names like a married couple. There are gift tax issues.

The exact rules actually depend on the nature of the assets and state law. Some joint assets are treated as gifts on funding when they are titled jointly - real estate, for example. The titling of a stock certificate (or bond) is treated the same way.

But for bank accounts, for example, just putting money into a joint bank account is usually not a taxable gift so long as the contributor has the right to withdraw without the other person's consent (under the joint account agreement and state law). On brokerage accounts, that's generally the rule too. But this would depend on your state law.

Bottom line, though, in general, is the use of joint accounts can be problematic. Even if there isn't a gift on funding, who wants to prove how much each member of the couple contributed and/or took out? For example, if Jim contributed a lot more then Mike, it is possible that Mike may already have "overdrawn." If so, is there an obligation on Jim to seek reimbursement from Mike? Probably so, and if he doesn't enforce it, then that is probably a gift.

On the other hand, if Jim had/has a separate account, he could just pay for the household expenses and there would not be a gift issue. So keeping separate accounts may still be the better alternative. If a joint account is desired for household expenses, then each partner might contribute a monthly amount from his separate account into that joint account. That would be easy to trace and since all contributions are equal there should be no gift tax issues.

- Cohabitation Agreements

One final issue worthy of discussion with the clients would be the execution of a cohabitation agreement. There are some resources available on-line regarding these, but essentially, they are agreements entered into by non-married, cohabiting partners.

These agreements may cover issues including, but not limited to: how the expenses will be apportioned during the relationship; distribution of property upon the death of one partner; distribution of property if the relationship breaks up; dealing with debts; and determining health

care rights and obligations.

Some other common issues addressed in these agreements include: support for the financially less well-off partner; protecting the more affluent partner against future claims for support of the couple breaks up; and compensating a homemaker partner. Many other issues may be addressed as well.

Essentially, a cohabitation agreement might address many of the concerns discussed herein. Jim and Mike could declare how their assets will be titled, how to pay mutual expenses, how to dispose of property on death or dissolution of the relationship, and how health care and medical decisions will be made.

Conclusion

Planning for same-sex couples is challenging and important work. Remember that there is more to planning then just understanding tax vehicles. You also need to consider the unique needs and circumstances of your clients. With the background rules of gift and estate tax in mind, a good deal of planning can be done.

Jeffrey A. Baskies, Esq., who practiced estate planning in Florida for many years, is currently the CEO of Lawyers Weekly Inc. in Boston. Board certified as a specialist in wills, estates and trusts law by the Florida Bar, his column runs regularly in Lawyers Weekly USA, the national newspaper for small law firms. If you have questions or issues relating to estate planning, please feel free to e-mail Jeff at jbaskies@lawyersweekly.com. All questions are

encouraged.