Accounting Issues and Tax Planning for the Unmarried Couple

This presentation deals with unmarried couples living together who have no intention of getting married.

A. INCOME TAX

I. The Marriage Penalty

a. Basic Concept

Unmarried working couples generally file as single. They cannot file a joint return since this filing status is limited to "married" couples. Marriage is generally defined under state law. This has led the "marriage penalty" since, in general, marriage increases the cumulative tax that a married couple, with both working, would otherwise pay if each had remained single.

Marriage penalties result from the combination of progressive tax rates and taxing married couples as single units. With progressive taxes (which impose higher rates on higher incomes) and tax brackets that are not twice as wide for couples as for individuals, some married couples' income is taxed at higher rates than if each spouse's income was taxed separately. The 10 and 15 percent brackets for joint filers are twice as wide as those for single filers, but the higher rate brackets are less than twice as wide. A couple is not obliged to file a joint tax return, but their alternative—filing separate returns as a married couple—almost always results in greater tax liability.

A. Marriage Penalty: A couple incurs a marriage penalty if the two pay more income tax by filing jointly as a married couple than if they file single.

1. Spouses with similar incomes are more likely to incur marriage penalties than if one spouse earns most of the income. This occurs because the combined incomes in joint filing can push both spouses into higher tax brackets.

Example (Table 1): Consider parents of two children where each parent earns $100,000 and the family has itemized deductions totaling $40,000. Filing jointly, their taxable income is $144,000, on which their 2015 income tax liability is $27,588; they would get no child credit because their combined income is too high to qualify. If they file separately, one as single and the other as the head of a household with two children, the single filer would owe a tax of $14,794 and the head-of-household filer would owe $11,323 minus a child credit of $750, or $10,573, yielding a total tax of $25,366. Their joint tax bill is thus $2,222 higher than the sum of their hypothetical individual tax bills, imposing on them a marriage penalty equal to 1.1 percent of their pretax income.

TABLE 1

Calculation of the Marriage Penalty for a Hypothetical Couple with Two Children

2015

Item	Couple Filing Separately[a]		Couple filing jointly
	Spouse one	Spouse two	
Adjusted gross income	$100,000	$100,000	$200,000
Less personal exemptions	$4,000	$12,000	$16,000
Less 20 percent for itemized deductions[b]	$20,000	$20,000	$40,000
Equals taxable income	$76,000	$68,000	$144,000
Of which:			
Taxable at 10 percent	$9,225	$13,150	$18,450
Taxable at 15 percent	$28,225	$37,050	$56,450
Taxable at 25 percent	$38,550	$17,800	$69,100
Taxable at 28 percent	$0	$0	$0
Regular tax liability	$14,794	$11,323	$27,588
Alternative minimum tax	$0	$0	$0
Child tax credit	$0	$750	$0
Tax liability after credits	$14,794	$10,573	$27,588
Final tax liability	**$25,366**		**$27,588**
Marriage penalty (difference in tax liabilities)		**$2,221**	
As share of adjusted gross income		**-1.1%**	

Source: Tax Policy Center calculations.
Note: Detail may not sum to totals because of rounding.
(a) When the couple files separately, spouse one files as single and spouse two as head of household with two children.
(b) Itemized deductions are state and local taxes (10 percent of AGI), mortgage interest (5 percent of AGI), and charitable contributions (5 percent of AGI).

B. Marriage Bonus: A couple receives a marriage bonus if they pay less tax filing jointly than they would if they were single.

1. If one spouse earns all of a couple's income, that couple will not incur a marriage penalty. Almost always, they will receive a marriage bonus. This is because joint filing shifts some of the higher earner's income into a lower tax bracket.

Example (Table 2): Consider a couple with two children and $200,000 in total earnings, all earned by spouse two. Under 2015 tax law, they will receive a marriage bonus of more than $9,000 as a result of three factors. First, filing jointly, the couple can claim $16,000 in personal exemptions, a third more than what they could claim if spouse two filed as head-of-household claiming two children and the other spouse filing a single return—with no earnings, spouse one could not claim an exemption. Second, because tax brackets for joint returns (other than the 10 percent and 15 percent brackets) are wider than those for head-of-household returns, much of the couple's income is taxed at lower rates under joint filing than the 28 percent marginal rate the spouse two would pay filing separately. Finally, spouse two would fall under the alternative minimum tax (AMT) filing separately, boosting taxes by an additional $4,942. Combining these factors yields a marriage bonus of $9,229, or 4.6 percent of their adjusted gross income. More than half of that bonus would result from the difference in AMT liability.

TABLE 2
Calculation of the Marriage Bonus for a Hypothetical Couple with Two Children
2015

Item	Couple Filing Separately[a]		Couple filing jointly
	Spouse one	Spouse two	
Adjusted gross income	$0	$200,000	$200,000
Less personal exemptions	$4,000	$12,000	$16,000
Less 20 percent for itemized deductions[b]	$0	$40,000	$40,000
Equals taxable income	$0	$148,000	$144,000
Of which:			
Taxable at 10 percent	$0	$13,150	$18,450
Taxable at 15 percent	$0	$37,050	$56,450
Taxable at 25 percent	$0	$79,400	$69,100
Taxable at 28 percent	$0	$18,400	$0
Regular tax liability	$0	$31,875	$27,588
Alternative minimum tax	$0	$4,942	$0
Child tax credit	$0	$0	$0
Tax liability after credits	$0	$36,817	$27,588
Final tax liability	**$36,817**		**$27,588**
Marriage bonus (difference in tax liabilities)		**$9,229**	
As share of adjusted gross income		**4.6%**	

Source: Tax Policy Center calculations.
Note: Detail may not sum to totals because of rounding.
(a) When the couple files separately, spouse one files as single and spouse two as head of household with two children.
(b) Itemized deductions are state and local taxes (10 percent of AGI), mortgage interest (5 percent of AGI), and charitable contributions (5 percent of AGI).

Citation: TPC is the Tax Policy Center which is a joint venture of the Urban Institute and the Brookings Institution. See www.taxpolicyenter.org.

b. **Tax Provisions that Promote a Marriage Penalty.**

i. Itemized Deduction Phase-Out. IRC § 68.

A. A taxpayer whose filing status is single will have an itemized deduction phase out starting at $257,500 of AGI.

B. A taxpayer whose filing status is married filing jointly will have an itemized deduction phase out starting at $309,000 (instead of 2 times $257,500 or $515,000). Married couples must either itemize or take the standard deduction. Unmarried couples have more flexibility in that one can itemize and consequently deduct home mortgage interest, real estate taxes, and charitable deductions while the other can take the standard deduction.

ii. Net Investment Income tax threshold. IRC § 1411

A. A taxpayer whose status is single receives a net investment income threshold of $200,000 before the 3.8% Medicare tax is imposed on any net investment income above the threshold.

B. A taxpayer whose status is married filing jointly receives a net investment income threshold of $250,000 before the 3.8% Medicare tax is imposed on any net investment income above the threshold.

Example: During Year 1 (a year in which section 1411 is in effect), A, an unmarried individual, has modified adjusted gross income of $190,000, which includes $50,000 of net investment income. A has a zero tax imposed under section 1411 because the threshold amount for a single individual is $200,000. If during Year 2, A has modified adjusted gross income of $220,000, which includes $50,000 of net investment income, then A has a section 1411 tax of $760 (3.8% multiplied by $20,000, the lesser of $50,000 net investment income or $20,000 excess of modified adjusted gross income over the threshold amount). IRC Reg. Section 1.1411-2(b)(2)

iii. Limitation of Capital Losses. IRC § 1211(b)(1)

A. Capital losses can only be deducted against capital gains. Any excess loss can be allowed to reduce ordinary income up to $3,000 per tax return. In the case of married individuals filing separate returns the limitation is $1,500.

Example: Susan and Ben live together and are not married. Each has a capital loss carryover of $2,000 from the sale of stock and no other capital transactions during the year. When they file as single, each can deduct a $2,000 a capital loss against their ordinary income.

Now, assume they are married and have a combined capital loss of $4,000. Under Section 1211(b), they will only be able to deduct $3,000 (not $4,000) of the capital loss from their ordinary income.

If one individual has a large capital loss carryover and no expectation of incurring future capital gains it would be beneficial to marry a partner who regularly incurs capital gains. This transforms a loser into a winner.

iv. Miscellaneous Itemized Deductions and Medical Expense Floors. IRC §§ 67(a) and 213

A. For these deductible expenses a combined income will raise the floor thus lowering the deduction. The limitation is based on combined AGI.

v. Personal Exemption Phase-Out. The personal exemption phase-out reduces personal exemptions ($4,000 in 2015) for both taxpayers and their dependents by 2 percent for each $2,500 (or part of $2,500) that adjusted gross income exceeds the threshold for the relevant filing status. The 2001 Tax Act phased down the phase-out and then eliminated it entirely for 2010. The 2010 Tax Act extended the repeal through 2012. The American Taxpayer Relief Act of 2012 allowed phase-out to resume as scheduled but raised thresholds above those set under previous law. IRC § 151.

In 2015, the phase-out occurs over the following income ranges. Thresholds are indexed for inflation after 2015.

FILING STATUS	PHASE-OUT BEGINS	PHASE-OUT ENDS
Single	$258,250	$380,750
Head of Household	$284,050	$406,550
Married Filing Jointly or Qualifying Widow(er)	$309,900	$432,400
Married Filing Separately	$154,950	$216,200

Example: Single filer with no dependents and AGI = $277,000: AGI exceeds phase-out by $18,750 ($277,000 -$258,250); divide that excess by $2,500 = 7.5, which rounds up to 8. Reduction is 16% (8 x 2%) of $4,000, which is $640.

Married couple with two children and AGI = $347,000: AGI exceeds phase-out by $37,100 ($347,000 -$309,900); divide that excess by $2,500 = 14.84, which rounds up to 15. Reduction is 30% (15 x 2%) of $16,000, which is $4,800.

If the married couple in this example were single and neither had AGI over $258,250 the phase-out would not have affected them.

vi. Taxation of Social Security Benefits. Social security benefits for single taxpayers are included in income when modified AGI exceeds $34,000. For married taxpayers filing jointly, AGI must exceed only $44,000. Therefore, unmarried couples have potential additional protection up to $24,000 ($34,000+$34,000-$44,000).

c. **Tax Provisions that Promote a Marriage Bonus.**

i. Passive Activity Losses—In determining whether an individual materially participates in an activity, the participation of the spouse shall be taken into account. IRC § 469(h)(5).

Participation of Spouse. In the case of any person who is a married individual for the taxable year, any participation by such person's spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) shall be treated, for purposes of applying section 469 and the regulations thereunder to such person, as participation by such person in the activity during the taxable year. IRC Reg. Section 1.469-5T(f)(3).

Example: Paul and Marilynne are married but file separate tax returns. They have one son, David. The shareholders of the S Corp, for the years at issue, are Marilynne and David. The Tax Court found that Paul materially participated in the S Corp's business. Therefore, Marilynne was also treated as materially participating. The Tax Court allowed Marilynne to deduct the losses from the S Corp. Graffia v. Comm'r, 106 T.C.M. (CCH) 261 (2013).

ii. Sale of Principal Residence. IRC § 121

A. Gain from the sale of a principal residence can be excluded if, during the 5-year period ending on the date of the sale, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more. The exclusion is $250,000 however when a joint return is filed the exclusion is increased to $500,000.

Example: 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 them from the sale does not exceed each taxpayer's available limitation amount of $250,000. IRC Reg. Section 1.121-2(a)(4) Ex.1.

Example: The facts are the same as in Example 1, except that A and B are married taxpayers who file a joint return for the taxable year of the sale. A and B are eligible to exclude the entire amount of realized gain ($256,000) from gross income because the gain realized from the sale does not exceed the limitation amount of $500,000 available to A and B as taxpayers filing a joint return. IRC Reg. Section 1.121-2(a)(4) Ex.2.

For the $500,000 exclusion to apply both spouses must meet the "use" requirement but only one spouse can meet the "ownership" requirement.

B. Property used by former spouse pursuant to divorce or separation instrument. --an individual shall be treated as using property as such individual's principal residence during any period of ownership while such individual's spouse or former spouse is granted use of the property under a divorce or separation instrument. IRC § 121(d)(3)(B).

Example: Susan and Charles, unmarried, are living together in a house that they both own. They each have a basis of $50,000. Susan moves out but Charles decides to keep living there. Six years later the house is sold for $500,000. If each receives half of the proceeds from the sale of the house, then Charles can exclude the entire gain ($250,000-$50,000-$200,000) but Susan will have to report $200,000 of gain ($250,000-$50,000).

Example: Susan and Charles are married with a child and the divorce decree allows Susan to remain in the house until the child goes to college. When the house is sold neither Charles nor Susan will report any gain since Charles is deemed to have "used" the house while Susan was still living there.

iii. Net Operating Loss Deduction. IRC § 172

A. If a married couple filing a joint return for any taxable year, did not make a joint return for any of the taxable years involved in the computation of a net operating loss carryover (or a net operating loss carryback) to the taxable year for which the joint return is made, such separate net operating loss carryover or carryback is a joint net operating loss carryover (or joint net operating loss carryback) to such taxable year. IRC Reg. Section 1.172-7. This rule assumes that they were married when they did not file a joint return.

Example: Susan and Allan are married but have never filed a joint return. Susan has a $35,000,000 net operating loss carryover from her loss on her Madoff investment and no income. Allan has earned income of $ 1,000,000. If Susan and Allan were married when she incurred her loss she will be allowed to offset Allan's income with her loss if they file a joint return.

If the loss predates the tax year in which the couple married, then the loss is personal to Susan and it cannot be used to offset Allan's income.

Example: Taxpayers filed a joint return for the tax year in question. The husband had AGI of $8,044.19 and the wife had a $20,000 net operating loss from a business she operated in the tax years before she married. The net operating loss reduced their income to zero. The Tax Court disallowed the net operating loss deduction because it was incurred in a tax year before the taxpayers were married. Calvin v. U.S., 354 F.2d 202 (10th Cir. 1965).

iv. Dependency Exemption

A. Taxpayers are allowed one exemption for each person who can be claimed as a dependent. A dependent may be either a qualifying child or a qualifying relative of the taxpayer. Several tests must be met before a dependency exemption is allowed. A citizen or resident test applies to both qualifying children and other qualifying relatives. In addition, a qualifying child must satisfy tests relating to relationship, age, abode, support, and joint returns. Qualifying relatives also include individuals, other than the taxpayer's spouse, who had the same abode as the taxpayer and were members of the taxpayer's household during the taxpayer's tax year (IRC § 152(d)(2)(H)). Although these dependents are called "qualifying relatives," this category includes persons who have no family relationship to the taxpayer.

B. A married taxpayer, not filing a joint return, may claim an additional exemption for their spouse in any taxable year that they are determined to be married. (note: whether someone is considered a spouse is determined at the end of the taxable year. See IRC § 7703(a)(1)). IRC § 151(b)

C. An individual is not a member of the taxpayer's household, or considered a spouse, if the relationship between the individual and the taxpayer violated local law. See Buckley v. Comm'r, 37 T.C. 664 (1962).

d. Allocations of Deductions Affecting Unmarried individuals

I. Mortgage interest payments. IRC § 163(h)

An individual who is jointly and severally liable on a mortgage is entitled to deduct all the interest on the mortgage if they actually paid the interest. Funds paid from a joint account with two equal owners are presumed to be paid equally by each owner, absent evidence to the contrary. IRS Letter Ruling 201451027 (October 1, 2014).

Example: A taxpayer paid interest on a mortgage secured by the marital residence which was owned jointly by the taxpayer and his former wife. The Service disallowed half the interest, but the court allowed the deduction, stating that "A deduction in respect of the payment of interest on a joint obligation is allowable to whichever of the parties liable thereon makes the payment out of his own funds. Inasmuch as it is clear here that petitioner made the home mortgage payments and respondent does not challenge the fact that he was an obligor on the mortgage, petitioner is clearly entitled to deduct the full amount of the stipulated mortgage interest paid." Castanada-Benitez v. Comm'r, 41 T.C.M. (CCH) 1213 (1981).

Example: Taxpayers are an unmarried couple and are jointly and severally liable on a mortgage, and the bank either issues a Form 1098 under only one social security number, or both. One or both taxpayers claim the mortgage interest deduction on their individual returns. Since both taxpayers are liable on the mortgage both are entitled to claim the mortgage interest deduction to the extent of the mortgage interest paid by either taxpayer. If the mortgage interest is paid from separate funds, each taxpayer may claim the mortgage interest deduction paid from each one's separate funds. If the mortgage interest is paid from a joint bank account in which each has an equal interest, it would be presumed that each has paid an equal amount absent evidence to the contrary. IRS Letter Ruling 201451027 (Situation #2).

ii. Real Estate Taxes

A. The Tax Court has long held that to be entitled to this deduction, a taxpayer must show not only that he paid the taxes, but that he or she actually had the real estate taxes imposed upon them, regardless of what other contractual obligations require a taxpayer to pay those real estate taxes

Example: The husband and his wife divorced and the wife was awarded sole ownership of the house in a divorce settlement. As a result of receiving full ownership of the house, the wife was primarily liable for real estate taxes. Husband also signed an agreement, with the bank that held the mortgage, guaranteeing the real estate taxes to be paid should the wife default. Because husband was not the primary obligor to pay the real estate taxes (since he did not own the house or was required to do so under the separation agreement) the Tax Court disallowed the deduction. Johnson v Comm'r, 39 T.C.M. (CCH) 868 (1980).

e. Attribution of ownership.

Unmarried couples are not related under certain sections of the Internal Revenue Code which allows for tax planning. These sections include:

Section 267 "Losses, Expenses, and Interest with Respect to Transaction Between Related Taxpayers"
Section 318 "Constructive Ownership of Stock"
Section 2701 "Special Valuation Rules in Case of Transfers of Certain Interests In Corporations or Partnerships"
Section 2702 "Transfers of Interests in Trusts"
Section 2704 "Treatment of Certain Lapsing Rights and Restrictions"

Example: A owns 79 percent of the stock of Corporation X, and a trust for A's spouse owns the remaining 21 percent of the stock. A's spouse is deemed to own the stock owned by the trust (section 318(a)(2)(B)). A, in turn, constructively owns the stock so deemed to be owned by his spouse (section 318(a)(1)(A)(I)). Thus, A is treated as owning all the stock of Corporation X, and any gain A recognizes from the sale of depreciable property to Corporation X is treated under Section 1239 as ordinary income.

f. Modified Adjusted Gross Income under the Affordable Care Act.

Adjusted Gross Income or AGI is defined under Section 62 of the IRC as generally your gross income less certain above the line deductions. See page 1, line 37, of 2015 Form 1040. Under the Affordable Care Act modified adjusted gross income is AGI plus the following items of income:

1) Untaxed foreign income.
2) Non-taxable Social Security Benefits.
3) Tax exempt interest income.

B. INCOME/GIFT ISSUES

a. "Gross income does not include . . . property acquired by gift, bequest, devise, or inheritance." IRC § 102.
b. Gifts to spouses
    i. The value of a gift to a donee, who at the time of the gift is the donor's spouse, is allowed as deduction in computing gift tax. IRC § 2523.

c. A gift is defined as . . . proceeds from a detached and disinterest generosity, out of affection, respect, admiration, charity or like impulses And, importantly, if the payment proceeds primarily from the constraining force of any moral or legal duty,' or from 'the incentive of anticipated benefit of an economic nature it is not a gift. Comm'r v. Duberstein, 363 U.S. 278, 285 (1960).

i. Because gifts are excluded under IRC § 102, the tax question that almost always arises is who is taxed: the donor (as a gift) or the donee (as income)?

ii. Generally the question becomes what is the nature of the transfer.

d. NY Cohabitation: "New York courts have long accepted the concept that an express agreement between unmarried persons living together is as enforceable as though they were not living together, provided only that illicit sexual relations were not 'part of the consideration of the contract' . . . ". Morone v. Morone, 50 N.Y.2d 481, 486 (1980).

i. The Tax Court has articulated the test to determine whether proceeds are income or a gift. The proper inquiry is into the nature of the damages. If an award is a substitute for income then the damages themselves are income.

e. Gift or Income

Income Example: The decedent promised to name petitioner in his will. When he did not she sued the estate for services rendered and entered into a settlement agreement. Although briefly engaged, the decedent convinced the petitioner to forgo a legal marriage but stay with him as though they were married. The petitioner and decedent always maintained separate apartments, but (i) she made his life as comfortable as possible, (ii) she watched his diet and health, (iii) cared for him when he was ill, (iv) she kept tract of his appointments and concerned herself with his personal needs. The Tax Court found that the nature of this settlement to be income rather than a gift. Green v. Comm'r, 54 T.C.M. (CCH) 764 (1987).

Gift Example: A wealthy widower was partial to the company of young women. The widower became involved with twin sisters and gave each of them, over the course of several years, over a half million dollars. One of a series of letters, excluded at trial, from the widower to one of the sisters said "I get as great if not greater pleasure in giving that you get receiving . . . I love giving things to you and see you happy and enjoying them." The Seventh Circuit found that these excluded letters proved that the transfers of wealth were gifts rather than income even in the light of a sexual relationship between the decedent and the sisters. U.S. v. Harris, 942 F.2d 1125, 1127 & 1130 (7th Cir. 1991)

Palimony Example: Violet and Gregg cohabited for 24 years. Violet did not work during the relationship and was financially supported by Gregg. She took care of the house, was the hostess at parties the couple threw, and cared for Gregg when he was sick. The relationship resembled that of a married couple including sexual relations. During the relationship the couple acquired numerous assets.

After 24 years of cohabiting, Violet and Gregg separated. Because Violet did not work during the relationship, she sued Gregg and won. After an IRS audit the Tax Court found the nature of the lawsuit was that of a property settlement after a divorce and found that the transfers were a taxable exchange, although there was no taxable gain. Reynolds v. Comm'r, 77 T.C.M. (CCH) 1479 (1999).

Example: The decedent had a close personal relationship with a women from 1963 until 1992 when the decedent died. During this period they lived together and traveled as husband and wife. She had unrestricted access to the decedent's wealth and had a joint bank account. She received many gifts and they owned a residence jointly. The decedent executed (i) an agreement for her services, (ii) six different wills, and (iii) six different codicils. All of these documents made provisions for her. The Tax Court found that this relationship was closer to that of a husband and wife rather than an employer-employee. The court also held that the bequests were gifts and not income. Cavett v. Comm'r, 79 T.C.M. (CCH) 1662 (2000).

f. Gift basis rules

Under IRC § 1041 no gain or loss is recognized on transfers of property between spouses, or between former spouses incident to a divorce, unless the transferee spouse is a nonresident alien (in which case the transfer triggers gain) (IRC §§ 1041(a) and (d)). A transfer that qualifies for tax-free treatment under Code Sec. 1041 is treated as a gift, meaning that neither the transferor nor the transferee recognizes any income as a result of the transfer. As with gifts generally, the transferee spouse takes the transferor's basis in the property.

There is no similar rule for unmarried couples. In this situation, there could have a taxable event if the cost basis in the property being transferred exceeds the value of the property received. So if A transfers $100,000 to B in exchange for B interest in artwork, B could have a tax liability if their cost basis in artwork is less than $100,000.
Because of this it is recommended that unmarried couples keep detailed records as the ownership and cost basis of assets acquired during the relationship.
It may be recommend to have the parties form a partnership and contribute the assets acquired during the relationship. Capital accounts can be maintained under a written partnership agreement.

C. RETIREMENT PLANNING

a. Individual Retirement Accounts – *Kay Bailey Hutchison Spousal IRA limit*

I. Traditional IRAs

A. For a spousal IRA, for 2015, the most that can be contributed for the year is the lesser of the following two amounts:

1. $5,500 ($6,500 if age 50 or older) or
2. The total compensation includible in the gross income of both spouses reduced by the higher earning spouses contribution to a traditional IRA and a ROTH IRA.,

B. Summary--As long as a married couple earns $11,000 or more of combined income for the year, $5,500 can be contributed to a traditional IRA for each spouse regardless of how much either spouse earns (IRS Publication 590-A).

Example: Kristin, a full-time student with no taxable compensation, marries Carl during the year. Neither of them was 50 or older by the end of 2015. For the year, Carl has taxable compensation of $30,000. He plans to contribute (and deduct) $5,500 to a traditional IRA. If he and Kristin file a joint return, each can contribute $5,500 to a traditional IRA. This is because Kristin, who has no compensation, can add Carl's compensation, reduced by the amount of his IRA contribution ($30,000 − $5,500 = $24,500), to her own compensation (-0-) to figure her maximum contribution to a traditional IRA. In her case, $5,500 is her contribution limit, because $5,500 is less than $24,500 (her compensation for purposes of figuring her contribution limit). IRS Publication 590-A.

b. Inheriting an IRA

i. Options for surviving spouse:

A. Treat it as your own IRA by designating yourself as the account owner,

B. Treat it as your own by rolling it over into your IRA, or to the extent it is taxable, into a:

1. Qualified Employer Plan,

2. Qualified employee annuity plan (Section 403(a) plan)

3. Tax-Sheltered annuity plan (Section 403(b) plan)

4. Deferred compensation plan of a state or local government (Section 457 plan), or

ii. Options for someone other than spouse.

A. If someone other than a surviving spouse inherits an IRA they cannot treat themselves as the owner of the account; this means you:

1. Cannot make contributions to the IRA, or

2. Cannot roll over any amounts into or out of the IRA.

If the IRA owner dies on or <u>after</u> his or her required beginning date you must base the required minimum distributions for the years after the year of death on the longer of your single life expectancy or the owner's life expectancy.

If the owner dies <u>before</u> his or her required beginning date you must base the required minimum distributions your own life expectancy.

<u>D. GRANTOR TRUST PROVISIONS (IRC §§671-678).</u>

a. Under these rules the grantor is treated as the owner of all items of income, deduction, and credit of a trust if the grantor, the grantor's spouse, or in some cases a "nonadverse" or "related or subordinate party" presumed to be subservient to the wishes of the grantor, holds certain powers over or interests in the trust.

i. Related or Subordinate Parties: A related or subordinate party means any nonadverse party who is—

A. The grantor's spouse if living with the grantor;

B. Any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

C. A related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence. IRC §§ 672(c)(1) and (2).

ii. Grantor treated as holding any power or interest of grantor's spouse.
In general a grantor shall be treated as holding any power or interest held by—

1. Any individual who was the spouse of the grantor at the time of the creation of such power or interest, or

2. Any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor. IRC §§ 672(e)(1)(A) and (B).

When planning and drafting a trust, attention must be paid to the grantor trust rules to ensure the tax burden falls where intended.

This is because in certain situations, the grantor will find taxation under the grantor trust rules advantageous (e.g., the grantor is in a lower tax bracket than the trust . . . or wishes to engage in a tax-free transaction with the trust). In other cases, the grantor will wish to avoid application of the grantor trust rules (e.g., the grantor does not wish to pay tax on income).
Because unmarried couples will not fall within the spousal attribution rules of the definition of related or subordinate party with respect to each other (unless there is an employment relationship) they will be much less likely to trigger the grantor trust rules.

E. GIFT TAXES

a. Lifetime transfers to spouses are not subject to gift taxes as long as both spouses are U.S. citizens. IRC § 2523 allows for an unlimited marital deduction for these transfers and provides for much flexibility in planning. Transfers between unmarried couples are either taxable gifts, if they exceed the IRC § 2503(b) annual exclusion or in some cases treated as income.

b. Transfers to ex-spouses.

i. Where a married couple enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into any transfers of property made pursuant to such agreement—

A. To either spouse in settlement of his or her marital or property rights, or

B. To provide a reasonable allowance for the support of issue of the marriage during minority.

The transfer shall be deemed to be transfers made for a full and adequate consideration in money or money's worth. IRC § 2516.

Example: An unmarried couple separated after cohabiting for 24 years. A state court held that claimant was entitled to a certain amount of the property amassed over the 24 year relationship as a property interest. The Tax Court held that transfers were more akin to a property settlement of jointly owned property rather than income for services. This was considered a taxable exchange. Reynolds v. Comm'r, 77 T.C.M. (CCH) 1479, 5 (1999).

c. Gift Splitting.

i. In general. —A gift made by one spouse to any person other than their spouse shall be considered as made one-half by each spouse, but only if at the time of the gift each spouse is a citizen or resident of the United States. An individual shall be considered as the spouse of another individual only if they are married to such individual at the time of the gift and does not remarry during the remainder of the calendar year. IRC § 2513

F. ESTATE TAXES

a. Under the unified transfer tax system a unified credit is used to offset estate and gift tax liability. The federal estate tax exclusion is $5,430,000 in 2015 and it increases to $5,450,000 in 2016. For New York State, the estate tax exclusion is $3,125,000 for decedents dying on or after April 1, 2015 and on or before March 31, 2016. The exclusion is scheduled to increase to $4,187,000 for decedents dying on or after April 1, 2016 and on or before March 31, 2017 and finally to $5,250,000 after April 1, 2017 and on or before December 31, 2018.

b. Jointly Held Property. IRC § 2040.

i. Non-spousal Jointly held property – The entire value of jointly held property is included in the decedent's gross estate unless it can be shown that the surviving joint owner actually contributed to the assets. IRC §2040(a). Thus the burden of proof is on the estate to show that the surviving joint tenant contributed towards the purchase price.

ii. Spousal Jointly held property – In the case of any qualified joint interest, the value included in the gross estate is one-half of the value of such qualified joint interest.

2) Qualified joint interest defined.—The term "qualified joint interest" means any interest in property held by the decedent and the decedent's spouse as—(A) tenants by the entirety, or (B) joint tenants with right of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants. IRC §§ 2040(b)(1), (2)(A), and (2)(B).

i. Gallenstein Exception. – If spouses purchased property as joint owners before 1976 and sell it after 1981 then the non-spousal jointly held property rule applies.

Gallenstein Case: The taxpayer and her husband bought 73.6 acres of farmland in 1955 for $38,500. Husband paid for the land out of his earnings. After the husband's death the taxpayer reported the entire value of the farmland on her husband's amended estate tax return. The taxpayer then sold the farmland in 1988 for $3,663,650. She then amended her income tax returns, requesting a refund, as she had declared a multi-million dollar capital gain after the sale of the farmland. The taxpayer argued that she received a 100% step up in basis. Congress amended Code section 2040 in 1976 and 1981 requiring spouses to only include 50% of jointly held assets in the gross estate, regardless of who originally purchased the asset. Thus, the IRS argued these amendments only entitled the taxpayer to a 50% step up in basis. The Seventh Circuit disagreed. Because the farmland was purchased before either the 1976 or 1981 amendments were enacted then section 2040, as it was in force in 1955, would apply. Therefore, since 100% of the farmland was included in the gross estate, 100% of the farmland would receive a step-up in basis. Gallenstein v. U.S., 975 F2d 286 (6^{th} Circuit 1992).

c. Portability. IRC § 2010(c)(2)(B). For decedent's dying on or after January 1, 2011.

i. Applicable exclusion amount. —Under IRC §§ 2010(c)(2)(A) and (B) the unused portion of a decedent's applicable annual exclusion may be utilized by the estate of the decedent's surviving spouse at their death. The deceased spousal unused exclusion amount is commonly called "DSUE".

Example: In 2002, having made no prior taxable gift, husband makes a taxable gift valued at $1,000,000 and reports the gift on a timely filed gift tax return. Because the amount of the gift is equal to the applicable exclusion amount for that year ($1,000,000), $345,800 is allowed as a credit against the tax, reducing the gift tax liability to zero. Husband dies in 2015, survived by wife . Husband and wife are U.S. citizens and neither has any prior marriages. Husband's taxable estate is $1,000,000. The executor of husband's estate timely files an estate tax return and elects portability, thereby allowing wife to benefit from husband's DSUE amount of $4,430,000.

There is no portability for New York State estate tax.

G. ETHICAL CONCERNS

a. Tax/Estate Planning
  i. When should couples have separate counsel?
  ii. Getting married for tax planning purposes.
  iii. Discuss joint and several liability with clients.
  iv. Malpractice concerns.

b. Prenuptial and Postnuptial Agreements
  i. NY Courts will enforce expressed contracts between unmarried couples living together so long as "illicit sexual relations" are not part of the consideration of the contract. Morone v. Morone, 50 N.Y.2d 481, 486 (1980).

ii. However, NY Courts will not enforce implied contracts between unmarried couples living together because there is too much danger of fraud. This is based on the NY Legislator's abolition of common-law marriage in 1933.

c. **Example:**

i. Edward has $10,000,000 and wants to give $4,000,000 to his girlfriend, Susan. What are the ethical consideration of getting married (or not getting married)?

Contact:

James R. Grimaldi, Esq., CPA
Tax Partner - Citrin Cooperman & Company, LLP
P: 212.697.1000
E: jgrimaldi@citrincooperman.com