

Status Update: Federal Tax Questions Continue to Trouble Domestic Partners and Same-Sex Spouses

RESPONSIBLE OFFICIALS

Peggy Bogadi, Commissioner, Wage and Investment Division
William J. Wilkins, Chief Counsel

DEFINITION OF PROBLEM

Domestic partners and same-sex spouses face unique federal tax challenges while the legal landscape rapidly evolves. The National Taxpayer Advocate's 2010 Annual Report to Congress (2010 Report) listed five questions about taxation of domestic partners and same-sex spouses, two of which the IRS has addressed.¹ Since then, additional issues have created several more conundrums that significantly affect individuals as well as corporations with contracts covering same-sex couples. Questions stem from IRS treatment of community property, such as subjecting a proprietor's same-sex partner who does not work in the business to self-employment tax. Outdated processes have rejected electronically filed (e-filed) returns that reflected withholding in excess of that on Forms W-2, *Wage and Tax Statement*, even after the IRS confirmed that domestic partners allocate withholding credit to the partner taxed under community property.²

Since the 2010 Report, same-sex marriage laws have advanced in five states and two countries, while domestic partnerships have become available in three additional states.³ Data newly derived from the 2010 Census double the number of same-sex couples previously reported.⁴ Consequently, more than one million individuals in same-sex marriages and domestic partnerships need guidance on federal tax questions.

¹ See National Taxpayer Advocate 2010 Annual Report to Congress 211, 215 (Most Serious Problem: *State Domestic Partnership Laws Present Unanswered Federal Tax Questions*).

² This issue is addressed by IRS, *Work Request Notification 20120622161808* (June 22, 2012) (modifying Form 8958, *Allocation of Tax Amounts Between Married Filing Separate Spouses, Same-Sex Spouses, or Registered Domestic Partners with Community Property Rights*).

³ See Marriage Equality Act, N.Y. Assembly Bill 8354 (2011) (effective 30 days after enactment on June 24, 2011); *Perry v. Brown*, 671 F.3d 1052 (9th Cir. 2012) (finding unconstitutional, pending further appeal, 2008 Calif. Prop. 8 ban on same-sex marriage); Maine Question 1 (referendum approved Nov. 6, 2012); Md. Sen. Bill 241, 430th Sess. (2012) (approved by referendum Nov. 6, 2012); Wash. Sen. Bill 6239, 62nd Leg. (2012) (approved by referendum Nov. 6, 2012); *Denmark Approves Same-Sex Marriage and Church Weddings*, BBC News, bbc.co.uk/news/world-europe-18363157 (June 7, 2012); John Lyons, *Brazil Top Court Grants Equal Rights to Same-Sex Unions*, WALL ST. J. (May 6, 2011); Del. Sen. Bill 30, 146th Gen. Assemb. (enacted May 11, 2011) codified at Del. Code Tit. 13, Ch. 2 (effective 2012); Ill. Religious Freedom Protection & Civil Union Act, Pub. Act No. 96-1513 (2011); R.I. House Bill 6103 (2011) (effective Jul. 1, 2011).

⁴ See Gary J. Gates & Abigail M. Cooke, *U.S. Census Snapshot*, Williams Inst., Univ. of Calif., L.A. (2010) 1, 3 (reflecting 131,729 and 514,735 same-sex marriages or other partnerships, respectively, 17 percent of which were raising their own children).

ANALYSIS OF PROBLEM

Background

The Defense of Marriage Act (DOMA) continues to prohibit federal recognition of same-sex marriages.⁵ Pending Supreme Court review, the First Circuit appellate court has held that “denial of federal benefits to same-sex couples lawfully married in Massachusetts has not been adequately supported by any permissible federal interest.”⁶ In a case recently affirmed by the Second Circuit, the Justice Department argued, and the trial court agreed, that “DOMA unconstitutionally discriminates” by effectuating a tax that otherwise “the estate would not have paid due to the marital deduction.”⁷

Assuming the current validity of DOMA, the IRS has yet to answer several questions. In response to the 2010 Report, the IRS took the position that guidance would be premature in a rapidly evolving landscape and unwarranted for an insignificant number of taxpayers. Nonetheless, the IRS has published guidance for relatively discrete populations.⁸ Moreover, in a 2011 letter to a taxpayer, the IRS Office of Chief Counsel (CC) treated Illinois opposite-sex civil union partners as married filing jointly,⁹ which DOMA presumably would not allow for same-sex partners. On the other hand, state and federal courts have indicated that partners are not “spouses” to whom DOMA would apply.¹⁰ Consequently, the federal tax status of partners is now unclear.

⁵ See 1 U.S.C. § 7, Pub. L. No. 104-199, 110 Stat. 2419 (1996).

⁶ *Massachusetts v. U.S. Dep’t of Health & Human Servs.*, 682 F.3d 1, 16 (1st Cir. 2012).

⁷ Defendant U.S.’ Memo. of Law in Response to Plaintiff’s Mot. for Summary Judgment and Intervenor’s Mot. to Dismiss at 1, *Windsor v. U.S.*, 833 F.Supp.2d 394 (S.D.N.Y. Aug. 19, 2011) (No. 10 Civ. 8435); *Windsor*, 833 F.Supp.2d 394 (holding DOMA unconstitutional for IRC § 2056 purposes), *aff’d* No. 12-2335 (2nd Cir. Oct. 18, 2012); see also *Pedersen v. OPM*, No. 3:10-cv-1750 (VLB) (D.Conn. Jul. 31, 2012) (holding DOMA unconstitutional).

⁸ See, e.g., Rev. Proc. 2010-41, 2010-48 I.R.B. 781 (including guidance for return preparers without a Social Security number due to religious objection); Rev. Proc. 2010-31, 2010-40 I.R.B. 413 (setting forth guidance on when a foreign adoption is final for parents who claim a tax credit for expenses of adopting a child); Notice 2010-30, 2010-18 I.R.B. 650 (containing guidance for military spouses who are civilians working in a U.S. territory but claiming residence in a state); Rev. Rul. 2004-71, 2004-2 C.B. 74 (applying IRC § 6402 refund offset to community property in Arizona and Wisconsin); Rev. Rul. 2004-72, 2004-2 C.B. 77 (applying refund offset to community property in California, Idaho, and Louisiana); Rev. Rul. 2004-73, 2004-2 C.B. 80 (applying refund offset to community property in Nevada, New Mexico, and Washington); Rev. Rul. 2004-74, 2004-2 C.B. 84 (applying refund offset to community property in Texas); Rev. Rul. 68-277, 1968-1 C.B. 526 (disregarding anti-miscegenation statutes as unconstitutional); Rev. Rul. 58-66, 1958-1 C.B. 60 (recognizing common-law marriage).

⁹ Gen. Info. Ltr. (Aug. 30, 2011) (“if Illinois treats the parties to an Illinois civil union who are of opposite sex as husband and wife, they are considered ‘husband and wife’ for purposes of Section 6013 of the Internal Revenue Code, and are not precluded from filing jointly”).

¹⁰ See *Smelt v. Orange County*, 447 F.3d 673 (9th Cir. 2006) (denying standing to challenge DOMA by partners who “are not in a relationship that has been dubbed marriage by any state, much less by the State of California”) *cert. den’d* 549 U.S. 959 (2006); *Bishop v. Okla.*, 447 F. Supp. 2d 1239, 1247 (N.D. Okla. 2006) (denying partners standing to challenge DOMA even though state statute grants a civil union “all the same benefits, protections and responsibilities under law” as marriage, because “a Vermont civil union is not the equivalent of a marriage”), *rev’d & remanded* on other issue 333 Fed. Appx. 361 (10th Cir. 2009); *Strauss v. Horton*, 46 Cal.4th 364, 445 (2009) (“the designation of ‘marriage’ is, by virtue of the new state constitutional provision, now reserved for opposite-sex couples”); *Knight v. Schwarzenegger*, 26 Cal.Rptr.3d 687, 690 (2005) (“domestic partners act did not constitute an amendment of the defense of marriage initiative”).

The IRS Has Released Informal Guidance that Addresses Some Questions About Domestic Partner and Same-Sex Spousal Taxation.

The IRS Answered Questions TAS Posed

While professing that guidance would be premature, the IRS nevertheless posted questions & answers (Q&As) on its website, IRS.gov, addressing some questions specifically posed by the 2010 Report in the context of a discussion of same-sex couples in community property states. Curiously, these Q&As “for Registered Domestic Partners (RDPs) in Community Property States and Same-Sex Spouses in California” purported to be limited geographically, while buried on the website at an uncertain level of authority.¹¹ As currently updated, the Q&As are not limited to California, although they still do not constitute formal rule-making. At this point, the Q&As have answered two questions from the 2010 Report:¹²

*[Q] Does a parent-child relationship persist even if DOMA disregards the parent’s marriage?*¹³

[A] “If a same-sex partner is the stepparent of his or her partner’s child under the laws of the state in which the partners reside, then the same-sex partner is the stepparent of the child for federal income tax purposes.”¹⁴

*[Q] Is a domestic partner or same-gender spouse in a community property state deemed to provide, for dependency purposes, the support that he or she earns?*¹⁵

[A] “A registered domestic partner can be a dependent of his or her partner if the requirements of sections 151 and 152 are met. However, it is unlikely that registered domestic partners will satisfy the gross income requirement of section 152(d)(1)(B) and the support requirement of section 152(d)(1)(C). * * * ”¹⁶

The IRS Answered Additional Questions and Raised Others

Further, the IRS addressed the following question, which the 2010 Report did not pose:

[Q] “Are registered domestic partners each entitled to take credit for half of the total estimated tax payments paid by the partners?”

¹¹ Sept. 16, revised Nov. 16, 2011.

¹² As updated August 4, 2012, IRS.gov features three linked articles: *IRS Provides Answers to Community Property Filers*, <http://www.irs.gov/uac/IRS-Provides-Answers-to-Community-Property-Filers>; *Answers to Frequently Asked Questions for Same-Sex Couples*, <http://www.irs.gov/newsroom/article/0,,id=258326,00.html> [hereinafter *FAQs*] (listing eight FAQs); *Questions and Answers for Registered Domestic Partners and Same-Sex Spouses in Community Property States*, <http://www.irs.gov/uac/Questions-and-Answers-for-Registered-Domestic-Partners-and-Same-Sex-Spouses-in-Community-Property-States> [hereinafter *Q&As*] (listing 21 Q&As).

¹³ National Taxpayer Advocate 2010 Annual Report to Congress 211, 215.

¹⁴ FAQs, *supra* note 12, at 8th FAQ.

¹⁵ National Taxpayer Advocate 2010 Annual Report to Congress 211, 215.

¹⁶ Q&As, *supra* note 12, at 3rd Q&A.

[A] “Unlike withholding credits, which are allowed to the person who is taxed on the income from which the tax is withheld, a registered domestic partner can take credit only for the estimated tax payments that he or she made.”¹⁷

While the Q&As confirm, as a matter of federal tax law, allocation of withholding credit to the partner taxed under state community property law, the IRS has rejected e-filed returns where the withholding exceeds that on Forms W-2. For example, a California domestic partner may have to file as single for federal tax purposes but nonetheless pay tax on half her partner’s earnings. Accordingly, the taxpayer may claim credit for the requisite withholding on the partner’s, rather than her own, Form W-2. However, IRS systems have not been able to connect the taxpayer’s return with the partner’s Form W-2 because they are not married, resulting in automatic, electronic rejection. To avoid this problem, the IRS needs to establish a process that will allow e-filing.¹⁸ Consequently, revisions of the relevant forms to cross-reference partner returns are pending in the IRS.

Although the informal guidance solves some problems that have arisen since 2010, it raises even more questions about others. For example, a frequently asked question (FAQ) clarifies the application of the adoption credit to same-sex parents:

[Q] “If a taxpayer adopts the child of his or her same-sex partner as a second parent or co-parent, may the taxpayer (“adopting parent”) claim the adoption credit for the qualifying adoption expenses he or she pays or incurs to adopt the child?”

[A] “Yes. The adopting parent may claim an adoption credit to the extent provided under the law. The law does not allow taxpayers to claim an adoption credit for expenses incurred in adopting the child of the taxpayer’s spouse. However, this limitation does not apply to adoptions by same-sex partners because same-sex partners, even if married for state law purposes, are not treated as spouses under federal law.”¹⁹

On the other hand, a Q&A takes a controversial legal position:

[Q] “How should registered domestic partners report Schedule C [Profit or Loss from Business (Sole Proprietorship)] income that is community property?”

[A] “Half of the income, deductions, and net earnings of a business operated by a registered domestic partner must be reported by each registered domestic partner on a Schedule C (or Schedule C-EZ). In addition, each registered domestic partner owes self-employment tax on half of the net earnings of the business. Although the self-employment tax rules contain a provision that overrides community income

¹⁷ Q&As, *supra* note 12, at 9th Q&A.

¹⁸ On rejected e-filing, see *supra* Most Serious Problem: *Despite Some Improvements, the IRS Continues to Harm Taxpayers by Unreasonably Delaying Processing of Refunds that Trigger Systemic Filters.*

¹⁹ FAQs, *supra* note 12, at 6th FAQ.

treatment in the case of spouses (section 1402(a)(5) of the Internal Revenue Code), this provision does not apply to registered domestic partners.”²⁰

Sole proprietors do not split self-employment income, even in community property states, under a general definition that this is “the gross income derived by an individual from any trade or business carried on by such individual.”²¹ Specifically, the law indicates that business income that is community property shall be treated as that “of the spouse carrying on such trade or business.”²²

Literally, this provision would not apply to same-sex couples, who cannot be recognized as spouses under DOMA, even if they have community property. Yet the general rule still would impose self-employment tax only on the individual carrying on the business. In a peculiar twist of logic, the IRS appears to have concluded that because the specific provision for spouses does not apply, an opposite result — rather than the general rule — prevails.

Historically, the specific spousal provision had contained a presumption in favor of the husband as owner of business income that courts struck as unconstitutional in 1980.²³ In the absence of an operative spousal provision, the IRS then ruled that business income under community property belonged to “the person carrying on the trade or business.”²⁴ In 2004, Congress effectively codified this result.²⁵ It is unclear why the IRS could not issue a similar ruling now that same-sex partners are in an analogous position in which the spousal provision is inoperative for them. Even if the IRS will not issue a similar ruling, it remains unclear why a Q&A, rather than authoritative rulemaking, would be the proper means to resolve this legal interpretation.²⁶ Instead, commentators have complained about the current anomaly in which a same-sex community property owner is uniquely subject to self-employment tax even if not working in the business.²⁷

Taxpayers Need Further Guidance.

While the IRS has answered several questions, a few specific questions from the 2010 Report remain outstanding:

“Is alimony under state domestic partnership or same-sex marriage law includible by the recipient and deductible by the payer?”

²⁰ Q&As, *supra* note 12, at 7th Q&A.

²¹ IRC § 1402(a).

²² IRC § 1402(a)(5).

²³ See *Carrasco v. Sec’y of Health, Educ’n & Welfare*, 628 F.2d 624, 629 n. 7 (1st Cir. 1980).

²⁴ Rev. Rul. 82-39, 1982-1 C.B. 119.

²⁵ See Pub. L. No. 108-203.

²⁶ On vehicles for legal guidance, see 26 C.F.R. § 601.201.

²⁷ See *Practitioner Group Seeks Revisions to Publication on Community Property*, 2011 TAX NOTES TODAY 48-15 (Mar. 2, 2011).

“Is community property created upon marrying or partnering with an individual of the same sex a taxable gift?

“Do same-sex tenants by the entirety have a qualified joint interest for estate tax purposes?”²⁸

Meanwhile, the following issues have arisen or remain unanswered: How can an insurance company comply with federal tax law concerning favorable pay-outs from annuity contracts or qualified plans to surviving spouses in a state that recognizes same-sex marriage?²⁹ A state insurance commissioner could preclude an insurance company from offering contracts or plans that would discriminate against same-sex spouses recognized in the state.³⁰ However, a non-discriminatory contract or plan could run afoul of DOMA for federal tax purposes.

Another question arises if a court places a child with the parent’s same-sex partner — who may be precluded from adoption in certain states. Would that come within the definition of “eligible foster child,” meaning “an individual who is placed with the taxpayer by . . . judgment, decree, or other order of any court of competent jurisdiction” for tax dependency purposes?³¹ Literally, a court may place the child, if not with a traditional foster parent, with a same-sex parent. Thus, the terms of the definition could apply to changing social and legal circumstances. Currently, the only reason to deny the dependency deduction would be failure to recognize the parental role of the partner. In short, ongoing questions require further guidance.

The IRS Should Prepare for Questions.

While commentators may perceive any guidance as partisan, taxpayers need clarity, which they may prefer over uncertainty even if the result is unfavorable. Uncertainty leads to taxpayer burden, disputes, and litigation, ultimately eroding compliance and confidence in the IRS.³²

The Supreme Court has granted a *writ of certiorari* concerning same-sex marriage for a potential decision in the summer of 2013.³³ Although questions may be premature, taxpayers are already asking what happens if DOMA lapses. If the Supreme Court finds a constitutional flaw in the statute, would that finding be retroactive? Could same-sex spouses

²⁸ National Taxpayer Advocate 2010 Annual Report to Congress 211, 215. As cited above, the Justice Department has argued, and the courts have agreed, that an estate tax arising only if the surviving spouse is the same sex as the decedent represents unconstitutional discrimination. See *Windsor v. U.S.*, 833 F.Supp.2d 394 (S.D.N.Y. 2012), *aff’d* No. 12-2335 (2nd Cir. Oct. 18, 2012).

²⁹ See IRC §§ 72(s) & 401(a)(9) (generally allowing spouses longer deferral than other beneficiaries).

³⁰ See Mark E. Griffin, *Conflicting Definitions of “Spouse” Under DOMA and State Law*, 6 TAXING TIMES (Soc’y of Actuaries) 13, 15 (May 2010).

³¹ See Fla. Stat. § 63.042(2)(a) (limiting joint adoption to husband and wife); Miss. Code § 93-17-3 (disallowing adoption by same-sex couples); Utah Code § 78B-6-117 (prohibiting adoption “by a person who is cohabiting in a relationship that is not a legally valid and binding marriage”); IRC § 152(f)(1)(C) (defining “eligible foster child”).

³² See Scott James, *From IRS to Gay Couples, Headaches and Expenses*, NY TIMES (June 12, 2011).

³³ See Adam Liptak, *Supreme Court to Take up Gay Marriage*, NY TIMES (Dec. 7, 2012).

amend their returns to file jointly? Conversely, would same-sex spouses who had avoided federal marriage penalties be held harmless? What would be the federal filing status of same-sex spouses legally married in one state but residing in a different state that does not recognize their marriage?³⁴ Either way that the Supreme Court rules on DOMA, there will be federal tax questions.

CONCLUSION

In an evolving legal landscape, the IRS has issued answers about domestic partners and same-sex spouses, but more questions have arisen. Despite requests, the IRS has yet to publish comprehensive, authoritative guidance. Failure to render guidance on the fundamental question of the taxable unit of more than one million individuals impairs tax administration.³⁵ In conclusion, the National Taxpayer Advocate again recommends that the IRS publish clarifying guidance, rules, and regulations when taxpayers need answers.

³⁴ Cf. Rev. Rul. 58-66, 1958-1 C.B. 60 (recognizing common-law marriage of taxpayers “who later move into a state in which a ceremony is required to initiate the marital relationship”); Restatement of Conflict of Laws § 121 (stating general rule that marriage is valid if recognized where celebrated).

³⁵ See Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389 (1975) (discussing fundamental questions of taxation of the family unit).