Estate Planning for the Unmarried Couple/Non-Traditional Family (With Forms) (Part 2)

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Part 1 of this outline appeared in the December 2005 issue and covered ethical issues of joint representation, same-sex marriage, the Defense of Marriage Act, and practices to ensure that property is distributed appropriately.

E. Methods to Minimize Taxes

1. Defining the Rights of Unmarried Partners to Jointly Owned Property

   A. General Federal Estate and Gift Tax Considerations

      I. The rules allowing transfers between spouses to avoid transfer or income taxes do not apply to unmarried couples. Internal Revenue Code ("Code") §§2056(a), 2523(a), and 1041. (All section references are to the Code unless otherwise indicated.) Accordingly, any transfers between partners may be taxable (subject to the section 2503(b) annual exclusion, the donor’s available applicable exclusion, and the exclusion from gift tax for tuition and medical expenses under section 2503(e)).

   B. Indirect Gifts Arising from Pooled Expenses

      I. The value of taxable gifts between unmarried partners becomes difficult to quantify in the context of shared living expenses. When partners pool income and one party receives more income than the other, pooling may cause a net transfer to the party with less income, resulting in a taxable gift. This result may be partially
ameliorated by entering into a contractual arrangement between the partners providing for mutual and adequate consideration. The amount of the gift is the difference between the value of the property transferred and the consideration received. §251.2(b). However, the exchange of consideration sufficient to make a promised transfer enforceable for state contract law purposes will not necessarily prevent some part of the transfer from being a gift for federal tax purposes, unless the transferor receives consideration having an economic value equal to the property transferred.

II. To the extent a net transfer from the greater income earner to the lower income earner is viewed as being paid in consideration for the lower income earner’s love, emotional support, or other services upon which a monetary value may not be placed, the transfer is a gift.

III. If the contractual arrangement provides that the net transfer from the higher income earner to the lower income earner is an advance to be repaid upon the happening of some event (for example, the lower income partner finishing school, or becoming gainfully employed, or the higher income partner retiring), the couple will be treated as being in a debtor-creditor relationship. These types of arrangements should be avoided unless the loan provides for adequate stated interest and the advanced sums will actually be repaid. Sections 163(h), 1274, and 7872 address below-market interest and gift loans by imputing interest income in the amount of the applicable federal rate to the creditor, taxing the creditor as making a gift of the interest, and denying the debtor’s interest deductions. If the debt is never repaid, Section 61(a)(12) treats the amount advanced as income to the debtor from the discharge of indebtedness. Section 7872(c)(2)(A) of the Code provides a de minimis exception for gift loans between individuals for amounts of $10,000 or less. Thus, generally, for smaller loans, there is neither imputed interest nor a taxable gift.

C. Joint Tenancies. Joint tenancy ownership of assets is one of the most popular estate planning devices for unmarried couples. When contributions by both parties are equal, and when the intentions of both parties with regard to management and disposition of the assets are identical, joint tenancy is an efficient and economical estate planning tool. Joint tenancy in the nontaxable estate may avoid the need for disclosure to family members at the time of the disposition.

1. Joint Tenancy May Result in an Unintended Gift

(1) For the client with a taxable estate, joint tenancy can result in unintended consequences. When an asset, such as a house, is purchased in joint tenancy, if the parties contribute equally to the purchase, then acquiring the asset in joint tenancy is not a taxable event. However, if one partner purchases or contributes to an asset
(OTHER THAN A BANK ACCOUNT OR U.S. BONDS), AND HAS IT CONVEYED TO
HIMSELF AND HIS PARTNER IN JOINT TENANCY WITH RIGHT OF SURVIVORSHIP,
THEN THE PURCHASE CONSTITUTES AN IMMEDIATE GIFT OF THE VALUE OF THE
TRANSFER IN EXCESS OF THE ANNUAL EXCLUSION. TREAS. REG. §
25.2511-1 (H)(5), AND CODE §2503(B).

(2) UPON THE DEATH OF ONE JOINT TENANT, THE ENTIRE VALUE OF
THE 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 ACQUISITION OF THE ASSET. §2040(A). THE BURDEN OF
PROOF IS ON THE TAXPAYER AND MAY BE DIFFICULT TO SUSTAIN WITHOUT
METICULOUS RECORD KEEPING. IF CLIENTS INTEND TO OWN REAL PROPERTY IN
JOINT TENANCY, THEY SHOULD DOCUMENT THEIR INTENTIONS; THEIR
CONTRIBUTIONS TO POINTS; AND THE DOWN PAYMENT, MORTGAGE PAYMENTS, AND
HOME IMPROVEMENTS.

(3) THERE IS AN EXCEPTION TO THE PRESENT GIFT RULE FOR JOINT
BANK ACCOUNTS AND U.S. BONDS: THE TRANSFER, AND THUS A COMPLETED GIFT,
DOES NOT OCCUR UNTIL THE JOINT HOLDER WRONGFULLY REMOVES MONEY FROM THE
ACCOUNT. TREAS. REG. §25.2511-1 (H)(4).

II. NON-TAX DISADVANTAGES OF JOINT TENANCIES

(1) IN ADDITION TO THE TAX DISADVANTAGES, THERE ARE OTHER
PROBLEMS WITH JOINT TENANCIES. UNDER SOME STATE STATUTES, A JOINT
OWNER OF A BANK ACCOUNT CAN WITHDRAW THE OTHER PARTY’S MONEY FROM
THE ACCOUNT WITHOUT THE PARTY’S CONSENT OR KNOWLEDGE. SEE, E.G., RCW
30.22.110. THIS COULD BE AVOIDED BY REQUIRING TWO SIGNATURES ON AN
ACCOUNT. WASHINGTON DOES NOT HAVE A STATUTORY EQUIVALENT TO RCW
30.22.110 APPLICABLE TO SECURITIES ACCOUNTS. REVENUE RULING 69-148,
1969-1 C.B. 226, PROVIDES THAT A JOINT TENANCY SECURITIES ACCOUNT
CONSTITUTES A COMPLETED GIFT EXCEPT WHEN THE ACCOUNT AGREEMENT
allows the donor to remove assets from the account without the
consent of the donee. Thus, unless an account agreement allows for a
UNILATERAL WITHDRAWAL, A SECURITIES ACCOUNT DOES NOT CONSTITUTE A
COMPLETED GIFT.

(2) ASSETS TITLED JOINTLY, SUCH AS REAL ESTATE, STOCK, OR A
MOTOR VEHICLE, CANNOT BE SOLD WITHOUT THE CONSENT OF BOTH JOINT
OWNERS. THIS PROTECTS THE OWNERS, BUT IT ALSO OFTEN RESULTS IN A
DEADLOCK BETWEEN PARTNERS ON THE APPROPRIATE DISPOSITION OF AN ASSET.

(3) SOME PRACTITIONERS RECOMMEND THAT PARTNERS ESTABLISH A
PARTNERSHIP OR LIMITED LIABILITY COMPANY TO TAKE TITLE TO A HOME, TO
FACILITATE ACCURATE RECORD KEEPING, AND ALSO TO PROVIDE PROTECTION
AGAINST A CREDITOR OR A PARTNER FORCING PARTITION. BUT USING AN ENTITY
FOR A PRINCIPAL RESIDENCE ACQUISITION WILL PREVENT THE PARTNERS FROM
USING THE EXCLUSION FOR CAPITAL GAIN ON SALE UNDER SECTION 121.
(SECTION 121 PERMITS EXCLUSION OF UP TO $250,000 OF GAIN BY AN
2. ADULT ADOPTION

A. PURPOSE OF ADULT ADOPTION

I. One method by which same-sex couples have sought to obtain some certainty with respect to their estate planning intentions is to have one partner adopt the other. There are several motivations behind this planning technique, including establishing a family relationship for purposes of entitlements and other benefits (e.g., social security, health insurance, survivor benefits), desiring to create a legal bond with another individual, and establishing a legal heir and secure inheritance rights. See Gwendolyn L. Snodgrass, Creating Family Without Marriage: The Advantages and Disadvantages of Adult Adoption Among Gay and Lesbian Partners, 36 Brandeis J. Fam. L. 75 (1997-1998).

Because estate intestacy laws do not allow for the distribution of a decedent partner's estate to his or her surviving partner, some unmarried couples resort to adoption, rather than rely solely upon other more conventional estate planning techniques.

II. The effectiveness of this technique varies from jurisdiction to jurisdiction. Adult adoptions may provide an effective means of nullifying the status as heirs of the adopter's relatives so that they are without standing to contest an assignment of property. Considering the frequency of challenges by relatives claiming that a decedent's partner exerted undue influence over the decedent, the adoption strategy appears attractive to many unmarried partners. For information concerning adoption in Washington, see Washington Family Law Deskbook, ch. 60 (Wash. State Bar Assoc. 2d ed. 2000).

III. Another reason an adult may wish to adopt a partner is to bring the adoptee within the class of beneficiaries under a pre-established estate planning instrument. One partner may be a beneficiary of a trust providing for distribution of her share to her descendants upon her death, but if she has none, then to some other specified group of individuals. In this case, adoption may bring the partner into the permissible class of recipients of the trust share upon the death of the current income beneficiary. Before reaching the conclusion that adoption will bring an individual into a class of beneficiaries, there must be a careful examination of the dispositive intent set forth in the instrument.

IV. The statutory treatment of adoption differs from state to state. Not all states permit adult adoption, and some require the adoptee to be younger than the adopter. The possibility of prosecution
For incest in the applicable state should also be considered before opting for this planning method. Washington's incest statute, RCW 9A.64.020, applies to adopted descendants younger than the age of 18. But see Restatement (Second) of Conflict of Law §290 cmt. C (ALI 1971) (providing that a state may disallow inheritance in connection with out-of-state adoption when inheritance would violate strong local public policy); Restatement (First) of Conflict of Law §143 cmt. A, illus. (1934) (providing an example when adoption in one state will not be recognized for inheritance purposes in another state that does not permit such adoption).

V. It is important to carefully consider who will adopt from whom. The partner who is likely to die first should be the adopter. Another concern is that an adoptee loses the right to inherit by intestacy from biological relatives. Adult adoption also triggers income tax considerations such as dependency exemptions and head of household status that should be considered, and clients need to understand that it is unlikely that an adoption may later be revoked or renounced once final.

B. Estate planning opportunities following the adoption of a partner—transfers of a trade or business, many estate planning opportunities arise once a partner has been adopted. Two particularly notable techniques are discussed below:

I. Special valuation rules of Section 2032A

(1) Section 2032A provides a special valuation rule for real property used in farming or a trade or business, with a maximum reduction in value of $870,000 in 2005. Section 2032A allows the qualified real property to be valued at its actual use, rather than its highest and best use. To qualify, the “decedent or a member of the decedent’s family” must have owned and used the property for the qualifying use before death, the property must pass to a “member of the decedent’s family,” and the property must continue to be used for the qualifying use by a “member of the decedent’s family.” §2032A(b). Members of the decedent’s family are defined as including: (i) an ancestor; (ii) the decedent’s spouse; (iii) a lineal descendant of the decedent, the decedent’s spouse, or the decedent’s parents; or (iv) the spouse of such lineal descendants. §2032A(e)(2). Although the definitions of Section 2032A are based on legal relationships, and therefore do not recognize informal relationships, they do include adopted children, stepchildren, sons- and daughters-in-law, and half-blood relations. Id. Thus, Section 2032A may provide planning opportunities to non-traditional families in the right circumstances.

II. Section 6166 election to pay estate taxes on qualified businesses in installment.