ESTATE PLANNING FOR NONTRADITIONAL FAMILIES

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I. FUNDAMENTALS.

For the last fifteen years or so,[1] written materials I have offered regarding this subject matter have been styled "estate planning for unmarried couples." In 2013, however, the legal landscape for same-sex couples has been transformed completely enough that it has eclipsed my attempts to categorize or contain the subject matter in a caption or a title for a presentation. "Estate planning for nontraditional families" will have to do for now. By this terminology, I intend to include not only same-sex couples who are married, in registered domestic partnerships, or in civil unions, but also those same-sex and opposite-sex couples who choose not to marry or who legally cannot marry.

By mid-2013, many state and federal judicial and legislative changes in the law (amid, perhaps as importantly, unrelenting media attention) redefined who can marry, as well as the law governing civil unions and registered domestic partnerships, and the recognition or non-recognition by one jurisdiction of marriages solemnized in another jurisdiction. http://www.nclrights.org/wp-content/uploads/2013/07/Relationship_Recognition.pdf As of this writing, same-sex couples may marry in fifteen states and the District of Columbia. http://www.nclrights.org/wp-content/uploads/2013/07/Relationship_Recognition_State_Laws_Summary.pdf Meanwhile, in the aftermath of the U.S. Supreme Court's decision in *United States v. Windsor*[2] declaring unconstitutional a portion of the federal Defense of Marriage Act, federal agencies (and, to some extent, private employers, educational institutions, health care providers, lenders, asset custodians, and others) are formulating policies to implement the updated meaning of "marriage" under federal law and to identify the marital status of those whose lives they touch.

Thus, the term "unmarried" has conclusively been rendered insufficiently specific to be useful in describing groups of couples with similar estate planning concerns. Indeed, same-sex couples who marry in so-called "recognition states" may now be positioned in a way that is nearly identical to their opposite-sex married counterparts. The situation for those couples who marry in recognition states and reside in or relocate to non-recognition states is far more complex, both for the married couples themselves and for their employers, health care providers, lenders, and others.

In the meantime, while same-sex couples now marry in various jurisdictions, households made up of unmarried and unrelated adults have not disappeared. Far from it. Over the last thirty or forty years, naturally enough, the increase in American households made up of unmarried

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[1] But not "ever since the Roosevelt administration[,]" as some have uncharitably claimed.

[2] 570 U.S. ____, 133 S.Ct. 2675; 2013 U.S. LEXIS 4935

and unrelated adults has led to increased demand for estate planning arrangements that meet their unique needs. It is useful to survey the available estate planning techniques for unmarried and unrelated adults and to contrast them with familiar techniques for married couples.

In the immediate legal environment regarding marriage recognition, we must address many complexities created by changes in circumstances as well as changes in state and federal marriage recognition laws. Unlike opposite-sex married couples, who enjoy relative uniformity of the laws of different jurisdictions as to their marital status and its effects (with, among American jurisdictions, the notable exception of community property law), the effect of a same-sex couple's marriages can differ across time, across state or national borders, and across areas of law. What is the legal effect of the marriage of a same-sex couple? What is the effect of a married same-sex couple's relocation to a new state of residence? What is the effect of a marriage that is recognized for most (but not all) federal law purposes and for purposes of the law of the state of celebration of the marriage, but not (as in Arizona) under the law of the state where the couple resides?

Some of these challenges are familiar to advisers working with opposite-sex couples who marry. For example, advisers of same-sex couples will now be called upon to consider the effect of prenuptial agreements and the impact of state community property laws. Other legal concerns are unique to same-sex couples. For example, how will advisers structure prenuptial agreements for couples whose marriages are recognized by the states in which they were solemnized, as well as by the federal government for some purposes, but not by the state in which the couples resides?

Changes in state laws establishing same-sex domestic partner registry or recognizing same-sex marriage have created an ever-shifting legal landscape for same-sex couples, and the recent changes in federal law recognizing such marriages creates an intricate overlay for analysis by those advising same-sex couples. Shifting state law on same-sex marriage and on recognition of same-sex marriages entered into in other states or countries, as well as the extent to which federal agencies implement policies recognizing same-sex marriages that are legal under state law, have created a minefield for couples attempting to navigate the legal and tax implications of how the law treats their relationships.

Another remarkably complex array of rules in the immediate legal environment regarding same-sex marriage is the law of where same-sex married couples can divorce. http://www.nclrights.org/wp-content/uploads/2013/07/Divorce_in_DOMA_States_Attorney_Guide.pdf Such questions, along with even more complex questions regarding adoption, child custody, child support, and related family matters involving same-sex couples (married or otherwise) are beyond the scope of these materials.

II. GENERAL ESTATE PLANNING CONCERNS FOR DOMESTIC PARTNERS.

These materials will discuss a variety of planning techniques, often by describing their use in what I will now regard as "traditional" planning for same-sex couples and other couples who had chosen not to marry, and then describing how and when to terminate or unravel such planning techniques. It will become commonplace to identify planning techniques that were created by or for unmarried couples who later marry and whose marriages will be recognized for relevant purposes. Advisers will find themselves recommending that some of those planning techniques are no longer necessary due to the marriage. With respect to certain estate tax reduction techniques that will be discussed herein, advisers will find that such techniques are obviated either by the marriage of previously unmarried domestic partners or by the dramatic increase in the federal estate tax lifetime exclusion in recent years.

Estate planning for unmarried couples, whether it be for same-sex couples or opposite-sex couples (collectively referred to herein as "domestic partnerships"), often involves planning for substantial bequests or trust distributions to the survivor of the persons involved in the domestic partnership (referred to herein as "domestic partners"). Although many estate planning issues and federal estate tax reduction strategies applicable to domestic partners are identical to those for married taxpayers, other issues arise only in planning for domestic partners. Further, some other techniques can be used for domestic partners that are not applicable to married taxpayers.

Prior to the U.S. Supreme Court's ruling in *Windsor v. U.S.*, declaring unconstitutional the federal Defense of Marriage Act, that federal law's express nonrecognition of legally-solemnized same-sex marriages had created complications for couples whose marriages were recognized for state law purposes but not for federal law purposes. If anything, now that federal law no longer ignores same-sex marriages solemnized under the law of recognition states, such complications are replaced by far greater complications for those couples whose marriages are now recognized for some federal law purposes but not under the laws of their state of residence.

For purposes of prior iterations of these materials, I have long referred to "domestic partnerships" and "domestic partners" as including those same-sex couples who are legally married under state law. Such terminology, while inexact, suitably reflected for the purposes of prior iterations of these materials that such marriages were not recognized under federal law for tax purposes or for nearly any other purpose. Now, in these newly revised materials, I can only use the terms "domestic partnerships" and "domestic partners" to refer to couples who are not legally married in any jurisdiction. Henceforth, and in particular due to the unconstitutionality of the federal Defense of Marriage Act, marriage is a legally significant status for all same-sex married couples, even for those residing in non-recognition states. Prior to the unconstitutionality of the federal Defense of Marriage Act, such same-sex marriages were widely regarded as largely symbolic in nature for those same-sex couples residing in non-recognition states. The fact of their marriages had little or no impact on their relationship to one another for legal or tax purposes.

Despite the growing population of unmarried adults, private companies, courts, and law-makers have been reluctant to recognize cohabiting unmarried adults as a family unit, whether for political, moral, fiscal, or religious reasons. For example, spouses of persons covered by most public and private employer-provided health insurance policies are entitled to health insurance benefits as a result of their married status, generally without income tax consequences to the employed spouse. By contrast, domestic partner health insurance benefits are being implemented slowly, only by a few governmental and certain private employers, and with largely unfavorable tax consequences to both employer and employee.

To offer other examples, while spouses are entitled to bring wrongful death actions under most states' laws in the event of their spouse's death due to the negligence of another,[3] unmarried domestic partners (except where registered under state law, as in California) may not do so. Further, state intestacy laws invariably provide inheritance rights to the spouses of intestate

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[3] *See, e.g.*, Arizona Revised Statutes Section 12-612, which provides that "[a]n action for wrongful death shall be brought by and in the name of the surviving husband or wife or personal representative of the deceased person for and on behalf of the surviving husband or wife, children or parents, or if none of these survive, on behalf of the decedent's estate." Accordingly, a domestic partner of a decedent can bring an action for wrongful death only if he or she has been named in the decedent's Will *and* if the decedent is not survived by children or parents.

decedents,[4] while domestic partners of decedents do not have such rights.[5] Accordingly, same-sex domestic partners residing in non-recognition states (or opposite-sex domestic partners who choose not to marry) must implement testamentary or contractual mechanisms to accomplish estate transfer results that would be automatic for many married persons. Nowadays, same-sex domestic partners residing in recognition states have the additional option of marrying.

Perhaps most importantly, the Internal Revenue Code[6] does not specifically address the tax consequences of domestic partnership, even though it now observes a "place of celebration" rule with respect to married same-sex couples for all federal tax purposes. Unmarried domestic partners cannot take advantage of the federal estate and gift tax marital deduction provisions of the Code,[7] or the federal gift tax provisions regarding gift-splitting.[8] Both married couples and unmarried domestic partners can avail themselves of the federal gift tax annual exclusion[9] (currently $14,000 per donee per year) and the federal gift and estate tax applicable exclusion amount ($5,250,000 for gifts and $5,250,000 for decedents dying in 2013). However, many other estate tax reduction techniques are available only to married couples. Notably, the federal gift and estate tax unlimited marital deduction affords married couples (but not domestic partners or anyone else) the ability to transfer unlimited amounts of property to one another during life or at death without federal transfer tax consequences. Also, spouses (but not domestic partners) can make gifts of income interests in property to each other through inter vivos or testamentary QTIP trusts or through inter vivos or testamentary charitable remainder unitrusts, all without federal gift or estate tax consequences.

As noted above, federal estate tax reduction planning under current law is now relevant only to those unmarried couples in which one or both taxpayers expect to leave a taxable estate in excess of $5,250,000, a much higher exemption than what had been available under prior federal estate tax law. Those relatively few high-net-worth same-sex unmarried couples who would be impacted by federal estate tax liability would now do well to analyze whether, when, and where to marry, now that the U.S. Department of the Treasury and the Internal Revenue Service have

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[4] *See, e.g.*, A.R.S. Section 14-2102.

[5] *See, e.g.*, A.R.S. Section 14-2103. *But see* Sections 6401 and 6402 of the California Probate Code, extending partial inheritance rights to domestic partners who have registered with the State of California.

[6] References in this paper to "the Internal Revenue Code" or "the Code" are to the Internal Revenue Code of 1986, as amended. All section references herein are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated. Historically, interpretation of the Internal Revenue Code has relied on state law for a determination of whether a particular taxpayer is "married" for tax purposes. The U.S. Supreme Court ruling in *United States v. Windsor* specifically considered the application of the federal Defense of Marriage Act, 28 U.S.C.A. § 1738C, which had prevented the IRS from recognizing same-sex marriage for federal estate tax marital deduction purposes, and declared a portion of the statute unconstitutional.

[7] 26 U.S.C.A. Sections 2053 and 2523.

[8] 26 U.S.C.A. Section 2513.

[9] 26 U.S.C.A. Section 2503(b).

determined that same-sex married couples will be treated as married based on the law of the jurisdiction in which the marriage was solemnized (a so-called "place of celebration" rule), as opposed to the law of the state in which the couple resides.10 Such high-net-worth married couples may have relatively few legal incentives to marry under current law, other than the specter of significant federal tax savings; their relative financial freedom may render them far less reliant than most Americans on such federal benefits as Social Security, Medicare, Veterans Administration benefits, and the like, that would be impacted by marriage.

Spouses further benefit from the laws of the various states regarding community property,[11] tenancy by the entirety, intestacy, spousal exempt property and allowances,[12] and the like. Such benefits are now being extended to same-sex couples who marry in recognition states and to same-sex and opposite-sex domestic partners where provided by law.

Advisers in community property states must anticipate, along with the advent of same-sex marriage recognition, an increased incidence in couples who marry, after having have lived together as domestic partners for many years, perhaps for decades. Such couples may or may not be accustomed to regarding their collective income and assets as combined or joint, or the functional equivalent of community property, during the period of their cohabitation. Those couples who are not in the habit of thinking of their respective assets, income, and debts as being common or joint may benefit greatly from advice regarding the effect of community property law with respect to the portion of their income and assets that accrues after the marriage. Some such couples in community property states may, in fact, choose not to marry because of the effect of community property law on their respective assets or, perhaps more dramatically, on their respective debts.

An important area in tax planning for domestic partners relates to the designation of beneficiaries of qualified retirement plans and IRAs, as well as the rules governing taxation of distributions from retirement plan accounts and IRAs of deceased retirement plan participants or IRA beneficiaries to their surviving unmarried domestic partners. Importantly, most (but not all) of the valuable tax benefits from the deferral of distributions from qualified plans and IRAs are available only to widows and widowers of retirement plan participants and IRA beneficiaries, and not to the domestic partners, children, or other death beneficiaries of the retirement plan participant or IRA beneficiary. In recent years this inequity was alleviated somewhat by changes in the retirement plan laws liberalizing the inherited IRA rules to create a more level playing field as between spouse beneficiaries and nonspouse beneficiaries of retirement plan participants.

With regard to the qualified retirement plan benefits distributable to the same-sex spouses of plan participants, lawyers and courts will enjoy analyzing some fascinating choice-of-law

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10 Rev. Rul. 2013-17. The term "spouse" is defined broadly in the ruling to include all same-sex marriages that were performed in a domestic or foreign jurisdiction having the legal authority to sanction marriages – the "place of celebration" principle – without regard to the state law where the spouse is domiciled. The decision is effective prospectively as of September 16, 2013 (with an optional retroactive effective date for payroll and tax refunds within the statute of limitations). The IRS also promises to issue additional guidance regarding the impact on qualified plans, cafeteria plans, and a streamlined payroll refund process for employers, and issues surrounding possible retroactivity.

11 *See, e.g.*, A.R.S. Section 25-211.

12 *See, e.g.*, A.R.S. Sections 14-2402, 14-2403.

questions, while surviving same-sex spouses and other plan beneficiaries grapple with unexpected swings in the substantive results in particular cases. Relevant choice-of-law questions include (i) which state law governs whether the participant and his or her spouse are legally married for federal law purposes and (ii) which state law governs the administration of retirement plans of employers who have offices in more than one state. The Department of Labor has now weighed in on this question, providing some measure of legal certainty, if not uniformity in practical application by plan administrators and IRA custodians.13

Instructional is the first important federal court ruling in such a case decided after the federal Defense of Marriage Act was declared unconstitutional, but prior to when relevant IRS and Department of Labor policies were formulated and announced. At issue in *Cozen O'Connor v. Tobits*[14] was whether a qualified retirement plan was required to provide a qualified pre-retirement survivor annuity (or QPSA, a benefit available only to spouses of plan participants) to a same-sex surviving spouse of a plan participant. The participant and her wife were legally married in Canada in 2006. The two lived in Illinois, which does not issue marriage licenses to same-sex couples but does legally recognize a same-sex marriage performed in another jurisdiction as a civil union. After the plan participant died in 2010, her widow requested payment of the survivor benefit from the plan as the surviving spouse of the participant. The participant's parents made a competing claim for the survivor benefits under the plan terms.

The court noted that the term "spouse" was not defined by the plan and that as a result, it had to determine if the widow was in fact a spouse under ERISA and the Internal Revenue Code. It noted that "following the [Supreme] Court's ruling [in *U.S. v. Windsor*], the term 'Spouse' is no longer unconstitutionally restricted to members of the opposite sex, but now rightfully includes those same-sex spouses in 'otherwise valid marriages.'" The court then found that "post-*Windsor,* where a state recognizes a party as a 'Surviving Spouse,' the federal government must do the same with respect to ERISA benefits—at least pursuant to the express language of the ERISA-qualified Plan at issue here." Because Illinois, the couple's place of domicile, was held to have recognized the marriage as valid (albeit as a "civil union" under Illinois law), the court held that the widow was to be treated as the "spouse" of the participant for purposes of the plan and, therefore, was entitled to the QPSA benefits.

Notably, the court specifically found that Pennsylvania law did not apply even though the plan included a choice-of-law provision referencing Pennsylvania law and the plan sponsor was headquartered in Pennsylvania. The court based its analysis of whether the participant and her spouse were legally married on the law in the state where the couple was domiciled.

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13 DOL Technical Release No. 2013-04. Following the lead of the IRS in Rev. Rul. 2013-17, the Department of Labor issued its guidance on September 18, 2013, providing that, where the Secretary of Labor has authority to regulate with respect to the limited provisions of ERISA where the term "spouse" is used, "spouse" will be read to refer to any individuals who are lawfully married under any state law, including same-sex spouses, and without regard to whether their state of domicile recognizes same-sex marriage. Thus, for ERISA purposes as well as federal tax purposes, an employee benefit plan participant who marries a person of the same sex in a jurisdiction that recognizes same-sex marriage will continue to be treated as married even if the couple moves to a state that does not recognize same-sex marriage. http://www.dol.gov/ebsa/newsroom/tr13-04.html

14 No. 2:11-cv-00045 (E.D. Pa. July 29, 2013). A copy of the opinion in the case appears at http://www.gpo.gov/fdsys/pkg/USCOURTS-paed-2_11-cv-00045/pdf/USCOURTS-paed-2_11-cv-00045-1.pdf

Also of note is the fact that the court found that the couple's status as a "civil union" under Illinois law was sufficient to validate their Canadian marriage and establish the widow as the participant's surviving spouse. Left unanswered is how the court would have ruled if the couple had lived in a non-recognition state or in a state with a constitutional ban against legal recognition of same-sex relationships.

The *Tobits* decision may be the first example of a court reading *Windsor* broadly to find avenues to provide parity in treatment to same-sex couples. It may also provide a roadmap to the White House as it directs federal agencies to develop guidance regarding how same-sex spouses should or may be treated under ERISA and the Code.

As illustrated by the *Tobits* ruling, spouses, but not domestic partners, reap the benefit of various laws protecting their interests regarding distribution and taxation of qualified retirement plan accounts and IRAs, including the rollover rules,[15] QJSAs,[16] and QPSAs.[17] Also, a qualified plan participant's spouse must consent in writing to the designation by the participant of any death beneficiary other than the spouse,[18] while a domestic partner of a qualified plan participant has no such rights. As noted above, the Department of Labor recently clarified that same-sex spouses, as determined under a "place of celebration" analysis, are entitled to be treated as spouses for all purposes under ERISA-governed retirement plans, regardless of the state in which they reside.

Outside of the retirement planning area, opposite-sex spouses can benefit from certain features of the federal tax laws. For example, in community property states, upon the death of one spouse, a surviving spouse (if of the opposite sex) would benefit from the federal income tax step-up in basis in both "halves" of the community property.[19] Other, less apparent distinctions between married and unmarried taxpayers in the federal estate tax regime involve the favorable estate tax treatment of joint tenancy property owned by married couples (and distinctly unfavorable estate tax treatment of joint tenancy property owned by domestic partners).[20]

Not all differences in tax treatment between unmarried couples and married couples are unfavorable to the unmarried couples. Consider the benefit to unmarried taxpayers, as well as to both opposite-sex and same-sex married couples, of the inapplicability of certain estate freeze and

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[15] 26 U.S.C.A. Sections 408(d), 402(c). *See* Article VI.

[16] 26 U.S.C.A. Section 401(a)(11)(B).

[17] *Id.*

[18] 26 U.S.C.A. Sections 410(a)(11), 417(a)(2).

[19] 26 U.S.C.A. Section 1014. Such basis adjustment presumably applies for same-sex spouses, now that the federal Defense of Marriage Act no longer remains in force, and in view of the IRS adoption of a "place of celebration" rule.

[20] 26 U.S.C.A. Section 2040. The general rule regarding estate taxation of joint tenancy interests appears in Section 2040(a), while a more lenient rule for joint tenancy interests between husbands and wives appears in Section 2040(b). *See* text accompanying footnotes 98-100 below.

attribution provisions.[21] Because the federal tax laws were not designed in contemplation of the unique circumstances of unmarried domestic partners, their tax and estate planning require special attention and resourcefulness, both in recognizing the issues and opportunities presented and in applying the tax laws to their circumstances.

High-net-worth unmarried couples (same-sex and opposite-sex alike) may choose to include significant charitable bequests in their estate planning. For couples in which one or both partners may have taxable estates, creative uses of split-interest charitable trusts and other techniques can help these couples achieve their estate planning goals and carry out their charitable giving intentions. Conversely, couples that are unlikely to be burdened by federal gift and estate taxes can make split-interest charitable gifts at death without worrying about qualifying for estate tax charitable contribution deductions.

Advisers must assess whether particular individuals' relationships will be recognized for various purposes as marriages, or the equivalent thereof, under applicable state law.[22] Under federal tax law, unmarried domestic partners (as distinguished in court rulings or in federal tax policy from same-sex couples who have married) are not distinguished from unmarried persons who are not coupled.

One old-fashioned technique persists in rare cases. Where marriage is unavailable or undesirable, in some states, an older domestic partner may choose the technique of an adult adoption of his or her domestic partner, thereby creating a family relationship sanctioned by state law.[23] However, care must be taken to insure that such adopted domestic partners are entitled to inherit from their adoptive "parents" under the intestacy provisions of those states' laws.[24]

For opposite-sex couples, the adviser must determine whether the laws of the state of residence would impose the rights and responsibilities of common-law marriage.[25] Many states

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[21] *See, e.g.*, 26 U.S.C.A. Sections 2701, 2702. These statutes operate to increase estate tax valuation of property transferred to or for the benefit of a "member of the family" where the transferor or an "applicable family member" retains an interest. Transfers between unmarried domestic partners are not subject to these restrictions, because the definitions of "member of the family" and "applicable family member" and other family attribution rules in the Code do not include domestic partners. *See* text accompanying footnotes 69-75 below.

[22] *See, e.g.*, A.R.S. Sections 25-111, 25-112 (license and ceremony required for Arizona marriages; common law marriages not recognized).

[23] *See* In Polo Country, a Tale of Death, Money, and Adoption, New York Times, February 13, 2012 (reporting on wealthy bachelor adopting his girlfriend in order to avoid the impact of creditors' claims on his livelihood, so that funds from a substantial family trust could be appointed to her under a special power of appointment that was limited to family members).

[24] In general, domestic partners are well advised not to rely on state intestacy statutes to materialize each other's expectancy of receiving an inheritance from the other. Joint tenancy ownership of assets by domestic partners is often an appropriate method of ownership, although it can lead to vexatious federal estate tax reporting problems for high-net-worth unmarried domestic partners. *See* text accompanying footnotes 98-100 below.

[25] The legal consequences of common-law marriage status, if recognized, would not be uniformly favorable for the taxpayers. For example, the IRS may be motivated to characterize particular

have eliminated common-law marriage by statute.[26] Other states have modified by statute the rights and responsibilities of their citizens who are treated as married at common law.

III. MARRIAGES VS. DOMESTIC PARTNERSHIPS: LEGAL ATTRIBUTES

A. Tax laws. Federal tax laws do not uniformly favor married taxpayers over unmarried taxpayers, although state laws distinguishing between married and unmarried citizens ordinarily do create privileges, exemptions, and other favorable legal treatment for married persons relatively more often than for unmarried persons. For estate planning purposes, the importance of the federal estate tax unlimited marital deduction[27] in planning for high-net-worth married couples cannot be overstated. The lack of any comparable deduction for unmarried domestic partners informs all estate planning for well-to-do domestic partners, as well as for other high-net-worth unmarried persons on whom others are relying for financial support.

1. Federal income tax rates. Ordinarily, the federal income tax liability of a husband and wife will exceed the federal income tax liability of an unmarried couple who together earned an total amount of income equal to that earned by the married couple. The Code treats married couples filing joint individual federal income tax returns as a single economic unit. Married couples filing separate individual federal income tax returns usually pay less in federal income tax liability than their counterparts who file join individual federal income tax returns. However, Congress has forbidden married taxpayers who file separate individual federal income tax returns from taking advantage of certain federal income tax benefits.[28] Additional complications are introduced for some same-sex married couples who now will file joint income tax returns with the IRS. Same-sex married couples in "recognition" states will file joint income tax returns at both the federal and state levels. Some state taxing authorities (including, improbably, Virginia) have adopted a policy of accepting or requiring that such couples file joint income tax return filings at a state level as well as with the IRS, while other state taxing authorities require that such married couples continue to file individual income tax returns at a state level. This last situation constitutes a virtual about-face from the circumstances prior to *Windsor* and the IRS adoption of a "state of celebration" rule: under that incongruent collection of taxing regimes, same-sex married couples in recognition states such as Massachusetts and California were obligated to prepared and file joint income tax returns in their states, even though they had no legal

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taxpayers' living arrangements as common-law marriages for income tax purposes, to the extent that the taxpayers' marginal federal income tax rates would be higher if their relationship were characterized as a marriage.

[26] *See, e.g.*, A.R.S. Section 25-111; *Gamez v. Industrial Commission*, 114 Ariz. 179, 559 P.2d 1094 (App. 1976). Arizona does not authorize common-law marriages but will accord to such marriage entered into in another state the same legal significance as if marriage were effectively contracted in Arizona. *Grant v. Superior Court In and For Pima County*, 27 Ariz.App. 427, 555 P.2d 895 (App. 1976). Arizona's defense-of-marriage statute contravenes the effect of this decision with respect to same-sex couples married in other states.

[27] 26 U.S.C.A. Section 2056(b).

[28] *See, e.g.,* 26 U.S.C.A. Section 408A (conversion of traditional IRA to Roth IRA prohibited for married taxpayers filing separate individual federal income tax returns, but permitted for married couples filing jointly within certain combined modified adjusted gross income limits).

authority to file on any basis other than separate income tax returns with the IRS. The IRS adoption of a "state of celebration" rule has led to brisk business in preparing and filing amended returns for those same-sex married couples who were married and filing individual federal income tax returns prior to the *Windsor* decision.

The proposed elimination of the "marriage penalty" inherent in the federal income tax laws from time to time becomes a *cause celebre* in Congress. Through the structuring of the federal income tax brackets, Congress controls the extent to which the income tax is assessed differently against married taxpayers as opposed to single taxpayers. The current federal income tax rate structure could motivate domestic partners to remain unmarried, because the top federal income tax bracket applies only to high income, both for single taxpayers as well as for married couples.[29] Thus, if two taxpayers, each earning $150,000 in a particular tax year, were married to one another, a considerable portion of their combined income would be taxed at the highest marginal federal income tax rate. Conversely, if two unmarried taxpayers each earned $150,000, then their separate federal income tax liabilities would be calculated at a relatively lower marginal federal income tax rate. With such figures, the resulting reduction in the total federal income tax liability along the order of magnitude of $10,000 would not be out of the realm of possibility.

Litigation to invalidate the differing marginal federal income tax rates for married and unmarried taxpayers on constitutional grounds has been unsuccessful.[30] In general, courts have held that the "marriage penalty" inherent in the federal income tax laws has not been an insurmountable, or even significant, obstacle in the path of taxpayers wishing to marry.[31]

From time to time, certain married couples have divorced at the end of December of each year and remarried at the beginning of the subsequent year in order to be eligible to file individual federal income tax returns, therein calculating their respective federal income tax liability as single taxpayers rather than as married taxpayers. Such divorces followed by remarriages have been unsuccessful in reducing federal income tax liability, even if the divorce proceedings were valid in the state or foreign country in which they took place.[32] However, spouses who dissolve their marriage in a manner that is valid under applicable state law and who do not remarry will be treated as single for tax reporting purposes, even if they continue to live together.[33]

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29 26 U.S.C.A. Section 1. *See* 26 U.S.C.A. Section 1(f), which indexes the federal income tax bracket thresholds for inflation in later years.

30 *See, e.g., Druker v. Com'r*, 697 F.2d 46 (2d Cir. 1982); *Mapes v. U.S.*, 576 F.2d 896 (Ct. Cl. 1978).

31 The Supreme Court has never addressed the validity of the federal income tax rate structure under the equal protection clause of the Fourteenth Amendment to the Constitution. For additional discussion of this issue, see Pilzner, "Tax Liability Differences between Married and Unmarried Couples: Do the Married Filing Statuses Violate Equal Protection?" 40 WAYNE L. REV. 1337 (Spring 1994).

32 Rev. Rul. 76-255, 1976-2 C.B. 40; *Boyter v. Covm'r*, 668 F.2d 1382, 82-1 USTC para. 9117 (4th Cir. 1981), *rem'g* 74 T.C. 989 (1980) (Haitian divorce proceedings not given full faith and credit where taxpayers' purpose was tax avoidance).

33 *See* PLR 7835076.

2. Federal estate and gift tax issues. As noted above, much of the planning for reducing federal gift and estate tax for unmarried persons focuses on techniques intended to mimic the effect of the federal gift and estate tax marital deduction, which is available only to married couples.[34] From a public policy standpoint, the marital deduction seeks to ensure that a surviving spouse's standard of living will not be impaired as a result of death taxes resulting from the death of a spouse. Unfortunately, no such mechanism protects the unmarried couple from the potentially devastating effects of federal estate taxes.

Affluent domestic partners may have to undertake significant planning for the federal estate tax liability that will be due upon the death of either partner in excess of the deceased partner's federal estate tax applicable exclusion amount ($5.250,000 for decedents dying in 2013). The applicable planning techniques are similar to those used by married couples seeking to reduce the effect of the federal estate tax on the assets to be distributed to their children or other heirs upon the death of the survivor of them. However, married taxpayers are only occasionally motivated to take advantage of more complex estate planning techniques to benefit their children or other beneficiaries, who often are no longer relying on the taxpayers for financial support. Conversely, domestic partners often conclude that they must resort to such relatively esoteric planning techniques in order to avoid erosion by the federal estate tax of the assets they accumulated together. These techniques include the use of charitable remainder trusts, grantor retained annuity trusts, qualified personal residence trusts, and irrevocable life insurance trusts, all of which will be discussed in these materials.

Other tax benefits available to married couples that are unavailable to domestic partners include the application of the marital deduction to the value of a spouse's intervening noncharitable interest in a charitable remainder trust, and the reverse QTIP election[35] to maximize the generation-skipping transfer tax lifetime exemption of a predeceased spouse.

Certain aspects of the federal gift tax laws also provide certain exemptions or opportunities to married taxpayers but not to unmarried taxpayers. The federal gift tax unlimited marital deduction operates to make all gifts between spouses free from federal gift tax liability.[36] It may be some small consolation to domestic partners that the income tax consequences of gifts are no different for married recipients than for unmarried recipients: the donee has a carryover basis for income tax purposes, and the gift does not generate any federal income tax liability to the donee.[37]

B. Planning for disability. Planning for disability involves significantly different considerations for the unmarried adult than for the married adult. State laws involving powers of attorney, advance medical directives, surrogate medical decision makers,[38] and guardianship and

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[34] 26 U.S.C.A. Section 2056(a).

[35] 26 U.S.C.A. Section 2652(c)(3).

[36] 26 U.S.C.A. Section 2523(a).

[37] 26 U.S.C.A. Section 1041(b).

[38] *See, e.g.*, A.R.S. Section 36-3231. If an Arizona resident is unable to make or communicate medical treatment decisions and has no health care power of attorney, health care providers are directed to contact certain persons, in an indicated order of priority, who then will have authority to make health care decisions for the patient. Unmarried domestic partners are included in the hierarchy of persons to be

conservatorship typically (though not always) fail to take into account the special situations of domestic partners. Also, the administration and observance of such laws often gives the benefit of the doubt to a spouse or child purporting to act on behalf of a disabled person. Conversely, unmarried persons often encounter suspicion, prejudice, and miseducation when trying to carry out the wishes of their disabled partners regarding financial matters and health care.

On the other hand, in planning for disability, unmarried status can occasionally be advantageous. It has been observed that for purposes of qualifying a disabled spouse for government long-term care assistance benefits, the assets of both spouses are often taken into account by the Medicaid program or equivalent programs administered by the various states, even in situations (such as late-in-life second marriages) in which the spouses have carefully maintained separate assets and have avoided commingling their respective assets. Such married couples may be blindsided by these rules, which would then require the healthy spouse's assets to be "spent down," in accordance with Medicaid or Medicaid-equivalent eligibility requirements, in order to pay for the care of the disabled spouse. It is not unknown for elderly married couples to divorce, or to choose not to marry, in order to avoid the purview of these laws. Such Medicaid and Medicaid-equivalent spend-down requirements do not apply to unmarried domestic partners of persons seeking Medicaid and Medicaid-equivalent eligibility.

C. **Probate and estate administration**. As noted above, state intestacy laws invariably provide inheritance rights to the spouses of intestate decedents,[39] while domestic partners of decedents do not have such rights.[40] Thus, if a person intends to provide for his or her unmarried domestic partner in the event of his or her death, affirmative steps must be taken to document this intention with a will, a trust, or a combination of these and other governing instruments.

Domestic partners often intend to benefit each other in their wills or other estate planning. Like many well-intentioned persons, they often do not have executed documents in place to carry out their intentions. Unlike married couples, however, domestic partners often would not choose to distribute their remaining assets to their intestate heirs (ordinarily, their parents, siblings, and the like) in the event of death. Unfortunately, the safety net of the intestacy laws will not carry out the intentions of such domestic partners in the event that no documents are in place. Accordingly, attorneys and other advisers working with domestic partners may want to encourage them to execute such documents immediately, in order to avoid the unintended consequences of intestacy. Indeed, if such documents are executed, advisers can avoid criticism for having failed to document their clients' intentions timely.

Further, persons who would choose to nominate their domestic partners as personal representatives can do so easily by executing a will to that effect. The intestacy laws do not

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contacted, but only if no other person has assumed any financial responsibility for the patient. A.R.S. Section 36-3231(A)(4). A patient's adult children or parents will have priority over a domestic partner.

[39] *See, e.g.*, A.R.S. Section 14-2102.

[40] *See, e.g.*, A.R.S. Section 14-2103. *But see* Sections 6401 and 6402 of the California Probate Code, extending partial inheritance rights to domestic partners who have registered with the State of California.

facilitate the appointment of domestic partners as personal representatives of intestate decedents.[41] Under Arizona law, in appropriate circumstances, the surviving domestic partner could claim priority for appointment, if the surviving domestic partner could establish that he or she was a creditor of the decedent. However, the appointment of a creditor of the decedent would require the consent of other heirs of the decedent, who have higher priority for appointment.[42] Although probate statutes permitting decedents' creditors priority for appointment were not drafted with domestic partners in mind, it is often not difficult to establish the existence of a debt owed by an intestate domestic partner to a surviving domestic partner in order to permit the surviving domestic partner to assert priority for appointment on the basis that the surviving domestic partner is a creditor of the estate.

Another probate complication for some same-sex couples is the requirement that probate notices (in Arizona, of informal appointments or formal petitions) must be given to the decedent's heirs-at-law. This requirement can thwart the couple's privacy concerns and, if there are no living parents, children, siblings, or other close relatives of the decedent, can trigger the need for a costly and time-consuming heir search in order to identify the decedent's heirs-at-law and their whereabouts. One welcome consequence of same-sex marriage is that, for those dying survived by a same-sex spouse and no children, for purposes of the laws of states that recognize the same-sex marriage, the surviving same-sex spouse would be the only intestate heir of the decedent.

IV. ESTATE PLANNING WHERE TRANSFER TAXES ARE NOT A FACTOR.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") implemented large increases in the federal estate and generation-skipping transfer tax exemptions in the years from 2001 to 2010. In turn, the 2010 tax act increased the federal estate, gift, and generation-skipping transfer tax exemptions to $5,000,000 for 2011 and 2012, increasing to $5,250,000 for 2013. The increased exemption amounts under the new laws impact the selection of appropriate estate planning techniques based on the projected size of an estate.

Before EGTRRA, proper planning for a married couple's relatively modest estate of, say, $1,000,000 involved an estate tax reduction component. After EGTRRA, and particularly after the 2010 tax act, the estate tax has ceased to apply to large numbers of taxpayers upon each scheduled increase in the federal estate and generation-skipping transfer tax exemptions. The 2010 tax act extends this analysis to the gift tax, along with the increase in the gift tax exemption to $5,250,000. Estate planning alternatives for unmarried domestic partners, who should be acutely sensitive to estate tax issues due to the inapplicability of the unlimited marital deduction, are becoming far more flexible, as ever fewer taxpayers' estates will be subject to the estate tax.

At least in the short term, fewer and fewer taxpayers will need to implement estate planning techniques that seek to reduce estate taxes. Ever increasing numbers of unmarried

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[41] *See, e.g.*, A.R.S. Section 14-3203(A).

[42] A.R.S. Section 14-3203(A)(7). This approach is effective only if the decedent's family members with priority for appointment are cooperative in consenting to the appointment of the surviving domestic partner as personal representative. Obtaining such consents can be difficult or impossible in cases in which the surviving domestic partner suffers a strained or nonexistent relations with the intestate heirs. Conversely, where the interested parties are cooperative, it can be an effective "cleanup" strategy in intestacy cases involving domestic partners.

domestic partners will be able to implement more flexible techniques. Fewer taxpayers will need to resort to implementing such techniques as testamentary charitable remainder trusts qualifying for federal estate tax charitable contribution deductions. Such testamentary charitable remainder trusts, which could still be useful in very large estates, are described in considerable detail below. However, more taxpayers can implement trusts with charitable remaindermen, without the need for those trusts to qualify for federal estate tax charitable contribution deductions. As described in greater detail below, an interesting drafting exercise will be to create trusts that will be split into qualifying and nonqualifying testamentary charitable remainder trusts, depending on the size of the taxpayer's estate and the amounts of the federal estate tax annual exclusion in the year of the taxpayer's death.

A. Documenting the intentions. Unmarried domestic partners often intend to benefit each other in their wills or other estate planning. When discussing estate planning with unmarried couples, advisers can emphasize that the unintended consequences of dying without proper documents in place can be devastating to the surviving domestic partner.

Domestic partners should consider executing (1) wills, (2) general durable powers of attorney for financial matters, (3) health care powers of attorney and living wills, and (4) in certain circumstances, revocable trusts. The dispositive wishes of each domestic partner can be can be carried out by a will. Domestic partners can provide for their own financial well-being in the event of incapacity through the use of general durable powers of attorney for financial matters and, where appropriate, revocable trusts. Domestic partners can provide for their own health care in the event of incapacity through the use of health care power of attorney and living wills.

Unmarried same-sex domestic partners who marry, even if they reside in non-recognition states, would do well to update their documents to reflect the marriage. Such couples can update not only their wills and powers of attorney and other estate planning documents, but also such governing instruments as qualified plan beneficiary designations, IRA beneficiary designations, and life insurance beneficiary designations, to state that the relationship with the designated beneficiary is a marital relationship. Some advisers are suggesting this strategy so that such third parties as taxing authorities, IRA custodians, life insurance companies, and others, depending on the timing of a client's death and the applicable laws at that time, can later be asked to regard the survivor as a spouse for purposes of the asset or benefit being transferred.

B. Handling competing goals. The estate planning documents of unmarried domestic partners often provide for various beneficiaries (*e.g.*, surviving domestic partner and surviving children from a previous relationship, or surviving domestic partner and charitable organizations). The interests of these beneficiaries are often adverse to one another. Such planning situations are often not unlike planning for clients with spouses and children from previous marriages.

Where the potential beneficiaries of domestic partners include one another and a smattering of "remainder" beneficiaries, planning need not be complicated. Domestic partners can execute wills providing for one another and for the family members or other beneficiaries upon the death of the survivor of them. This approach is particularly smooth if each domestic partner wishes to benefit the same class of beneficiaries. For example, if both domestic partners want to benefit the children of one of them, then the planning is simplified by their identifying the same objects of their bounty.

However, more commonly, the domestic partners do not wish to benefit the same groups of beneficiaries in the event that neither of them is surviving. Two nontax issues arise in the event that the domestic partners do not wish to benefit the same class of ultimate beneficiaries. First, as with married couples, the domestic partners may be concerned that the survivor of them will change his or her will or other governing instruments to disinherit the beneficiaries favored by the first to die of the domestic partners. Such concerns can be resolved by provisions in *inter vivos* or testamentary trusts that hold certain or all of the assets in trust for the benefit of the surviving domestic partner, with the remainder to the favored class of family members or other noncharitable beneficiaries. Using this approach, through the use of (1) testamentary powers of appointment, (2) preserving the surviving domestic partner's flexibility in the trust distribution language, and (3) judicious selection of successor trustees, each domestic partner can precisely calibrate the level of flexibility given to the surviving domestic partner over the assets of the trust. If the estates are not likely to incur federal estate tax liability, and if there are no large qualified plan or IRA balances distributable to such trusts, then no tax issues necessarily need to be taken into account.

Second, some couples may be concerned that if they were to die within a short period of time of one another, their combined estates would constitute a windfall for the favored beneficiaries of the domestic partner who lived longer, or who was deemed to have lived longer in the case of their simultaneous deaths. To address this concern simply, domestic partners may provide in their wills that in that event, the estate of the first to die would not be distributed to the personal representative of the estate of the second to die, but rather would be distributed directly to the remainder beneficiaries designated in the will of the first to die or, alternatively, administratively combined and then divided among the two classes of remainder beneficiaries designated by the domestic partners, respectively. The assets could be divided equally or in any other manner specified by the domestic partners in their wills. Unlike high-net-worth married couples, who cannot impose lengthy survivorship requirements without jeopardizing the marital deduction, unmarried persons may make such provisions, with survivorship requirements of any length, without negative tax consequences. The most immediate practical limitation on this type of provision is the surviving domestic partner's tolerance for holding the deceased domestic partner's estate in administrative "limbo" while waiting for the surviving domestic partner to outlive the stated survivorship period.

Many unmarried same-sex domestic partners residing in community property states will marry as laws evolve to permit such marriages. To the extent they then reside or own property in a "recognition" state, their assets acquired during the marriage will then likely be subject to community property law. Advisers will need to assist such married couples in identifying which assets are under the testamentary control of which spouse. As noted above, longtime domestic partners who later marry may be accustomed to thinking of the household assets in terms of "yours" and "mine" rather than subject to their respective undivided interests in property or any aggregate-theory notions of community property law.

As further noted above, unmarried domestic partners (and married same-sex couples) may have no particular wish to benefit any noncharitable beneficiaries, excepting one another. If there is no concern about minimizing estate tax liability (or income tax liability upon distribution of qualified plan and IRA proceeds), domestic partners may use the techniques described above where they wish to include charitable organizations among the beneficiaries of their estates. Domestic partners can include provisions in *inter vivos* or testamentary trusts that hold certain or all of the assets in trust for the benefit of the surviving domestic partner, with the remainder to the favored class of charitable beneficiaries. If the estates are not likely to incur federal estate tax

liability, and if there are no large qualified plan or IRA balances distributable to such trusts, then there is no need to include the relatively inflexible provisions that would be required in order for the estates to qualify for estate tax or income tax charitable contribution deductions. Using this approach, through the use of (1) testamentary powers of appointment, (2) preserving the surviving domestic partner's flexibility in the trust distribution language, and (3) judicious selection of successor trustees, and without including the less flexible provisions that would be required in order to minimize taxes in larger estates, each domestic partner can precisely calibrate the level of flexibility given to the surviving domestic partner over the assets of the trust.

V. TRANSFER TAX REDUCTION PLANNING.

A. Maximizing tax-free giving opportunities. High-net-worth unmarried domestic partners should consider making use of federal gift tax annual exclusions and of one or both of their respective federal gift and estate tax applicable exclusion amounts to reduce their overall federal transfer tax exposure or create liquidity for the benefit of the surviving domestic partner. These planning opportunities are particularly useful in situations in which one domestic partner can expect his estate to be subject to federal estate tax liability, while the other domestic partner's estate is not expected to be large enough to take full advantage of the available applicable exclusion. Such planning opportunities may create results analogous to the use of portability of a deceased spouse's estate tax exemption that is newly available under federal estate tax law for married couples.

Not unlike other high-net-worth taxpayers, high-net-worth unmarried domestic partners almost always underutilize the federal gift tax annual exclusion. Not uncommonly, they shy away from making annual exclusion gifts to their domestic partners or others because of unwillingness to give up control over even relatively insignificant assets. Notwithstanding alarming divorce rates and the otherwise evident impermanence of modern marital relationships, the author has observed that domestic partners are generally reluctant (more so than, say, spouses in second marriages) to make gifts of investment assets to each other, often due to their perception of the impermanence of domestic partnerships generally. Perhaps the increasing numbers of same-sex domestic partners who choose to marry will lessen this phenomenon.

1. Annual exclusion gifts. As noted above, annual exclusion gifts from a high-net-worth individual to his or her unmarried domestic partner can be effective in reducing federal estate tax liability, insofar as the federal gift tax unlimited marital deduction[43] is not available to unmarried domestic partners. Further, for gifts of future interests not subject to the federal gift tax annual exclusion, or gifts to which an unmarried domestic partner chooses to allocate a portion of his or her applicable credit amount,[44] gifts between unmarried domestic partners are subject to gift tax.

Another inequity in the gift tax laws, although one that appears to have created little hardship for most unmarried domestic partners, is created by the gift tax statute providing that a gift by a husband or wife to a third party will be considered to have been made one-half by each spouse, even though all of the gifted property may have belonged to one spouse prior to the gift.[45]

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[43] 26 U.S.C.A. Section 2523(a).

[44] 26 U.S.C.A. Section 2505(a).

[45] 26 U.S.C.A. Section 2513.

This "gift-splitting" opportunity allows a spouse making gifts to leverage his or her available gift tax annual exclusion amounts by the amount of the spouse's available gift tax annual exclusion amounts. Gift-splitting is not available to unmarried domestic partners or other unmarried taxpayers.

Another insidious and pervasive gift tax issue lurks in the households of unmarried domestic partners. Although gifts of discrete investment or luxury items can easily be identified as triggering federal gift tax liability, federal gift tax liability also attaches to transfers that are less easily identifiable, such as the regular provision of lodging, food, and the like. Quite often, unmarried domestic partners share living expenses. If each domestic partner does not contribute equally to these shared living expenses, then it could be argued that one-half of the amount by which the contributions of one domestic partner exceed the contributions of the other domestic partner constitutes a gift. To the extent that such amount exceeds the available annual federal gift tax exclusion, the donor incurs an obligation to report the transfer on a federal gift tax return and to allocate a portion of the applicable credit amount to the transfer. Such gift tax reporting obligations are imposed on domestic partners, but not on married couples, who benefit from the federal gift tax unlimited marital deduction. The author is unaware of any IRS enforcement efforts regarding gift tax reporting of such domestic arrangements.

2. Lifetime applicable exclusion amount. Unmarried domestic partners rarely take advantage of the federal gift tax applicable credit amount[46] during their lifetime, whereupon the credit is available to their estates and for the benefit of the surviving domestic partners and others. As with annual exclusion gifts, domestic partners sometimes avoid making unified credit gifts because of unwillingness to relinquish control over their assets. Also, for domestic partners with comparable life expectancies, the success of such techniques in reducing federal transfer taxes often depends on their ability to predict accurately which of them will outlive the other.

Gifts of applicable credit amounts by a high-net-worth individual to his or her unmarried domestic partner should be planned advisedly. Many such taxpayers choose to leave their entire estates, potentially valued at millions of dollars for federal estate tax purposes, to their surviving domestic partners. In such situations, planning opportunities for leveraging the applicable exclusion amount constitute one of the simplest and most valuable transfer tax reduction techniques for unmarried domestic partners. Just as the ultimate beneficiaries of married couples can benefit from post-transfer appreciation of the applicable exclusion amount if it is transferred during the taxpayer's lifetime, a surviving unmarried domestic partner can benefit from his or her partner's lifetime transfer of highly appreciating assets in a manner calculated to take advantage of the applicable credit amount. Typically, such planning is implemented by transfer to an irrevocable trust or, in certain circumstances, by transfer directly to the unmarried domestic partner. Planning for anticipated growth in the value of assets over time is the simplest form of leveraging the applicable exclusion amount. More advanced leveraging techniques that can be useful for unmarried domestic partners are discussed below.

B. Leveraging the lifetime applicable exclusion amount. As noted above, estate planning for unmarried domestic partnerships often involves planning large bequests or trust

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[46] The estates of decedents dying in 2013 will be entitled to lifetime applicable exclusions of $5,250,000. 26 U.S.C.A. Section 2010(c). The gift tax applicable exclusion amount is $5,250,000.

distributions to the survivor of the persons involved in the domestic partnership (hereinafter, the "domestic partners"). A surviving domestic partner, who by definition was not married to the decedent, will not benefit from the deferral of federal estate tax liability that would have been occasioned by the federal estate tax marital deduction. Important techniques to assist domestic partners in making optimum use of the lifetime applicable exclusion amount ($5,250,000 for decedents dying in 2013) include the testamentary charitable remainder trust, the grantor retained annuity trust, and the qualified personal residence trust.

Perhaps of equal importance, and perhaps to be expected at least as often as opportunities to implement these estate tax reduction techniques for unmarried couples who plan to remain unmarried, are any available procedures for high-net-worth same-sex couples who have married or who plan to marry, to unravel or terminate these more sophisticated estate tax reduction techniques that they implemented when it was not foreseeable that an unlimited gift tax marital deduction or estate tax marital deduction would ever become available to them. In the coming years, at the insistence of clients who no longer need to plan for reduction in estate tax liability, because they married or because of the increase in the estate tax lifetime exclusion amount, planners will be obliged to use their creativity to explore and test mechanisms to terminate or defuse estate tax reduction planning arrangements that were intended to be irrevocable and unamendable.

Domestic partners often seek to minimize federal estate taxes and to maximize the income and assets flowing to the surviving domestic partner. Without the benefit of many of the estate tax reduction strategies available to married persons, estate planners must use techniques such as testamentary charitable remainder trusts, grantor retained annuity trusts, and qualified personal residence trusts to permit domestic partners to achieve tax results similar to those that would be available to married couples simply by operation of law. Testamentary charitable remainder trusts in particular, have been underutilized in estate planning for domestic partners.

1. **Testamentary charitable remainder trusts**. Domestic partners may have no particular wish to benefit noncharitable beneficiaries, excepting one another. For example, domestic partners may not find it important to benefit their own relatives, much less the relatives of their domestic partners. Indeed, perhaps more often than married persons, unmarried persons in domestic partnerships (and particularly same-sex couples) may experience indifferent, strained, volatile, or hostile relationships with other family members and may choose to affirmatively dis-inherit those family members. Domestic partners are often reluctant to make large outright bequests or distributions to one another because of the possibility that such assets ultimately would devolve to the beneficiaries of their domestic partner's estate, whether by intestacy or otherwise.

Nevertheless, domestic partners may anticipate that payment of federal estate taxes will significantly impair the livelihood and wherewithal of the survivor of them. Testamentary charitable remainder unitrusts provide one estate tax reduction strategy in the nature of a "marital deduction substitute" for such taxpayers.

Examples. Americans from many walks of life can use testamentary charitable remainder trusts. The following examples offer some unexpected situations in which this technique can be helpful.

> EXAMPLE 1: An elderly man is devoted to his much-younger domestic partner and to his local opera company, but does not wish his estate to enrich his domestic partner's relatives. Significant estate tax liability is anticipated. He brightens upon learning that his estate can benefit his domestic partner for life, and his favorite

charity (rather than the disfavored relatives) thereafter, at a reduced estate tax cost, by the use of a testamentary charitable remainder trust.

EXAMPLE 2: A childless unmarried couple have lived together for fifteen years. They choose not to marry because one of them is the recipient of significant periodic payments from the settlement of a wrongful death case. These payments will end if she remarries. A testamentary charitable remainder trust may provide the survivor of them with benefits as similar as possible to a marital deduction trust.

EXAMPLE 3: After the deaths of both of their spouses, an elderly man and woman, who were childhood sweethearts, reunite after forty years and decide to live together. At first, they make no provision for one another in their estate planning, preferring instead to provide for their respective children. As the relationship matures, they choose not to marry because of concerns about depleting their respective estates in the event of a catastrophic illness of one of them. They can provide for the survivor of them through reciprocal testamentary charitable remainder trusts.

EXAMPLE 4: A new bride, whose husband is completely incapacitated in an automobile accident, will receive substantial periodic payments for life in settlement of her tort claims. Ten years later, with her husband living in a nursing home with a normal life expectancy and no hope of recovery, she lives together with her boyfriend and a new baby. A testamentary charitable remainder trust would permit her to provide significant support to her boyfriend in the event of her death.

Planning situations of this type are endemic among well-to-do same-sex domestic partners, and they are increasingly common among opposite-sex domestic partners. Also, unmarried, divorced, or remarried taxpayers may want to provide in their estate plans for significant financial support to a person or persons other than a spouse.

The following discussion of testamentary charitable remainder unitrusts is not intended to imply that advisers should shun other charitable split-interest trusts, including inter vivos charitable remainder unitrusts. However, the features of testamentary charitable remainder unitrusts very often can dovetail nicely with the tax and non-tax goals of many domestic partners. The testamentary charitable remainder unitrust should be a basic weapon in the estate planner's armory of techniques for domestic partners.

a. Curtailed income tax benefits. All but the most avid proponents of charitable remainder unitrusts now refrain from recommending these trusts for taxpayers who have no intent to benefit charitable institutions. As a practical matter, the creation of a charitable remainder unitrust during the lifetime of the taxpayer in today's tax environment presupposes that the donor has a nontax dispositive intention that the unitrust assets should benefit charity after the termination of the noncharitable interests in the assets.

b. Testamentary charitable remainder unitrusts. Due to federal income tax law changes, perhaps the use of inter vivos charitable remainder unitrusts cannot be recommended as often as in the past. Conversely, the benefits of testamentary charitable remainder unitrusts remain relatively undiminished, despite changes in the federal income tax laws.

Of course, testamentary charitable remainder unitrusts can be ideal strategies for unmarried domestic partners inclined to give significant assets to favored charitable organizations (*see* Example 1). Such a taxpayer may be content to use a testamentary charitable remainder unitrust to direct his or her estate to charity, after providing for a payment stream to be paid to his or her domestic partner, either for life or for a term of years.

Perhaps surprisingly, testamentary charitable remainder unitrusts may also prove attractive to unmarried domestic partners who are indifferent to charitable giving but who have only one or two noncharitable beneficiaries in mind. In a nation without estate taxes, such domestic partners typically would choose to leave their entire estates to each other or to other nonmarital, noncharitable beneficiaries. However, for high-net-worth unmarried domestic partners, the federal estate tax creates a powerful disincentive for such gifts. Some couples will obviate these concerns by marrying.

The federal estate tax reduction benefits of charitable remainder unitrusts, including testamentary charitable remainder unitrusts, have remained largely intact despite changes in the federal income tax area. However, the enactment of the ten-percent remainder rules[47] as part of the Taxpayer Relief Act of 1997 limited the creation of inter vivos and testamentary charitable remainder trusts alike. The application of the ten-percent remainder rules, which were intended to curb perceived federal income tax abuses involving the use of charitable remainder trusts, is an unfortunate limitation on the operation of testamentary charitable remainder trusts, which have never had the effect of reducing federal income tax liability, except in the case of testamentary charitable remainder trusts funded with distributions from qualified plan accounts and IRAs.

c. Residuary testamentary charitable remainder unitrusts. For unmarried domestic partners, perhaps the most useful strategy can be to create, through a provision in a will or trust, a formula gift to a noncharitable beneficiary (such as the taxpayer's domestic partner) equal to the amount of the taxpayer's then remaining federal estate tax applicable exclusion amount (up to $5,250,000 in 2013), followed by a residuary gift to a charitable remainder unitrust. The surviving domestic partner could receive the formula bequest outright or in trust. The charitable remainder unitrust would then distribute periodic annuity or unitrust payments to the taxpayer's noncharitable beneficiary at a reduced estate tax cost.

In the foregoing scenario, it is anticipated that the value of the estate for federal estate tax purposes will be offset by a federal estate tax charitable contribution deduction. The deduction is based on the actuarial value of the portion of the charitable remainder trust that will likely not be distributed to the noncharitable beneficiary and ultimately will likely be distributed to the charitable beneficiary.[48]

The residuary testamentary charitable remainder trust, following a formula bequest or distribution intended to maximize the use of the decedent's applicable exclusion amount, will provide the noncharitable beneficiary with an outright distribution that is optimum for federal estate tax purposes. Although the noncharitable beneficiary will often be dissatisfied not to receive outright distribution of the entire estate, nevertheless a formula distribution of this nature will

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[47] 26 U.S.C.A. Sections 664(d)(1)(D), (d)(2)(D).

[48] Treas. Regs. Section 20.2055-2(a); Treas. Regs. Section 1.664-2(c); Treas. Regs. Section 1.664-4(b)(3), (b)(4).

maximize the effectiveness of the estate tax reduction capabilities of both the applicable federal estate tax exclusion amount and the charitable remainder unitrust.

Persons who anticipate that assets will pass from their estates to split-interest charitable trusts (such as testamentary charitable remainder trusts) must seriously consider the liquidity issues posed by the federal estate tax anticipated to be due with respect to the noncharitable beneficiaries' interest in the charitable remainder trust. Creating liquidity for the payment of such federal estate tax liabilities is of increasing importance as the total value of assets distributable to split-interest charitable trusts grows. The ages of the noncharitable beneficiaries also affect the amount of the federal estate tax liability on estate assets transferred to testamentary charitable remainder unitrusts.

Potential donors to testamentary charitable remainder trusts sometimes believe that such trusts will eliminate all federal estate liability on the assets transferred to the testamentary charitable remainder trust. In fact, the portion of the federal estate tax liability to be offset by the federal estate tax charitable contribution deduction depends on the actuarially calculated value of the remainder interest that will ultimately be distributed to charity. Thus, advisers should be vigilant in planning for payment of the potentially significant federal estate tax liability that will not be offset by the federal estate tax charitable contribution deduction.

The donor's estate plan can create liquidity for the payment of federal estate tax through irrevocable life insurance trusts or otherwise. Alternatively, the estate plan documents can provide for the amount of the federal estate tax liability to be calculated and paid from the donor's revocable living trust or estate prior to the transfer of assets to the charitable remainder trust created by the donor's will or revocable living trust. Under this second scenario, the amount passing to the charitable remainder trust (and the amount of the corresponding federal estate tax charitable contribution deduction) will be "grossed down" in order to enable the donor's estate or revocable living trust to pay any associated federal estate tax liability.[49]

d. Testamentary charitable remainder trusts for IRD assets. Testamentary charitable remainder unitrusts can be particularly efficient beneficiaries of a taxpayer's interest in qualified retirement plans (such as 401(k) plans, 403(b) plans, profit sharing plans, and money purchase pension plans) and IRAs. Unmarried domestic partners, particularly those without children who rely on them for financial support, often have accumulated significant assets in qualified plans and IRAs. To the extent that a domestic partner has not contrived to withdraw all such qualified plan or IRA assets prior to death, such assets are included in the estate of the domestic partner for federal estate tax purposes. Further, even for those taxpayers whose estates are not large enough to trigger federal estate tax liability, such qualified plan or IRA assets constitute income in respect of a decedent (IRD) and trigger federal income tax consequences to the surviving unmarried domestic partners or other non-spouse, noncharitable recipients of such assets. Assets of qualified plan accounts or IRAs created for the benefit of a now-deceased unmarried domestic partner must be distributed to the beneficiaries designated by the decedent with respect to the qualified plan account or IRA within prescribed time periods, which distributions will constitute taxable income to the beneficiaries (other than charities).

Many unmarried domestic partners, like other qualified plan participants and IRA beneficiaries, have not focused on the unique procedural requirements of estate planning for IRA

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49 *See* Treas. Regs. Section 1.664-1(a)(6), Ex.(4).

and qualified plan benefits. State law ordinarily has no domestic-partner counterpart to probate statutes nullifying estate planning provisions and designations in favor of divorced spouses.[50] Accordingly, surviving unmarried domestic partners (and perhaps charitable organizations and split-interest charitable trusts) can benefit from greater awareness of these issues.

> EXAMPLE 5: Accounting firm adopts 401(k) plan. Young tax manager at accounting firm designates her then live-in boyfriend as the death beneficiary of the account maintained for his benefit. Seven years later, the account balance has grown to $150,000, and the tax manager and her boyfriend have acrimoniously ended their relationship. The tax manager is unexpectedly killed while traveling abroad. The $150,000 will be distributed to the former boyfriend.

As this example illustrates, the consequences of inadvertent failure to plan properly for the domestic partners' interests in qualified plans and IRAs are often drastically different than what the decedent would have intended.

The cumulative effect of the income and estate taxes on the qualified plan or IRA assets distributable to non-spouse, noncharitable beneficiaries can be confiscatory. Accordingly, when selecting from among various assets in a taxable estate to fund a charitable bequest or distribution, it is most often advisable to choose qualified plan or IRA assets to fund the bequest or distribution, in order to take advantage of the federal income tax charitable contribution deduction to offset federal income tax liability, as well as (for high-net-worth taxpayers) to take advantage of the federal estate tax charitable contribution deduction for federal estate tax purposes.

Taxpayers can easily understand the income and estate tax benefits of outright charitable contributions of IRA and qualified plan account balances at death. The similar benefits of charitable remainder unitrusts can be less obvious to potential donors. It is true that the federal estate tax reduction benefits of the contribution of IRA and qualified plan account balances to testamentary charitable remainder unitrusts are not absolute. However, such trusts do limit the associated federal estate tax liability to the amount of tax attributable to the noncharitable beneficiary's interest in the trust. In other words, no federal estate tax liability accrues with respect to the actuarial value of the interest ultimately passing to charity.

The federal income tax reduction benefits of contributing IRAs and qualified plan accounts to testamentary charitable remainder unitrusts are quite different from the federal estate tax reduction benefits, and perhaps the income tax reduction helps many surviving domestic partners more immediately. The contribution of an IRA or qualified plan account to a testamentary charitable remainder unitrust results in deferral of all income tax liability that otherwise would have been triggered by the death of the qualified plan participant or IRA beneficiary. Income tax liability is later payable by the surviving domestic partner upon receiving distributions from the charitable remainder trust, to which the qualified plan or IRA makes distributions in order to generate liquidity for the payment of unitrust payments to the surviving domestic partner. In conjunction with strategic elections by the plan participant or IRA beneficiary regarding the form and timing of plan distributions, testamentary charitable remainder unitrusts can be used to defer income tax liability on qualified plan or IRA distributions, sometimes for decades.

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[50] *See, e.g.*, A.R.S. Section 14-2804.

e. *Effect of ten-percent remainder provisions.* As noted above, younger taxpayers' use of charitable remainder trusts was significantly curtailed by the enactment of the so-called "ten-percent remainder provisions" of the Taxpayer Relief Act of 1997.[51] Under the ten-percent remainder rules, the actuarially calculated present value of the charity's remainder interest in a charitable remainder trust must equal at least ten percent (10%) of the net fair market value of the property as of the date the property is contributed to the trust.

Some existing testamentary charitable remainder unitrusts not in compliance with the ten-percent remainder interest provisions can be cured by amending the trust or will to reduce the unitrust payout rate.[52] Formula amendments to revocable living trusts containing testamentary charitable remainder unitrust provisions, whereby the trust's stated unitrust payout rate will be reduced to the extent necessary to comply with the ten-percent remainder provisions, could also be considered. Alternatively, such amendments could shorten the term of a testamentary charitable remainder trust to twenty years or less.

f. *Wealth replacement.* Importantly, the taxpayer should consider creating liquidity for the payment of federal estate tax liability on the portion of the charitable remainder unitrust likely to be paid out to the noncharitable beneficiary in the form of annuity or unitrust payments. Often the taxpayer's applicable exclusion amount will be utilized to shelter illiquid assets (such as a personal residence) from estate tax, rather than to create liquidity for the payment of estate tax liability. In any event, the noncharitable beneficiary will be loath to pay estate taxes from the assets sheltered by the applicable exclusion amount.

Life insurance, if available and affordable, is an efficient method of creating the liquidity needed to pay estate tax liability. Such life insurance coverage could be owned by an irrevocable life insurance trust or by a noncharitable beneficiary, although neither alternative is ideal. Determining appropriate beneficiaries for irrevocable life insurance trusts in this context may be difficult. Domestic partners may create revocable living trusts that, in turn, create testamentary charitable remainder trusts, with the goal of providing for each other and for charitable organizations. Naturally, they would choose to name each other and their charitable beneficiaries as the beneficiaries of the irrevocable life insurance trusts as well. However, such choices will result in outright distributions of income and principal from the irrevocable life insurance trusts to noncharitable beneficiaries who were thought to be inappropriate recipients of such outright distributions from the revocable trusts. Insurance-averse or uninsurable taxpayers may choose to create this liquidity, albeit less efficiently, by creating an irrevocable trust to be funded with annual exclusion gifts.

g. *Drafting Issues.* When drafting testamentary charitable remainder trusts, choosing between unitrusts and annuity trusts, or among standard, net-income, net-income-with-makeup, or "flip" trusts, impacts the drafting of the will or trust in which the testamentary charitable remainder trust language appears. Analysis of these alternatives does not present any additional issues uniquely applicable to domestic partners. Choosing from among the various alternative forms of charitable remainder trusts will hinge on various factors, including (1) the types of assets anticipated to be available for the funding of the testamentary charitable

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51 26.U.S.C.A. Sections 664(d)(1)(D), (d)(2)(D).

52 26 U.S.C.A. Section 2055(e)(3)(J).

remainder trust, (2) the anticipated income needs of the noncharitable beneficiary, and (3) the preferences of the taxpayer as to the relative amounts to be distributed to charitable and noncharitable beneficiaries under his estate plan.

Regulations permit "flip" charitable remainder unitrusts, including testamentary "flip" charitable remainder unitrusts. As reflected in the regulations, it is contemplated that "flip" trusts will be used in situations where the assets to be transferred into the charitable remainder trust are not readily marketable. Notably, the regulations define the parameters of events that can trigger the "flip" as those events the occurrence of which are beyond the donor's control. Presumably such events could include a litany of events relating to the donor's domestic partner, including his or her retirement, disability, bankruptcy, or termination of employment. Planning opportunities using "flip" unitrusts may prove attractive to unmarried domestic partners in ways that are not relevant to married couples.

Testamentary charitable remainder unitrusts were historically often appropriate for the estate plans of younger individuals. However, the flexibility of testamentary charitable remainder unitrusts for such taxpayers was considerably restricted by the enactment of the ten-percent remainder provisions.[53] The ten-percent remainder provisions apply to testamentary charitable remainder trusts in much the same manner as to inter vivos charitable remainder trusts. The effect of the ten-percent remainder provisions is particularly problematic where, as often is the case, the proposed noncharitable beneficiary of the charitable remainder trust is considerably younger than the taxpayer. Careful analysis of the actuarial calculations will determine the effect of the ten-percent remainder rule on the ability of the estate planning arrangement to qualify as a testamentary charitable remainder unitrust.

h. *Tax Apportionment.* One easily overlooked aspect of testamentary charitable remainder unitrusts is that the actuarially determined value of the intervening noncharitable beneficiary's interest in the trust is subject to federal estate tax liability in the estate of the donor. The magnitude of the estate tax problem increases with the increasing size of the charitable remainder trust itself, as well as with the periodic increases since 1998 in the estate tax applicable exclusion amount, which in many testamentary charitable remainder trusts is a benchmark in the formula for determining the value of the assets to be allocated to the testatmentary charitable remainder trust. Accordingly, planning for payment of estate taxes is particularly difficult for residuary testamentary charitable remainder unitrusts, where the value of the assets in the charitable remainder trust cannot be determined with any certainty until the death of the person whose Will or revocable trust agreement creates the testamentary charitable remainder trust.

The payment of federal estate tax liability from a charitable remainder trust is a disqualifying event. Accordingly, the estate planning documents should contemplate other sources from which the federal estate tax liability can be paid. The author's highly unscientific survey of computer programs calculating the tax effect of charitable remainder trusts reflects that many of such computer programs contemplate that large estate tax liabilities resulting from intervening noncharitable interests in charitable remainder trusts are provided for prior to the funding of the charitable remainder trust itself.[54] For example, an illustration of the effect of a residuary

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[53] 26.U.S.C.A. Sections 664(d)(1)(D), (d)(2)(D).

[54] Examples in the regulations contemplate a similar procedure. *See* Treas. Regs. Section

testamentary charitable remainder trust in a $10,000,000 estate might reflect that a noncharitable beneficiary or beneficiaries will be distributed the portion of the estate covered by the applicable exclusion amount of the taxpayer. The amount of the applicable exclusion, under current law, depends on the year in which the taxpayer's death will occur. Thereafter, an additional amount will be set aside for the payment of the federal estate tax liability occasioned by the creation of the charitable remainder trust. Finally, the remaining assets will be transferred to the charitable remainder trust, net of the amounts set aside to pay the anticipated federal estate tax liability. Calculation of this amount requires a circular computation. In effect, the amount transferred to the charitable remainder trust is "grossed down" in order to create liquidity for the payment of the federal estate tax liability. The "grossing down" reduces the amount transferred to the charitable remainder trust and, therefore, reduces the federal estate tax charitable contribution deduction available for the actuarially calculated value of the charity's interest in the charitable remainder trust.

The tax apportionment clause of the taxpayer's will should be carefully crafted to dovetail with the testamentary charitable remainder unitrust. For example, tax apportionment clauses commonly provide that all federal estate tax liability will be borne by the taxpayer's residuary estate. Such a provision could trigger disastrous tax results, including the failure of the arrangement to qualify as a charitable remainder trust (and federal estate tax liability triggered by distributions for the benefit of charity), if the estate plan also includes a testamentary charitable remainder trust created by a residuary bequest or distribution in a will or revocable trust. One possible drafting solution would be to provide that under no circumstances shall the charitable remainder trust be required to shoulder any estate tax burden.

Of course, the estate plan can be structured to require specifically the payment of any federal estate tax liability generated by the creation of the testamentary charitable remainder trust from other estate assets or from sources outside the taxpayer's estate. Typically, it is not desirable to require that such estate tax liability be paid from the amount excluded from federal estate tax liability by the taxpayer's applicable exclusion amount. A more palatable alternative may be to create a separate fund not includable in the taxpayer's estate for the payment of such federal estate tax liability.

This result can obtain through the creation of an irrevocable life insurance trust for the purpose of holding an insurance policy on the life of the taxpayer. The proceeds of the life insurance will conveniently provide liquidity for the payment of the estate taxes generated by the creation of the testamentary charitable remainder trust. However, as noted above, determining the dispositive provisions of the irrevocable life insurance trust can be problematic.

i. *Conclusions.* Testamentary charitable remainder unitrusts are hardly a seamless strategy for wealth transfer between unmarried domestic partners. Domestic partners may choose to avoid the complex and expensive legal and administrative requirements of charitable remainder trusts by purchasing additional life insurance to create liquidity to pay federal estate tax liability. Also, a domestic partner may balk at the prospect of his or her surviving domestic partner's giving up control over the assets that will constitute the trust estate of the charitable remainder unitrust.

1.664.1(a)(6), Ex.(4).

2. **Grantor retained annuity trusts**. The unavailability of the federal estate and gift tax marital deductions may motivate high-net-worth unmarried domestic partners, more than other high-net-worth individuals, to consider planning opportunities using grantor retained annuity trusts (GRATs).[55] A taxpayer can transfer property to a GRAT, retaining an annuity interest for a period of years, after which the remaining property in the trust passes to the individual's domestic partner or other family members. The federal gift tax consequences of transfers to GRATs depend on the rate of return to be earned by the trust. The IRS actuarial tables provide factors for calculating the GRAT's anticipated rate of return (and consequently the federal gift tax consequences of the transfer) based on the applicable federal rate in the month in which the transfer occurs.

Because the taxpayer who transfers property to a GRAT for the benefit of his or her domestic partner is retaining an annuity interest, he or she is treated for federal gift tax purposes as transferring only a remainder interest in the property to his or her domestic partner. The current federal gift tax consequences of the transfer are favorable relative to an outright transfer of the same property.

Further, a taxpayer's transfer of a remainder interest in property through a GRAT may in fact more closely approximate the taxpayer's intentions to benefit his or her domestic partner, as compared to an outright transfer of the property.[56] When considering planning strategies involving transfers to their unmarried domestic partners, many taxpayers demonstrate heightened concerns about retaining control over their assets. Transfers with retained interests, such as transfers to GRATs, may prove to be palatable to individuals who will not consider outright transfers of the same property due to concerns about control of the property.

Commentators have illustrated that the use of GRATs does not necessarily result in an improvement in estate tax treatment as compared to making outright gifts.[57] While GRATs remove appreciation in excess of the applicable federal rate from a donor's estate, outright gifts remove all appreciation in the donated asset from the donor's estate. Also, the federal transfer tax reduction effectiveness of transferring assets to a GRAT is lessened by the addition of the annuity payments from the GRAT back into the donor's estate. Thirdly, the federal transfer tax reduction benefit of a GRAT is diminished or eliminated if the donor does not survive the term of years of the GRAT's existence. An outright gift compares favorably to a GRAT in this respect as well,

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[55] Since the enactment of Sections 2701 through 2704 of the Internal Revenue Code, grantor retained annuity trusts constitute the only viable planning technique for married couples and parties otherwise related by blood, from among the available statutory split-interest trusts involving grantor-retained interests, namely, grantor retained income trusts (GRITs), grantor retained annuity trusts (GRATs), grantor retained unitrusts (GRUTs). Because unmarried couples are not included in the statutory definitions of persons within the purview of Sections 2701 through 2704, unmarried couples can avail themselves of GRITs and GRUTs as well as GRATs.

[56] If the investment performance of the property transferred to a GRAT is better than the applicable federal rate, then the remainder interest will actually be worth more than the amount at which it was valued for gift tax purposes. Accordingly, the present environment of extremely low applicable federal rates and better than average investment performance is ideal for gifts to a GRAT.

[57] *See e.g.*, Katzenstein, *Economic and Evaluation Planning Opportunities: GRITs, GRATs, GRUTs and QPRTs*, 1997 ALI-ABA ESTATE PLANNING IN DEPTH 1221 *et seq.* (1997).

because the donor of an outright gift need not survive for any certain period of time in order for the federal estate reduction tax benefit to obtain.

It has been observed that GRATs can be helpful estate tax reduction strategies for assets whose appreciation potential is uncertain. If the value of an asset transferred to a GRAT diminishes, then the donor will not have squandered any of his or her applicable exclusion amount or annual exclusion amounts by applying them to the transfer to the GRAT. Using applicable exclusion amounts advisedly is particularly important for high-net-worth domestic partners, who will not benefit from any marital deduction and therefore cannot afford to waste their only uncomplicated estate tax reduction strategy, namely, the lifetime applicable exclusion.

Transferring assets to a GRAT may be a less attractive long-range strategy than making outright gifts, due to the inability to shift all of an asset's appreciation out of the estate, the addition of the annuity payments from the GRAT back into the donor's estate, and the risk that the taxpayer will not survive the term of the GRAT. Nevertheless, taxpayers may find it attractive to make larger current gifts with reduced federal gift tax liability by the use of a GRAT. In particular, this feature of a GRAT may be attractive to individuals who would choose to leave all of their considerable estates to their surviving domestic partners but for federal transfer tax consequences. Gift planning for these persons is again informed by the fact that no federal estate tax marital deduction will be available to defer the federal estate tax liability. Such persons are often highly motivated to avoid erosion by federal estate tax of the assets to be transferred to their surviving domestic partners. Such individuals may choose to leverage their available federal transfer tax exclusions during their lifetime by making gifts to their unmarried domestic partners.

3. **Qualified personal residence trusts**. An attractive option for older individuals with younger unmarried domestic partners may be to create a qualified personal residence trust for a highly-appreciated home.[58] The creation of a qualified personal residence trust can be ideal for some individuals who would prefer to dedicate as much of their applicable exclusion amounts as possible to the transfer of liquid assets, as opposed to the personal residence, to their surviving domestic partners. The QPRT can reduce the amount of applicable exclusion needed to shelter a gift of a personal residence from transfer tax liability.

While the individual who creates a GRAT will receive annuity payments that will have the affect of increasing the size of his estate, the individual who creates a QPRT will receive only the continuing use of the personal residence held by the QPRT, which does not increase the value of the individual's estate for federal estate tax purposes. At the end of the term of a QPRT, the QPRT property will pass to the surviving domestic partner, at which time the individual who created the QPRT can arrange to lease the residence from the new owner. This can be an effective planning strategy for couples with substantially disparate assets. If a high-net-worth unmarried domestic partner can anticipate substantial federal estate tax liability upon his or her death, and if the omnipresent control issues attendant to large gifts can be resolved, the use of the QPRT can deliver the residence to the domestic partner with greatly reduced federal transfer tax liability concerns.

A donor who survives the term of a QPRT no longer has any legal right to possession of the residence unless there is a rental arrangement with the donee. The IRS may scrutinize the lease

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[58] The qualified personal residence trust and its less popular companion, the personal residence trust, sometimes called a "personal residence GRIT," are grantor retained income trusts containing a personal residence rather than an income-producing asset. Treas. Regs. Section 25.2702-5(c).

arrangement to verify that the lease was entered into at arm's-length. Many donors balk at the requirement to lease their former residences from their beneficiaries (typically, their children) after the end of the term of a QPRT. Conversely, certain unmarried domestic partners may be more than willing to enter into arrangements to lease their residences from their domestic partners. Also, although the IRS has proscribed the sale of a personal residence from a QPRT to its grantor or to the grantor's spouse or any entity controlled by the grantor or the grantor's spouse,[59] the IRS has not prohibited the sale of a personal residence from a QPRT to the unmarried domestic partner of the grantor. Thus, a grantor's unmarried domestic partner can purchase the grantor's residence from a QPRT without running afoul of the proposed regulations.

The need for a bona fide lease arrangement allows a QPRT donor to reduce his estate even further through continuing rental payments to the beneficiaries (again, typically his or her children). Similarly, a high-net-worth unmarried domestic partner can reduce his estate in this manner by making rental payments to his or her domestic partner as the new owner of the residence.

In a typical planning situation involving a QPRT, a taxpayer transfers a residence in which, by definition, he or she is then living, to a QPRT for the benefit of children or other beneficiaries who do not reside with the taxpayer in the residence that is the subject of the QPRT. In a planning situation involving unmarried domestic partners, both the taxpayer who owns the residence prior to the transfer and the beneficiary who will own the residence at the end of the term of the QPRT ordinarily live in the residence before, during, and after the term of the QPRT. Care should be taken in preparing the leases or other arrangements characterizing the circumstances under which the individual who created the QPRT and his or her domestic partner are living in the residence, both during the term of the QPRT and thereafter.

4. **Private annuities.** Unmarried individuals, particularly those with considerably younger[60] domestic partners, can also plan effectively with private annuities.[61] A private annuity can effectively remove a substantial amount of wealth from an estate for federal estate tax purposes, because the taxpayer has transferred property out of his or her estate in exchange for an annuity payment stream, which typically ends upon the taxpayer's death. Also, a private annuity accomplishes an estate freeze effect by removing future appreciation from the transferor's gross estate. For domestic partners, the creation of private annuities can ameliorate the unavailability of the marital deduction. Finally, a private annuity permits the owner of

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[59] Prop. Regs. Section 25.2702-5(c)(9) (effective for QPRTs created after May 16, 1996). Also, a sale or transfer to another grantor trust created by the grantor or the grantor's spouse is deemed a sale or transfer to the grantor or the grantor's spouse, as the case may be. *Id.*

[60] To avoid gift tax consequences upon the creation of a private annuity, the actuarial value of the annuity promise must equal the value of the transferred property as determined under rate tables. 26 U.S.C.A. Section 7520; IRS Publications 1457 and 1458. The rate tables assign the life expectancy of the transferor. Subject to regulations governing "terminally ill" transferors, the estate-reduction power of private annuities can be leveraged when the transferor's actual life expectancy is shorter than that prescribed by the Section 7520 rate tables. *See* Treas. Regs. Sections 1.7520-3(b)(3), 20.7520-3(b)(3), and 25.7520-3(b)(3).

[61] A private annuity agreement requires one party to transfer property to another party in return for the transferee's agreement to make periodic payments to the transferor for his life.

non-income-producing property to make that property productive and can result in favorable deferral of income taxes over the period during which the annuity payments will be received.

Private annuities must be unsecured obligations in order for the transaction to avoid IRS characterization for federal estate tax purposes as a transfer with a retained life estate.[62] Accordingly, private annuities are appropriate only in those circumstances in which the transferor trusts the transferee implicitly.[63] Also, a transferor may not feel secure unless the transferee under the private annuity has some independent means, other than the proceeds of the liquidation of the transferred property, to meet the annuity payment obligation.

Private annuities can also be used by both unmarried domestic partners to remove property from both of their estates for the benefit of a child, a niece or nephew, or other beneficiary. Joint and survivor private annuities can be more affordable for the transferee, because the actuarial calculations based on both transferors' lives can result in much lower payments. Also, joint and survivor annuities can provide an income stream for a surviving domestic partner. Joint and survivor private annuities are permissible even if the transferors are not married and are not eligible for the marital deduction. Such joint and survivor annuity arrangements involving two unmarried domestic partners as transferors do, however, result in completed gifts to each other[64] measured by the difference between the value of each transferor's contribution and the value of each transferor's annuity interest.

C. Generation-skipping transfers. For unmarried domestic partners, as well as for others who name non-family members as beneficiaries of amounts in excess of the exemption amount, planning for the generation-skipping transfer tax involves careful application of the rules regarding assignments of persons to particular generations with respect to the transferor. For non-family members, generation assignments are based on the relative ages of the transferor and transferee.[65] Spouses are assigned to the same generation for purposes of calculating generation-skipping transfer tax liability, and therefore no generation-skipping transfer tax liability can arise with respect to transfers between spouses. Conversely, there can be generation-skipping transfer tax liability as between a high-net-worth individual and his or her much younger domestic partner.

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[62] 26 U.S.C.A. Section 2036. *See, e.g., Bell Est. v. Com'r*, 60 T.C. 469 (1973) (if the annuity promise is secured by the transferred property, then the transferor's gain in the transferred property will be recognized in the year of sale).

[63] Because transferors often hesitate to transfer valuable assets directly to their unmarried domestic partners, private annuity arrangements involving trusts for the benefit of the transferees may be more palatable to the transferors. However, private annuity trusts are subject to strict IRS scrutiny and must be structured accordingly.

[64] Each transferor's gift can be excluded from gift tax by the filing of a gift tax return and allocation of a portion of the transferor's applicable exclusion amount to the gift. The transferor's annual exclusions from the gift tax cannot be used because the gifts of annuity interests do not constitute gifts of a present interest.

[65] 26 U.S.C.A. Section 2651(d).

Unmarried domestic partners are not included in the class of family members for whom generation assignments are based on lineage.[66] Any person not more than twelve and one-half (12½) years younger than the transferor is assigned to the transferor's generation.[67] Any person who is more than twelve and one-half (12½) years younger than the transferor but less than thirty-seven and one-half (37½) years younger than the transferor is assigned to the first generation below the transferor.[68] Any person more than thirty-seven and one-half (37½) years younger than the transferor but less than sixty-two and one-half (62½) years younger than the transferor is assigned to the second generation below the transferor.[69] Occasionally, planners will be required to consider the generation-skipping transfer tax implications of estate planning strategies for unmarried domestic partners where an age difference of more than thirty-seven and one-half (37½) years occurs.

More frequently, perhaps, individuals wish to make provision in their estate planning for the children or other beneficiaries of their unmarried domestic partners, and where no family relationship exists, the age-based rules for generation assignments will apply. In such circumstances, if the amounts to be transferred could exceed the available exemption amounts, planners will be required to consider the generation-skipping transfer tax implications of estate planning strategies for clients' domestic partners' children and other family members where an age difference of more than thirty-seven and one-half (37 ½) years occurs. However, if the transferee has been validly adopted under state law by the transferor, then the transferee is assigned to the first generation below the transferor based on lineage, and therefore the generation-skipping transfer tax liability that would otherwise attach to any such transfer can be avoided.

Finally, it is important to remember that large distributions by the estates or trusts of unmarried persons to their grandnieces and grandnephews, for example, can give rise to generation-skipping transfer tax liability based on lineage.

D. Opportunities created by Chapter 14. Since 1990, Chapter 14 of the Internal Revenue Code has imposed unfavorable gift tax consequences on certain intra-family transfers. Such restrictions on intra-family transfers of interests in corporations and partnerships,[70] intra-family transfers of interests in trusts,[71] and certain lapsing voting and liquidation rights in family partnerships and corporations,[72] do not apply to many transfers involving unmarried domestic partners, who lack a family relationship recognized as such by the Internal Revenue Code. Planners will have an opportunity to identify whether such arrangements between domestic partners who later marry (and, more importantly for tax purposes, between taxpayers and

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66 26 U.S.C.A. Section 2651(b), (c).

67 26 U.S.C.A. Section 2651(d)(1).

68 26 U.S.C.A. Section 2651(d)(2).

69 26 U.S.C.A Section 2651(d)(3).

70 26 U.S.C.A. Section 2701.

71 26 U.S.C.A. Section 2702.

72 26 U.S.C.A. Section 2704.

the children or other relatives of the domestic partners whom they later marry) will become subject to family attribution rules such as those found in Chapter 14 as a result of those marriages.

1. Section 2701. Section 2701 generally applies to transfers of interests in corporations and partnerships to members of the transferor's family in cases in which the transferor retains an ownership interest with certain distribution preferences or other preferred rights. For purposes of the special valuation rules of Section 2701 for such intra-family transfers of interests in corporations and partnerships, neither a taxpayer's unmarried domestic partner nor a child of a taxpayers' domestic partner is included in the definition of "a member of a transferor's family"[73] or an "applicable family member."[74] Accordingly, transfers between unmarried domestic partners and transfers between a taxpayer and the child of the taxpayer's domestic partner do not constitute transfers between family members for purposes of the Section 2701 special valuation rules.[75] Thus, the attempt of Section 2701 to limit the transfer tax reduction capabilities of corporate and partnership recapitalization freezes is ineffective with respect to transfers of business interests between domestic partners or, perhaps more importantly for transfer tax purposes, to the children of a stockholder's domestic partner. Again, planners must consider that the choice of some domestic partners to marry will bring their intra-family transactions under the purview of the family attribution rules of Chapter 14 and other parts of the Internal Revenue Code and the possible unanticipated and/or unpleasant tax consequences of that result.

2. Section 2702. Since 1990, Section 2702 has governed whether a transfer of an interest in trust to a family member of the transferor constitutes a taxable gift and provides special valuation rules for determining the value of the gift. Unmarried domestic partners are not included in the definition of transferee "family members" for purposes of valuing intra-family transfers of interests in trusts.[76] Accordingly, the special valuation rules of Section 2702 do not apply to transfers of interests in trusts between unmarried domestic partners or to the children of a domestic partner. Transfers to domestic partners of interests in GRATs, GRITs, and other split-interest trusts will not result in the valuation of the interest retained by the grantor at zero, which result would otherwise obtain under Section 2702.

3. Section 2704. Section 2704 prescribes special valuation rules for purposes of valuing lapsing voting or liquidation rights in family partnerships or corporations. Unmarried

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[73] 26 U.S.C.A. Section 2701(a)(1); Treas. Regs. Section 25.2701-1(a)(1). A member of the transferor's family is defined as the transferor's spouse, lineal descendants of the transferor or the transferor's spouse, and the spouse of any such lineal descendant. Thus, the Section 2701 definition of family member does not include a transferor's parents, siblings, nieces or nephews, domestic partner, or children of a domestic partner.

[74] 26 U.S.C.A. Section 2701(e)(2); Treas. Regs. Section 25.2701-1(d)(2). An applicable family member includes the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor, but not a domestic partner or any relative of a domestic partner.

[75] 26 U.S.C.A. Section 2701.

[76] 26 U.S.C.A. Section 2702(e), *citing* 26 U.S.C.A. Section 2704(c)(2); Treas. Regs. Section 25.2702-2(a)(1). Transferees who are "family members" under Section 2702 include the taxpayer's spouse, lineal descendants and ancestors, and siblings, as well as the taxpayer's spouse's lineal descendants and ancestors (but not siblings), and the spouses of any persons in either category.

domestic partners are not included in the definition of transferee "family members" for these purposes.[77] Accordingly, the special valuation rules of Section 2704 do not apply to lapsing voting or liquidation rights in family partnerships or corporations to the extent that those lapsing voting or liquidation rights result in transfers to domestic partners or to the children of a domestic partner.

E. Effect of other family attribution rules in Internal Revenue Code. As noted above, unmarried domestic partners may avail themselves of certain traditional transfer tax reduction and freezing techniques because their relationships are not recognized as family relationships under Chapter 14. In addition, many transactions undertaken by unmarried domestic partners will be given effect for certain tax purposes, to the benefit of the domestic partners, even though the tax treatment of similar transactions would be subject to special rules under the Internal Revenue Code if such transactions were undertaken by married couples or other persons who are determined to have familial relationships under the Internal Revenue Code.

For example, when a taxpayer sells or exchanges property to a family member at a loss, such a loss is disallowed for income tax purposes,[78] but a taxpayer can sell or exchange property to his or her domestic partner, the loss is not disallowed. Similarly, any otherwise allowable interest expense deductions are disallowed if the payee is a family member with respect to the payor,[79] but not if the payor and payee are unrelated. A loan bearing interest at a below-market rate has certain income and gift tax consequences for family members,[80] but not for domestic partners and others not included in the Code's definition of a family member. Finally, family attribution of stock ownership[81] does not extend to a stockholder's domestic partner or to any persons related to the domestic partner.

VI. CREATING LIQUIDITY TO DEFRAY ESTATE TAX LIABILITY.

A. Life insurance and irrevocable life insurance trusts. Unmarried domestic partners may be motivated to use life insurance products for the same reasons as other persons. In addition, high-net-worth unmarried domestic partners may choose to acquire life insurance coverage to create liquidity for the payment of estate taxes, because their estates will be ineligible for the federal estate tax deferral occasioned by the federal estate tax marital deduction. Not only will the domestic partners often require additional insurance coverage to meet this need, but they must also plan differently for the ownership of the policies so that the proceeds of the policies will

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77 26 U.S.C.A. Section 2702(e), *citing* 26 U.S.C.A. Section 2704(c)(2); Treas. Regs. Section 25.2702-2(a)(1). Transferees who are "family members" under Section 2702 include the taxpayer's spouse, lineal descendants and ancestors, and siblings, as well as the taxpayer's spouse's lineal descendants and ancestors (but not siblings), and the spouses of any persons in either category. Note the effect of Rev. Rul. 2013-17 which would have the effect of including same-sex spouses as taxpayers' family members.

78 26 U.S.C.A. Section 267. Section 267 disallows losses from a sale or exchange between certain related parties. For purposes of Section 267, a "family member" includes the taxpayer's spouse, ancestors, lineal descendants, and siblings. 26 U.S.C.A. Section 267(c)(4).

79 26 U.S.C.A. Section 483(e).

80 26 U.S.C.A. Section 7872.

81 26 U.S.C.A. Section 318.

not be subject to federal estate tax liability. Married couples have an advantage over domestic partners because any policy proceeds paid to a surviving spouse and included in the deceased spouse's will themselves qualify for the federal estate tax marital deduction.[82] Conversely, policy proceeds payable to the domestic partner of an insured will be included in the insured's estate if the insured had incidents of ownership in the policy.[83] Accordingly, when planning for insurance policies held for the benefit of an insured's domestic partner or for the creation of liquidity for the payment of the insured's federal estate tax liability, the goal from a federal estate tax reduction perspective is to make certain that the insured holds no incidents of ownership in the policy.

Also, to the extent that the surviving domestic partner does not consume the proceeds from the policy insuring the life of the predeceased domestic partner, and if the surviving domestic partner's estate is subject to federal estate tax liability, the policy proceeds will be taxed in the surviving domestic partner's estate.

One planning technique for life insurance held for the benefit of an unmarried domestic partner is for the domestic partner, as the intended beneficiary of the policy proceeds, to own the policy. Taxpayers often find this technique to be appealingly simple. However, the admittedly more complex techniques involving the transfer of policies to special purpose trusts (typically known as irrevocable life insurance trusts) can protect the insureds from the whims and caprices of their domestic partners, who otherwise would have the power to change policy beneficiary designations, stop making required premium payments on policies, borrow all the cash values out of the policies, or otherwise thwart the insured's intentions with respect to the policies. Also, if the relationship of the insured and his or her domestic partner deteriorates, the ownership of the policy by the domestic partner can become an intolerably inflexible arrangement.

Finally, ownership of a life insurance policy by an unmarried domestic partner of an insured may violate state law regarding insurable interests. Under some state laws, the lack of a familial relationship, recognized in law, between domestic partners can trigger the application of state laws regarding the "insurable interest" of an unmarried person as the beneficiary of the proceeds of life insurance policies of his or her deceased domestic partner.[84] Also, with respect to selection from among life insurance products, domestic partners may confront practical limitations of the life insurance underwriting process.

Unlike the proceeds of a policy held by the beneficiary outright, the proceeds of a policy held in an irrevocable trust can escape federal estate tax liability in the estates of both the insured and his or her domestic partner. Further, a policy held in an irrevocable life insurance trust will not trigger federal estate tax consequences in the event of an unanticipated order of death. Conversely, if an insured's unmarried domestic partner holds a policy on the insured's life and predeceases the insured, then the cash surrender value of the policy would be includable in the domestic partner's estate for federal estate tax purposes.[85] It is also important to note that irrevocable trusts can be drafted to terminate the domestic partner's interest at the end of his or her relationship with the

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82 26 U.S.C.A. Section 2056(a).

83 26 U.S.C.A. Section 2042(2).

84 *See, e.g.,* A.R.S. Section 20-1104.

85 Treas. Regs. Section 20.2031-8(a)(1).

insured and to provide the trustee a discretionary distribution power to make certain that the trust is administered in a manner not inimical to the interests of the insured, despite changing personal circumstances. Finally, as with all trusts, an irrevocable life insurance trust allows the grantor to create considerable flexibility and control over distributions from the trust. Concerns about major changes in the insured's circumstances can often be addressed by drafting limited powers of appointment in favor of obedient and deferential third parties, giving them the power to change the trust terms, name new beneficiaries, or appoint trust assets out of the irrevocable trust. Also, if it is not anticipated that the trust will generate taxable income during the period before the policy matures, the insured can consider providing an independent third party with the right to alter or amend the terms of the trust to address changes in the tax laws or to add or remove beneficiaries.[86]

Sometimes overlooked are the income tax consequences of transfers of life insurance policies. To review an important exception to the general rule that life insurance proceeds are not subject to income tax liability,[87] the transfer-for-value rule[88] provides that the proceeds paid on a policy which was transferred during the insured's lifetime for valuable consideration constitute income to the extent the proceeds exceed the transferee's basis in the policy. Exceptions to the transfer-for-value rule include transfers to the insured, a partner of the insured, a partnership including the insured, or a corporation of which the insured is a shareholder or officer.[89] Ordinarily, transfers of policies between domestic partners occur without consideration, and thus the transfer-for-value rule would not render the proceeds of the transferred policy subject to federal income tax liability. However, if a policy is transferred to the unmarried domestic partner of the insured under the policy in return for consideration, then the domestic partners should consider strategies for transferring the policy that fall within an exception to the transfer-for-value rule. Such strategies would be similar or identical to those implemented by business partners with respect to insurance policies held for the purpose of funding buy-sell agreements.

B. Irrevocable trusts funded with cash or securities. An insurance-averse or uninsurable taxpayer may choose to create liquidity, albeit not as efficiently as with the use of appropriate insurance products, by creating an irrevocable trust to be funded with annual exclusion gifts. This technique can be appropriate for taxpayers who wish to make gifts to their domestic partners but who wish to impose restrictions or conditions on the use of the assets. Although annual exclusion gifts to an irrevocable life insurance trust of cash, or even of highly-appreciating property, are perhaps less efficient than other strategies for utilizing the unified credit, such as GRATs, QPRTs, or (as noted above) irrevocable life insurance trusts, their relative simplicity can be attractive. Advisers are challenged to craft an arrangement that is irrevocable but anticipates and provides for all circumstances under which the grantor would want to modify the dispositive provisions. For example, attorneys face an intricate drafting task to define in the trust agreement the circumstances under which the grantor's unmarried domestic partner will no longer have any

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[86] 26 U.S.C.A. Section 674. Such a power would render the irrevocable life insurance trust a grantor trust for federal income tax purposes, and the insured, as the grantor of the trust, would be subject to federal income tax liability in the event that the trust were to generate any income.

[87] 26 U.S.C.A. Section 101(a)(1).

[88] 26 U.S.C.A. Section 101(a)(2); Treas. Regs. Section 1.101-1(b).

[89] *Id.*

beneficial interest in the trust, in the event the domestic partnership arrangement ends. Unlike other status, such as "dead," "pregnant," or (nowadays) "married," there is no litmus test for "living together" that is simple to administer. Trustees and other third parties have no bright-line rule available to them to determine who is living together and who isn't. Now that same-sex marriage is permitted in a number of jurisdictions, a corresponding problem is arising with respect to couples who wed at a time when such marriages, while legal in a very modest number of contexts, were largely symbolic, and who don't bother to get divorced when their relationships later end.

VII. QUALIFIED PLAN BENEFITS AND IRAs.

A. Designating a beneficiary. Designating unmarried domestic partners, children, or other non-spouse, noncharitable beneficiaries of qualified plans and IRAs can trigger income tax consequences unanticipated and unintended by the participant or IRA beneficiary. Unfortunately, no federal income tax spousal rollover is permitted for a participant's designation of his domestic partner or children as beneficiaries. For many professionally-employed domestic partners who now choose to marry, the federal income tax spousal rollover may be the most significant federal benefit of their marriage.

A qualified plan participant's spouse must consent in writing to the designation by the participant of any death beneficiary other than the spouse. Qualified plan benefits cannot be transferred to a beneficiary other than a spouse if no such written consent exists. Conversely, no such rule restricts the flexibility of unmarried qualified plan participants. Viewed from another perspective, the domestic partner of a qualified plan participant does not enjoy the same protections as the spouse of a qualified plan participant with respect to distribution of benefits after the death of the participant. This author has recently advised more than a few clients who were unaware of this legal regime (so-called spousal "REA rights") at the time they chose to marry their longtime domestic partners; at least one such client allowed as how she might have chosen not to enter into the marriage if that information had been available to her.

Other planning imperatives or opportunities may prompt the participant to designate his or her unmarried domestic partners or the children of their domestic partners as beneficiaries. Although no income tax spousal rollover is available for a qualified plan or IRA account designated in favor of an unmarried domestic partner or children, the unmarried domestic partner of the children of the participant may be in a lower tax bracket. In some cases, the relatively young age of the domestic partner or the children may create attractive opportunities for long-term income tax deferral through recalculation of life expectancies, etc., allowing continued tax-free accumulation of income.

Rather than make an outright beneficiary designation in favor of an unmarried domestic partner or children, a participant may choose to designate qualified plan proceeds in favor of a trust for the benefit of incorrigible, spendthrift, or disobedient domestic partners or children. The participant's decision to designate qualified plan proceeds for his or her domestic partner or children outright or into a trust will be based on non-tax considerations.

Some unmarried domestic partners may want to designate charities as qualified plan beneficiaries. Plan participants with charitable intent can fulfill their charitable commitments by designating charities as the beneficiaries of a qualified plan account or IRA. For very high-net-worth circumstances, the qualified plan or IRA proceeds may escape a combined estate tax and income tax burden of up to 80% if the domestic partner chooses to name charities as the

beneficiaries. For some qualified plan participants without children and with charitable intent, the combined tax burden that would result from distribution of the qualified plan or IRA account proceeds to the participant's domestic partner, pinpoints the IRA or qualified plan as the ideal asset for a planned charitable bequest. However, designating charities as beneficiaries of qualified plans or IRAs is no longer as attractive a proposition for the extremely wealthy from a tax perspective as it was prior to the repeal of the excess accumulation penalty. Plan participants should always consider making any charitable gifts through their qualified plan beneficiary designations. The federal income tax charitable contribution deduction from such gifts would offset the federal income tax liability on the qualified plan or IRA proceeds, in addition to the estate tax charitable contribution deduction, which eliminates the federal estate tax liability arising with respect to any estate asset bequeathed to charity. Some longtime domestic partners who choose to marry may be surprised that neither of them can designate qualified plan benefits in favor of a charity without spousal consent.

An unmarried qualified plan participant who intends in any event to make a charitable disposition at death can avoid considerable federal income tax liability by funding such dispositions with qualified plan or IRA proceeds rather than with non-IRD assets. Unmarried qualified plan participants who have not considered charitable giving may be persuaded to do so when they consider the anticipated erosion of their remaining account balances by both income and estate taxes at death.

For how long can immediate recognition of income on the IRA be avoided? Qualified plans and traditional IRAs permit tax-deductible contributions and tax-free compounding of investment returns until funds are distributed or withdrawn. The taxpayer's primary goal is usually to postpone the receipt of benefits for as long as possible in order to defer income tax liability. Much of the work in planning for IRAs and qualified plans involves dovetailing the income tax deferral planning with a participant's estate tax reduction planning and the minimum distribution rules.

Roth IRAs, which have no mandatory distribution rules, and distributions from which are generally not subject to income tax, are largely unaffected by the complex interface between the income tax laws and the estate tax laws. Eligible participants who intend to benefit their surviving unmarried domestic partners with any retirement plan account proceeds remaining at death should consider funding new Roth IRAs and converting existing traditional IRAs to Roth IRAs.

Due to the anti-alienation rule of ERISA, qualified plan accounts cannot be funded into trust or otherwise transferred during the life of the participant. Qualified plan benefits remaining at death are distributed according to the provisions of the plan document *unless* the participant has completed a *beneficiary designation* and has submitted the completed beneficiary designation to the plan administrator. Most plan documents include default provisions for the distribution of plan benefits of deceased participants where the participants have not submitted completed beneficiary designations. Needless to say, employer plan documents rarely, if ever, provide for distribution to the deceased participant's domestic partner. Therefore, it is very important for domestic partners who are plan participants to complete and submit their beneficiary designations in order to avoid arbitrary distributions governed by the plan document. The failure of the participant in *Cozen O'Connor v. Tobits*, discussed at the beginning of these materials, to complete a beneficiary designation form for her profit sharing plan account triggered the events that led to that case.

B. Choosing distribution options. The distribution rules for qualified plan and IRAs permit plan participants and IRA beneficiaries to select from among certain lifetime distribution

options. They also govern how quickly the benefits must be distributed after the death of the plan participant or IRA beneficiary. The rules governing unmarried participants are quite different (and considerably less favorable) than those governing married participants.

Subject to certain exceptions, a plan participant or IRA beneficiary must begin to take distributions from the qualified plan or IRA on or before his or her required beginning date ("RBD"), which is April 1 of the year following the year in which he or she turns age 70½.[90] By filing a complete beneficiary designation and election of distribution options with the plan administrator or IRA custodian or trustee, the plan participant or IRA beneficiary may affect the rate at which the qualified plan or IRA makes distributions to him or her.

The simplest manner in which distributions may be made (either by designation by the participant or IRA beneficiary, or by inadvertent failure of the participant or IRA beneficiary to name a designated beneficiary) is in installments over the actuarially calculated life expectancy of the plan participant or IRA beneficiary. The rate at which the distributions are made can be reduced (and, therefore, the time at which they are subject to income tax liability can be deferred) by choosing to take distributions over the lives of the participant and another designated beneficiary.[91] Under the April 2002 final regulations governing minimum distributions, the designated beneficiary of an unmarried participant, just like nearly all other designated beneficiaries, will be deemed to be no more than ten years younger than the participant, under a uniform life expectancy table that is actually same table that applied to unmarried participants' beneficiaries under the now-obsolete minimum distribution incidental benefit (MDIB) rule.[92] Distributions to a domestic partner from his or her qualified plan account or IRA can now be based on his life expectancy and the life expectancy of a person no more than ten years younger than the participant, even if the age difference between the domestic partners exceeds ten years, and this rule is now the same rule that applies to all other qualified plan beneficiaries.

If the plan participant or IRA beneficiary dies without having exhausted the funds in the plan account or IRA, distributions are made at the more favorable rate calculated by using the actual original joint life expectancy of the plan participant and the designated beneficiary. If the domestic partner/designated beneficiary is more than ten years younger than the participant, the effect of the death of the participant would be to lengthen the payout period significantly for the remaining account balance and, accordingly, to defer recognition of income tax liability. This rule is an exception to the general rule that the beneficiary of a deceased participant's account will continue to receive distributions "at least as rapidly" as the participant received them prior to the participant's death.[93]

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[90] 26 U.S.C.A. Section 401(a)(9).

[91] Treas. Regs. Section 1.401(a)(9), Q & A D-2. "Designated beneficiary" is a term of art in ERISA and the Code, meaning "an individual who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event." The designated beneficiary is ordinarily named by the participant in a beneficiary designation form, but can also be predetermined by language in the qualified plan document itself.

[92] Treas. Regs. Section 1.401(a)(9)-2.

[93] 26 U.S.C.A. Section 401(a)(9)(B)(i).

Under the April 2002 final regulations regarding minimum distributions, unmarried plan participants and IRA beneficiaries no longer face the question of whether to elect annual recalculation of their life expectancies. Annual recalculation of a participant's life expectancy is now subsumed in the required life expectancy tables used for all beneficiaries, ensuring that the account will not be exhausted before the participant's death, but also resulting in the participant's life expectancy being reduced to zero for purposes of determining the distribution rate for the remaining proceeds in the account after the participant's death. The 1987 proposed regulations contemplated an additional option, namely, to elect not to recalculate life expectancies, which is no longer an option under the April 2002 final regulations.

Married plan participants and IRA beneficiaries are well advised not to name trusts for the benefit of their spouses as primary beneficiaries of their plan accounts or IRAs, both because such trusts do not qualify for the valuable spousal rollovers and because such trusts must comply with certain rules in order to constitute "designated beneficiaries" of plan accounts or IRAs. Unmarried participants, however, are not sacrificing any potential rollover benefits by naming trusts as beneficiaries of their plan accounts or IRAs, because the beneficiaries of those unmarried participants are not entitled to rollover treatment.

Further, the rules regarding naming such trusts as designated beneficiaries have recently been relaxed somewhat.[94] A qualified plan beneficiary or IRA owner can name a trust as the account beneficiary if (1) the trust is valid under state law, (2) the trust beneficiaries can be identifiable from the trust instrument, (3) the trust is irrevocable or will become irrevocable upon the death of the plan participant or IRA owner, and (4) a copy of the trust document (or a certificate of trust in the form specified by the final regulations) is provided to the plan administrator or IRA custodian no later than the end of the year following the year of death.[95] Accordingly, if a plan participant or IRA beneficiary has important non-tax reasons for naming a trust for his or her domestic partner as the beneficiary of his or her plan accounts or IRAs, he or she can do so, while deferring lifetime payout of distribution of plan benefits over the joint life expectancy of both domestic partners.

Even after the promulgation of the April 2002 final regulations regarding minimum distributions from qualified plans and IRAs, there are disadvantages to naming trusts as beneficiaries of IRAs and qualified plans. The disadvantage arises from the requirement that, even if a trust complies with the four rules noted above in order for the trust beneficiaries to be considered "designated beneficiaries," then each of those trust beneficiaries must, in turn, meet the requirements to be considered a "designated beneficiary" of the qualified plan or IRA. Essentially, a "designated beneficiary" must be an individual; estates and charities cannot be "designated beneficiaries." In order to avoid a morass of policies propounded in IRS private letter rulings regarding which trust beneficiaries can and cannot constitute "designated beneficiaries," trust drafters can avail themselves of two informal "safe harbors." First, the trust could qualify as a so-called "conduit trust," in which the MRDs from the qualified plan account or IRA are required to flow directly through the trust to the trust beneficiaries. Such distributions, while enabling the desired tax result, would often thwart the nontax purpose of the trust (often, to prevent the beneficiary from controlling the funds). Second, the trust could be drafted so that

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[94] Treas. Regs. Section 1.401(a)(9)-1, Q & A D-5, D-6, and D-7.

[95] Treas. Regs. Section 1.401(a)(9)-4.

under no circumstances could any retirement benefit pass through the trust to a non-individual beneficiary.

For unmarried persons who die while they are employed and are continuing participants in an employer's 401(k) plan or other qualified retirement plan, the law allows any retirement plan account balance to be transferred to an inherited IRA for the unmarried participant's beneficiary (such as a child or a domestic partner) with less draconian income tax consequences. A provision in 2008 tax statutes requires employer-sponsored qualified retirement plans to offer nonspouse beneficiaries the opportunity to roll over an inherited plan account balance to an inherited IRA created to receive the rollover on behalf of the nonspouse beneficiary. Under prior rules, qualified plans could, but were not required to, offer nonspouse beneficiaries this rollover option. The rollover option gives much-needed flexibility to those who inherit retirement plan accounts from someone other than their spouse, such as a parent, an uncle, or an unmarried domestic partner. For some time, nonspouse beneficiaries of IRAs (as opposed to employer-sponsored retirement plan accounts) have had access to a rollover-type option that IRS has sanctioned. While nonspouse beneficiaries can't treat an inherited IRA as their own, they can make trustee-to-trustee transfers to another IRA if the ownership of the new IRA is set up in the same way as the ownership of the old IRA, that is, in the name of the decedent for the benefit of the IRA beneficiary. The new law is intended to provide equivalent options to a nonspouse beneficiary, whether the distributable amount is from an IRA or an employer-sponsored retirement plan.

Finally, spouses of qualified plan participants benefit from rules requiring qualified joint and survivor annuities[96] and qualified preretirement survivor annuities[97] in defined benefit plans and money purchase pension plans, while domestic partners do not benefit from any corresponding rule. Marriage recognition laws have added considerably to the ranks of potential surviving spouses who will benefit under public and private pension plans alike.

VIII. JOINT TENANCY.

Holding property in joint tenancy can be a boon for most unmarried domestic partners. The survivorship form of ownership permits the surviving domestic partner to acquire title to the entire asset automatically, without probate court involvement, upon the death of the first joint tenant to die. At most, for Arizona real property, the surviving joint tenant must record an affidavit of surviving joint tenant or, alternatively, a certified copy of the death certificate of the first joint tenant to die in order to remove the first joint tenant's name from the title to the property as a matter of record.

However, unmarried domestic partners are entitled only to a partial step-up in income tax basis upon the death of the first joint tenant. Conversely, opposite-sex married couples in Arizona who hold real estate or other property in their names as community property are eligible for a step-up in basis as to the entire property upon the death of one spouse. Accordingly, unmarried domestic partners with low income tax basis in property, particularly if one of the domestic partners contributed all of the consideration for the purchase and maintenance of the property, may choose not to hold property in joint tenancy form. In such a case, the domestic partner who contributed most or all of the consideration toward the purchase and maintenance of the property

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[96] 26 U.S.C.A. Section 401(a)(11)(B).

[97] *Id.*

may choose to hold the property in his or her individual name. If the domestic partner owning the low-basis property predeceases the other domestic partner, then a step-up in income tax basis will be available as to the entire property. Planners can analyze whether the anticipated expense of probate proceedings is justified in light of the benefit of the step- up in basis on the property and the likelihood that the surviving domestic partner will sell the property relatively soon after the owner's death. IRS policies regarding whether same-sex couples' marriages are recognized for federal tax purposes based on state of residency or otherwise may inform the result for basis adjustment of Arizona joint tenancy property owned by a surviving joint tenant who was married to the deceased joint tenant under the laws of a recognition state.

Analysis of joint tenancy ownership for high-net-worth unmarried domestic partners involves completely different concerns than for other joint tenants. First and foremost, high-net-worth domestic partners should be aware of the obligation upon the death of a high-net-worth individual to report to the IRS on the federal estate tax return the ownership of property held in joint tenancy with someone other than a spouse. The current version of IRS Form 706 specifically requires disclosure of any such property on Line 9 on page 3 of Form 706. This line item asks whether any non-spousal joint tenancy property was excluded, in whole or in part, from the gross estate. If the "yes" box is checked, the return preparer must attach a description of the property, the names of the joint tenants, a statement of total value of the property, the portion excluded, and the reason for the exclusion.[98] The full value of joint property is presumed to be part of the gross estate,[99] but the presumption may be overcome if it is established that a part of the property originally belonged to or was contributed by the other joint tenant, *i.e.*, by proof of actual cash contributions or inheritance records. Some portion of the joint property may be excluded on account of the work history of a surviving joint tenant.

Must the estate tax return preparer rebut the presumption of includability in the estate for federal estate tax purposes of the full value of non-spousal joint-tenancy property? The only case on point held that the preparer must rebut the presumption if possible[100]. The preparer may be tempted not to rebut the presumption and thereby obtain for the taxpayer a "free" stepped-up income tax basis in a non-taxable estate. The preparer should be alert to this issue, because the transferee of the overvalued property may rely on the valuation and run afoul of the overvaluation penalty under Section 6662(b)(3). With respect to same-sex spouses who reside in nonrecognition states like Arizona, whether or not their marriage is recognized for federal estate tax purposes (although an issue that applies to an exceedingly modest number of taxpayers) will have significant impact on the bottom line for some taxpayers, regarding issues such as the estate tax effect of joint tenancy ownership of property.

Because unmarried domestic partners often treat their assets as being held jointly, even though legal title to those assets may not reflect the respective contributions of each joint tenant to the acquisition and maintenance of the property, it can be very difficult for a surviving joint tenant to meet the IRS burden of proof regarding the exclusion of non-spousal joint tenancy property from the estate. For this reason, it is often preferable for such property to be held in trust, as tenants

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98 Form 706, Instructions for Schedule E.

99 Treas. Regs. Section 20.2040-1(b); Form 706, Instructions for Schedule E.

100 *Madden v. Com'r*, 52 T.C. 845 (1969), *aff'd per curiam*, 440 F. 2d 784 (7th Cir. 1971).

in common, by an individual domestic partner, or otherwise, rather than as joint tenants with right of survivorship.