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Income Tax Savings May Be Becoming Available to Registered Domestic Partners

In addition to providing a life partner, a support system, and the opportunity for a big party, getting married often saves you taxes. For most couples, especially those in which one spouse has a significantly higher income than the other spouse, marriage leads to significant tax savings compared to payment of taxes as unmarried individuals. The savings occur in large part because each partner can claim one-half of the total income earned by the couple. This "income averaging" often results in the application of a lower tax rate.[1]

In a significant departure from its prior rulings, the IRS recently extended the benefit of income averaging to registered domestic partners living in California. The persuasive new authorities issued by the IRS likely will also apply to registered domestic partners living in Washington. Thus, registering as a domestic partner may now save you taxes.

The Benefit of Income Averaging

To understand the benefit of income averaging, it is necessary to understand that the income tax rate is much higher on the last dollar of income earned by a taxpayer than it is on the first dollar of that taxpayer's income. For example, for unmarried individuals, 26 USC Section 1(c) provides that 2010 taxes are calculated according to the following table:

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If Taxable Income Is…	The Tax Is...
Below $8,375	10% of Taxable Income
Over $8,375, Below $34,000	$837.50 plus 15% of excess over $8,375
Over $34,000, Below $82,400	$4,681.25 plus 25% of excess over $34,000
Over $82,400, Below $171,850	$16,781.25 plus 28% of excess over $82,400
Over $171,850, Below $373,650	$41,827.25 plus 33% of excess over $171,850
Over $373,650	$108,421.25, plus 35% of excess over $373,650

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Thus, for a taxpayer (let's call him Josh) with $250,000 of taxable income, the first dollar he makes is taxed at 10% and the last dollar he makes is taxed at 33% (the tax on the last dollar of taxable income is called the "marginal tax rate"). Since his total tax bill is $67,616.75 on $250,000 of taxable income, his average rate of tax is 27.0%.[3]

For a second taxpayer (let's call him Brent) with $50,000 of taxable income, the first dollar he makes is taxed at 10% and the last dollar he makes is taxed at 25%. Since his total tax bill is $8,681.25 on $50,000 of taxable income, his average rate of tax is 17.4%.

Previously, the IRS took the position that, even if Josh and Brent are registered domestic partners, because they are unmarried, Josh must report his own income and pay his $67,616.75 in taxes while Brent must report his own income and pay his $8,681.25 in taxes, resulting in the couple paying a total of $76,298.[4]

Recently, however, the IRS ruled that for registered domestic partners living in California, each partner should now report one-half of the couple's total income on his individual income tax return. If Josh and Brent were California registered domestic partners, for example, each would report $150,000 of taxable income (half of their $300,000 total income). Since the tax on $150,000 of taxable income is $35,709.25, the couple would pay a total of $71,418.50. This is a tax savings of $4,879.50 for the year. The benefits of income averaging are even greater if one partner is a stay-at-home parent or otherwise not employed. If Brent had no income, income averaging would reduce the couple's total tax bill by $10,198.25, from the $67,616.75 previously payable by Josh alone to $57,418.50 payable by the community.

Recent IRS Rulings Extend the Benefit of Income Averaging to California Registered Domestic Partners

On May 28, 2010, the IRS issued critical rulings extending the benefit of income averaging to California registered domestic partners.

In a Private Letter Ruling, the IRS reversed its prior opinion that California registered domestic partners should each report their own earned income.[4] It ruled that a taxpayer who is a California registered domestic partner "must report one-half of the community income, whether received in the form of compensation for personal services or income from property, on his federal income tax return."[5] Since registered domestic partner income is community property by operation of law "[t]he vesting of half of [a] Taxpayer's earnings in his partner does not result in a transfer of property by Taxpayer to his partner for federal gift tax purposes."[6] Thus, for federal income tax purposes, each partner receives one-half of the community income without the higher earning partner having made any taxable gift to the lower earning partner. The IRS reasoned that "[f]ederal tax law generally respects state property law characterizations and definitions" and that "California treats the earned income of registered domestic partners as community property for both property law purposes and state income purposes."[7] Thus, federal law should respect California's characterization that earned income of a registered domestic partnership is deemed one-half owned by each registered partner.

In an even more significant move, the IRS Office of Chief Counsel endorsed and expanded upon the Private Letter Ruling in a Chief Counsel Advice ("CCA") Memorandum.[8] Following the reasoning of the Private Letter Ruling, the CCA Memorandum observes that as of January 1, 2007, California law treated the earned income of registered domestic partners as community property for state property law purposes and state income tax purposes. Since "[f]ederal tax law generally respects state property law characterizations and definitions" federal tax law should also treat the earned income of registered domestic partners as community property.[9] The CCA Memorandum concluded that "for tax years beginning after December 31, 2006, a California registered domestic partner must report one-half of the community income, whether received in the form or compensation for personal services or income from property, on his or her federal income tax return."[10] Since this advice significantly differed from

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prior advice,[11] the CCA Memorandum specifically provides that "[f]or tax years beginning before June 1, 2010, registered domestic partners may, but are not required to, amend their returns to report income in accordance with this" CCA Memorandum.[12] Thus, California registered domestic partners may amend returns from tax year 2007 (when earned income of domestic partners became community property for all state law purposes) through tax year 2009 to take advantage of income averaging. For tax years 2010 and forward, California registered domestic partners must each report one-half of the total income of the registered domestic partnership on their individual income tax returns. For many couples, this new rule will result in very significant tax savings. Further, it seems to reflect a shift in IRS policy, by which the IRS will increasingly follow state law characterizations of the property of registered domestic partners as community property.[13]

Limits of New Authorities

Only the specific taxpayer who requested a Private Letter Ruling may rely on that ruling. Further, Private Letter Rulings and Chief Counsel Advice have no value as precedent in litigation. 26 USC Section 6110(k)(3) provides that these sources may not be "used or cited as precedent." However, Private Letter Rulings are often helpful in understanding a position of the IRS. More importantly, Chief Counsel Advice carries weight within the IRS. The Internal Revenue Manual 33.1.1 provides that the Office of "Chief Counsel is the legal advisor to the Commissioner of Internal Revenue and the Service's officers and employees on all matters pertaining to the interpretation, administration, and enforcement of the internal revenue laws and related statutes." The Office of Chief Counsel is instructed to "ensure that legal advice rendered reflects a uniform application of the tax laws and a fair disposition of the matter at hand." Where there is "any doubt regarding the position of the Service" the Office of Chief Counsel is instructed to resolve that doubt before rendering advice.

Implications for Washington

On September 29, 2006, California amended prior law[14] to provide that earned income of a registered domestic partner would be treated as community property for state income tax purposes.[15] The recent IRS rulings only follow state community property characterizations after the date on which state law made domestic partner income community property for state income tax purposes.[16] While Washington does not have an income tax, the IRS rulings seem to support extension to Washington registered domestic partners.

First, like California, Washington treats income earned by registered domestic partners as community property for all state law purposes. RCW Section 26.60.015 provides that "[a]ny privilege, immunity, right, benefit or responsibility" granted to a person because of marriage "is granted on equivalent terms" to a person because of domestic partnership registration. The registered domestic partner rights are to be "liberally construed to achieve equal treatment, to the extent not in conflict with federal law, of state registered domestic partners and married spouses."[17] Income of registered domestic partners is community property as of "the date of initial registration of the domestic partnership or June 12, 2008 [when Washington law expanded domestic partnership rights to everything but marriage], whichever is later." Thus, the reasoning in the recent IRS rulings should apply equally to Washington registered domestic partners.[18]

Second, the recent IRS rulings cite Poe v. Seaborn, a United States Supreme Court case arising from Washington for the proposition that federal income tax rules should follow state community property characterization. "In Poe v. Seaborn, 282 U.S. 101 (1930), the Supreme Court held that for federal income tax purposes a wife owned an undivided one-half interest in the income earned by her husband in Washington" and must report half that income on her "separate return regardless of which spouse earned the income."[19] Since the lack of a state income tax did not defeat community property treatment of income for federal income tax purposes in Poe, it seems unlikely to defeat such treatment now. In short, while there has been no test case yet from

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Washington, there now seems a strong case that Washington registered domestic partners may each report one-half of the community's income on their federal income tax returns, and may file amended returns for tax years commencing June 12, 2008. This can result in significant federal income tax savings for registered domestic partners.

Rebecca Morrow

This paper is a publication of Skellenger Bender, PS, and summarizes general legal information, including recent developments. This general information is neither legal advice nor tax advice. No action should be taken on the basis of this paper without legal and/or tax advice based on your specific circumstances. For further information, please contact Rebecca N. Morrow at (206) 387-4733.

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[1] The married filing jointly tax schedule effectively replaced the benefits of income averaging for many couples.
[2] For simplicity, all calculations ignore deductions and exemptions.
[3] Chief Counsel Advice 200608038 previously provided that income earned by a registered domestic partner could not be treated as community property for federal income tax purposes. On the contrary, each registered domestic partner was required to pay tax on the income he earned.
[4] Private Letter Ruling 201021048.
[5] Private Letter Ruling 201021048.
[6] Private Letter Ruling 201021048.
[7] Private Letter Ruling 201021048.
[8] CCA 201021050.
[9] CCA 201021050 (citing U.S. v. Mitchell, 403 U.S. 190 (1971) and Burnet v. Harmel, 287 U.S. 103 (1932)).
[10] CCA 201021050.
[11] See endnote 3, above.
[12] CCA 201021050.
[13] See, e.g., CCA 201021049 (providing that since California community property law applies to registered domestic partners, the IRS may consider the assets of a taxpayer's registered domestic partner when deciding whether to accept that taxpayer's Offer in Compromise).
[14] CCA 201021050 (citing The California Domestic Partner Rights and Responsibilities Act of 2003, which gave registered domestic partners "the same rights, protections, and benefits . . . as are granted to and imposed on spouses" except that the earned income of a registered domestic partner could "not be treated as community property for state income tax purposes.").
[15] CCA 201021050 (citing California Senate Bill 1827 (effective January 1, 2007)).
[16] Accordingly, California registered domestic partners may only amend their returns to take advantage of income averaging if those returns were filed after California began treating the earned income of domestic partners as community property for state income tax purposes.
[17] RCW Section 26.60.015.
[18] Note that because RCW Section 26.60.030 allows registered domestic partnerships to form between cohabitants who are members of the opposite sex if at least one partner is at least 62 years old, the new IRS rulings may benefit some heterosexual couples.
[19] CCA 201021050 (citing Poe v. Seaborn, 282 U.S. 101 (1930)).

About the Author

REBECCA MORROW is a Senior Associate at Skellenger Bender, P.S. Rebecca received her B.S. in Political Science from Santa Clara University in 2000, her J.D. from Yale Law School in 2003, and her Taxation LL.M. from the University of Washington in 2010. Her practice focuses on family law, estate planning, probate, and tax law. Subsequent to receiving her LL.M. in Taxation, Rebecca was selected to be an Adjunct Professor at the University of Washington's Master of Professional Accounting Taxation Program. She will teach Estate Tax, Gift Tax, and Income Taxation of Trusts and Estates.