

# Insights for Preferred Clients



## Planning Considerations for Same-Sex Couples

Life partners must consider unique issues when developing their financial and estate plans

Partners in same-sex relationships often share the same financial goals as married spouses, but they face additional hurdles from federal and state laws in the United States that were written for traditional marriages. Addressing institutional biases requires specialized planning and, in many cases, will require partners to incur additional costs as well. Edward G. Poole, an attorney with Anderson & Poole in San Francisco, Calif., and a member of the Attorney Network program,\* who advises numerous gay and lesbian couples, uses a driving analogy: "Marriage is like the express road," he says. "Domestic partnership is the toll road. Partners must recognize that they aren't treated as one unit and must plan each step they take."

### Legal Issues

The federal Defense of Marriage Act (DOMA), which was signed into law in September 1996, has two major provisions. First, *marriage* is defined under federal law as "a legal union of one man and one woman as husband and wife." The term *spouse* "refers only to a person of the opposite sex who is a husband or a wife." Second, each state (and other political territories such as possessions) has the power to recognize or deny the legality of same-sex marriages that are recognized in another state.

As a result of DOMA:

- Same-sex couples cannot file their income taxes as married filing jointly
- Employer-paid health insurance premiums for an employee's same-sex partner are treated as taxable income
- Single taxpayers can exclude up to \$250,000 in gain when selling their personal residence (versus \$500,000 for married couples, even though the residence is owned in one spouse's name)

DOMA sets federal standards, but several states give same-sex partners many of the same rights that are available to spouses under state laws. New Jersey adopted a domestic partnership law in January 2004 that will recognize similar partnerships from other states, including Massachusetts' gay marriages, Vermont's civil unions and Hawaii's reciprocal beneficiary relationships. California has offered partnership registration since 1999, and the state's Domestic Partner Rights and Responsibilities Act of 2003, which took effect on January 1, 2005, expands the rights and responsibilities of registered same-sex couples. The law extends most of the rights and duties of marriage under California law to persons registered as domestic partners.

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Partners must register with the appropriate state or local government agency to be recognized under these laws, but the registration process is inexpensive and straightforward. Seattle's registration requirements for domestic partners are typical. Both partners must be: 18 years of age or older; engaged in a committed exclusive relationship; and not related in a manner that would bar marriage in Washington State.

Entering any of these arrangements brings responsibilities as well as benefits, however, and partners should consider the decision carefully. Specifically, what obligations do partners have if the relationship ends? It may seem harsh to plan for a partnership's demise while it is strong, but many same-sex relationships—like traditional marriages—will end during the partners' lives. "Many of the relationships I see dissolve at some point," Poole says. "It is incumbent upon partners to recognize this. Each partner should have separate legal counsel before they enter a domestic partnership or talk to someone about estate planning."

### **Estate Planning**

Domestic partners should start the estate planning process by deciding how they want their assets distributed at death (and during life, if lifetime giving is applicable). After establishing the distribution plan, partners must coordinate supporting documents and arrangements—wills, beneficiary designations, trusts, etc.—to achieve the desired distribution.

#### *Wills*

A will is the cornerstone of the estate planning process, so it is essential that both partners have current wills. If either partner dies intestate—without a will—

the intestacy laws of the deceased's resident state will determine the distribution of any assets that lack a joint owner or beneficiary. These laws generally do not recognize a same-sex partner; instead, the assets will be distributed to the deceased partner's surviving relatives in a sequence that typically includes children, parents and siblings.

#### *Revocable Living Trusts*

A revocable living trust can be a versatile supplement to a will. The trust document, which is established during a person's lifetime, names a trustee and successor trustee to manage the assets transferred to the trust. For example, a man might name himself as trustee and his partner as successor trustee. The trust's terms can specify that the individual will manage the trust until he becomes incapacitated or turns over control voluntarily. At that time, his partner would become the trustee. Revocable living trusts have an additional benefit: The trust's assets avoid probate, which reduces delays and administrative costs while increasing the estate's privacy.

#### *Durable Powers of Attorney*

A durable power of attorney gives the person named—the "attorney"—the power to act in another's place. This document facilitates management of someone's finances if he or she is unable to act competently due to illness, incapacity or another reason. Domestic partners can name each other or another adult as attorney. Depending on the powers specified in the document, the person named could buy and sell investments, pay bills and so on. This arrangement is needed to manage assets that cannot be owned jointly, such as pension plans and individual retirement accounts. In a domestic partnership, if

one partner does not create a durable power of attorney, the other partner will require a court's permission to manage his or her affairs. Family members, who might oppose a partner's interests, could file similar petitions and create potentially expensive and damaging litigation.

#### *Asset Ownership Forms*

Property ownership forms influence the taxation and distribution of an estate's assets. Solely owned property is included in the decedent's estate and distributed according to his or her will or local intestacy laws. Property owned jointly with right of survivorship passes directly to the surviving owner, but the estate tax treatment is more complex. The law assumes that 100 percent of the property is included in the estate of the first partner to die, unless the surviving owner can prove he or she contributed toward the purchase. For property held by partners as tenants in common, the surviving owner does not automatically receive the deceased partner's share because the decedent's will or the state intestacy laws control that share. However, only the decedent's share of the asset is included in his or her estate—there is no presumption of 100 percent ownership.

#### *Effective Beneficiary Designations*

An individual's will distribution plans must work in tandem with his or her assets' titles and beneficiary designations to achieve the desired results. To prevent conflicts, both partners should review and coordinate the distribution arrangements for all of their assets. Some financial assets that allow beneficiary designations require careful attention, however, because the amounts involved can be substantial and they have specific requirements. These assets include life insurance and retirement plans.

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## Tax Planning

The requirement to file as two single taxpayers can create tax-reduction opportunities when partners are in different federal income tax brackets. Ideally, the lower-bracket partner should report investment income and capital gains while the higher-bracket partner should claim deductions. There are restrictions with this income- and deduction-shifting strategy, however. Taxpayers cannot separate an asset from its income; in other words, the taxpayer who owns the asset is responsible for the tax on its income. Likewise, domestic partners can't decide arbitrarily which person will claim a particular deduction: only the taxpayer who incurred the deductible expense can take it.

As a result, the higher-bracket partner must transfer ownership of the asset to the lower-bracket partner in order to transfer an asset's income, which means the gift-tax regulations come into play. Current law allows a donor (i.e., the gift-giver) to give another person (who is not his or her spouse) a maximum of \$11,000 per calendar year without incurring gift taxes. The amount above \$11,000 is considered a taxable gift that reduces the donor's lifetime estate-tax exclusion.

*Life Insurance.* Life insurers require an "insurable interest" between the insured and the beneficiary. Examples of insurable interests include traditional marriage, business partnership and joint home ownership, so the insurer might not recognize a partner's interest in the other partner's life. One possible solution to this problem is to establish a trust and

have the trust purchase the policy on the partner who is to be insured. The trust can name itself as the life insurance beneficiary with the surviving partner as the trust's beneficiary.

*Self-Funded Retirement Plans.* This category includes 401(k)s, 403(b)s for nonprofit organizations' employees, IRAs and SEP-IRAs. Because same-sex couples lack both the rollover option and the unlimited marital estate-tax deduction that are available to spouses, they must plan for potential estate taxes and income taxes on retirement plans. If the deceased partner's estate is taxable, federal estate taxes on retirement plans can total over 40 percent of the accounts' value, and the tax is generally due within nine months of death.

The surviving partner has more control over the timing of income taxes because the IRS allows several options for taking distributions from the deceased partner's plan. The "five-year rule" allows beneficiaries of inherited IRAs to take distributions in any amount and frequency, provided they deplete the account by December 31 of the fifth year from the partner's death. (This option is available only if the deceased partner had not started taking distributions from his or her account.) Another option is to take distributions based on the surviving partner's life expectancy; these distributions must start by December 31 of the year following the partner's death. If the deceased partner was taking required distributions, the beneficiary's distributions are based on his or her life expectancy or the deceased partner's, whichever period is longer.

A Roth IRA conversion, which must be completed while the account owner is alive, is also worth considering if either

partner qualifies. (The modified adjusted gross income for the year must be less than \$100,000 to qualify for the conversion.) The first step is to roll over eligible retirement plan balances to a traditional IRA, which are then converted to a Roth IRA. The amount converted is taxable income, but the 10 percent penalty on early IRA withdrawals is not incurred. A partner who inherits a Roth IRA must take distributions based on his or her life expectancy, but those distributions are tax-free.

*Employer-Funded Retirement Plans.* The spouse of an employee enrolled in an employer-funded retirement plan is the default beneficiary, but there is no similar default option for same-sex couples in most states. In those states, the employee-partner must file any required forms with the plan administrator to ensure that the surviving partner is the beneficiary. Domestic partners should check with their human resources departments to find out what they must do to designate each other as beneficiaries.

### *Partner-Owned Businesses*

Life partners who are also business partners should ensure that the business would survive if one or both partners become ill or die unexpectedly. Long-term illness or disability has a double impact because it reduces both the business' and the owner's incomes. In addition, if a partner cannot return to work, he or she may wish to sell his or her share of the business to the healthy partner. A continuation plan funded with disability income insurance that provides income for the disabled owner and cash for the healthy partner to finance a buyout can solve both of these problems.

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A business owner's death creates multiple problems. The deceased partner's business interest will be included in his or her estate; if the estate is taxable, his or her administrator will require liquid assets to pay the estate taxes. The surviving partner also must facilitate an orderly transfer of the business ownership, which usually means acquiring the deceased partner's interest.

A buy-sell agreement funded with life insurance allows the survivor to buy the deceased partner's interest, and his or her estate can use the sales proceeds to pay any estate taxes. Buy-sell agreements should be discussed when the business is first created, if possible, and the terms should be part of the partnership agreement or articles of incorporation. The business' legal structure—partnership, corporation or limited liability company (LLC)—influences the steps needed to ensure a smooth ownership transfer. Each structure has advantages and disadvantages that extend beyond estate planning, however, and both partners should seek legal and accounting advice before selecting or changing a structure.

#### *Reducing Estate Taxes*

Gifts transfer an asset's value and its future appreciation from the gift-giver's estate and reduce potential estate taxes. Gifts over \$11,000 reduce the gift-giver's lifetime credit<sup>1</sup>; nonetheless, large gifts can be an effective income- and estate-tax planning tool. Completed gifts are irrevocable, however: once an asset is gifted, it cannot be reclaimed.

*Charitable Remainder Trusts.* Charitable remainder trusts (CRTs) can reduce income and estate taxes while also generating income for an individual, his or her partner or both of them. A CRT's operation is straightforward: the donor contributes assets to the trust, and the donation generates a tax deduction for the donor based on the asset's value and the selected income option. The trust can sell the property without incurring capital gains taxes and reinvest the proceeds in income-producing assets. The trust then pays the beneficiary income for a set period or life. When the trust's income period expires, the charity retains the trust's assets.

*Life Insurance Trusts.* Life insurance proceeds provide liquidity for estate taxes or investment to generate additional income for the insured's survivors. If the insured owns his or her policy, however, the policy's proceeds are included in his or her estate. To avoid this inclusion, the partner who is paying the policy's premiums should first establish an irrevocable life insurance trust and transfer funds to the trust. The trust can then apply for and purchase the policy. Such an arrangement, structured properly, will keep the proceeds out of the insured's estate.

#### **Medical Concerns**

Same-sex couples can face additional biases when dealing with healthcare providers. Completing healthcare directives and learning local policies can reduce the likelihood of problems.

#### *Healthcare Directives*

It is impossible to predict medical emergencies. When they occur, the stricken partner might be incapable of expressing his or her wishes regarding healthcare decisions, leaving the healthy partner without guidance. This dilemma can be avoided by creating healthcare declarations, also known as living wills, and powers of attorney for healthcare. Living wills allow partners to express their wishes regarding the use or avoidance of life-sustaining medical treatments. A healthcare power of attorney authorizes the chosen person—the agent—to make healthcare decisions for that person if he or she cannot.

There are two types of healthcare powers of attorney: springing and durable. Springing powers take effect when a person becomes incapacitated, as defined in the document; durable powers remain effective until cancelled. There is a potential problem with springing powers, however, which may make it difficult for the agent to follow the stricken partner's instructions. The problem stems from the Health Insurance Portability and Accountability Act (HIPAA). Under HIPAA guidelines, medical service providers might prevent the agent from obtaining the information needed to determine if the sick partner is incapacitated. If that happens, the power of attorney won't activate, effectively thwarting the document's instructions. The solution: he or she should switch to a durable power of attorney or complete any HIPAA authorization forms that may be required. A properly completed form will allow the healthcare provider to release the information needed to determine the stricken partner's status.

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<sup>1</sup> The lifetime gift tax exclusion is \$1 million

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### *Visitation and Notification Rights*

There have been widely reported incidents of hospital staff refusing to recognize same-sex partners as a patient's immediate family. No one needs the added stress of being denied these rights when a partner is ill; preemptive action is the best strategy in those states that do not recognize same-sex unions in some fashion. Although the following actions do not guarantee access, they reduce the likelihood of problems:

- Partners should contact the doctors involved, particularly the primary care physicians, so they are aware of a partner relationship and the potential problem.
- Partners should contact the hospital or treatment facility's patient advocate to learn its policy on partners' rights and ask what documentation it requires to prevent problems.

### **Conclusion**

The key to effectively handling these challenges and creating a successful long-term financial plan is flexibility. Partners' financial needs and resources will change over time, as will the laws affecting their finances, and any plan must adapt to those changing circumstances. Same-sex couples cannot afford the luxury of assuming that the government will safeguard their interests, at least not at the federal level for the foreseeable future. It is a difficult situation, but one that can be managed with expert financial and legal advice.

The preceding is only a general discussion of the subject planning for same-sex couples and is only for information purposes. The laws are complex and subject to change. Neither UBS Financial Services Inc. nor its employees provide tax or legal advice. You should consult with your attorney and tax advisors regarding your personal circumstances before undertaking any planning strategy.

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060330-0565-V111

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