

TAX COMPLICATIONS FOR SAME SEX COUPLES IN CALIFORNIA

By: Brian Chase, Senior Staff Attorney, Lambda Legal

When my client David Pearce lost his partner of fourteen years to cancer, the county of San Diego expressed its condolences by doubling his real estate taxes.

To their friends, David and his partner, David Garrison, were "the two Davids" or "David squared." They met in 1990 at an Easter potluck, started dating and moved in together a year later. They became registered as domestic partners as soon as California's first statewide domestic partnership law (AB 26) went into effect in 2000. (Stats. 1998, ch. 588) AB 26 provided limited new rights for domestic partners, just the right to visit each other in hospitals and health benefits for state employees. But, it was an important step forward for same-sex couples in California.

Soon after they started living together, David Garrison was diagnosed with cancer. David and David spent the next 10 years battling his disease. They shared a wonderful life despite David's illness, but on July 28, 2004, after 14 years together, David passed away.

David Garrison left the home they shared to David Pearce through his living trust. Soon after inheriting the property, the taxes on the home went from \$3,053 to \$7,826 per year. David also was billed an additional \$4,248.54 as a "supplemental assessment" for the time between David Garrison's death and the next tax bill. David's predicament was an all too typical example of the confusion, uncertainty and unfairness that can bedevil unmarried couples, including registered domestic partners, when it comes time to pay taxes.

Proposition 13 ("Prop 13"), which was approved by the voters in 1978, added Article 13A to the California Constitution. Under Article 13A of the California Constitution property tax reassessments generally are capped at 2 percent per year for as long as a person owns a particular piece of real estate, no matter how much real estate values increase. When there is a "change of ownership," the property is reassessed at full market value.

Prop 13 did not define the phrase "change in ownership." Accordingly, interpretation of the phrase has been left to the courts, the Legislature, and the voters acting through the initiative process. (*Amador Valley Joint Union High School Dist. v. State Board of Equalization* (1978) 22 Cal.3d 208.) Immediately following the passage of Prop 13, both the Legislature and the State Board of Equalization (the "Board") sought to define "change in ownership." (See, e.g., former Rev. & Tax. Code sec. 110.6, excluding from "change in ownership" any interspousal transfer to create or terminate a community property interest or joint tenancy.) The process of defining the term "change of ownership" was lengthy and involved. (See *Pacific Southwest Realty Co. v. County of Los Angeles* (1991) 1 Cal.4th 155, 160.) The

effort incorporated recommendations of a 35-member task force that included legislative staff, members of the Board, county assessors, and taxpayer representatives. (*Ibid.*) The task force concluded that “change of ownership” meant a transfer of “(1) a present interest; (2) the beneficial use; and (3) rights substantially equivalent in value to fee interest.” (Id.) The Attorney General subsequently was called upon to confirm that a bare change in legal title without a corresponding transfer of beneficial use does not constitute a change in ownership. (63 Ops.Cal.Atty.Gen. 304 (1980).)

In 1979 the Legislature added Sections 62 and 63 to the Revenue and Taxation Code. (Stats. 1979, ch. 242.) Sections 62 and 63 specifically provide that transfers of real property between spouses do not constitute a change in ownership for reassessment purposes. The exclusion for interspousal transfers was added to the Constitution in 1986 with the passage of Proposition 58. (Const. Art. XIII A, sec. 2(g).) Unfortunately, at the time of David Garrison’s death, transfers between registered domestic partners had not yet been specifically excluded from the definition of “change in ownership” by either statute or Article 13A of the Constitution. Registered domestic partners were only offered an explicit statutory exemption from the definition of “change in ownership” with the enactment of SB 565, which went into effect on January 1, 2006, but was not retroactive. (Stats. 2005, ch. 416.)

When David Garrison passed away, however, registered domestic partners were entitled to some protection from reassessment under a Board rule providing “[t]he following transfers do not constitute a change in ownership:...[a]ny transfer of separate property inherited by a surviving domestic partner, as defined in subdivision (b) of section 37 of the Probate Code, by intestate succession upon the death of a registered domestic partner.” (Cal. Code Regs., 18, sec. 62.240(k)) (the “Rule”) The Rule was enacted in 2003 by the Board, which is authorized to adopt rules and regulations equalizing the assessment of real property by local county assessors in California. (Gov. Code sec. 15606, subd. (c).)

The Rule was, however, interpreted inconsistently by assessors across California. Some assessors read the Rule as providing a blanket reassessment exemption for all transfers of real property between registered domestic partners. This interpretation was consistent with the Board’s stated understanding “that a transfer taking place due to the death of a registered domestic partner does not constitute a ‘change in ownership’ for purposes of Article XIII and XIII A of the California Constitution, regardless of whether the property passes to the surviving registered domestic partner via a will or the laws of intestacy.” (Questions and Answers Regarding Changes to Property Tax Rule 462.240 – Exclusion for Registered Domestic Partners (April 26, 2004).)

Despite the Board’s clear guidance, some assessors interpreted the “by intestate succession” language of the Rule to exclude any transfers that occurred due to an estate-planning device, such as a will or living trust. An administrative agency’s interpretation of the relevant laws and regulations it is charged to enforce is generally entitled to great weight. (*Mantzoros v. State Bd. of Equalization* (1984) 87 Cal. App. 2d 140, 143.)

Deference is even more appropriate where an agency is interpreting its own regulations. (Ibid.) California courts have held consistently and recently that the determination of what is or is not a change of ownership for reassessment purposes is a matter as to which the Board's opinions carry great weight. In explaining the deference given to a Board opinion, the First District Court of Appeal, for example, has held that, "the Board is positioned to establish consistent rules regarding change in ownership." (*Reilly v. City and County of San Francisco* (2006) 142 Cal. App. 4th 480, 491.) Despite this seemingly incontrovertible authority, some county assessors declined to follow the Board's interpretation of the Rule and insisted that it only protected registered domestic partners whose partners died intestate. This interpretation created a bizarre and illogical Catch-22 for registered domestic partners, who were forced to forgo reasonable and necessary estate planning in order to avoid potentially ruinous property tax increases for the surviving partner on the couple's home.

Finally, some assessors, including the Assessor for San Diego County, decided to ignore the Rule completely. When David Pierce challenged the reassessment of the property he had inherited from his domestic partner, the assessor sent him a letter flatly stating, "(T)here is no constitutional authority permitting an exemption for domestic partners."

When an assessor disagrees with an administrative rule issued by the Board of Equalization, he or she is under a statutory obligation to challenge the rule in court. (Rev. & Tax. Code sec. 538(a).) An assessor lacks the authority simply to ignore any rule with which he or she disagrees, but that is precisely what the San Diego County Assessor chose to do in David Pearce's case.

Other assessors, however, did challenge the Rule in Court. On April 4, 2005, Michael Strong, the Assessor of Sutter County, and Webster Guillory, the Assessor of Orange County, filed suit in the Superior Court for Sacramento County, arguing that the Board had exceeded its statutory and constitutional authority by enacting the Rule (the "*Strong* litigation"). These assessor plaintiffs argued in the *Strong* litigation that the amendments to Article 13A providing specific exemptions from the definition of "change in ownership" impliedly had repealed the Legislature's (and, by extension, the Board's) ability to enact similar exemptions. The Honorable Jack Sapunor of the Superior Court disagreed, noting "there is a well-established presumption against the implied repeal of a statute by a later constitutional provision." (*Strong v. State Board of Equalization* (Super. Ct. Sacramento County, 2005, No. 05 AS 01701 [citing, *Metropolitan Water District v. Dorff* (1979) 98 Cal.App.3d 109, 114].)

Plaintiffs appealed the decision to the Third District Court of Appeal, arguing that any exclusion from the definition of "change in ownership" must be enacted by a constitutional amendment. The Court of Appeal unanimously upheld the decision of the Superior Court, explaining that "Proposition 13 does not expressly, or by necessary implication, preclude the Legislature from creating exemptions from the phrase 'change in ownership'; it simply provides that taxes 'shall not exceed' a set amount unless there

has been a change in ownership.” (*Strong v. State Bd. of Equalization* (2007) 155 Cal.App.4th 1182, 1194.) Plaintiffs sought review by the California Supreme Court, which was denied. (*Ibid.*)

The resolution of the *Strong* litigation made clear that the Legislature and the Board had the power to grant surviving registered domestic partners the same protection from being taxed out of their homes that surviving spouses have enjoyed. It did not, however, provide any benefit to people like David Pearce, whose partner had passed away prior to the effective date of SB 565. The Legislature offered some relief with the passage in 2007 of SB 559, which allowed any registered domestic partner whose property had been reassessed due to a transfer from his or her domestic partner to file a form with the local assessor and have the assessment rolled back. (Stats. 2007, ch. 555.) Under SB 559, a property owner must seek reassessment on or before June 30, 2009. David Pearce’s story has a bittersweet ending. David’s property tax assessment ultimately was reduced to the level it would have been had the San Diego County Assessor recognized and respected David and David’s domestic partnership. David was not, however, given a refund of the extra taxes he was forced to pay, nor does the correction of his taxes make up for the Assessor’s unjustified disregard for David and David’s fourteen-year relationship. The ultimate resolution for David was less-than-perfect, but far better than the almost complete non-recognition of unmarried couples for tax purposes that existed less than a decade ago, before the advent of registered domestic partnerships in California.

Although some issues surrounding the taxation of real property owned by registered domestic partners in California have been resolved, gay and lesbian couples continue to face a host of other tax complications. Even with the advent of marriage for same-sex couples in California, the complications will continue. The federal government taxes domestic partner employee benefits or benefits to married same-sex partners as income, so domestic partners who place their partner on their employer’s health plan can face a hefty, and often unanticipated, tax liability. Federal law exempts transfers between spouses from gift and inheritance taxes (26 U.S.C. sec. 1041), but there is no such exemption for domestic partners and the federal government currently refuses to recognize legal marriages of gay and lesbian couples. (28 U.S.C. sec. 1738C.) Accordingly, same-sex couples can incur many thousands of dollars in tax liability if either partner relies on the other’s employer-provided health plan.

The lack of any current recognition for registered domestic partners or married same-sex couples at the federal level causes other hardships. Just this year registered domestic partners in California began filing state income tax returns jointly, but the lack of any federal recognition made these filings significantly more complicated. In 2006 California enacted SB 1827, which requires that registered domestic partners file their California income tax returns as married couples do, either as “married filing jointly” or “married filing separately.” (Stats. 2006, ch. 802.) Registered domestic partners cannot file their state tax returns as single individuals. Federal law, however, does not consider domestic partners “spouses,” which prohibits registered domestic partners from filing

joint federal returns. (1 U.S.C. sec. 7, 26 U.S.C. 1(a)(1).) Married spouses generally determine their adjusted gross income (“AGI”) for their state tax return by looking to the AGI on their federal return, but because the federal government does not respect registered domestic partnerships, the federal AGI for registered domestic partners is likely to be significantly different for many couples than their state AGI. As a result, for their 2007 returns registered domestic partners were required to calculate their federal AGI as a single person, and then separately calculate what their federal AGI would be as if they were in a federally recognized marriage in order to determine their California AGI. (California Franchise Tax Board Publication 737, Tax Information for Registered Domestic Partners (2007).) Because the federal government does not recognize same-sex couples’ marriages as valid, married gay and lesbian couples are likely to face similar complications with their 2008 filings. This process can be both confusing and expensive, but it is an inevitable consequence of the failure of the federal government to recognize same-sex couples for tax purposes.

Federal discrimination between the treatment of same-sex and different-sex couples will also complicate the tax treatment of community property earned within California. Federal law typically follows state law in assigning ownership of community property income by splitting community property income evenly between spouses, regardless of which spouse actually generated the income. (*Poe v. Seaborn* (1930) 282 U.S. 101.) The Internal Revenue Service, however, has stated that it will ignore long-standing precedent and disregard California community property earned by registered domestic partners. (Internal Revenue Service Chief Counsel Memorandum 200608038 (February 24, 2006).) Internal Revenue Code Publication 555 was revised in 2007 to include language expressly stating “[i]f you are a registered domestic partner in California the rules discussed in the publication for reporting community income do not apply to you.” It is unclear whether or not the federal government will continue to disregard state community property law once same-sex couples begin to marry in California.

Finally, many people, including employers, police, government officials and hospital personnel, simply do not understand what a “registered domestic partnership” means. When the assessor of San Diego County fails to comprehend that registered domestic partners should be treated like married couples, it plainly demonstrates the problems inherent in not providing same-sex couples with the same legal designation as different-sex couples. The simple fact that registered domestic partnership is different than marriage implies that registered domestic partners do not enjoy the comprehensive protections of marriage. As Californians see gay men and lesbians welcomed into each others’ families through marriage, it will demonstrate that having one set of laws governing all families is far more straightforward and workable than creating a wholly separate realm of law applicable to same-sex couples.

Marriage for same-sex couples in California takes nothing away from different-sex couples and will alleviate much of this confusion. A potential challenge to marriage equality at the ballot box in November, however, may make the legal status of same-sex couples even more uncertain, at least in the near term. Ultimately, having a single legal

status for both gay and straight couples will alleviate significant legal ambiguity and strengthen family ties. Once the positive effects of marriage are visible, it ought to be clearer to those still getting use to the idea of married gay couples that we should not go back to the confusing two-tier system we have had in the past.

Brian Chase is a Senior Staff Attorney based in Lambda Legal's Western Regional office in Los Angeles. Lambda Legal is the largest and oldest national legal organization committed to achieving full recognition of the civil rights of lesbians, gay men, bisexuals, transgender people and those with HIV. Brian was co-counsel in the Strong litigation and was the principal drafter of SB 559. Brian received his J.D. with honors from Tulane and his undergraduate degree from Wake Forest. He can be reached at bchase@lambdalegal.org.