

## Domestic partners

The following describes some of the tax considerations that arise when unmarried persons live together as domestic partners.

*Filing status.* Domestic partners who aren't married can't file a joint return. A domestic partner can file as head of household if he or she meets the requirements for that filing status, i.e., maintaining a household that is the main home of a relative who qualifies as a dependent. However, maintaining a home for the other domestic partner, or for a child of the domestic partner who isn't the taxpayer's biological or adopted child, doesn't entitle a taxpayer to file as head of household.

*Dependency deduction.* A domestic partner can qualify as a taxpayer's dependent if all of the following requirements are met:

- The partner is a member of the taxpayer's household. This means that the partner must live for the entire year (except for temporary absences) in a household that the taxpayer maintains by paying more than half of the household expenses. However, if the taxpayer's relationship with the domestic partner violates local law, the partner won't be considered to be a member of the taxpayer's household.
- The taxpayer provides more than half of the partner's support. Support items include food and clothing, lodging, medical and dental care, education, and recreation. Tax-exempt items, such as social security, are included in making the support computation. However, scholarships and Medicare benefits are not included.
- The partner cannot have gross income above a certain limit (\$3,400 for 2007, \$3,300 for 2006). The full amount of gross income is counted, including business or rental income before deductions. However, tax-exempt income isn't counted here.

*Child tax credit.* Taxpayers are entitled to a child tax credit for each qualifying child who is the taxpayer's dependent, with the credit phased out for taxpayers whose income exceeds certain levels. The credit is available for a biological child, adopted child, or stepchild, but not for the child of a domestic partner.

*Medical expenses.* Medical expenses paid for oneself or one's spouse or dependents are an itemized deduction to the extent that the expenses total more than 7.5% of adjusted gross income. Medical expenses that one domestic partner pays on behalf of the other domestic partner aren't deductible unless the partner whose expenses are paid qualifies as the payor's dependent. However, a person can qualify as a dependent for this purpose regardless of his or her gross income.

If medical expenses aren't deductible under the above rule, consider having one partner give money to the other partner, who will then use it to pay his or her own medical bills.

*Home mortgage interest.* Mortgage interest on a primary residence is an itemized deduction. The deduction can be taken by the person who both owns the home and pays the interest. Thus, where domestic partners own their home jointly, each can deduct the amount of interest that he or she pays. If the home is in the name of one partner, only that partner can claim the deduction, and only to the extent that he or she pays the interest. If the non-owner plans to pay part of the interest, the deduction can be preserved by giving the funds to the owner, who will then make the interest payment.

*Sale of home.* A taxpayer can exclude from income up to \$250,000 of gain from the sale of a home owned and used by the taxpayer as a principal residence for at least two of the five years before the sale. The full exclusion applies to only one sale every two years. A married couple filing jointly is entitled to a \$500,000 exclusion if either spouse meets the two-year ownership requirement and both spouses meet the two-year use requirement.

Thus, if both partners own homes that qualify for the exclusion, each can sell the home and exclude up to \$250,000 of the gain, for a total of \$500,000. Since the partners aren't married, it makes no difference that the sales occur within two years of each other. On the other hand, domestic partners aren't entitled to the \$500,000 exclusion that is available to married couples.

*Health benefits for domestic partners.* An employee can exclude from income the cost of employer-provided coverage for the employee, his spouse, or his dependents under an accident or health plan. Many employers have extended this coverage to the domestic partners of employees. However, unless the domestic partner qualifies as a dependent of the employee, the difference between the value of the coverage and payments made by the employee for the coverage is included in the employee's gross income. Income tax and Social Security (FICA) tax will be withheld on this included amount, even though the employee isn't getting any additional cash wages. But the employee is then treated as providing the coverage from his own funds, with the result that benefits received under the plan are tax-free.

*Retirement savings and pensions.* A participant in a pension plan or other qualified retirement plan, like a 401(k) plan, is entitled to name a domestic partner as the beneficiary of the plan in the event of the participant's death. At death, plan benefits may be distributed in a lump sum or as an annuity. If an annuity form of distribution is not available and the beneficiary chooses not to take a lump sum, then the benefits can remain in the plan, but they would have to be distributed in accordance with certain minimum distribution requirements. The surviving domestic partner is subject to income tax on the benefits as they are distributed. A surviving domestic partner is not currently allowed to make a tax-deferred rollover of a deceased partner's retirement benefits into his or her own IRA, as a deceased participant's surviving spouse can, but this will be allowed starting in 2007.

*Estate and gift tax.* Because domestic partners aren't married, they do not qualify for the unlimited marital exclusion from the gift and estate taxes. Up to \$12,000 (for 2006 and 2007) of gifts that one partner makes to the other each year are tax-free under the annual gift tax exclusion. After that, taxpayers begin to use up their unified credit, which exempts \$2,000,000 (for estates of decedents dying in 2006 or 2007) or \$1 million (for gift tax purposes in 2006 through 2009).

The gift tax doesn't apply to payments of another person's tuition made directly to a school or to payments of another person's medical expenses made directly to a medical care provider. Thus, such payments can be made on behalf of domestic partner without incurring gift tax liability.