Tax Deductions of Palimony Arrangements

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The Ninth Circuit U.S. Court of Appeals recently addressed whether a contract claim arising from a palimony agreement can be deducted from the estate for tax purposes. (Estate of Shapiro v. U.S., 11 C.D.O.S. 2293)

For 22 years, Bernard Shapiro and Cora Chenchark lived together in Nevada, but never married. Throughout that time, Bernard paid Cora's living expenses and provided her with a weekly spending allowance. Cora cooked, cleaned and managed their household, but otherwise did not contribute any financial assets to the household. The couple split in 1999 when Cora learned that Bernard was involved with another woman. Cora sued Bernard in Nevada state court for breach of contract, claiming that they had agreed to pool their resources and share equally in each other's assets while living together. In 2000, while the lawsuit was pending, Bernard died, but his estate continued to defend against Cora's claims and ultimately won a jury verdict which found there was no contract between them. Cora appealed, and while the appeal was pending, she and Bernard's estate settled for approximately $1 million.

Bernard's estate had filed an estate tax return in May 2001 while Cora's suit was still active and paid $10.6 million in estate and generation-skipping taxes to the federal government. When Cora's lawsuit was settled, the estate filed an amended estate tax return claiming a $3.5 million refund of estate taxes based on a deduction from the value of the taxable estate for Cora's contract claim. When the IRS disallowed the refund claim, the estate filed a tax refund suit in federal district court in Nevada, claiming that Cora's claim was worth $5 million and generated a tax refund of $2 million. The estate later added additional claims to its refund suit, bringing the total refund sought to $4.8 million. The parties filed cross motions for summary judgment.

The district court, applying Nevada law, granted the government's motion for summary judgment and denied the estate's tax refund. Under the estate tax provisions, to qualify as a deductible expense reducing the value of the taxable estate, a claim against an estate must be allowable under the law of the state in which the estate is administered, and if the claim is founded on a promise or agreement, the claim must be "contracted bona fide and for an adequate and full consideration in money or money's worth." IRC §2053(c)(1)(A). The district court held that on the uncontested facts averred in the government's motion for summary judgment, there was no evidence that Cora ever contributed anything to the relationship other than love, support and the management of Bernard's household, and that, under Nevada law, this was insufficient consideration to support a contractual agreement. Thus, since there was no contract between Cora and Bernard for the pooling of their resources during their relationship, the settlement money Cora obtained from the estate was actually a gift from Bernard, and the estate was not entitled to a deduction under §2053 for the payment of a gift.

The Ninth Circuit reversed, with one judge dissenting, holding that the district court had incorrectly interpreted Nevada law regarding the creation of a "palimony" agreement. Under Nevada law, a court may examine the conduct of the unmarried parties to determine whether their actions support the conclusion that they intended to share their property as though they were married.
Furthermore, under California and Arizona law (although this issue has not yet been addressed by Nevada courts), one party's promise to perform homemaking services is considered adequate consideration to support a contract for a property-sharing agreement between unmarried cohabitants.

Having found that Cora's claim against the estate was founded in a contract that would be recognized under Nevada law, the Ninth Circuit, however, remanded the case back to the district court to determine whether the contract was for "adequate and full consideration in money or money's worth" as required to deduct the claim from Bernard's estate under federal law (IRC §2053). In short, the court found that while Cora's claim against the estate rested on a valid contract under Nevada law, that might not be enough — the estate is entitled to deduct the claim under federal law only if it is supported by "adequate and full consideration" and therefore is not a gift to Cora. The dissenting judge would have affirmed the district court's decision because, in his view, the facts established that Cora provided only her 'love and affection' to Bernard, which under long-standing precedent is not considered adequate and full consideration for tax purposes. Indeed, this may end up being the factual conclusion of the district court on remand of the case.

While this decision dealt with a palimony situation in Nevada, it is likely to have come out the same way if Cora and Bernard had lived in California. Nevada and California laws are consistent on these issues as to unmarried cohabitants who are not registered domestic partners, and the Ninth Circuit applied both Nevada and California law in determining that Cora's domestic services alone may be treated as consideration for a shared-property agreement between unmarried cohabitants. The estate's chances for a deduction would most certainly have been improved if Cora had worked outside of the home and contributed her income or other property as part of a contractual agreement to share property. The problem with a palimony arrangement is that the courts will not enforce either an express or implied contract between unmarried partners when it is based solely on the provision of sexual services. In this case, the Ninth Circuit viewed Cora's provision of domestic, household services (cleaning, cooking, etc.) as something more than that, and something that had some value. But the court did not go so far as to say that the value of her services were "full and adequate consideration" for half of what otherwise would be Bernard's multimillion-dollar estate. That's the standard that the estate has to meet in order to establish that Cora's settlement payment was a deductible contract claim against the estate's assets and not a nondeductible gift. And that's the question that will be addressed on remand.

Similarly, if Bernard had titled any of 'his' assets in Cora's name or as joint tenants or tenants in common, the court would have seen this as evidence of their agreement to share assets in the same way married couples do in community property jurisdictions. In Nevada, the courts look to the conduct of the unmarried partners to determine whether they had an implied contract to share assets, and so if Bernard had transferred title to Cora that 'conduct' would support her claim that they had an agreement to do so.

Finally, although their relationship pre-dated the registered domestic partnership laws in California, if Bernard and Cora today had registered as California domestic partners they would have been afforded under current law the same rights and responsibilities that previously were available only to married individuals, including, for years after 2007, treating property acquired during the partnership as community property. Thus, there is no need, generally, for registered domestic partners to enter into any type of palimony agreement. For federal tax purposes, whether a domestic partner is taxed on one-half of the community income earned by the other partner is in a state of flux, but the IRS recently has issued an opinion stating that unmarried partners may report income on a community basis if they reside in a state where community property laws apply to them.

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