Registered Domestic Partner (RDP) Issues

Subject: Tax-Favored Accounts (non-retirement)

Law: IRC §§220, 223, 530.

Discussion:

In general, the Internal Revenue Code establishes several tax-favored special purpose accounts – Archer Medical Savings Account (MSAs), health savings accounts (HAS), and education savings accounts (education IRA) to allow taxpayers to get special tax treatment for amounts accumulated to pay for particular expenses. In some cases, eligibility is limited to certain taxpayers. Eligibility rules may depend on the circumstances of a spouse or provide special rules for married individuals. Income earned on amounts in these accounts is exempt from tax. Contributions to some accounts are deductible. Excess contributions are subject to a federal excise tax every year the account has an excess contribution. Distributions from these accounts for qualified purposes are exempt from tax. Qualified expenses frequently include expenses for family members. Transfers of accounts incident to divorce are exempt from tax and may retain their status as a tax-favored account. A change in account beneficiary amongst members of the family may be nontaxable. Nonqualified distributions are includible in gross income and often subject to an additional tax.

In general, California provides comparable if not identical treatment for these accounts other than HSAs. Current California law does not recognize HSAs. There is no California tax on excess contributions to any account. California law allows a deduction for contribution to the same extent as allowable for federal purposes. In the case of an Archer MSA, the California deduction is based on the amount allowed on the federal return. California additional tax on nonqualified distributions is imposed at a lower rate.

Problems:

If provisions related to tax favored accounts are modified to treat an RDP as a spouse for California purposes, a person that is an eligible account owner for federal purposes may not be an eligible individual for California purposes. Distributions that could be a qualified distribution for California purposes may not be qualified for federal purposes. As a result, the amount of the distribution would be includible in gross income for federal purposes and subject to an additional tax. Transfer of a tax-favored account incident to divorce could be nontaxable for California purposes but taxable for federal purposes and subject to an additional tax. In addition, amounts transferred incident to divorce would not be a tax-favored account for federal purposes. A change in beneficiary to an RDP or dependent of a RDP might be a taxable distribution for federal purposes subject to inclusion in gross income and subject to an additional tax of distribution.

Alternatives:

1. Revise California law to establish California-only tax-favored accounts. (It's unclear whether a person engaged in the business of administering such accounts would do so for California-only tax-favored accounts.)
2. Revise California law to clarify the California tax treatment of a transaction or event involving an RDP to reduce adverse impacts, prevent unintended consequences, and minimize taxpayer burden.