SUTHERLAND

LEGAL ALERT

August 30, 2013

A Marriage Made in Washington: Treasury and IRS Recognize Same-Sex Marriages for Tax Purposes

On August 29, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS), following the U.S. Supreme Court's decision in *United States v. Windsor*, jointly announced the issuance of Revenue Ruling 2013-17 (the Ruling), providing guidance on the federal taxation of same-sex couples. *Windsor* invalidated, on equal protection grounds, the limitation of marriage to opposite-sex couples in the Defense of Marriage Act (DOMA). The Ruling holds that for all federal tax purposes, including income, gift and estate tax, the IRS will recognize same-sex marriages that are legally valid in the jurisdiction where the couple married, regardless of whether the state in which the couple resides would recognize the marriage.

Citing the need for uniformity in federal tax law and the administration of employee plans, the Ruling answers the most fundamental question that employers, individual taxpayers and others had following *Windsor*: whether the law of the state of a same-sex couple's domicile or the law of the state in which they entered into their marriage would control their status for federal tax purposes. The Ruling specifically says that same-sex marriages legally entered into in any state that recognizes such marriages, including the District of Columbia, a U.S. territory, or a foreign country[1], will be recognized for all federal tax purposes. The Ruling does not, however, extend to same-sex couples in registered domestic partnerships or civil unions.

Refund Claims

The Ruling applies prospectively beginning on September 16, 2013, but employers and employees may rely upon the Ruling retroactively for purposes of filing certain credit or refund claims related to the changed law. In related Treasury and IRS releases, the agencies said they intend to issue future guidance with a streamlined process for employers to file refund claims for payroll taxes paid previously on health benefits or other fringe benefits provided to an employee's same-sex spouse. The IRS also issued two sets of Frequently Asked Questions (FAQs) with the Ruling that separately address questions for same-sex couples and couples in domestic partnerships, including several questions regarding employer refund claims relating to payroll taxes on benefits previously provided to same-sex spouses. The Ruling provides that, for purposes of refund claims by an individual or his or her employer, amounts an employee paid on an after-tax basis for health or other fringe benefits for a same-sex spouse can be treated as pre-tax contributions if the employer had a cafeteria plan and the employee made pre-tax salary reduction contributions for his or her own coverage.

Retroactivity

The Ruling specifies that retroactive reliance on it for benefit plan purposes is limited to the exclusions from income for:

[1] In the United States there are now 14 jurisdictions that issue marriage licenses to same-sex couples: California Connecticut, Delaware, the District of Columbia, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New York, Rhode Island, Vermont, and Washington. In addition, certain counties in New Mexico (which neither prohibits nor authorizes same-sex marriage) are beginning to issue same-sex marriage licenses.

- Employer contributions for health plan coverage under Internal Revenue Code (Code) section 106;
- Qualified tuition reductions under Code section 117(d);
- Meals and lodging furnished for the convenience of the employer under Code section 119;
- Dependent care assistance under Code section 129; and
- Certain miscellaneous fringe benefits under Code section 132.

At this time the Ruling may not be relied upon retroactively with respect to matters relating to qualified retirement plans and certain other arrangements. The IRS has promised future guidance on how *Windsor* and the Ruling will apply to cafeteria plans, qualified retirement plans and other tax-favored arrangements for periods prior to September 16, 2013. Presumably, this will include guidance on how to apply the spousal continuation rule of Code section 72(s)(3) to non-qualified annuities and the minimum required distribution rules of Code section 401(a)(9) to Individual Retirement Accounts and Annuities, 403(b) annuities and qualified plans. The Ruling indicates that future guidance will take into account the impact of retroactivity on all taxpayers involved, including plans, plan sponsors, employers, employees and affected beneficiaries, and will provide sufficient time for qualified plans to be amended and corrected as necessary to preserve existing favorable tax treatment.

Estate Taxes

The Ruling also makes clear that same-sex couples married in jurisdictions that recognize such marriages are entitled to the federal gift and estate tax marital deduction for interspousal transfers during life and at death on the same basis as opposite-sex married couples. (In fact, *Windsor* involved a claim for refund of federal estate tax on property passing to a surviving, same-sex spouse.) Although the Ruling has wide-ranging effects on estate planning for same-sex couples, in connection with employee plans and annuity contracts, the Ruling allows plan balances and annuities payable to a surviving same-sex spouse beneficiary to pass free of estate tax at the death of the employee spouse or annuity owner.

State Income Tax Implications

For states that do not recognize same-sex marriage but follow federal adjusted gross income, federal gross income or federal taxable income for state income tax purposes, a key question will be whether same-sex spouses may file a joint state income tax return and whether the value of health insurance coverage for a same-sex spouse will be taxable. Before *Windsor*, income was imputed for the value of health insurance coverage and other fringe benefits for federal and state income tax purposes unless the state recognized same-sex marriage or recognized another same-sex relationship and provided that income would not be imputed. Many states have a state constitutional amendment or statute similar to DOMA that remains in effect but the states follow federal adjusted gross income or a similar federal measure for tax purposes. Unless these states change their laws or determine otherwise, it is possible that income will not be imputed on the value of these benefits for a same-sex spouse due to the states following federal income measures. For states that do not recognize same-sex marriages and do not follow a federal income measure, the value of the health insurance coverage and other fringe benefits provided to same sex spouses will, in most cases, continue to be taxable.

The Ruling will have a significant impact on the administration of employee benefit plans, from both the employer and employee perspective, and will also impact non-qualified annuity contracts. The chart below outlines the impact of *Windsor* and the Ruling on various employee benefit provisions and annuity contracts, taking into account the guidance contained in the related FAQs.

RETIREMENT PLANS AND ANNUITY CONTRACTS	
Benefit or Provision Impacted	**Impact of *Windsor* and the Ruling**
Qualified Joint and Survivor Annuities (QJSAs)	▪ Same-sex spouses are "spouses" for purposes of determining the right to and calculating the QJSA benefit ▪ Spousal consent rights, including for plan loans, apply to same-sex spouses ▪ A same-sex spouse's survivor annuity under a QJSA is not taken into account when determining maximum benefits under Code § 415(b)
Qualified Pre-retirement Survivor Annuities (QPSAs)	▪ Same-sex spouses are considered "spouses" for purposes of determining the right to and the calculation of the QPSA benefit and other spousal death benefits
Beneficiary Designations	▪ Default spousal designations apply to same-sex spouses
Minimum Required Distributions	▪ Spousal deferral rules that apply to death benefits apply to same-sex spouses under Code § 401(a)(9)
Hardship Distributions	▪ Plans that provide for hardship distributions for payment of a spouse's medical, tuition, or funeral expenses must allow hardship distributions for such expenses related to a same-sex spouse
Qualified Domestic Relations Orders (QDROs)	▪ Plans are required to honor QDROs that order the distribution of benefits to former same-sex spouses
Individual Retirement Account (IRA) Deductions	▪ Community property laws still are not taken into account for purposes of determining an individual's maximum IRA deduction under Code § 219(b)
Non-Qualified Annuity Contracts – Spousal Continuation	▪ Non-qualified annuity contracts may (but are not required to) allow spousal continuation under Code § 72(s)(3) on the death of an owner regardless of the sex of the deceased owner's spouse and regardless of the state(s) of residence, as long as the marriage was valid in the state where contracted

WELFARE PLANS	
Benefit or Provision Impacted	**Impact of *Windsor* and the Ruling**
Taxation of Spousal Health Coverage	▪ Value of a same-sex spouse's health insurance is not treated as federal taxable income (though whether it will be treated as state taxable income depends on state law) ▪ Individuals who paid taxes on the value of same-sex spouse health insurance provided by an employer, or on the premiums paid for such coverage, may file refund claims to recover those taxes, as long as the statute of limitations on refund claims is still open ▪ Employers who paid FICA taxes in connection with provision of same-sex spouse health benefits may file refund claims to recover those taxes, as long as the statute of limitations on refund claims is still open (guidance on a streamlined process forthcoming) ▪ Employers may make adjustments for related over-withholding of income tax in the *current* year provided they reimburse the affected employee before the end of the calendar year (Claims related to over-withholding of income tax in *prior* years must be made by the employee.) ▪ Employers must make reasonable efforts to locate affected former employees before filing a claim for a refund of the employer portion of FICA taxes (additional guidance forthcoming)
COBRA Coverage	▪ Same-sex spouses and children of same-sex couples must be offered COBRA election rights
Special Enrollment Rights	▪ Participants with same-sex spouses must be offered special enrollment rights upon marriage or birth of child ▪ Same-sex spouses who decline health coverage under their employer's plan due to coverage provided under a spouse's plan must be offered a special enrollment right under their plan when coverage under their spouse's plan ends ▪ Same-sex spouses must be offered a special enrollment right when coverage options under the plan are introduced or eliminated
Family and Medical Leave Act (FMLA)	▪ Same-sex spouses may be entitled to FMLA leave in order to care for a same-sex spouse ▪ A "qualifying exigency" arising out of the fact that a same-sex spouse is on active military leave may trigger FMLA rights
Cafeteria Plans	▪ Cafeteria plans must permit participation by same-sex spouses to the extent the plans permit participation by opposite-sex spouses (though it may depend on plan terms) ▪ Employees with same-sex spouses will be allowed to make corresponding changes to benefits upon marriage, divorce, legal separation, or annulment, or upon death of a same-sex spouse ▪ An unpaid leave of absence by a same-sex spouse may trigger the right to coverage changes ▪ Changes to a same-sex spouse's coverage under his or her health plan may permit corresponding changes to cafeteria plan elections
Flexible Spending Account (FSA) and Dependent Care Assistance Benefits	▪ Expenses of same-sex spouses likely must be eligible for reimbursement under healthcare FSA arrangements ▪ Child care expenses for eligible children of same-sex spouses must be eligible for reimbursement under a dependent care FSA or other dependent care assistance plan

Health Savings Account (HSA)/Heath Reimbursement Account (HRA) Benefits	▪ Expenses of same-sex spouses must be eligible for HSA reimbursements and likely must be eligible for HRA reimbursements ▪ Same-sex couples are eligible for two times the family contribution limit with respect to HSAs
Wellness Programs	▪ Wellness programs made available to spouses likely must be made available to same-sex spouses
Meals and Lodging	▪ Meals and lodging provided to an employee's same-sex spouse or his or her dependent are excludible from the employee's income under Code § 119
Tuition Reduction	▪ A tuition reduction provided to an employee's same-sex spouse or his or her dependent is excludible from the employee's income under Code § 117(d)
Fringe Benefits	▪ No additional cost services and qualified employee discounts provided to an employee's same sex spouse are excludible from the employee's income under Code §§ 132(a)(1) and (2)

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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