Patterson Belknap Webb & Tyler LLP

Employee Benefits and Executive Compensation Alert September 2013

Important IRS Guidance on Same-Sex Marriage

Earlier this summer we sent you an Alert concerning the U.S. Supreme Court's historic ruling (***United States v. Windsor***) regarding same-sex marriage. This decision declared, as unconstitutional, Section 3 of the federal Defense of Marriage Act, which defined "spouses" and "marriage" for purposes of federal law as including only persons of the opposite sex. Thus, following the *Windsor* decision, same-sex spouses will now be recognized for purposes of federal law, including, among many others, federal tax law and the Employee Retirement Income Security Act (ERISA).

Windsor Left Many Open Questions

While the impact of the Supreme Court's ruling on employee benefit plans and arrangements will be substantial, the *Windsor* decision, as we noted in our earlier Alert, left many questions unanswered with respect to its impact on such plans and arrangements. The two most fundamental questions are: (i) what state law controls in determining whether a same-sex marriage, and therefore such same-sex partners' status as "spouses," will be recognized in applying federal law post-*Windsor*, and (ii) does, and if so to what extent will, the *Windsor* decision have retroactive effect? While additional guidance is necessary and will be forthcoming from the various federal agencies having jurisdiction over the many federal laws impacted by marital and spousal status, the Internal Revenue Service and U.S. Treasury Department (collectively, "IRS") have issued initial guidance on the subject and offered some answers to these and other important questions.

IRS Provides "State of Celebration" Standard

The key threshold question to be addressed by the federal agencies is what state law controls in determining an individual's status as a same-sex spouse for purposes of the various rights and benefits available to spouses under federal law. On August 29, 2013, the IRS issued its initial round of same-sex marriage tax guidance (in the form of an informal announcement, revenue ruling (Revenue Ruling 2013-17), and frequently asked questions) which answered that threshold question for purposes of federal tax law by adopting a ***"state of celebration"*** rule, meaning that same-sex couples who are married in a U.S. state (including the District of Columbia and U.S. territories) or foreign country whose laws authorize same-sex marriages will be considered lawfully "married," and as "spouses," under federal tax law, even if they live in a state that does not recognize the validity of same-sex marriages. Thus, for instance, a same-sex couple that is validly married in New York, but who resides in Pennsylvania (where same-sex marriage is not currently recognized) will continue to be treated as married (and as spouses) for federal tax purposes.[1]

Civil Unions and Domestic Partnerships Not Covered

The IRS guidance makes clear that for federal tax purposes "marriage" does not include registered domestic partnerships, civil unions, or similar formal relationships recognized under state law that are not denominated as a

[1] It is noted that, in contrast, the U.S. Department of Labor ("DOL") has indicated that for purposes of the federal Family and Medical Leave Act ("FMLA") a "state of residence" rule applies, rather than a "state of celebration" rule. Thus, for purposes of the FMLA, a same-sex spouse otherwise validly married will be eligible for the benefits of the FMLA only if the same-sex spouses live in a state that recognizes same-sex marriage. Therefore, unless the DOL's guidance is changed, a same-sex spouse may therefore be treated as a spouse for federal tax purposes, but not for FMLA purposes.

marriage under that state's law, and thus the terms "spouse," "husband" and "wife" do not, under federal tax law, include the individuals entering into such "non-marriage" relationships. This treatment under the federal tax law of such relationships applies whether the individuals are of the opposite or same-sex.

Tax Impact on Health and Welfare Plans

In light of the Supreme Court's *Windsor* decision and in accordance with the IRS's guidance, employees who have same-sex spouses who were provided health plan coverage under the employee's employer-sponsored health plan in prior periods will have the opportunity to seek refunds of federal taxes paid with respect to such spousal coverage that, under *Windsor* and the IRS's guidance, is now eligible for favorable tax treatment. While the IRS's guidance paves the way for employees and employers to claim refunds of certain federal taxes paid with respect to the health plan coverage of an employee's same-sex spouse, additional guidance may be forthcoming.

Health Plan Coverage

If an employer provided health coverage for an employee's same-sex spouse and the value of such coverage was included in the employee's income (*i.e.*, because the federal tax law's exclusion from income for the value of such coverage applies only to an employee, employee's spouse and eligible "tax" dependents), the employee can now file amended income tax returns (IRS Form 1040X) for all tax years for which the statute of limitations has not closed, *i.e.*, an "open tax year," (generally covering tax year 2010 and later tax years). These amended income tax returns should reflect the employee's married status and same-sex partner's status as a spouse for federal tax purposes and the exclusion from taxable income of the income previously imputed to the employee for the value of the health plan coverage of the same-sex spouse.

Cafeteria Plan Contributions

If an employer sponsored a cafeteria plan that allowed employees to pay premiums for health coverage on a pre-tax basis, an employee who participated in such plan who paid for the employee's health coverage on a pre-tax basis but was required to pay for the employee's same-sex spouse's coverage on an after-tax basis may file an amended income tax return for any open tax year to exclude from income the premium contributions that the employee paid on an after-tax basis for the health coverage of the employee's same-sex spouse. Although the IRS's guidance now recognizes an employee's right to pay for a same-sex spouse's health plan coverage on a pre-tax basis, the guidance does not address, for the 2013 plan year, whether an employee may make a mid-year election to change his or her health plan coverage or flexible spending account elections to reflect the federal tax law's new recognition of the employee's same-sex spouse as a spouse under the employer's cafeteria plan. Hopefully, additional guidance will be issued soon to address this issue.

FICA Tax Refunds

For any open tax year, an employer may claim a refund of, or make an appropriate adjustment for, any excess social security taxes and Medicare taxes that were paid with respect to the health plan coverage of the employee's same-sex spouse. Notice to affected employees may be required and special administrative procedures will be provided in future guidance from the IRS for employers to seek such refunds. [2]

[2] It remains unclear from the IRS's guidance whether employers will be able to claim a refund or make an appropriate adjustment for the portion of social security taxes and Medicare taxes paid for by the *employee* with respect to the health plan coverage of the employee's same-sex spouse.

Income Tax Refunds

In the situations described above regarding the provision of health plan coverage to a same-sex spouse with after-tax income amounts, employers may not file claims for refunds or otherwise make adjustments with respect to the income tax withholding that was made from the employee for such coverage in prior tax years (*i.e.*, tax year 2012 and prior years). Recovery of such income taxes may be obtained by the employee by filing an amended income tax return. However, employers may make adjustments for income tax withholding that was overwithheld from the employee in the current tax year (*i.e.*, 2013 tax year) due to such employee's same-sex spouse's health plan coverage in the current tax year, provided the employer has repaid or reimbursed the employee for the overwithheld income tax before the end of the current calendar year.

Impact on Qualified Retirement Plans

Qualified retirement plans, such as 401(k), 403(b) and defined benefit pension plans, must apply the **"state of celebration"** same-sex spouse rule on and after September 16, 2013. The IRS intends to issue additional guidance regarding the application of the *Windsor* case and the IRS's guidance described in this Alert to qualified retirement plans with respect to periods **before** September 16, 2013. In addition, the IRS indicated that it will provide further guidelines concerning how qualified retirement plans and other tax-favored retirement arrangements must comply with the *Windsor* decision and the IRS's guidance, which additional guidelines will address plan amendment requirements (including the timing for adoption of such amendments) and any necessary corrections to plan operations for periods prior to the issuance of such additional guidance.

Next Steps for Employers

The IRS's announcement that it will use a **"state of celebration"** rule for purposes of federal tax law should be welcome news for employers and plan sponsors with respect to the administration and operation of their employee benefit plans and arrangements. For instance, beginning no later than September 16, 2013, if at all possible, employers should stop imputing income to employees with respect to the health plan coverage of their same-sex spouses and such employees should be permitted to obtain pre-tax reimbursements from health flexible spending accounts with respect to the eligible medical expenses of their same-sex spouses that are incurred on or after September 16, 2013.

With a September 16, 2013 effective date shortly upon us for applying a state of celebration rule and the other aspects of the IRS's guidance to a wide variety of employer-sponsored benefit plans and arrangements (*e.g.*, qualified retirement plans, cafeteria plans, group health plans), employers need to be proactive in reviewing and revising the operation of their plans and arrangements so as to ensure compliance with applicable federal tax law. Most employers will need to determine whether employees with same-sex partners are married in order to make appropriate plan changes.[3]

For instance, at least for participants who retire on or after September 16, 2013 under a qualified pension plan or a 403(b) plan subject to joint and survivor annuity requirements and who have same-sex spouses recognized for federal tax purposes, such participants will need to be provided a qualified joint and survivor annuity as the normal form of benefit (subject to applicable spousal consent requirements in the event the participant with a same-sex spouse desires to change the form of benefit or beneficiary of the pension benefits), rather than a benefit in the form of a

[3] Depending on the applicable state law, state income tax, withholding and tax reporting requirements with respect to same-sex spouses may differ from the federal tax requirements, particularly in those states that do not follow the federal rules for such tax purposes.

single life annuity as is the case for an unmarried participant. Similarly, a same-sex spouse will need to be the automatic death beneficiary under qualified retirement plans (including 401(k) plans and other defined contribution plans) and 403(b) plans, unless the same-sex spouse consents to another designated beneficiary. These changes, among many others required by the IRS's guidance, can require operational and systems changes under an employer's plan. Hopefully, future guidance from the IRS will offer reasonable methods and appropriate transition relief to enable employers to bring their plans into compliance. However, if they haven't yet done so, employers are strongly encouraged to begin immediately the process of identifying their plans and arrangements that refer to "spouse" and "marriage" to determine what plan provisions will need to change and how plan administration will need to be modified in order to satisfy the new requirements under the IRS's guidance.

Please contact any of the attorneys listed below if you would like assistance with understanding and implementing the changes required as a result of the *Windsor* decision and the IRS's guidance.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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