SHEARMAN & STERLING LLP

EXECUTIVE COMPENSATION & EMPLOYEE BENEFITS

CLIENT PUBLICATION

July 10, 2013

The End of DOMA: Federal Tax and Benefits Implications

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

John J. Cannon III
New York
+1.212.848.8159
jcannon@shearman.com

Kenneth J. Laverriere
New York
+1.212.848.8172
klaverriere@shearman.com

Doreen E. Lilienfeld
New York
+1.212.848.7171
dlilienfeld@shearman.com

C. Jones Perry Jr.
New York
+1.212.848.8854
jperry@shearman.com

Linda E. Rappaport
New York
+1.212.848.7004
lrappaport@shearman.com

Sharon Lippett
New York
+1.212.848.7726
sharon.lippett@shearman.com

SHEARMAN.COM

The US Supreme Court's recent ruling in *United States v. Windsor* ("*Windsor*") struck down key portions of the federal Defense of Marriage Act ("DOMA") as unconstitutional. This decision will allow many same-sex spouses to enjoy federal tax and survivor benefits previously available only to those in opposite-sex marriages, and has implications for employers and administrators of retirement and group health plans.

Background

Windsor began with a federal estate tax refund claim brought by Edith Windsor following her wife's death. In 2007, Windsor and her wife, Thea Spyer, were married in Canada after forty years together as residents of New York. While New York did not permit same-sex marriages at that time, by a directive from the governor of New York, such marriages were recognized if valid where performed. Upon Spyer's death in 2009, Windsor inherited her entire estate as her surviving spouse. However, because DOMA restricted the federal definition of "marriage" to opposite-sex couples, the Internal Revenue Service (the "IRS") did not recognize the couple's marriage for federal estate tax purposes. Accordingly, the IRS refused to permit Spyer's estate to claim the marital deduction, and Windsor's inheritance was reduced by the full amount of the estate's $363,053 federal estate tax liability. Windsor filed a refund claim on the grounds that DOMA unconstitutionally discriminated against same-sex married couples.

Windsor's lower courts victories were affirmed by the Supreme Court on June 26, 2013, in a decision holding that, "DOMA seeks to injure the very class [of same-sex spouses] New York seeks to protect. By doing so, it violates basic due process and equal protection principles applicable to the Federal Government."

On June 27, 2013, the IRS issued a statement that the agency "will be working with the Department of Treasury and Department of Justice, and ... will move swiftly to provide revised guidance in the near future." However, there are many federal tax and survivor benefits that same-sex spouses should be entitled to under current guidelines. Couples should be aware of their newly available tax planning opportunities, and consider consulting a tax advisor to discuss the federal tax consequences of the *Windsor* decision.

Administrators of retirement and group health plans subject to the Internal Revenue Code of 1986, as amended (the "Code") should also be aware of the effects of *Windsor* on their plans and review the plan documents to identify provisions and practices that will requirement amendment.

Federal Income Tax

Married couples filing joint federal income tax return may find advantages in combining their income, deductions, tax credits and tax brackets. Prior to *Windsor*, same-sex couples married under state law could file joint New York state income tax, but were required to file single federal returns. From this point onward, same-sex spouses whose marriages are recognized by their state of residence should be able to file federal returns jointly.

Filing a joint federal return will likely reduce a couple's income tax liability if one spouse has a high income, while the other earns substantially less or does not work. However, it may increase their tax liability — resulting in a so-called "marriage penalty"— when the spouses' incomes are similar and substantial. While single tax filers reach the top income tax bracket of 39.6% if their income exceeds $400,000, married couples reach that bracket if they earn a combined $450,000. Ultimately, the tax consequences of filing a joint return will depend on each couple's income and other circumstances.

Same-sex couples selling their primary residence will see substantial capital gains tax savings, since a married couple filing jointly can exclude up to $500,000 in gain, regardless of whether one spouse held title alone. If the title-holding spouse filed as a single taxpayer, this exclusion amount would be limited to $250,000.

In addition, married same-sex couples will no longer be subject to income tax when a non-dependent spouse is provided with health insurance through the other spouse's employer. In the past, the value of such health insurance coverage was treated as taxable "imputed income." Furthermore, employees could not pay for a same-sex spouse's coverage with pre-tax dollars. Moving forward, employers' payments for same-sex spouses will be treated as tax-free benefits and employed spouses can use pre-tax dollars to pay for coverage.

Post-DOMA Estate Planning

Unlimited Marital Estate and Gift Tax Deduction

Before *Windsor*, a gift or bequest to a same-sex spouse was taxable as a donative transfer to an unrelated party. The amount of any property transferred would reduce an individual's applicable unified estate and gift tax exclusion amount (the "Applicable Exclusion Amount"), currently $5.25 million, adjusted annually for inflation. The top marginal transfer tax rate of 40% would be imposed on any transfers in excess of the Applicable Exclusion Amount.

Married same-sex couples can now claim the unlimited marital deduction from federal estate and gift tax. This means that an individual may transfer, during his or her lifetime or at death, property in any amount to his or her same-sex spouse free of federal estate or gift tax.

Many existing estate plans were developed on the assumption that any gift or bequest to a same-sex spouse over the Applicable Exclusion Amount would be heavily taxed. Now that such transfers, if properly structured, are entitled to the unlimited marital deduction, couples may wish to modify their estate planning documents to provide that any assets in excess of the Applicable Exclusion Amounts will pass to the surviving spouse, either outright or in a properly structured marital trust. Doing so will defer any federal estate tax until the death of the surviving spouse. Since there are many types of marital trusts and other planning tools now available to same-sex spouses, couples should consider exploring their full range of options with an advisor.

Estate Tax Portability

Portability entitles a surviving spouse to use any portion of his or her deceased spouse's unused Applicable Exclusion Amount (the "DSUE"). A surviving same-sex spouse will now be able to use this extra exclusion amount to make additional tax-free gifts or reduce the tax liability of his or her own estate. While portability does not apply to a deceased spouse's unused federal generation-skipping transfer ("GST") tax exemption, a marital trust may be designed to permit the surviving spouse to make use of his or her remaining GST tax exemption amount.

Gift Splitting

In addition to the $5.25 million Applicable Exclusion Amount, individuals can also make use of an annual gift tax exclusion amount of $14,000 per donee. Both of these exclusion amounts can be doubled when transfers are "split" by a married couple. Thus, a same-sex spouse can now make a donative transfer from his or her own assets and, with the other spouse's consent, have the transfer treated as made one-half by the other spouse for federal tax purposes. By acting together, the couple can make gifts of up to $28,000 to any individual each year without using any portion of either spouse's Applicable Exclusion Amount. Once the annual gift tax exclusion amount for a given year is exhausted, the couple can still make combined gifts or bequests of up to $10.5 million over their lifetimes without incurring federal estate or gift tax.

Retirement Accounts

A married person can contribute funds to his or her spouse's individual retirement account ("IRA"). In addition, a surviving spouse named as the beneficiary under a decedent's qualified retirement account can "roll over" the account into his or her own account, potentially extending the benefit of the tax-free deferrals, because the surviving spouse is not required to take minimum distributions or lump sum distributions until he or she reaches age 70½. This benefit is now available to married same-sex couples, who should consider naming each other as the beneficiaries of their respective accounts in order to defer income tax on the rolled over account as long as possible.

Social Security Benefits

Same-sex spouses whose marriages are recognized by their states of residence can now apply for Social Security benefits on their spouses' earnings, as well as survivor benefits after their spouses' deaths. It should be noted that the Social Security Administration typically looks to the state law of a person's residence to determine whether a person is married, which may create problems for couples that move to a state where same-sex marriage is not recognized.

Life Insurance Policies

Many same-sex spouses own individual life insurance policies naming the other spouse as beneficiary, either directly in a beneficiary designation or indirectly through a life insurance trust. This is intended, in part, to ensure the surviving spouse will have sufficient liquid assets to pay the federal estate taxes due when the first spouse dies. However, with the unlimited marital deduction and portability now available to married same-sex couples, the need for such liquidity may be reduced. Couples may wish to consider replacing their individual policies with so-called "survivor" or "second-to-die" policies that pay benefits only upon the death of the surviving spouse. Such policies provide liquidity for children or other surviving beneficiaries, and are generally less expensive than individual policies.

Retroactive Application and Amended Returns

Retroactive Application of *Windsor*

The extent to which same-sex spouses will be allowed to amend prior federal tax returns depends on whether *Windsor* is applied retroactively, and whether the applicable limitations period has passed with regard to a specific return. Generally,

a law that is declared unconstitutional was unconstitutional from the time of its passage. For this reason, it is likely that *Windsor* will apply retroactively to some extent. This means that the limitations period for a particular return will likely determine whether or not amendment is possible.

In general, a claim for a federal tax refund must be filed within the later of (i) three years from the date on which the relevant tax return was filed or due (including extensions), or (ii) two years from the date on which the tax was paid. Some have suggested that statutes relating to this period of limitation could be changed to permit same-sex couples to amend returns as far back as the year of their marriage, on the basis that neither spouse lawfully could have amended his or her tax returns prior to the *Windsor* decision. However, absent legislative change, or regulatory guidance stating that the period of limitations for same-sex couples was effectively "frozen" prior to *Windsor*, claims filed beyond the established period of limitations will be time barred. Because the IRS will require substantial time to develop new policies and regulations in response to *Windsor*, same-sex spouses may wish to file a protective claim preserving their ability to receive a refund after IRS guidance is issued.

Amended Income Tax Returns

Both spouses may amend prior year income tax returns within the period of limitations and receive a refund if the tax paid based on their single filer status exceeds the amount owed based on their newly established married joint filer status. However, couples do not have a duty to amend past returns, which were filed in accordance with then-existing law and revenue procedures. As discussed above, certain couples may face increased tax liability when filing jointly. Spouses who believe they may be eligible for a refund should consult an advisor to discuss the specifics of their circumstances and consider whether an amended return should be filed.

Amended Estate Tax Returns

If a person's estate paid federal tax on assets inherited by his or her surviving same-sex spouse, an amended estate tax return filed within the period of limitations will allow the estate to claim a refund. If the decedent died in or after 2010 without exhausting his or her Applicable Exclusion Amount, the surviving spouse may claim the DSUE to make additional tax-free gifts and reduce the tax liability of his or her own estate.

Amended Gift Tax Returns

If a person made inter-spousal gifts within the period of limitations that were subject to federal gift tax, or reduced his or her Applicable Exclusion Amount, an amended return may be filed to retroactively claim the unlimited marital deduction. To the extent either spouse has paid gift taxes or used a portion of his or her Applicable Exclusion Amount by making gifts to third parties within the period of limitations, an amended return may be filed to retroactively split such gifts with the other spouse. In either case, the amended return should allow the donor spouse to receive a refund or reclaim the appropriate portion of his or her Applicable Exclusion Amount.

Employee Benefit Plans

Health Plans

In states that allow or recognize same-sex marriage, group health benefits for non-dependent same-sex spouses are no longer subject to federal income tax. Any spousal benefits offered under group health plans must be extended to same-sex spouses in states that recognize same-sex marriages. COBRA continuation coverage and special enrollment rights provided under the Health Insurance Portability and Accountability Act (HIPAA) are now available to same-sex spouses on the same basis that they are available to opposite-sex spouses. For example, same-sex spouses must receive 36 months of COBRA coverage in the event of divorce and, if they lose coverage under another plan, may now be immediately

covered under the spouses' plans. In addition, same-sex spouses will have the right to take a leave under the Family and Medical Leave Act (FMLA) for the serious health condition of their spouses. As discussed more fully below, it is still unclear whether a legally married same-sex couple will be considered married for plan and benefits purposes if the couple resides in a state that does not recognize same-sex marriage.

Retirement Plans

Qualified retirement plans (including 401(k) plans) are now required to provide that same-sex spouses in states that allow or recognize same-sex marriage are entitled to survivor benefits and must consent in writing to the waiver of those benefits. In a defined benefit plan, this requirement means that participants with same-sex spouses must receive their benefit in the form of a 50% (or greater) joint and survivor annuity, with the spouse as the joint annuitant, unless the spouse waives that benefit. This change raises questions regarding the validity of existing non-spousal beneficiary designations and may require that plan participants revise their beneficiary forms or get spousal consent to maintain the existing form.

Same-sex spouses will now have the benefit of the more favorable provisions available to opposite-sex spouses relating to:

- Required minimum distributions, which permit spouses to defer distribution until the participant would have attained age 70 ½).
- Rollover distributions, which permit spouses to rollover (either via a direct or 60-day rollover) their qualified plan benefits to their own IRA or another employer plan; and
- Hardship withdrawals, which permit withdrawals for the medical, tuition and funeral expenses of a spouse (even if not the participant's primary beneficiary under the plan).

As discussed below, it is unclear whether a legally married same-sex couple will be considered married for retirement plan purposes if the couple resides in a state that does not recognize same-sex marriage.

Implications for Plan Sponsors

Plan sponsors should update plan documents and administrative practices and procedures to give effect to *Windsor*. For example, plan sponsors may consider amending any plan provisions that define "marriage" or "spouse" to refer to relevant state law or to otherwise reflect similar treatment of same-sex and opposite-sex married couples, and providing notice to participants of newly available benefits for same-sex spouses. In addition, plan sponsors may be required to make changes to income tax withholding practices to account for tax exemptions for health benefits provided to same-sex spouses.

Retroactive Effect

If *Windsor* is given retroactive effect, the administrative burdens and cost to companies, retirement plans and other benefits providers will not be measurable until the IRS provides guidance on how the ruling will be given retroactive effect. Issues that would need to be addressed if *Windsor* is given retroactive effect include the effects on benefits under qualified retirement plans already paid to non-spousal beneficiaries without the consent of the same-sex spouse and whether employees with same-sex spouses will be able to file amended returns for reimbursement of imputed taxes for benefits that are tax-exempt under *Windsor*.

Addressing Inconsistent State Law

The IRS typically looks to the laws of a taxpayer's state of residence to determine whether he or she is validly married for federal tax purposes.[1] This is in contrast to the standard employed in other areas of federal law affected by DOMA, such as immigration, in which the validity of a marriage is determined based on the jurisdiction where the couple wed.

Section 2 of DOMA, which was not repealed by the *Windsor* decision, allows states to refuse to recognize same-sex marriages performed in other states. This means that same-sex couples who move to states where same-sex marriage is not recognized may still face obstacles to claiming the federal tax and survivor benefits of married status. For example, the IRS may not recognize a same-sex marriage if the spouses reside in Florida in a given tax year, even if they were legally married in New York and deemed married for federal tax or survivor benefit purposes while residing there. Similarly, the FMLA regulations define "Spouse" as "a husband or wife as defined or recognized under State law for purposes of marriage in the State where the employee resides," which suggests that a same-sex spouse that resides in a state that does not recognize same-sex marriage may not be entitled to benefits under the FMLA.

Despite the inconsistencies in state law, some question whether the IRS will institute a "patchwork" recognition policy that could foreseeably lead to inconsistent outcomes and taxpayer confusion. Employers which operate or have participants in multiple states may be required to develop different administrative systems for states that do or do not recognize same-sex marriage. Because the word "spouse" is not defined in the Internal Revenue Code as applying only to opposite-sex couples, the IRS should in theory be able to interpret the word according to its own internally developed policies.

Many believe the IRS will address this and other issues raised by the *Windsor* decision through formal guidance within the next year. If not, such issues will likely be resolved by litigation or legislation in the relatively near future. In the meantime, it is not clear whether *Windsor* will be interpreted to require IRS recognition of same-sex marriages that are not recognized in the state where the spouses are resident or domiciled.

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069

[1] While not certain, it appears unlikely that domestic partners and those in civil unions will benefit from *Windsor*. The Supreme Court's decision is limited in scope to requiring that the federal government recognize the "lawful marriages" of same-sex couples. This would not seem to require the recognition of "marriage equivalent" status that is not "marriage" under state law.