BURNS & LEVINSON LLP

TAX UPDATE

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# *United States v. Windsor*: Tax Issues

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Although the decision of the United States Supreme Court in *United States v. Windsor* invalidating much of the Defense of Marriage Act (DOMA) affects at most approximately 20% of the population of the United States, it has changed the operation of more tax provisions than the major tax acts since 1969. It may be apocryphal, but it is said that approximately 1,100 tax provisions depend to some extent on a determination of whether a taxpayer is married. The effect can be analogized to the major tax acts of 1976, 1986 and 2001. Unlike legislation which is generally not retroactive and has fixed effective dates, court decisions tend to be retroactive.

### *Status issues:*

This tax update focuses solely on federal tax issues, although there are many other important issues which will arise after *Windsor*. While many state tax issues will be resolved consistently with the federal result, there will be significant differences, particularly in states which do not recognize same-sex marriages. The threshold question is: What does it mean to be married for tax purposes? The IRS takes the view that marriage is determined by applicable state law. In Revenue Ruling 58-66 (which deals with a taxpayer married under common law who moved to a state which required a marriage ceremony), the IRS ruled that the applicable state law was the law of the state where the marriage was entered into regardless of whether the spouses move to a state where their marriage would not be permitted or recognized. Much has been said about the uncertain status of same-sex spouses who were legally married in states allowing same-sex marriages and then move to a state which does not permit such marriages.

The result in *Windsor* occurred because a marriage which was valid where celebrated was recognized for federal tax purposes in the state of residence where it would not have been recognized under state law principles. President Obama said in an "off the cuff" comment that if a marriage was legal where it was celebrated, it should be recognized for all purposes. While this is not the law for many purposes, it is the law for federal tax purposes. Due to the widespread confusion about this issue, perhaps the IRS will restate this view which is supported by the "full faith and credit" clause of the Constitution that requires recognition of other states' actions generally.

There is no law with respect to whether legally recognized civil unions and domestic partnerships will be recognized as marriages. The IRS could conceivably grant marital status administratively, but it would be foolhardy to predict what will happen in respect to civil unions and domestic partnerships at this time.

Joint income tax returns and estate and gift tax marital deductions are two of the most significant tax areas where marital status is determinative of tax benefits and burdens. However, there are many others, and the effects of joint returns and marital deductions are far-reaching.

### *Income tax issues:*

Income tax rates are determined by the taxpayers' status as married filing jointly, married filing separately, head of household or unmarried. Before *Windsor* same-sex spouses were only permitted to file as single; after *Windsor* same-sex spouses are generally required to file either as married or married filing separately. If both spouses have substantially equal incomes and no or few items which get markedly different treatment on a joint return, their tax bill goes up whether they file jointly or separately. Many items are limited or otherwise affected by adjusted gross income, for example, medical expense deductions, miscellaneous itemized deductions, Roth IRA contributions, charitable contributions and numerous credits and exemptions. As a result, filing a joint return may radically change the amount of taxable income in comparison with the aggregate of taxable incomes on the taxpayers' separate returns. The only sure way to tell whether a joint return is beneficial is to compute the tax both ways.

Marital status changes the tax character of transactions. Gains and losses are not recognized on sales and exchanges between spouses. Employer health benefits for a person unrelated to the employee are taxable. Before *Windsor*, the IRS treated same-sex spouses as unrelated persons for purposes of tax provisions whose application is affected by a marital relationship, such as attribution of ownership between spouses for most corporate and partnership transactions. This can affect a host of transactions, such as:

- the status of foreign corporations as controlled foreign corporations,
- the status of corporate distributions as dividends or capital gains,
- allowance of losses on certain transactions,
- the character of gains on sales of depreciable property to entities,
- allowance of medical expense deductions,
- taxability of employer-provided health care benefits,
- the period for distribution of retirement benefits from a decedent (spousal rollovers), and
- the determination of whether a transaction with a tax exempt entity (charity or retirement plan for example) is a prohibited transaction.

In some cases, S corporations and classification of non-corporate entities, for example, there will be a spousal unity rule. A trust for the benefit of the donor's spouse is a grantor trust. *Windsor* is something of a

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windfall for the payor of alimony to a same-sex spouse and a possible calamity for the recipient. Will the courts grant relief to reflect the changed expectations of the parties? Similarly, qualified domestic relations orders (QDROs) will be available to same-sex marriage participants who get divorced.

***Estate, gift and generation-skipping transfer tax issues:***

Some of the most significant changes relate to estate, gift and generation-skipping transfer tax (GST) laws. Much has been said about the availability of the marital deduction (the issue in *Windsor*). The same principles apply to the gift tax where there is no joint return, but there is an election to split gifts between spouses. It is uncertain whether gift tax returns can be amended to allow gift splitting. If there is a large enough age disparity between same-sex spouses, a transfer to an unrecognized spouse could have triggered a GST tax. Spousal recognition – a consequence of *Windsor* – solves that issue.

Portability of exemptions depends on marital status. The amount of a beneficiary's withdrawal right, which qualifies for annual exclusion treatment, depends on the donor's marital status. The death of a surviving spouse with a qualified terminable interest property trust (QTIP) is a transfer for GST purposes, which gives rise to an exemption. Spousal unity rules are pervasive in the transfer tax area, and grantor retained income trusts (GRITs) were an example of a technique which was effective where the donor's spouse had the retained interest. A decedent's unused estate and gift tax exemption can pass to a surviving spouse while it would have been lost on an unrecognized same-sex spouse. Joint property is deemed owned 50% by each spouse at the time of the first spouse's death. In the case of a non-spousal joint owner, the taxable amount is determined based on their relative contributions. The list could go on.

***Procedural issues:***

2009 income tax returns that were on extension and later year returns generally may be amended from single to joint filing status if they have not been the subject of an audit and three years has not elapsed since the due date or extended filing date. It is uncertain and unlikely that relief from statute of limitations time bars can be given administratively, and it is likely to require legislation. Estate tax returns and other returns generally have a statute of limitations of the later of three years from the due date or extended filing date, or two years from the date of payment. Social Security taxes on employer-provided health benefits will affect thousands of individuals who may have to file claims for refund. Amounts involved for employers may be larger, although the number of claims is likely to be smaller.

The IRS has not given any guidance as to how it intends to handle the likely procedural morass. Massachusetts announced that it would grant refunds without requiring the filing of a formal claim when the Supreme Judicial Court held that a midyear effective date for legislation increasing the tax on capital gains was unconstitutional. However, in that case it was relatively simple for the claim to be determined from the face of the return. In some cases taxpayers may have filed protective refund claims; in one case the IRS advised the taxpayer to file a new claim with a date-stamped copy of the protective claim and an amended return. Because the statute of limitations may be running out for some taxpayers even as they read about the effects of *Windsor*, it is incumbent on same-sex married taxpayers and employers of same-sex married persons to contact their lawyer or accountant to review how *Windsor* affects their previous filings. Many, but not all, adverse tax results can be corrected by filing timely amended returns. In some cases taxpayers will have to look for possible legislative or administrative relief.

Taxpayers are likely to have structured their affairs so as to minimize their tax burdens. These taxpayers may have depended on non-recognition of a same-sex marriage. A sale between same-sex spouses to generate a loss will turn out to be ineffective. Taxpayers may have relied on the absence of a federally-recognized marriage to avoid ownership attribution, and the list goes on. It may be possible to rescind or amend transactions now determined to have undesirable consequences, for example an installment sale between same-sex spouses. Taxpayers may get away with these transactions unless they are ongoing or reportable on a tax return which has yet to be filed. A taxpayer who takes a reporting position in good faith relying on the law as enforced by the IRS at the time of filing has no obligation to amend, but if the IRS audits the return the law should be applied to deny the benefit. Taxpayers who filed as single and are reclassified as married filing separately and have their deductions reduced as a result of the newly determined marital status may have tax liability. It is not known what approach the IRS will take in respect to the many taxpayers who may want to amend their returns and the many taxpayers who will not want that their tax liabilities adjusted. Can they be required to file? There is likely to be guidance at some point, but the IRS is stretched at the moment as a result of sequestration, and it is uncertain how long this will take. In the meantime, same-sex spouses should review with their lawyer and accountant their tax reporting situation and review the transactions with their spouse.

***Planning issues:***

Same-sex spouses should review their estate plans to reflect the availability of QTIPS as well as retirement plan beneficiary designations to reflect the requirements of the Retirement Equity Act. Prenuptial agreements should be reviewed and post-nuptial agreements should be considered to reflect these changes. Many of these issues may have been considered in the pre-*Windsor* environment, but what once seemed an optimal plan may be less desirable in the new world. Employers should review their employee benefit programs to see how well adapted they are for their employees who are same-sex spouses. Same-sex spouses should review their existing plans and opportunities with their attorneys.

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