

## TAX IMPLICATIONS OF THE SUPREME COURT'S DECISION HOLDING DOMA UNCONSTITUTIONAL

JULY 2013



Recently, in *Windsor v. U.S.*, the Supreme Court made history by striking down a key provision in the Defense of Marriage Act (DOMA) that defined marriage as between a man and woman for federal law purposes. Although DOMA wasn't typically viewed as a tax law, it carried significant tax consequences for married same-sex couples who have traditionally been unable to do things like file a joint return or take advantage of a number of favorable estate-planning provisions.

The Supreme Court's decision means that the federal government, including the IRS, must now treat same-sex couples who are legally married in states that permit same-sex marriage the same as their heterosexual counterparts. However, the court's decision also raises a number of unanswered questions, including whether and to what extent it will apply retroactively, and how conflicts between state laws will be resolved.

This report provides an explanation of the *Windsor* case and the Supreme Court's decision, an analysis of the as-yet unanswered questions raised by the opinion, a list of which states recognize same-sex marriage and when they began (or are scheduled to begin) doing so, a description of several key tax-planning opportunities now available to same-sex married couples, and a brief overview of the decision's impact on employers.



### *Facts of the case*

In '63, Edie Windsor met Thea Spyer in New York City. Shortly thereafter, they entered into a committed relationship and lived together in New York. In '93, they registered as domestic partners in New York City, and in 2007, they got married in Canada. Spyer died in February 2009, leaving her estate to Windsor. At the time, New York recognized same-sex marriages from other jurisdictions. Because of DOMA, the estate did not qualify for the Code Sec. 2056(a) unlimited marital deduction for the amount left to Windsor. As a result, Spyer's estate had to pay \$363,053 in federal estate tax. Windsor paid this amount in her capacity as executor of the estate, then sued for a refund and declaration that DOMA § 3 is unconstitutional. She prevailed in the district court and again in the Second Circuit Court of Appeals.

### *Supreme Court opinion*

In a majority opinion delivered by Justice Kennedy (joined by Justices Ginsberg, Breyer, Sotomayor, and Kagan), the Supreme Court held that DOMA § 3 was an unconstitutional deprivation of equal protection.



**OBSERVATION:** Section 2 of DOMA, allowing states to refuse to recognize same-sex marriages performed under the laws of other states, wasn't at issue in this case.

## **Tax implications of the Supreme Court's decision holding DOMA unconstitutional Windsor, (Sup Ct 6/26/2013) 111 AFTR 2d ¶ 2013-2385**

In one of its most highly anticipated decisions, the Supreme Court has struck down section 3 of the Defense of Marriage Act (DOMA), which required same-sex spouses to be treated as unmarried for purposes of federal law. By a margin of 5-to-4, the court has held that the denial of federal recognition to same-sex couples validly married under state law was an unconstitutional deprivation of due process and equal protection. Although DOMA is not primarily viewed as a tax law, this case will have far-reaching tax implications for married same-sex couples.

### *Background on DOMA*

In '96, Congress enacted, and President Clinton signed into law, DOMA. Section 3 of DOMA defines marriage for purposes of administering federal law as the "legal union between one man and one woman as husband and wife." It further defines "spouse" as "a person of the opposite sex who is a husband or wife."

After determining that it had jurisdiction to hear the case, the Supreme Court traced the history of same-sex marriage in New York, noting that over time, its exclusion had come to be seen as unjust. New York first recognized same-sex marriages performed elsewhere, like that of Windsor and Spyer, and then went on to permit same-sex marriage. This evolution was consistent with the longstanding tradition that the regulation of marriage is within the authority and realm of the separate states, and the federal government has generally deferred to state-law policy decisions with respect to domestic relations.

The court found that DOMA treated married couples within the same state differently, and that its effect was to impose restrictions, stigma, and disabilities onto a state-defined class. It further stated that "DOMA writes inequality into the entire United States Code." It makes unequal a subset of state-sanctioned marriages in areas ranging from taxes to Social Security and veterans' benefits. Accordingly, the majority struck down DOMA as invalid, but stated that its opinion and holding are confined to "lawful marriages."

## Unanswered questions

While the decision makes clear that the federal government must recognize a lawful same-sex marriage, it left a number of issues unanswered, including the following:

- **Effective date.** The Supreme Court determined that Windsor was entitled to an estate tax refund, which essentially gave its holding retroactive effect. However, it isn't clear whether the IRS must apply the decision retroactively in all cases in which the limitations period is open, retroactively only in cases where protective refund claims were previously made, or only prospectively. If IRS concludes that the ruling is to be applied retroactively, it presumably would not compel married same-sex couples who because of DOMA filed as single taxpayers to refile as married persons, but would give them the choice to do so; for example, to claim joint filing status or some other tax break available to married couples.
- **Conflicting state laws.** The Court left open the question of which state law is relevant for determining whether a same-sex couple is married. It is unclear whether the federal government will recognize a same-sex couple as married where they were married in a state allowing same-sex marriages, but are domiciled in a state that does not recognize such marriages. A stronger case for federal recognition may arise where the couple was married and resided in a state recognizing same-

sex marriages, and later moved to state that does not recognize same-sex marriages. Presumably, IRS will address these issues in guidance. Note, though, that even if the federal government recognized the marriages in these cases, the couple would have to file their state returns as single individuals.



**OBSERVATION:** This issue wasn't implicated in the Windsor case since New York recognized same-sex marriages performed in other jurisdictions at the time of Spyer's death.



**OBSERVATION:** It is unclear what effect, if any, the Court's opinion will have in states that have marriage-equivalent domestic partnerships or civil unions, which may not fall within the court's "lawful marriages" terminology. It is not known how the IRS will treat such unions. However, a 2011 IRS Chief Counsel letter concluded that opposite-sex civil union partners in Illinois (which allows civil unions regardless of gender) could file a joint federal tax return because Illinois treats them equivalently to spouses. Following the Supreme Court's *Windsor* decision, the same analysis may apply to same-sex civil union partners and same-sex domestic partners in marriage-equivalent states (i.e., Colorado, Hawaii, Illinois, Nevada, New Jersey, and Oregon).

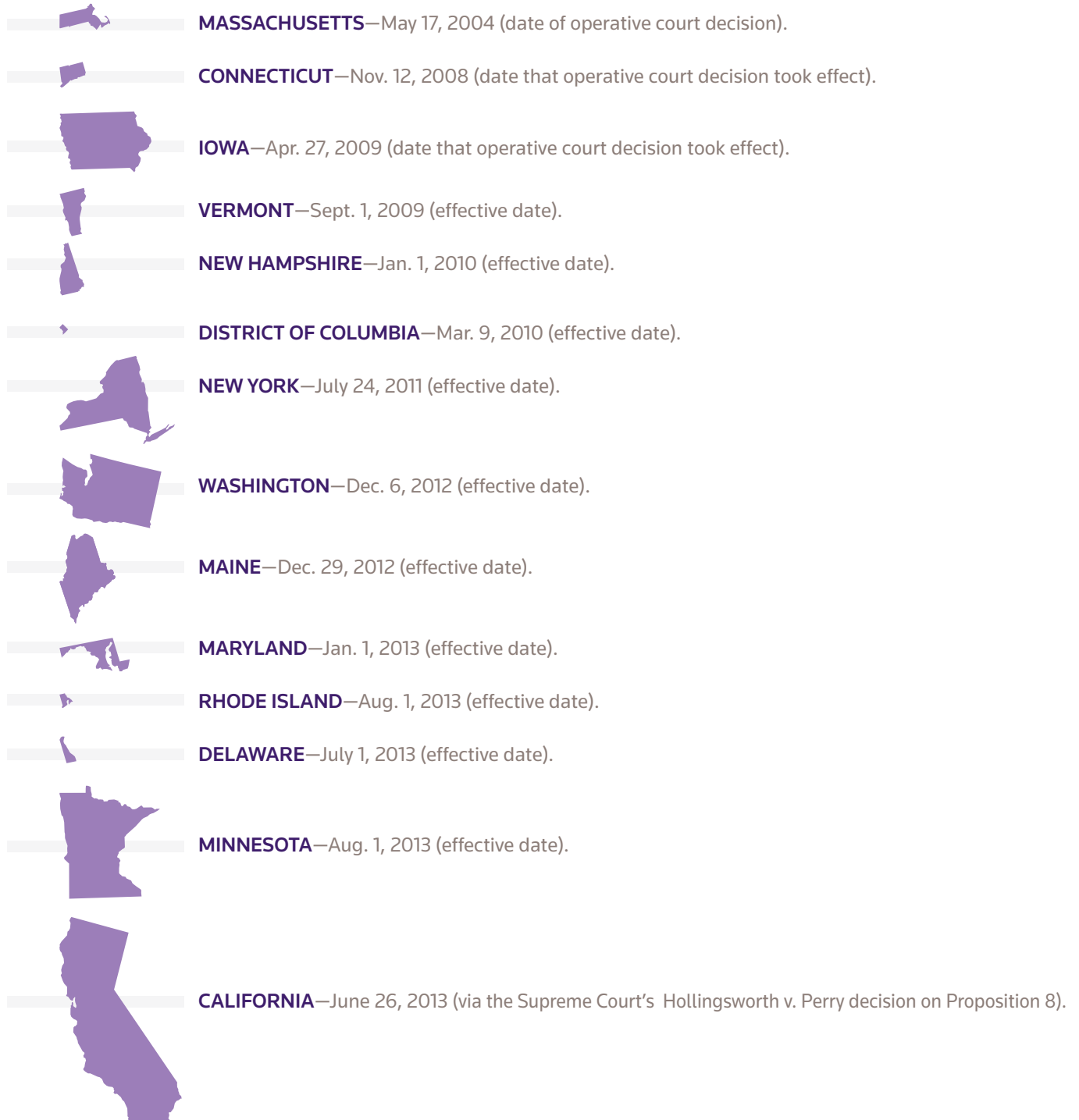


## States that recognize same-sex marriage

The following states and the District of Columbia have (or are set to have) same-sex marriage as of the time of publication. The list is presented in chronological order, by the date of allowance (in general, the effective date of the law allowing same-sex marriage, except where otherwise noted). Many of the states listed below also recognized out-of-state same-sex marriages before allowing it under the laws of their state. Additionally, there are other states that currently recognize out-of-state same-sex marriages but do not currently allow it under the laws of their state.



**OBSERVATION:** These populous states are estimated to comprise approximately a third of the U.S. population.





### Effect on tax law administration

The following are among the tax breaks newly available to legally married same-sex couples:

- The right to file a joint return, which can produce a lower combined tax than the total tax paid by the same-sex spouses filing as single persons (but this can also produce a higher tax, especially if both spouses are relatively high earners);
- the opportunity to get tax-free employer health coverage for the same-sex spouse; and
- the opportunity for a surviving spouse to stretch out distributions from a qualified retirement plan or IRA after the death of the first spouse under more favorable rules than apply for nonspousal beneficiaries.

Many other tax provisions are affected by a taxpayer's marriage status, such as the deductibility of alimony paid to a spouse or former spouse and the availability of the innocent spouse protections.

### Consider filing amended returns

Married same-sex couples who filed separate federal returns due to DOMA should consider filing amended returns or protective refund claims where applicable; for instance, if they paid higher taxes as a result of not being able to file jointly, if one spouse had capital gains in a year that would have been effectively cancelled by the other spouse's capital losses, or if they were previously taxed on health benefits provided to a spouse. The general statute of limitations for refunds is three years from filing or two years from payment, whichever date falls later.

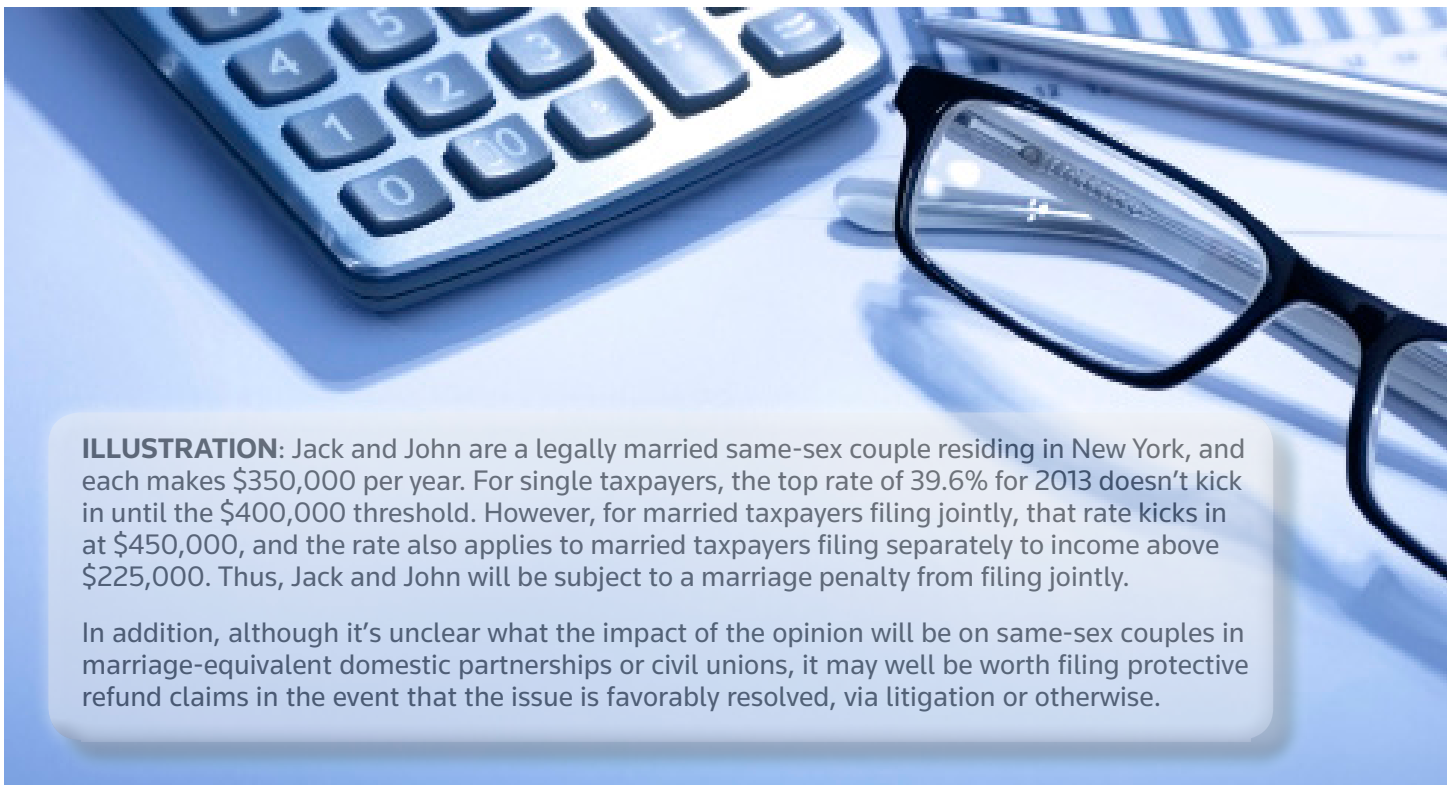


**OBSERVATION:** As discussed above, the extent to which this decision will be applied retroactively isn't clear, but it may nonetheless be worth filing protective refund claims in situations where the statute of limitations could expire before this issue is resolved.



**OBSERVATION:** Presumably, the IRS will issue procedures to facilitate these claims.

However, if both same-sex spouses are high earners, they should first do the math and compute whether filing an amended return would result in a marriage "penalty."



**ILLUSTRATION:** Jack and John are a legally married same-sex couple residing in New York, and each makes \$350,000 per year. For single taxpayers, the top rate of 39.6% for 2013 doesn't kick in until the \$400,000 threshold. However, for married taxpayers filing jointly, that rate kicks in at \$450,000, and the rate also applies to married taxpayers filing separately to income above \$225,000. Thus, Jack and John will be subject to a marriage penalty from filing jointly.

In addition, although it's unclear what the impact of the opinion will be on same-sex couples in marriage-equivalent domestic partnerships or civil unions, it may well be worth filing protective refund claims in the event that the issue is favorably resolved, via litigation or otherwise.

## Estate planning

There are many favorable estate and gift tax provisions available to married couples, including those listed below. Married same-sex couples should consider amending their estate plans to take advantage of these provisions:

- the opportunity for either spouse to utilize the marital deduction to transfer unlimited amounts during life to the other spouse, free of gift tax (for instance, by making a spouse co-owner of a home);
- the opportunity for the estate of the first spouse to die to get a marital deduction for amounts transferred to the surviving spouse;
- the opportunity for the estate of the first spouse to die to transfer the deceased spouse's unused exclusion amount to the surviving spouse; and
- the opportunity to consent to make "split" gifts (i.e., gifts to others treated as if made one-half by each).

As illustrated by the Windsor case, these provisions can yield significant tax savings.



**OBSERVATION:** It is worth noting that, for purposes of the Code, a couple that marries by the end of the year is treated as married for the entire tax year.

## Major effect on employers

The Windsor ruling also has an effect on employers. In certain states, employees' withholding may have to be adjusted to reflect their new filing status, health coverage provided to a same-sex spouse may be tax-free, and key terms of pension and retirement plans may also require changes.



**OBSERVATION:** IRS will presumably also clarify the time frame and procedures for employers to make these, and other, changes.



**OBSERVATION:** Similar to the complications discussed above, it's not entirely clear how the new rules will apply, for example, to same-sex spouses who work in a state that recognizes their marriage, but live in a state that does not.

## Bottom line

The Supreme Court's decision will have a significant effect on the taxation of same-sex married couples. Although the holding provides these couples with the same federal tax treatment as their heterosexual counterparts, it also raises a number of issues that will require further guidance. Stay tuned for further coverage.

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EBIA's guide for employers and advisors covers all stages of the design and administration of domestic partner benefits. Written and edited by experienced benefits attorneys, it is being comprehensively revised in light of the Supreme Court's DOMA decision and related agency guidance (as it becomes available). Coverage includes plan design and administration, tax compliance, state-law impacts, plus special issues for health, retirement, and other benefits (dependent care assistance, adoption assistance, and more). All with full legal citation, plus charts, tables, checklists, and sample documents.

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With the Supreme Court's invalidation of section 3 of the Defense of Marriage Act (DOMA), same-sex marriage can now be recognized under federal law. The ruling creates significant impacts for all plan sponsors, even those not currently providing benefits to same-sex spouses or other domestic partners. Whether you are a plan sponsor, service provider, or advisor, join our experts in this 90-minute web seminar as they help you understand how the historic ruling changes benefits law and affects plan design.

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### PPC'S GUIDE TO PRACTICAL ESTATE PLANNING

Provides updated guidance on the estate and gift tax benefits now available to legally married same-sex couples, including the opportunity to (a) claim the unlimited marital deduction for lifetime transfers from one spouse to the other, (b) make "split" gifts (i.e., gifts to others that are treated as if made one-half by each spouse), (c) claim the unlimited marital deduction for testamentary transfers from the decedent spouse to the surviving spouse, (d) transfer the deceased spouse's unused exclusion amount to the surviving spouse (i.e., the portability election), and (e) stretch out distributions from an IRA or qualified retirement plan after the death of the first spouse with more favorable tax treatment than that available to nonspouse beneficiaries. Certain benefits will no longer be available to legally-married same-sex couples, such as the transfers to a qualified personal residence trust from one spouse to the other.

### PPC'S 706/709 DESKBOOK

Provides updated guidance on the opportunity for a legally married same-sex couple to claim the unlimited marital deduction for transfers to the spouse during lifetime or at death.

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