EYE ON WASHINGTON

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Defense of Marriage Act

On June 26, 2013, the Supreme Court of the United States delivered its opinion on *United States v. Windsor*, striking down as unconstitutional Section 3 of the Defense of Marriage Act ("DOMA"). Section 3 of DOMA defined "marriage" as meaning "only a legal union between one man and one woman as husband and wife." DOMA effectively denied same-sex couples who were legally married in states where same-sex marriages are recognized over 1,000 Federal rights and benefits afforded to heterosexual married couples as was reported widely in the press and as stated by Justice Kennedy writing for the majority in the Supreme Court's opinion.

In declaring Section 3 of DOMA unconstitutional under the Fifth Amendment to the United States Constitution, the broad reach of the Supreme Court's opinion is clear as it pertains to Federal rights and benefits conferred to married couples. What was less than clear immediately after the announcement of the Court's decision was whether same-sex couples legally married and residing in a state that recognizes same-sex marriages (a "Recognition State") would continue to be entitled to their Federal benefits if that couple were to move to a state where same-sex marriages are not recognized (a "Non-Recognition State"), or whether a same-sex couple married in a Recognition State but who resided in a Non-Recognition State would be treated as "married" under a variety of Federal laws.

With respect to Federal tax law, these issues have been clarified by the U.S. Department of the Treasury and the Internal Revenue Service. On August 29, 2013, Treasury and the IRS issued Revenue Ruling 2013-17 and ruled that same-sex couples legally married in a Recognition State, the District of Columbia, a U.S. territory or a foreign country will be treated as married for Federal tax purposes regardless of whether or not the couple lives in a jurisdiction that recognizes same-sex marriages. Revenue Ruling 2013-17 went into effect on September 16, 2013.

This article will focus on summarizing the planning and reporting implications under selected Federal income, gift and estate tax laws for same-sex couples legally married in any of the jurisdictions in the United States where same-sex marriages are currently recognized, regardless of the jurisdiction in which the couple resides.

Federal Income Tax Laws

Filing Status for Federal Income Tax Returns

› **Under DOMA:** Same-sex married couples were not entitled to file their Federal income tax returns as "married filing jointly" or "married filing separately." Each of the two individuals would have been required to file separate income tax returns as single taxpayers.

› **After DOMA:** Same-sex married couples are now required to file their Federal income tax returns as "married filing jointly" or "married filing separately." The practical implications of this will vary depending on the relative income levels of the two spouses. As a general rule, if both spouses generate significant amounts of taxable income their combined Federal income tax liability will likely increase filing under either married status in comparison to filing as single taxpayers. In contrast, if one of the spouses is the primary income earner and the other spouse generates little or no taxable income, their combined Federal income tax liability married filing jointly may be lower than what they would have owed filing as two single taxpayers. Married status for filing purposes is determined as of the last day of the taxable year.

Highest Marginal Income Tax Rate

- **Under DOMA:** As single taxpayers for Federal income tax purposes, each spouse would have been taxed separately and each would have been taxed at the highest Federal marginal income tax rate of 39.6% when his or her individual taxable income exceeded $400,000.
- **After DOMA:** If the couple chooses to file their Federal income tax return as married filing jointly, they will be subject to the 39.6% marginal income tax rate when their combined taxable income exceeds $450,000. If they file married filing separately, each spouse will be subject to the 39.6% marginal income tax rate when their separately reported taxable income exceeds $225,000.

Capital Gains and Qualified Dividends

- **Under DOMA:** As single taxpayers for Federal income tax purposes, each spouse would have been taxed separately and the long term capital gains and qualified dividends tax rate of each would have been determined separately. For each individual, long term capital gains and qualified dividends would have been taxed at the highest tax rate of 20% (as opposed to a 0% or 15% tax rate for lower income taxpayers) if his or her individual taxable income exceeded $400,000 in the taxable year in which the capital gains were realized or the dividends were received.
- **After DOMA:** If the couple chooses to file their Federal income tax return as married filing jointly, their combined long term capital gains and qualified dividends will be subject to the highest tax rate of 20% if their combined taxable income exceeds $450,000. If they file married filing separately, the long term capital gains and qualified dividends of each spouse whose separately reported taxable income exceeds $225,000 will be subject to the 20% tax rate.

Net Investment Income Tax

- **Under DOMA:** In addition to any ordinary income tax or capital gains tax otherwise due, starting in 2013 a 3.8% net investment income tax is assessed on the net investment income of certain high income taxpayers. Generally speaking, as single taxpayers the net investment income of the individual spouses would have been exposed to the additional 3.8% net investment income tax separately if the individual spouse's own modified adjusted gross income exceeded $200,000.
- **After DOMA:** If the couple chooses to file their Federal income tax return as married filing jointly, their combined net investment income will be exposed to the 3.8% additional net investment income tax when their combined modified adjusted gross income exceeds $250,000. If they file married filing separately, each individual spouse's net investment income will be exposed to the additional 3.8% net investment income tax if the individual spouse's modified adjust gross income exceeds $125,000.

Alternative Minimum Tax

- **Under DOMA:** For 2013, the standard alternative minimum tax (AMT) exemption amount for each of the spouses filing as single taxpayers would have been $51,900.
- **After DOMA:** As married filing jointly, the couple's combined standard AMT exemption amount for 2013 is $80,800. If the spouses file as married filing separately, each spouse's individual AMT exemption amount for 2013 is $40,400.

Standard and Itemized Deductions

- **Under DOMA:** As single taxpayers, each of the spouses would have been entitled to a standard deduction of $6,100 for 2013. To benefit from itemizing deductions, each of the two spouses would have had to incur their own separate deductible expenses in excess of the standard deduction amount; however, as single taxpayers each spouse's itemized deductions would have been reduced by 3% (referred to as a "phase out") of the amount by which the individual's spouse's adjusted gross income ("AGI") exceeded $250,000, up to a maximum reduction of 80% of the itemized deductions.
- **After DOMA:** As married filing jointly, the couple's combined standard deduction for 2013 is $12,200. The couple will be allowed to combine their deductible expenses in determining whether their total itemized deductions exceed their married status standard deduction amount. If the spouses file married filing separately, their individual standard deduction amount for 2013 is $6,100 (the same amount as for single taxpayers). As for the phase out of itemized deductions, if filing married filing jointly, the couple's itemized deductions will be reduced by 3% of the amount by which their combined AGI in 2013 exceeds $300,000, subject to the 80% limitation referenced above. For married persons filing separately, their phase out of itemized deductions would begin at an AGI level in 2013 of $150,000.

Gain Exclusion from Sale of Principal Residence

- **Under DOMA:** As single taxpayers, each of the spouses would have been entitled to exclude up to $250,000 of gain from the sale of a principal residence once every two years, but each spouse would have had to independently meet the ownership and use requirements specified under the Internal Revenue Code (the "Code") to qualify for the exclusion. These requirements would typically be met by having the spouses own their principal residence as tenants in common or some other form of joint ownership; however, if only one spouse owned their principal residence, only the owner spouse would have been entitled to the one $250,000 exclusion.
- **After DOMA:** As married filing jointly, both spouses will still need to meet the principal residence use requirement under the Code, but it may be possible to qualify for the higher $500,000 exclusion amount afforded married couples who file jointly even if the principal residence is owned by only one of the two spouses.

Qualified Plan and IRA Spousal Rollovers

- **Under DOMA:** The rules regarding distribution requirements for beneficiaries of qualified plans and individual retirement accounts are very detailed and complex. But generally speaking, if one spouse was a participant in a qualified plan or the owner of an individual retirement account and named his or her same-sex spouse as the beneficiary of the participant's plan balance or IRA, the surviving spouse would have been required to take distributions from the plan or IRA using one of three alternatives available to non-spouse beneficiaries in order to avoid penalties imposed under the Code for not taking distributions as soon and as rapidly as required.

- First, the surviving spouse would have been entitled to take distributions over the life expectancy of the decedent spouse if the decedent spouse had already begun taking required distributions at the time of death.
- Second, the surviving spouse would have been entitled to take distributions over the life expectancy of the surviving spouse provided the surviving spouse started taking distributions no later than the year of the decedent spouse's death.
- Or third, the surviving spouse could have elected to take distributions of the plan or IRA balance in full by the end of the calendar year of the fifth anniversary of the decedent spouse's death if the decedent died before being required to start taking distributions.

› **After DOMA:** In addition to the three alternatives summarized above, the Code allows a surviving spouse (now including a same-sex spouse) beneficiary to take the inherited qualified plan or IRA and roll the balance over to an IRA in the surviving spouse's own name (referred to as a "spousal rollover"). By doing so, the surviving spouse would have the added flexibility to delay taking distributions until after the surviving spouse reaches the age of 70 ½.

Federal Gift Tax Laws

Unlimited Marital Deduction

› **Under DOMA:** Federal gift tax laws allow an individual to make an unlimited amount of gifts to the individual's spouse either outright or through the use of certain qualifying trusts relying on what is referred to as the "unlimited marital deduction" without the imposition of any Federal gift tax as long as the individual's spouse is a United States citizen. While DOMA was in effect, gifts to a same-sex spouse would not have qualified for the unlimited marital deduction and would have been subject to the gift tax annual exclusion and lifetime exemption amounts set forth below, and would have been required to file Federal gift tax returns under certain circumstances.

› **After DOMA:** Unlimited amounts of gifts may be made from one same-sex spouse to another either outright or through the use of certain qualifying trusts without any gift tax and without the need to file any Federal gift tax returns by relying on the unlimited marital deduction.

Annual Exclusion

› **Under DOMA:** Every individual is allowed to gift up to $14,000 per calendar year to as many individuals the taxpayer desires (including to a same-sex spouse) without the imposition of any gift tax or the need to file a Federal gift tax return. Gifts by an individual to a non-U. S. citizen spouse qualify for a higher annual gift tax exclusion amount of $143,000 during 2013. While DOMA was in effect, gifts to a non-citizen same-sex spouse would not have qualified for the higher annual gift tax exemption amount and would have been limited to the smaller $14,000 amount.

› **After DOMA:** An individual who makes gifts to a same-sex spouse who is a U. S. citizen does not need to rely on the annual exclusion to make tax-free gifts to the spouse as the gifts would now qualify for the unlimited marital deduction. If the same-sex spouse is not a U. S. citizen, gifts to the spouse during 2013 would have qualified for the higher gift tax annual exclusion amount of $143,000.

Lifetime Exemption/Applicable Exclusion Amount

› **Under DOMA:** As of 2013, each individual was allowed to make $5,250,000 (this amount is referred to as the "applicable exclusion amount" and is indexed for inflation) of lifetime gifts over and above any gifts that are exempted from gift tax by the unlimited marital deduction or the annual exclusion (referred to as "taxable gifts"). Previously, under DOMA when an individual made any taxable gifts to a same-sex spouse, the spouse making the gift would have been required to file a Federal gift tax return reporting the gifts and to use an allocable portion of the individual's applicable exclusion amount. Once an individual makes total taxable gifts that exceed the individual's applicable exclusion amount, the individual is required to pay Federal gift tax equal to 40% of the amount of the excess gifts.

› **After DOMA:** Since gifts by an individual to a same-sex spouse would now qualify for the unlimited marital deduction (subject to the limitations set forth above), gifts between a same-sex married couple can be made gift tax free without any dollar limitation, gifts would not need to be sheltered from Federal gift tax through the use of either individual's applicable exclusion amount and gifts would not trigger any Federal gift tax filing requirements.

Federal Estate Tax Laws

Unlimited Marital Deduction

› **Under DOMA:** Federal estate tax laws allow an individual at death to leave an unlimited amount of wealth to the individual's spouse either outright or through the use of certain qualifying trusts relying on what is referred to as the "unlimited marital deduction" without the imposition of any Federal estate tax as long as the individual's spouse is a United States citizen. If the surviving spouse is a non-U.S. citizen, the decedent spouse may leave an unlimited amount of wealth for the benefit of the surviving spouse without incurring any Federal estate tax at death using a certain type of trust known as a "qualified domestic trust" ("QDOT"), providing a modified variation of what is referred to as the unlimited marital deduction. While DOMA was in effect, assets left to a same-sex spouse would not have qualified for the unlimited marital deduction or the deduction allowed with the use of QDOTs and would have been subject to the applicable exclusion amount set forth below.

› **After DOMA:** Wealth left to a same-sex spouse either outright, through the use of certain qualifying trusts or through the use of a QDOT for a non-citizen surviving spouse will qualify for the unlimited marital deduction and will not be subject to estate tax at the decedent's death. Assets left to a surviving spouse will instead be subject to potential estate tax at the surviving spouse's subsequent death.

Applicable Exclusion Amount

- **Under DOMA:** As of 2013, each individual who dies is allowed to leave Federal estate tax-free an amount of wealth up to any portion of the decedent's applicable exclusion amount (in 2013, $5,250,000 as referenced above) not used during the individual's lifetime. Previously, under DOMA when an individual left assets at death to or for the benefit of a same-sex spouse, the decedent's estate would have been required to file a Federal estate tax return reporting the amount of wealth left to the same-sex spouse and use an allocable portion of the decedent's unused applicable exclusion amount to shelter that wealth from Federal estate tax. If the decedent's total taxable estate (including the amount of wealth left to the same-sex spouse) exceeded the amount of the decedent's unused applicable exclusion amount, the decedent's estate would have been required to pay Federal estate tax equal to 40% of the amount of the taxable estate in excess of the decedent's unused applicable exclusion amount.
- **After DOMA:** Wealth left to a same-sex spouse either outright, through the use of certain qualifying trusts or through the use of a QDOT for a non-citizen surviving spouse will now qualify for the unlimited marital deduction (as discussed above), and thereby preserve the use of the decedent's unused applicable exclusion amount to shelter portions of the decedent's wealth the decedent may desire to leave to other heirs or trusts for the benefit of heirs (including the surviving spouse). Additionally, through the use of a relatively new provision under our Federal tax laws referred to as "portability", a married individual is afforded the flexibility of using any remaining applicable exclusion amount at death or at the surviving spouse's subsequent death with proper and timely filed elections made by the estate of the first spouse to die. The use of the portability provisions may in certain situations result in an overall lower amount of Federal estate and capital gains taxes for the couple's heirs.

Jurisdictions Allowing Same-Sex Marriage

Jurisdictions that currently allow same-sex marriages in the United States are California, Connecticut, Delaware, the District of Columbia, Hawaii, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New Jersey, New Mexico, New York, Rhode Island, Vermont and Washington. In Illinois, same-sex marriages will be recognized beginning on June 1, 2014.

Effective Date, Actions on Certain Tax Returns and Uncertainties

Rulings of the Supreme Court of the United States generally become effective 25 days after the date of the Court's opinion. The declaration of Section 3 of DOMA as unconstitutional under the Court's decision in *United States v. Windsor* accordingly went into effect on July 21, 2013.

Same-sex couples who were married and filed Federal income tax returns, gift tax returns or estate tax returns within the last three years prior to the Supreme Court's ruling in *Windsor* should consult with their tax professionals to determine whether filing an amended return would entitle them to possible tax refunds or the return of any applicable exclusion amount they may have used to avoid paying gift taxes. In the press release announcing Revenue Ruling 2013-17, the IRS and Treasury stated that individuals who were in same-sex marriages may, but are not required to, file amended returns choosing to be treated as married for Federal tax purposes for prior tax years still open under the Code's statute of limitations. Generally, the statute of limitations for filing a refund claim is three years from the date the return was filed or two years after the date the tax was paid, whichever is later. Consequently, refund claims may currently still be filed for tax years 2010, 2011 and 2012.

As for other non-tax related Federal laws, a lingering area of uncertainty centers on Section 2 of DOMA, which was not the subject of the case before the Supreme Court in *United States v. Windsor* and which remains in effect. Section 2 of DOMA provides that "No State, territory, or possession of the United States, or Indian tribe, shall be required to give effect to any public act, record, or judicial proceeding of any other State, territory, possession, or tribe respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other State, territory, possession, or tribe, or a right or claim arising from such relationship." As such, questions pertaining to a broad range of Federal laws (other than Federal tax laws) remain over whether a same-sex couple married and residing in a Recognition State who subsequently moves to a Non-Recognition State or a couple who resides in a Non-Recognition State but who travels to a Recognition State to get married will be treated as married.

Summary

The decision in *United States v. Windsor* and the rulings in Revenue Ruling 2013-17 will have broad and long lasting tax planning implications for same-sex couples who have been or will be married in Recognition States. Because it will take time for tax planning professionals to process the range of planning implications for affected couples and because each couple's situation is specific to them, individuals should exercise caution and seek the advice of their financial and planning professionals before moving forward with any planning strategies or the filing of any Federal tax returns or amended returns based on the demise of Section 3 of DOMA.

*This is an update of the "Eye on Washington" newsletter originally published on July 4, 2013 on the Supreme Court's *Windsor* decision, and reflects certain developments that have occurred at the Federal and state levels since the date of the Supreme Court's decision. In updating this article, the author has chosen to continue to use 2013 tax figures in the sections contrasting how same-sex married couples would have been taxed in 2013 before and after the *Windsor* decision.

Note: All Federal tax figures included in this article are based on information obtained from the Internal Revenue Code and original source documents published by the Internal Revenue Service.

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