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Tax and Estate Guidance for California Same-Sex Couples Post-*Windsor*

IN *UNITED STATES V. WINDSOR*, the U.S. Supreme Court held that Section 3 of the Defense of Marriage Act (DOMA), which required married same-sex couples to be treated as unmarried for federal law purposes, is a deprivation of equal protection under the Fifth Amendment to the U.S. Constitution.[1] With approximately 198 separate Internal Revenue Code (IRC) provisions that refer to marital status,[2] the *Windsor* case was poised to effect major changes in the tax lives of married same-sex couples.[3] The case did not, however, hold that all of DOMA is unconstitutional. *Windsor* challenged only Section 3 of DOMA and did not overturn Section 2, which allows states not to recognize a same-sex marriage performed in another jurisdiction.[4] Following *Windsor*, states may continue to ban same-sex marriage within their jurisdiction and for state law purposes decline to recognize same-sex marriages validly entered into in another jurisdiction. This allows the country be to be divided into "recognition states" and "nonrecognition states." Since federal tax law historically has looked to the states on the issue of marriage, the existence of recognition and nonrecognition states leaves open the possibility that a same-sex couple validly married in a jurisdiction that allows same-sex marriage but domiciled in a nonrecognition state would not be considered married for federal tax purposes.[5] The Internal Revenue Service promised guidance.

On August 29, the Department of Treasury and the IRS issued Revenue Ruling 2013-17 and Notice IRS-2013-72, ruling that same-sex couples legally married in a jurisdiction that recognizes their marriage will be treated as married for all federal tax purposes, including income, gift, and estate taxes, and that such spouses are included for purposes of federal tax law in the terms "spouse," "husband and wife," "husband," and "wife," and that the term "marriage" includes the marriage of a same-sex couple. This ruling applies regardless whether the couple is domiciled in a recognition or nonrecognition state. Treasury Secretary Jacob J. Lew described the ruling as providing "certainty and clear, coherent tax-filing guidance for all legally married same-sex couples nationwide."[6] While Revenue Ruling 2013-17 resolves many questions about the tax and estate consequences of *Windsor*, the IRS may provide additional guidance.[7]

The IRS began applying Revenue Ruling 2013-17 in September, but affected taxpayers who wish to rely on the ruling may do so for earlier periods, as long as the applicable limitations period for filing a claim under IRC Section 6511 has not expired.[8] Pursuant to Section 6511, a taxpayer may generally file a claim for refund for three years from the date a return was filed or two years from the date the tax was paid, whichever is later (unless the taxpayer has an agreement with the IRS extending this period); therefore, married same-sex taxpayers may amend tax returns and file refund claims for tax years 2010, 2011, and 2012. If recognition of the same-sex marriage would not benefit the taxpayer for tax purposes, there is no obligation to file an amended return.[9] Pursuant to the prospective application of Revenue Ruling 2013-17, the IRS will not review past returns for issues created as a result of recognition of the taxpayer's marital status.[10]

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Following *Windsor* and Revenue Ruling 2013-17, California tax attorneys with married same-sex clients have extensive work to accomplish on behalf of these clients. For same-sex clients who reside in California and were legally married in California or another jurisdiction,[11] the end of Section 3 of DOMA may have brought a false sense of security and the belief that the only change that they will need to make is changing their income tax filing status to married filing jointly or married filing separately. In fact, the end of Section 3 of DOMA requires a full-scale audit of of their tax planning. Income, gift, and estate tax plans will likely need review, and tax refunds may be applied for, if appropriate. In addition to working with currently married same-sex couples, tax attorneys should be advising any widowed or divorced clients to analyze how the end of their same-sex

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marriage is affected. Finally, there are same-sex couples who are not married but are considering whether to marry. While the decision to marry is unlikely to be motivated by the couple's tax plan, tax attorneys should be prepared to discuss how marriage will affect the couple's tax plan and whether California's registered domestic partnership is an appropriate alternative.

Married Same-Sex Couples Living in California

Married same-sex couples living in California now have all the benefits and burdens under state and federal tax law that apply to a married heterosexual couple, and tax attorneys should be prepared to provide guidance on how such changes will impact a couple's income, gift, and estate tax plans.

Attorneys should advise married same-sex couples living in California to assess their current income tax filing status and other elements of their income tax plan. Beginning with the next income tax filing for calendar year 2013, these clients need to determine whether to file as married filing jointly or married filing separately.[12] This change alone will offer more efficient tax preparation for those married same-sex couples that previously were required to file as separate unmarried individuals (and as separate filers, to divide deductions, allocate to different returns children claimed as dependents, and so on) and may now choose to file as married filing jointly. These clients should also update the claimed allowances on their Form W-4, Employee's Withholding Allowance Certificate, as this may affect future withholdings, and review their quarterly estimated income tax payments if applicable.

For those tax years that remain open (again, 2010, 2011 and 2012, unless an agreement was entered into extending the statute of limitations) married same-sex couples should also determine if they are entitled to an income tax refund based on a lower tax liability than otherwise would have applied if they had been eligible to file as married filing jointly or married filing separately at the time of the filing. Specific income tax items to consider in determining whether the change in filing status may result in a refund include, among others, claiming personal and dependency exemptions, standard or itemized deductions, the earned income tax credit or child tax credit, and exclusion of gain from sale of a principal residence owned by one spouse. Married same-sex couples and their employers also may seek refunds or adjustments of overpayment of FICA taxes and federal income tax withholding (employment taxes) with respect to certain benefits provided to a same-sex spouse of an employee that would otherwise have been excluded from the employee's gross income and wages if the marriage had been recognized. Such benefits include health coverage benefits or fringe benefits that were provided by the employer to the same-sex spouse and are excludable from income under IRC Sections 106, 117(d), 119, 129 or 132.[13] While this financial analysis should be done to determine if an income tax refund is available, some married same-sex couples may find that the recognition of their marriage increases their income tax liability due to the "marriage penalty." Married couples who file jointly, and in which each spouse has relatively high earnings, generally owe more tax than they would if each filed as a single unmarried taxpayer because while marginal tax brackets for married joint return filers are higher than for single filers, the brackets are not twice as high. If the marriage penalty would otherwise have applied in past years, then no action need be taken as there is no obligation to amend past income tax returns in this circumstance.[14]

In the same manner that a married same-sex couple's income tax plan must be updated to reflect the change in the law, so must their gift and estate plans be updated. Prior to *Windsor,* married same-sex couples were treated as unrelated individuals under the tax laws. As a result, any lifetime gift or bequest under an estate plan to a same-sex spouse was treated as a taxable gift to an unrelated party rather than a gift that qualified for the unlimited marital deduction for gifts and bequests to a spouse.[15] A taxable gift to an unrelated party would reduce the transferor spouse's applicable unified estate and gift tax exclusion amount (currently $5.25 million, indexed for inflation and scheduled to increase to $5.34 million in 2014, referred to as the "applicable exclusion amount"), and if the aggregate amount of gifts and/or bequests to the same-sex spouse and others exceeded the applicable exclusion amount, a gift or estate tax would be due.[16] The availability of the unlimited marital deduction now allows married same-sex couples to delay the imposition of these transfer taxes on gifts and bequests between spouses until gifts in excess of the applicable exclusion amount are made to persons other than the spouse or until the death of the surviving spouse.

Many gift and estate plans, however, were drafted without marital deduction planning. With the availability of the unlimited marital deduction, several elements of an existing gift and estate plan should be reviewed. First, the unlimited marital deduction is available to outright gifts or bequests to a spouse and is also available to gifts or bequests made in trust for a spouse as long as terms of the trust will allow the transferred property to be characterized as qualified terminable interest property (QTIP).[17] A QTIP trust (also commonly known as a marital trust) not only offers the unlimited marital tax deduction but also allows the transferor spouse to have control over the disposition of assets at the surviving spouse's death, since the transferor as the trust creator has the power to determine the remainder beneficiaries of the trust. Without the benefits of the unlimited marital deduction, however, married same-sex couples may have been less inclined to utilize trusts in their estate plan. These clients should revisit their estate plan to determine if a QTIP trust is appropriate for their plan. In addition, if a gift to a same-sex spouse was made outright or in a QTIP trust in a tax year that remains open, an amended gift tax return should be filed to apply for the benefits of the unlimited marital deduction and either restore that portion of the taxpayer's applicable unified estate and gift tax exclusion amount that was improperly allocated to the gift to the same-sex spouse or QTIP trust and/or to apply for a refund of gift taxes paid.

Since a primary benefit of the unlimited marital deduction in estate tax planning is to delay the imposition of an estate tax, many married same-sex couples may have purchased and maintained life insurance on each spouse's life as part of their gift and estate plan in order to provide the surviving spouse sufficient liquidity to pay the estate tax due in the absence of the unlimited marital deduction. These individual life insurance policies may no longer satisfy their purpose if the gift and estate plan eliminates any estate tax on the first spouse's death. If liquidity remains a concern upon the surviving spouse's death, the couple may wish to modify their gift and estate plan by substituting the individual life insurance policies for a second-to-die life insurance policy, which is often less expensive.

There may also be elements of a gift and estate plan that are not for the benefit of the surviving spouse but are still affected by marital status, including planning with retirement benefits or taking advantage of the ability of spouses to split gifts. For planning with retirement benefits, consider that if there is a qualified retirement plan intended to benefit someone other than the employee's spouse at the employee's death, a spousal consent is required. This requirement would not have been imposed on a married same-sex couple before *Windsor*. In order to ensure that the nonspousal beneficiary designation for a qualified retirement plan is honored, the beneficiary designation with the spousal consent should be reexecuted. Alternatively, married same-sex couples may want to reconsider a beneficiary designation for someone other than the surviving spouse. These couples may now take advantage of qualified retirement plan benefits available for spouses, including rollover distributions, which permit the sur-

viving spouse to roll over her or his qualified retirement plan benefits to her or his own qualified retirement plan or another employer plan, and delays in required minimum distributions from an inherited plan, which permit spouses to defer distributions until the plan participant would have attained the age of 70½ and would have been required to take the required minimum distributions.

Another benefit now available to married same-sex couples is gift splitting, by which a nongifting spouse may consent to treat half of all gifts made by a gifting spouse as made by the nongifting spouse. The availability of gift-splitting mitigates the use of the gifting spouse's applicable exclusion amount. For open tax years, this is another analysis point to determine if amended gift tax returns should be filed.

Due to the breadth of changes that may be appropriate for a married same-sex couples' income, gift, and estate plan, as well as the possibility for tax refunds in open tax years, California tax attorneys should be working with these clients to ensure that they take advantage of the benefits of marital status that are now available.

Widowed and Divorced Same-Sex Spouses

Since the tax issue in *Windsor* was a refund for federal estate tax based on the marital deduction for a bequest to a surviving spouse, tax attorneys should clearly be planning to amend any estate tax returns filed for open years that will result in a refund of estate tax. Tax attorneys should also be reviewing estate tax returns for a decedent dying in 2010 and thereafter to maximize the benefits of spousal portability. Portability entitles a surviving spouse to take advantage of the unused portion of a deceased spouse's applicable unified gift and estate tax exemption (DSUE).[18] The DSUE may be used for either lifetime gifts or bequests made by the surviving spouse, and the DSUE augments the surviving spouse's applicable unified gift and estate tax exemption for these gifts and bequests.[19] As the DSUE will only exist for nontaxable estates, tax attorneys should be careful not to focus only on estate tax refund claims of their widowed same-sex clients.

Divorced clients who have ended a same-sex marriage also require advice post-DOMA. Among the federal tax laws based on marital status are those that govern the tax treatment of spousal support payments and transfers of property incident to divorce. Pursuant to *Windsor* and Revenue Ruling 2013-17, the tax treatment of alimony and transfers of property incident to divorce are now also available to same-sex couples under a divorce, separation instrument, or court order.

Spousal support payments that qualify as "alimony" within the meaning of IRC Section 71 are includable as income to the recipient and deductible by the payor.[20] If the divorcing parties do not want the alimony to be taxable to the recipient under IRC Section 71, the terms of their settlement agreement or divorce judgment may permit opting out of this treatment. If the settlement agreement or divorce judgment is silent on the matter, the default rule of taxing the alimony received by the recipient applies. As same-sex couples divorcing pre-*Windsor* and their family law attorneys may not have anticipated that this tax treatment would be available to the divorcing couple, it is likely that many existing settlement agreements or divorce judgments are silent. There are three issues to consider with a same-sex divorced client and his or her alimony obligations or receipts. If the client is the payor, amended income tax return should be filed for all open years claiming the deduction under IRC Section 215. If the client is the recipient, since the IRS is only applying Ruling 2013-17 prospectively and will not be reviewing past returns for issues created as a result of the recognition of the taxpayer's marital status after *Windsor*, no amended tax returns need be filed. However, beginning with the 2013 tax year the recipient must begin including the alimony as income. If taxing the alimony is not consistent with the former couple's intent, but their settlement agreement or divorce judgment is silent because of their belief that these laws did not apply to them, the former couple must also consider returning to court to modify the agreement or judgment to reflect their intent, if the court retained jurisdiction.

Another benefit now available to divorced same-sex couples is the preferential tax treatment under IRC Section 1041 for transfers of property incident to a divorce. Pursuant to that section, property transferred between spouses because of a divorce is not subject to income or gift tax. If a client's divorce occurred recently enough that the statute of limitations for the year in which the transfers occurred remains open, amended income tax returns should also be filed to take advantage of IRC Section 1041 and the characterization of these transfers as nontaxable events.

Another issue to consider for same-sex divorced clients involves the distribution of the spouses' retirement plans in the divorce. Retirement plans are commonly divided in California upon divorce based on a claim of a community property interest in the plan. Generally, if a spouse acquires an interest in an employee's retirement plan upon divorce, and the retirement plan is not covered by ERISA, it is possible to obtain a qualified domestic relations order that causes the tax on the distribution to be paid by the recipient spouse rather than the employee spouse. If the distribution is made pursuant to a nonqualified domestic relations order—the only order available to married same-sex couples prior to *Windsor*—the employee spouse is liable for the tax on the distribution. As with the alimony and transfers incident to divorce, amended income tax returns for the open tax years should be filed by the employee to take advantage of IRC Section 1041 and the characterization of these transfers as nontaxable events.

Same-Sex Couples Considering Marriage

In addition to same-sex marriage, California also allows same-sex couples to register as domestic partners.[21] The U.S. Supreme Court's ruling in *Hollingsworth v. Perry*, which resulted in the allowance of same-sex marriage in California, did not invalidate or change the existing California laws for registered domestic partners.[22] Accordingly, registered domestic partners in California continue to have the same rights, protections, and benefits, and are subject to the same responsibilities, obligations, and duties under California law as are granted to and imposed upon spouses, including the application of state tax laws in the same manner as a married couple.[23]

In the unlikely event that same-sex clients are seeking advice to choose between marriage or registered domestic partnership solely on the basis of the tax benefits and burdens, attorneys will need to look at the specific financial facts for the couple, specifically their earnings, their current and potential net worth, and the nature of their assets (including ownership of ERISA plans and IRAs). This level of analysis is necessary because while California's registered domestic partners are treated in the same manner as a married couple for California's state tax law purposes, the relationship is not recognized as a marriage under federal tax law.[24] Revenue Ruling 2013-17, extending the protections and benefits of the federal tax law to married same-sex couples regardless of their state of residency, expressly does not apply to registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law.

As described above, married same-sex couples in California will have now consistent filing status, exemptions, and other tax attributes on both their state and federal tax returns. In contrast, registered domestic partners in California will essentially have two tax filings. Registered domestic partners are required to file their California state income taxes as married filing jointly or married filing separately but are required to file as unmarried individuals on their federal income tax returns.[25] This results in the additional cost of separately prepared returns for the

state and federal filings.[26] Under such circumstances there are also numerous exclusions and deductions that are available to the domestic registered partners under California but not federal tax law. Examples include 1) an exclusion from gross income for employer-provided accident and health insurance for a registered domestic partner and his or her dependents,[27] 2) an exclusion from gross income for medical expense reimbursement paid by the employer for a registered domestic partner and his or her dependents, if the expense was not previously deducted,[28] 3) an itemized deduction for medical expenses for a registered domestic partner and his or her dependents,[29] 4) a deduction for long-term health insurance expenses paid for a registered domestic partner and his or her dependents,[30] and 5) a deduction for self-employed health insurance expenses incurred for a registered domestic partner and his or her dependents.[31] There may, however, be some federal income tax benefit to registered domestic partnership based on the division of community income. While the IRS does not recognize a registered domestic partnership as a marriage for federal tax law purposes, it does recognize that the relationship creates community property and specifically community income pursuant to California state law.[32] Accordingly, for federal tax purposes, the registered domestic partners must each report half the combined community income earned by the partners on their unmarried individual tax returns.[33] These and other federal income tax considerations for registered domestic partners are comprehensively addressed at the IRS Web site.[34]

The current and potential net worth of the clients is important in assessing the gift and estate tax benefits that may be lost in a registered domestic partnership but are available in a marriage. California does not have an independent gift or estate tax, while the benefits of an unlimited marital deduction for federal gift or estate tax purposes or portability for federal estate tax purposes are only available to a married couple. Similarly, only federal law governs the benefits of an inherited ERISA plan or IRA, which are only available to a married couple.

Although each situation is unique, from a tax perspective marriage is likely to be a better option than registered domestic partnership for same-sex couples in California.

Preparing Records for Refund Claims for Closed Years

One very important tax issue remains open post-*Windsor* and the IRS rulings. If Section 3 of DOMA is unconstitutional, should taxpayers who paid tax liabilities in excess of the true amount owed because of the then-application of DOMA be barred from seeking refunds just because the tax year at issue is closed? While the income tax liability for a married same-sex couple is as likely to increase as to decrease if an amended income tax return is filed, for gift and estate tax purposes the change is always in the taxpayer's favor if gifts or bequests were made to or in trust for the benefit of a same-sex spouse that qualifies for the unlimited marital deduction. The availability of the unlimited marital deduction would ameliorate either the reported decrease in the gift and estate tax exemption and/or eliminate a transfer tax that was due for such gifts and bequests. It is anticipated that there will be at least one taxpayer who has incurred such a tax liability for a closed tax year who will pursue a challenge. If such challenge is successful, similarly situated taxpayers should assemble appropriate documentation now and be prepared to file their refund claims for closed tax years promptly.

The *Windsor* case and subsequent guidance from the IRS means a major change in the tax lives of same-sex couples in California, including married couples and those contemplating marriage, as well as those whose same-sex marriage has ended by death or divorce. These clients may require guidance from their tax attorney in changing their income, gift, and estate tax plans post-*Windsor* or in filing for income, gift, or estate tax refunds pursuant to Revenue Ruling 2013-17, or both. Tax attorneys should also be prepared to work with their clients to comply with future guidance from the IRS or to take advantage of a future successful challenge that may allow for tax refunds in closed tax years. ■

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[1] United States v. Windsor, 570 U.S. ____ (2013) (Docket No. 12-307). *See also* CCH FEDERAL ESTATE AND GIFT TAX REPORTS, Issue No. 1224, No. 361 (July 1, 2013).

[2] *See* D. Shah, *Defense of Marriage Act—Update to Prior Report 1*, GAO-04-353R, Jan. 24, 2004, *available at* www.gao.gov/new.items/d04353r.pdf (identifying 198 IRC sections that refer to marital status).

[3] *See* http://www.nclrights.org/site/DocServer/Post-DOMA_General-Overview.pdf (The National Center for Lesbian Rights published fact sheets on the impact of the end of Section 3 of DOMA on federal law, including Social Security, the Family and Medical Leave Act, and immigration). *See also* http://www.nclrights.org/site/PageServer?pagename=DOMA_FAQ_2013.

[4] Windsor, 570 U.S. ____ .

[5] *Id. See also* Patricia A. Cain, *Which Marriages Should Be Recognized by the IRS? available at* http://meetings.abanet.org/meeting/tax/FALL13/media/div-tax-cain-outline2.pdf; Margot L. Crandall-Hollick, Molly F. Sherlock, & Carol L. Pettit, *The Potential Federal Tax Implications of* United States v. Windsor *(Striking Section 3 of the Defense of Marriage Act (DOMA)): Selected Issues*, CONGRESSIONAL RECORD SERVICE, 2

(2013) *available at* http://taxprof.typepad.com/files/crs_doma.pdf, *quoted in* Matthew Dalton, Harrison Tyler, & Patrice Gray, *IRS Promises Guidance After DOMA Decision*, TAX NOTES TODAY 125-3 (June 28, 2013).

[6] Annie Lowrey, *Gay Marriages in All States Get Recognition from the I.R.S.*, NEW YORK TIMES, Aug. 30, 2013, at A12.

[7] Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (Aug. 29, 2013).

[8] *Id.*

[9] Treas. Reg. §1.461-1(a)(3).

[10] Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (Aug. 29, 2013).

[11] California's ban on same-sex marriage under Proposition 8 was invalidated following the U.S. Supreme Court's decision in Hollingsworth v. Perry, 570 U.S. ____ (2013) (Docket No. 12-144). *See also* Maura Dolan, *Prop 8: Gay Marriages Can Resume in California, Court Rules*, LOS ANGELES TIMES, June 28, 2013, at http://articles.latimes.com/2013/Jun/28/local/la-me-in-prop-8-gay-marriage-20130608. Same-sex marriages are now permitted in California, and California is a recognition state of same-sex marriages performed in other jurisdictions.

[12] Married same-sex clients whose 2012 income tax returns were on extension until October 15, 2013, have made this filing status decision for 2012.

[13] The IRS is providing special administrative procedures for these purposes and also for services performed by an individual in the employ of the individual's spouse that are not in the course of the employer's trade or business or that are domestic services in the employer's home, which are excepted from FICA tax under IRC Section 3121(b)(3)(B). *See* I.R.S. Notice 2013-61 (Sept. 23, 2013).

[14] Treas. Reg. §1.461-1(a)(3); Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (Aug. 29, 2013).

[15] I.R.C. §§2056, 2523.

[16] I.R.C. §§2010, 2505.

[17] I.R.C. §2056.

[18] I.R.C. §2010(c)(4).

[19] There are certain limitations on the use of DSUE. For example, a surviving spouse may only use the DSUE of his or her last deceased spouse, meaning that if a surviving spouse remarries and the subsequent spouse dies, the surviving spouse loses the DSUE of the first deceased spouse but may use the DSUE (if any) of the second deceased spouse.

[20] I.R.C. §§71, 215.

[21] FAM. CODE §297.

[22] Hollingsworth v. Perry, 570 U.S. ____ (2013); http://www.sos.ca.gov/dpregistry.

[23] FAM. CODE §297.5(a).

[24] Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (Aug. 29, 2013).

[25] https://www.ftb.ca.gov/individuals/faq/dompart.shtml.

[26] The separate filings of the state and federal income tax returns is the same burden that married same-sex couples living in nonrecognition states will face.

[27] I.R.C. §106(a); REV. & TAX. CODE §17021.7.

[28] I.R.C. §105(b); REV. & TAX. CODE §17021.7.

[29] I.R.C. §213(a); REV. & TAX. CODE §17021.7.

[30] *Id.*

[31] I.R.C. §162(l); REV. & TAX. CODE §17021.7.

[32] I.R.S. PUBLICATION 555, COMMUNITY PROPERTY.

[33] *See* Q. 9, IRS's Answers to Frequently Asked Questions for Registered Domestic Partners and Individuals in Civil Unions, http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Registered-Domestic-Partners-and-Individuals-in-Civil-Unions.

[34] *See* http://www.irs.gov/uac/Answers-to-Frequently-Asked- Questions-for-Registered-Domestic-Partners-and-Individuals-in-Civil-Unions.