The Supreme Court Said We're Married ... Now What?

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We recently sent an E-Alert on what the recent Supreme Court same-sex marriage decisions mean for employers, but what do those decisions mean for the couples themselves in terms of employer and tax benefits?

What the Supreme Court Did (and Didn't Do)

In *United States v. Windsor*, the Supreme Court struck down Section 3 of the Defense of Marriage Act ("**DOMA**"), which had prevented the federal government (including the IRS) from recognizing a legally-valid marriage of a same-sex couple. Because the Court found Section 3 unconstitutional, the decision is both retroactive and forward-looking for tax purposes. The Court did not address whether a state (as opposed to the federal government) may *(i)* decline to issue valid marriage licenses to same-sex couples resident in that state, or *(ii)* decline to recognize a legally-valid marriage of a same-sex couple from another state. Resolution of those two issues will need to wait for another day, as they were not before the Supreme Court in *Windsor*. Although the constitutional right to marry was before the Court in *Hollingsworth v. Perry* (the case involving California's Proposition 8 ban on same-sex marriage), the Supreme Court ruled on procedural grounds only, not reaching the merits. However, as a practical result of the *Hollingsworth* decision, Proposition 8 is no longer valid and same-sex marriages have resumed in California.

What Will the IRS Do?

The IRS (as if it did not have enough on its plate already with Affordable Care Act rule-making and other highly-publicized matters) must now address the tax treatment of same-sex spouses going forward as well as for prior years. When Section 3 of DOMA was still the law, the IRS tried as best it could to address these issues in Q&A format but has since updated its Web page to alert taxpayers that this guidance is now out-of-date after *Windsor* and that the IRS is hoping to issue revised guidance as quickly as possible (see here,

here and here). It is safe to guess that the IRS, rather than go through the time-consuming process of drafting and holding hearings on proposed regulations, will issue revised guidance in similar Q&A format or other "informal" means, and will also publish "official" guidance through notices and revenue procedures. The IRS might also issue "safe harbor" procedures under which same-sex couples can elect certain tax treatments without having to wait for the inevitable tax controversies to wend their ways through the IRS audit process and the courts. These safe harbors, if issued, will likely provide as follows:

Both parties to the same-sex marriage must notify the IRS of, be bound by, and report consistently between them with, the elected tax treatment.

The parties must also report consistently issue-by-issue. That is, the parties are either "married" or "single" across the board: they cannot choose to be "married" where the tax result is good, and "single" to get a good tax result somewhere else.

If the parties elect a "safe harbor" tax treatment and court decisions later produce a different treatment, both the IRS and the parties are bound by the original elected treatment (such being the price of the certainty and predictability that a safe harbor offers).

What about civil unions and domestic partners?

Many same-sex couples entered into "civil unions" or "registered domestic partner" ("**RDP**") relationships (because the state refused to issue them a legal marriage license). *Windsor* did not address the status of those relationships (the survivor and her partner in *Windsor* had been legally married in Canada, which status was recognized in New York where they lived). While one cannot predict exactly how the IRS will treat civil unions or RDPs, it *might* adopt procedures allowing such couples to be treated as legally married if they choose (particularly if the couple entered into a civil union or RDP because they were prohibited from marrying under state law, and/or if the applicable state treats a civil union or RDP as the equivalent of marriage for tax and other purposes as California has done).

Family Wealth Planning

Now that same-sex married couples are respected as such for federal purposes, the federal gift and estate tax treatment that had always applied to opposite-sex married couples will apply to same-sex couples as well. For example, individuals currently have a set amount (currently $5,250,000) of cash and other assets that they may gift during a lifetime, with the unused portion reducing his or her taxable estate upon death. However, gifts between spouses do not reduce that lifetime exemption, and upon the first spouse's death their unused exemption carries over to the surviving spouse and no estate tax is imposed upon the first death. These inter-spousal benefits are now available to same-sex married couples (in fact, this was the very issue in *Windsor*, where the surviving spouse was forced to pay nearly $370,000 in estate tax upon the death of her partner.) The bottom line is this: any estate plan that a same-sex married couple prepared based on "old" DOMA tax laws is now certainly out-of-date, and such a couple should consult with their estate-planning attorney and draw up a new plan that meets their tax-saving, lifestyle and other goals.

Joint Versus Separate Return

With *Windsor*, same-sex married couples can now file a joint federal income tax return on Form 1040: they are no longer forced to file separately, though they can continue doing so if they choose. Generally, filing jointly reduces taxes where there is a large disparity between what the spouses earn (for example, one

works and the other is a "stay at home" spouse). However, because of the interplay of single-versus-married tax rates (the so-called "marriage penalty"), filing jointly can result in significantly higher taxes if both spouses are high earners. Whether to file singly or jointly is a decision that each couple needs to make based on their unique facts, and upon consultations with their CPA or tax advisor.

Windsor certainly simplifies the filing headaches for a same-sex married couple in California who files jointly under state law (as California always permitted) but then had to file separately for federal purposes (and prepare a complex California schedule reconciling the federal and state returns). Now, such a couple can simply prepare a joint Form 1040 federal tax return; attach that to a joint California Form 540 tax return; and do a few calculations to arrive at the state tax liability.

Health benefits

Windsor also eliminates the unfair situation whereby a "worker" spouse had imputed taxable income for federal purposes if he or she provided employer group health insurance coverage and other benefits to his or her same-sex spouse (such benefits were never considered taxable income when provided to an opposite-sex spouse) These health benefits – and, by extension, the federal taxes based on such imputed income – could easily amount to thousands of dollars. (See our past E-Alert on this subject.)

Some Unusual Situations

In many cases, "married" status may force tax consequences on a couple that they do not expect or want. For example, it has always been the case that no loss is recognized for federal income tax purposes if an individual sells an asset to his or her spouse. Therefore, some same-sex married couples may have entered into such sales (entirely properly) so long as the federal government refused to respect their relationship. As another example, if a married same-sex couple splits up and one makes payments to the other under a settlement, those payments may now be considered "alimony" (deductible by the payor, but income to the payee) whereas previously they were not.

Since 2002, the IRS has also allowed "spouses" owning an unincorporated business to choose whether to report that business on a Form 1065 partnership return or as a sole proprietorship on Schedule C to their personal Form 1040 return. Under DOMA, the IRS denied similar flexibility to same-sex spouses: they were forced to go through the motions of preparing a partnership return and issuing K-1 schedules. With *Windsor*, a same-sex married couple may now opt to report on Schedule C which is a lot simpler (but may have other disadvantages which, again, a couple should weigh with their CPA or tax advisor).

Some have wondered whether the IRS may now audit past transactions and force "married" treatment on a same-sex couple that had previously obtained a tax benefit on the ground that they were not married under DOMA. The answer is yes: the IRS is legally entitled to do this within the statute of limitations (generally three years after the return was filed). For political and public relations reasons, however, it is hard to believe that the IRS would do so except in the most abusive situations.

Refunds

Windsor leaves the door open for significant refund claims by same-sex married couples – for example, because they could have filed jointly for prior years, or because health benefits for the non-worker spouse should not have been taxable. (In the *Windsor* case itself, the estate taxes to be refunded to the surviving spouse will be just below $370,000 before interest.) The deadline for filing a refund claim is generally three

years from the filing date of a return (or, if later, two years after the tax was paid). Filing a refund claim is – like filing jointly versus separately – a decision that the couple should make with their CPA or tax advisor, considering the dollars at stake and the possibility that the IRS may turn around and audit on other issues. (Remember that the IRS can audit an issue that has nothing to do with the couple's having claimed a benefit based on their non-married status under DOMA – for example, a spouse "forgot" to report thousands of dollars of consulting income.)

Conclusion

We will keep you apprised as the IRS sorts through these issues and releases new guidance. In the meantime, please contact us if you have any questions about what the fall of DOMA means for your income tax, family wealth and business planning, and your prior tax returns.