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The DOMA Ruling: Its Impact on Tax, Estate and Asset Protection Planning

Legal Alert

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On June 26, 2013, the U.S. Supreme Court struck down the Defense of Marriage Act (DOMA), the 1996 federal statute that denied federal recognition of same-sex marriages. The decision has extraordinary impacts for married same-sex couples with regard to federal benefits and protections previously afforded only to opposite sex married couples under DOMA. Thirteen states[1] and the District of Columbia currently recognize same-sex marriage, representing approximately one third of the U.S. population.

While it is currently unclear how the Supreme Courts decision will affect federal benefits and protections in states that recognize domestic partners and civil unions, such as New Jersey, the impact for married same sex couples will be substantial as over 1,100 federal laws are affected, including tax, veterans benefits and the Family Medical Leave Act. This article highlights some of the implications of this momentous Supreme Court decision for Trust and Estate Planning, Taxes and Employee Benefits.

Estate Tax: Prior to this ruling, estate tax planning for same sex couples was very complex. Now, planning techniques previously only available to opposite sex married couples will be extended to married same-sex couples. The current federal estate tax exemption amount is currently $5.25 million. The exemption is pegged to inflation. For married couples, any amount in excess of $5.25 million can, in most circumstances, be structured to qualify for the unlimited marital deduction, effectively eliminating the estate tax at the death of the first spouse. Married same-sex couples can now utilize this unlimited marital deduction to eliminate or defer federal estate tax until the death of the survivor.

Another useful tool is the option to transfer a deceased spouses unused tax exemption to a surviving spouse. For example, if the first spouse to die had assets of $3 million against his or her $5.25 million federal exemption amount, the executor can elect to transfer the remaining $2.25 million to the survivor, preserving for the surviving spouse a federal exemption of $7.5 million (plus inflation adjustments on the survivors own exempt amount).

Gift Tax: Married same-sex couples can now make unlimited tax-free transfers to each other during their lifetimes. Under DOMA, gift transfers between married same-sex couples were taxable and reduced the federal exemption amount of the transferor because such transfers were treated as taxable gifts. In addition, married same-sex couples can now elect to make gifts to others by splitting the gift. This means that if one spouse makes gifts to other people, for gift tax purposes, the gift can be treated as one half by the spouse making the gift and the other half by the other spouse. This allows gifts by one spouse to qualify for two annual exclusion gifts of $14,000 each, or up to $28,000 total. The exclusion level is pegged to inflation.

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There are just a few drawbacks generally thought of as minor regarding marital status under our federal estate and gift taxes. Certain types of gifts called grantor retained income trusts, which were outlawed for related parties, remained a very favorable technique for same-sex married couples before the decision. In addition, certain trusts that are considered owned by both spouses did not apply to same-sex married couples before the Court decision.

Income Tax: Under our federal income tax laws, there are overwhelming advantages to the recognition of marital status. In addition to the election to file a joint tax return in any year, examples include:

a. Generally lower income taxes if only one spouse earns income, or if earnings are disproportionate.

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b. Combining exemptions for the couple, their children and dependents, and deduction limitations, such as charitable gifts.

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c. Interchangeability in qualifying for tax exclusions, such as the gain on sale of a personal residence.

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d. The opportunity to deduct medical and dental expenses paid by one spouse for the other.

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e. The non-recognition of gain or loss on transfers between spouses.

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There are, however, a few drawbacks, including potentially higher income tax rates for married couples if both spouses earn at a high level, or if they have higher levels of capital gain income, the ability to step up tax basis through inter-party sales and double up on retirement benefits available to unmarried individuals who work for the same employer.

Under ERISA, the federal pension law, and the federal tax laws as well, spouses have certain protected rights and benefits in the retirement benefits of the other spouse in the event of death, retirement or divorce. Most of these rights would be considered favorable for planning purposes, but some do limit the options for the spouse whose benefits are in issue.

Employee Benefits: Married same-sex couples can now obtain health and other employee benefits from their employers on a pre-tax basis under plans that provide benefits for the employee, the spouse, and family members. Prior to the Supreme Courts ruling, an employee needed to pay income tax on the portion of income that was used to pay for the health benefits to a same-sex partner. The decision will require those benefits now be paid on a pre-tax basis in the same manner of opposite sex married couples.

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Social Security: Married same-sex couples will now be able to enjoy the same benefits Social Security provides to opposite-sex married couples, including (1) the spousal retirement benefit, which, if requirements are met, allows the spouse of a retired worker to receive the greater of his/her own benefit or 50% of the spouses benefit (2) the spousal disability benefit, which pays benefits to people who cannot work and provides that a spouse may be eligible for up to 50% of the disabled spouses benefit, and (3) the survivor benefit, which provides a surviving spouse benefits equal to the greater of the surviving spouses own benefit or the deceased spouses benefit.

State Income and Transfer Taxes: While the Court decision addresses the federal tax law only, states often follow federal law in applying tax filing status and exemptions. The reasons behind states not having same-sex marriage equality laws are politically sensitive. Nevertheless, the DOMA decision may entice some state legislatures to more favorably consider allowing same sex marriage laws, thereby also extending the numerous tax advantages to married same sex couples. For example, in both New Jersey and PA, gifts to spouses of almost every nature are exempt from state transfer inheritance tax and estate tax.

Asset Protection: Marital status is a critical factor in consideration of asset protection planning. For example, only married couples can own their residence, and in certain states intangible assets, as tenants by the entirety. This special ownership status prevents creditor claims brought against either spouse alone from affecting these special assets. And, for married couples, the creation of such interests is tax exempt for gift tax purposes.

In addition, some states provide creditor protection and protected inheritance rights for a homestead held by spouses.

Asset protection laws in many states are such that married couples have been able to achieve asset protection through the use of trusts that are designed to be income tax neutral. By contrast, these techniques are quite difficult to achieve for unmarried individuals. Now, married same-sex couples will be able to employ them.

Ongoing Developments: The Court decision has an immediate effect only for individuals who are married under state law. The general sense is that this ruling is part of an accelerating trend toward acceptance of same-sex marriage, but the road ahead is not easily charted for states currently without such laws. In states where political considerations delay change, we can expect additional litigation addressing the issues that extend beyond the Supreme Court decision. For example, despite laws in many neighboring states recognizing marriage of same-sex couples, neither New Jersey nor Pennsylvania recognize marital status. It is likely to be determined whether New Jerseys current law permitting civil unions offers protection or benefits under the federal law or the Courts decision. The likelihood of ongoing developments will make it critical for same-sex couples to be even more careful to update their tax and estate planning by consulting their counsel and advisors regularly.

Implications:

1. Guidance is needed. It is unclear how quickly the federal agencies will react to provide regulatory guidance on the impending changes. It will be necessary to interpret issues such as the impact on states that have civil union but not marriage laws. Guidance will also be necessary on the interpretation of federal benefits for couples that were married in a state recognizing same sex marriages, but that live in a state that does not recognize same-sex marriages.
2. There are some disadvantages to married same-sex couples now being treated in the same manner as opposite sex married couples. Same-sex couples will now fall into the category of related parties which will remove some estate planning tools that were useful in planning for same-sex couples, such as the grantor retained income trust. In addition the income tax marriage penalty will now impact married same-sex couples in the same manner as opposite-sex married couples.
3. Couples in same-sex marriages should consider filing amended tax returns and/or refund claims for prior tax years before the expiration of the applicable limitations periods (generally, three years from the filing of the return).
4. Going forward, married same-sex couples will need to file their income tax returns either joint or married filing separately. Couples will need to analyze which filing status if better for them.
5. Consideration should be given as to whether to file for a refund on tax paid by individuals for same-sex spouse employee benefits.

In closing, the Supreme Court decision was a momentous step toward equality for same-sex couples in the United States, but there are many details to be worked through at the federal and state levels before true parity is achieved. Same-sex couples should consult with their advisors to ensure that they are making the right choices for themselves and optimizing tax and estate planning tools for their specific situation.

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[1] Connecticut, Delaware, District of Columbia, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New York, Rhode Island, Vermont, Washington and California currently recognize same-sex marriage. Even more states recognize some form of domestic union or partnership including Colorado, Hawaii, Illinois, Maine, Nevada, New Jersey, Oregon and Wisconsin.