OBERGEFELL v. HODGES IMPACT ON SAME-SEX RELATIONSHIP RECOGNITION

Planning Considerations for Both Married and Unmarried Same-Sex Couples

State and federal laws pertaining to same-sex relationship recognition have seen dramatic changes over the past 20 years, creating uncertainty and challenges for same-sex couples as they develop wealth transfer and estate plans. The first significant development occurred in 1996, when Congress passed the so-called Defense of Marriage Act (DOMA), which was later signed into law by President Bill Clinton. The bill had two main functions. Section 3 of DOMA prevented the federal government from recognizing same-sex marriages for the purposes of federal laws or programs. Section 2 of DOMA absolved individual states from having to legally acknowledge the relationships of gay and lesbian couples who were married in another state or jurisdiction.

In *U.S. v. Windsor,* Edith Windsor challenged the constitutionality of Section 3 of DOMA after she was required to pay estate taxes on assets she inherited from her deceased spouse (the couple entered into a valid marriage in Canada, which was recognized in New York, where they resided). On June 26, 2013, the U.S. Supreme Court ruled in favor of Windsor and found Section 3 of DOMA to be unconstitutional. In its holding, the Court ruled that Section 3 violated basic due process and equal protection principles by denying a same-sex couple who was married in a jurisdiction that permits such marriages (and who resided in a state that recognizes such marriages) the benefits and responsibilities that come with the federal recognition of their marriage. The *Windsor* case, however, did not address the constitutionality of Section 2 of DOMA, thus leaving states with the option to not perform same-sex marriages or recognize same-sex marriages validly performed in other states or jurisdictions.

Since the *Windsor* decision, same-sex couples have navigated a patchwork of relationship recognition laws from state to state. For example, a same-sex couple could feasibly marry in a state that permits same-sex marriage but reside in a non-recognition state, meaning the couple would be considered married for federal purposes but not have their marriage recognized by the their state of residence.

A LANDMARK COURT RULING

On January 16, 2015 the U.S. Supreme Court agreed to hear arguments in the case *Obergefell, et al. v. Hodges.* The case consolidated four cases from Ohio, Michigan, Kentucky and Tennessee that challenged the constitutionality of those states' bans on same-sex marriage and/or those states' refusal to recognize valid same-sex marriage from other jurisdictions. The two questions before the Court in *Obergefell* were:

- Does the Fourteenth Amendment require a state to license a marriage between two people of the same sex?
- Does the Fourteenth Amendment require a state to recognize a marriage between two people of the same sex that was legally licensed and performed in another state?

On June 26, 2015, the Supreme Court ruled 5-4 that state-level same-sex marriage bans are unconstitutional, and that states must recognize valid same-sex marriages performed in other jurisdictions. The holding in *Obergefell* now means that same-sex couples may be able to marry in any jurisdiction in the United States and their marriage will be recognized regardless of their state of residence. While this holding provides greater access to marriage for same-sex couples, there are still many planning considerations for same-sex couples, depending on whether or not they choose to get married. This paper will provide a high-level overview of the potential wealth and estate planning impact of *Obergefell* for married and un-married same-sex couples.

KEY PLANNING CONSIDERATIONS FOR MARRIED COUPLES

The Unlimited Marital Deduction and Portability

Under the U.S. tax code, any person can make gifts of property valued at up to $14,000 per year in 2015 to an unlimited number of individuals. These "annual exclusion" gifts do not incur any federal gift tax. However, gifts in excess of the annual exclusion amount may either be subject to federal gift tax (payable by the person making the gift) or they may count toward an individual's lifetime federal gift or estate tax exclusion, which stands at $5.43 million in 2015.

For many affluent same-sex couples, the most significant impact of marriage on their estate and wealth transfer plans is access to the unlimited marital deduction. The deduction allows U.S. citizens who are parties to a federally recognized marriage to make unlimited transfers of assets between one another, during life or at death, without incurring any federal gift tax or estate tax at the first death. Further, a gift from one spouse to another spouse does not count toward the transferor's lifetime federal gift and estate tax exclusion amount.

The benefits of the unlimited marital deduction are perhaps most obvious for couples with unequal wealth. Suppose Ryan and Jerome are in a civil union in Illinois, but they are not parties to a federally recognized marriage. Jerome is a successful hedge fund manager and has a net worth of $10 million. Ryan is an urban planner for a small city and has a net worth of $200,000. If Jerome passes away and leaves his entire estate to Ryan, there will likely be estate tax due on any amount passing to Ryan that is in excess of Jerome's unused lifetime exemption amount, if any. Because Ryan and Jerome are not considered married for federal purposes, Ryan is not able to take advantage of the unlimited marital deduction, which would allow him to inherit Jerome's entire estate free of any federal estate taxes. Had the two men been parties to a federally recognized marriage, Ryan would have been able to inherit Jerome's estate without paying any federal estate tax because of the unlimited marital deduction.

"Portability" is another wealth and estate planning technique that is only available to married couples. If a couple is married, and the first spouse dies without using all of his/her federal estate tax exclusion, the unused portion of the exclusion may be transferred to the surviving spouse. The ability to transfer a deceased spouse's unused federal estate tax exclusion to the surviving spouse is known as portability. Consider Ryan and Jerome again, but this time assume that the couple is married and Jerome passes away first with his entire federal exclusion amount intact. Not only can Ryan inherit Jerome's $10 million estate free and clear of any federal estate tax because of the unlimited marital deduction, but Jerome's unused federal exclusion amount can transfer to Ryan. Ryan can therefore make lifetime or testamentary gifts – up to $10.86 million in 2015 – without triggering federal gift or estate taxes.

Federal Income Tax Planning

One of the most common questions same-sex couples ask when deciding whether to get married is how marriage may impact a couple's federal income tax burden. In light of the Windsor ruling and the subsequent Revenue Ruling 2013-17 from the IRS, same-sex married couples generally must file their federal income taxes as either married filing jointly or married filing separately. The impact of marriage on a couple's federal tax burden can be significant, and it is important for same-sex couples and their advisors to discuss how marriage may affect a couple when it is time to file their taxes.

Some of the federal income tax implications of marriage include:

- Deductibility of mortgage interest;
- Taxation of employer-provided health benefits;
- Ability to offset capital gains of one spouse with the capital losses of the other; and
- Opportunity to exclude $500,000 on gain from the sale of a primary residence.

Prior to getting married, same-sex couples may wish meet with their CPA or tax attorney to understand the impact of marriage on their particular federal income tax burden. Each couple has its own unique circumstances, which is why blanket statements about tax planning should be avoided.

Trust Planning

As previously discussed, same-sex married couples now have access to the unlimited marital deduction and portability, meaning a same-sex spouse can now transfer some or all of his/her estate to the surviving spouse during life or at death without incurring any federal gift or estate tax. Some may question if this negates the need for trust planning between same-sex spouses. Experience tells us that thoughtful trust planning can be invaluable for married couples, even with the unlimited marital deduction and the ever-increasing federal lifetime exemption amount.

First, using trusts to transfer wealth at death can provide a desirable degree of privacy, as compared to transferring wealth via a will. Generally speaking, when an individual dies and the assets in his or her estate pass via the decedent's will, the will is submitted to the probate court and is therefore open to public inspection. By contrast, property held in trust passes to designated beneficiaries outside of the probate process and the trust document is not subject to public inspection. For many couples, the added privacy that trusts afford is worth the time and expense to create the trusts.

Same-sex married couples may also consider using trusts for their wealth and estate plans if there are other individuals or organizations that will receive assets following the death of the second spouse to die. Consider Maria and Joan, a married couple with a combined estate valued at $10 million. Maria has two children from a prior marriage. Maria wishes to support Joan after Maria's death, but does not want the assets to pass to Joan outright because she also wishes to support her two adult children and several nonprofit organizations following the death of Joan. Maria may consider funding a trust that provides a certain level of support to Joan after Maria's death, but with the remaining assets passing outright to her children and various charities after Joan's death.

The laws and the majority of American society have shown rapid progress in recognizing same-sex relationships, but within many families there may remain feelings of entitlement to a loved one's assets and less benevolence toward an inheriting same-sex spouse. Trusts are not impervious to attack by disgruntled "would-be" beneficiaries, but may be less so than simple wills. Imagine Maria and Joan again, and suppose that Maria's family does not support their marriage. Maria may want to name a trustee to hold and distribute assets to Joan via trusts instead of passing assets to her through a will in the event Maria's family contests the will during the probate process in an attempt to prevent Joan from inheriting. Further, there may be tactics that a trustee can use to prevent non-spouse beneficiaries from contesting the validity of a trust, such as making distributions to beneficiaries during life and documenting the beneficiaries' acceptance of the distributions.

The above scenarios demonstrate how important it is for same-sex couples to work with advisors who can ask the right questions and provide the right guidance on the most effective and efficient ways to transfer assets at life and at death.

Retirement Planning

For same-sex couples where one or both partners are considering retirement in the near future, marriage may offer additional planning techniques and protections. For example, for same-sex couples where one or both partners has retirement assets in an a traditional individual retirement account (IRA), marriage now offers access to important planning options that are not available to non-married couples.

The distribution rules that treat a federally recognized spouse named as the sole beneficiary of a decedent spouse's IRA more favorably than a non-spouse beneficiary are particularly important. First, if spouses have an age difference greater than 10 years, and the older spouse designates the younger spouse his/her sole beneficiary, the required minimum distributions (RMDs) for that account are based on their joint life expectancy, resulting in smaller mandatory distributions after the older spouse reaches age 70½. Second, a surviving spouse who is the sole designated beneficiary of his/her late spouse's IRA is entitled to roll the inherited assets into his/her own IRA, or keep the IRA as an inherited account with special "spousal" benefits. These features may enable the surviving spouse to reduce or defer distributions in ways not permitted to a non-spouse beneficiary.

Consider the following scenario:

Alonso is the surviving spouse of James, who died at age 65 owning a traditional IRA. Alonso is age 48, and is the sole designated beneficiary of the IRA. If James had reached age 70½, his first RMD would have been calculated using a factor of 32.6 rather than the 27.4 factor typically used for a participant's first RMD. Under the RMD rules that apply to a surviving spouse who is the sole designated beneficiary of an IRA, Alonso may opt any of the following methods of fulfilling the minimum distribution requirements: (1) withdraw the IRA in full before the end of the fifth year following the year of James's death; (2) roll the inherited account into his own IRA, allowing him to defer distributions until he reaches age 70½; or (3) leave the IRA in James's name, and defer RMDs until the year that James would have attained age 70½ (in 7½ years), and begin taking distributions over Alonso's then-remaining life expectancy, as found on the IRS Single Life Table.

Notably, Alonso may elect to roll over the inherited IRA at any time, allowing him to defer RMDs until the year before James would have reached age 70½ and then roll the assets over to his own IRA, so as to defer RMDs until his own required beginning date. By combining these options, Alonso will be permitted to take distributions before reaching age 59½ without paying the 10% tax on early distribution, yet be permitted to roll the assets over to his own IRA at a time when the rollover will permit deferral and reduction of the RMDs.

The above scenario shows the flexibility that a surviving spouse has when he/she is named as the sole beneficiary of a deceased spouse's IRA. However, the results in any particular scenario are highly fact dependent, so that if James's age at death or Alonso's status as the sole beneficiary had been different, then the planning options and outcomes could have been very different. Therefore, it is important for married couples to consult with their advisors to understand how best to plan for inherited IRAs and qualified retirement accounts.

PLANNING CONSIDERATIONS FOR UNMARRIED COUPLES

While the *Obergefell* decision may be a cause celebre and a civil rights landmark for the LGBT community, it is not likely that every same-sex couple will mail their wedding invitations immediately. Same-sex couples have lived together as domestic partners and family units for generations without the ability to marry and many have grown accustomed to these arrangements. The 2010 U.S. Census was the first census to address living arrangements of same-sex couples and since they are only done every ten years, it also the latest census data we have. This census was taken six years after Massachusetts became the first state to allow same-sex marriage but, significantly, the census was taken well before the June 2013 *Windsor* decision that gave same-sex couples married status for **Federal** purposes. The Census Bureau's tally shows that in 2010 only 152,335 same-sex households identified as married, whereas 440,989 same-sex households identified as unmarried.[1]

While these figures might not seem relevant given the rapid changes in Federal and state laws over the last five years, it may show that even given the right to legally marry, same-sex couples may be slow to embrace matrimony as best for their personal situation.

There are various reasons that same-sex couples may choose not to exercise their right to marry, including some financial reasons:

Income Tax "Marriage Penalty"[2]

In some instances, a married couple may be subject to the so-called "marriage penalty" when they file a federal income tax return with a "married filing jointly" status. Generally, spouses who earn a similar income are more likely to be negatively impacted by the marriage penalty than couples

MARRIAGE TAX ANALYSIS

Fact Pattern	
Spouse 1 Income: $265,000.00	**Spouse 2 Income: $185,000.00**
Single Filing Status	
Tax Owed: $67,728.53 Effective Rate: 26.6%	Tax Owed: $41,987.25 Effective Rate: 24.0%
Combined Tax: $109,715.78 Effective Rate: 25.5%	
Married Filing Separately	
Tax Owed: $75,403.15 Effective Rate: 29.1%	Tax Owed: $45,415.50 Effective Rate: 25.7%
Combined Tax: $120,818.65 Effective Rate: 27.8%	
Penalty/Benefit over Single Status: –$11,102.87 Penalty/Benefit over Single Status: –2.2%	
Married Filing Jointly	
Tax Owed: $120,389.00 Effective Rate: 27.5%	
Penalty/Benefit over Single Status: –$10,673.22 Penalty/Benefit over Single Status: –1.99%	

1 Census.gov, CB-CN.181, September 27, 2011.

2 The marriage penalty refers to the higher federal taxes faced by some married couples who file their federal tax return as "married filing jointly," higher taxes that would not be faced by two otherwise identical single people with the exact same income.

with a disparity in income. Working with a knowledgeable advisor can help a same-sex married couple to analyze this issue. It should be noted that the estate tax benefits of marriage (noted above) may offset a couples concern over the negative impacts of the income tax regime. The following scenario outlines the importance of understanding the potential impact of marriage on a couple's federal income tax burden.

Retirement Benefits

While many individuals are aware of the rules pertaining to Individual Retirement Accounts, some same-sex married couples may be surprised to learn that the federal recognition of their marriage may impact one spouse's ability to change beneficiary designations on some retirement accounts. The Retirement Equity Act of 1984 includes protections for surviving spouses of certain qualified defined benefit and defined contribution plans, such as 401(k) plans. For example, the same-sex spouse of a qualified retirement plan participant will generally be considered the participant's default beneficiary under the plan. Further, a retirement plan participant in a same-sex marriage will now need to obtain written consent from the same-sex spouse in order to add or change a beneficiary of the plan. It is important to note that, for the purposes of federal taxation, couples who are parties to a civil union, registered domestic partnership or similar relationship are not considered "married" for federal purposes. Thus, the spousal protections under the Retirement Equity Act of 1984 do not extend to civil unions or domestic partnerships. Same-sex couples in civil unions or domestic partnerships are nonetheless encouraged to review all of their estate planning documents, including beneficiary designations, to ensure partners are protected to the extent desired by the couple.

Homestead Rules

The laws of a number of states provide for a surviving spouse to have occupancy rights in the marital homestead, regardless of the provisions of the estate plan of the deceased spouse. These homestead rights function in a manner similar to a life estate. Example: John and Jim are married and living in Texas. Their personal residence is in John's name and belonged to John prior to the marriage, making it his separate property under Texas law. John has a will that leaves the residence to his nieces and nephews upon his death. However, since the residence is subject to the homestead provisions of the Texas Constitution, the residence cannot be distributed so long as Jim elects to use or occupy it. There are other state laws protecting the rights of spouses that may need to be considered as couples contemplate marriage and update their estate planning documents. An estate planning attorney who is familiar with the laws in your state of domicile should be consulted.

Planning Techniques for Couples that Do Not Marry

For those couples that choose not to marry, there are numerous techniques that estate planners have been employing for decades – for same-sex and opposite-sex couples alike.

Titling Assets. Special care should be taken when titling property such as real estate, bank accounts or securities accounts to avoid undesirable gift tax consequences between unmarried partners. To be sure of the proper way to title property, consult your attorney or other advisor when purchasing real estate or opening financial accounts.

Transferring Wealth Using Trusts. There are numerous forms of trusts that can assist unmarried couples in transferring wealth from one partner to another. These include, but are not limited to: Grantor Retained Income Trusts (GRITs), Grantor Retained Annuity Trusts

(GRATs), Charitable Remainder Uni-Trusts (CRUTs) and Intentionally Defective Grantor Trusts (IDGTs). While these trusts are different from each other, they each take advantage of particular tax laws to achieve specific goals. For example, a GRIT may be a useful planning technique for unmarried couples who want to transfer wealth within the relationship. However, due to IRS and Treasury regulations, a GRIT would not be a successful or practical wealth transfer vehicle for a married couple. For more information about trust planning technique, same-sex couples may want to consult a wealth advisory or estate planning attorney.

Discounting Techniques. The ability to apply discounts to values of assets gifted or bequeathed to others provides a tremendous opportunity for gift and estate tax savings. Generally, discounts may be available when assets have a limited market for sale (lack of marketability discount) and/or when you do not own a controlling interest in the asset (lack of control discount). Real estate and limited partnership interests are prime examples of assets to which these discounts may be applied.

Partnership Agreements. Domestic partnership agreements have been used for many years by unmarried, same-sex partners. These agreements formalize financial arrangements between the partners, document the contributions each partner is making to the whole, creates a legal entity to jointly own property and anticipate the agreed upon division of property if the partnership is dissolved. Since property held in a partnership does not pass through probate, it is an excellent way to title real estate held outside the couple's domicile.

BASIC DOCUMENTS ARE ESSENTIAL

Regardless of marital status basic estate planning documents are essential, but for unmarried same-sex couples these documents may be even more crucial to ensuring your loved ones are cared for and your wishes are carried out. Work with a knowledgeable estate planning attorney to complete documents such as:

- Last will and testament
- Durable power of attorney
- Power of attorney for health care
- HIPPA authorization
- Directive to physicians

CONTINUED IMPORTANCE OF STATE LAW

Although the *Obergefell* decision legalizes same-sex marriage in all 50 states, there likely will be continued debate for some time on nuances of law in various states. Therefore, there is a need for continued attention to state law on planning for matters such as:

Dissolution

Divorce law will continue to vary from state to state. Issues such as alimony and division of property are treated differently in California than they are in Texas (for same-sex and opposite-sex couples). Community property states will view property ownership differently than non-community property states. And, of course, child custody and the rights of non-biological parents will continue to be debated, creating a need for specialized planning.

Pre and Post-nuptial Agreements

Prenuptial and post-nuptial agreements are estate and wealth planning techniques that allow a couple to make certain decisions about financial matters during and after marriage. For some couples, the idea of planning for divorce is unpleasant. But for practical reasons, a pre or post-nuptial agreement may be an effective way for a couple to plan for all contingencies. This may be especially true where one or both spouses enter the relationship with significant personal or family wealth. These agreements are contractual in nature, and governed by state law. A valid pre or post-nuptial agreement can cover a variety of topics including: identifying which items are considered separate or community property (for community property states); ownership of residences in the event of divorce; the financial obligations of each spouse during the marriage; how disagreements are to be resolved in the event the relationship ends; and, whether or not the agreement terminates after the couple has been married for a certain period of time. Pre and post-nuptial agreements cannot resolve certain issues, such as child custody or whether one partner will be exempt from paying child support at a later date. Further, the validity of pre and post-nuptial agreements may be challenged by either party, so it is important to understand the law of the state where the agreement is executed to ensure both parties meet all formalities and requirements.

Powers of Attorney

The inconsistent application of marriage rights of same-sex couples in all 50 states creates the need for the "belt and suspenders" approach of having current durable (financial) powers of attorney and healthcare powers of attorney for spouses, particularly those who may travel to states that are traditionally less accepting of same-sex couples. Ensuring that your designated agent can make decisions in the time of your incapacity in whatever state you may be in at the time is of primary importance.

Dying Intestate

The laws governing inheritance vary significantly from state to state. A last will and testament (and/or alternative estate planning documents) will appoint a personal representative to see that your property is distributed as you so direct upon your death. Without these documents in place, state law governs what happens to your property. In many states, only a percentage of your estate passes to your surviving spouse with the remaining percentage to other lineal descendants (e.g., children, siblings, parents, nieces and nephews). As discussed above, having basic estate planning documents in place is crucial to ensuring that your wishes are carried out after death.

CONCLUSION

By any measure, the *Obergefell* decision is a landmark event for same-sex couples. With it comes the opportunity for same-sex couples to engage in the same types of estate planning techniques and strategies that opposite-sex couples have used for many years. However, we expect there will continue to be issues for same-sex spouses to overcome, so it is important to understand the laws of your state. More than ever, same-sex couples can and should seek the advice of trusted financial advisors, accountants and attorneys to help them plan for the short- and long-term.

For more information, contact a Northern Trust representative or visit notherntrust.com.

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