LINE OF SIGHT

UNITED STATES v. WINDSOR AND REVENUE RULING 2013-17

THE IMPACT ON SAME-SEX RELATIONSHIP RECOGNITION AND WEALTH TRANSFER PLANNING

OVERVIEW AND BACKGROUND

On June 26, 2013, the U.S. Supreme Court decided *United States v. Windsor*, finding Section 3 of the Defense of Marriage Act (DOMA) 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 the benefits and responsibilities that come with the federal recognition of their marriage. The Court, however, did not provide for the legalization of same-sex marriages in all states, but rather held that a same-sex couple married in a jurisdiction that permits such marriages (and residing in a state that recognizes such marriages) shall be considered married for purposes of federal law.

October 2013

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Following the decision, many unanswered questions remained, particularly with regard to how the U.S. Government would treat couples who are parties to a valid same-sex marriage but living in a state that does not recognize such marriages. Some of those unanswered questions were recently answered when the U.S. Treasury Department and the Internal Revenue Service (IRS) issued Revenue Ruling 2013-17[1]. In the ruling, the Treasury Department and the IRS confirmed that all legally married same-sex couples will be treated as married for federal tax purposes whether or not a couple lives in a jurisdiction that recognizes same-sex marriages.

Revenue Ruling 2013-17 has significant wealth planning, estate planning and tax implications for married same-sex couples across the country. This piece will touch upon some of those implications and provide practical advice to same-sex couples to help them understand what their marriage may or may not mean from a federal tax perspective.

THE IMPACT OF REVENUE RULING 2013-17 ON SAME-SEX RELATIONSHIP RECOGNITION

Immediately following the *Windsor* decision, many same-sex couples were uncertain about the status of their relationship, especially couples who were legally married but living in a state that did not recognize their marriage.[2] Much of the uncertainty results from the fact that a federal government agency can set its own rules regarding eligibility for the federal rights and benefits governed by that agency.

Federal agencies generally follow one of two approaches for determining if a married couple is eligible for a particular federal benefit. Some agencies, such as U.S. Citizenship and Immigration Services, look to the "place of celebration" to determine if a married couple is eligible for a particular federal benefit. Agencies that follow the "place of celebration" rule will grant same-sex couples federal rights and benefits as long as the couple was validly married in a jurisdiction that permits same-sex marriages.

Other agencies, such as the Social Security Administration, traditionally look to the "place of domicile" when determining whether a married couple is eligible for certain federal benefits. Agencies that follow the "place of domicile" rule will determine if a married couple is eligible for a particular benefit based on whether the state where the couple has established their primary residence recognizes the marriage as legal and valid.

For many same-sex couples, obtaining a civil union, having a commitment ceremony or registering as domestic partners feels like a marriage. Same-sex couples may even refer to themselves as "married" even if they were not officially married in a place where same-sex marriages are legal. For those couples, it is important to understand that the IRS did not extend full federal tax benefits to couples in registered domestic partnerships, civil unions or other similar formal relationships recognized under state law. Couples who are parties to a civil union or domestic partnership must get married to be eligible for the full rights and benefits of marriage for federal tax purposes.

[1] The complete text of Revenue Ruling 2013-17 can be found at http://www.irs.gov/pub/irs-drop/rr-13-17.pdf

[2] At the time of publication, 13 states and the District of Columbia permit same-sex marriages. 35 states have a state constitutional amendment or statute prohibiting same-sex marriage.

In Revenue Ruling 2013-17, the IRS and U.S. Treasury stated that, for the purposes of federal taxation, couples will be treated as married based on the "place of celebration" rule. This means that same-sex couples will be treated as married for the purpose of federal taxation if they were married in a state or jurisdiction that permits same-sex marriage, regardless of where the couple is domiciled. Revenue Ruling 2013-17 has the potential to impact a number of same-sex married couples.

IMPACT OF REVENUE RULING 2013-17 ON WEALTH TRANSFER PLANNING FOR SAME-SEX COUPLES

Unlimited Marital Deduction

The unlimited marital deduction is one of the most important wealth transfer planning techniques available to married U.S. citizens. 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 the death of the first to die, without incurring any federal gift tax or estate tax.

Immediately following the *Windsor* decision, same-sex married couples living in a state that refused to recognize their marriage were not able to utilize the unlimited marital deduction. With Revenue Ruling 2013-17, same-sex married couples can now take advantage of the unlimited marital deduction regardless of where they live. For couples with unequal wealth, the unlimited marital deduction now gives those couples a choice to equalize wealth via transfers of assets during life, without incurring any federal gift taxes. The unlimited marital deduction also allows a same-sex spouse to bequeath some, or all, of her estate to her wife at death free of federal estate tax.

Federal Tax Filing Considerations

Filing Status and Amended Income Tax Returns

Revenue Ruling 2013-17 means that same-sex married couples must now follow the same federal income tax filing requirements as opposite-sex married couples regardless of where the same-sex couple lives. That means that for tax year 2013 and going forward, same-sex spouses generally must file their federal tax returns using a married filing separately or jointly filing status. Additionally, if a same-sex married couple has not filed an income tax return for tax year 2012 as of September 16, 2013, that couple must file using a married filing separately or jointly filing status.

The IRS advises that same-sex married couples who timely filed their federal income tax returns for tax years 2012 and earlier may (but are not required to) amend their federal tax returns to file using married filing separately or jointly filing status, provided the period of limitations for amending the return has not expired.[3] In some instances, a same-sex couple may reap significant tax benefits by amending a prior federal income tax return. Some of the potential federal tax benefits of filing as a married couple include:

- The ability to offset capital gains of one spouse with the capital losses of the other
- The $500,000 exclusion on gain from the sale of a primary residence
- Income tax charitable deduction carryforward
- An overall lower tax rate
- The potential to reclaim taxes paid on domestic partner health benefits

However, in some instances, a same-sex married couple may be subject to the so-called "marriage penalty"[4] when they file their federal income tax return with a "married filing jointly" status. Generally, same-sex married spouses who earn a similar income are more likely to be negatively impacted by the marriage penalty than couples with a disparity in income. Working with a knowledgeable advisor can help a same-sex married couple determine if it makes financial sense to amend previous federal tax returns.

Titling Real Property

As many same-sex couples and their advisors know, titling real property within same-sex relationships has traditionally proved challenging. With the Windsor decision and the guidance from the IRS in Revenue Ruling 2013-17, same-sex married couples now have far more flexibility regarding how they title real property, especially in light of the unlimited marital deduction. Perhaps the most important change is the ability of same-sex married couples to title real property as joint owners with right of survivorship without incurring any gift tax implications. This is true even if only one spouse provides all of the assets to purchase the property, as the unlimited marital deduction allows the purchaser to share title with his/her spouse tax free. This opportunity may be especially meaningful to couples with a wealth disparity, where one spouse pays for most or all of a property that is subsequently held as joint tenants with right of survivorship.

In some instances, same-sex married couples who purchased property in the past three years and titled the property as joint tenants with right of survivorship may want to file amended federal tax returns, and may even be due a refund for gift taxes paid within the past three years. Consider the following checklist:

- ❏ Was the couple married in a place that permits same-sex marriage?
- ❏ Did the couple purchase real property (home, condominium, commercial building) at some point in the past three years as a married couple?
- ❏ Is title to property held as joint tenants with right of survivorship?
- ❏ Did one spouse contribute more than 50% of the purchase price for the property?
- ❏ Did the spouse who provided the majority of the funding file a gift tax return for the value of the property that was "gifted" to the spouse who provided less (or no) funding?

If a same-sex married couple answered "yes" to all of the above questions, there may be an opportunity for one of the spouses to file an amended gift tax return (or possibly obtain a refund for gift tax(es) paid by the spouse). Couples considering filing an amended return should do so only after consulting with a tax attorney and financial advisor to ensure filing an amended return is in the best interests of the couple.

[3] A taxpayer generally may file a claim for refund for three years from the date the return was filed or two years from the date the tax was paid, whichever is later. For information on filing an amended return, go to Tax Topic 308, Amended Returns, at http://www.irs.gov/taxtopics/tc308.html.

[4] 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.

Potential Estate Tax Refunds

The key issue at stake in the *Windsor* case concerned Edith Windsor's claim for a refund for the federal estate taxes paid from the estate she inherited from her deceased wife. Under DOMA, the federal government did not recognize Edith Windsor's same-sex marriage, and therefore Windsor could not take advantage of the unlimited marital deduction and inherit her wife's estate without incurring any federal estate tax. Following the *Windsor* decision, Edith Windsor was able to recoup the estate taxes that she paid, plus interest.

Taxpayers who paid federal estate taxes on assets inherited from a deceased same-sex spouse in the past three years may be eligible for a refund. Such taxpayers are encouraged to review their estate tax filing immediately, and seek counsel from an estate planning attorney or other trusted advisor. As previously noted, there is a statute of limitations for filing amended returns, including federal estate tax returns, so taxpayers who may be eligible for an estate tax refund should act quickly to preserve any potential claim that they might have.

ESTATE AND WEALTH PLANNING CONSIDERATIONS IN LIGHT OF WINDSOR AND REVENUE RULING 2013-17

Windsor and Revenue Ruling 2013-17 now provide same-sex couples with unprecedented access to many estate planning techniques long enjoyed by opposite-sex married couples. However, it is important for same-sex couples, regardless of marital status, to have a well-executed, complete estate plan. Despite progress at the federal level, the lack of same-sex relationship recognition continuity among the states has created some potential estate planning landmines for same-sex couples.

Powers of Attorney

The lack of same-sex marriage across all 50 states could cause unwanted and unintended headaches for same-sex married couples. Consider Brenda and Jane, who were married in Massachusetts in 2009 and now reside in New York. Brenda and Jane enjoy all of the rights of marriage at both the state and federal level, because they were validly married in, and currently reside in, a state that recognizes their marriage. Despite the broad protections Brenda and Jane enjoy as a same-sex married couple, a failure to have a fully developed estate plan could present the couple with unwanted consequences.

Suppose Brenda and Jane decided to travel to Florida for vacation. The couple has never executed powers of attorney for property or health care. Florida has a state constitutional amendment prohibiting same-sex marriage and does not recognize Brenda and Jane's marriage. If Jane were to become injured or incapacitated during the vacation, Brenda may not be allowed to make decisions regarding Jane's health care. Such a scenario highlights the need for same-sex couples to complete a thorough estate plan, regardless of marital status.

Prenuptial Agreements

Prenuptial agreements are an estate and wealth planning technique that allows a couple to make certain decisions about financial matters during and after marriage but before a couple officially ties the knot. For some couples, the idea of planning for divorce before the marriage even occurs is unpleasant. But for practical reasons, a prenuptial agreement may be an effective and efficient 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.

Prenuptial agreements are contractual in nature, and governed by state law.[5] A valid prenuptial 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 prenuptial agreement terminates after the couple has been married for a certain period of time. Prenuptial 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 prenuptial 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.

Retirement Planning and Beneficiary Designations

One of the most important changes for same-sex married couples stemming from *Windsor* and Revenue Ruling 2013-17 is the ability of same-sex married spouses to take advantage of retirement planning opportunities that were not previously available to same-sex couples.

IRA Rollovers

Under the federal laws and regulations that govern traditional individual retirement accounts (IRA), an account owner is required to take required minimum distributions (RMD) from a traditional IRA when the account owner reaches a certain age (currently age 70 ½ years). An IRA owner can elect a beneficiary to receive the IRA when the account owner dies. Generally, the distribution rules are not as favorable for a non-spousal beneficiary as for a federally recognized spousal beneficiary. For example, distributions to a non-spouse beneficiary must begin prior to the end of the year following the death of the account owner. A federally recognized spouse, by contrast, can "rollover"[6] an IRA from a deceased spouse and not start taking distributions until the surviving spouse reaches 70 ½ years of age.

[5] A same-sex couple that plans to reside in a state that does not recognize same-sex marriage should consult with a family law attorney in the state where they intend to live to determine if same-sex prenuptial agreements are valid in that state. While prenuptial agreements for opposite-sex married couples are valid in all 50 states and the District of Columbia, their legality for same-sex married couples has not been tested in all of the 35 states that do not permit or recognize same-sex marriage.

[6] In the context of IRA, a "rollover" allows a surviving spouse beneficiary to receive the deceased spouse's IRA assets into the surviving spouse's own IRA and treat those assets as if they belonged to the surviving spouse.

Same-sex married couples can now take advantage of the preferable rollover rules for spousal beneficiaries of traditional IRAs, regardless of where the couple lives. The ability of the surviving spouse to delay receiving distributions may be particularly important if there is a significant age difference between the IRA account owner and the spousal beneficiary, as the spousal beneficiary can allow the "rolled over" IRA assets to accumulate and grow before reaching the age for required minimum distributions.

Spousal Consent to Change Beneficiary Designations

While many individuals are aware of the rules pertaining to IRAs, some same-sex married couples may be surprised to know 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 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.

CONCLUSION

The laws pertaining to same-sex relationship recognition are ever changing, both at the federal level and among the states. 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. While *Windsor* and Revenue Ruling 2013-17 offer a new world of wealth and estate planning opportunities to same-sex couples, understanding the full financial impact of marriage, and the inconsistencies in state and federal law, remains vitally important for same-sex couples.

FOR MORE INFORMATION

Northern Trust's LGBT and Non-Traditional Family Practice has the expertise to help navigate the financial and estate planning challenges facing LGBT individuals and same-sex couples. To learn more, please visit **northerntrust.com/lgbt**.

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