

Tax Planning for Same-Sex Married Couples

Regulatory Guidance Provides a Road Map for Planning Opportunities

Since the United States Supreme Court ruled that Section 3 of the Defense of Marriage Act (DOMA) was unconstitutional, Financial Planners and Estate Planners have speculated on how the various federal agencies and programs would apply their policies to same-sex married couples. In particular, how would the differences in state laws affect which same-sex couples would be eligible for federal benefits?

The Internal Revenue Service has now provided much-needed clarity through Revenue Ruling 2013-17, which states that all legal same-sex marriages will be recognized for federal tax purposes, and that the laws of the state where the couple lives will have no bearing. This ruling applies to all same-sex marriages that are legally performed in the United States, a United States territory or foreign country, even if the couple lives in a state that does not recognize the marriage.

Federal Income Tax Planning

The IRS announced that it will begin applying the terms of their ruling starting September 16, 2013. For tax year 2013 and beyond, same-sex couples who are married as of December 31, 2013 will now be required to file a federal income tax return as a married couple, either jointly or separately. The impact on the couple's total tax liability, however, will depend on their personal situation:

- In cases where the income is disproportionately earned by one spouse, filing jointly can result in a reduced tax liability.
- In cases where the two spouses have similar levels of income, they may find they'll pay more tax as a couple than they did as two single individuals. This is due to differences in the tax brackets for higher-income singles and married couples (often referred to as "the marriage penalty").

Same-sex married couples may also wish to review their prior year tax returns, within the statute of limitations, to determine if filing jointly will result in a lower overall tax liability. The statute of limitations for amending tax returns is the later of:

- three years from the filing deadline (generally April 15, or the date the return was actually filed if the return was extended) or
- two years from the date the taxes were paid.

For same-sex married couples, this means that an amended federal income tax return may be filed for tax years 2010 through 2012. In addition, if each same-sex married spouse filed an extension for their 2009 tax return, they would have three years from the date their returns were filed to amend the return (potentially as late as October 15, 2013). Filing an amended return for these prior years is not required, but should be evaluated for each tax year within the statute of limitations.

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Same-sex married couples that have not yet filed their 2012 tax returns have a small window to decide how to file that return. Until September 16, 2013, these couples can choose to file as individual taxpayers or a married couple for 2012. After that date, they will be required to file a married 2012 federal income tax return on or after September 16, 2013.

Employer Group Health Insurance Premiums

Effective September 16, same-sex married couples that purchased health insurance coverage through employer plans on an after-tax basis are now able to pay for that coverage on a pre-tax basis. In addition, employer subsidies to offset the cost of coverage should be considered non-taxable, rather than imputed income under prior law. Tax refunds could be generated by both of these items by filing an amended tax return for the applicable years. These changes should be factored into the decision to amend prior year tax returns.

Additional Factors to Consider Before Changing Filing Status

When deciding whether to file a joint return for 2012 and earlier or continuing to file two single returns, there are a number of other factors to consider, including the following:

- Two single taxpayers with relatively equal levels of income are likely to have a lower combined tax liability than they would if they were to file as a married couple. As their income increases, this difference is magnified due to the differences in the single and married tax brackets at higher income levels. For example:
 - In 2012, a single taxpayer reached the top of 15% tax bracket at taxable income of \$35,350. For a couple that point is reached at \$70,700, exactly double the single amount.
 - However, the top of the next bracket, 25%, is \$85,650 for singles but only \$142,700 for couples.
 - Therefore, two singles each with \$85,650 of taxable income would each pay approximately \$17,500 in tax (total of \$34,900). Once they're married, their combined income of \$171,300 would reach into the 28% bracket, and they'd pay more than \$35,700, or almost \$1,000 more.
- By combining their income to file jointly, two single taxpayers will see their Adjusted Gross Income rise. This increase will make it more difficult to claim deductions based on AGI, including medical expenses and miscellaneous itemized deductions. Joint filers may also find it more difficult to claim deductions for IRA contributions.
 - On the other hand, a larger AGI will make it easier to avoid the limitation on deducting charitable contributions.

Beyond the decision for 2012 and earlier, same-sex couples (as well as opposite-sex couples) may also wish to consider the several new taxes taking effect in 2013 before choosing to get married. While the thresholds for these new taxes are all higher for joint taxpayers than for singles, they are usually much less than twice the single amount. For example, the new 20% capital gain rate applies to single taxpayers with income over \$400,000, but applies to couples at just \$450,000, meaning that a couple where the spouses

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have similar income levels may find themselves at that higher tax rate by filing jointly. The same is true for items such as:

- The phase-out of itemized deductions and personal exemptions
- The new 3.8% Medicare tax on investment income
- The additional 0.9% Medicare tax on earned income

Qualified Retirement Plans

Qualified retirement plans under ERISA must now also recognize legal same-sex marriages. Therefore, plan sponsors will need to update beneficiary designation forms for same-sex married couples to show the spouse as the sole primary beneficiary unless they sign a waiver of consent. Moreover, if the plan is a defined benefit plan or money purchase plan, any survivor's benefit (under a qualified joint and survivor annuity), must be made available to a legal same-sex spouse and provide payments over both the employee's and spouse's lifetime. If the plan is a defined contribution plan and the employee elects to rollover the assets, the same-sex spouse must now consent to the rollover.

It should be noted that Individual Retirement Accounts (IRAs) are not governed by ERISA law. Therefore, an IRA owner may not be required to name his/her spouse as the sole primary beneficiary of the IRA, nor are IRA custodians required to receive spousal consent when an IRA owner names someone other than a spouse as the primary beneficiary. However, many IRA custodians, including Baird, do require this consent if the IRA owner lives in a community property state.

Federal Estate and Gift Tax Planning

For 2013, same-sex married couples can now gift assets to each other under the unlimited marital deduction without having to file a gift tax return. Moreover, same-sex married couples will be able to transfer the first deceased spouse's unused federal estate tax exemption to the surviving spouse under the portability provisions. For gifts or deaths that occurred in prior years, same-sex married couples and surviving spouses may amend prior year federal gift tax returns or federal estate tax returns within the statute of limitations to preserve exemptions or receive refunds.

While future guidance will clarify these rules at the federal level, estate planning in states that do not recognize same-sex marriages and have a form of state death taxes may create additional challenges. Currently, there are 8 states that do not recognize same-sex marriages and impose a form of state death taxes: Hawaii, Illinois, Kentucky, Nebraska, Oregon, Pennsylvania, New Jersey and Tennessee.

State Income Tax Planning

While all same-sex married couples will be required to file a married federal income tax return for 2013, these same couples may not be eligible to file joint state income tax returns. There are currently 29 states that have a constitutional ban on same-sex marriage, plus 6 that restrict marriage to "one man and one woman" and 2 that have no policy on same-sex marriages. Therefore, same-sex couples in those 37 states will continue to file single returns in their resident state while also filing a joint federal return.

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Further complicating things, 24 of these 37 (rising to 25 in 2014) reference the federal income tax return when calculating the state income tax. These 25 states are listed below.

States Whose Constitution Prohibits Same-Sex Marriages				States with Laws Restricting Marriage to One Man & One Woman	States That Neither Recognize nor Prohibit Same-Sex Marriages
Arizona Colorado ^ Georgia Idaho Kansas	Kentucky Louisiana Michigan Missouri Montana	Nebraska North Carolina* North Dakota Ohio Oklahoma	Oregon # South Carolina Utah Virginia Wisconsin	Hawaii ^ Illinois ^ Indiana West Virginia	New Mexico

* - Effective 2014

^ - Recognize state-level spousal rights through civil unions

- Recognize state-level spousal rights through domestic partnerships

Because these states reference a federal tax return with a filing status that is invalid for the state, those 24 states will have to determine how to accommodate this new law. There are three primary potential outcomes for these states:

1. Require each spouse to prepare pro forma individual federal income tax returns, which would then be the basis for their individual state income tax return.
2. Require each member of the same-sex married couples to split their joint federal income and deductions, which would then be the basis for an individual state income tax return.
3. Decouple from the federal income tax system and require same-sex married couples to file individual state income tax returns based on state-specific rules.

Social Security

In early August, the Social Security Administration announced that it was processing retirement benefits for same-sex married couples. However, the claims being processed to date have only been for same-sex married couples residing in states that recognize same-sex marriages. The Social Security Administration (SSA) is waiting for the Department of Justice to provide further guidance as to whether not claims should be processed for any legal same-sex marriage, regardless of residency. Despite the limitation in place today, the SSA is encouraging all eligible same-sex married couples to apply right away to preserve their filing date, which the SSA uses to determine the start of potential benefits.

Future Expectations

Over the coming months, there will likely be additional federal guidance in determining which programs and benefits are available to same-sex couples. The federal government appears headed toward a uniform application of federal benefits to all same-sex married couples, regardless of whether their state recognizes the marriage. This move weakens the control currently held by individual states, leaving advocates for marriage equality hopeful that more states will concede and move to adopt laws recognizing same-sex marriages.