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IRS Fix For Same-Sex Marriage Is More Than Meets The Eye

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Law360, New York (December 05, 2013, 9:36 AM ET) -- On Aug. 29, the Internal Revenue Service released Revenue Ruling 2013-17, providing guidance on the tax treatment of same-sex spouses in the wake of United States v. Windsor.[1] Under the new guidance, same-sex couples validly married in a jurisdiction whose laws authorize the marriage are treated as married for all federal tax purposes, regardless of the jurisdiction in which they live. This has implications not only for individuals that are in a same-sex marriage and companies that employ them, but also potentially for a wide range of other taxpayers.

Background

Prior to Windsor, the Defense of Marriage Act included a provision that generally purported to prohibit the federal government from recognizing same-sex marriages.[2] The IRS interpreted this provision to prevent same-sex spouses from being married for federal tax purposes. Earlier this year, however, the Supreme Court held in Windsor that this provision of DOMA is unconstitutional.

Same-Sex Spouses Now Treated as Married

In light of the Windsor decision, the IRS is providing guidance in the Revenue Ruling on how it will treat same-sex spouses. Beginning Sept. 16, 2013, the IRS began treating all married same-sex couples as married for all tax purposes. This means that such same-sex spouses now qualify for all of the same benefits, and are subject to the same obligations, as opposite-sex spouses.

When Are Same-Sex Couples “Married”?

The IRS ruled that same-sex couples are married for federal tax purposes if the individuals are lawfully married under the laws of a jurisdiction (whether in the U.S. or outside the U.S.) having the legal authority to sanction marriage. However, this treatment does not extend to individuals who have entered into a registered domestic partnership, civil union, or other similar formal relationship under applicable law that is not denominated as marriage under the laws of that jurisdiction. Accordingly, even if a same-sex couple with a civil union is treated the same as a married couple under state law, the same-sex couple will still not be treated as married for federal tax purposes.

That said, the IRS also ruled that the test is whether the marriage was lawful in the jurisdiction in which it occurred, not where the couple is living. So, a same-sex couple living in a jurisdiction that does not recognize same-sex marriage will be treated as married for federal tax purposes if they are married under the laws of a jurisdiction (whether in the U.S. or outside the U.S.) that sanctions same-sex marriage.

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Implications for Married Same-Sex Couples

Same-sex spouses will now be subject to the same benefits and burdens as opposite-sex spouses. This will likely simplify the tax situation for many same-sex spouses and provide them with planning opportunities that they previously did not have. But, by the same token, they may find that by being treated as married, they will be unable to take advantage of certain opportunities they previously had. So, the result may be a mixed bag for some taxpayers.

As a result of their marriage being recognized, same-sex spouses will now qualify for a number of estate planning benefits. Gifts between same-sex spouses, for example, will now qualify for gift tax exemptions available to transfers between “spouses.” Accordingly, same-sex spouses that have been engaging in any estate or other wealth-transfer planning should revisit those plans and revise them as appropriate to take into account this new interpretation.

However, while one spouse would previously have been able to claim an adoption credit for adopting the other spouse’s child, this is no longer available. This is because an adoption of the child of a person recognized as a spouse for tax purposes does not qualify for the credit.

Being married, same-sex spouses must now also generally file tax returns as “married filing jointly” or “married filing separately,” and no longer as “single” or “head of household.” This means that they will be subject to different rate brackets (which may increase or decrease their aggregate taxes) and will be unable to use a standard deduction for one spouse and itemize deductions for the other.

In some cases, it will also complicate state tax return filings. If same-sex spouses are required to file tax returns in states that still do not recognize their marriage for tax purposes, they may nevertheless be required to prepare “mock” federal tax returns as unmarried individuals to include with those state tax returns.

Implications for Employers

The principle consequence of this new ruling to employers is that they need to now update their employee benefit arrangements. Because their marriages will now be recognized by the IRS, companies will need to ensure that all of their tax-advantaged employee benefits are offered to same-sex spouses of their employees in the same manner as they are offered to opposite-sex spouses. This includes benefits associated with employee benefit plans, employer-provided health coverage benefits, and fringe benefits.

So, employers will be required to permit the same-sex spouse to enroll in programs, such as employer-provided health coverage benefits, that previously were not offered them. It also means that certain salary reductions for the employee attributable to benefits provided to the employee’s same-sex spouse that were taken on an after-tax basis now be taken on a pre-tax basis. In many cases, this will require amending the employer’s plans.

Unfortunately, the IRS has yet to provide meaningful guidance on how to accomplish these goals. The Revenue Ruling did provide that if an employee made a pre-tax salary-reduction election for health coverage under a section 125 cafeteria plan sponsored by an employer and also elected to provide health coverage for a same-sex spouse on an after-tax basis under a group health plan sponsored by that employer, the salary reductions for

the spouse's coverage can be treated as pre-tax salary reductions. Beyond that, employers will need to wait for the guidance IRS said it intends to issue in the future on the application of these rules to other employee benefits, plans and arrangements.

Same-Sex Tax Equalization Payments

Some employers have been providing "tax equalization" payments to their employees to cover the additional taxes associated with providing equivalent benefits to same-sex spouses that previously were only tax-free when provided to same-sex spouses. In light of the Revenue Ruling, employers should reconsider these payments, as some or all of the beneficiaries may no longer be subject to tax on the benefits provided to the employee's spouse.

Continuing these equalization payments to employees in same-sex marriages recognized by the IRS will be a windfall for those employees, so it would be appropriate to discontinue these payments to those employees. However, many of these policies included equalization payments to same-sex couples in relationships that still are not recognized as marriages for tax purposes, such as civil unions. Employers that want to continue to put individuals in these situations in the same after-tax position as "married" couples will need to continue these payments for those individuals.

Retroactive Application

Although this new treatment is only mandated since Sept. 16, 2013, the IRS is permitting taxpayers to apply this rule for filing returns and claiming credits and refunds for any open tax years. If a taxpayer files a return or claims a credit or refund, the taxpayer must adjust all items affected by the marital status required to be reported on the return or claim to be consistent with the ruling. A taxpayer cannot selectively apply these rules to only some items. On its face, however, the Revenue Ruling would permit taxpayers to amend only selected returns without having to amend all returns.

This means that same-sex couples may file amended returns for prior open tax years as a married couple if they were married at the time. But, because they must use their married status for all purposes, couples should carefully consider the overall impact of the change on their situation before making any such amendments.

Employers are similarly entitled to apply this rule retroactively to prior period returns. In particular, if an employer had provided benefits to a same-sex spouse of an employee that are tax-free when provided to the husband or wife of an employee (such as health care coverage) but had treated it as wage income to the employee under the old interpretation, the employer may claim a refund for payroll taxes paid on such benefits. Sole proprietors that employ their same-sex spouses may also claim refunds for payroll taxes paid on wages paid to their spouses.

Additional Guidance

In an effort to assist taxpayers with issues addressed in the ruling, the IRS has published a list of questions and answers at the following website:

http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples

The IRS also indicated in the Revenue Ruling that it will issue further guidance on applying the Windsor decision to employee benefits and employee benefit plans and

arrangements, including the potential consequences of retroactive application of the rules to all taxpayers involved. Further, the IRS has indicated that it will issue guidance with a special administrative procedure for employers seeking refunds of payroll taxes where the employee cannot be found or elects not to participate in the refund.

Unanswered Questions

Even though the new guidance may seem straightforward, it has very broad implications. The IRS has counted more than 200 tax statutes and regulations that refer to spouses and marriage. The focus of the Revenue Ruling on employment-related issues disguises the fact that a wide range of taxpayers, including entities that are not employers and individuals that are not part of a same-sex relationship, can be affected by the new interpretation.

There are many situations in which the ownership of securities or assets of an individual can be attributed to his spouse for tax purposes. This attribution can result in a variety of special tax consequences, such as the disallowance or deferral of losses, the taxability of otherwise untaxed events, or the qualification for or application of certain sets of rules.

As a result of this new interpretation, the attribution rules could cause entities that previously had qualified for, or avoided, certain status to now find themselves in a different status. For example, consider a foreign corporation owned 10 percent by each of five unrelated U.S. individuals, 5 percent by each of eight unrelated U.S. individuals, and 5 percent each by two otherwise unrelated individuals that are same-sex spouses whose marriage is now recognized. Whereas, the corporation previously was not a controlled foreign corporation (CFC); by virtue of this ruling, the corporation will suddenly find itself a CFC. Moreover, all of the 10 percent owners of the corporation will find that they are subject to the CFC rules that they probably carefully tried to avoid. Real estate investment trusts that are not widely held could similarly find that they have lost their REIT status.

Special consequences arising from the attributed ownership can also have an impact on the basis of assets held by taxpayers. There may be taxpayers that have been treating their assets as having a tax basis that is different than the basis the assets would have had if this interpretation had always applied. Without further guidance from the IRS, it is not at all clear in such a situation what basis the taxpayer should use if he does not (or, because the applicable tax year is closed, is unable to) amend the return for the prior year in which the special rule would have applied.

These are only a couple of the many potential issues that taxpayers may face. The fact that these kinds of issues were not acknowledged in the Revenue Ruling suggests that the IRS is not focused on issuing any guidance addressing these other issues, at least in the near future. Even so, practitioners and taxpayers would be well advised to carefully consider the impact of this new interpretation on all aspects of their tax planning.

—By Afshin Beyzaee, Liner Grode Stein Yankelevitz Sunshine Regenstreif & Taylor LLP

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[1] 570 U.S. ___, 133 S. Ct. 2675 (2013).

[2] 1 U. S. C. §7.

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