McCandlish Holton
Attorneys at Law

Client Alert

SECTION 3 OF THE DEFENSE OF MARRIAGE ACT RULED UNCONSTITUTIONAL & SUBSEQUENT DEVELOPMENTS: ANALYSIS OF CONSEQUENCES FOR BUSINESS MANAGERS AND PROFESSIONALS

THOMAS C. FOSTER AND JENNIFER L. LIGON

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Executive Summary: On June 26, 2013, the Supreme Court of the United States held that Section 3 of the Defense of Marriage Act is unconstitutional. In the little more than four months since that ruling, other courts and applicable regulatory agencies have responded with certain needed guidance. This article briefly reviews what is now known about these developments for employee benefit plan administration, estate planning, and tax issues that are likely to be important to business managers and professionals. It also notes certain questions that still await further judicial decisions and/or administrative guidance.

Background: The Defense of Marriage Act ("DOMA") was enacted in 1996, in part, as a reaction to the possibility that states would begin to legally recognize same-sex marriage. Section 3 of DOMA ("Section 3") provides that, for the purpose of any federal law or regulation, the word "marriage" solely means the legal union between one man and one woman. Additionally, the word "spouse" means a person of the opposite sex who is a husband or wife. More than 1,000 federal laws have been identified in which these definitions are used and for which they are important. Included among the federal laws are numerous provisions in the Internal Revenue Code (the "Code"), many of which are favorable for married spouses, but some of which are unfavorable. One favorable provision is Section 2056(a), which permits the estate of the first spouse to die to take a marital deduction for amounts transferred to the surviving spouse. Because of Section 3, Section 2056(a) of the Code only applies to opposite-sex married couples, meaning that the estate of a same-sex married individual who predeceases his or her same-sex spouse may not take advantage of the marital deduction, thereby potentially subjecting the estate to federal estate taxes that the estate of an opposite-sex married individual would not have to pay. This very situation was the predicate for United States v. Windsor and, ultimately, the decision to hold Section 3 unconstitutional.

Edith Windsor and Thea Spyer began a committed relationship shortly after they met in 1963. In 2007, they married in Canada and then returned to their home in New York, where their Canadian marriage is deemed valid. In 2009, Spyer died, leaving her estate to Windsor. Because Spyer and Windsor were not "spouses" for purposes of the Code, Spyer's estate could not take advantage of the marital deduction in Section 2056(a) and, thus, had to pay more than $363,000 in federal estate taxes. Windsor paid this amount but then sued for a refund, contending that Section 3 violated the guarantee of equal protection. On June 26, 2013, in

United States v. Windsor, the Supreme Court of the United States held that Section 3 is unconstitutional, as it violates the principles of equal protection, as applied to the federal government through the Due Process Clause of the Fifth Amendment, when applied to same-sex marriages that are lawful under applicable state law.

Which Same-Sex Marriages Are Affected? Windsor's holding clearly applies to individuals in same-sex marriages that have been solemnized by celebrations, wherever performed, that are recognized in their states of domicile, who have not subsequently been divorced. Those are the "Clear Cases." (Currently 14 U.S. states plus the District of Columbia recognize same-sex marriages. Further, certain foreign countries allow same-sex marriages, e.g., Canada.)

However, in addition to the Clear Cases, there are individuals who have entered into solemnized same-sex marriages, in jurisdictions where such marriages are permitted, who, on the relevant date for the federal law in question (e.g., the date of death for estate tax purposes), are domiciled in a state that does not recognize same-sex marriages. For those individuals, whether they are "married" will depend upon whether the federal law looks to the law of the jurisdiction where the marriage took place or the current state of domicile. Certain bodies of federal law have precedents regarding which of those approaches applies. For example, immigration law has looked to the place where the marriage occurred, whereas Social Security has looked to the state of domicile. However, there are many important federal laws for which consistent rules have not previously been established. The increased importance of the question, in light of the Windsor decision, has resulted in the question receiving new attention from the applicable regulatory agencies, such as the Internal Revenue Service ("IRS") for tax issues, and the courts.

Post-Windsor Guidance of Note: On July 22, 2013, just one month after the Windsor decision, a federal court in Ohio addressed whether Ohio can treat as invalid same-sex marriages lawfully solemnized out of state, when Ohio law has historically recognized as valid opposite-sex marriages lawfully solemnized out of state. In that case, James Obergefell and John Arthur had lived together in a committed relationship in Ohio for more than twenty years. Mr. Arthur was recently stricken with a terminal illness and was in hospice care. The couple flew in a specially equipped hospice airplane to Maryland, where their marriage was solemnized in accordance with the laws of Maryland. They then returned to their Ohio home, where the state constitution and a state statute deny recognition of same-sex marriages, contrary to Ohio's general recognition of marriages performed in other jurisdictions, including certain marriages that could not be solemnized in Ohio (e.g., minors and cousins). Messrs. Obergefell and Arthur petitioned the United States District Court for the Southern District of Ohio to order the Ohio Registrar of death certificates to, upon Mr. Arthur's death, record Mr. Arthur as "married" and Mr. Obergefell as his "surviving spouse." On July 22, 2013, in Obergefell v. Kasich, the court granted the requested order, finding that Ohio's nonrecognition of their marriage discriminates against Messrs. Obergefell's and Arthur's rights under the equal protection clause of the United States Constitution.

On July 29, 2013, in O'Conner v. Tobits, a federal court in Pennsylvania held that a same-sex marriage solemnized in Canada that was recognized by Illinois where the couple was domiciled entitled the surviving individual to be treated as the deceased employee's "surviving

spouse" for purposes of benefits under a private employer's profit-sharing plan governed by the Employee Retirement Income Security Act of 1974 ("ERISA") and that was intended to be qualified under the Code.

On approximately August 20, 2013, the Wage and Hour Division of the U.S. Department of Labor added the following definition to its Family and Medical Leave Act ("FMLA") Fact Sheet #28F. "Spouse means a husband or wife as defined or recognized under state law for purposes of marriage in the state where the employee resides, including common law marriage and same-sex marriage."

On August 29, 2013, the IRS issued Rev. Rul. 2013-17 specifying that, effective September 16, 2013, all marriages that are valid in the jurisdiction where entered into will be recognized for all federal tax purposes. Same-sex married individuals who paid additional income taxes due to having been treated as single in open taxable years (generally the prior three completed years) may file amended federal returns to claim refunds. Conversely, such individuals who paid lower federal taxes due to having been treated as single are not required to file amended federal returns. Further, employers are permitted to file for open year refunds of FICA (Social Security and Medicare) taxes paid with respect to such employees.

On September 18, 2013, the Employee Benefits Security Administration of the U.S. Department of Labor issued Technical Release 2013-04 adopting the same state of celebration position for ERISA issues that the IRS had previously adopted for tax issues.

On September 23, 2013, the IRS issued Notice 2013-61 specifying the process by which employers may correct excess withholding from employees and excess payments by employers, for open years, for employees in same-sex marriages.

Virginia Employees? Virginia currently has both constitutional and statutory prohibitions on forming and recognizing same-sex marriages. Challenges to those prohibitions have been filed, but it is not yet known whether they will be successful. Therefore, at this time, recognition for federal law purposes of same-sex "marriages" solemnized in other states or foreign countries of Virginia-domiciled individuals will differ depending on the federal law in question.

In general, Virginia has a "fixed conformity" income tax regime. When computing Virginia income taxes, individuals, with very limited exceptions, begin with their federal filing status (e.g., married filing jointly, married filing separately, single or head of household), federal adjusted gross income, and other federal tax attributes and make adjustments specified by the Virginia tax code. However, on November 8, 2013, the Virginia Department of Taxation (the "Department") issued Tax Bulletin 13-13 announcing that Virginia's constitutional and statutory prohibitions on forming and recognizing same-sex marriages requires Virginia to deconform from the federal income tax treatment of same-sex marriages.

Virginia's deconformity from the newly established federal policy impacts both Virginia individual income taxpayers as well as certain businesses. Same-sex couples who file federal income tax returns jointly or as married taxpayers filing separately will be required to file their Virginia income tax returns as single individuals. As a result, each same-sex married individual

will need to recalculate his or her federal adjusted gross income for Virginia income tax purposes. Also, same-sex married individuals may not be able to claim certain above-the-line deductions and certain personal and dependency exemptions, or may be limited in their ability to do so, for Virginia income tax purposes.

Tax Bulletin 13-13 goes on to state that deconformity may also require certain businesses to make adjustments when filing their Virginia income tax returns. More specifically, these businesses may have to back out deductions they had claimed for same-sex spouse and dependent fringe benefits. The Department's proposed deconformity adjustment is apparently based on a misunderstanding of the federal income tax change wrought by Windsor and Rev. Rul. 2013-17. What changed was that, henceforth, same-sex spouse benefits will be excludible from employees' W-2 wages, the same as for opposite-sex spouses. Both before and after the recent federal tax law changes, employers are able to deduct those amounts as ordinary and necessary employee compensation. Fortunately, the Department stated that it intends to issue additional guidance for affected individuals and businesses prior to the 2014 tax filing season. Hopefully, that additional guidance will correct the current guidance for employers.

Employee Benefit Plan Administration: Businesses will need to begin treating married same-sex individuals as married for employee benefit plan administration purposes. For both ERISA and federal tax issues, that determination will be based on the jurisdiction in which the marriage was formed. Examples of marriage-dependent employee benefit plan administration concerns are as follows:

- Same-sex spouses of retirement plan participants will have the same entitlement to qualified joint and survivor annuities, preretirement survivor annuities, and death benefits as opposite-sex spouses. Businesses should be wary of relying on previously executed beneficiary designations by individuals who claimed to be "single," but may have been actually in same-sex marriages. Payment of death benefits to someone other than the same-sex spouse, in reliance on such erroneous designations, may result in double liability.
- Same-sex spouses who have been covered under group health plans will be "qualified beneficiaries" under the same terms as opposite-sex covered spouses for purposes of COBRA continuation coverage.
- Required minimum distributions ("RMDs") from employers' retirement plans will begin to be computed for employees with same-sex spouse beneficiaries under the same favorable rules applicable to employees with opposite-sex spouse beneficiaries.
- Employees' same-sex spouses will now themselves be parties-in-interest and disqualified persons for purposes of "prohibited transactions."
- Attribution rules, which sometimes require aggregation of separate business entities owned by spouses for testing whether certain types of plans cover a nondiscriminatory group of employees, will now apply equally to same-sex spouses as to opposite-sex spouses. Therefore, employers with significant ownership by individuals in same-sex marriages will be wise to review their plan designs.

Payroll Administration: Employers that have treated employer and employee contributions for employee benefits (e.g., health insurance coverage) provided to same-sex spouses of employees as "after-tax" will need to begin treating such contributions as before-tax for federal income tax purposes. As a federal tax issue, marital status will be determined based on the jurisdiction in which the marriage was formed. However, such benefits may remain after-tax for Virginia income tax purposes.

Family and Medical Leave Act: Employers will need to begin treating same-sex spouses the same as opposite-sex spouses for purposes of employee eligibility for FMLA leave. It appears that marital status in the state of domicile will control for this purpose.

Individual Retirement Accounts: Same-sex spouses will, henceforth, be able to make use of the more liberal rollover and RMD rules applicable to opposite-sex spouse beneficiaries of IRAs. However, same-sex spouses of IRA owners will now themselves be disqualified persons for purposes of "prohibited transactions" (e.g., self-dealing) pertaining to IRAs in the same manner as opposite-sex spouses. For example, the law that prohibits one spouse's IRA from loaning money to a business owned by the other spouse now more definitely applies to same-sex spouses. The question remains whether such a transaction, if permissible when entered into, will now need to be undone, and, if so, how to undo the transaction without committing further "prohibited transactions." As a tax issue, marital status will be determined based on the jurisdiction in which the marriage was formed.

Estate and Gift Taxes: Individuals in same-sex marriages, who have significant assets, should reconsider their estate planning in light of Windsor. Those individuals will now be entitled to the unlimited marital deductions for estate and gift tax purposes. Such individuals who reported taxable transfers for during-lifetime gifts or for testamentary gifts to their same-sex spouses should consider whether they are entitled to file for refunds, especially if the transfers were within the past few years. As a tax issue, marital status will be determined based on the jurisdiction in which the marriage was formed.

Income Taxes: Individuals in same-sex marriages who have been filing their federal income tax returns as "single" will now be able to file jointly, noting, however, that not filing jointly will result in the generally unfavorable "married filing separately" status (and further noting the impact of Virginia's deconformity from the federal income tax treatment of same-sex married couples discussed above). As a tax issue, marital status will be determined based on the jurisdiction in which the marriage was formed.

Summary: The Windsor decision and subsequent judicial and regulatory agency guidance will cause same-sex spouses to be treated the same as opposite-sex spouses for many important federal law purposes. This brief article highlights a few of the federal and state law issues that are likely to be important to business managers and professionals. Should you have any questions about this article or about the implications of the Windsor decision with respect to your specific concerns and/or opportunities, please feel free to contact Thomas C. Foster at (804) 775-3874 or tfoster@lawmh.com.

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