Tax Consequences of the Decision to Strike DOMA

On June 26, 2013 the U.S. Supreme Court’s decision in E.S. Windsor (2013-2 USTC ¶50,400, 133 S.Ct. 2675) made it mandatory for the federal government to recognize same-sex marriages sanctioned by the states. The Supreme Court held that section 3 of the Defense of Marriage Act (DOMA) is unconstitutional because it violates the principles of equal protection (P.L. 104-199).

Recently released Revenue Ruling 2013-17 (Sept. 16, 2013), determines that for Federal tax purposes the terms “spouse,” “husband and wife,” “husband,” and “wife,” include an individual married to a person of the same sex if the individuals are lawfully married under state law and the term “marriage” includes such a marriage between individuals of the same sex. For Federal tax purposes, the IRS adopts a general rule recognizing a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages. The IRS also ruled that the terms “spouse,” “husband and wife,” “husband” and “wife” do not include individuals (whether of the opposite sex or same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state.

For over 50 years the IRS has relied on Revenue Ruling 58-66 in which the IRS determined that it recognizes the marital status of individuals as determined under state law in the administration of the Federal income tax laws. Although states have different rules of marriage recognition, uniform nationwide rules are essential for efficient and fair tax administration.

While same-sex couples are applauding the Supreme Court decision in Windsor, the ramifications of that decision are not universally positive for married same-sex couples. The overall benefits with respect to estate planning, retirement, health care and other employee benefits certainly outweigh possible negative consequences. Even from a tax perspective, the positive aspects of recognition of same-sex marriages for gift and estate tax purposes may outweigh any negative income tax results. Still, many same-sex couples may find that their federal income taxes go up as a result of the Supreme Court’s action and the marriage penalties inherent in many federal tax provisions.

A commonly recognized category of persons likely to be relatively adversely impacted by the Internal Revenue Code are double income couples with no children. A number of tax breaks in the Code are focused on children or enhanced based on children. Many other tax breaks have phase-outs where the married filing jointly phase-out is larger than, but not twice as large as, the single filer phase-out. For married couples with one wage earner, these phase-outs typically result in a marriage bonus. For married couples with roughly equal wage-earners, however, these same provisions can result in a marriage penalty. Many same sex couples could suffer a marriage penalty when filing tax returns.

Once a marriage is recognized for federal tax purposes, the single filing tax brackets are no longer available to taxpayers. Taxpayers must choose either married filing jointly or married filing separately. There are only unusual circumstances where married filing separately would be beneficial from a tax perspective.
Tax Rates

The Economic Growth and Tax Relief Reconciliation Act of 2001 included marriage penalty relief by doubling the size of the standard deduction for joint filers and doubling the income range for the 10- and 15-percent tax brackets for joint filers. However, a potential marriage penalty remained in the size of the higher tax brackets, with the top tax bracket kicking in at exactly the same level of taxable income for both single and joint filers. The American Taxpayer Relief Act of 2012 restored a top tax bracket of 39.6 percent at income levels that also create a potential marriage penalty—$400,000 for single filers and $450,000 for joint filers.

The Administration had pushed to have higher tax brackets start at $200,000 for single filers and $250,000 for joint filers. Compromise on the 2012 legislation pushed those numbers higher, but the Administration was successful under health care reform with having the 0.9-percent additional Medicare contribution tax on earned income and the 3.8-percent tax on net investment income kick in at those income levels, also with a potential marriage penalty. The 2012 legislation also brought back the phase-out of itemized deductions and exemptions. These phase-outs also occur at levels that create a possible marriage penalty, $250,000 for single filers and $300,000 for joint filers.

For 2013, a same-sex couple could each earn up to $73,200 and not have it taxed in a higher tax bracket if they got married. The potential marriage penalty from other tax breaks for married same-sex couples hits at various income levels.

Tax credits

Marital status also affects the operation of many tax credits. Combined income could either place the joint filers within a credit’s phase-out range or above it so that they are no longer eligible for the credit. The numbers used here are for 2012 unless otherwise indicated. At the low end of the income spectrum, the credit for the elderly and disabled starts to phase out at $7,500 for single filers and $10,000 for joint filers. The earned income credit starts to phase out at $7,770 for single filers with no children and at $12,980 for joint filers with no children. Either could penalize a same-sex couple with higher taxes now that their marriage is recognized for federal tax purposes.

In the retirement savings area, the eligibility for an IRA deduction starts to phase out at $58,000 for single taxpayers and $92,000 for joint filers. The eligibility to make a Roth IRA contribution starts to phase out at $110,000 for single filers and $173,000 for joint filers. Both could have an adverse impact on a same-sex couple deciding to get married, just as they would on an opposite sex couple deciding to get married. However, it is widely recognized that the Roth contribution limit can be avoided by making contributions to a traditional IRA and then doing a conversion to a Roth.

If children are a factor in the same sex relationship, some child-related tax breaks also include a potential marriage penalty. The Child Tax Credit starts to phase out at $75,000 for single filers and $110,000 for joint filers. Both the adoption credit and the dependent care credit start to phase out at the same income level for both single and joint filers: $15,000 in the case of the dependent care credit and $189,710 for the adoption credit. Several of the tax breaks related to education, such as the American Opportunity Credit, the Lifetime Learning Credit, Coverdell Education Accounts and the Student Loan Interest deduction do not come with a potential marriage penalty, although the savings bond interest exclusion still does, with a single filer phase-out starting at $72,850 and for joint filers at $109,250.
Itemized Deductions

In addition to the marriage penalty from the overall itemized deduction phase-out, the percentage of adjusted gross income limits on certain itemized deductions also create a potential marriage penalty. The 10-percent threshold for medical expense deductions, the two-percent threshold for miscellaneous itemized deductions, and the 10-percent threshold for casualty losses all create the possibility of reduced deductions for married as compared to single filers.

Other Tax Effects

Even aside from the regular income tax, the alternative income tax also comes with a potential marriage penalty, with the AMT tax rates kicking in at the same income levels for both single and joint filers and the AMT exemption amount being $50,600 for single filers and $78,750 for joint filers.

One benefit that cannot be overstated is that tax filing becomes more simplified if a same-sex couple can file a joint return for both federal and state purposes. Some tax breaks only available to married couples, such as the $500,000 exclusion of the sale of a home, are now available to same-sex couples.

Beyond the federal income tax, the federal estate and gift tax are more beneficial for married individuals. And beyond taxes, workplace health and pension benefits, Social Security retirement and survivor benefits, and insurance rates are all likely to be more favorable for same-sex couples whose marriages are recognized. The Windsor decision is also expected to affect whether certain forms of employee compensation are nontaxable. Married opposite-sex couples are not taxed on the portion of health insurance premiums the employer pays for the opposite-sex spouse. It is possible that this treatment will be extended to married same-sex couples.

District Court Follows Windsor Decision

Following the Windsor decision, a district court in Pennsylvania has ruled that a deceased law firm employee’s same-sex spouse was entitled to death benefits provided through the law firm’s Employee Retirement Income Security Act (ERISA) qualified plan (O’Connor, DC Pa, July 29, 2013). The court applied the U.S. Supreme Court’s decision in Windsor, 2013-2 USTC ¶50,400, June 26, 2013, and found that the federal government was required to recognize the marriage.

An employee of a law firm married her partner in Canada in 2006. The employee died in 2010. The law firm provided a survivor annuity under an ERISA-qualified plan. Both the employee’s surviving spouse and her parents claimed the benefits. The surviving spouse filed an interpleader action in a Pennsylvania district court, which was placed on the suspense docket pending the Supreme Court’s ruling in Windsor. The Supreme Court issued its decision on July 8, 2013, holding that Section 3 of the Defense of Marriage Act (DOMA) was invalid and that federal law must recognize marriages recognized as valid under state law.

The district court found that the deceased law firm employee’s spouse was entitled to the death benefits. First the petitioner qualified as a “spouse” for purposes of the plan. The plan was qualified under ERISA and contained several hallmarks of an ERISA-qualified plan, the court found. For example, the law firm’s plan document required that to qualify as a “spouse” for benefits purposes, the individual must have been married to the plan participant for at least one year. Further, the spouse was required to waive his or her right to be the plan participant’s beneficiary in writing. Absent this waiver, the death benefits would go to the surviving spouse.
Secondly, the court found that after the Windsor decision, federal law could no longer restrict the term “spouse” for benefits purposes to those in a marriage between members of the opposite sex.

Third, the court found that the petitioner was the employee’s surviving spouse under federal law. They had married in 2006 and obtained a valid Canadian Marriage Certificate. The United States Constitution required that the federal laws and regulations acknowledge the marriage, the court found.

IRS Releases FAQs

In recently released FAQs (www.irs.gov), the IRS responds to questions arising from Rev. Rul. 2013-17. Since Federal agencies will recognize marriages that are valid under state law, for the tax year 2013 and going forward, same-sex spouses must file using a married filing separately or jointly filing status. For tax year 2012 and all prior years, same-sex spouses who file an original return on or after Sept. 16, 2013, generally must file using a married filing separately or jointly filing status. For tax year 2012, same-sex spouses who filed their tax return before Sept. 16, 2013 may choose (but are not required) to amend their federal tax returns to file using married filing separately or jointly filing status. For tax years 2011 and earlier, same-sex spouses who filed their tax returns timely may choose (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.

If a taxpayer adopts the child of his or her same-sex spouse the taxpayer may not claim an adoption credit.

For all years for which the period of limitations for filing a refund claim is open, if an employer provided health coverage for an employee’s same-sex spouse, the employee may claim a refund of income taxes paid on the value of coverage that would have been excluded from income had the employee’s spouse been recognized as the employee’s legal spouse for tax purposes. This claim for a refund generally would be made through the filing of an amended Form 1040. (Tax Topic 308, Amended Returns).

Other topics addressed by the FAQs include:

- Taxpayer’s same-sex spouse may not be a dependent of the taxpayer
- A taxpayer who is married cannot file using head of household status
- Married couples must either both claim the standard deduction or both itemize deductions
- An adopting same-sex parent may not claim the adoption credit
- Refunds of Social Security and Medicare taxes for same-sex spouse employees
- Cafeteria plan premium refunds
- Rules applying to qualified retirement plans

The IRS intends to issue further guidance on how qualified retirement plans and other tax-favored retirement arrangements must comply with the Windsor decision.

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Paychex Details Potential Impact to Businesses on U.S. Supreme Court's Decision to Overturn Defense of Marriage Act

As America’s small businesses prepare for changes related to DOMA, many employers are already taking a proactive step to reevaluate the way they handle payroll reporting, administration, and employee benefits.

Paychex’ regulatory and compliance team has been following this issue closely and is now focused on helping business owners better understand the Court’s decision so they can take steps to react to this change in the law. Here are a few examples of the changes that will take place as a result of the Court’s finding:

• Same-sex spouses will now be eligible for pre-tax benefits such as health insurance premiums and FSA/Sec 125 participation. Not only will this impact the employees’ taxable income, it will directly impact an employer’s tax liability, which is determined by its employees’ taxable incomes.

• Employers could see more administrative burdens as they may need to amend benefit plan documents and payroll tax calculations.

• There could be a significant increase in leaves taken under the Family Medical Leave Act (FMLA). FMLA provides up to 12 weeks of unpaid job-protected leave to eligible employees to care for an immediate family member, including a spouse.

As a result of these changes, this year’s open enrollment periods may be different and likely raise more questions by your clients and their employees. This presents a great consultative opportunity.

Paychex will maintain regular communication with government agencies such as the Internal Revenue Service as they provide further clarity on this change. Visit the regulatory section of www.paychex.com for updates as they become available.

Publication date: September 30, 2013. The material contained above is current only as of the date of publication. These materials are for informational purposes only. They are not legal advice and should not be relied on as such. You should contact your attorney to obtain advice with respect to any particular issue or problem.