

Federal TAX ISSUES AFFECT SAME-SEX COUPLES

By Brad Gould, Esq. and Dana Apfelbaum, Esq.

With the repeal of Section 3 of the federal Defense of Marriage Act (DOMA) in *United States v. Windsor*, 133 S. Ct. 2675 (2013), CPAs will be called on to address issues related to same-sex married couples living in Florida. This article, the first of a two-part series, will highlight some of the income-, estate- and gift-tax issues at hand. The second article will discuss related estate- and business-planning issues.

Windsor repealed Section 3 of DOMA. In response, the IRS issued Revenue Ruling 2013-17 and a set of frequently asked questions to determine if two people will be considered married for tax purposes. In these documents, the IRS announced a “State of Celebration” approach, meaning the validity of a same-sex marriage is determined based on the jurisdiction in which the marriage was entered into, regardless of the couple’s domicile. Revenue Ruling 2013-17 provides that, with regard to the more than 200 Internal Revenue Code (IRC) provisions and IRS regulations concerning spouses and marriage, the terms “husband and wife,” “husband,” “wife” and “marriage” encompass same-sex spouses if they were lawfully married in a jurisdiction allowing same-sex marriages, and will be applied in a gender-neutral way henceforth.

Income tax

The good news...

There are many income tax benefits available to married couples. For instance, there is a benefit to filing jointly where one spouse earns significantly more than the other. Now, same-sex couples also can use the increased tax bracket. Another benefit is that married couples may exclude up to \$500,000 of the gain on the sale of a principal residence (single taxpayers only can exclude \$250,000). Married couples also can combine their activity for material participation purposes.

Another significant benefit exists with “spousal rollover” for deferred compensation plans. By rolling benefits over, the surviving spouse becomes the “participant” or “owner” of the benefits, gaining deferral advantages such as a slower rate of required minimum distributions (RMDs) and a later starting date for RMDs if the deceased spouse was older than the surviving spouse. The benefits and availability of electing spousal rollover should be individually analyzed in each situation. There are some situations where such an election is not possible

or desirable (i.e. younger deceased spouse or prenuptial agreements limiting the survivor's rights of withdrawal).

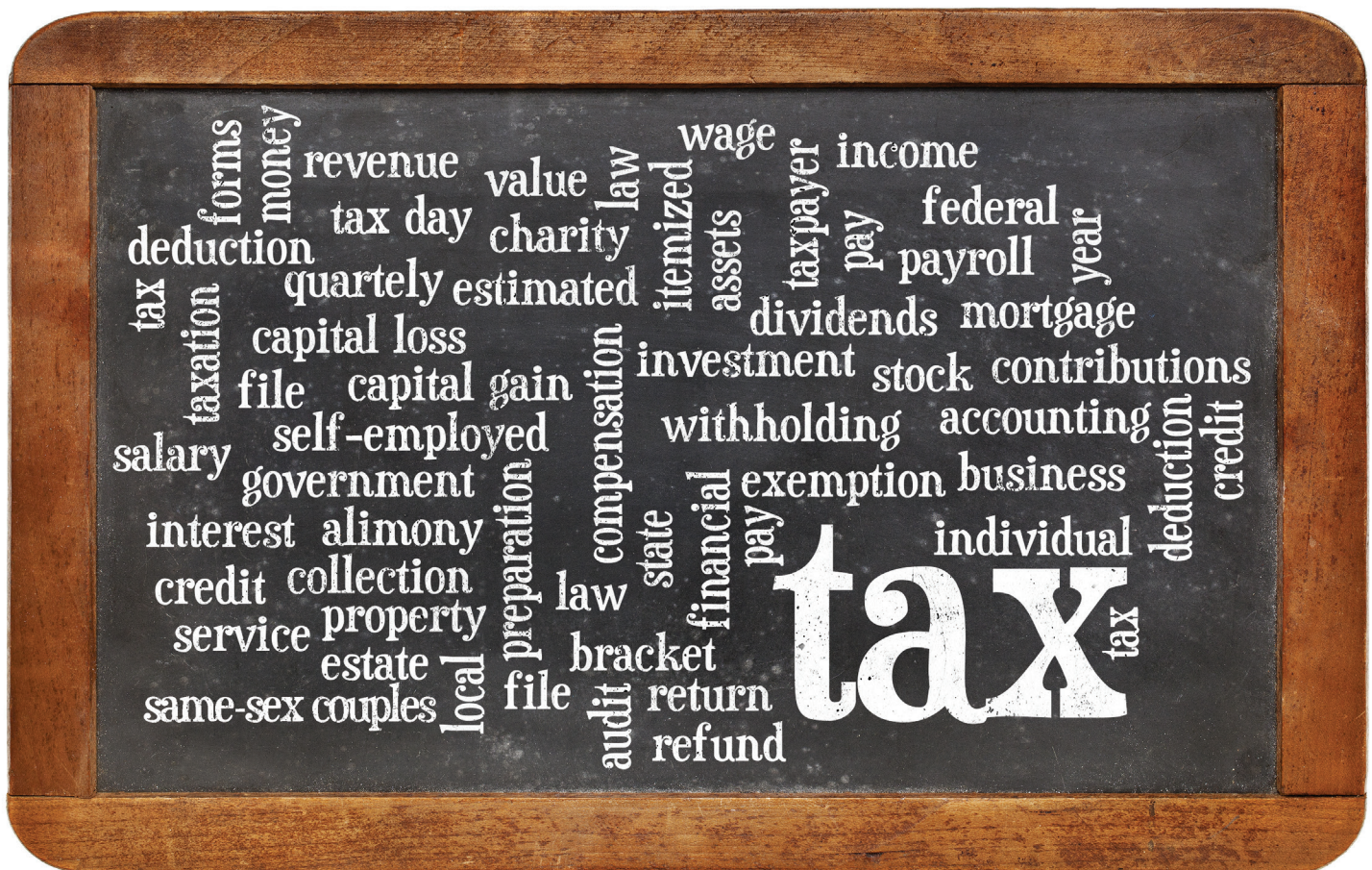
And the bad news...

There are several income tax provisions that penalize married couples. When both spouses are high wage-earners, filing jointly likely will result in a higher tax liability than filing separately. Further, if a married couple files separately, both returns must either itemize or claim the standard deduction, regardless of whether this is the best choice for both.

Trusts benefitting spouses sometimes are treated differently than other trusts. IRC § 672(e)(2) provides that the grantor of a trust shall be treated as holding any power or interest held by his or her spouse. If a person becomes the spouse of the grantor after the power or interest is created, the trust may become a grantor trust for the same reason and the liability for the associated income tax may shift to the trust grantor. Accordingly, special attention should be given to qualified subchapter S trusts (QSSTs) and electing small business trusts (ESBTs) as grantor-trust status trumps the QSST or ESBT elections.

Any trust may toggle into grantor status, including life-insurance trusts and other irrevocable trusts. Existing trusts should be reviewed and same-sex couples now considered married should carefully consider amending past returns. ➔

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Estate and gift tax

The good news...

Same-sex spouses now may take advantage of the estate and gift tax marital deductions in IRC §2056 and 2523, respectively. These provisions allow property to pass outright or in certain kinds of trusts to a spouse without incurring tax.

Portability also now is available to same-sex spouses, allowing a surviving spouse to use his or her own exclusion and the deceased spousal unused exclusion to pass up to \$10,680,000 free of tax in 2014. This is done by making an affirmative election on a promptly filed estate-tax return for the first deceased spouse.

Same-sex spouses now may elect to split gifts pursuant to Code Section 2513. It provides that one spouse may treat half of the total gift to any given donee as having been made by his or her spouse, thereby taking advantage of

two annual exclusions (\$28,000 total in 2014) per donee. To take advantage of “gift-splitting,” the non-donor spouse must affirmatively consent to split all gifts on the donor’s gift tax return.

Divorcing same-sex spouses now may take advantage of IRC § 2516. This applies to certain property transfers to an ex-spouse made pursuant to a written agreement regarding marital and property rights where divorce occurs “within the three-year period beginning on the date one year before such agreement is entered into (whether or not such agreement is approved by the divorce decree).” Same-sex couples now may make such property transfers without incurring gift tax.

And the bad news...

The special valuation rules of IRC § 2701-2704 are designed to curb techniques used to reduce transfer tax value, but not the economic benefit to the recipient of the interest. To this end, IRC § 2704(b) provides that certain

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“applicable restrictions” that otherwise would justify valuation discounts are to be ignored in intra-family transfers of interests in family controlled entities. IRC § 2702(a) provides that the value of retained interests is to be ignored in all but very select transactions to family members.

Same-sex spouses previously were not considered family members for purposes of this rule, therefore escaping the special rules. However, that no longer is the case.

One casualty of this change is the Grantor Retained Income Trust (GRIT), formerly a popular planning tool for same-sex couples due to discounts allowed because same-sex partners were not considered family members. As this no longer is so – and, because of Windsor’s retroactivity – the gift values of past GRITs may change. Although no extra tax would arise because of the availability of the marital deduction, whatever value was left to the gift to the same-sex spouse may have used applicable exclusion

before the Windsor decision. Getting that back may prove difficult, but IRS guidance is expected on this issue.

Tax practitioners need to know their clients and be aware of the issues same-sex married couples face. Practitioners need to carefully review prior returns to see if amending open years will be beneficial and must make sure they file correct returns prospectively. Practitioners also must carefully review their clients’ trusts to ensure income is properly reported. **FCT**

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