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The IRS Formal Guidance Recognizing Same-Sex Marriages Has Benefit and Payroll Implications for Employers

By Judith Wethall, GJ Stillson MacDonnell, and Finn Pressly

After months of speculation, on August 29, 2013, the Internal Revenue Service published formal guidance on the treatment of same-sex spouses under the Internal Revenue Code. In Revenue Ruling 2013-17, the IRS confirmed that a same-sex couple will be considered married for federal tax purposes if the couple was married in any jurisdiction—including a foreign country—that recognizes same-sex marriage.

The new guidance allays concerns that the IRS would choose the more restrictive "domicile rule," which would have excluded couples who reside in states that do not recognize same-sex marriage. Instead, the guidance confers favorable tax treatment for all married same-sex couples, including couples that live in states that do not recognize same-sex marriage.

Though the new guidance goes into effect September 16, 2013, taxpayers have the right to file amended returns for past tax years in accordance with the guidance. For example, if an employee was unable to pay for his/her same-sex spouse's health coverage on a pre-tax basis, the employee may file amended federal income tax returns to recoup income and other taxes paid as a result of the prior tax treatment of the benefits. The IRS also issued detailed FAQ guidance explaining how individuals in same-sex marriages should file their tax returns. The IRS has promised further guidance specifically for employee benefit plans.

Background

When the Defense of Marriage Act (DOMA) was passed in 1996, many lawmakers were concerned that if one state approved same-sex marriage, the "full faith and credit" rule would require all other states to recognize same-sex marriages. To prevent that result, DOMA implemented a two-prong approach at both the state and federal levels. First, at the state level, Section 2 of DOMA created an exception to the full faith and credit rule by allowing states to disregard same-sex marriage certificates issued in other jurisdictions. Meanwhile, Section 3 of DOMA focused on federal legislation, mandating that "marriage" and "spouse," when used in federal law, meant only the union of opposite-sex couples.

The constitutionality of Section 3 of DOMA went before the Supreme Court in *United States v. Windsor*. The case concerned increased estate taxes assessed against the estate of the decedent, who was lawfully married to and survived by her spouse in a same-sex marriage. The couple was

married in Canada in 2007, and the marriage was later recognized as valid under New York law. When one spouse died in 2009, she left her entire estate to the other. However, under DOMA, the surviving spouse and executrix of the estate could not take advantage of the marital exemption from the federal estate tax. The estate paid $363,053 in additional estate taxes, but then petitioned for a refund, challenging the constitutionality of DOMA. While the case was technically an estate tax issue, the breadth of the ruling includes nearly every area of federal law—including federal income taxes, federal payroll taxes, and employee benefit plans.

The Supreme Court sided with the surviving spouse and ruled that Section 3 of DOMA violated the Equal Protection clause of the U.S. Constitution. However, the decision did not affect Section 2 of DOMA (which limits the full faith and credit provisions of the Constitution), and left in place the provisions that allow individual states to recognize, or decline to recognize, same-sex marriages performed in sister states.

Though the decision had far-reaching implications across every area of federal law, it was unclear how the ruling would impact employee benefit plans as well as payroll taxes. Specifically, the decision left open the question of how the federal government would determine whether a couple was legally married. Given the fact that states vary widely in their treatment of same-sex couples, there was no simple answer as to how status would be determined. Some employers and same-sex couples expressed concern that that government would apply the so-called "domicile rule," which would have at looked the law in the couple's current state of residence to determine whether a valid marriage exists. Adding to this concern, the Department of Labor issued guidance under the Family Medical Leave Act (FMLA) in August that reiterated the position it had taken in the regulations that a spouse for purposes of the FMLA is one who is recognized as such under the law in the state in which the employee resides. The Social Security Administration took a similar position in an update it published to its Program Operations Manual System late this summer.

The lack of guidance from the IRS left employers in a two-month holding pattern with respect to fielding questions from employees about their employee benefit plans. On top of that, employers could not implement any changes to plan or payroll tax administration without knowing how to properly tax the benefits or wages for same-sex spouses.

Revenue Ruling 2013-17

On August 29, 2013, the IRS issued Revenue Ruling 2013-17 (along with an FAQ publication) to explain how it would evaluate whether a couple is married for purposes of federal tax law. The IRS opted for a broader interpretation of the status of "marriage." The Revenue Ruling explained that a couple will be considered "married" for federal tax purposes if their certificate was issued by a jurisdiction that at the time recognized same-sex marriage. The IRS position is based on, and consistent with, the long-standing tax recognition of common law marriages—a doctrine that also determines marriage based upon status in the state where the "marriage" was entered into. (Rev. Rul. 58-66). The new ruling means that couples living in states that do not recognize same-sex marriage will still be treated as married for purposes of federal tax law.

While the effective date of the Revenue Ruling is listed as September 16, 2013, some portions of the Revenue Ruling have retroactive effect, particularly with regard to an individual's ability to reverse unfavorable tax treatment afforded to same-sex couples in prior tax years. Until the *Windsor* decision, benefits provided to same-sex couples were considered taxable income to the employee (unless the employee's partner/spouse qualified as the employee's tax dependent). This resulted in additional income imputed to the employee on his/her W-2. Additionally, employees could not pay for a same-sex spouse's/partner's benefits on a pre-tax basis.

Revenue Ruling 2013-17 gives same-sex couples the green light to file amended returns for past tax years to recoup any extra taxes paid as a result of "imputed income." This right extends only to those tax years that are still considered "open"—generally limited currently to 2010, 2011, and 2012. (Certain taxpayers who have signed individual agreements with the IRS may be able to seek refunds for earlier tax years.)

IRS Notes that Civil Unions Will Not be Treated as Marriages

Many states offer marriage-equivalent rights in the form of civil unions. For example, Illinois recognizes civil unions for opposite-sex and same-sex couples. Under Illinois law, civil union partners are guaranteed the same rights as married couples. Other states, like California, provide for registered domestic partnerships as well as marriage for same-sex relationships. Accordingly, some anticipated that all of these relationships, collectively referred to as "Domestic Partnerships," would also be considered "marriages" for tax purposes. However, the IRS opted to recognize only those who legally marry.

Impact on Employee Benefit Plans

While the new Revenue Ruling answers many fundamental questions about the taxation of same-sex benefits, it does not resolve all questions. To that end, the Ruling also noted that the IRS would be issuing future guidance to assist sponsors of employee benefit plans in administering the tax effects of providing benefits same-sex couples.

In the meantime, employers should review their benefit plan design and plan documents to determine whether they are ready to implement the new definition "spouse" as of September 16. As we have previously discussed,[1] the definition of "spouse" affects nearly every facet of employee benefit plan administration, including:

- Qualified Retirement Plans—A "spouse" for purposes of qualified plan distribution options now includes a same-sex spouse. Plan administrators should also be aware that the spousal consent rules for certain distribution options will apply with equal force to same-sex couples.
- COBRA—Same-sex spouses must be given the opportunity to elect to continue their group health plan coverage after a loss of coverage due to a qualifying event. While many employers that offered coverage to domestic partners and same-sex spouses pre-*Windsor* offered COBRA-equivalent benefits, some did not. Now, a same-sex spouse can be considered a "qualified beneficiary" under COBRA, which means that he/she must be provided formal COBRA notices and the opportunity to continue health coverage after a COBRA "qualifying event."
- HIPAA—The special enrollment rules for newly acquired spouses now extend to new same-sex spouses. It remains unclear whether the Supreme Court's decision (or Revenue Ruling 2013-17) should be considered a special enrollment event.
- Flexible Spending Accounts—Both health FSAs and dependent care FSAs will use the new definition of "spouse" to determine whether expenses are reimbursable from an employee's account.
- Health Savings Accounts (HSAs)—The annual contribution limits for married couples now apply to same-sex couples.

Impact on Payroll Taxes

The Revenue Ruling has implications that are both retroactive and prospective for federal tax purposes, and it creates new tensions between state and federal payroll tax laws.

For the purposes of a retroactive tax "correction" at the federal level, an employee can seek a refund of overpaid federal income or other taxes by filing an amended return within the period open for statute of limitation purposes. For most individuals, this will be tax years 2010 and forward. Such married individuals need not file amended returns, but as of September 16, 2013, they will be considered married for federal tax purposes for the entire year. On a prospective basis, they generally will have to file as a "married couple." For high, dual-income couples, this change will likely expose them to the "marriage penalty" faced by opposite-sex couples.

While individuals who have entered into a domestic partnership, civil union or a similar relationship will not be considered to be married for federal tax purposes, like any other same-sex couple, they can marry in any jurisdiction that allows same-sex marriages. If they do so, they will be treated by the IRS as being married. If an employee who has been receiving same-sex benefits—but not because of a recognized marriage—does not now marry, then any benefits provided by the employer will continue to be taxable for federal—and likely state tax—purposes.

The position of the IRS may create some conflicts in states that have state or local income taxes that provide for such taxes to follow the same rules as the rules in the Internal Revenue Code. Since most states do not currently recognize same-sex marriages, absent conforming legislation or pro-active litigation in those states, it is likely that an employee residing in states where same-sex marriage is currently prohibited or not otherwise recognized, will need to file separate state tax returns in those states and will continue to be considered single for payroll tax and state law benefit purposes.

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1 *See* Susan Hoffman, Joni Andrioff, and Finn Pressly, *Same-Sex Marriages and Benefit Plans After Windsor*, Littler Insight (Jul. 9, 2013)

The IRS has indicated that as to Income, Social Security and Medicare (FICA) taxes (the latter is paid by both employers and employees) during the open tax years (generally 2010 to now) an employer and employee can—but are not required to—seek refunds on taxes paid. Employers cannot recoup refunds on income taxes other than for the current year, but both employers and employees can recoup refunds on the FICA taxes paid in open years. The IRS indicated that it will be issuing further guidance on the refund process. Depending on how states react to the IRS position, a state may also allow for non-income tax refunds at the state level.

From an employer's perspective, if an employee seeks and receives a refund, the employer may be required to issue an IRS form W-2c reflecting the change/correction in the reportable federal wages and taxes paid.

For the 2013 tax year, the IRS has authorized employers to make in-year adjustments with respect to income and other taxes (FICA), both prospectively and retroactively.

The Revenue Ruling does not become effective until September 16. Consequently, if an employer and an employee want to align withheld taxes with actual liability for 2013, there is little time left in the year to make meaningful payroll tax changes for the calendar year.

The income tax withholding level is generally set through an employee completing and updating, as appropriate, an IRS form W-4. States also typically accept the W-4 form for state withholding purposes. Since marital status is included on the IRS W-4 form, individuals who are married for federal tax purposes now or in the future should update their W-4 exemptions to reflect their marital status. It remains to be seen how states that do not recognize such marriages will react to this IRS interpretation. It is very likely that many will no longer accept IRS form W-4 and will require the use of the state's form for setting state level (and in some cases local level) withholding, thus complicating the income tax withholding process.

Recommendations for Employers

Employers should conduct a general review of their new hire paperwork, open enrollment process, and other related employee paperwork to use gender-neutral language when soliciting spousal information.

Employers should develop administrative practices and a communication plan to potentially solicit employees who have entered in to a same-sex marriage to disclose such relationships so that proper adjustments can be made for not only benefit purposes but also tax reporting purposes.

Employers may want to evaluate whether to continue to offer health care benefits to unmarried same-sex and opposite-sex domestic partners in light of the fact that the IRS will now recognize both opposite-sex and same-sex marriages regardless of where the employee lives. After finalizing their eligibility rules, employers should perform a thorough review of their plan documents to confirm that their use of the word "spouse" properly reflects their intended eligibility design.

Similarly, employers who have grossed-up wages of employees who obtain health care coverage for their domestic partners should consider whether or not to continue such practices.

Employers should review their year-end open enrollment packages and coordinate with any third party administrators to ensure that their plans are modified appropriately in light of *Windsor* and this Revenue Ruling and anticipated additional 2013 Rulings. This review should include reexamination of ERISA and other plan documents as well as plan administration including, but hardly limited to, benefits distribution and COBRA.

Employers also should assess whether to seek tax refunds for FICA taxes payments previously paid on benefits provided to same-sex spouses.

Finally, employers should continue to watch for additional guidance from the IRS on how it will handle other issues related to the taxation of same-sex spouses in light of the *Windsor* decision.

GJ Stillson MacDonnell is a Shareholder in Littler Mendelson's San Francisco office, Judith Wethall is a Shareholder in the Chicago office, and Finn Pressly is an Associate in the Chicago office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, or Ms. MacDonnell at gjmacdonell@littler.com, Ms. Wethall at jwethall@littler.com, or Mr. Pressly at fpressly@littler.com.