Estate Planning After DOMA

By Jennifer A. Birchfield

On June 26, 2013, the United States Supreme Court issued decisions in Windsor v. United States and Hollingsworth v. Perry, two landmark cases regarding government recognition of same-sex marriage.

In Windsor, the Court struck down Section 3 of the Defense of Marriage Act ("DOMA") as an unconstitutional deprivation of personal liberty. Section 3 of DOMA provided that, for purposes of federal law, the term "marriage" refers to opposite-sex marriage only. The majority decision noted that (i) the ability to regulate state recognition of civil marriage is central to each state's domestic relations law and (ii) Section 3 of DOMA impermissibly created two classes of married couples within states that recognize same-sex marriage ("recognition states") by depriving same-sex spouses of the federal benefits bestowed on opposite-sex spouses. As a result of this decision, the same federal benefits will be granted to both opposite-sex and same-sex spouses in all recognition states. It should be noted, however, that the case did not address the constitutionality of Section 2 of DOMA. Section 2 provides that states may choose to deny legal recognition to same-sex spouses married outside of such state. Within states that choose to exercise their Section 2 right not to recognize same-sex marriage, it is unclear what federal benefits same-sex spouses may receive (more on this below).

The Hollingsworth case hinged on a procedural issue with the Court ultimately deciding that the appellants (proponents of California's Proposition 8) did not have standing to bring suit on behalf of the State of California. The Court's decision left in place a lower court's ruling that Proposition 8's constitutional bar on same-sex marriage violated the federal due process and equal protection clauses. As the Court did not address the constitutionality of same-sex marriage bans and the lower court's decision applies to intrastate matters only, this case changes little outside the State of California but may constitute a harbinger of things to come.

This Client Alert explains the estate planning opportunities available to same-sex couples in D.C., Maryland, and Virginia in the wake of Windsor and Hollingsworth. Please call us to discuss whether these suggestions would be useful in your situation.

1. Federal Estate and Gift Tax Planning Opportunities.[1]

    a. *Use of Marital Deduction for Gift and Estate Tax Purposes.* The most obvious transfer tax benefit provided by Windsor to same-sex spouses residing in recognition states is use

[1] In 2013, every individual may give away $5.25 million (the "exclusion amount") free of federal gift and estate tax during such individual's lifetime or at death. This exclusion amount is indexed for inflation for future years. Transfers in excess of this amount are subject to a 40% tax rate.

of the unlimited marital deduction to shelter assets from federal gift tax for transfers during lifetime and estate tax for transfers upon death.[2]

Gift Tax Planning: Prior to Windsor, transfers between same-sex spouses in excess of the annual gift tax exclusion amount (currently, $14,000 per donee) were subject to federal gift tax. This includes property purchased (such as real estate) or contributed (such as checking account funds) by one spouse and transferred into the joint names of both spouses, with one-half of such property being deemed a taxable gift to the non-purchasing or non-contributing spouse. Now, however, such transfers between same-sex spouses residing in a recognition state may be made free of federal gift tax. As such, same-sex spouses should consider the benefits provided by certain forms of joint property ownership without fear of triggering a gift tax.[3] Additionally, same-sex spouses in recognition states may elect on their federal gift tax returns to treat gifts made by one spouse to a third party as coming one-half from each spouse for gift tax purposes, thereby using both spouses' ability to make annual exclusion gifts.

Estate Tax Planning: Same-sex spouses residing in a recognition state may also implement the same estate planning structures as opposite-sex couples with respect to the federal estate tax.[4] Such spouses may transfer property outright to a surviving spouse or to a specially structured trust for such spouse's benefit (a "marital trust") and rely on the marital deduction to shelter the transferred assets from federal estate tax until the surviving spouse's death.

b. *Use of Portability Planning.* In addition to passing assets estate tax-free to a surviving spouse, same-sex spouses residing in recognition states post-Windsor may take advantage of the "portability concept" first effective under federal law in 2011 and made permanent in 2013. Under current law, a deceased spouse's personal representative may make a portability election on the deceased spouse's federal estate tax return to transfer any unused portion of the deceased spouse's exclusion amount to the surviving spouse. For more detail on the income and estate tax benefits of portability, see our Tax Planning Updates entitled Estate Tax Planning in 2013, Portability – Immediate Action Items, and Portability, By-Pass Trusts, and Special By-Pass Trusts.[5]

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[2] Please note that the unlimited marital deduction does not apply to lifetime transfers to a non-U.S. citizen spouse and will only apply to post-mortem transfers to a non-U.S. citizen spouse if the property is held in a qualified domestic trust for such spouse's benefit.

[3] For example, if spouses hold property as tenants-by-the-entirety, in most situations a creditor of only one spouse may not force the partition and sale of the property without the consent of the other spouse.

[4] The facts underlying Windsor focus on this exact issue. Edie Windsor and her late spouse, Thea Spyer, were married in Canada in 2007 and resided in New York City until Ms. Spyer's death in 2009. When Ms. Windsor attempted to claim the marital deduction on Ms. Spyer's federal estate tax return, the Internal Revenue Service denied the claim, as DOMA barred federal recognition of Ms. Windsor and Ms. Spyer's state-recognized marriage. Ms. Windsor then filed suit on the basis that the federal government's denial of her spousal status violated Ms. Windsor's constitutional right to equal protection. As a result of the Supreme Court's decision in Windsor, Ms. Windsor was granted a refund for the taxes paid due to her inability to use the marital deduction.

[5] These Updates were written when the law was unclear regarding the benefits same-sex spouses could derive from portability. Following Windsor, the benefits afforded by portability are available to same-sex spouses residing in recognition states.

c. *Tax Refunds for Returns Filed within the Past Three Years*. But what about those same-sex spouses who paid federal estate or gift tax on interspousal transfers due to the non-recognition of their marriage under DOMA? If the estate or gift tax return was filed within the past three years, these individuals should file an amended estate or gift tax return to claim any available refund. For those individuals who filed a return more than three years ago, it is unclear whether a refund will be barred by the three-year statute of limitations that applies to federal estate and gift tax returns. Further guidance on this matter is expected from the Internal Revenue Service in the near future.

2. State Estate Tax Opportunities in D.C. and Maryland. Prior to Windsor, D.C. recognized a state estate tax marital deduction for assets distributed outright to a same-sex spouse. [6] However, as D.C. relied on federal rules to determine whether a marital trust qualified for the marital deduction for state estate tax purposes, all assets transferred to a marital trust for a surviving same-sex spouse were subject to D.C. estate tax. Under Maryland law, same-sex spouses were barred from using the marital deduction in any form until the amendment of Section 7-309(b) of the Maryland Code earlier this year. As a result of such amendment, same-sex spouses may receive the marital deduction for outright distributions to a surviving spouse and those made to a marital trust for the surviving spouse's benefit. With the repeal of Section 3 of DOMA, both D.C. and Maryland now will provide the same planning benefits to same-sex spouses. This will enable same-sex spouses to avoid payment of any state estate tax until the death of the surviving spouse by relying on the marital deduction to eliminate estate tax on transfers to a surviving spouse upon the first spouse's death. Additionally, this may permit the surviving spouse to avoid payment of state estate tax altogether by moving to a state that does not impose a state estate tax.[7]

3. Virginia – The Odd Man Out. As Virginia's constitution currently forbids the recognition of same-sex marriage within the state, it is unclear what federal benefits same-sex spouses living in Virginia may receive. Many commentators argue that, given the continued validity of a marriage performed in a recognition state during any period in which the couple resides in a non-recognition state, federal benefits must apply to all couples married in a recognition state, regardless of their state of residence. For example, if a same-sex couple were married in Maryland but later moved to Virginia, their time in Virginia would not invalidate their marriage and, thus, they should continue to receive any federal benefits granted to married couples. The executive branch is expected to act in the near future to resolve the uncertainty regarding federal benefits available to same-sex spouses in non-recognition states.

   Additionally, federal courts in several states are currently exploring constitutional attacks to a non-recognition state's ability to deny legal recognition to out-of-state same-sex marriages and state bans on same-sex marriage in their entirety. For example, a District Court in Ohio recently held that failing to recognize a same-sex marriage performed in a recognition state on the basis of Ohio's bar against same-sex marriage deprived such same-sex spouses of their constitutional right to equal protection under the law.[8] In Michigan, a District Court

[6] Currently, both D.C. and Maryland impose a state estate tax on estates above $1 million.

[7] Virginia seems the most obvious option, since it does not have a state estate tax. However, Virginia's current constitutional ban on same-sex marriage and the resulting tax effects should be considered.

[8] In Obergefell v. Kasich, the U.S. District Court for the Southern District of Ohio Western Division held that Ohio violated the constitutional rights of a same-sex couple married in Maryland but living in Cincinnati when it broke from a long history of recognizing out-of-state marriages due to the sexual orientation of the spouses. No. 1:13-cv-501, 2013

denied the state's request to dismiss an action challenging the constitutionality of Michigan's prohibition against joint adoption by same-sex couples and same-sex marriage.[9] In Pennsylvania, ten same-sex couples, a widow, and two children of one of the plaintiff couples filed suit against Governor Thomas W. Corbett and various other state officials for enforcing the state's DOMA law.[10] Three days later, the Pennsylvania Attorney General Kathleen G. Kane announced that she would not defend the law due to her belief that the law violates both the U.S. and Pennsylvania Constitution.[11] Given the flurry of activity regarding this issue, it is unclear if Virginia's constitutional ban on same-sex marriage will remain in effect. In the meantime, we suggest that same-sex spouses residing in Virginia adopt estate plans that address both the possibility of recognition and non-recognition of their marriage for federal tax purposes.

If you have any questions about these suggestions, please contact one of our lawyers.

VIRGINIA A. McARTHUR bio
vmcarthur@mcarthurlaw.com

RICHARD S. FRANKLIN bio
rfranklin@mcarthurlaw.com

MOLLY B.F. WALLS bio
mwalls@mcarthurlaw.com

JENNIFER A. BIRCHFIELD bio
jbirchfield@mcarthurlaw.com

U.S. Dist. Lexis 102077 (S.D. Ohio July 22, 2013). The District Court reasoned that the state treated opposite-sex out-of-state marriages differently from same-sex out-of-state marriages to impose inequality on same-sex couples and, without a legitimate state purpose to support such suspect treatment, this disparate treatment proved unconstitutional. Given Virginia's recognition of certain out-of-state marriages (e.g., recognition of common law marriages valid under the law of the state in which the relationship was created), could a similar argument be far behind for Virginia courts?

[9] Deboer v. Snyder, No. 12-cv-10285, 2013 U.S. Dist. LEXIS 98382 (E.D. Mich. July 1, 2013).

[10] Whitewood v. Corbett, No. _____ (M.D. Pa. filed on July 8, 2013).

[11] Attorney General Kane will not defend DOMA, Pennsylvania Office of Attorney General, http://www.attorneygeneral.gov/press.aspx?id=7043 (last visited July 31, 2013).