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Estate Planning Opportunities Arising from Recent Landmark Supreme Court Decisions Concerning Marriages of Same-Sex Couples

On June 26, 2013, the US Supreme Court (the "Supreme Court") struck down Section 3 of the federal Defense of Marriage Act (DOMA) as unconstitutional in the case of *United States v. Windsor* ("*Windsor*"). In a related case, the Supreme Court also dismissed an appeal from the federal district court ruling that struck down California's Proposition 8 (which overturned marriages of same-sex couples in California) as unconstitutional in the case of *Hollingsworth v. Perry* ("*Perry*"), leaving intact the district court's ruling that Proposition 8 is unconstitutional and cannot be enforced. This advisory summarizes the estate and income tax planning opportunities and other topics for consideration arising from the *Windsor* and *Perry* decisions. Married same-sex couples should consult with their advisors in light of their particular facts and circumstances in order to take maximum advantage of the change in the law. Unmarried same-sex couples should now consider whether to marry.

In *Windsor*, Edith Windsor and Thea Spyer, a same-sex couple, were married in Canada in 2007 after having been together in New York for over forty years. New York law did not permit marriages between same-sex couples at the time but recognized marriages of same-sex couples performed in other jurisdictions. Spyer died in 2009, and Windsor inherited all of Spyer's estate as Spyer's surviving spouse. However, because of DOMA, which defines "marriage" as "a legal union between one man and one woman as husband and wife" and "spouse" as "a person of the opposite sex who is a husband or a wife", the federal government refused to recognize the couple's marriage for federal estate tax purposes. As a result, Windsor's inheritance from Spyer was not entitled to the unlimited marital deduction from federal estate tax that would have been available had Windsor and Spyer's marriage been recognized by the federal government. After paying the estate taxes owed on her inheritance as a result of DOMA, Windsor sued for a refund of the estate taxes on the grounds that DOMA unconstitutionally discriminated against same-sex married couples. Windsor prevailed in the US District Court for the Southern District of New York and also in the US Court of Appeals for the Second Circuit. The Supreme Court has now agreed with Windsor, holding that "DOMA seeks to injure the very class [of married same-sex couples] New York seeks to protect. By doing so it violates basic due process and equal protection principles applicable to the Federal Government." The Supreme Court further explained that DOMA's "demonstrated purpose is to ensure that if any State decides to recognize same-sex marriages, those unions will be treated as second-class marriages for purposes of federal law."

In *Perry*, two same-sex couples wished to become married in California. Though the California Supreme Court held in 2008 that the California Constitution required the State of California to recognize marriages of same-sex couples, California voters passed Proposition 8 later the same year, amending the California Constitution to provide that only "marriage between a man and a woman is valid and recognized in California." As a result of Proposition 8's passage, the two couples were unable to marry. They sued the California governor, attorney general and various other state and local officials responsible for enforcing California's marriage laws (the "California officials"), claiming that Proposition 8 violated their rights to due process and equal protection under the US Constitution. In the US District Court for the Northern District of California (the "district court"), the California officials refused to defend Proposition 8, but the private parties who were the proponents of Proposition 8 (the "Proposition 8 proponents") successfully intervened to defend the measure. After the district court held that Proposition 8 was unconstitutional, the California officials declined to appeal the decision and the Proposition 8 proponents appealed. The US Court of Appeals for the Ninth Circuit upheld the district court's ruling that Proposition 8 was unconstitutional. The Supreme Court dismissed the appeal from the district court on the grounds that the Proposition 8 proponents lacked standing to appeal because they were

merely private parties and were not properly authorized under state law to defend the constitutionality of Proposition 8. As a result of the Supreme Court's ruling, the district court's ruling that Proposition 8 is unconstitutional remains in place and California soon will be required to permit same-sex couples to marry. As a result of the *Windsor* decision, such marriages also will be entitled to federal recognition.

Estate Planning Opportunities Arising from *Windsor*

The Supreme Court's ruling in *Windsor* requires the federal government to recognize marriages of same-sex couples. Note, however, that the Supreme Court limited the scope of its decision to "lawful marriages". Therefore, the decision likely will not be interpreted to require the federal government to recognize so-called "marriage equivalent" status that is not actually "marriage" under state law, i.e., civil unions, domestic partnerships and registered domestic partnerships. The District of Columbia and thirteen states permit marriages of same-sex couples. Those states are California (effective once the stay issued by the Ninth Circuit is lifted pursuant to the *Perry* decision, which is likely to be imminent), Connecticut, Delaware (effective July 1, 2013), Iowa, Maine, Maryland, Massachusetts, Minnesota (effective August 1, 2013), New Hampshire, New York, Rhode Island (effective August 1, 2013), Vermont and Washington.

Another unresolved issue is whether the Supreme Court's decision applies to married same-sex couples who lawfully married in a jurisdiction that permits marriages of same-sex couples (e.g., New York), but who are domiciled and/or resident in a state that does not permit or recognize such marriages (e.g., Texas). Accordingly, until these issues are resolved as a result of subsequent litigation, legislation and/or regulation, it is not clear whether *Windsor* will be interpreted also to apply to same-sex couples with a marriage-equivalent status (but not marriage) or married same-sex couples who are domiciled and/or resident in a state that does not permit and/or recognize marriages of same-sex couples.

Against that background, at a minimum, married same-sex couples domiciled and/or resident in states that permit and/or recognize marriages of same-sex couples likely will be entitled to the more than 1,000 benefits available to married opposite-sex couples under federal law. Some of those 1,000 benefits present immediate estate planning opportunities, including the following:

1. *Review estate planning documents to ensure that the amount and structure of any spousal bequests remain appropriate.*

Federal recognition of marriages of same-sex couples leads to the availability of the unlimited marital deduction from federal estate tax and gift tax for transfers between same-sex spouses. Existing estate planning documents may have been drafted with the assumption that any gift or bequest to a spouse of the same sex over and above the individual's applicable exclusion amount from federal estate tax and/or federal gift tax (the "Applicable Exclusion Amount" —currently $5,250,000, adjusted annually for inflation) would be subject to federal estate tax (currently at a maximum rate of 40%). However, that assumption is no longer true. Indeed, such gifts and bequests, if properly structured, are now entitled to the unlimited marital deduction. In addition, under the so-called "portability" provisions of federal gift and estate tax laws, under certain circumstances a surviving spouse of the same sex will also be entitled to use any portion of the deceased spouse's unused Applicable Exclusion Amount (the "DSUE"), allowing the surviving spouse to make additional tax-free gifts and/or reduce the amount of estate taxes owed upon the surviving spouse's death (note, however, that DSUE does not increase the surviving spouse's applicable exemption from the federal generation-skipping transfer tax ("Federal GST Exemption")). Accordingly, a married same-sex couple may wish to modify their estate planning documents to provide that any assets included in their estates in excess of the Applicable Exclusion Amounts will pass to the surviving spouse, either outright or in a properly structured marital trust for the spouse's benefit, thus deferring all federal estate taxes until the death of the surviving spouse.

Estate planning documents may also be revised, if appropriate, to include a separate marital trust that is designed to permit a spouse to use any of the individual's unused Federal GST Exemption that remains after the individual's death.

2. *Review retirement account beneficiary designations and joint and survivor annuity elections to ensure that they remain appropriate.*

A surviving spouse is entitled to roll over a decedent spouse's retirement account into the surviving spouse's retirement account without being required to take minimum distributions or lump sum distributions until such time as the surviving spouse ordinarily would be required to take minimum distributions (usually upon reaching age 70½). As a result of the *Windsor* decision, this benefit is now available to married same-sex couples. Accordingly, married same-sex spouses should consider naming each other as the beneficiary of his or her retirement accounts in order to defer income tax on the rolled over retirement account as long as possible.

With regard to any retirement plans that are covered by the Employee Retirement Income Security Act of 1974 (ERISA), the spouse of a participant in such a plan may automatically be a beneficiary of the retirement plan as a result of the *Windsor* decision. Accordingly, if a participant in an ERISA-covered plan (e.g., a 401(k) plan) wishes to designate someone other than his or her spouse as a beneficiary, such participant will need to obtain the consent of his or her spouse to make such a designation effective. Prior to *Windsor*, consent was not needed from a spouse of the same sex. However, after *Windsor*, such consent is now required. Separately, if a participant previously made an election to waive joint and survivor annuity benefits after the date of the marriage, the participant may be able to make a new election at this time, and a new election may be required in order to be valid if the marriage is newly recognized under *Windsor*.

3. *Consider replacing individual life insurance policies with survivor policies.*

Many same-sex spouses previously purchased individual life insurance policies of which the other spouse is the beneficiary (either directly via beneficiary designation or indirectly through a life insurance trust) in order to provide the surviving spouse with sufficient liquid assets that may be used to pay federal estate taxes due upon the death of the first to die. With the unlimited marital deduction and DSUE now available to married same-sex couples, as explained above, there may be little or no need for such liquidity upon the death of the first spouse to die. Thus, a married same-sex couple should consider replacing such individual policies with so-called "survivor" or "second-to-die" policies that pay benefits only upon the death of the surviving spouse. Such policies will still provide liquidity to children or other beneficiaries of the married same-sex couple and are generally less expensive than individual policies having the same death benefits.

4. *Consider splitting gifts between spouses.*

Until now, each spouse could make gifts only up to the annual exclusion amount from federal gift tax and/or federal generation-skipping transfer tax (the "Annual Gift Tax Exclusion Amount" and the "Annual GST Exclusion Amount", respectively—each currently $14,000) without using any portion of his or her Applicable Exclusion Amount. Going forward, however, each spouse may now make gifts from his or her own assets and, with the other spouse's consent, have such gifts deemed to have been made one-half by the other spouse for purposes of federal gift tax and GST tax laws. Both spouses acting together in this way currently may give up to $28,000 to any individual without using any portion of either spouse's Applicable Exclusion Amount (note that the Annual GST Exclusion Amount does not always apply to gifts made in trust).

5. *Amend previously filed federal estate, gift and income tax returns and/or file protective claims as appropriate.*

Gifts made to spouses. If one spouse previously made taxable gifts to the other spouse and reduced the donor's Applicable Exclusion Amount by the amount that the gift exceeded the Annual Gift Tax Exclusion Amount and/or the donor's Federal GST Exemption by the amount that the gift exceeded the Annual GST Tax Exclusion Amount, it may be possible to amend the donor's prior gift tax returns (subject to the limitations period discussed below) and retroactively claim the marital deduction for the gifts made in those years, thus increasing the donor's Applicable Exclusion Amount and/or reclaim the Federal GST Exemption used. By doing so, the donor may make additional tax-free gifts and/or reduce federal estate and/or GST taxes due upon his or her death. Similarly, any gift taxes or GST taxes actually paid may be refundable.

Gifts made to third parties. To the extent that either spouse previously used a portion of his or her Applicable Exclusion Amount and/or paid gift taxes or GST taxes by making gifts to third parties over and above his or her Annual Gift Tax

Exclusion Amount and/or Annual GST Exclusion Amount, it may be possible to amend prior federal gift tax returns in order to retroactively split such gifts with the other spouse, thus increasing the donor's Applicable Exclusion Amount and/or Federal GST Exemption. Again, doing so will allow the donor to make additional tax-free gifts and/or reduce federal estate taxes and GST taxes due upon the donor's death. Similarly, any gift or GST taxes actually paid may be refundable.

Inheritances from decedent spouses. In cases where a decedent spouse's estate paid federal estate taxes on assets that were inherited by a surviving spouse of the same sex, it may be possible to amend the decedent spouse's federal estate tax return (subject to the limitations period discussed below) and retroactively claim a refund for the estate taxes paid. If the decedent spouse's estate did not pay estate taxes and he or she died in 2010 or a subsequent year, under the portability provisions of federal estate tax laws, the surviving spouse may be able to claim the deceased spouse's DSUE, thus allowing the surviving spouse to make additional tax-free gifts and/or reduce the amount of estate taxes owed upon the surviving spouse's death (note, however, that DSUE does not increase the surviving spouse's Federal GST Exemption).

Income taxes. Both spouses may also amend prior year income tax returns to change their filing status from single to married filing jointly and obtain a refund if the amount of tax owed based on their married filing status is less than that owed based on their prior single status.

Retroactivity. The extent to which married same-sex couples will be allowed to amend prior tax returns depends on the extent to which *Windsor* is applied retroactively and whether the applicable limitations period has passed with regard to each tax return (i.e., ordinarily three years from the date the tax return was originally due or filed (if on extension) or two years from the date the tax was paid, whichever is later). For example, it may no longer be possible to amend a 2009 individual income tax return due on April 15, 2010, that was not put on extension, but individual income tax returns for 2010, 2011 and 2012 likely may be amended. That said, it is conceivable that the Internal Revenue Service (IRS) will permit amendments as far back as the year of the marriage on the basis that neither spouse lawfully could have amended his or her tax returns prior to the *Windsor* decision. In either case, it will take some time for the IRS to develop policies and procedures to implement *Windsor*, and amended returns should be filed in accordance with applicable published guidance from the IRS, if available. In any situation where the limitations period is about to expire for a particular tax return, a married same-sex couple should consider filing a protective claim for a refund with the IRS in order to preserve the ability to obtain such a refund after the IRS has provided a means to amend the return.

6. *Reside in a state that permits and/or recognizes marriages of same-sex couples.*

If a married same-sex couple was lawfully married in a jurisdiction that permitted the marriage but now reside in a state that does not permit and/or recognize the marriage, that couple should consider moving to a state that either permits marriages of same-sex couples or recognizes such marriages lawfully performed in other states if they wish to be certain to enjoy the federal benefits now potentially accorded to marriages of same-sex couples.

7. *Non-citizen spouses should consider seeking permanent residency and/or becoming citizens.*

Until now, non-citizen spouses were not eligible for citizenship or permanent residency on the basis of their marriage to a spouse of the same sex who was a US citizen. As a result of the *Windsor* decision, however, non-citizens may be eligible for permanent residency and/or citizenship on that basis. Though there are many benefits to becoming a permanent resident or citizen, there are also numerous tax and non-tax consequences that should be carefully considered before making such an important decision.

Estate Planning Opportunities Arising from *Perry*

California will now be required to permit marriages of same-sex couples, but other states that do not permit and/or recognize marriages of same-sex couples will not be required to do so. California married same-sex couples will enjoy all of the benefits available to married couples under federal law and thus should consider the above recommendations. In addition, married same-sex couples in California should consider the following recommendations:

1. *Amend previously filed California income tax returns and/or file protective claims as appropriate.*

Married same-sex couples may be permitted to amend prior year California income tax returns to change their filing status and obtain a refund for any income taxes that were overpaid. Note that the normal limitations period for amending California returns expires four years after the original due date of the return (or the actual filing date if the return was put on extension) or one year from the date the tax was paid, whichever occurs later. If the limitations period for any particular tax return is about to expire, a married same-sex couple should consider filing a protective claim for a refund until such time as the State of California provides appropriate guidance for amending prior returns. Note that, as discussed above with regard to the limitations period for federal tax returns, it is conceivable that a married same-sex couple may be permitted to amend their returns through the first year of their marriage.

2. *Amend previously filed tax returns and/or file protective claims with other states as appropriate.*

Married same-sex couples may also be entitled to amend prior gift tax and/or estate tax returns filed with other states that recognized marriage but not marriage equivalents (e.g., California registered domestic partnerships) at the time in question and receive a refund of taxes paid and/or reclaim any state gift tax and/or estate tax exemption. Again, the limitations period (if one applies) for amending such returns will vary by state. If the limitations period for any particular tax return is about to expire, a married same-sex couple should consider filing a protective claim for a refund until such time as the state provides appropriate guidance for amending prior returns.

We Can Help

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any member of Katten's Trusts and Estates practice.

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