Tax Practice Issues with DOMA

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Last year, the U.S. Supreme Court repealed Section 3 of the Federal "Defense of Marriage Act" (DOMA) in United States v. Windsor, 133 S. Ct. 2675 (2013). Since then, the IRS issued guidance including Revenue Ruling 2013-17, Notice 2013-61, Notice 2014-19 and a set of FAQs concerning a wide variety of federal tax issues relating to same-sex couples. Although Florida currently does not issue marriage licenses to same-sex couples or recognize same-sex marriages performed in other states, Florida CPAs will be called upon to address issues related to same-sex married couples. This article will highlight some hot spots for CPAs who provide income, estate and gift tax issues to consider.

Section 3 of DOMA provided that "the word 'marriage' means only a legal union between one man and one woman as husband and wife, a 'spouse' refers only to a person of the opposite sex who is a husband or a wife." All federal agencies were required to follow DOMA and all federal laws and regulations involving spouses only applied to heterosexual couples. After Windsor, federal agencies began to issue new guidance to determine how the term "spouse" would be defined in specific circumstances.

On September 16, 2013, the IRS published Revenue Ruling 2013-17. The ruling provides that, with regard to the more than two hundred (200) Internal Revenue Code provisions and Regulation sections concerning spouses and marriage, those terms will be applied in a gender-neutral way. In order to do so, the IRS adopted a "state of celebration" rule which "recognizes the validity of a same-sex marriage that was valid in the state where it was entered into, regardless of the married couple's place of domicile." This means that if a same-sex couple is validly married in California, they are married for Federal tax purposes without exception.

Impact on Federal Taxes

There are many Federal tax provisions impacted by the repeal of Section 3 of DOMA and, unfortunately, this article can only discuss a few of them. Therefore, the ultimate takeaway for a CPA providing tax advice or compliance services is to pause whenever dealing with a provision addressing spouses and make to thoroughly analyze the issues and facts at hand.

Income Taxes

The most obvious income tax issue presented by the repeal of Section 3 of DOMA is the filing status of taxpayers. If taxpayers were validly married, then they are not single…even if Florida does not recognize their marriage. Accordingly, same-sex spouses are treated exactly the same as all opposite-sex spouses. Thus, they must file as married (either jointly or separately) or as a surviving spouse in the case of death. Rev. Rul. 2013-17 permits, but does not require, same-sex spouses to file amended income returns for their open tax years. CPAs need to analyze open years to determine if their clients can obtain a refund.

Another income tax related issue is the tax treatment of trusts. The key issue here is that trusts are grantor-owned trusts based upon the facts of any specific situation. Grantor trust status is not elective. The use of irrevocable trusts is a common estate planning technique for same-sex

couples. CPAs need to carefully review the terms of trusts established by same-sex spouses prior to their marriage to determine the nature of the trust.

Typically such trusts were taxed as complex trusts, unless S corporation stock was involved. This means that the trust or the beneficiary of the trust bears the income tax liability associated with the trust. However, if the beneficiary and grantor are now married, the trust may be a grantor-owned trust, thus shifting the tax burden from the trust or the beneficiary to the grantor. CPAs need to make sure that the right taxpayer bears the tax liability.

Another issue with trusts concerns S corporations. In order for a trust to be a permitted shareholder of an S corporation, the trust must either be a (i) grantor owned trust; (ii) a Qualifying Subchapter S Trust ("QSST"); or (iii) an Electing Small Business Trust ("ESBT"). The grantor trust rules take priority over ESBT and QSST elections. This is true even for trusts that were not initially grantor-owned trusts – such trusts can become grantor owned trusts at any time. When a shift in status occurs, the taxpayer who is allocated items of income from the S corporation also changes. Therefore, CPAs representing trustees and/or representing S corporations need to carefully review trusts holding S corporation stock to determine the status of the trust and identify who needs to receive a Schedule K-1.

Gift, Estate and GST Taxes

The state of celebration rule also applies to transfer taxes. Gifts or devises to same-sex spouses qualify for the unlimited marital deduction and same-sex spouses can elect to split their gifts. CPAs need to carefully review prior gift and estate tax returns to determine if they needed to be amended or supplemented in order to obtain a refund, take advantage of the Deceased Spouse Unused Exemption amount, or make sure their clients are efficiently using their unified credits.

Know Your Client

CPAs need make sure they ask the right questions to determine if their client is married, regardless of their spouse's gender. CPAs should review their annual tax questionnaires and client intake forms to elicit the necessary information. They should consider an educational outreach (newsletter or blog article) to clients educating them on the change in the law. Once a CPA knows that a client is in a same-sex marriage, the CPA will need to gather more facts in order to analyze open tax years. In the end, the fundamental rule of all tax professionals applies to same-sex spouses: know your client.