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Personal Planning Strategies

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Estate Planning Opportunities in a World Without DOMA

On June 26, 2013, the United States Supreme Court issued its decisions in *Windsor v. United States and Hollingsworth, et. al. v. Perry et. al.*, thus ending a four year "fast-track" judicial expedition of the validity of the federal "Defense of Marriage Act," or "DOMA," and the comparable state law statutes and constitutional provisions. This newsletter summarizes both cases, the Supreme Court's decisions, and the federal and state law effect with respect to estate planning for same-sex married couples.

Windsor v. United States

Edie Windsor met her late-spouse, Thea Spyer, in New York City in 1963; thereafter, Windsor and Spyer entered into a committed relationship and lived together in New York for over 40 years. In 1993, when the option became available, Windsor and Spyer registered as domestic partners in New York City. In 2007, as Spyer's health began to deteriorate due to her multiple sclerosis and heart condition, Windsor and Spyer traveled to Canada, where same-sex marriage was legal, and married. At that time, New York did not allow same-sex marriages to be performed within the state but did recognize those performed legally in other jurisdictions.

Spyer died in 2009, leaving her estate to Windsor and naming Windsor as executor. Windsor filed Spyer's federal estate tax return claiming a marital deduction for Spyer's property passing to Windsor. The marital deduction shields property passing outright to a spouse, or to a trust (known as a "QTIP" trust) for the benefit of a spouse, from estate tax. The Internal Revenue Service (the "Service") denied the marital deduction because for federal purposes, under DOMA, "spouse" is defined as "a person of the opposite sex who is a husband or a wife." Windsor filed suit in 2010 in the Southern District of New York seeking a refund of estate taxes paid.

Both the Southern District of New York and the Second Circuit Court of Appeals held that DOMA was unconstitutional and Windsor was entitled to a tax refund.

Hollingsworth, et al. v. Perry et al.

On the heels of the California Supreme Court's ruling allowing same-sex marriages, Proposition 8 sought to add a new provision to the California Constitution's Declaration of Rights, immediately following the due process and equal protection clauses, to state that "only marriage between a man and a woman is valid or recognized in California." Following a contentious campaign period, Proposition 8 passed with 52.3% of the vote and, as of the next day, the language of Proposition 8 became Article I, Section 7.5 of the California Constitution.

In May 2009, two same-sex couples, plaintiffs Kristin Perry and Sandra Stier, and Paul Katami and Jeffrey Zarrillo, filed an action after being denied marriage licenses by the County Clerks of Alameda County and Los Angeles County, respectively, alleging that Proposition 8 violates the Fourteenth Amendment to the United States Constitution. The Northern District of California held a 12-day bench trial, and, in a thorough opinion in August 2010, held that Proposition 8 was unconstitutional.

A group of concerned individuals, who were part of the Proposition 8 initiative and not representatives of the state, represented the interests of the state on appeal. The Ninth Circuit Court of Appeals affirmed the decision, but limited the scope of its opinion to the constitutionality of the process leading toward Proposition 8. In other words, the Ninth Circuit's opinion was limited to California only and was not a broad statement on the constitutionality of state law DOMA provisions.

***Windsor* – Supreme Court Holding**

The Supreme Court, by a 5-4 majority, held that DOMA is unconstitutional for depriving the equal liberty of persons that is protected by the Fifth Amendment of the U.S. Constitution. The Supreme Court affirmed its stance by stating that the concept of the regulation of domestic relations is the virtually exclusive province of the states in which the federal government has no interest. The Court further stated that DOMA's avowed purpose and practical effect are to impose a separate status and a stigma upon all who enter into same-sex marriages made lawful by the unquestioned authority of the states.

As a result of *Windsor*, the federal government is prohibited from placing any classification on the recognition of marriages – leaving the question of whether same-sex couples can marry to the states.

***Perry* – Supreme Court Holding**

In a not-so-surprising move, also in a 5-4 opinion, the Supreme Court held that the appellants did not have standing to appeal the Northern District of California's order and remanded the case to the Ninth Circuit for dismissal based on lack of standing. The Supreme Court never addressed the merits of the case.

The Aftermath – on the Federal Level

For federal purposes, same-sex married couples are now treated the same as opposite-sex married couples. This means that many federal benefits are now legally available to all married individuals. In the estate planning arena, such benefits include, but are not limited to:

- claiming the marital deduction for gift and estate tax purposes – as mentioned above, the marital deduction shields property passing outright to a spouse, or to a QTIP trust for the benefit of a spouse, from estate tax;

- electing portability of the deceased spouse's unused applicable exclusion amount – each individual is entitled to an "applicable exclusion amount," which currently is set at $5.25 million and is adjusted for inflation. This amount can pass to individuals at death without causing a federal estate tax liability. In 2013, "portability" became an option. Portability allows a surviving spouse to use the deceased spouse's unused applicable exclusion amount, thereby permitting the survivor to transfer $10.5 million (using today's numbers) at his or her death without incurring an estate tax;

- splitting of gifts to third parties for annual exclusion purposes – each individual is entitled to gift an amount equal to the "annual exclusion amount" (currently $14,000) to donees. A married individual may transfer two times the annual exclusion amount (i.e., $28,000) to a donee if his or her spouse agrees to "split" the gift;

- naming the spouse as the beneficiary under a qualified retirement account and allowing the spouse to "roll over" the account. By rolling over the account, the surviving spouse may (1) consolidate the account with his or her own retirement accounts and (2) use his or her own age to calculate required minimum distributions, which would result in delaying required minimum distributions if the deceased spouse was older than the survivor;

- filing joint income tax returns;
- simplifying the basis and contribution rules with respect to jointly owned property;
- eliminating adverse tax consequences for the transfer of property pursuant to a marriage settlement agreement; and
- granting certain Social Security, Medicare and Medicaid benefits.

The above benefits can result in greater tax savings for same-sex couples and an extension of government programs to them. These benefits also can apply to prior years. A statute that is unconstitutional is deemed to be *void ab initio*, i.e., void from the outset, meaning that DOMA should be treated as never having existed and that same-sex couples always should have been treated the same as opposite-sex couples. In past years, some married couples would have paid less in federal taxes had they been permitted to file joint federal income tax returns or claim the marital deduction upon the death of a spouse (similar to Windsor with respect to Spyer's estate) or upon a lifetime gift to the spouse. **These taxpayers should file amended tax returns as soon as possible.** There may be some, however, for whom the ability to file amended tax returns may be closed due to the expiration of the applicable statute of limitations. The statute of limitations is usually three years from the date a return is filed. For these taxpayers, it would seem unlikely that either Congress or the Service would allow the limitations period to reopen as a result of *Windsor*. Instead, such taxpayers will likely have to proceed through judicial means to attempt to reopen the applicable limitations period.

In the immediate aftermath of the *Windsor* opinion, commenters pondered whether federal marital rights are available to same-sex spouses who reside in a state that does not recognize same-sex marriage. Upon review, the answer should be that they are entitled to such benefits. States that do not recognize same-sex marriages are not declaring that such marriages are illegal; such states are merely not "recognizing" the marriage. Thus, the parties are still legally married. If Congress or the Service were to opine that "marriage" for federal purposes is only a marriage if the state of residence recognizes the marriage, such a restriction actually is imposing a federal definition of marriage, which is exactly what the *Windsor* decision stated was impermissible.

The Aftermath – on a State Level

As a result of the Supreme Court's "lack of standing" dismissal of *Perry*, the issue of whether same-sex couples can marry is left to the individual states. With respect to California, the dismissal directed the Ninth Circuit to deny the original appeal for lack of standing, meaning the holding of the Northern District of California's decision would remain in place. Commentators thought it would take the Ninth Circuit at least 25 days to carry out the Supreme Court's instructions, but on June 28, 2013, the Ninth Circuit dismissed the appeal of *Perry*, making California the 14th jurisdiction to legalize same-sex marriage. For the remaining 36 states, legalization becomes a question for the various state legislatures, state judiciaries or voter referenda.

A state's stance on same-sex marriage has a major effect on certain state law rights. For example, if a legally married same-sex couple switches their domicile and residence to a state, such as Florida, which not only prohibits same-sex marriage but expressly refuses to recognize a same-sex marriage from another jurisdiction, the couple will be sacrificing several important state law marital rights. For example, the couple cannot avail themselves of such spousal privileges as: (1) tenancy-by-the-entirety, (2) homestead protection (where applicable), (3) elective share rights, (4) spousal retirement benefits and (5) spousal governmental benefits.

Furthermore, if the couple wishes to get divorced, they become residents of a "no man's land." If the domiciliary state does not recognize the marriage, it would be impossible for the couple to divorce in that state. In most instances, the couple would be forced to move back to the state where they married to become residents for a requisite time period before a divorce could be entertained by the applicable court. Exceptions are found in Vermont, Delaware and Minnesota, where couples married in one of such states can get divorced in that state even if they do not reside in that state.

The parties to a same-sex marriage are not the only ones affected by the *Perry* decision. For example, consider the scenario under which a trust is governed by the laws of a state that does not recognize same-sex marriage, but where a beneficiary has a same-sex spouse and the trust contains certain provisions with respect to the beneficiary's spouse. The trustee of the trust has no clear guidance on whether the provisions of the trust apply to the same-sex spouse. For example, suppose that a trust is governed under Florida law and provides for the payment of all income to A, discretionary principal to A, and, upon A's death, A is granted the power to decide how the remaining principal should be distributed among A's spouse and descendants. This power is referred to as a "special power of appointment." In default of the exercise of the power, the property passes to A's descendants or, in default thereof, to A's siblings. A is married to a same-sex partner, B, in a valid same-sex marriage in New York, and A has no children. A has one living sibling, C. Suppose that upon A's death, A purports to exercise her special power of appointment in favor of B. C challenges the exercise of the power because under Florida law – the law governing the trust – A's marriage to B is not recognized, so therefore A should be deemed to have died without a spouse, and since A left no descendants, the balance of the trust should be paid to C.

Consider further the scenario under which B is artificially inseminated and bears twin children, D and E. Pursuant to New York law, children born during a marriage are considered to be the children of both spouses, so A never legally adopts D and E. Suppose that A fails to exercise the special power of appointment upon her death. To whom does the balance of the trust pass – in equal shares to D and E, or to C? C demands that he receive the balance because D and E are only A's children as a result of New York law pertaining to spouses, and since B is not considered to be A's spouse under Florida law, it follows that D and E, who are not A's biological children, cannot be considered to be A's children under Florida law.

Both of these situations could be alleviated by including in the trust documents definitions of formerly innocuous terms such as "spouse" and "descendant." These definitions can be tailored to reflect a client's wishes and should be considered by all clients, not just same-sex spouses.

Conclusion

Each client's situation should be considered carefully, and estate planning documents should be reviewed thoroughly. Tax planning that may be in place in testamentary documents may be out-of-date, given these decisions. We encourage you to contact us at your earliest convenience to discuss in more detail how *Windsor* and *Perry* affect you and your family.

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