How Same Sex Couples Should Plan For DOMA Ruling

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The U.S. Supreme Court announced in December 2012 that it will examine the constitutionality of the Defense of Marriage Act (DOMA) in U.S. v. Windsor. The timing of such review is appropriate considering the increased activity of certain states introducing same sex marriage legislation, the U.S. Department of Justice announcing in 2011 that it would no longer defend DOMA's constitutionality, as well as recent public opinion polls reflecting a shift toward more Americans supporting same-sex marriage.

Leo Matarazzo

The court decision, which is expected this summer after oral arguments commence this month, will have a significant impact on estate planning for same sex couples. Interestingly, the legality of same sex couples could very well be determined by an estate tax issue.

Section 3 of DOMA defines a spouse as a person of the opposite sex, which means that the federal government will not recognize same-sex marriages. On the other hand, New York state, as well as a handful of other states, specifically allow for same sex marriage. This disparity has complicated estate planning for same sex couples as the tax and non-tax benefits afforded same sex couples at the state level are not available at the federal level. As such, it is important for same sex couples to have an appropriate plan in place.

U.S. v. Windsor

U.S. v. Windsor focuses specifically on the estate tax marital deduction for a same sex couple. The couple was married in Canada and were residents of New York. The decedent spouse left her assets to the surviving spouse in a manner that would qualify for the marital deduction and not generate estate taxes, but for the application of DOMA.

The marital deduction was denied and the estate was liable for $363,053 of federal estate tax. In June 2012, the Southern District of New York court allowed the marital deduction and in October 2012, the Second Circuit held Section 3 of DOMA was unconstitutional as its definition of a spouse as a person of the opposite sex violated the Equal Protection clause of the Constitution.

Impact of Upcoming Supreme Court Decision

If the Supreme Court holds that DOMA is unconstitutional, it would clearly simplify estate planning for same sex spouses who reside in states that recognize same sex marriage. For the first time, there would be consistent treatment both on the federal and state level. However, for same sex couples who reside in states that do not recognize same sex marriage, it would still require state legislative action for such couples to receive any federal or state benefits.

If DOMA is found to be constitutional by the Supreme Court, estate planning will continue to be a complex process for same sex couples, and they will continue to be denied federal benefits, which as discussed further below, include estate, gift and income tax planning benefits and the right to receive government benefits such as social security.

Planning Issues for Same Sex Couples

Regardless of whether DOMA is ultimately found unconstitutional, it is imperative for same sex couples to put in place a proper tax, financial and estate plan.

Wills

When New York legalized same sex marriage in 2011 by enacting the New York Marriage Equality Act, it conferred intestacy and elective share rights in the surviving spouse of a same sex couple. Under New York Estates, Powers and Trusts Law 5-1.1-A, a surviving spouse is permitted to an elective share roughly equal to one-third of the decedent spouse's estate. This means that a surviving spouse cannot completely be disinherited.

If a New York decedent spouse dies intestate (i.e. without a Will), EPTL 4-1.1 provides that the surviving spouse is entitled to receive the decedent spouse's entire estate if the decedent has no children. If the decedent spouse has children, the surviving spouse is entitled to receive $50,000 plus one-half of the remaining assets, with the balance of the assets passing to the children.

While the same sex surviving spouse's rights are now somewhat protected under the intestacy statute in New York and other jurisdictions that recognize same sex marriage, it is not prudent to rely on the intestacy statutes to dispose of one's assets. If the same sex couple owns property outside of New York in a state that

does not recognize same sex marriage, the intestacy statutes of that state will not recognize the surviving same sex spouse.

Surviving spouses of the same sex that reside in states that do not recognize same sex marriage are not entitled to such benefits. As such, it is even more important that Wills are in place to effectively dispose of one's assets in a manner consistent with one's desires.

From an estate tax perspective, the New York Marriage Equality Act ensures that same sex couples are entitled to the unlimited marital deduction for New York estate tax purposes. New York state imposes an estate tax with rates ranging from 4 percent to 16 percent on estates with assets valued in excess of $1 million dollars passing to someone other a spouse or charity. Any assets passing to a spouse outright or subject to a qualifying marital trust (known as a QTIP or Qualified Terminable Interest Property Trust) will not generate New York estate taxes.

In comparison, under new federal legislation enacted in January 2013, the federal estate tax is taxed at a top rate of 40 percent and the applicable exclusion amount is $5.25 million (adjusted for inflation). This means that assets in excess of $5.25 million passing to someone other than a "spouse" or charity either during an individual's lifetime or at death will be taxed at 40 percent. Since DOMA defines a spouse as a person of the opposite sex, any assets passing to a same sex spouse will utilize the surviving spouse's applicable exclusion amount, and to the extent that assets passing to the surviving same sex spouse exceed the applicable exclusion amount, a federal estate tax will be triggered.

To deal with the disparate treatment between the state and federal levels, a New York resident in a same sex marriage should consider creating an exemption trust under his or her Will for the surviving spouse that will be funded with $1 million at the decedent's death to take advantage of the decedent spouse's New York estate tax exemption. The exemption trust could be held for the benefit of the surviving spouse, children and any other beneficiaries. The balance of the decedent spouse's assets can pass into a trust that qualifies for the marital deduction trust for New York purposes.

If DOMA is repealed by the time of the decedent's death, the marital trust can also qualify for the marital deduction for federal purposes. If DOMA is still in effect at the time of the decedent's death, the "marital trust" for state estate tax purposes will not qualify for the marital deduction for federal estate tax purposes but instead will utilize a portion of the surviving spouse's federal estate tax exemption. So long as the remaining assets do not exceed the decedent spouse's federal estate tax exemption, no federal estate taxes will be due.

At the surviving spouse's death, the remaining assets in the trusts will pass to the couple's children or other beneficiaries. To the extent the assets took advantage

of the first spouse to die's estate tax exemptions, the assets will pass estate tax free to the remainder beneficiaries at the surviving spouse's death. To the extent the assets qualified for the marital deduction at the first spouse's death, the estate taxes will be deferred at the first spouse's death until the death of the surviving spouse, at which time the assets will be taxable. This approach takes into account the disparity between the federal and state legislation and provides some flexibility to minimize and/or defer estate taxes to the extent possible.

Gifting

As noted above, the federal applicable exclusion is currently $5.25 million. This amount can be left to someone other than a spouse during lifetime or at death. To the extent the applicable exclusion is utilized during lifetime, it will reduce the available applicable exclusion at death. There is also a $14,000 annual exclusion gift which enables a donor to gift up to that amount to any beneficiary in a given year without utilizing a portion of his or her $5.25 million applicable exclusion. A spouse may elect to "gift split" a gift made by one spouse so that the gift is treated as being made one-half from each spouse. This allows an individual to gift up to $28,000 to a beneficiary in a given year without utilizing his or her $5.25 million applicable exclusion.

Similar to the estate tax, the gift tax allows for an unlimited marital deduction for any gifts made to a spouse. Because of DOMA, any transfers made between same sex couples that exceed $14,000 in a given year will utilize a portion of the donor spouse's applicable exclusion and will require that a gift tax return be filed with the Internal Revenue Service by April 15 in the year following the transfer. Same sex couples also do not have the benefit of gift splitting.

If DOMA is declared unconstitutional, this will enable same sex spouses to freely transfer assets between each other. From a planning perspective, this will enable spouses to equalize assets (i.e. have the wealthier spouse transfer more assets to the other spouse) to take advantage of the less wealthy spouse's estate tax exemptions if he or she is the first spouse to die. From a practical perspective, this will also simplify joint accounts and payment of expenses without having to worry about any gifting implications. If DOMA remains intact, same sex couples will have to continue to be careful when making gifts or other transfers to each other, establishing and maintaining joint accounts and paying for everyday expenses.

Life Insurance Trust

Same sex couples should also consider the use of a life insurance trust as an estate tax savings mechanism. Life insurance is a favored asset for estate planning purposes because insurance proceeds payable at death can be kept out of the insured's estate without utilizing the insured's applicable exclusion. If the insured is not the owner of a life insurance policy and his or her estate is not

the beneficiary of the policy, the life insurance proceeds will not be taxed in his or her estate. This is the case when an insurance trust is the owner and beneficiary of a life insurance policy, regardless of the relationship between the insured and the trust beneficiaries.

For example, if an individual owns a policy insuring his or her individual life and designates his or her same sex spouse as the beneficiary, the proceeds payable at death will be includable in the individual's estate for federal estate tax purposes and for state estate tax purposes if the individual dies in a state that does not recognize same sex marriage (In New York and other jurisdictions that recognize same sex marriage, there would be no separate state estate tax imposed because of the marital deduction).

By contrast, if a policy is owned by an insurance trust and the trust is named as the beneficiary as well, the proceeds payable to the trust at death generally will not be included in the insured's estate for both federal and state estate purposes, even in states that do not recognize same sex marriage.

In addition, if the trust is drafted properly, the same sex spouse can be both a beneficiary and the trustee and the proceeds would not be includable in the surviving spouse's taxable estate at his or her subsequent death, even though the surviving spouse maintained broad control and derived benefit from the assets. As such, the remaining proceeds at the surviving spouse's death would pass estate tax free to the couple's children or other beneficiaries.

In addition to the potential estate tax benefit of life insurance, it may also be appropriate for same sex couples to consider a whole life insurance policy that builds up cash value as an additional investment vehicle, particularly when considering that a same sex spouse will not receive any social security benefits nor the income tax benefits afforded a surviving opposite sex spouse that inherits an IRA.

Regardless of the Supreme Court's decision in U.S. v. Windsor, it is imperative that a same sex couple consult with their legal, financial and tax advisers to ensure that a proper plan is in place to navigate through the complex issues and distinctions at the federal and state level.

--By Samuel Weiner and Leo Matarazzo, Cole Schotz Meisel Forman & Leonard PA

Samuel Weiner is the co-managing shareholder of Cole Schotz Meisel Forman & Leonard's tax, trusts & estate department and works in the firm's New Jersey office.

Leo Matarazzo is an associate in the tax, trusts & estates department of Cole Schotz Meisel Forman & Leonard in the firm's New Jersey office.