Cooley

September 25, 2013

The U.S. Supreme Court's recent decision to overturn the Defense of Marriage Act with respect to same-sex spouses who are married under applicable state law and recent guidance issued by the U.S. Internal Revenue Service ("IRS") and the U.S. Department of Labor ("DOL") regarding same-sex spouses will have wide-reaching effects on the tax treatment and administration of employee benefit plans. Employers should begin to undertake a review of their employee benefit plans to consider how the decision and guidance may affect such plans regarding the recognition of same-sex spouses for purposes of federal law.

Background

Section 3 of the federal Defense of Marriage Act ("DOMA") defines "marriage" and "spouse" as excluding same-sex partners for purposes of interpreting any federal law, ruling, regulation or interpretation of rulings by federal agencies. On June 26, 2013, the Supreme Court held in *US. v. Windsor* that the definition of marriage under DOMA "is unconstitutional as a deprivation of the equal liberty of persons that is protected by the Fifth Amendment." The *Windsor* case involved a tax refund claim by Edith Windsor, the surviving spouse of a same-sex couple. The couple was married in Canada and resided in New York, a state that recognizes same-sex marriages. Following the death of her spouse, Windsor was denied a federal estate tax exemption for surviving spouses because DOMA didn't recognize Windsor's marriage for purposes of federal tax law. Windsor paid $363,053 in estate taxes and sought a refund for that amount, which the IRS denied. Windsor brought suit and the District Court held that Section 3 of DOMA is unconstitutional, which was affirmed by the Second Circuit, and ordered the IRS to refund Windsor's estate tax, with interest. The Supreme Court affirmed the Second Circuit's ruling, holding that same-sex marriages recognized under applicable state law must also be recognized for purposes of interpreting federal law.

The *Windsor* decision only affects the application of federal laws to same-sex couples, and only to the extent same-sex marriage is recognized by applicable state law. It neither requires a state to recognize same-sex spouses who were married in other states, nor does it require a state to permit same-sex marriage. Also, it does not affect the application of federal laws to couples who are in a domestic partnership, civil union or any other sort of unmarried same-sex relationship.

Interpretation of Supreme Court's decision

The Supreme Court's ruling on DOMA creates a number of issues regarding the application of federal laws to same-sex spouses. As the Supreme Court noted in its opinion, DOMA applies to the interpretation of over 1,000 federal laws, many of which relate to the employer/employee relationship and the tax treatment of same-sex spouses participating in employee benefit plans, including, for example, federal laws related to income and employment taxes, qualified retirement plans, health and welfare benefits, COBRA benefits, Social Security benefits, and family and medical leave.

One of the most significant issues related to the Supreme Court's decision is the application of the ruling to same-sex spouses residing in states where same-sex marriages are not recognized by state law. Thirteen states and the District of Columbia currently have laws that recognize same-sex spouses.[1] The *Windsor* ruling makes clear that same-sex spouses residing in states where same-sex marriage is recognized by state law have the same rights as opposite-sex spouses under federal law. The *Windsor* decision does not address, however, to what extent same-sex spouses legally married in a state that recognizes same-sex marriage will be recognized for purposes of federal law if the same-sex spouses reside in a state where same-sex marriage is not recognized.

A second significant issue is to what extent the Supreme Court's ruling on DOMA applies retroactively. The *Windsor* case involved retroactive relief in the form of an estate tax refund, but it is not clear whether the federal government will take a uniform position that the definitions of "marriage" and "spouse" under DOMA have been invalid since DOMA was adopted or since the effective date of the *Windsor* decision, which was July 21, 2013. Retroactive application of the *Windsor* decision would have significant effects on the tax treatment of same-sex spouses and employer administration of benefit plans. For example, same-sex spouses may have retroactive

claims for spousal rights under qualified retirement plans. Retirement plans may need to be amended retroactively to address the status of same-sex spouses to avoid loss of qualified status. Also, many employers provide healthcare benefits to same-sex spouses of their employees but have imputed income to their employees based on the cost of providing the benefits to the same-sex spouses because, due to DOMA, same-sex spouses were not entitled to receive healthcare benefits on a pre-tax basis. If the *Windsor* decision is applied retroactively, employees who received coverage from their employer for their same-sex spouses would have the right to file amended tax returns to seek refunds of the taxes paid upon the imputed income. In addition, employers may be required to issue amended Forms W-2 to the affected employees and may also be entitled to the refund of any employment taxes paid by the employer on the employees' imputed income.

Federal agency guidance

Federal agencies with jurisdiction over laws and regulations governing employee benefit plans appear to be working together to develop consistent guidance regarding the interpretation of the *Windsor* decision and its effects on employee benefit plan administration, at least with respect to adopting a uniform approach to using a state of celebration versus a state of domicile rule.

IRS

The IRS provided some clarity on these issues in Revenue Ruling 2013-17 and related answers to frequently asked questions for same-sex couples, available here and here. In this guidance, the IRS adopted a state of celebration rule, holding that same sex marriages will be recognized for federal tax purposes if the same-sex couple is lawfully married under any state law (or law of any US territory or possession or any foreign jurisdiction with legal authority to sanction marriages), even if the couple resides in a state that does not recognize same-sex marriage. The IRS noted that a rule recognizing same-sex marriage based on where a couple resides would raise significant challenges for employers that operate in more than one state, or that have employees who move between states with different marriage recognition rules. The IRS guidance states, however, that registered domestic partnerships, civil unions or other similar formal relationships that are recognized under state law but are not denominated a marriage under that state's law will not be recognized for purposes of federal tax law.

The IRS guidance is effective prospectively as of September 16, 2013, but can be relied upon retroactively if the statute of limitations has not expired. (Typically the statute of limitations with respect to a tax year expires on the later of three years following the date the return was filed or two years following the date the tax was paid.) Taxpayers may file amended returns based on marital status and the recognition of same-sex spouses for federal tax purposes under this guidance for prior tax years for which the statute of limitations has not expired. Employees may also file for refunds of income and employment taxes paid during prior open tax years with respect to income that was imputed to the employee due to health care coverage or other fringe benefits provided by the employee's employer to the employee's same-sex spouse. Similarly, employers may file for refunds for prior open tax years for employment taxes paid with respect to income imputed to employees due to benefit plan coverage for same-sex spouses.[2] Revenue Ruling 2013-17 also states that, effective September 16, 2013, qualified retirement plans must treat a same-sex spouse as a spouse for purposes of satisfying the federal tax laws related to qualified retirement plans.

The IRS guidance did not indicate whether employers are required to provide amended Forms W-2 to employees to whom income was imputed with respect to employee benefit plan coverage for same-sex spouses.[3] The IRS has indicated that additional guidance is forthcoming on the application of the *Windsor* decision to employee benefit plans. It is expected that future guidance, especially in the qualified retirement plan area, will address plan amendments and any necessary corrections related to plan operations for periods before such guidance is issued.

DOL

On September 18, 2013, the DOL issued Technical Release 2013-04, under which the DOL also adopted a state of celebration rule for purposes of interpreting the terms "spouse" and "marriage" under the Employee Retirement Income Security Act of 1974 ("ERISA"). The DOL noted that it issued its guidance after consulting with the Department of Justice, the Department of Treasury and other appropriate federal executive agencies regarding the interpretation of the *Windsor* decision. The release holds that for purposes of interpreting ERISA, the terms "spouse" and "marriage" will be read to refer to individuals who are lawfully married under any state law, including individuals married to a person of the same sex who were legally married in a state that recognizes such marriages, but live in a state that doesn't recognize same-sex marriage. Similar to the IRS

guidance, the DOL's guidance states that the terms spouse and marriage do not include individuals in a formal relationship recognized by a state that is not denominated a marriage under state law, such as a domestic partnership or a civil union, regardless of whether individuals in those types of relationships have the same rights and responsibilities as individuals who are married under state law. The DOL's guidance does not address retroactivity of the DOL's interpretation. The Secretary of Labor indicated in a news release announcing the guidance that the DOL plans to issue additional guidance regarding the application of the *Windsor* decision in the near future.

Effect on administration of benefit plans

The overturn of DOMA will have significant effects on the design and administration of benefit plans, especially to the extent that eligibility for benefits and the tax treatment of benefits is based on an individual's status as a "spouse." The following list includes some specific thoughts about the effect of the *Windsor* decision and the recent IRS and DOL guidance on various employee benefits and several issues for employers to begin considering.

Health benefits: Employers are no longer required to impute income to an employee if health benefits are provided to the employee's same-sex spouse. Same-sex spouses and their children are eligible to receive benefits under health flexible spending accounts, health savings accounts and health reimbursement accounts, as well as dependent care accounts. Employees can make mid-plan year elections under a cafeteria plan based upon a change in their legal marital status.

Tax withholding and employment tax refunds: Since income is no longer imputed for an employee with health coverage for a same-sex spouse, the employer will no longer need to withhold income or employment taxes relating to that coverage. The IRS has not yet provided guidance on whether employers must provide amended Forms W-2 to employees to whom income was imputed in prior open tax years for a same-sex spouse's health benefits, except for when an employer files for a refund or credit of employment taxes (see footnote 3).

COBRA benefits: Same-sex spouses have the right to make an independent election for COBRA coverage and to receive COBRA notices.

Definition of spouse: Employers need to consider how to define "marriage" and "spouse" for purposes of all benefit plans that utilize those terms. Specifically, employers need to identify plan provisions where the terms should now be defined to include same-sex spouses and should also identify plan provisions where, while not required, employers want those terms to include domestic partner relationships or only same-sex spouses recognized by applicable state law. Plan documents and summary plan descriptions will need to be updated to reflect any changes, although the IRS has indicated that, at least with respect to qualified retirement plans, plan amendments need not be adopted just yet.

Beneficiaries and spousal consent rules: Same-sex spouses now have automatic beneficiary rights under qualified retirement plans if a beneficiary is not selected. The current rules requiring spousal consent with respect to the designation of a non-spouse beneficiary and to receipt of a participant loan under retirement plans also apply to same-sex spouses.

Retirement distributions: Same sex-spouses are entitled to survivor benefits, including qualified joint and survivor annuities and pre-retirement annuities, from plans that provide for such distribution options. Same-sex spouses are also treated as spouses for purposes of the minimum required distribution rules and have the right to roll over a distribution from a deceased participant's retirement account to another retirement account maintained by the same-sex spouse. Participants in retirement plans may take hardship withdrawals with respect to qualifying events relating to a same-sex spouse.

Qualified domestic relations orders ("QDROs"): If a same-sex marriage is being dissolved, a qualified retirement plan must accept and process a QDRO in the same manner that a QDRO for an opposite sex marriage is accepted and processed, including making distributions to former same-sex spouses.

Nonqualified deferred compensation plans: Nonqualified deferred compensation plans that relate to qualified plans as excess benefit plans may be affected by the definition of spouse under the qualified plan. In addition, participants in nonqualified deferred compensation plans may be entitled to distributions upon an unforeseeable emergency arising due to events related to a same-sex spouse that cause a severe financial hardship (such as

the illness or accident of the spouse).

FMLA: Same-sex spouses are recognized for purposes of employee rights under the Family and Medical Leave Act.

There still remain unanswered questions regarding how the Supreme Court's decision to overturn DOMA for purposes of federal law will apply to employee benefit plans. We recommend that employers start reviewing employee policies and plans now to determine how this change will affect their benefit plans in light of the recent guidance issued by the IRS and DOL.

Notes

1. The states include California (based on the U.S. Supreme Court's ruling in *Hollingsworth v. Perry* reinstating same-sex marriage), Connecticut, Delaware, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New York, Rhode Island, Vermont and Washington.
2. On September 23, 2013, the IRS released Notice 2013-61 regarding optional administrative procedures that employers may use to correct overpayments of employment taxes for 2013 and prior years with respect to same-sex spouse benefits.
3. Notice 2013-61 states that if an employer files a claim for refund or credit of employment taxes for a prior year, the employer must provide amended Forms W-2 to employees, but the guidance does not require that amended Forms W-2 be provided in the absence of filing for a refund or credit.

Key Contacts

Thomas Welk San Diego	twelk@cooley.com +1 858 550 6016