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Love and Marriage After DOMA

On June 26, 2013, by a 5-4 majority, the United States Supreme Court held the federal "Defense of Marriage Act" ("DOMA") unconstitutional as depriving equal liberty to all persons, namely same-sex couples, as guaranteed by the Fifth Amendment to the U.S. Constitution. The Supreme Court also affirmed that the regulation of domestic relations is the exclusive province of the states, in which the federal government has no interest.

Windsor v. United States

In Windsor v. United States, Edie Windsor filed suit in a New York Federal Court seeking a refund of estate taxes paid by her on the estate of her late spouse, Thea Spyer. The two women met in 1963 and lived together in a continuous committed relationship until Spyer's death in 2009. In 1993, when the option first became available, Windsor and Spyer registered as domestic partners in New York City. The couple later married in Canada, where same-sex marriage was legal. At that time, New York did not allow same-sex marriage, but did recognize those performed legally elsewhere. 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 trust for the benefit of a spouse) from estate tax. The Internal Revenue 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." Both the trial court and the Court of Appeals held DOMA unconstitutional and awarded Windsor a tax refund.

The Supreme Court Holding

By a 5-4 majority, the Supreme Court affirmed that DOMA is unconstitutional in that it deprives equal liberty to all persons, including same sex couples, under the Fifth Amendment to the U.S. Constitution. As noted above, the Court further stated that the regulation of domestic relations is the exclusive province of the states in which the federal government has no interest. The Court condemned DOMA noting that its avowed purpose and practical effect is 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 passing legislation defining marriage, leaving the question of whether same sex couples may marry exclusively to the states.

Hollingsworth, et al. v. Perry, et al.

The Supreme Court also ruled on a case out of California concerning state law DOMA provisions. In the wake of California's decision to allow same sex marriage, the legislature passed Proposition 8 amending the California Constitution to state that "only marriage between a man and a woman is valid or recognized in California."

When the County Clerks of Alameda and Los Angeles Counties denied marriage licenses to two same sex couples citing Proposition 8, the couples filed suit claiming that Proposition 8 is unconstitutional and violates the Fourteenth Amendment to the United States Constitution. The federal trial court held Proposition 8 unconstitutional and a group of concerned citizens, purporting to represent the interests of the state, appealed. The federal appellate court affirmed the decision, but limited the scope of its opinion to the constitutionality of the process leading to the passage of Proposition 8. It did not address the broader issue of state law DOMA provisions.

On further appeal, the Supreme Court held that the appellants did not have standing to appeal the lower court's order and remanded the case back to the California trial court for dismissal. The Supreme Court never addressed the merits of the case.

Federal Law

For federal purposes, all marriages, same sex or opposite sex, are now treated equally. This means that federal benefits afforded opposite sex married couples are now available to same sex married couples. In the estate planning arena, such benefits include, but are not limited to:

1. claiming the marital deduction for gift and estate tax purposes;
2. electing portability of the deceased spouse's unused applicable exclusion amount;
3. splitting of gifts to third parties for annual exclusion purposes;

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4. naming the spouse as the beneficiary under a qualified retirement account and allowing the spouse to "roll over" the account;
5. filing joint income tax returns;
6. simplifying the basis and contribution rules with respect to jointly owned property;
7. eliminating adverse tax consequences for the transfer of property pursuant to a marriage settlement agreement; and
8. 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 prospectively and, in limited cases, retroactively.

Intersection of Federal and State Laws

On August 29, the United States Department of Treasury and the Internal Revenue Service issued a ruling (Revenue Ruling 2013-17) that provides that same-sex couples legally married in jurisdictions that recognize their marriages will be treated as married for all federal tax purposes. The ruling applies regardless of whether the couple lives in a jurisdiction that recognizes same-sex marriage or a jurisdiction that does not recognize same-sex marriage.

The issue of whether same-sex couples can marry is still left to the individual states. Florida does not now recognize same-sex marriage. Under Florida law, marriage is defined as the legal union of only one man and one woman as husband and wife. No other legal union is valid or recognized. Florida law further provides that same sex marriages entered into in other jurisdictions are not recognized for any purpose in Florida.

Conclusion

How a relationship will be treated under state and federal law is an important part of estate planning. Whether it is a same-sex or opposite-sex relationship or marriage, there are planning strategies and techniques available to help protect loved ones.

Portability

The American Taxpayer Relief Act of 2012 (the "2012 Act") made permanent the overall estate and gift tax structure enacted as part of the 2010 Act. The applicable exclusion amount for estate and gift taxes is set at $5,000,000 (increased for inflation after 2011). For 2013, the inflation-indexed applicable exclusion amount is $5,250,000. The estate and gift tax applicable exclusion amounts are unified in that the full exclusion amount is available for lifetime gifts and any exclusion used during life reduces the exclusion available at death. The unused exclusion amount of one spouse is portable and can pass to the surviving spouse.

As discussed below, the portability provision may be helpful to those who have not done proper planning, but it will not replace many of the benefits of using credit shelter trusts (trusts that take advantage of the applicable exclusion amount) as part of your estate plan. However, in some situations (especially for families with less than $10 million), portability may be preferable to a credit shelter trust because of the ability to benefit from an additional basis step-up at the death of the surviving spouse.

For portability to apply, the estate of the first spouse must make an election for it to apply on a timely filed estate tax return (even if an estate tax return would otherwise not be required). The amount of applicable exclusion amount ported to the surviving spouse does not increase with future inflation and can be lost if the surviving spouse remarries.

The portability provision for a predeceased spouse's unused applicable exclusion amount does not negate the benefits of creating a credit shelter trust at the first spouse's death. Merely transferring the unused applicable exclusion amount to the surviving spouse (without funding a credit shelter trust at the first death) could still result in significantly higher tax at the second spouse's death because the ported exclusion does not increase with time. All appreciation between the death of the first spouse and the death of the second spouse will be subject to estate tax at the second spouse's death.

> **Example:** Assume there is no index-adjustment in the $5,000,000 applicable exclusion amount. Assume the full $5,000,000 applicable exclusion amount is available at the first spouse's death and the first spouse to die has at least that much in assets. Also assume that the surviving spouse has his or her own assets which are equal to or greater than the then available applicable exclusion amount at the time the surviving spouse dies. If the first spouse's full $5,000,000 applicable exclusion amount is funded into a credit shelter trust at the first spouse's death, then the assets of the credit shelter trust (plus appreciation thereon) is completely excluded from the surviving spouse's taxable estate. If, instead, the first spouse relies on the portability provision, his or her $5,000,000 applicable exclusion amount – plus any appreciation – is included in the surviving spouse's estate. However, only $5,000,000 of applicable exclusion amount is available to offset those assets which are includable in the taxable estate of the surviving spouse. If the surviving spouse lived for an additional 10 years and the $5,000,000 of assets owned by the first spouse appreciates to $10,000,000 (an approximate 7% rate of return), there would be an additional $2,000,000 of federal estate tax owed (assuming a 40% rate) as a result of relying solely on portability of the unused applicable exclusion amount of the first spouse to die.

Additionally, a credit shelter trust generally protects the assets from claims of the surviving spouse's creditors or a future spouse while an outright devise to the surviving spouse would provide no creditor protection. Portability also provides the first spouse to die no control regarding the disposition of assets after the second death or during the life of the surviving spouse. *However, under certain circumstances, where the combined value of property at the surviving spouse's death is not anticipated to result in an estate tax liability, portability of the applicable exclusion amount might be preferable for estate tax reasons because using portability, and allowing all of the combined property to be included in the surviving spouse's estate, will allow all of the property to be eligible for a basis step-up at the second spouse's death. The higher income and capital gains tax rates as a result of the 2012 Act makes the potential benefit of a second basis step-up more valuable, especially if there would be little or no estate tax due in any event. There is no clear-cut rule that can be applied, and many factors need to be considered in determining the best course of action.*

Furthermore, the portability provision only applies to the estate and gift tax exclusion amounts. As a result, any unused GST Exemption of the first spouse to die is permanently lost. At a 40% GST tax rate, wasting $5,000,000 of GST Exemption has a cost of $2,000,000 in immediate tax on generation-skipping transfers, plus additional future tax costs with respect to property that could have been placed into GST-exempt trusts lasting multiple generations. Bottom line, while helpful, portability is not a panacea and cannot be relied upon as an alternative to proper planning.

How Does the New 3.8% Medicare Surtax Impact You?

The Medicare Surtax: Don't blink, you may miss it!

With all the talk about new legislation to avert the fiscal cliff, you may have missed an important change to the Medicare tax that will impact upper income taxpayers. Beginning with the 2013 tax year, a new 3.8% Medicare "surtax" will apply to all taxpayers whose income exceeds certain threshold amounts (the "Threshold Amounts"). For individuals, the tax applies to the lesser of: (1) net investment income, or (2) the excess (if any) of modified adjusted gross income ("MAGI") over the threshold amount of $200,000 for single taxpayers and $250,000 for married taxpayers filing jointly. For trusts and estates, the tax applies to the lesser of: (1) the undistributed net investment income or (2) the excess (if any) of adjusted gross income over the dollar amount at which the highest tax bracket for trusts and estates begins.

Prior to January 1, 2013, the Medicare payroll tax of 2.9% applied only to earned income. This means that the tax applied only to wages you were paid by your employer, plus tips. Your employer deducted 1.45% from your paycheck and was responsible for the other 1.45%. In the past, taxpayers were not required to pay Medicare taxes on income generated from investments, such as capital gains, dividends, and taxable interest. Under the new Medicare "surtax", high wage earners will pay an additional 0.9% on wage (or self-employment) income above the Threshold Amounts to bring the total Medicare tax on wages above the Threshold Amounts to 3.8% (1.45% employee tax + 1.45% employer tax + 0.9% surtax).

For example, an individual whose MAGI will be $225,000 in 2013 will pay the 1.45% Medicare tax on the first $200,000, then 2.35% (1.45% plus an additional 0.9%) on the next $25,000. The taxpayer's employer will be required to withhold the extra 0.9% once the taxpayer's wages exceed the individual Threshold Amount.

If you are married and you and your spouse each earn $150,000, your employers will withhold only 1.45%, because neither income exceeds the individual Threshold Amount. However, if you file jointly, your combined income of $300,000 exceeds the Threshold Amount for filing jointly, and you will owe an additional 0.9% on $50,000 (the amount by which your joint income exceeds the applicable Threshold Amount).

What is "investment income" and what is not?

It is important to remember that net investment or "unearned" income includes net rental income, dividends, taxable interest, net capital gains from the sale of investments (including second homes and rental properties), royalties, passive income investments in which you do not actively participate (including partnerships) and the taxable portion of nonqualified annuity payments. Net investment income does not include tax exempt interest from municipal bonds, withdrawals from retirement plans and payouts from defined benefit pension plans or annuities that are part of retirement plans. Also exempt are life insurance proceeds, veteran's benefits, Social Security benefits and income from businesses, including S corporations and partnerships in which you actively participate. Be aware, however, that if you have reached age 70 and have begun taking the minimum required distributions from a traditional IRA, 401(k), or 403(b) plan, these withdrawals are included in MAGI and, when added to net investment income and wages, can push you over the Threshold Amounts and subject you to the surtax.

How can I plan around the new surtax?

There are a number of ways to plan around the 3.8% surtax. The first is to reduce "investment income" through the investment in municipal bonds, IRA and qualified plans, tax deferred annuities, life insurance, depreciation on real estate, 15% depletion allowance on oil and gas and intangible drilling cost deductions on passive oil and gas. Another is to reduce MAGI by reducing investment income in the ways described above.

You can also use a non-grantor charitable lead trust, which provides the grantor with a gift tax deduction at the time of the gift and, at the end of the term, distributes the assets to a family member at a reduced estate/gift tax cost. Another alternative is to transfer cash or assets to a tax-exempt irrevocable charitable remainder trust that pays income for life or a term of years. Installment sales can also be used. Or you can use tax-deferred investment vehicles like fixed annuities ("leap frog" annuities) to shelter interest from federal tax until you retire and start withdrawals. Once you retire, your income will presumably drop below the surtax threshold, allowing you to "leap over" your wage earning years.

The best defense is a good offense, so be prepared and plan early!

The Other Side of the Fiscal Cliff (Revisited)

The American Taxpayer Relief Act of 2012 (the "2012 Act")

The 2012 Act prevented a significant portion of the "Bush Tax Cuts" from expiring, while raising tax rates on higher-income taxpayers for both income and estate and gift tax purposes. So what is the practical effect?

The 2012 Act makes the following permanent:
(1) income tax rates and brackets (subject to inflation adjustments); (2) the inflation indexing for the alternative minimum tax; and (3) the overall structure for estate, gift and generation-skipping transfer taxes. What does "permanent" mean? Congress can still enact changes to the tax law, but the 2012 Act provides that the major provisions setting forth tax rates are "permanent" in the sense that they will not automatically expire.

Income Tax Rules

The 2012 Act increases the tax rates for ordinary income and capital gains for certain taxpayers. It reinstates the pre-2001 top marginal income tax rate of 39.6% for ordinary income and 20% for long-term capital gains for individuals with income above $400,000 and married couples filing a joint return with income above $450,000.

It also reinstates the limitation on itemized deductions and phase-out of personal exemptions, thereby increasing marginal tax rates. This change affects individuals with adjusted gross income above $250,000 and married couples filing a joint return with adjusted gross income above $300,000 (collectively, the "Limitation Thresholds"). The limitation on itemized deductions requires taxpayers to reduce certain itemized deductions (including mortgage interest, state and local taxes, and charitable contributions) by 3% of the amount of adjusted gross income in excess of the Limitation Threshold, with an overall cap of 80% of the itemized deductions. This results in a 1.1 to 1.2 percentage point increase in the marginal tax rate. The phase-out for personal exemptions gradually reduces the amount of personal exemptions. Personal exemptions will be completely eliminated for a taxpayer with an adjusted gross income more than $125,000 in excess of the Limitation Threshold.

Estate, Gift and GST Tax Rules

The 2012 Act also makes permanent the overall estate and gift tax structure enacted as part of the 2010 Act. For 2013, the inflation-indexed applicable exclusion amount is $5,250,000. The estate and gift tax applicable exclusion amounts are unified in that the full exclusion amount is available for lifetime gifts and any exclusion used during life reduces the exclusion available at death. With certain limitations, the unused exclusion amount of one spouse is portable and can pass to the surviving spouse. The tax rate for estates and gifts above the applicable exclusion amount has increased from 35% to 40%.

Under the 2012 Act, the GST Exemption amount remains tied to the applicable exclusion amount for estate tax purposes and the GST tax rate continues to equal the maximum estate tax rate (40%). It should be noted that the GST Exemption is not portable between spouses.

The 2012 Act maintains the unification of the estate and gift tax systems, allowing for the ability to make substantial taxable gifts, without incurring any gift tax. A husband and wife who have not made any prior taxable gifts can make taxable gifts up to $10,500,000 in 2013 without incurring gift tax. If a husband and wife fully used their combined applicable exclusion amount of $10,240,000 in 2012, they can make additional taxable gifts equal to a combined $260,000 in 2013.

There are numerous ways to take advantage of the gift tax exclusion amount under the 2012 Act. These gifting possibilities include: (i) lifetime gifts held in dynasty trusts; (ii) funding life insurance trusts to hold life insurance on your life; (iii) transferring interests in a personal residence through a Qualified Personal Residence Trust; and (iv) forgiving existing promissory notes.

Other Notable Rules

The 2010 Act allowed individuals over age 70½ to make a direct distribution from their IRA to a charitable organization of up to $100,000 per year without including the distribution in gross income (no charitable deduction is allowed). That provision has been extended through December 31, 2013. The amount of the qualified charitable distribution counts against the individual's required minimum distribution for the year (no charitable deduction is allowed).

Notwithstanding the permanency provisions of the 2012 Act, more changes are likely. Stay tuned.

1. All references to available/allowable estate tax exemptions and credits relate only to persons who are U.S. citizens; references to gift tax exemptions/exclusions generally apply to U.S. citizens and U.S. Lawful Permanent Residents (i.e., "green card" holders). While most transfer tax savings techniques discussed can be fine-tuned to benefit non-U.S. citizens, the results will differ and must be addressed on a case-by-case basis.

2. **The 2013 Annual Exclusion** is an aggregate of $14,000 per donee, from each donor; or $28,000 per couple, if a husband and wife file a "split gift" Gift Tax Return on gifts made from either of their assets this year. **Medical/Tuition ["ed/med"] Exclusion Gifts** allow a donor to pay an unlimited amount for anyone's medical or tuition expenses (including health insurance premiums), if paid directly to the service provider, without incurring any gift tax or use of their unified credit; and, if properly structured, ed/med gifts should not reduce the $14,000 amount available to be given to the same person by a donor each year.

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