

Friday, July 19, 2013

How the Recent DOMA Ruling Impacts You

On June 26th, 2013 the U. S. Supreme Court issued its decision in *Windsor v. United States*. In *Windsor*, Section 3 of the Defense of Marriage Act (DOMA) was challenged. Section 3 prevents same-sex married couples from benefitting from more than 1100 federal programs and laws that are available to opposite sex married couples. The Supreme Court found that Section 3 of DOMA was unconstitutional; however Section 2 of DOMA still stands. Section 2 allows states to discriminate against same-sex couples married in other states. The Respect for Marriage Act, which would fully repeal DOMA, is currently pending in Congress. As a result, the final impact of the ruling is still opaque. Some federal programs determine marital status based on where the couple lives, rather than whether a lawful wedding occurred in a state where marriage is recognized. In the short term, the state you chose to settle in could have a significant impact on some of the benefits you're entitled to, at both the State and Federal levels. The far reaching implications of the decision are impossible to encapsulate in one article, but I've attempted to cover some of the more pertinent issues which I believe will impact your lives.

Federal Income Taxes

Based on IRS practice, a couple is able to file their taxes as 'married filing jointly' or 'married filing separately' if they are considered to be married by the jurisdiction in which they reside (state of domicile)¹.

Until further clarification is provided by the IRS, it appears that if your resident state doesn't recognize same-sex marriage; then you cannot file a joint federal return. However, the IRS has recognized common law marriages, so this area is still not clear².

For those couples who are married and living in a jurisdiction that recognizes same-sex marriage, you have the ability to file a joint federal return. In fact, you can no longer file as an 'individual' or 'head of household'. If you're not married and considering marriage, you should look into whether filing a joint tax return benefits you. Because the brackets for married couples aren't twice what the single brackets are, you may end up paying more in federal income taxes. With couples who both have high incomes, this is the most likely case. In fact, the net tax impact, "...stands squarely against couples of all genders who bring down more than \$146,400 a year together. At that level if each spouse earns about half of that shared income, the government will grab 5% more of every marginal dollar than what they owed when they were single."³ Couples that will benefit the most will be those where a large income disparity exists between the individuals, one with a low income and one with a very high income. The spouse

¹ <http://www.lambdalegal.org/publications/after-doma-federal-taxes>

² <http://www.lambdalegal.org/publications/after-doma-federal-taxes>

³ <http://thetrustadvisor.com/news/domacost>

with the higher income, who pays the majority of the tax, will benefit from capturing more income at a lower bracket.

Let's use two examples to illustrate these points. Couple A is not married and has income of two partners of \$125,000 each, for a total income of \$250,000. Filing as single, their marginal tax bracket is 28% for each of them and Federal tax is \$28,293 each, for a total tax bill of \$56,586. If Couple A then got married and use married filing jointly status for household income of \$250,000 this puts them into the 33% marginal bracket. Total Federal tax comes in at \$ 58,814; a \$2,228 tax increase!

Now let's take Couple B which consists of an unmarried couple where one partner earns \$0 annually and the other earns \$250,000 annually. Filing as single, total tax is \$66,631. If Couple B then got married and filed jointly; their total tax is \$58,814. This results in a \$7,817 tax savings!

Other key tax considerations are the impact of the Affordable Care Act (ACA) and the American Taxpayer Relief Act of 2012 (passed in January). Under the ACA an additional 3.8% tax is levied on net investment income for singles if income exceeds \$200,000, but this same tax is due on married couples whose incomes exceed \$250,000. The additional .9% levied on earnings to support Medicare under ACA has the same thresholds. Under the ATRA, singles earning \$400,000 and up will pay an additional 4.6% on earned income and 5% higher capital gains tax, yet married couples reach this threshold at \$450,000, only \$50,000 higher for combined incomes. Again, because the tax thresholds for marrieds are not double the single thresholds, if your incomes are high you reach the threshold sooner if married.

Married couples now also have the ability to exclude \$500,000 of gain on the sale of a primary residence (assuming they meet the other rules) from consideration for capital gains tax. In addition, if you are on your partner's health benefits through their employer, they will no longer have to pay tax on the value of the benefits you receive.

What Financial Planning Opportunities Exist?

For married couples in jurisdictions that recognize same-sex marriage, you now have true household income in the eyes of the IRS. If your partner has investment carry forward loss, you may be able to use their carry forward capital losses to offset taxable capital gain you realize (on sales of investable assets including real property, land and collectibles.). For any loss that isn't used to offset gain, you can use up to \$3,000 per year of loss to reduce taxable household income.

If you were married prior to this year, you should work with a tax advisor to determine the impact of amending prior year's tax returns to capture tax savings. The statute of limitations for amending returns is 3 years. You should also look into adjusting your withholdings or quarterly estimated taxes for 2013 and into the future.

Investment opportunities for clients now in higher tax brackets include municipal bonds (as municipal bond interest isn't subject to the 3.8% Medicare surtax on investment income under the Affordable Care Act levied on singles earning over \$200,000 and marrieds over \$250,000). Also appreciate assets that you can depreciate. Real estate is an attractive asset to own because you obtain an inflation hedge and use depreciation to reduce taxable rental income. With mortgages still at relative historic lows, this is a great opportunity for this type of investment. If you don't want to become a landlord there are public and non-public investments that you can participate in to access this asset class. Other investments that provide depreciation include Master Limited Partnerships, which manage energy infrastructure for

commodities like oil and natural gas. Keep in mind, that with depreciation you are deferring realization of the tax until you sell the asset (preferably when your income tax bracket is lower).

Also, now is the time to look at opportunities for potential Roth conversions for those individuals with lower marginal tax rates since you're married you cannot file as single, so if your income is taxed at a lower rate today than it will be after marriage, it probably makes sense to perform those conversions now.

Federal Gift and Estate Taxes

No more tax due on asset transfers between spouses. In addition, at the death of the first spouse, there is no more federal estate tax due!

For married same-sex couples, there is no longer a worry about exceeding annual gift exclusions by giving money to a partner. This still applies to gifts to children, but spouses are able to commingle assets without any negative tax repercussions. So, changing the deed on a residence to add your partner for estate planning purposes doesn't trigger a taxable gift, as it did before DOMA was overturned. If you made a taxable gift in the past and didn't file a gift tax return, you should consult with a tax advisor. It is still unclear whether the government will view these changes in tax law on a retroactive basis, or strictly moving forward.

On the estate tax side of things, married same-sex couples now have access to the 'unlimited marital deduction'. This means that no matter how large your estate is at death, everything you leave to your partner he or she will receive free of federal estate tax. In addition, the 'estate tax exemption' (or amount of assets which you can transfer free of federal tax to anyone) of \$5,250,000 per person (in 2013) is portable for married persons. This means that if your partner only uses a portion of his or her exemption, you are able to add the unused portion to your exemption. Thus you are able to transfer more assets to family and other heirs without federal estate taxation.

What Financial Planning Opportunities Exist?

If you haven't added your partner onto your deed, you should now consider it. Joint titling allows the property to avoid the expenses, delays and costs associated with the probate process (incurred by anything directed by your Will). For couples in jurisdictions that recognize same sex marriage you have the additional ability to title your home as 'Tenants by the Entirety'. This is a property titling reserved exclusively for spouses which affords you creditor protection, as each of you own an indivisible interest in that property.

Even though you have the ability to leave your estate exemption to a spouse, you may still want to use a portion of it to fund a trust for the benefit of your spouse or other heirs. A Qualified Terminable Interest Property or QTIP Trust allows assets passing to a spouse to be held in trust as long as the surviving spouse has a lifetime interest in the property. QTIP Trusts allow you to have more control over how the funds will ultimately be distributed at your spouse's subsequent death, specifically useful when children are involved. Leaving assets in trust for the benefit of a partner can also help protect them from future divorce. Consider a situation where, upon your passing, you leave your partner assets outright. If they were to subsequently get married and divorced, they could lose half the assets you left them. If you place assets in trust instead, you can structure the trust to protect the assets not only from divorce but also from creditors.

Social Security

Spouses can now benefit from their partners' earnings via Social Security benefits.

Social Security uses the wage earner's state of residence for purposes of determining whether they are married and eligible for spousal benefits. Prior to the Supreme Court's decision on DOMA, same-sex couples were unable to receive Social Security benefits based on their partners' earnings. With Section 3 now rendered unconstitutional, spouses in states that recognize same-sex marriage can now receive benefits on behalf of their partner, in retirement and at the death or disability of their spouse.

The 'retirement spousal benefit' is a benefit for lower earning individuals whose spouses accrue a larger Social Security benefit throughout their lifetimes. Recognized spouses are able to obtain half of their partner's retirement Social Security benefit. In addition, if you outlive your spouse, you have the option to continue to collect your benefit or opt to collect 100% of his or her Social Security benefit.⁴

What Financial Planning Opportunities Exist?

There are different strategies couples can employ to receive their Social Security. One such strategy is to 'file and delay'. Under this strategy, an individual opts to receive half of their spouse's benefit while delaying taking theirs until a later date. As you delay taking your Social Security benefits, you're able to accrue additional credits (until age 70), thus increasing the payment you will receive. Assuming you have a normal life expectancy and are healthy, this strategy usually makes sense.

Federal Employee Benefits

Spouses are now able to receive health and pension benefits on behalf of their civilian partners.

There is no statute prohibiting a married couple from obtaining spousal health coverage, even if the employee lives in a state that doesn't recognize same-sex marriage.⁵ According to the Office of Personnel Management, marriage constitutes a 'qualifying life event' and allows an employee to submit a change to their healthcare benefits up to 31 days before and 60 days after the qualifying event. The spouse of a retiring employee can continue health coverage, assuming certain conditions are met.⁶

Spouses are also entitled to a (reduced) survivor annuity under FERS based on the employee's income and creditable years of service. To qualify, the spouse must have been married for 9 months. If the employee is already retired, they have up to 2 years from the date of the marriage to apply for spousal pension benefits. However, federal regulations, "applying to FERS and CSRS define 'marriage' as 'a marriage recognized in law or equity under the whole law of the jurisdiction with the most significant interest in the marital status of the employee...or retiree.'"⁷ This makes the availability of spousal pension benefits questionable for those individuals who live in states that do not recognize same-sex marriage.

⁴ <http://www.lambdalegal.org/publications/after-doma-social-security>

⁵ <http://www.lambdalegal.org/publications/after-doma-federal-employees>

⁶ <http://www.lambdalegal.org/publications/after-doma-federal-employees>

⁷ <http://www.lambdalegal.org/publications/after-doma-federal-employees>

What Financial Planning Opportunities Exist?

Applying for spousal healthcare benefits is an obvious choice; however, opting for the survivor annuity is a bit more complicated. In order to provide a survivor benefit to your spouse, you as the employee take a reduced annuity today. This reduction in the annuity payment is an expense you pay to ensure your spouse receives something at your death. But can you do it in a more cost effective way? If you're healthy and can obtain life insurance, it's prudent to get an idea of what the cost of life insurance would be if you were to buy a policy large enough to replace the pension in lieu of opting for the survivor annuity. In many cases, it's much cheaper to purchase insurance rather than take the reduced annuity payment.

Immigration

Citizens who have foreign national partners can now sponsor them for a green card.

Without the ability to personally sponsor a partner, many individuals are at the mercy of employer provided visas (H1B) or student visas in order to be with their loved ones. Now that same-sex marriage is recognized at the federal level, an individual can sponsor their partner on a K-1 fiancé visa. The K-1 requires that you marry your spouse-to-be within 90 days of acceptance into the U.S. (this is actually what my wife and I had to do to be together). In general, marriage based visas are processed faster than other applications for lawful permanent residency.⁸ Marriages in jurisdictions outside the U.S. count, as long as they are lawfully entered into, in fact, Edie Windsor, the plaintiff in the Supreme Court case, got married in Canada.⁹ The U.S. Citizenship and Immigration Services (USCIS) determine viability of marriage based on where the marriage took place, as opposed to whether the couple currently resides in a state that recognizes same-sex marriage. This means that you can now lawfully live out your lives together without worrying about immigration status!

What Financial Planning Opportunities Exist?

Generally, individuals emigrating to the U.S. must wait 5 years to apply to become U.S. Citizens, however, spouses of U.S. citizens can apply in 3 years (as long as still married and living with their spouse).¹⁰ Noncitizens can accrue benefits toward social security as long as they have lawful status. In order to collect benefits they must have worked for 40 quarters of a year (or 10 years) and meet other eligibility requirements.¹¹

From an estate planning standpoint, U.S. Citizens are able to leave \$5,250,000 in 2013 to a non-citizen spouse. Without citizenship status, in order to minimize taxation on assets left to non-citizen spouses, a Qualified Domestic Trust (QDOT) is required to take full advantage of the unlimited marital deduction.¹² If you're planning on sponsoring your partner for immigration purposes, you won't need this trust once they receive citizenship status, but obtaining citizenship generally takes 3 years.

In closing, there are significant federal benefits now available to married same-sex couples, specifically in jurisdictions that recognize their marriages. At the moment, given that same-sex marriage is

⁸ <http://immigrationequality.org/2013/06/the-end-of-doma-what-your-family-needs-to-know>

⁹ <http://immigrationequality.org/2013/06/the-end-of-doma-what-your-family-needs-to-know>

¹⁰ <http://www.lambdalegal.org/publications/after-doma-immigration>

¹¹ http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/183/~noncitizens-receiving-social-security-benefits

¹² <http://www.nolo.com/legal-encyclopedia/estate-planning-when-you-re-married-noncitizen.html>

recognized in DC and Maryland, it may appear that it makes sense for couples who live in VA to up and move to MD or DC, but there is no rush. If you marry in a jurisdiction that recognizes same-sex marriage but live in or move to a jurisdiction that doesn't recognize same-sex marriage (such as VA) and later seek a divorce, you may be caught in a gray area of family law. When there is more clarity on the implementation of the decision, VA residents may find that some of the benefits can be realized without crossing the border! In the meantime, I look forward to discussing any questions you may have as it relates to your family's situation.

Sincerely,

Nicholas E. Burkholder, CFP®

Many of the references and information in this newsletter are from a series of fact sheets prepared by a coalition of LGBT organizations. For more detailed information, please visit HRC's website at: <http://www.hrc.org/resources/entry/doma-get-the-facts> or Lambda Legal's website at <http://www.lambdalegal.org/publications/after-doma>.

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