

Some Negative Impacts of DOMA on Same-Sex Spouses

By Michelle Chapin

By now you have almost certainly heard that the U.S. Supreme Court struck down the federal definition of marriage as “marriage only between a man and a woman” in *United States v. Windsor*, 570 U.S. ____ (2013). As a result, same-sex spouses can now enjoy many federal benefits that were previously unavailable to them.

What may have not been as clear, however, is that some estate tax benefits that same-sex spouses used to enjoy are no longer available. Here are two areas where the impact of this case will be felt:

Selection of Trustees. Often irrevocable trusts are designed to exclude the trust assets from estate taxes in the estates of the *grantor* (i.e., the person funding the trust) and the trustee (i.e., the person managing the trust assets for the beneficiary). Excluding the trust assets from the grantor’s estate is not possible if the grantor retains too much power, an example of which is the unfettered power of a grantor to remove and then replace the trustee. In 1995, the IRS conceded that it would not deem the grantor’s power to remove and replace the trustee as excessive if the trust prohibited the grantor from replacing the trustee with someone “related or subordinate” to the grantor. For this purpose, the grantor’s spouse is treated as a “related” party.

Prior to the *Windsor* ruling, a grantor could remove a trustee and name his or her same-sex spouse as the successor trustee without risking estate tax inclusion. Since the marriage was not recognized for federal tax purposes, the same-sex spouse was not treated as a spouse and thus, was not regarded as a related party. As a result of the Supreme Court’s decision in *Windsor*, same-sex spouses will lose this benefit.

Valuation Rules. The Internal Revenue Code provides special rules for determining the value of business interests transferred among family members. Section 2701 provides certain guidelines for determining the value of a business interest transferred by the business owner or his or her spouse or any of their ancestors (*an applicable family member*) to any other family member if the applicable family member retains an interest such as a distribution right or an extraordinary payment right. The retained rights are valued at zero and the full value of the business is deemed to have been transferred and thus subject to gift tax, if applicable, even though only a partial interest was transferred.

For example, assume that a father, who is the sole owner of a business, wants to transfer to his children all of the *common* stock while he retains the *preferred* stock that includes a right to receive dividends and liquidating distributions before common stockholders. Since the children are family members, the value of the father’s retained preferred stock is deemed to be zero. The IRS treats him as having transferred the full value of the company to his children, which means that he either utilizes some of his gift tax exemption to make the gift, or if he has no remaining exemption, he would owe gift tax. Upon the father’s death, his estate is taxed as if he owns the entire business. His estate obtains no discount to the value of his shares as a result of owning only a partial interest in the company, although his estate receives a credit for the gift tax already paid. Thus, while the shares are taxed only once, the timing is accelerated.

Before the *Windsor* decision, these rules did not apply to transfers between same-sex spouses since the donor’s or decedent’s same-sex spouse was not treated as a family member. The business owner could transfer common stock to his or her same-sex spouse while retaining preferred stock *without* having the value of the retained preferred stock attributed to the common stock. With the passage of *Windsor*, transfers between same-sex spouses or their family members will trigger the attribution rules, making this type of business planning less desirable for same-sex spouses.

The *Windsor* ruling, which requires the federal government to recognize same-sex married couples as spouses, serves to equalize the treatment of same-sex spouses and heterosexual spouses. The decision thus grants same-sex spouses many of the same benefits and *disadvantages* available to opposite-sex

spouses. As a result, IRS rules that were enacted to prevent abusive tax practices among family members will now apply to same-sex spouses.

In the next installment, we will look at the effect of the Windsor case on transfers to same-sex spouses in trust (IRC §2702) and lapsing rights and restrictions among family members (IRC §2704).