PLANNING TECHNIQUES AND PRACTICE POINTERS FOR REPRESENTING SAME-SEX COUPLES

DC Bar Taxation Section
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STATE-LEVEL BENEFITS OF MARRIAGE EQUALITY IN DC AND MARYLAND

- Authority to make healthcare decisions for incapacitated spouse
- Priority in appointment as conservator of the property of incapacitated spouse
- Ability to recover for wrongful death
- Inheritance rights in the event spouse dies intestate
- Elective share rights
- Ability to hold real property as tenants by the entireties
- Exemption from real estate transfer and recordation taxes
- Marital deduction for state estate tax purposes
  - Not yet recognized in MD. Need legislative action. See 98 Opinions of the Attorney General (January 18, 2013).
  - Recognized in DC, but only if bequest is outright (because of unavailability of DC-only QTIP election).
- Exemption from MD inheritance tax

ABSENCE OF FEDERAL BENEFITS

- State recognition of same-sex marriage does not result in any recognition for federal purposes.
- Defense of Marriage Act (DOMA) was enacted in 1996 as a reaction to the "threat" of same-sex marriage in Hawaii.
- Section 3 of DOMA, codified at 1 U.S.C 7, provides as follows: "In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife."
- On October 18, 2012, in Windsor v. U.S., an estate tax refund case, the U.S. Court of Appeals for the 2nd Circuit held that Section 3 is unconstitutional because it violates the Equal Protection Clause of the 5th Amendment). The U.S. Supreme Court will hear oral arguments in Windsor on March 27th.
- It is of course far from clear that the Court will hold DOMA unconstitutional.
- In fact, the Court may not rule on the merits of the case at all . . . . .

LOOKING FOR A REASON NOT TO DECIDE WINDSOR ON THE MERITS?

- On December 11, 2012, the Court appointed Professor Vicki Jackson of Harvard Law School to argue that neither the Bipartisan Legal Advisory Group (BLAG) (who is defending the law on behalf of House Republicans), nor the Justice Department (who stopped defending the law in February 2011), has legal standing to appear in court and that, as a result, the Court has no authority to hear the case.

- In any event, even if the Court rules that Section 3 of DOMA is unconstitutional, effective representation of same-sex couples who reside in states that do not allow same-sex marriage will continue to present challenges for estate planners.

OVERVIEW: HOW IS PLANNING (TAX AND NON-TAX) FOR SAME-SEX COUPLES DIFFERENT?

- Disposition of Assets
  - Last Will & Testament or Pourover Will/Revocable Trust
  - Lifetime Gifts (Outright or in Trust)
  - Inter-spousal Gifts
  - Gifts to Third Parties
  - Jointly Held Property
  - Life Insurance Beneficiary Designations (or ILITs)
  - Qualified Retirement Accounts

- Disability Planning
  - Durable General Financial Power of Attorney
  - Healthcare Power of Attorney & Advance Medical Directive
  - HIPAA Release

Last Will & Testament or Pourover Will/Revocable Trust

- Revocable Trust provides privacy and built-in disability planning.
- Consider robust definition of "Spouse" for future generations, especially where descendants are given limited powers of appointment in favor of spouses.
- Structure of bequest to surviving same-sex partner or spouse
  - If outright, bequest will be hit with federal estate tax twice if size of estate is large enough and survivor doesn't consume the assets before his or her death.
  - If bequest is in trust and trust is properly structured, bequest will be sheltered from federal estate tax upon death of second spouse or partner to die.
  - Where state estate tax marital deduction is available only for outright bequests (as is currently the case in DC), need to balance potential state estate tax savings on first death with the loss of protection from creditors and the loss of insulation from later federal estate tax caused by making an outright bequest.
  - Consider having marital bequest structured as QTIP-able trust.

ROBUST DEFINITION OF SPOUSE

- **Spouse and Surviving Spouse.** For all purposes of this Agreement, the "Spouse" of a descendant of the Grantor means the person (if any) who is married to such descendant at such time as marital status is relevant, and the "Surviving Spouse" of a descendant of the Grantor means the person, if any, who was married to such descendant at the time of the descendant's death, regardless of whether such person is of the same sex or of the opposite sex as such descendant, and the determination of whether such person is, or in the case of a Surviving Spouse was, married to such descendant shall be determined not by the law of the State of Delaware but by the law then in effect in the jurisdiction that is the domicile of such descendant; *provided, however*, that in furtherance of the Grantor's desire to treat equally those descendants to whom marriage is available and those descendants to whom marriage is unavailable as a result of state laws prohibiting same-sex marriage, the definition of "Spouse" shall include a person with whom, at such time as marital status is relevant, a descendant of the Grantor has entered into a civil union or domestic partnership recognized under the law of such descendant's domicile, and the definition of "Surviving Spouse" of a descendant shall include a person with whom such descendant was, at the time of such descendant's death, in a civil union or domestic partnership recognized under the law of such descendant's domicile; and *further provided*, that where the law of a descendant's domicile does not recognize civil unions or domestic partnerships entered into between persons of the same sex, the definition of "Spouse" or "Surviving Spouse," as the case may be, shall include a person (i) to whom such descendant is not related by blood or a degree of consanguinity that would prohibit marriage under the law of the domicile in which such descendant resides or resided at the time of such descendant's death, (ii) with whom such descendant shares a permanent residence or with whom such descendant shared a permanent residence at the time of such descendant's death and (iii) with respect to whom such descendant (or, in the case of a determination to be made with respect to a Surviving Spouse, the Personal Representative of such descendant's estate) is able to provide to the then serving Individual Trustees at least two (2) documents evidencing economic interdependence, which documents, by way of example and not by way of limitation, include a deed reflecting joint ownership of real property, a Will or trust agreement pursuant to which such person is named by such descendant as a beneficiary, a life insurance policy of which such person is named by such descendant as a beneficiary or a power of attorney pursuant to which such descendant names such person as his or her attorney-in-fact for financial matters, and the determination as to whether the evidence provided is sufficient to establish that such person qualifies as a Spouse or Surviving Spouse of such descendant shall be made by the then serving Individual Trustees acting by majority, and the decision of the Individual Trustees shall be binding on all parties.

EXAMPLE

Steve and Christopher live in DC. They got married in October 2010. Steve has about $20 million of assets. Christopher has minimal assets. Steve would like for Christopher to have access to all of his assets following his death.

Option 1: A "Sweetheart Will." Everything to Christopher outright. Steve's estate pays $6M FET ($15M in excess of applicable exclusion amount (AEA) x 40%) and no DC estate tax (marital deduction). Christopher nets $14M and lives off the income produced. When he dies, his estate pays $3.6M FET ($9M in excess of AEA x 40%) and about $2M ($13M in excess of $1M DC exemption x 16%) in DC estate tax. Total taxes paid by couple: $11.6M.

Option 2: Fractional Division with Residue Outright. Steve sets aside $5M in a standard credit shelter trust, balance outright to Christopher. Steve's estate pays $6M federal estate tax and about $600K DC estate tax (only $4M is subject to DC estate tax because there is $1M exemption and $15M qualifies for the marital deduction) so about $8.5M passes to Christopher outright. At Christopher's death, credit shelter trust bypasses his estate. His estate pays $1.4M in federal estate tax ($3.5M in excess of AEA x 40%) and about $1.2M in DC estate tax ($7.5M in excess of DC exemption amount x 16%). Total taxes paid by couple: $9.2M.

Option 3: Fractional Division with Residue in Trust. Same as Option 2 except the residue (i.e., the $15M over and above Steve's AEA) is held in trust as well (trust could be QTIP-able). Steve's estate pays $6M federal estate tax and about $3M in DC estate tax. At Christopher's subsequent death, Christopher's estate pays no estate tax. Total taxes paid by couple: $9M.

*All numbers are approximate and used for illustration only.

LIFETIME GIFTS

- Gifts from One Spouse or Partner to Other
  - The unavailability of the federal gift tax marital deduction makes inter-spousal or inter-partner transfers difficult. (Difficulty mitigated by current applicable exclusion amount except for HNW clients).
  - Spousal portability of applicable exclusion amount not available.
  - Consider fun and potentially very effective leveraging techniques (GRITs, CLTs and GRATs where appropriate). (Hold off on GRIT until Windsor is decided.)
  - No complications with annual exclusion gifts ($14,000 for 2013).
  - No complications with payments of medical and educational expenses.

- Gifts to Third Parties
  - Gift-splitting under IRC Section 2513 not available.

  - Example 1. Ken made a gift of $10M to a trust for his grandchildren on December 31, 2012. Barbara has consented to split the gift with Ken for gift and GST tax purposes. No gift or GST tax is due.

  - Example 2. Ken's brother Kevin made a gift of $10M to a trust for his grandchildren on the assumption that gift-splitting was available to him because he married his spouse Adam in 2012. Adam would like to consent to split that gift. He cannot. Kevin made an extremely expensive assumption.

JOINTLY HELD PROPERTY

- Gift Tax Considerations.
  - Real Estate. With other joint assets, a person who purchases property and has title conveyed to himself and his same-sex spouse or partner with right of survivorship results in an immediate taxable gift to the noncontributing partner of one-half the value of the property
  - Bank and Brokerage Accounts. A taxable gift does not arise upon the creation and deposit of cash into a joint bank account. The gift does not occur until the noncontributing joint tenant withdraws funds from the account with no duty to account to the other joint tenant for the use of the proceeds. The joint bank account rules also apply to joint brokerage accounts if the contributing joint owner can withdraw his or her own contribution without the consent of the other joint tenant. Tenancies by the Entireties
- Estate Tax Considerations. When individuals other than federally recognized spouses own property in survivorship form, the entire value of the property is included in the estate of the first owner to die unless the surviving owner can show how much each owner contributed to the purchase price of the property. The burden of proof is on the surviving owner.

TENANCIES BY THE ENTIRETIES

- While each co-owner of a JTWROS property may unilaterally sever the joint ownership, both spouses must consent to the severance before TBE property can be severed.

- A co-owner's interest in TBE property is fully protected from such co-owner's creditors unless both co-owners are liable to the same creditor on the same claim.

LIFE INSURANCE

- A life insurance policy may be needed to provide liquidity to pay estate taxes on the first death.
- If so, life insurance policy should be owned by an irrevocable life insurance trust (ILIT) so that the policy proceeds are not included in the decedent's taxable estate (no marital deduction).
- Remind clients to make sure their beneficiary designation forms are up to date.

Qualified Retirement Account Beneficiary Designations

These are non-probate assets that do not pass under a participant's Will (unless they are made payable to his or her estate).

- Designation of Beneficiary. Opposite-sex spouses have mandatory survivorship rights to qualified retirement accounts. If the account owner wishes to leave the assets to a non-spouse beneficiary, the spouse must consent in order for the intended disposition to be effective. Same-sex spouses do not have this protection.
- Spousal Rollover
  - Per Section 408(d)(3), a surviving spouse (recognized as such for federal purposes) may roll over a deceased spouse's plan benefits (both ERISA qualified plans and IRAs) into his or her own plan at the death of the first spouse, and the surviving spouse is not required to start distributions from the plan (including the portion of the plan consisting of the rollover amount) until his or her own required beginning date (April 1st following the year in which he or she reaches the age of 70 ½).
  - Since 2007 trustee-to-trustee rollovers are available for nonspousal beneficiaries (including same-sex partners), but the amounts rolled over are still subject to the RMD rules, which means that a nonspousal beneficiary will be required to receive a distribution of a portion of the inherited IRA each year over his or her lifetime (or, if not rolled over before the end of the year following the death of the deceased, the entire IRA will be required to be distributed within 5 years).

MISCELLANEOUS TAX CONSIDERATIONS

- SLATs and Section 677. So long as an opposite-sex spouse is a beneficiary of a trust (as is the case with the many so-called "spousal lifetime access trusts" (SLATs) created in 2012), the trust is automatically a grantor trust for income tax purposes (per Section 677), and it is not possible to "toggle off" grantor trust status. A SLAT created for the benefit of a same-sex spouse is not a grantor trust under Section 677. (Of course, it is possible to make the trust a grantor trust using other grantor trust powers.)

- Section 121 Exclusion from Gain on Sale of Principal Residence. For a married couple filing a joint return, only one spouse need qualify for the 2-year ownership requirement; for other joint owners, both must satisfy the 2-year requirement in order to exclude up to a total of $500K of gain.

- Generation-Skipping Transfer Tax. Generation assignments are based on lineage for transfers to family members and on age for transfers to nonfamily members. The transferor and the transferor's spouse's children, nephews, nieces and their spouses are members of the first generation, and the ages of the nieces and nephews are not relevant. So, for example, if Karen, who is 40 years old, wants to make a large direct gift to her husband's niece, who is only 2 years old, she can do so without using any of her GST tax exemption. However, were Karen married to a woman, and wanted to make a gift to her spouse's 2-year niece, the gift will be a direct skip, because the niece is more than 37 ½ years younger than Karen.

PLANNING FOR INCAPACITY

- State law protections are no substitute for a comprehensive Durable General Power of Attorney.
- State law protections are no substitute for a comprehensive Healthcare Power of Attorney and Advance Medical Directive.
- Under the privacy rule of the Health Insurance Portability and Accountability Act (HIPAA), a person authorized under applicable law to make healthcare decisions for another individual is the individual's "personal representative," i.e., the person to whom protected health information may be released. Although a same-sex spouse has the ability under DC and MD law to make healthcare decisions for his or her spouse, it would be prudent to avoid all ambiguity and have the clients sign a HIPAA release (either as a stand-alone document or as part of the Healthcare Power of Attorney/Advance Medical Directive).