V. Employee Benefits and Tax Consequences of United States v. Windsor

A. Introduction

Historically, the Defense of Marriage Act ("DOMA") limited the definition of "marriage" to "a legal union between one woman and one man as husband and wife," and spouse to "a person of the opposite sex who is a husband or wife."[1] Although a growing number of individual states had recognized same-sex unions, federal law refused to recognize those unions as legitimate marriages.[2] Despite sharing many of the same features of heterosexual unions, such as emotional and financial dependency, federal law did not require employers to provide equal employment benefits for same-sex and heterosexual spouses.[3] Importantly, the Internal Revenue Service ("IRS") did not consider these unions "marriages" for tax purposes and did not allow same-sex couples to utilize many tax-favored employment benefits.[4] Then, on June 26, 2013, the United States Supreme Court struck down section 3 of DOMA and held that it is unconstitutional to prohibit recognition of same-sex marriages for purposes of federal law.[5]

The Supreme Court's decision in *United States v. Windsor* led to interesting ramifications for employers and employees alike.[6] Although the Supreme Court's decision allowed same-sex couples to immediately marry in states that recognized same-sex marriages, many of the financial consequences of federal recognition continue to unfold.[7] Recently, the IRS released Notice 2014-1, which interpreted some of *Windsor*'s implications for employee benefits and tax consequences.[8] Notice 2014-1 discusses changes to employee cafeteria benefits, health plans, flexible spending accounts

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[1] 1 U.S.C. § 7 (2012).
[2] *Id.*; *see* MARGOT L. CRANDALL-HOLLICK ET AL., CONG. RESEARCH SERV., R43157, THE POTENTIAL FEDERAL TAX IMPLICATIONS OF UNITED STATES V. WINDSOR (STRIKING SECTION 3 OF THE DEFENSE OF MARRIAGE ACT (DOMA)): SELECTED ISSUES 2 (2013).
[3] EMPLOYER'S HANDBOOK: COMPLYING WITH THE IRS EMPLOYEE BENEFIT RULES ¶ 372 (2013), *available at* 2004 WL 4110818.
[4] I.R.S. Notice 2014-1, 2014-2 I.R.B. 270.
[5] United States v. Windsor, 133 S. Ct. 2675, 2696 (2013).
[6] *See* discussion *infra* Parts B and C.
[7] *See generally* CRANDALL-HOLLICK ET AL., *supra* note 2.
[8] I.R.S. Notice 2014-1, 2014-2 I.R.B. 270.

("FSAs"), and health savings accounts ("HSAs") in light of the *Windsor* decision and mandates how employers should apply these changes retroactively.[9] The IRS's advisory opinion is helpful in applying *Windsor*'s holding to the realm of employment benefits, but it is only the very beginning, and many questions remain for employers and employees alike.[10]

B. Background

DOMA's limited definition of both "marriage" and "spouse" prohibited all federal laws from recognizing same-sex couples.[11] Many laws that regulate employee benefits are federal laws, as is the tax code.[12] Therefore, DOMA's limiting language adversely affected same-sex couples' financial status and well-being.[13] Prior to June 26, 2013, section 3 of DOMA inhibited employers from allowing employees' same-sex spouses to receive coverage, pre-tax, under an employer's cafeteria plan because they were married to an employee.[14] As a result, individuals covering their same-sex spouses were paying much more each year in taxes for the same types of benefits than individuals who covered their opposite-sex spouses.[15]

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[9] *See id.*

[10] *See* discussion *infra* Part D.

[11] 1 U.S.C. § 7 (2012).

[12] *See* Stephen Douglas et al., *Employee Benefit Plans After Supreme Court's DOMA Decision*, TOWERS WATSON (Aug. 1, 2013), http://towerswatson.com/en-US/Insights/Newsletters/Americas/insider/2013/Employee-Benefit-Plans-After-Supreme-Courts-DOMA-Decision.

[13] United States v. Windsor, 133 S. Ct. 2675, 2694 (2013) ("DOMA's principal effect is to identify a subset of state-sanctioned marriages and make them unequal . . . Responsibilities, as well as rights, enhance the dignity and integrity of the person. And DOMA contrives to deprive some couples married under the laws of their State, but not other couples, of both rights and responsibilities.").

[14] I.R.S. Notice 2014-1, 2014-2 I.R.B. 270. This did not mean that same-sex spouses could never receive coverage under a cafeteria plan pre-tax but rather that the spouse must have otherwise qualified as a dependent in order to receive such benefits. *See id.*

[15] CRANDALL-HOLLICK ET AL., *supra* note 2, at 1.

1. *United States v. Windsor*

On June 26, 2013, the Supreme Court found section 3 of DOMA unconstitutional because it violated the Fifth Amendment.[16] This decision invalidated the prohibition against federal recognition of same-sex marriage and held that the federal government will recognize individual states' determinations that persons of the same sex can marry legally.[17] The Supreme Court indicated that the decision would have a monumental effect on tax administration.[18] This decision, however, only dictates the application of federal laws to same-sex couples that are legally married under the laws of an individual state.[19] The decision does not require each state to individually permit or accept same-sex marriages, or even accept same-sex couples that lawfully married in another state for the purposes of state laws.[20] Rather, it requires states to apply federal laws equally to all lawfully married couples, no matter if they are same or opposite sex.[21]

While the decision clarified that same-sex couples and opposite-sex couples are equal for federal law purposes in states that recognize same-sex marriages, it did not address the comparative rights between same-sex couples and opposite sex couples in states that do not recognize same-sex marriage.[22] Furthermore, the decision only invalidated a previously accepted federal definition of "marriage" and "spouse."[23] Therefore, it seems that the *Windsor* decision does not extend this idea of equality beyond state-recognized same-sex marriages to state-recognized same-sex civil unions.[24]

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[16] *Windsor*, 133 S. Ct. at 2696.
[17] *Id.*
[18] "The Court observed in particular that section 3 burdened same-sex couples by forcing 'them to follow a complicated procedure to file their Federal and state law taxes jointly' and that [it] 'raise[d] the costs of health care . . . by taxing health benefits provided by employers to their workers' same-sex spouses.'" Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (citing *Windsor*, 133 S. Ct. at 2694–95).
[19] *Windsor*, 133 S. Ct. at 2696.
[20] *See id.*
[21] *Id.*
[22] *See id*.
[23] *Id.* For the precise definition voided, see 1 U.S.C. § 7 (2012).
[24] *Windsor*, 133 S. Ct. at 2696; *see also* CRANDALL-HOLLICK ET AL., *supra* note 2, at 2, n.11 ("It is important to note that a civil union is a legal

2. Sections 125 and 223 of the Internal Revenue Code

Whether or not federal law recognizes an individual as a spouse makes a remarkable difference for that couple's employee benefits plans and tax exemptions.[25] The federal government taxes employee benefits differently depending on with whom employees share them.[26] Certain employee benefits are provided to spouses tax-free, and, therefore, individuals have a financial interest in having a legally recognizable marriage and spouse.[27] Similarly, employers have a substantial interest in the federal law's definition of spouse.[28] For many companies, substantive changes must be made in light of the Supreme Court's decision in *Windsor*.[29] It is not only labor intensive for companies to make substantive changes to their employee benefits distribution scheme, but also laborious for companies to monitor and understand the marriage laws of other states and countries.[30]

The IRS issued Notice 2014-1 in December 2013 to assist employers in applying the *Windsor* decision to their existing employment benefits programs.[31] The purpose of Notice 2014-1 is to guide employers on applying the "rules under section[s] 125 . . . and 223 of the [Internal Revenue Code] as those two provisions relate to the participation by same-sex spouses in certain employee benefits

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protection conferred at the state, not the federal level. As such a variety of benefits . . . may not apply to civil unions.").

[25] *See* CRANDALL-HOLLICK ET AL., *supra* note 2, at 1.

[26] *See, e.g.*, 26 U.S.C. § 223(b)(5) (2012).

[27] *See* I.R.S. Notice 2014-1, 2014-2 I.R.B. 270.

[28] *See* Douglas, *supra* note 12.

[29] *Id.*; *see* Daniel C. Hagan et al., *The Supreme Court's DOMA Decision: Impact of the Changing Definition of Spouse on Employee Benefits*, JONES DAY COMMENTARY 1 (July 2013), http://jonesday.com/files/Publication/bd854f37-54eb-428b-bd83-f50605591 2fd/Presentation/PublicationAttachment/f349cfa8-5553-4afb-b81a-f555cec 3812b/Supreme%20Court%20DOMA%20Decision.pdf ("To the extent that same-sex spouses are lawfully married, however, employers need to consider what benefits and protections must be extended to same-sex spouses under their employee benefit plans.").

[30] *See* Douglas, *supra* note 12.

[31] *See* I.R.S. Notice 2014-1, 2014-2 I.R.B. 270.

plans following the Supreme Court decision in [*Windsor*], and the issuance of Rev. Rul. 2013-17, 2013-28 I.R.B. 201."[32]

The Internal Revenue Code exempts certain types of employment benefits from employees' calculation of their gross annual income.[33] For example, section 125 of the Internal Revenue Code defines cafeteria plans and other "qualified benefits," all of which are not included in calculating employees' gross annual income.[34] Under section 125(d)(1), a cafeteria plan is a "written plan under which—(A) all participants are employees, and (B) the participants may choose among 2 or more benefits consisting of cash and qualified benefits."[35] Other benefits that the IRS eliminates from calculating an employees' annual gross income include other "qualified benefits," such as employee contributions to "employer-provided accident and health plan[s]," health savings accounts, and flexible spending accounts.[36] Treasury Regulation section 1.125-4 states that employees can change their elections in a cafeteria plan in the middle of their coverage period under limited circumstances.[37] One of these circumstances is a change in legal marital status.[38] This ability to alter election selections mid-coverage period allows employees to immediately realize these benefits, as opposed to waiting until the next election period.[39]

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[32] *Id.*
[33] *See, e.g.*, 26 U.S.C. § 125(a) (2012).
[34] *Id.* § 125(f).
[35] *Id.* § 125(d)(1).
[36] *See* I.R.S. Notice 2014-1, 2014-2 I.R.B. 270. "[T]he term "qualified benefit" means any benefit which, with the application of subsection (a), is not includable in the gross income of the employee by reason of an express provision of this chapter." 26 U.S.C. § 125(f). Under 26 U.S.C. § 223(d), a health savings account is a type of trust that an employee establishes to pay for "qualified" medical expenses. 26 U.S.C. § 223(d). Under 26 U.S.C. § 223(d)(2), "qualified medical expenses" include medical expenses for an employee's spouse. *Id.* A flexible spending account ("FSA") is a benefit program in which employees are reimbursed for certain expenses, like medical or dependent care programs. *Id.*
[37] Treas. Reg. §1.125-4 (as amended in 2001).
[38] *Id.*
[39] *Id.*

C. Implications of the Supreme Court's Decision in *United States v. Windsor*

The IRS issued a Revenue Ruling in August 2013 to address the IRS's interpretation of the *Windsor* decision.[40] The Ruling stated that "for Federal Tax purposes, the terms 'spouse,' 'husband and wife,' 'husband,' and 'wife' include [same-sex individuals who] are lawfully married under state law, and the term 'marriage' includes such a marriage between individuals of the same sex."[41] Some same-sex couples will benefit from a "marriage bonus" by filing jointly, as opposed to individually, after the *Windsor* decision.[42] A marriage bonus sometimes exists when couples file their taxes together and, as a result, incur lower tax liability than when they file as two individuals.[43] Conversely, other same-sex couples may actually face a "marriage penalty," experiencing an increase in tax liability when they file their taxes jointly.[44]

The August 2013 Ruling clarified that even if a same-sex couple domiciles in a state that does not recognize same-sex marriage, federal law will still recognize the marriage as long as the couple married in a state that does recognize same-sex marriages.[45] It "assures legally married same-sex couples that they can move freely throughout the country knowing that their federal filing status will not change."[46] Further, these uniform nationwide rules will help provide "for efficient and fair tax administration."[47] However, marriage, for federal tax purposes, does not include "formal relationships" that are not state law-recognized marriages.[48] Finally, the Revenue Ruling answered a lingering question; taxpayers may rely on *Windsor*'s changes retroactively.[49]

Notice 2014-1 informed taxpayers that, now, employers may treat employees who were married to a same-sex spouse by June 26,

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[40] *See* Rev. Rul. 2013-17, 2013-38 I.R.B. 201
[41] *Id.*
[42] CRANDALL-HOLLICK ET AL., *supra* note 2, at 5.
[43] *Id.*
[44] *Id.*
[45] Rev. Rul. 2013-17, 2013-38 I.R.B. 201.
[46] *See* Lydia Beyoud, *Legal Same-Sex Marriage Recognized For Federal Tax Purposes, IRS, Treasury Say* 40 Pens. & Ben. Rep. (BNA) 2081, 2081 (Sept. 3, 2013) (quoting Treasury Secretary Jacob J. Lew).
[47] *Id.*
[48] *Id.*
[49] *Id.*

2013 as having made a change in marital status for the purpose of their cafeteria plans.[50] This allows those couples to make changes to their elections under their cafeteria plans midway through their coverage period.[51] Employers must allow their employees to make these changes to their plans at any time during a coverage period that includes June 26, 2013 or December 16, 2013, the date the IRS released the notice.[52] For companies that calculated their benefits pursuant to a calendar-year schedule, this ability to make mid-period changes made little difference because the IRS delivered the Notice two weeks before the end of 2013.[53] However, the IRS explained that it would defer to any changes made between June 16, 2013 and December 16, 2013 pursuant to this guidance.[54] The IRS further stated that employers should alter language that excludes same-sex spouses from cafeteria plans, but it did not set a specific deadline by which employers must make that change.[55] Further, it appears that if an employer already permitted plan amendments for changes in marital status, the employer need not change its amendment policy.[56]

Notice 2014-1 also informed taxpayers about how the IRS viewed the changes for HSAs, FSAs, and employer-provided accident and health plans.[57] Perhaps the most fundamental portion of this announcement was that employees may receive retroactive compensation for out-of-pocket expenses incurred because of the pre-*Windsor* tax-laws.[58] Now, employers must permit an employee to pay for health benefits pre-tax and this mandate includes expenses already incurred through any benefit period including December 16, 2013.[59] Employees have a couple of options to realize this tax break.[60] First, the employee can continue paying for their spouse's health coverage on an after-tax basis and seek one reimbursement at

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[50] I.R.S. Notice 2014-1, 2014-2 I.R.B. 270.
[51] *Id.*
[52] *Id.*; *see* Carrie Herrick et al., *More Post-DOMA Guidance from the IRS – Cafeteria Plans, FSAs and HSAs*, BENEFITS BRYAN CAVE (Dec. 27, 2013), http://benefitsbryancave.com/more-post-doma-guidance-from-the-irs-cafeteria-plans-fsas-and-hsas/.
[53] *See* Herrick et al., *supra* note 52.
[54] *Id.*
[55] *Id*.
[56] *Id.*
[57] *See* I.R.S. Notice 2014-1, 2014-2 I.R.B. 270.
[58] Herrick et al., *supra* note 52.
[59] *Id.*
[60] *Id.*

the conclusion of the benefit plan period.[61] In the alternative, employees can elect to start paying for their spouse's benefits pre-tax immediately, and be compensated for the difference at the close of the current tax period.[62] The IRS mandates that employers make these changes by the later of (a) the time when an employer would have had to make the mid-year change based on an employee's changed marital status, or (b) a "reasonable time after December 16, 2013."[63]

Similarly, the IRS stated in Notice 2014-1 that employees may seek reimbursements for out-of-pocket FSA expenses incurred by their same-sex spouses.[64] If the FSA coverage period is a calendar year, employees may seek reimbursements for all of their same-sex spouse's expenses incurred after January 1, 2013.[65] If the employer measured the FSA period with different dates, an employee can retroactively seek reimbursement for the period that included June 26, 2013.[66] These changes are especially monumental for companies who maintain "zero-out" FSA plans.[67] Before this change, employees with same-sex spouses whose companies had "zero-out" plans possibly struggled to eliminate their FSA balance each term, while still incurring additional unrecorded taxable expenses for their spouse.[68] While the IRS used permissive language when advising reimbursements for FSAs, other federal statutes, such as Title VII, may provide redress should an employer allow only heterosexual couples to capitalize on benefits, while excluding same-sex couples.[69]

Finally, Notice 2014-1 explained that, consistent with contribution limits imposed on heterosexual couples, same-sex spouses must now respect the annual joint contribution limits for both HSAs and dependent care FSAs.[70] To the extent that a same-sex

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[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] I.R.S. Notice 2014-1, 2014-2 I.R.B. 270. These expenses include health expenses, dependent care, and adoption-assistance FSA. *Id.*
[65] *Id.*
[66] *Id.*
[67] *See* Herrick et al., *supra* note 52.
[68] *Id.*
[69] *Id.*
[70] I.R.S. Notice 2014-1, 2014-2 I.R.B. 270. In 2013, the HSA contribution limit was $6450 and the dependent care FSA contribution limit was $5000. *Id.* A married couple, for the purposes of contributions, may only contribute

couple exceeds the yearly contribution limit for either their HSA or FSA, their excess funds will be included in the couple's gross annual income and taxed.[71]

While same-sex married couples will likely experience large tax benefits from the *Windsor* decision, the federal government's budget will be affected only minimally.[72] In 2011, "the U.S. Census Bureau estimate[d] that there [were] 605,472 same-sex couples in the United States."[73] This number reflects "less than one-half of one percent of all tax returns filed" in 2011.[74] Further, only 27.8% of the 605,472 same-sex couples indicated that they were married, and it is unclear what percentage of the 27.8% are legally married under state law.[75] Even considering an increase in same-sex marriages as more states legalize same-sex unions, it is clear from the statistics that the increase from the perspective of the federal government is minimal considering the broader, taxpaying picture.[76]

D. Uncertainties

Although the IRS rulings and notices have helped clarify marital status for the purpose of federal tax returns and forms, the notices do not apply to state tax returns.[77] This raises an issue for states who require taxpayers to include information about their federal tax returns on their state forms.[78] Many same-sex couples who self-identify as "married" live in states that do not recognize same-sex marriage.[79] Moreover, approximately twenty-four states do not recognize same-sex marriage and "require taxpayers to reference the federal tax returns when they fill out their state tax forms."[80] A policy think tank, the Tax Foundation, has proposed several possible solutions that would require little effort for the affected taxpayers.[81]

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as much annually tax-free as an individual may. CRANDALL-HOLLICK ET AL., *supra* note 2, at 8.

[71] I.R.S. Notice 2014-1, 2014-2 I.R.B. 270.

[72] CRANDALL-HOLLICK ET AL., *supra* note 2, at 3.

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] Beyoud, *supra* note 46.

[78] *Id.*

[79] *See* CRANDALL-HOLLICK ET AL., *supra* note 2, at 3.

[80] Beyoud, *supra* note 46.

[81] *Id.*

Tax Foundation proposed solutions such as "dummy federal returns," where spouses fill out federal tax forms with "single" status, allowing each spouse to split their joint federal return in half for their state filing.[82] Alternatively, Tax Foundation suggested creating a new filing status for same-sex couples.[83] Regardless, these are only proposed solutions, and a more permanent solution or solutions must be implemented in the long term.

Furthermore, the rulings are limited to marriages only.[84] Many states, however, recognize unions similar, but not equivalent to, marriages.[85] One primary concern is discriminating against persons not based on their sexuality, but rather on their marriage status, in violation of the Fifth and Fourteenth Amendments to the U.S. Constitution.[86] That general concern must be balanced with federalism concerns, because marriage and civil unions are institutions of the state, and not the federal, government.[87] However, including an additional portion of the half of one percent of American taxpayers does not seem like it would debilitate the federal government or its tax administration.[88] Most likely, it will only be a matter of time until these new tax benefits are further extended, but it is unclear in what manner this expansion will occur.[89]

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[82] *Id.*
[83] *Id.*
[84] CRANDALL-HOLLICK ET AL., *supra* note 2, at 2.
[85] *Id.* at 2 n.10.
[86] "Whether and whom to marry, how to express sexual intimacy, and whether and how to establish a family—these are among the most basic of every individual's liberty and due process rights." Goodridge v. Dep't of Pub. Health, 798 N.E.2d 941, 959 (Mass. 2003) (citing Lawrence v. Texas, 539 U.S. 558, 571 (2003); Planned Parenthood of Southeastern Pa. v. Casey, 505 U.S. 833, 851; Zablocki v. Redhail, 434 U.S. 374, 384 (1978); Roe v. Wade, 410 U.S. 113, 152–53 (1973); Eisenstadt v. Baird, 405 U.S. 438, 453 (1972); Loving v. Virginia, 388 U.S. 1, 12 (1967)).
[87] United States v. Windsor, 133 S. Ct. 2675, 2692 (2013) ("Against this background DOMA rejects the long-established precept that the incidents, benefits, and obligations of marriage are uniform for all married couples within each State, though they may vary, subject to constitutional guarantees, from one State to the next.").
[88] *See supra* notes 72–76 and accompanying text.
[89] For example, the marriage equality group, Freedom to Marry, has promised to work to expand the Supreme Court's ruling in *Windsor* and these subsequent changes to benefit and recognize same-sex domestic partnerships and civil unions. *See* Beyoud, *supra* note 46.

E. Conclusion

The Supreme Court's ruling in *United States v. Windsor* and the IRS's subsequent interpretations helped equalize same-sex spouses with heterosexual spouses for purposes of federal taxation.[90] While, in many ways, the decision and subsequent interpretations helped to bring change for the better, many issues remain in order to implement this effectively and equally.[91] At the very least, the IRS's notifications and rulings have helped guide employers and their attorneys to understand how *United States v. Windsor* changed federal legislation relating to employment benefits and spousal taxation.[92] On the other hand, the rulings are monumental for over 600,000 of our nation's citizens and will allow them to finally experience the financial benefits of a committed relationship.[93]

Bridgette C. Pighin[94]

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[90] *See* discussion *supra* Parts B–C.
[91] *See* discussion *supra* Part D.
[92] *See* discussion *supra* Part C.
[93] *American Community Survey Data on Same-Sex Couples*, UNITED STATES CENSUS BUREAU, http://census.gov/hhes/samesex/data/acs.html (last visited Apr. 16, 2014) ("Treating same-sex couples as married for federal tax purposes could have substantial financial implications for some affected couples . . . . Currently, the U.S. Census Bureau estimates that there are 605,472 same-sex couples in the United States (less than one-half of one percent of all tax returns filed), of which approximately 168,000 (27.8%) self-identify as married.").
[94] Student, Boston University School of Law (J.D. 2015).