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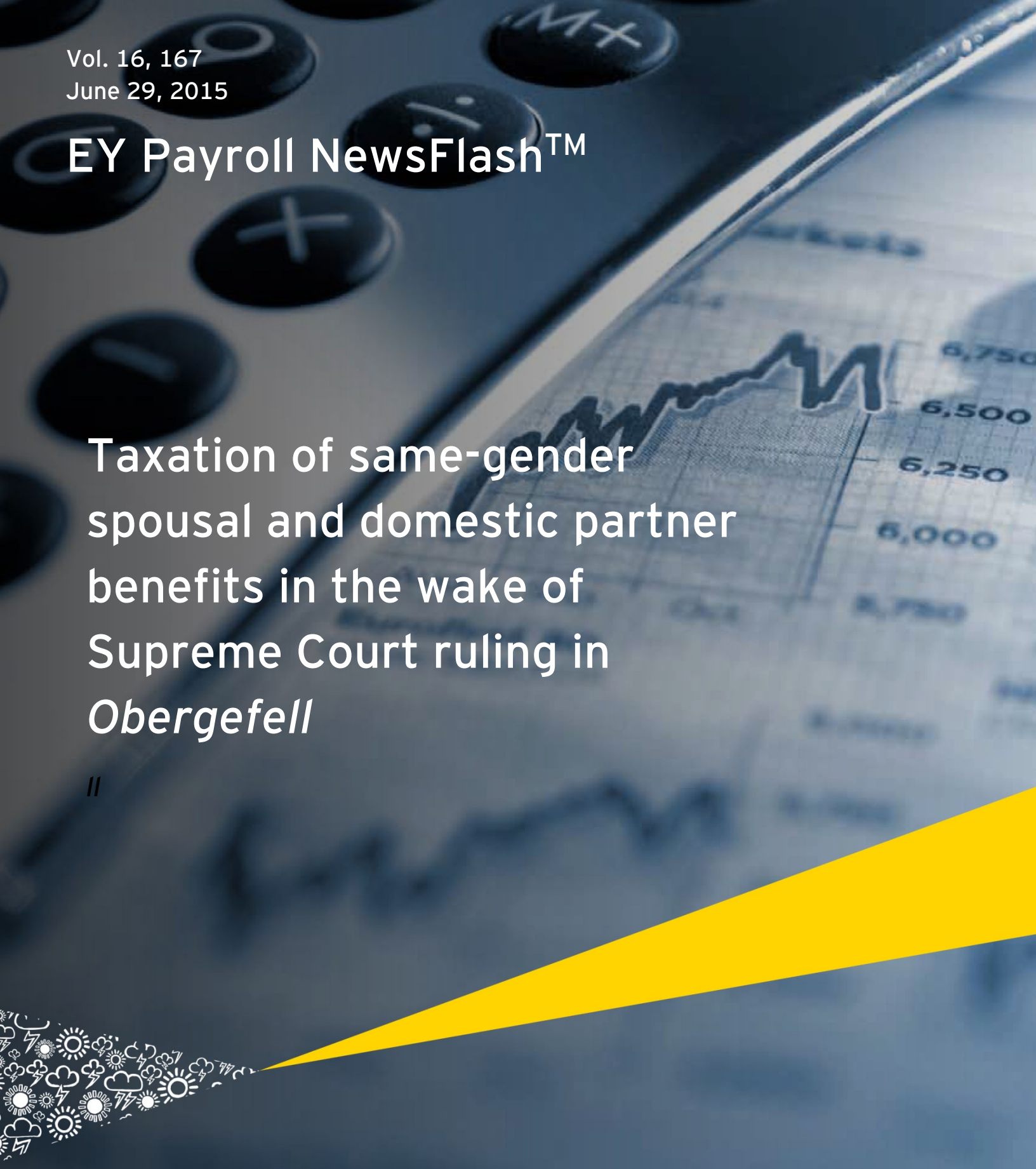

Taxation of same-gender spousal and domestic partner benefits in the wake of Supreme Court ruling in *Obergefell*

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Building a better working world

Taxation of same-gender spousal and domestic partner benefits in the wake of the Supreme Court ruling in *Obergefell*

Ernst &Young LLP insights

This historic ruling will, in time, simplify and streamline the state and local wage tax reporting and tax process for employers while giving affected employees tax relief on spousal benefits, such as health insurance.

It will take some time for states to implement this ruling; however, employers will need to immediately determine how benefit plans and payroll systems will be modified to accommodate the nationwide recognition of same-gender marriage.

Affected employees should be reminded that changing state and local tax rules may require they file a revised state/local Form W-4 reflecting their marital status. Some employees may also want to consider if revised state/local Forms W-4 are necessary because excess income tax was withheld on their spousal benefits in 2015.

Employers can expect that adjustments may be necessary to the 2015 Forms W-2 to reflect a reduction in state/local taxable wages attributable to spousal benefits. In some cases, 2015 Forms W-2c may be necessary for jurisdictions late in issuing revised guidance pursuant to same-gendered married couples. Employers will also need to consider if adjustments are needed on state/local gross up calculations for imputed spousal benefits that are no longer taxable in 2015.

Finally, benefits provided to partners of a civil union or domestic partnership are not directly affected by this Supreme Court ruling; nonetheless, states may eliminate these licensing options in light of the nationwide recognition of same-gender marriage. These shifts in state licensing rules could change the current tax treatment of civil union and registered domestic partnership benefits.

In the second of two landmark decisions on same-gender marriage, the US Supreme Court ruled on June 26, 2015 that the Fourteenth Amendment requires all states license marriage between two people of the same gender and recognize same-gender marriages lawfully licensed and performed in another state. The Court stipulated that religious entities have a First Amendment right to advocate against same-gender marriage, but states must issue marriage licenses. (*Obergefell v. US, No. 14-556, June 26, 2015*)

As of the date of this ruling, 37 states and the District of Columbia allowed same-gender couples to marry, leaving 13 states that continued to prohibit these marriages. Of the 13 states, eight immediately announced that the Supreme Court's decision will be upheld (Arkansas, Georgia, Kentucky, Michigan, Missouri, Nebraska, Ohio and South Dakota). The remaining states will not move forward until they receive a directive from the Federal Circuit Courts (Louisiana, Mississippi, North Dakota, Tennessee and Texas).

Background

On June 26, 2013, the US Supreme Court ruled in United States v. Windsor that Section 3 of the Defense of Marriage of Act (DOMA) (*P.L. 104-199*) is unconstitutional and that a lawfully married same-gender couple must be treated as married for federal purposes. For employment purposes, the ruling was limited to federal taxes and employee benefit rights and did not reach to the issue of a state's right to deny or recognize the marriage licensing of same-gender couples. Prior to this decision, only 13 states and the District of Columbia allowed same-gender couples to marry. *(See EY Payroll NewsFlash, Vol.14, 180, 6-28-2013)*

The ruling in *Windsor* triggered a change in state marriage laws in a number of states and legal challenges in others. On October 6, 2014, when the US Supreme Court declined to hear appeals from several states whose federal district courts overturned their bans on same-gender marriage, 25 states and the District of Columbia allowed same-gender couples to marry. The Supreme Court's decision not to hear the case in 2014 had the result of lifting the marriage ban in 11 additional states. (*See EY Payroll NewsFlash, Vol. 15, 209, 107-2014)*

Income tax changes are not automatic, effective dates could vary

Eventually, the *Obergefell* ruling will have the result of giving state (and local) tax marital status to all lawfully married couples, regardless of gender. It is important to emphasize, however, that this ruling in and of itself does not automatically trigger a change in employees' tax status or the current tax treatment of same-gender spousal benefits. Further, the effective date of such changes could vary by state. For this reason it is important that employers and taxpayers wait for published guidance from the respective taxing authorities before making tax changes involving marital status.

It could take some time for taxing authorities to amend their tax regulations and issue revised guidance. For example, Kansas began issuing marriage licenses on November 12, 2014; however, Kansas Department of Revenue guidance, last updated in 2013, continues to instruct that same-gender married couples not file their income tax returns as joint or married filing separately. (*Kansas Department of Revenue, Notice 13-18*; 2014 Kansas Allocation of Income Worksheet)

It is generally the case that an employee's marital status on December 31 applies for the entire calendar year. Accordingly, if a resident/work state's income tax regulations are amended to recognize same-gender marriage for tax year 2015, it would generally be the case that those couples lawfully married in the state of celebration as of January 1, 2015 will be treated as married in the resident/work state for the entire 2015 calendar year.

It is possible, but not likely, that in consideration of the *Obergefell* ruling, a state or local taxing jurisdiction would allow a same-gender couple lawfully married before 2015 to file amended returns for prior tax years.

- ***Form W-4.*** Affected employees should be instructed to monitor how changing tax rules may apply to them, and provide to their employers a revised state/local Form W-4 if they believe they are required to change their marital status for 2015 and future years for income tax withholding purposes.

Tax treatment of same-gender spousal benefits

For federal income tax purposes, health and other tax-exempt benefits provided to an employee's same-gender spouse are tax-free provided the employee was lawfully married under state or country law. The IRS makes it clear that health and other benefits provided to an employee's domestic partner (including civil unions and registered domestic partners) continue to be taxable. (*Revenue Ruling 2013-17*)

Whether the value of same-gender spouse or domestic partner benefits are included in taxable wages for state unemployment insurance or income tax withholding turns on the applicable state tax rules (and not its marriage laws), making their tax and reporting requirements complex.

Pennsylvania, for instance, extends tax-free status to health benefits whenever there is a moral or legal obligation of the employee to provide them to a partner (marriage is not a determining factor). States with marriage bans, like Louisiana, treat both same-gender spouse and domestic partner benefits as taxable. A number of other states, like, Maryland, follow the federal tax treatment of these benefits.

Clearly, the *Obergefell* decision will have the eventual result of harmonizing the federal, state and local tax treatment of same-gender spousal benefits. The question is when.

Businesses must continue to comply with the current state/local tax rules until revenue authorities publish revised guidelines. Such guidance may not be available until closer to the 2015 tax filing season, which for some states/localities could be as late as December or even into the early part of 2016.

- ***Retroactive adjustments.*** For those states that revise their tax rules this year to recognize same-gender marriage, it is not likely that employers will be required to retroactively adjust 2015 income tax withholding (or for earlier years, if taxpayers are allowed to file amended returns). However, affected employees will expect that their Forms W-2 (in particular, for tax year 2015) reflect the correct state and local taxable earnings so that they may recover any excess income tax withholding on their spousal benefits. For this reason, employers will need to carefully monitor changing tax rules in a number of jurisdictions and stand ready to make late-year adjustments to the 2015 Forms W-2, perhaps even issue 2015 Forms W-2c.

  In the meantime, employees should be instructed to monitor how changing tax rules may apply to them, and provide to employers a revised state/local Form W-4 if they believe they have had too much income tax withheld from their wages pursuant to their spousal benefits. As previously mentioned, some employees may also need to submit a revised state/local Form W-4 to reflect their marital status.

- ***Gross up.*** Employers that paid state and local income tax on behalf of their employees for imputed spousal benefits (gross up) will need to consider if adjustments need to be made in those states/localities where spousal benefits are no longer taxable for 2015.

The tax treatment of domestic partner benefits

A number of states (e.g., New Jersey) recognize as married for tax purposes couples who hold a civil union or domestic partnership license. Accordingly, benefits provided to partners under these circumstances are excluded from the state's taxable wages (although taxable for federal purposes).

In light of the *Obergefell* ruling, these states may amend their civil marriage laws, and if they do, civil union and domestic partnership benefits may no longer be tax-free. This is an area which will need to be closely monitored at the state level as the *Obergefell* decision has no direct impact on states' alternative partner licensing rules or the related state tax treatment of benefits provided to partners who do not hold marriage licenses federally recognized under *Revenue Ruling 2013-17* .