Benefits and Tax Consequences for Employers of Supreme Court DOMA Ruling

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July 11, 2013

The U.S. Supreme Court’s finding unconstitutional the Defense of Marriage Act (DOMA) provision denying recognition of the marital status of same-sex couples under federal law leaves many questions about the post-DOMA application of various federal employee benefit and tax rules. (See our article, U.S. Supreme Court Rules Legally-Married Same-Sex Spouses Entitled to Federal Recognition and Lifts California Ban on Same-Sex Marriages.) While government guidance is expected, this article explores the implications thus far of the decision on the benefit and tax issues. For this purpose, we consider only benefits that are subject to special federal tax rules and/or the Employee Retirement Income Security Act (ERISA).

Recognition of same sex marriage under federal tax and benefits law primarily affects:

1. Mandated spousal rights under tax-qualified retirement plans and COBRA continuation coverage; and
2. Federal tax treatment of benefits provided to eligible spouses, including tax treatment of coverage under group health plans and working condition fringe benefits.

In the case of other benefits subject to ERISA (and ERISA preemption of state law), principally group health insurance, employers continue to have the right to define the type of spousal relationships (and/or domestic partner relationships) that will be eligible for coverage. (There is one important caveat for benefits provided through insurance discussed in the “Group Health Plans” section below.)

Tax-Qualified Retirement Plans

Generally, tax-qualified retirement plans include 401(k) plans, 403(b) plans, money purchase pension plans and defined benefit pension plans (including cash balance pension plans). The federal law definition of spouse will affect the following areas:

- Spousal consent to payments to nonspouse beneficiary. This requirement applies to 401(k) plans and all other tax-qualified retirement plans.
- Spousal right to a qualified joint and survivor annuity from a money purchase pension or a defined benefit pension plan. This requirement does not apply to 401(k) or other defined contribution plans unless the plan offers a joint and survivor payment option (this is relatively rare).
- Spousal consent to early payment of plan benefits. Depending on plan design, this requirement typically will not apply to 401(k) or other defined contribution plans.
- Spousal consent to plan loans. As above, depending on plan design, this requirement typically will not apply.
- Somewhat more favorable rules for tax-free rollovers of plan distributions.
- Division of participant retirement benefits in a divorce or legal separation pursuant to a qualified domestic relations order.

Group Health Plans

Currently, there is no federal law that mandates group health plan coverage based on marital status. Because ERISA preempts state law, a state law definition of spousal status generally will not be relevant and an employer can define spousal status for plan coverage purposes as they choose.
There is one caveat: the rules are somewhat more complicated when an employer provides health benefits through insurance. (Note that benefits provided to a participant in an HMO are considered to be insured.) ERISA permits a state to regulate insurance and benefits provided through insurance — a special exception to the general ERISA preemption of state laws referred to as the “insurance savings clause.” Based on this exception, the Supreme Court held in Metropolitan Life Insurance Co. v. Massachusetts, 471 U.S. 724 (1985), that a state can mandate that an insurance policy provide certain coverages or benefits. An employer who buys the regulated policy indirectly becomes contractually bound to provide the state-mandated coverages and benefits. In the same case, the Supreme Court also made clear that the exception to ERISA preemption under the insurance savings clause does not apply to self-insured welfare plans.

If a state requires insurance policies provide coverages or benefits to same-sex spouses or domestic partners, an employer who purchases a policy subject to those requirements will become contractually bound to provide those benefits.

**COBRA Coverage**

If an employee’s spouse is covered under the employee’s group health plan immediately prior to a COBRA-qualifying event, then the spouse is entitled to elect COBRA coverage. The COBRA entitlement question is determined by whether or not the spouse was covered under the plan prior to the COBRA-qualifying event.

In addition, an employee who previously elected single coverage under COBRA has the right to change the coverage election at the time of open enrollment. If the plan at that time permits coverage for same-sex spouses of active employees, then the same option will have to be offered to individuals receiving COBRA coverage.

**Federal Tax Treatment**

The federal tax treatment of certain benefits depends upon spousal status. Most importantly, tax-free treatment of the cost of group health benefit coverage and benefit payments, pre-tax contributions under a Section 125-cafeteria plan and certain working condition fringe benefits depend upon the definition of spouse used in the Internal Revenue Code.

**Federal Definition of Spouse**

As of this writing, neither the Internal Revenue Service, the Department of Labor nor any other federal agency has announced how “spouse” will be defined for purposes of the various federal statutes that include spousal rights.

Prior to the enactment of DOMA, the IRS looked to state law to determine marital status for federal tax purposes. See IRS Revenue Ruling 58-66. The IRS likely will return to that position.

An even more interesting aspect of IRS Revenue Ruling 58-66 was the agency’s treatment of individuals who entered into a common law marriage in a state recognizing such marriages and later moved to a state that did not recognize common law marriage. In that situation, the IRS stated that it would continue to recognize the marriage for federal tax purposes.

It would not be surprising if the IRS applies the same rule to same-sex marriages for federal tax and benefit purposes. That is, as long as a couple marries in a state that recognizes same-sex marriage, that marriage would continue to be recognized for federal tax purposes if the couple moved to another state that did not recognize same-sex marriage. The IRS has announced that it would address this issue shortly.

**Other Issues**

**Retroactivity**

The most important question is whether the post-DOMA definition of spouse will be applied retroactively for federal tax or benefit purposes.

Given the significant administrative difficulties retroactive application could create, a wait-and-see approach should be considered. However, an employer may wish to file a protective refund claim for the employer portion of FICA (Social Security and Medicare) taxes. The oldest open tax year currently is 2010.

**Employer-Defined Coverage**

It is important to note that, other than with respect to retirement plans, and possibly certain insured group health plans, employers remain free under current law to define which type of spousal relationships will be eligible for coverage under plans subject to ERISA. Because of ERISA preemption, an employer is not obligated to adopt state law marital definitions in applying those plans.
Gross-Up Coverage

Employers who previously “grossed up” employees to cover the additional federal taxes owed for coverage of same-sex spouses should review those policies to adjust to the change in the federal tax treatment. On the other hand, employees who elect coverage for domestic partners who do not meet the requirements to be legally married under state law will still be subject to additional federal taxes for such coverage.

Review

Since there is no universal definition of spouse, employers should review all benefit plans and policies to determine where the term “spouse” is used and whether it is adequately defined.

If you have any questions about this or other workplace developments, please contact the Jackson Lewis attorney with whom you regularly work.

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