

## Is DOMA Gone? Gift and Estate Tax Returns and Same-Sex Spouses

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In 2012, the Defense of Marriage Act (DOMA) was struck down as unconstitutional by a number of federal courts across the country. On Dec. 7, 2012, the Supreme Court granted the petition for a writ of certiorari in *Windsor v. United States*,<sup>1</sup> and the Supreme Court will hear arguments in the case on March 27, 2013. While the Supreme Court has yet to rule on DOMA and the federal government continues to comply with it, given the current case law, same-sex married persons are already able to take the position on their tax returns that DOMA is unconstitutional.

### The Status of DOMA

The Defense of Marriage Act, enacted in 1996, states, in relevant part, that in “determining the meaning of any Act of Congress, or 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 wife.”<sup>2</sup>

DOMA’s reach is wide, affecting more than 1000 references to marriage in federal laws.<sup>3</sup> Many of these laws are tax provisions providing special benefits and status to married individuals. These benefits include the married status for income tax filing, the unlimited marital deduction for estate and gift tax purposes, and the tax-free treatment of exchanges between spouses and property settlements made in connection with divorces. Under DOMA, same-sex married persons cannot take advantage of these benefits.

To date, there have been at least six court decisions holding DOMA unconstitutional. These include the *Windsor* case, the *Gill* case decided by a district court in Boston and recently reaffirmed by the U.S. Court of Appeals for the First Circuit, and the *Golinski* and *Dragovich* cases, both decided by the U.S. District Court for the Northern District of California.<sup>4</sup>

In November 2011, the IRS made its most recent statement regarding its position on DOMA.<sup>5</sup> In a series of questions and answers regarding registered domestic partners in community property states and same-sex spouses in California, the IRS stated that “same-sex partners who are married under state law may not file using a married filing separately or jointly filing status because federal law does not treat same-sex partners as spouses.” The IRS’s position is in accord with the administration’s official position on DOMA.

As of February 2011, the Department of Justice announced that it would no longer defend the constitutionality of DOMA in litigation.<sup>6</sup> However, the administration still requires that agencies apply DOMA. “The President has instructed Executive agencies to continue to comply with Section 3 of DOMA, consistent with the Executive’s obligation to take care that the laws be faithfully executed, unless and until Congress repeals Section 3 or the judicial branch renders a definitive verdict against the law’s constitutionality.”<sup>7</sup>

Because the administration in general and the IRS in particular continue to apply DOMA and the ultimate outcome of *Windsor* is unknown, same-sex married persons are vulnerable to penalties

if they ignore DOMA on their tax returns. However, as discussed below, it appears that penalties may be avoided currently even if same-sex married individuals take the position on their returns that DOMA is unconstitutional.

### **Delinquency Penalties**

Delinquency penalties are imposed by Section 6651 of the Internal Revenue Code for failure to file a timely return, pay tax that is reflected on a return, or pay an assessed tax not shown on a return.<sup>8</sup> The only statutory basis for escaping a delinquency penalty is if the delinquency is “due to reasonable cause and not to willful neglect.”<sup>9</sup> Willful neglect has been defined by the Supreme Court in *United States v. Boyle* “as meaning a conscious, intentional failure or reckless indifference.”<sup>10</sup> Reasonable, with respect to reasonable cause, means that the taxpayer exercised ordinary care and prudence.<sup>11</sup>

A taxpayer’s belief that a return is due, but no tax is due, is not reasonable cause for failure to file.<sup>12</sup> The reasonable cause exception appears to be applied most often in situations where unexpected events arise that prevent the taxpayer from filing or paying or in situations in which the taxpayer appropriately relied on a qualified adviser. None of these grounds would be applicable to, say, the executor of a same-sex married person’s estate who chooses not to file an estate tax return because he or she believes the unlimited marital exemption is available and therefore no estate tax is due; the law requires a return to be filed for estates of a certain size even if no tax is due.

### **Accuracy-Related Penalties**

Code Section 6662 imposes an “accuracy-related penalty” which is normally 20 percent of the portion of an understatement of tax resulting from one or more of five specified causes, including “negligence or disregard of rules or regulations.”<sup>13</sup>

**Negligence Penalty.** The statute states that “negligence” includes a failure to make a reasonable attempt to comply with the provisions of the Code or to exercise ordinary and reasonable care in the preparation of a tax return. Two defenses are available to the negligence penalty. First, if a taxpayer can show that there was “reasonable cause” for the underpayment and that the taxpayer “acted in good faith,” a negligence penalty will not be imposed. Second, a return position that has a reasonable basis is not attributable to negligence.

The “reasonable basis” standard is defined partially in terms of a more stringent “substantial authority” standard. “If a return position is reasonable based on one or more of the authorities set forth in §1.6662-4(d)(3)(iii)...the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.” Court cases are one of the sources of acceptable authorities listed in §1.6662-4(d)(3)(iii). Further, the regulations state that the analysis should be blind as to the location of the court and the taxpayer’s jurisdiction. Therefore, if a return position is reasonable based on a court case, regardless of the taxpayer’s jurisdiction, the position will generally satisfy the reasonable basis standard. For this reason, same-sex married individuals nationwide should be able to rely on the court decisions in the U.S. Court of Appeals for the First, Second, and Ninth Circuits as evidence of the “reasonable basis” of their return position.

**Disregard of Rules or Regulations Penalty.** The accuracy-related penalty will also be imposed for understatement of tax due to disregard of rules or regulations. “Disregard” includes any careless, reckless, or intentional disregard of rules or regulations. However, the penalty for disregarding rules or regulations is not imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is adequately disclosed.

The disclosure exception does require that the position disclosed have a “reasonable basis.” Reasonable basis for these purposes is determined by the same analysis described above. Since a return position that DOMA is unconstitutional likely satisfies the reasonable basis standard as described above, a taxpayer should be able to avoid the disregard of rules and regulations penalty through adequate disclosure.

Disclosure is adequate for purposes of avoiding the penalty for disregarding rules or regulations if made in accordance with the provisions of Treas. Reg. §1.6662-4(f), which permit disclosure on a properly completed and filed Form 8275 or 8275-R. The statutory or regulatory provision in question must be adequately identified on the form. Disclosure must be adequately detailed so that the taxpayer disclosed enough relevant data concerning the treatment of the item to alert the IRS to a potential controversy.

### **Tax Preparer Penalties**

Under Section 6694, if a tax return preparer prepares any return for which any part of a tax liability understatement is due to an “unreasonable position” and the preparer knew or should have known of the position, the preparer must pay a penalty. A position is assumed to be unreasonable unless it is supported by “substantial authority, disclosed and supported by a “reasonable basis,” or if there was “reasonable cause for the understatement and the tax return preparer acted in good faith.”

**Substantial Authority.** There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of the authorities supporting contrary treatment. The substantial authority standard is less stringent than the more likely than not standard but more stringent than the reasonable basis standard described above and defined in §1.6662-3(b)(3). Substantial authority for a position exists only if there is substantial authority on the date the return was prepared or on the last day of the tax year to which the return relates.

As already mentioned, the regulations include an exclusive list of which types of sources are valid authorities in the analysis for substantial authority. The regulations specifically mention court cases as a permissive source of authority. They state that the applicability of court cases to the taxpayer’s situation by reason of the taxpayer’s residence in a particular jurisdiction is not taken into account in determining if there is substantial authority for a position.

That being said, according to the regulations there is definitively substantial authority for a position if the position is supported by controlling precedent of a U.S. Court of Appeals to which the taxpayer has a right of appeal regarding the position. In other words, an analysis of whether a return position is supported by substantial authority as demonstrated through court cases must

focus solely on the merits and holdings of the particular cases and not on the jurisdictions in which they were decided.

However, under the regulations, if the cases relied upon include controlling precedent of a U.S. Court of Appeals to which the taxpayer has a right of appeal, substantial authority exists and there is no need to delve into the merits of the cases. Consequently, in light of the First Circuit's recent decision in *Gill* and the Second Circuit's recent decision in *Windsor*, tax return preparers in the First and Second Circuits today have substantial authority for a position that relies on the unconstitutionality of DOMA.

**Reasonable Basis.** For purposes of the regulations, "reasonable basis" has the same meaning as described in the provisions regarding accuracy-related penalties. For this reason, as explained above, a tax return preparer for a taxpayer anywhere in the United States has a reasonable basis for asserting a tax position based on DOMA's unconstitutionality. However, positions that are supported only by a reasonable basis and lack substantial authority must be adequately disclosed.

The rules governing disclosure for tax return preparers are based on the same regulations that govern disclosure for avoiding accuracy-related penalties described above.

**Reasonable Cause Exception.** A Section 6694(a) preparer penalty for unreasonable positions may not be assessed if, considering all the facts and circumstances, there was reasonable cause for the understatement and the preparer acted in good faith. The regulations include a nonexclusive list of factors to consider in this analysis. The factors listed are: the nature of the error, the frequency of the errors, the materiality of the errors, the tax return preparer's normal office practice, reliance on the advice of competent and qualified persons, and reliance on generally accepted administrative or industry practice. Although the list in the regulations is not exhaustive it does not appear that a position based on a legal conclusion of constitutionality falls within the scope of "reasonable cause" as interpreted by the IRS. For this reason, it would not be prudent for a tax preparer to rely on the reasonable cause exception, particularly when the preparer can easily take advantage of the exception for disclosed positions that are supported by a reasonable basis.

### **Protective Claim for Refund**

Taxpayers should take steps to protect themselves in the event that the Supreme Court strikes down DOMA. Same-sex married persons who file in compliance with DOMA on their 2012 returns by treating themselves as single are well advised to file a protective claim for refund.<sup>14</sup> The benefit of a protective claim for refund is that it eliminates the pressure associated with the three-year statute of limitations for filing a standard claim for a refund.

Although the Supreme Court will likely rule on the fate of DOMA later this year, the protective claim for refund is simple enough that individuals would be wise to take advantage of its protective benefits. Individuals who choose this approach should file returns in accordance with DOMA and then file an amended return with the protective claim for refund attached. The form should state clearly that the claim for a refund is based on the unconstitutionality of DOMA which is pending in current litigation and as of yet unresolved nationally.

### **Reporting Gifts and Bequests**

Since the passage of DOMA, same-sex married persons have attempted to organize their financial lives to achieve the same security and benefits awarded to their heterosexual counterparts under the Code. Under DOMA, this is often impossible to achieve without a significant tax cost. For example, many U.S.-citizen married couples own their homes jointly and are not concerned about which spouse paid for the home when title is taken jointly given the unlimited gift tax marital deduction. Under DOMA, on the other hand, if one spouse in a same-sex marriage pays for more than 50 percent of a jointly owned home, he or she will have made a gift to the other spouse that does not qualify for the gift tax marital deduction.

Thus, the couple could not own their home jointly without the purchasing spouse incurring a gift tax of 40 percent on the value of the gift of the non-purchasing spouse's interest to the extent the gift exceeds the donor's available gift tax exemption. Similarly, when one spouse dies and leaves assets to his or her surviving U.S.-citizen spouse, there is no estate tax given the unlimited estate tax marital deduction. However, if the couple is a same-sex couple, under DOMA there is an estate tax of 40 percent to the extent the assets passing to the surviving spouse exceed the first-to-die's estate tax exemption amount. The recent case law means that, for the first time, same-sex married persons and their tax advisors and preparers should now be confident in assuming tax return positions consistent with DOMA's unconstitutionality and need not wait until the Supreme Court rules.

For example, many same-sex married persons may have made gifts to their U.S.-citizen spouses or transfers of property into forms of joint ownership with their U.S.-citizen spouses in 2012 to take advantage of the \$5.12 million gift tax exemption that, until President Barack Obama signed the American Taxpayer Relief Act of 2012 (the Act) on Jan. 3, 2013, was scheduled to return to \$1 million on Jan. 1, 2013. Individuals who made such transfers in 2012 may take the position on their gift tax returns filed prior to a Supreme Court decision, with full disclosure as described above, that DOMA is unconstitutional and that a gift tax marital deduction is available for those gifts such that no gift tax exemption was used.

If DOMA is later struck down by the Supreme Court, those individuals will have taken advantage of the unlimited marital exemption and will still have the full exemption amount to use for other purposes in future years. If DOMA is later upheld and the returns are not audited, the same result is achieved since the returns were filed in good faith and need not be amended. If DOMA is later upheld and the returns are audited, the gifts may simply reduce the donor's remaining gift tax exemption amount and still no tax will be due.

Individuals who made gifts to their same-sex spouses or transfers of ownership in amounts that exceeded their 2012 gift tax exemption amounts (in order to take advantage of the 35 percent gift tax rate in 2012 that, until Obama signed the Act, was scheduled to return to 55 percent on Jan. 1, 2013) face a more balanced analysis. While these individuals should feel confident that they will not be assessed penalties by the IRS if they fully disclose their position on their gift tax returns that DOMA is unconstitutional and that, therefore, a gift tax marital deduction is available, if the Supreme Court later upholds DOMA and the returns are audited, they will likely be required to pay gift tax and interest on the amount that exceeded the available exemption.

Estates of individuals who died in 2012 leaving assets to U.S.-citizen same-sex spouses are in a similar situation. They too may choose not to pay the estate tax on assets passing to the

surviving spouse, relying, with full disclosure on the estate tax return, on the unconstitutionality of DOMA and, therefore, the availability of the unlimited estate tax marital deduction; however, they too may be subject to estate tax and interest charges if DOMA is later upheld and the returns are audited.

In short, there is sufficient case law at this point to take the position on tax returns, fully disclosed, that DOMA is already gone. For some taxpayers, this is an opportunity that should be seriously considered.

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#### **Endnotes:**

1. 699 F.3d 169 (2d Cir. 2012).

2. 1 U.S.C. §7.

3. Cong. Budget Office, U.S. Cong., The Potential Budgetary Impact of Recognizing Same-Sex Marriages (June 21, 2004), <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/55xx/doc5559/06-21-samesexmarriage.pdf>.

4. *Windsor v. United States*, 699 F.3d 169 (2nd Cir. 2012); *Dragovich v. U.S. Dept. of the Treasury*, C 10-01564 CW, (N.D. Cal. May. 24, 2012); *Golinski v. U.S. Office of Pers. Mgmt.*, 824 F.Supp.2d 968 (N.D. Cal. 2012), hearing in banc denied, 680 F.3d 1104 (9th Cir. 2012); *Gill v. Office of Pers. Mgmt.*, 699 F.Supp.2d 374 (D. Mass. 2010) affd sub nom. *Massachusetts v. U.S. Dept. of Health & Human Services*, 10-2204, 2012 WL 1948017 (1st Cir. May 31, 2012).

5. Questions and Answers for Registered Domestic Partners in Community Property States and Same-Sex Spouses in California, <http://www.irs.gov/newsroom/article/0,,id=245869,00.html>.

6. Letter from the Attorney General to Congress on Litigation Involving the Defense of Marriage Act, <http://www.justice.gov/opa/pr/2011/February/11-ag-223.html>

7. Id.

8. Internal Revenue Code (IRC) §6651 (a).

9. Id.

10. 469 U.S. 241 (1985).

11. Treas. Reg. §301.6651-1(c).

12. *Jackson v. Comr.*, 864 F.2d 1521 (10th Cir. 1989); *Ballard v. Comr.*, 854 F.2d 185 (7th Cir. 1988).

13. IRC §6662(b)(1).

14. For more information see <http://www.irs.gov/publications/p556/ar02.html>.

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