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# HOW THE SUPREME COURT DECISION ON DOMA IN *U.S. V. WINDSOR* AFFECTS LIFE INSURANCE PRODUCTS

By Mark E. Griffin

**T**his article discusses the effects of the Supreme Court's recent decision in *United States v. Windsor, Executor of the Estate of Spyer, et al.* on the Federal income tax treatment of insurance products. This article will be supplemented in the next issue of TAXING TIMES to discuss Rev. Rul. 2013-17 and two sets of Frequently Asked Questions ("FAQs") which were released by the Internal Revenue Service after this issue went to press and which address the Federal tax treatment of same-sex spouses, registered domestic partners, and civil union partners.

On June 26, 2013, the Supreme Court decided in the Windsor case that section 3 of DOMA, defining "marriage" and "spouse" as excluding same-sex spouses, is unconstitutional. As a result, same-sex couples who are married in the District of Columbia and states that allow such unions are treated as spouses for purposes of federal law, including the Internal Revenue Code (the "Code"). Of particular interest to life insurance companies in light of the Windsor decision is the treatment of same-sex spouses under (1) the after-death distribution requirements in section 72(s); (2) individual retirement arrangements ("IRAs"); (3) the required minimum distribution rules in section 401(a)(9); (4) the eligible rollover distribution rules in section 402(c); and (5) the qualified additional benefit ("QAB") rules in section 7702(f)(5).<sup>1</sup>

## THE WINDSOR CASE BRIEFLY

Edith Windsor and Thea Spyer were married in Ontario, Canada, in 2007. They resided in the state of New York, which recognized the marriage. Thea Spyer died in 2009, leaving property to Edith Windsor, and her estate paid \$363,053 in federal estate taxes. Edith Windsor sought a refund of the estate taxes, claiming that the unlimited marital deduction under section 2056(a) applied, and the Internal Revenue Service denied the claim for refund. Edith Windsor then filed a claim for a refund in the U.S. Federal District Court for the Southern District of New York, which ruled that section 3 of DOMA is unconstitutional. The Second Circuit Court of Appeals upheld the decision. In affirming the appellate court's decision, the Supreme Court held that section 3 of DOMA is unconstitutional as a deprivation of the equal liberty of persons that is protected by the Fifth Amendment.

## IMPLICATIONS FOR INSURANCE PRODUCTS

As a result of the Windsor decision, spousal provisions applicable to life insurance and annuity contracts that are governed by federal law apply generally to same-sex spouses. As noted above, these spousal provisions include the following:

- 1. The spousal continuation rules for non-qualified annuities and IRAs.** In order for a non-qualified annuity contract to be treated as an annuity contract for federal income tax purposes, it must include the after-death distribution rules in section 72(s) that apply after the death of any "holder" of the contract. Section 72(s)(3) sets forth the so-called "spousal continuation rule" under which a designated beneficiary who is the deceased holder's surviving spouse can continue the contract as his or her own annuity contract. A similar spousal continuation rule applies to spouse beneficiary under an IRA.<sup>2</sup> These spousal continuation rules help explain why certain optional benefits, such as a guaranteed minimum withdrawal benefit, that are offered for joint lives under non-qualified annuity contracts and IRA annuity contracts, are limited to individuals who are spouses.
- 2. The spousal rules under section 401(a)(9).** Qualified trusts under section 401(a), qualified annuities under section 403(a), section 403(b) annuity contracts, and IRAs are subject to the minimum distribution requirements under section 401(a)(9). Section 401(a)(9) and the regulations thereunder set forth a number of special rules for a designated beneficiary who is the employee's spouse.<sup>3</sup> The effect of these special spousal rules is to delay or reduce the amount of the required minimum distributions that must be made where a spouse is the designated beneficiary. In addition, the section 401(a)(9) regulations include special rules relating to the maximum period over which required minimum distributions must be made, and the manner in which distributions must be made under a joint and survivor annuity, where the sole beneficiary is the employee's spouse.<sup>4</sup>
- 3. Eligible rollover distribution rules.** Special tax-free rollover rules apply to "eligible rollover distributions" under section 402(c)(4) that generally are made from a qualified

plan, section 403(a) annuity, section 403(b) contract, or governmental section 457(b) plan. These eligible rollover distribution rules also apply to any distribution attributable to an employee that is paid to the employee's spouse after the employee's death.<sup>5</sup>

**4. Family term coverage under life insurance contracts.** Section 101(f) provides statutory rules on the taxation of the proceeds of a flexible premium life insurance contract issued prior to 1985. Section 7702 sets forth the definition of "life insurance contract" for purposes of the Code, effective for contracts issued after 1984. Each of these sections includes special rules for the treatment of a "qualified additional benefit" ("QAB"), including family term coverage (such as term life insurance coverage on a spouse).<sup>6</sup>

**5. Certain other spousal provisions.** Other provisions of the Code which incorporate special treatment for spouses include (1) the exceptions to the taxable transfer rules in section 72(e)(4)(C) and section 1041 for certain transfers to spouses or former spouses; (2) exceptions to the 10 percent penalty tax under section 72(t) for distributions under a qualified retirement plan<sup>7</sup> which are for medical expenses, payments pursuant to a qualified domestic relations order, distributions to unemployed individuals for health insurance premiums, distributions for higher education expenses, and distributions for first time-homebuyers; and (3) special spousal rules applicable to qualified plans under which annuities can be issued (such as the rules requiring spousal consent and spousal annuities in certain circumstances).

Prior to the *Windsor* case, many life insurance companies made it a practice to provide disclosure to contract owners addressing the implications of DOMA under their contracts. Some companies have even included provisions addressing DOMA in their contract forms or in endorsements to their contracts. Hence, companies will need to review their contracts and related materials, such as prospectuses used with variable contracts, to determine whether they might need to be revised in light of the *Windsor* case.

It should be noted that the Supreme Court expressly limited its opinion and holding in the *Windsor* case to lawful marriages under state law. In particular, the *Windsor* case does not address the constitutionality of section 2 of DOMA, which generally recognizes states' rights to define marriage and spouse, and allows states to refuse to recognize same-sex marriages entered into in other states. The case does not



address whether there is a constitutional right to same-sex marriage, *i.e.*, the Court did not provide for the right to same-sex marriages in states that do not permit it.

As a result of the *Windsor* decision, spousal provisions applicable to life insurance and annuity contracts that are governed by federal law apply generally to same-sex spouses in the District of Columbia and states that recognize same-sex marriages. Because some states recognize such marriages, and others do not, life insurance companies may need to determine which state's rules apply to their contracts for purposes of administering the spousal rules that apply to their contracts. For example, some have asked whether spousal treatment applies to individuals who marry in a state that recognizes same-sex marriages (like New York) and later move to another state that does not recognize the marriage (like Florida). It will be interesting to see what action states might take with respect to this issue.<sup>8</sup>

This problem of differing state laws might be avoided with respect to employer plans that are subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). The provisions of ERISA generally supersede state laws as they apply to employee benefit plans.<sup>9</sup> Because of this pre-

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**Mark E. Griffin** is the managing partner of the Washington, D.C. law firm of Davis & Harman LLP and may be reached at [megriffin@davis-harman.com](mailto:megriffin@davis-harman.com).

emption, spousal provisions of an ERISA plan (such as the ERISA rules requiring spousal consent and spousal annuities in certain circumstances) can apply to same-sex spouses who are covered by the plan even if they live in a state that does not recognize same-sex marriages.

In addition, the Obama administration indicated that it intends to address this problem of differing state laws by applying spousal provisions in the federal law on the basis of where a couple weds, and not necessarily on where they live. Under this approach, a couple who is legally married in one state would

be treated as married for federal law purposes even if they move to a state that does not recognize the marriage.<sup>10</sup> The Internal Revenue Service also indicated that it will move quickly to revise guidance in wake of the Court's decision, but no details were given on what this guidance would involve.<sup>11</sup>

Other questions being raised about the impact of the *Windsor* case relate to the extent to which the decision (1) has retroactive application, *i.e.*, what impact the decision might have on existing or terminated contracts, and (2) applies to state laws which extend spousal rights to domestic partners and civil union partners.◀

#### END NOTES

- <sup>1</sup> Unless otherwise indicated all section references are to the Code.
- <sup>2</sup> Section 408(d)(3)(C); Treas. Reg. section 1.408-8, Q&A-5.
- <sup>3</sup> Section 401(a)(9)(B)(iv); Treas. Reg. section 1.401(a)(9)-3, Q&A-3(b) and Q&A-5; Treas. Reg. section 1.401(a)(9)-5, Q&A-4 and Q&A-5.
- <sup>4</sup> Treas. Reg. section 1.401(a)(9)-5, Q&A-4; Treas. Reg. section 1.401(a)(9)-6, Q&A-2.
- <sup>5</sup> Section 402(c)(9); Treas. Reg. section 1.402(c)-2, Q&A-12.
- <sup>6</sup> Section 101(f)(3)(E); Section 7702(f)(5).
- <sup>7</sup> For this purpose, a "qualified retirement plan" is defined in section 4974(c) to mean (1) a qualified plan under section 401(a); (2) a qualified annuity under section 403(a); (3) a section 403(b) annuity contract; (4) an IRA account or annuity contract under sections 408(a) and (b); and (5) any plan, contract, account or annuity which is determined by the Secretary of the Treasury to be such a qualified retirement plan.
- <sup>8</sup> For instance, the New York State Insurance Department issued several pronouncements addressing the application of DOMA. See, e.g., New York State Insurance Department, *Guidance for Filings Made to Comply with Supplement No. 1 to Circular Letter 27 (2008)* (Dec. 9, 2009) (at [http://www.dfs.ny.gov/insurance/life/guidance/p\\_guide\\_cl27\\_2008\\_supp1.htm](http://www.dfs.ny.gov/insurance/life/guidance/p_guide_cl27_2008_supp1.htm)). Presumably, the department will issue new guidance in light of the *Windsor* case.
- <sup>9</sup> See section 514 of ERISA at 29 U.S.C. § 1144.
- <sup>10</sup> Lisa Rein and Steve Vogel, *Administration Says It Will Press to Provide Marriage Benefits in All States*, The Washington Post, June 27, 2013 (at [http://www.washingtonpost.com/politics/administration-says-it-will-press-to-provide-marriage-benefits-in-all-states/2013/06/27/2f84d8e6-df5f-11e2-963a-72d740e88c12\\_story.html](http://www.washingtonpost.com/politics/administration-says-it-will-press-to-provide-marriage-benefits-in-all-states/2013/06/27/2f84d8e6-df5f-11e2-963a-72d740e88c12_story.html)).
- <sup>11</sup> *IRS Promises Revised Guidance After DOMA Decision*, Tax Notes Today (June 28, 2013).