SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2010 – Volume 6 Issue 2

CONFLICTING DEFINITIONS OF "SPOUSE" UNDER DOMA AND STATE LAW

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Under the Defense of Marriage Act of 1996 ("DOMA"), spouses are defined for purposes of federal law, including the Internal Revenue Code (the "Code"), as married individuals of the opposite sex.[1] However, an increasing number of states have extended the rights and benefits of a spouse under state law to civil union partners, domestic partners and same-sex spouses (collectively referred to herein as "Partners").[2] The interaction of these state laws with federal law can adversely affect the federal income tax treatment of nonqualified annuity contracts and qualified annuity contracts (including IRA and section 403(b) annuity contracts) with spousal provisions that are required under state law to apply to Partners.[3]

In particular, as discussed below, the application to a Partner of an annuity contract's spousal provisions that are governed by federal income tax law, such as the spousal rules under section 72(s) and section 401(a)(9), can result in the failure of the contract to satisfy these sections in form and/or operation. As a result, the contract can fail to be treated as a nonqualified or qualified annuity contract for federal tax purposes. This failure can result in severe adverse federal income tax consequences to the owner and the Partner, and can affect the issuer's withholding and reporting obligations with respect to the contract.

I. THE SPOUSAL PROVISIONS UNDER SECTION 72(s) AND SECTION 401(a)(9)

Section 72(s) sets forth certain after-death distribution requirements that a nonqualified annuity contract must satisfy in order to be treated as an annuity contract for federal income tax purposes. In particular, section 72(s)(3) provides generally that if the "holder" of a nonqualified annuity contract dies, a designated beneficiary who is the deceased holder's surviving spouse can continue the contract as his or her own annuity contract (the "spousal continuation rule"). Nonqualified annuity contracts typically contain this spousal continuation rule. Under this rule, a surviving spouse designated beneficiary is not required to take distributions that otherwise are required to be taken under section 72(s) by a nonspouse designated beneficiary. Hence, if a contract applies the spousal continuation rule to a nonspouse designated beneficiary, the contract will not require the nonspouse designated beneficiary to take distributions in accordance with section 72(s), and the contract will not be treated as an annuity contract for federal income tax purposes.

Section 401(a)(9) sets forth lifetime and after-death minimum distribution requirements that apply to qualified plans under section 401(a), qualified annuities under section 403(a), tax-sheltered annuities under section 403(b), governmental section 457(b) contracts, and IRAs. In the event that the designated beneficiary is the spouse of the employee or IRA owner (collectively, the "employee"), the following special rules apply for purposes of these requirements:

- The maximum period over which required minimum distributions may be made during the employee's lifetime is increased to the joint life expectancy of the employee and the spouse.[4]

- If the applicable distribution period over which required minimum distributions must be made after the employee's death is the designated beneficiary's life expectancy, the life expectancy can be recalculated annually if the employee's surviving spouse is the sole designated beneficiary, so that required minimum distributions can be stretched over a longer period than for a nonspouse designated beneficiary.[5]

- If the employee dies prior to the "required beginning date" by which lifetime minimum distribution must commence:

  - After-death required minimum distributions for life or life expectancy that otherwise must commence to a nonspouse designated beneficiary by the end of the calendar year following the year of the employee's death can be delayed by the surviving spouse designated beneficiary

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until the end of the calendar year following the year in which the employee would have attained age 70½;[6] and

- If the surviving spouse designated beneficiary dies before required minimum distributions commence, the after-death minimum distribution requirements are re-applied as if the surviving spouse were the employee.[7]

• In the case of an IRA, a designated beneficiary who is the deceased owner's surviving spouse may continue the IRA as his or her own, and thus delay required minimum distributions under section 401(a)(9), pursuant to a spousal continuation rule for IRAs that is similar to the spousal continuation rule for nonqualified annuity contracts.[8]

Qualified annuity contracts—including IRA and section 403(b) annuity contracts—typically include some or all of these special spousal rules under section 401(a)(9). The impact of these special rules is to delay or reduce the amount of the required minimum distributions that must be made when the employee's spouse is the designated beneficiary, as compared to the required minimum distributions that must be made to a nonspouse designated beneficiary. Hence, if these spousal rules are applied to a nonspouse designated beneficiary, the contract will not require distributions in accordance with section 401(a)(9), and thus the contract can fail to be treated as an IRA, 403(b) contract or other qualified annuity contract.

II. THE CONFLICT BETWEEN FEDERAL AND STATE LAW

As noted above, DOMA defines spouses as married individuals of the opposite sex for purposes of federal law, including the Code. Thus, for federal income tax purposes, spouses do not include: 1) civil union partners; 2) domestic partners, even if they are of the opposite sex; or 3) same-sex spouses, even though the marriage is valid under state law. As a result, in order for nonqualified and qualified annuity contracts to comply with the requirements of section 72(s) or section 401(a)(9), respectively, and enjoy the federal income tax benefits afforded to such contracts, the contract's spousal provisions that are governed by these sections must be interpreted in accordance with DOMA to apply only to married couples of the opposite sex.

However, a growing number of states extend spousal rights and benefits to Partners. This means that for contracts issued in those states, the spousal provisions in those contracts need to be applied to Partners. The problem is that if the spousal provisions are governed by federal tax law (like the spousal provisions in sections 72(s) and 401(a)(9), discussed above), applying those provisions to Partners, who are not treated as spouses under federal law, can cause the contracts to fail to constitute nonqualified annuities, IRAs, section 403(b) contracts or other qualified annuity contracts.

Example. Assume that the "holder" of a nonqualified annuity contract dies prior to the annuity starting date, and the designated beneficiary is the holder's Partner. Under section 72(s), the entire remaining interest in the contract must be distributed: 1) within five years after the holder's death; or 2) over the Partner's life, or over a period not extending beyond the Partner's life expectancy, commencing within one year of the holder's death.[9] If the contract provides that a Partner can continue the contract under the contract's spousal continuation provision, rather than take distributions under one of these alternative distribution methods, the contract will fail to comply with the section 72(s) after-death distribution requirements. As a result, the contract will not be treated as an annuity contract for federal income tax purposes, and the tax deferral that applies to annuity contracts under the Code will be lost.

Similarly, employer and employee contributions to a "failed" qualified annuity contract will not be deductible or excludible from the employee's income under the rules that otherwise apply to qualified annuity contracts. Also, the employee might be currently taxed on the contract's earnings. It is unclear how the issuer's withholding obligations under section 3405 and the reporting obligations under section 6047 would apply with respect to a failed contract.

III. THE NEED FOR GUIDANCE

In order for employees, designated beneficiaries and insurers to understand the federal income tax treatment of their contracts, it is important that guidance be issued at the state and/or federal level that addresses this conflict between DOMA and state law. Some states (like Nevada, which extends spousal rights to domestic partners)[10] have not addressed this issue. Other states have addressed this conflict by attempting to balance the states' interests in treating Partners like spouses and the federal tax law treatment of Partners as nonspouses. Different states have taken different approaches to striking this balance.

For example, Vermont, New Jersey and New Hampshire each have laws that extend spousal rights to civil union partners, and New York law provides spousal rights to same-sex spouses in a valid out-of-state marriage. Vermont—citing consumer protection concerns over the adverse federal income tax consequences that can result from applying the spousal continuation provision of a nonqualified annuity contract to civil union partners—does not require the spousal continuation provision under a nonqualified annuity contract to be extended to civil union partners.[11] New Jersey and New Hampshire require nonqualified annuity contract forms to be amended to permit a civil union partner to continue the contract after the holder's death under the contract's spousal continuation provision, provided that the civil union partner's entire interest is distributed in accordance with the contract's after-death distribution rules under section 72(s) that apply to a nonspouse designated beneficiary.[12] New York has adopted a similar approach with respect to contracts involving same-sex spouses in a valid out-of-state marriage.[13] These different approaches are aimed generally at avoiding the conflict between state law and the application of the Code under DOMA.

The fact that different states adopt different approaches to address this conflict means that the forms and administrative procedures that annuity issuers must adopt for treating Partners will differ from state to state. Given this fact—and that not all of the affected states have addressed this conflict—it is possible that one or more states might address this conflict in a manner that jeopardizes the treatment of annuity contracts as nonqualified and qualified annuity contracts.[14] An alternative manner of resolving this conflict is for the Treasury Department or Internal Revenue Service to issue guidance clarifying the circumstances in which the requirements of sections 72(s) and 401(a)(9) will be satisfied with respect to nonqualified and qualified annuity contracts that have a designated beneficiary who is the owner's Partner and are issued in states that extend spousal rights and benefits to Partners. The attraction of this federal approach is that owners, employees, Partners and insurers could take comfort that the approach would apply in all states.

IV. CONCLUSION

As explained above, the interaction of state law with DOMA can adversely affect the federal income tax treatment of nonqualified annuity contracts and qualified annuity contracts with spousal provisions that are required under state law to apply to Partners. This interaction can result in the failure of such contracts to satisfy the applicable requirements of section 72(s) or section 401(a)(9), and thus fail to be treated as a nonqualified or qualified annuity contract for federal tax purposes. This failure can result in severe adverse federal income tax consequences to the owner and the Partner, and can affect the issuer's withholding and reporting obligations with respect to the contract. ◂

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END NOTES

1 Pub. L. No. 104-199 (1996) codified at 1 U.S.C. § 7 (1997).
2 *See, e.g., http://moritzlaw.osu.edu/library/samesexmarriagelaws.php* for a listing of states that recognize civil union partnerships, domestic partnerships and/or same-sex marriages.
3 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.
4 Treas. Reg. section 1.401(a)(9)-5, Q&A-4.
5 Treas. Reg. section 1.401(a)(9)-5, Q&A-5.
6 Section 401(a)(9)(B)(iv)(I); Treas. Reg. section 1.401(a)(9)-3, Q&A-3(b).
7 Section 401(a)(9)(B)(iv)(II); Treas. Reg. section 1.401(a)(9)-3, Q&A-5.
8 See section 408(d)(3)(C); Treas. Reg. section 1.408-8, Q&A-5.
9 Section 72(s)(1)(B) and (2).
10 S. 283, 75th Gen. Sess. (Nev. 2009).
11 Vt. Ins. Bulletin No. 128.
12 N.J. Ins. Dep't. Bulletin 07-04; N.H. Ins. Dep't Bulletin INS 08-030-AB.
13 N.Y. Ins. Dep't Supplement No. 1 to Circular Letter 27 (2008) (Dec. 9, 2009).
14 On Nov. 21, 2008, the New York State Insurance Department ("NYSID") issued Circular Letter No. 27 (2008), providing generally that annuity contracts must be amended as necessary to extend spousal rights and benefits to same-sex spouses in a valid out-of-state marriage. On Aug. 10, 2009, the NYSID released Supplement No. 1 to Circular Letter No. 27 (2008), indicating that under section 72(s), a nonspouse beneficiary can continue a nonqualified annuity contract without taking distributions, and federal income taxes will be imposed at the end of the five-year period following the contract owner's death. This Supplement also suggested that a nonspouse beneficiary can delay taking required minimum distributions under a qualified contract in the same manner that a spouse beneficiary is permitted to delay distributions under section 401(a)(9), and federal income taxes (and possibly penalties) are imposed on the nonspouse beneficiary as if required minimum distributions are actually made. Insurers raised concerns about whether the NYSID's interpretation complies with sections 72(s) and 401(a)(9). In light of these concerns, this Supplement was replaced and superseded with a new Supplement dated Dec. 9, 2009, which provides generally that a same-sex spouse beneficiary is subject to the same distribution rules under section 72(s) and section 401(a)(9) that apply to nonspouse beneficiary.