

Client Alert

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The Treasury Department and the IRS Implement *Windsor* and Adopt “State of Celebration” Rule: Compensation and Benefits Considerations of Same-Sex Marriage Ruling

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On August 29, 2013, the Treasury Department and the IRS issued Revenue Ruling 2013-17 (“Rev. Rul. 2013-17”) and updated Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law (“FAQs”) to clarify and implement the federal tax consequences of *United States v. Windsor*.¹

As we explained in a previous Client Alert, *Windsor* overturned Section 3 of the Defense of Marriage Act (DOMA), which required the federal government to deny married same-sex couples the rights and benefits provided to married heterosexual couples. The U.S. Supreme Court held that the federal government must recognize same-sex marriages performed by states (and foreign jurisdictions). However, DOMA also provides states with the authority to refuse to recognize the marriages of same-sex couples from other states, and this portion remains in force. This left some confusion regarding whether the law of the state in which a married same-sex couple resides, or the law of the state or other jurisdiction in which that same-sex couple entered into marriage, would control the couple’s marriage status for federal tax purposes; Rev. Rul. 2013-17 answers this key question. Following the IRS’s approach with regard to common-law marriages, Rev. Rul. 2013-17 adopts the “state of celebration” approach for federal tax purposes,² holding that a same-sex couple legally married in any state (or other jurisdiction) that recognizes same-sex marriages will be treated as married for all federal tax purposes, including for income, gift and estate tax purposes, even if the couple resides in a state (or other jurisdiction) that does not recognize same-sex marriages. The effective date of this ruling is September 16, 2013 (though same-sex spouses may claim retroactive tax relief for overwithheld income taxes).

Rev. Rul. 2013-17 also holds that individuals in registered domestic partnerships, civil unions or other similar formal relationships recognized under state law that are not denominated as a marriage under the laws of that state are not considered to be married for federal tax purposes.

While employers seeking clarity about the treatment of their employees in light of *Windsor* will welcome the guidance in Rev. Rul. 2013-17 and the FAQs, employers should note that the holdings in Rev. Rul. 2013-17 and guidance provided in the FAQs are limited to federal tax purposes and do not address taxation at the state level.

We addressed some of the ramifications of *Windsor* for retirement, health and welfare plans in a previous Client Alert. Below we address some of the potential ramifications of *Windsor* for executive and equity compensation purposes, as well as clarifications provided in Rev. Rul. 2013-17 and the FAQs for qualified retirement and cafeteria plans. We note that marriage recognition comes with both additional benefits and additional limitations.

¹570 U.S. __ (2013).

²Note that the Department of Labor has issued guidance on FMLA leave, with a different approach: For FMLA purposes, the laws of the state of the employee’s residence determine whether a same-sex marriage is recognized.

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- **Golden Parachutes.** Securities owned by an individual's spouse generally will be aggregated with those held by the individual and can affect whether that individual is a "disqualified individual" subject to the negative tax consequences imposed by the golden parachute provisions of the Internal Revenue Code. Post-*Windsor*, securities owned by an individual's same-sex spouse will also be considered for determining whether that individual is a "disqualified individual" for purposes of the golden parachute rules.
- **Incentive Stock Options/Employee Stock Purchase Plans.** Employees who hold employer stock in amounts that exceed statutorily specified limits are subject to additional restrictions on incentive stock options (ISOs) (generally, the ISOs must be granted at a premium to the per share fair market value of the underlying stock and may not have a term of more than five years). In addition, employees who own employer stock in excess of specified limits may not participate in a tax-advantaged employee stock purchase plan (ESPP). Post-*Windsor*, stock owned by an individual's same-sex spouse will be considered when determining whether such statutorily specified limits have been exceeded. Accordingly, stock owned by an individual's same-sex spouse will affect whether that individual is subject to the additional ISO requirements, and also whether that individual is eligible to participate in an ESPP. On the beneficial side, as a result of *Windsor*, stock received through the exercise of an ISO or through the exercise of an option granted under an ESPP will be transferable between same-sex spouses, and will be transferable incident to a divorce between same-sex spouses, without jeopardizing the original option's tax-advantaged status under the Internal Revenue Code.
- **Deferred Compensation Distribution Events.** Same-sex married couples may now qualify for emergency distributions under deferred compensation plans. Events that directly affect an employee's same-sex spouse may now constitute an "unforeseeable emergency" with respect to the employee, thereby providing the employee the ability to take an early deferred compensation distribution in an emergency situation. Similarly, deferred compensation may be paid out early to a divorcing former same-sex spouse under a "domestic relations order" applicable to the spouse.
- **Refunds of Social Security and Medicare Taxes Paid on Benefits; Income Tax Withholdings.** With regard to health coverage for same-sex spouses paid for by the employer for which the value of the coverage had been included in the employee's income, and for premiums paid by employees on an after-tax basis, employers may claim a refund of, or make an adjustment for, any excess social security and Medicare taxes paid with respect to any filing period for which a claim for refund is open. Employers may not claim refunds of over-withheld income tax for prior years (although employees may do so provided the period of limitations for claiming a refund has not expired). Employers may, however, make adjustments for income taxes that were overwithheld from an employee *in the current year* (provided that the employer has repaid or reimbursed the employee for the overwithheld tax before the end of the year).
- **Qualified Retirement Plans.** Effective September 16, 2013, all qualified retirement plans must treat same-sex spouses as spouses for all purposes under the plans. This effective date appears to apply to plan operation and administration. The IRS will issue further guidance regarding required plan amendments.
- **Health and Welfare Benefits.** Same-sex spouses will be treated as spouses for purposes of Section 125 cafeteria plans, and other health and welfare benefits. The IRS will issue further guidance regarding cafeteria plans. We expect that this guidance will provide clarification regarding any special enrollment period to be provided for same-sex spouses and their children.

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- **Securities Law Issues.** Many U.S. securities laws contain rules that take into consideration an individual's marriage status and apply to "spouses." We discuss below some of the rules that impact executive and equity compensation that will be affected by *Windsor*. Unlike the Treasury Department and the IRS, the Securities and Exchange Commission has not yet clarified whether it will look to the "state of celebration" to determine whether individuals are considered married. Thus, some uncertainty still remains as to how these securities laws will be affected by *Windsor*.
- **Section 16 Reporting and Liability.** An officer or director subject to Section 16 of the Securities Exchange Act of 1934, as amended ("Section 16"), is presumed to retain an indirect pecuniary interest, and thus beneficial ownership, in securities held by members of his or her "immediate family," including a spouse, sharing the same household. Following *Windsor*, securities held by same-sex spouses will be presumed to give rise to beneficial ownership. Accordingly, for purposes of reporting under Section 16, an officer or director must include security holdings of a same-sex spouse sharing the same household. Moreover, a same-sex spouse married to such officer or director subject to Section 16 may also be subject to the filing requirements and short-swing profit liability rules of Section 16 as an "immediate family" member.
- **Accredited Investors.** Certain exemptions from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"), limit the number of investors who are not "Accredited Investors" (as defined under Rule 501 of Regulation D) that may participate in private placements (i.e., offerings of securities exempt from registration under the Securities Act). Among other things, the definition of "Accredited Investor" can be important in meeting the requirements of an exemption from registration for private company equity compensation plans. For most individual investors (other than officers or directors of the issuer), whether the investor qualifies as an Accredited Investor takes into account the net worth or the income of the investor either alone or jointly with the investor's spouse. Post-*Windsor*, this analysis would include the net worth and income of an investor's same-sex spouse.
- **Rule 144.** Rule 144 of the Securities Act provides a safe harbor under certain circumstances for "persons" selling securities deemed not to be engaged in a distribution and therefore not underwriters. The term "person" (i.e., the security holder seeking to sell under Rule 144) includes a spouse and any relative of that spouse. Post-*Windsor*, this term would include sales made by a person's same-sex spouse.
- **Form S-8 Registration.** Form S-8 may be used to register the exercise of an option and resale of the underlying stock by an employee's "family member" who has acquired the option from the employee through a gift or a domestic relations order. Before *Windsor*, the benefit of the Form S-8 registration was available to same-sex spouses only to the extent that the employee and the same-sex spouse shared a household. Post-*Windsor*, same-sex spouses should enjoy the benefit of registration regardless of whether the original employee and the same-sex spouse share the same household.
- **Rule 701.** Rule 701 of the Securities Act provides a registration exemption for offers and sales of securities to employees of private companies under compensatory plans or written compensatory agreements, including immediate family members who acquire the securities through a gift or domestic relations order. Securities originally exempt from registration pursuant to Rule 701 of the Securities Act

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would now be exempt when transferred to same-sex spouses through a gift or domestic relations order as a consequence of *Windsor*.

WHAT SHOULD EMPLOYERS DO?³

- In light of *Windsor* and Rev. Rul. 2013-17, and as additional guidance is forthcoming, employers should take care that the federally recognized marriage status of their employees is taken into consideration when administering executive and equity compensation arrangements.
- Beginning September 16, 2013, employers should treat all same-sex spouses as “spouses” for purposes of operating and administering all qualified retirement plans. This is particularly important for beneficiary designations, and making distributions from plans (particularly in the event of death), including minimum required distributions. This treatment applies regardless of the plan document terms (for which further guidance is forthcoming). We also recommend reviewing and updating plan distribution forms and administrative procedures to treat a same-sex spouse as a spouse for plan purposes. This includes a review of the marriage documentation requirements and procedures for distributions (including minimum required distributions), death benefits, QDROs, loans, hardships, and rollovers.
- For qualified retirement plans, plan administrators also need to provide notice to all plan participants that spousal consent is now required from same-sex spouses in order to designate any beneficiary other than the spouse and to elect non-spousal forms of annuities. We advise that this notice contain a warning that if such spousal consent is not obtained, any beneficiary designation other than the spouse, and for certain types of plans, any election of a form of distribution other than a qualified joint and survivor annuity or qualified optional survivor annuity with survivor benefits to the spouse, will not be honored.
- Employers also are advised to review operative executive and equity compensation documents to make sure that the provisions contained in such documents comply with *Windsor* and Rev. Rul. 2013-17.
- Employers should update enrollment materials and other plan paperwork for cafeteria, health and welfare benefits to reflect the new rules and options available to same-sex spouses.
- Employers should stop imputing income for health, welfare and fringe benefits provided to same-sex spouses no later than September 16, 2013.
- Employers may seek refunds of any excess social security and Medicare taxes paid for health coverage for same-sex spouses that was paid for by the employer for which the value of the coverage had been included in the employee’s income, and premiums paid by employees on an after-tax basis, for any filing period for which a claim for refund is open. The IRS will provide information about a special administrative procedure for this in the near future.

QUESTIONS?

Please contact your MoFo attorney or any member of the Compensation, Benefits & ERISA Group.

³Additional action items are listed in our prior Client Alert.

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