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IRS Issues "State of Celebration" Guidance for Same-Sex Couples

Further Guidance by 24 States May Be Required

By
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Executive Summary

The IRS today announced that, beginning with the 2014 tax filing season, they will use a "state of celebration" standard for recognizing marriages.[1] Consequently, any couple possessing a marriage license from any U.S. state may file a joint federal tax return. This standard is in contrast to a "state of residency" standard, in which federal joint filing would be permitted only by residents of states that recognize the marriage as valid.

Guidance from the IRS is required to conform the tax code to the Supreme Court's June 2013 decision in *United States v. Windsor*, which struck down section 3 of the Defense of Marriage Act (DOMA).[2] That decision invalidated a federal definition of marriage as between one man and one woman, and general reaction at the time suggested that the definition of marriage would thus revert to state law: if a state recognized your marriage, the federal government would recognize it; however, if a state did not recognize your marriage, the federal government would not. This interpretation is supported by the fact that Section 2 of DOMA, which permits states to refuse to recognize marriages that are at odds with their state's public policy, was not struck down.[3]

However, a "state of celebration" standard is broader, affecting even same-sex couples who have obtained a marriage certificate but currently live in a state that does not recognize their marriage as valid. The administration asserts that "state of celebration" is in line with private industry practice, which provides benefits to any employee that can demonstrate they are married, regardless of where they live. Many may

[1] U.S. Department of the Treasury, *All Legal Same-Sex Marriages Will Be Recognized for Federal Tax Purposes*, Aug. 29, 2013, http://www.treasury.gov/press-center/press-releases/Pages/jl2153.aspx.
[2] *United States v. Windsor*, 570 U.S. ____, Docket No. 12-307 (Jun. 26, 2013).
[3] *See* U.S. Const. art IV, sec. 1 ("[T]he Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.").

cheer the result, which resolves federal tax ambiguity for same-sex couples in the 13 states and the District of Columbia that recognize their marriage.[4]

The next step must be taken by the 24 states that do not recognize same-sex marriage but require taxpayers to reference the federal tax return when filling out their state tax form. Same-sex couples in those states will be able to file a joint federal income tax return but need guidance on how to prepare their state income tax return. Assuming a state does not opt to recognize same-sex marriage by next year, viable options include:

- permitting taxpayers to reference a "dummy" federal return reflecting single filing status for their state return, or

- permitting taxpayers to "split" a joint federal return down the middle, using one-half for each single state return, or

- creating a new filing status permitting any taxpayer that files a joint federal return to file a joint state return, especially if the state presently recognizes civil unions or domestic partnerships.

An option that should not be considered is to "delink," or "decouple," the state's tax code from the federal tax code. Such a step would impose huge compliance costs on nearly all state taxpayers and potentially cause economic damage. Such a response would be disproportionate since other viable options are available.

Tax Filing by Same-Sex Couples Before and After the IRS Ruling

To illustrate, take two same-sex couples, one living in Maryland (which recognizes same-sex marriage) and one living in Virginia (which does not). The Maryland couple, in the past, has been able to file a joint state return but has had to file separate federal returns. (Because Maryland's return references information on the federal return, Maryland and other same-sex marriage states have permitted taxpayers to prepare a "dummy" federal joint return to reference when preparing the state return.) Under either a "state of celebration" or "state of residency" rule, the Maryland couple would now be able to file joint returns at both the federal and state levels.

The Virginia couple has never been able to file joint returns at the federal or state levels, but because the IRS has adopted a "state of celebration" standard, they may now file a joint federal return so long as they have a marriage certificate issued by another state that recognizes same-sex marriage. Under a "state of residence" standard, state law defining marriage would apply and the couple would not be able to file federal or state joint returns. But under a "state of celebration" standard, the couple can file jointly at the federal level but must continue to file separately at the state level.

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[4] For information on how the tax code offers marriage bonuses and marriage penalties for different categories of taxpayers, see Nick Kasprak, *Effects of Marriage on Tax Burden Vary Greatly with Income Level, Equality*, Tax Foundation Fiscal Fact No. 352 (Jan. 10, 2013), http://taxfoundation.org/article/effects-marriage-tax-burden-vary-greatly-income-level-equality.

Table 1: Differences between "State of Residency" and "State of Celebration" Standards

	Under DOMA	Post-DOMA "State of Residency" Standard	Post-DOMA "State of Celebration" Standard
State recognizes same-sex marriage (e.g., Maryland)	Couple can file joint state return but must file separate federal returns; "dummy" federal return needed to fill out state return	Couple can file joint state and federal returns	Couple can file joint state and federal returns
State does not recognize same-sex marriage (e.g., Virginia)	Couple must file separate returns at both state and federal levels	Couple must file separate returns at both state and federal levels	Couple can file joint federal return but must file separate state returns, depending on state law

Source: Tax Foundation analysis.

State Laws on Same-Sex Marriage and Federal Tax Conformity

Currently, 13 states and the District of Columbia issue same-sex marriage licenses, 4 states recognize same-sex civil unions, 2 states neither recognize nor prohibit same-sex marriage, and 35 states ban same-sex marriage by statute or by constitutional provision. (See Table 2.)

Table 2: State Recognition of Same-Sex Marriage

Issues Same-Sex Marriage Licenses (13+DC)	California, Connecticut, Delaware, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New York, Rhode Island, Vermont, Washington, District of Columbia
Recognizes Civil Unions (4)	Colorado (bans same-sex marriage constitutionally), Hawaii (bans same-sex marriage by statute), Illinois (bans same-sex marriage by statute), New Jersey
Recognizes Domestic Partnerships (3)	Nevada (bans same-sex marriage constitutionally), Oregon (bans same-sex marriage constitutionally), Wisconsin (bans all same-sex unions constitutionally
Neither Recognizes nor Prohibits Same-Sex Marriage (2)	New Mexico, New Jersey
Same-Sex Marriage Banned by Statute (6)	Hawaii, Illinois, Indiana, Pennsylvania, West Virginia, Wyoming
Same-Sex Marriage Banned Constitutionally (9)	Alaska, Arizona, Colorado, Mississippi, Missouri, Montana, Nevada, Oregon, Tennessee
All Forms of Same-Sex Unions Banned Constitutionally (20)	Alabama, Arkansas, Florida, Georgia, Idaho, Kansas, Kentucky, Louisiana, Michigan, Nebraska, North Carolina, North Dakota, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, Wisconsin

Nearly all states reference the federal tax code at some point to minimize taxpayers' calculation, record keeping, and compliance burdens. (See Table 3.)

Table 3: State Conformity with Federal Tax Code, Least Complex to Most Complex

No State Individual Income Tax (7)	Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming
State Taxes Only Interest and Dividend Income (2)	New Hampshire, Tennessee
Starts with Federal Adjusted Gross Income, then Applies One Rate (4)	Illinois, Indiana, Michigan, Utah *North Carolina will join this group in 2014 as part of their recent state tax reform*
Starts with Federal Taxable Income, then Applies One Rate (1)	Colorado
Starts with Federal Taxable Income, then Applies Own Rates to Federal Brackets (2)	North Dakota, Vermont
Starts with Federal Taxable Income, then Applies Own Rates and Brackets (3)	Minnesota, North Carolina (until 2014), South Carolina
Starts with Federal Adjusted Gross Income, then Applies Own Rates and Brackets (25)	Arizona, California, Connecticut, Delaware, Georgia, Hawaii, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Oregon, Rhode Island, Virginia, West Virginia, Wisconsin
Starts with Federal Gross Income, then Applies Own Rate(s) and Bracket(s) (2)	Massachusetts, District of Columbia
Tax Calculation Does Not Reference Federal Return (5)	Alabama, Arkansas, Mississippi, New Jersey, Pennsylvania

Source: Tax Foundation review of state statutes.

24 States Should Provide Further Guidance to Taxpayers

Consequently, there are 24 states that do not recognize same-sex marriage but do require state taxpayers to reference their federal tax return when preparing their state tax return. These 24 states—Arizona, Colorado, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Michigan, Missouri, Montana, Nebraska, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, Utah, Virginia, West Virginia, and Wisconsin—must provide guidance to taxpayers on how to proceed before the 2014 tax season.

In these states, same-sex couples will file single returns at the state level but joint returns at the federal level. State law generally requires references to the federal return and filing status to match the federal return, which will be impossible. Assuming a state does not opt to recognize same-sex marriage by next year, states have several options for providing guidance to resolve this conflict:

- *Permit taxpayers facing a federal-state filing status conflict to reference a "dummy" federal return.* To resolve this with minimal impact to the state, taxpayers in this situation would be instructed to prepare a "dummy" federal return reflecting single filing and reference that when preparing the state return. Taxpayers who file married filing separately at the federal level would be permitted to file as single at the state level. Most taxpayers will be unaffected by this change, and while some same-sex taxpayers may face additional compliance costs, they will get the benefits of joint federal filing.

- *Permit taxpayers facing a federal-state filing status conflict to "split" their joint federal return*. Alternatively, this option also leaves most taxpayers unaffected while reducing the compliance costs for same-sex taxpayers. Under this option, taxpayers in this situation will be instructed that any reference to the federal tax return will be interpreted to mean half the amount on the filed joint federal return. For example, if the couple reports $50,000 in income on their joint federal return, each individual will report $25,000 in income on each state return. Depending on income disparity, this may have uneven effects on certain same-sex taxpayers, but would reduce compliance costs.

- *Create a new "federal joint return" filing status when a taxpayer files a federal joint return but cannot do so at the state level under state law*. Presently, taxpayers may file as single, as married filing jointly, as married filing separately, or as head of household. This option would create a new "federal joint return" status for couples who file married filing jointly or married filing separately at the federal level but are not permitted to do so at the state level under state law. Taxpayers would reference their federal return when preparing their state return, but the state would not recognize same-sex marriage. This option may be most ideal for states such as Colorado, Hawaii, and Illinois, which recognize civil unions but not same-sex marriage.

Depending on state law, this guidance may require only an administrative ruling by revenue officials. Alternatively, governors and legislators can enact changes legislatively.

States Should Resist Calls to Decouple from Federal Tax Law

Officials in these 24 states may face calls for the state to "delink," or "decouple," from the federal tax code to eliminate the need to clarify what same-sex couples filing jointly at the federal level should reference when preparing their state tax return. At first glance, this may seem a viable solution, since deleting all state references to the federal tax code eliminates all need to refer to the federal tax return. However, decoupling would impose new compliance costs on all state taxpayers.

Decoupling Would Impose Compliance Costs on All Taxpayers

A principle of sound tax policy is that tax systems should be as simple as possible because the cost of complying with complex tax systems is a real economic loss that distorts incentives and economic behavior. Decoupling violates this principle because it requires taxpayers to calculate income, exemptions, deductions, and credits with two conflicting accounting and tax systems. Taxpayers would need to keep two sets of books: one for federal law and one for each decoupled state with unique definitions and rules. This essentially doubles the cost of complying with the income tax, which would likely harm investment, job creation, and long-term tax revenues.

Taxpayers consistently complain about the complexity of the tax code, for good reason: in 2005, the estimated time and money cost of complying with the federal income tax code was 6 billion man-hours worth $265 billion. The code that year stood at 7 million words in 736 code sections, up from 718,000

words in 103 code sections in 1955. Decoupling makes this worse, by increasing both the cost of compliance for taxpayers and the cost of administration to revenue officials who track and enforce the code.

Decoupling Sends the Signal that the State is Unfriendly to Business and Investment

The extent to which a state welcomes business owners and entrepreneurs making decisions about where to locate investment capital, equipment, and jobs depends on a number of factors that the Tax Foundation attempts to gauge in our annual *State Business Tax Climate Index*. States can be termed "unfriendly" if they consistently move the state tax system away from a sound tax policy, such as with increased complexity, retroactivity, high burdens, economic distortions, and a lack of transparency.

Decoupling is a move away from sound tax policy, because it increases tax burdens, reduces stability, and exacerbates an already complex income tax code. Individuals and businesses should be wary of states that have decoupled, since it signals that the state cares more about parochial definitions and rules instead of long-term economic growth. While remaining coupled or recoupling is not in itself a signal of welcoming new investment, it signals a commitment to principled tax policy.

Conclusion

The concept of physical presence is tightly connected to tax and spending policy. Taxpayers pay income taxes, sales taxes, property taxes, and other taxes based on where they are when assessed, and taxpayers receive benefits based on which state they live in. The rise of swift transportation, instantaneous communication, and an interconnected world continue to challenge these deeply rooted historical standards. Using a "state of celebration" standard may be more realistic and more accurate, but it will present challenges in compliance and enforcement that would not occur under a "state of residence" standard. However, states have viable options for accommodating this federal change with minimal effort that would affect only a few taxpayers. States should resist calls to decouple, which would involve enormous costs for all taxpayers.

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