EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

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New York State Issues Tax Guidance on Same-Sex Marriage and Employee Benefits

On July 29, 2011, the New York State Department of Tax and Finance issued guidance regarding the impact of New York's legalization of same-sex marriage on the tax treatment of employee benefits provided to same-sex spouses. The following Alert describes the guidance and provides further background regarding a benefit plan's obligation to recognize a same-sex marriage in light of the New York Marriage Equality Act.

Background: New York Marriage Equality Act

While New York previously required the recognition of same-sex marriages legalized in other jurisdictions, same-sex marriages began to be legalized in the state of New York effective July 24, 2011. Further, the Marriage Equity Act generally requires that marriages of same-sex and different-sex spouses be treated equally in all respects under the laws of New York.

Certain religious organizations are exempted from the law's requirements to recognize a same-sex marriage. Please contact your Patterson Belknap relationship attorney if you are interested in learning whether you qualify for the religious organization exemption.

Federal and State Requirements: Complexity in the Benefits Arena

The New York requirement to treat same-sex spouses in the same way as different-sex spouses creates significant complexity in the benefits arena. As a starting point, the Federal Defense of Marriage Act prohibits the recognition of a same-sex marriage for purposes of certain Federal benefits laws. Moreover, because ERISA generally preempts state law, even if the provision of such benefits is not otherwise prohibited by Federal law, an ERISA-governed plan is generally not required to offer benefits to same-sex spouses. Insured plans, however, are an exception to ERISA preemption and must comply with applicable state law. Thus, ERISA preemption exempts a *self-insured health plan* from having to provide health benefits to a same-sex spouse. In contrast, an *insured health plan* subject to New York insurance law must provide health benefits to a same-sex spouse, if benefits are otherwise provided to an employee's different-sex spouse. Finally, a benefit governed exclusively by New York law must be offered with respect to a same-sex spouse if offered with respect to a different-sex spouse.

We note, however, that even if New York law requires that certain insured health benefits be offered to same-sex spouses, Federal law may impose some limitations on the provision of the benefits, as described further below.

Employers offering a domestic partner program in New York only to same-sex domestic partners may now be required to offer these benefits to different-sex partners as well. Please see the section below titled "Traps for the Unwary" for a discussion of the possible ramifications of New York's anti-discrimination laws on same-sex only domestic partner policies.

Tax Ramifications of Health Benefits Provided to Same-Sex Spouses

As readers may be aware, under Federal law, health benefits provided to an employee's same-sex spouse are considered taxable income to the employee if the spouse does not qualify as the employee's tax dependent and the employer must appropriately report and withhold on the value of the coverage.

Prior to the effective date of the Marriage Equality Act, New York income tax law followed Federal tax laws. If an employee was married in a state legalizing same-sex marriage to a non-tax dependent same-sex spouse, the employee was subject to New York income tax on the value of the coverage.

Following the effective date of the Marriage Equality Act (i.e., July 24, 2011), New York State's tax treatment of health benefits provided to non-tax dependent same-sex spouses now differs from the Federal tax treatment. The New York State Department of Taxation and Finance recently issued guidance providing that an employer should not withhold New York tax for New York State, New York City or Yonkers income tax purposes on the value of health coverage provided to an employee's same-sex spouse, regardless of whether the spouse is a tax dependent of the employee.

It appears that the New York State income tax treatment of health coverage provided to non-tax dependent same-sex spouses is only applicable effective July 24, 2011. Thus it appears that an employee, who was legally married in another state prior to July 24, 2011 to a non-tax dependent same-sex spouse, will still be subject to income tax on the value health coverage provided to the spouse prior to July 24, 2011.

Because the Federal tax treatment of health coverage provided to an employee's same-sex spouse depends on whether a spouse qualifies as the employee's tax dependent, employers should still require an employee requesting this coverage to annually submit a certification attesting to the spouse's tax dependent status. Employees should be further obligated to notify an employer as soon as possible if the spouse's tax dependent status changes mid-year. It does not appear that requiring this certification will violate New York's anti-discrimination rules described below because an employer must know the same-sex spouse's tax dependent status in order to properly administer the tax treatment of the health coverage.

Cafeteria Plans

For Federal purposes, tax-free benefits provided under a cafeteria plan qualified under Section 125 of the Internal Revenue Code may not be extended to a same-sex spouse, unless the spouse qualifies as an employee's tax dependent. An employee may therefore not pay for his or her same-sex spouse's health coverage on a pre-tax basis for Federal income tax purposes unless the spouse qualifies as the employee's tax dependent. In addition, a health flexible spending arrangement may not reimburse an employee with respect to medical expenses incurred with respect to a non-tax dependent same-sex spouse. Finally, the Section 125 plan change in status rules allowing an employee to make a mid-year election change may have limited applicability to an employee in connection with his or her same-sex spouse. In particular, if an employee marries a tax-dependent same-sex spouse mid-year, Federal law will not recognize the marriage as a change in status event allowing the employee to begin to pay for the spouse's coverage on a pre-tax basis. Thus, while the spouse could be added to the health coverage mid-year, the employee would appear to be required to pay for the coverage on an after-tax basis for the balance of the plan year. In contrast, it appears that an employee could make a mid-year election change in conjunction with a change in a tax dependent same-sex spouse's employment status.

It appears that an employee should be able to pay for a non-tax dependent same-sex spouse's health coverage on a pre-tax basis for purposes of New York income tax (but on an after-tax basis for Federal income tax purposes) under a cafeteria plan.

We note that it is common for a Section 125 cafeteria plan to merely provide that spouses are eligible for coverage under the plan, without specifying the application of the plan to same-sex spouses. We recommend that if a plan sponsor's plan lacks specificity, it amend the plan to clarify to what extent a same-sex spouse will be eligible for coverage.

Because the tax treatment of same-sex spouses under a Section 125 cafeteria plan still depends on whether a spouse qualifies as the employee's tax dependent, employers should require employees to submit a tax dependent certification, as described above.

Continuation Coverage Requirements

Federal law does not recognize a covered same-sex spouse as a qualified beneficiary eligible for Federal COBRA coverage. However, if a health insurance policy is subject to New York insurance law, the same-sex spouse will be eligible for medical continuation coverage in accordance with the New York insurance continuation coverage rules.

Please keep in mind that New York continuation coverage rules do not apply to separate dental and vision coverage. As such, New York continuation coverage law does not require a same-sex spouse to be provided with dental and vision continuation coverage, if these coverages are provided pursuant to a policy separate from the medical policy. However, the State's non-discrimination laws described below may require an employer to provide dental and vision continuation coverage to a same-sex spouse if coverage is provided to a different-sex spouse and the employer is a small employer not subject to Federal COBRA. Regardless, an employer could choose to offer dental and vision continuation coverage, so long as dental and/or vision insurer provides the employer with written consent to offer continuation coverage.

Retirement Plans

A retirement plan's governing law provision may cause some confusion as to what benefits are available to a same-sex spouse. Retirement plans frequently articulate the law governing the plan as follows: "to the extent not preempted by ERISA, unless otherwise indicated in the Plan, the Plan will be subject to [INSERT STATE] law." If a retirement plan defines a spouse as the person to whom a participant is married under state law, and the plan is governed by New York law under a governing law provision similar to that described above, a plan sponsor may incorrectly believe that all spousal benefits must be provided to same-sex spouses. As described below, however, Federal law prohibits certain benefits from being offered to a same-sex spouse.

Following are some retirement benefits/protections for which Federal law impacts a qualified retirement plan's[1] or Section 403(b) plan's ability to provide equal benefits to a same-sex spouse:

- **Joint and Survivor Annuity Rights.** Defined benefit plans and money purchase plans (other than non-electing church plans) must provide a married participant with a qualified joint and survivor annuity, unless the participant elects a different form of benefit *with his or her spouse's consent*.[2]

[1] Defined benefit plans (including cash balance plans) and defined contribution plans (including 401(k) plans) qualified under Section 401(a) of the Internal Revenue Code are considered "qualified plans."

[2] Defined benefit plans and money purchase plans (other than non-electing church plans) must provide a single life annuity to an unmarried participant, unless the participant elects a different form of benefit. A participant married to a same-sex spouse is considered an unmarried participant for purposes of this rule. Thus he or she will be required to receive his or her retirement benefit in the form of a single life annuity unless he or she elects a different form of benefit available under the plan.

Similarly, certain qualified plans and Section 403(b) plans (other than non-electing church plans), in order not to be subject to the joint and survivor annuity requirements, are legally required to provide that a participant must secure the consent of his or her spouse in order to name a non-spousal beneficiary. These legal requirements do not apply to a participant married to a same-sex spouse.

- **Distributions Under the Internal Revenue Code Section 401(a)(9) Rules.** The Internal Revenue Code establishes rules governing the timing by which a distribution must commence and the minimum amount of distribution that must be made at this required beginning date. The timing by which a distribution must be made, and the calculation of the minimum amount, may differ, depending on whether a beneficiary is a participant's spouse or the participant's non-spousal beneficiary. *A same-sex spouse must be treated as a non-spousal beneficiary for purposes of these rules*.
- **Eligible Rollover Distributions.** A same-sex spouse must be treated as a non-spousal beneficiary for purposes of eligibility for a rollover distribution. Thus a same-sex spouse may only rollover a distribution to an inherited IRA (or Roth IRA) in a direct rollover. The same-sex spouse may not rollover an otherwise eligible rollover distribution to a qualified plan or a Section 403(b) plan.
- **Hardship Distribution.** If a retirement plan is operated in accordance with the hardship distribution safe harbor rules, a participant may only request a hardship distribution in connection with otherwise qualifying expenses related to a same-sex spouse if that spouse qualifies as the participant's tax-dependent, or if the same-sex spouse is the participant's primary beneficiary under the plan.

There are some spousal retirement benefits which could arguably be (although not required to be) offered to a same-sex spouse. In particular, a retirement plan could choose to provide a pre-retirement survivor annuity to a participant's same-sex surviving spouse. It also appears that a retirement plan may require a participant to secure his or her same-sex spouse's consent to name a non-spousal beneficiary for any available death benefit. It should be noted that if a plan sponsor chooses to provide a death benefit to a same-sex spouse, the benefit must be nevertheless be operated under the Code Section 401(a)(9) rules noted above, as applicable to a non-spousal beneficiary.[3]

We note that if a retirement plan's governing law provision provides that New York law governs the plan to the extent not otherwise preempted by ERISA, a participant could argue that a retirement plan must recognize the same-sex spouse as a spouse in all instances where Federal law does not otherwise prohibit a retirement benefit being provided to a same-sex spouse. Therefore, unless the plan provides further guidance, a participant could argue that the formulation described above requires that a pre-retirement survivor annuity automatically be provided to his or her same-sex spouse or that the spouse be a default designated beneficiary unless the participant designated a different beneficiary with the spouse's consent.

We recommend that plan sponsors review their retirement plans to clarify which, if any, benefits are available to same-sex spouses. In the event a plan sponsor does not wish to extend benefits to a same-sex spouse, the plan sponsor could revise the plan's definition of "spouse" to clarify that a spouse is the person to whom the participant is married, but solely if recognized by Federal law.

[3] In particular, this requirement may necessitate a modification of the commencement date of a pre-retirement survivor annuity if provided to a same-sex spouse.

Traps for the Unwary

New York law prohibits discrimination based on sexual orientation. To that end employers should be wary of engaging in any of the following practices:

- Requiring an employee to submit proof of marriage to a same-sex spouse as a condition of receiving health coverage for a spouse if an employee is not required to submit proof of marriage to a different-sex spouse. We recommend employers ask for marriage certificates from all employees requesting spousal health coverage.
- Offering domestic partner benefits only to same-sex couples. Prior to the passage of the Marriage Equality Act, offering domestic partner benefits only to same-sex couples should not have violated New York's prohibition on sexual orientation discrimination because same-sex couples did not have a right to marry in the state. Because same-sex couples can now be married in New York, an employer who continues to offer domestic partner benefits may risk violating the State's anti-discrimination rules unless it offers these benefits to same-sex and different-sex partners. If an employer chooses to eliminate domestic partner benefits and require same-sex couples to marry as a condition of receiving benefits, it is arguable that an employer may be able to continue a domestic partner policy covering only same-sex couples for a limited transition period in order to allow same-sex couples time to get married.

It is also important for an employer to understand whether its insured health plan is required to recognize a same-sex marriage. An insured health plan is only subject to the New York requirement to recognize a same-sex marriage if the insurance policy is subject to New York law. If the insurance policy is governed by another state law, that state's law will govern whether the same-sex marriage must be recognized. For example, if an employer operating in New York and Oregon offers a health insurance policy plan through an insurance policy subject to Oregon law, the employer is not required to offer health coverage to an employee's same-sex spouse; even if the employee works in New York. In contrast, if the policy offered is subject to New York law and different-sex spouses are covered under the policy, it appears that an employer should offer health coverage to an employee working in Oregon whose same-sex marriage was legalized in a state legalizing same-sex marriage, even though same-sex marriage is not legalized in Oregon.

Finally, a self-insured health plan's governing law provision may cause confusion regarding whether the plan provides benefits to same-sex spouses. As described above, a self-insured health plan is generally exempt from State insurance requirements such as a requirement to cover same-sex spouses. However, if a self-insured health plan indicates that it provides coverage to spouses and the governing law provision provides that the plan will be governed by the laws of the State of New York to the extent not preempted by ERISA, an employee could argue to an employer not covered by an applicable religious exemption that this formulation generally requires a same-sex spouse to receive health coverage because ERISA does not prohibit the provision of this coverage to a same-sex spouse. We recommend that a plan sponsor of a self-insured health plan clarify the definition of "spouse" so that it is clear whether a same-sex spouse will be covered.

Recommendations

As part of efforts to comply with the New York Marriage Equality Act, we recommend employers undertake the following actions:

1. Review all insurance policies to determine whether New York law applies.
2. To the extent New York law does not govern the insurance policy, if you wish to provide health insurance coverage to a same-sex spouse, secure the insurer's written consent to extending this coverage.
3. Review self-insured health plans to clarify the extent to which benefits will be provided to same-sex spouses.
4. Review domestic partner policies (if any) to ensure any policy also cover different-sex couples.
5. Revise the Section 125 cafeteria plan to clarify the benefits available to same-sex spouses.
6. Consider requiring an employee requesting health coverage for a same-sex spouse, or enrolling in a health flexible spending arrangement, to submit an annual tax certification attesting to the tax-dependent status of his or her same-sex spouse, and to notify you as soon as possible if this status changes mid-year.
7. Review retirement plans to understand which benefits may not be offered to a same-sex spouse, and determine whether to offer retirement benefits to same-sex spouses, to the extent allowed by law.
8. Revise retirement plans (including the plans' governing law provisions) to clarify the extent to which benefits will provided to same-sex spouses.
9. Revise enrollment and other plan forms to clarify the rules that apply differently to same-sex and different-sex spouses.
10. Review forms to request the gender of an employee/participant and his or her spouse in order to ensure that benefits are properly administered.
11. Work with your payroll administer to ensure the proper Federal and state tax treatment of health benefits provided to same-sex spouses. ◆

If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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