The government could have opted here, as well as in Petaluma, Jade Trading, and Tigers Eye, to argue that outside basis is a partnership item. Instead, it appears to have made a strategic choice to forfeit the battle to win the war. The government is evidently seeking a near-blanket rule, a vindication of what it views as TRA’s sweeping grant of authority to impose an accuracy-related penalty in a partnership proceeding, subject only to the requirement that the penalty be somehow linked to an adjustment to any partnership item. The government is clearly overreaching in its jurisdictional argument. In doing so, it runs the very real risk of not only losing the case but also leaving unresolved the question that originally prompted the petition for certiorari.

Same-Sex Marriage and Estate Taxes: Why Windsor Is Still at Issue

By David J. Herzig

Same-sex marriage came to the forefront of national consciousness in 1993 when a Hawaiian state court held that refusing to grant marriage licenses to same-sex couples was sex-based discrimination.1 This opinion led observers to question whether other states would have to recognize the marriage under the full-faith and credit clause.2 Congress, under the effects clause,3 in 1996 enacted the Defense of Marriage Act (DOMA) to preempt the argument that states would have to recognize same-sex unions from other states.4 DOMA has two key parts: Section 2 empowered states to not recognize a same-sex marriage, and section 3 created a federal definition of marriage for the purposes of federal statutes.

Last June the U.S. Supreme Court in United States v. Windsor held that section 3 of DOMA was unconstitutional.5 Without a federal definition of marriage, most commentators — including Justice Antonin Scalia in his Windsor dissent — questioned how Treasury would interpret whether taxpayers were married for purposes of the Internal Revenue Code of 1986. Treasury was faced with determining which state’s definition of marriage would apply for federal tax purposes: the state in which the couple married (state of ceremony) or the state in

2“Full faith and credit shall be given in each state to the public acts, records, and judicial proceedings of every other state.”
3“And the Congress may by general laws prescribe the manner in which such acts, records, and proceedings shall be proved, and the effect thereof.”
which the couple lived (state of domicile). Either choice would bring challenges and benefits for Treasury and taxpayers.

Rather than leave taxpayers in a state of flux, Treasury issued Rev. Rul. 2013-17. The revenue ruling states that for federal tax purposes, same-sex couples legally married in jurisdictions that recognize their marriages will be treated as married for federal tax purposes regardless of whether their state of domicile recognizes that marriage. In other words, Treasury chose the state of ceremony as determinative for federal tax purposes. This was not surprising based on numerous prior statements by the administration and the actions of other administrative agencies.

Treasury’s intent was to treat all taxpayers equally and fairly. However, it is important to contemplate the potential results of this decision, because the revenue ruling may create a new set of problems. I am not opining on the wisdom of the ruling or whether an alternative would produce similar problems, but merely that the decision is problematic. To demonstrate that the problem is far more complex and needs additional thought, I would like to highlight an estate tax pitfall created by the revenue ruling. Under Rev. Rul. 2013-17, a same-sex couple that is married yet living in a state that does not recognize same-sex marriage and an independent estate tax will be unable to maximize the portable estate tax credit that a similarly situated heterosexual couple would have had. The crux of the problem lies with the apparent application of section 2056 and Estate of Chenoweth v. Commissioner and its progeny.

Assume Jennifer and Katherine were a validly married same-sex couple in New York. They moved to Illinois, which does not recognize their marriage. Jennifer and Katherine drafted a standard A/B estate plan that at the first death would create a credit shelter trust (funded with the maximum exemption amount) and a marital trust (with the rest of the assets). If Jennifer died today and the revenue ruling was applied, for federal purposes the credit shelter trust would fund with $5.25 million and the marital trust with everything else. While in Illinois, no marital deduction would be available and tax would be due.

Here’s the problem. Which trust is required to pay the state estate tax? A normal estate plan would have the state estate tax paid out of the marital trust because that trust is taxable at the second death. If the marital trust owes the tax, it will not be funded with the amount claimed on Form 706 for federal tax purposes. Under basic principles of section 2056, and under case law such as Chenoweth, the marital trust is underfunded and the marital deduction fails in part, triggering additional federal estate tax exasperated by an interrelated calculation. That would violate Windsor, as explained below. If the estate plan pulls the tax from the credit shelter trust (which it must now), the taxpayers most likely would lose the ability to maximize the exemption amount that all other taxpayers could.

Even though most affected taxpayers would gladly pay additional federal estate tax on the interrelated state estate tax instead of a federal-level estate tax on the entire marital trust amount, that should not be an either/or proposition. This article will try to make sense of the problem and explain what taxpayers should do until more guidance is issued.

A. Windsor

On June 26, 2013, the Court concluded in Windsor that section 3 of DOMA was unconstitutional. Section 3 had prospectively invalidated marriages of same-sex couples for purposes of federal laws, regardless of whether those laws were enacted before or after DOMA.

In Windsor, the Court, in an opinion by Justice Anthony M. Kennedy, rendered a 5-4 decision holding that (1) the petitioner had standing to bring the case, and (2) most importantly for our purposes, section 3 of DOMA was unconstitutional because it denied same-sex couples “equal liberty” guaranteed by the Fifth Amendment.

Congress enacted DOMA in 1996, in part to preempt the inevitable constitutional matter of whether states would be required under the full faith and credit clause to recognize same-sex unions from other states. Scalia’s dissent in Windsor posed a series of tax questions highlighting the full faith and credit issue that will emerge post-DOMA: “Imagine a pair of women who marry in Albany and then move to Alabama, which does not “recognize as valid any marriage of parties of the same sex.” Ala. Code section 30-1-19(e) (2011). When the couple files their next federal tax return, may it be a joint one? Which State’s law controls, for federal-law purposes: their

8Kennedy also wrote the Court’s historic gay rights cases, Romer v. Evans, 517 U.S. 620 (1996), and Lawrence v. Texas, 539 U.S. 558 (2003).
9For constitutional law scholars, this is not an insignificant point.
State of celebration (which recognizes the marriage) or their State of domicile (which does not)? (Does the answer depend on whether they were just visiting in Albany?) Are these questions to be answered as a matter of federal common law, or perhaps by borrowing a State’s choice-of-law rules? If so, which State’s?11

After Windsor, every federal statute that refers to marriage will no longer be tied to the unconstitutional section 3 definition. As I have discussed in previous articles, the federal government recognized before the adoption of DOMA in 1996 that the authority to create and regulate marital status was the exclusive prerogative of the states.12 The federal government consistently deferred to the state definition of marriage when considering eligibility for rights, responsibilities, or protections under the law.13 The general rule yields when states’ marriage laws fail to conform to constitutional guarantees.14 A question for another day — as the Court also deferred on this issue — is whether same-sex marriage rises to the level of a constitutional guarantee.

For now, we are in a country that has wildly divergent marriage laws among the states. For almost 200 years, states have adjudicated differences regarding their marriage laws. There have been significant policy distinctions between states in the arena of civil marriage laws.15 A large body of case law considers whether states can give effect to other states’ “racially mixed marriages, consanguineous or incestuous relationships, marriages involving minors, and other contentious relationship categories.”16

To avoid those issues, 37 states enacted legislation (so-called mini-DOMAs) to define marriage as a union between a man and a woman.17 Importantly, section 2 of DOMA was not declared unconstitutional by Windsor. The second purpose of DOMA was to provide that Congress has the authority to limit the full faith and credit clause by permitting states to not recognize same-sex marriages that are valid in other states. The constitutionality of section 2 has yet to be decided.

The enactment of DOMA did not settle the question of the impact of the full faith and credit clause on same-sex marriage; it created additional questions about the constitutional validity of the statute. Several members of Congress and many commentators have expressed doubts about the constitutionality of DOMA for a litany of reasons. Also, the full faith and credit clause has traditionally been used to require enforcement of a mandate, not to restrict one.18

1. State of ceremony versus state of domicile. If Scalia’s hypothetical is plausible, how should the IRS recognize the marriage for purposes of the code? There are almost 200 tax code provisions that turn on the definition of marriage.19 The problem facing the IRS is that, after section 3 of DOMA was held unconstitutional in Windsor, there is no federal statutory or common law definition of marriage,

12For example, in applying the 198 marriage provisions of the Internal Revenue Code of 1986 as amended, state or tribal recognition is the determining factor. See Rev. Rul. 83-183, 1983-2 C.B. 220 (“taxpayers who meet the requirements in their state of residence for a valid marriage may file a joint return even though they have never been legally declared married by a court of law”) (citing Ross v. Commissioner, T.C. Memo. 1972-122 and Rev. Rul. 58-66, 1958-1 C.B. 60); and Eccles v. Commissioner, 19 T.C. 1049, 1051 (1953), aff’d per curiam, 208 F.2d 796 (4th Cir. 1953) (for federal income tax purposes, the determination of marital status must be made in accordance with the law of the state of the marital domicile).
15See supra note 10.
16See supra note 10.
17See supra note 10.
18See, e.g., Statement of Sen. John Kerry, July 8, 2009, available at http://kerry.senate.gov/press/release/?id=c2ea21e6-4e00-4726-9925-90fe9c24f4fc (“In 1996, I voted against the so-called Defense of Marriage Act not just because I believed it was nothing more than a fundamentally political ploy to divide Americans, but because it is unconstitutional. Thirteen years later, I still defy you to find a single Senator who can credibly argue that it is within the Senate’s power to strip away the word or spirit of a constitutional clause by simple statute.”).
nor is there a federal statutory choice of law rule to guide the Service in choosing the correct law.\textsuperscript{20} Unless there is a federal statutory choice of law statute or a federal common law choice of law, how should the IRS, as an administrative agency, deal with Scalia’s hypothetical couple?

I have recommended that the default rule should be to incorporate state law in the absence of a controlling federal rule. This is supported by three principles: (1) section 2 of DOMA was not held unconstitutional; (2) the IRS historically has used the state of domicile when deciding on the taxation of community property; and (3) in the tax abuse case law, for example, foreign divorces, the IRS historically also used the state of domicile. Under these principles, it would seem that the Service should apply the state of domicile for the purposes of the code. However, using the state of domicile might also violate the principles under \textit{Windsor}. For example, more than half of same-sex couples who identify as married reside in states that do not recognize the marriages.\textsuperscript{21} Thus, applying the state of domicile for federal purposes would fail to give effect to the Supreme Court’s decision in \textit{Windsor}.

In a recent article, William Baude discussed these problems.\textsuperscript{22} Baude says that if Congress or administrative agencies were to act by a choice of law interpretation, the applicable rule should be state of ceremony. However, if the courts were to act through the creation of a federal common law definition of marriage, the applicable rule should be state of domicile. Because we are dealing with an agency action, Baude cites previous actions taken by the Veterans Administration in the 1940s for support that the IRS is within the scope of authority to act.\textsuperscript{23} There are nonetheless serious administrative law questions regarding the ability of an agency to act. For example, is this merely an interpretation of the statute?

2. Rev. Rul. 2013-17. Following the logic of Baude’s argument, Treasury issued Rev. Rul. 2013-17 on August 29, 2013. The ruling held that for tax code purposes, the word “marriage” includes same-sex couples. The ruling states that Treasury will treat a couple as married by looking to the state of ceremony regardless of whether that marriage is recognized in the couple’s state of domicile.

To reach that conclusion, Treasury has to demonstrate why such a ruling is within its interpretive powers. Using Rev. Rul. 58-66 as a starting point,\textsuperscript{24} the new guidance notes that the Service’s position has been the same for over half a century. The ruling continues to state that the IRS “has recognized marriages based on the laws of the state in which they were entered into, without regard to subsequent changes in domicile, to achieve uniformity, stability, and efficiency in the application and administration of the Code.”\textsuperscript{25} It should be noted, however, that the Service is not as generous about using the state of ceremony in a divorce context or other similar situations that may benefit the taxpayer.\textsuperscript{26}

The ruling then goes on to discuss why the state of domicile would be the incorrect position because of the inherent problems based on what Treasury opines as historical consistency.\textsuperscript{27} Moreover, the ruling posits that the most important criteria are fairness and ease of administration. For example, a “rule of recognition based on the state of a taxpayer’s current domicile would also raise significant challenges for employers that operate in more than one state, or that have employees (or former employees) who live in more than one state, or move between states with different marriage recognition rules.”\textsuperscript{28} The principal problem with the ruling is the failure to address how its reasoning differs from prior rulings and IRS positions. Does this ruling apply only to marriages of same-sex couples, or does it represent a broader policy change? For example, the ruling does not address prior precedent, such as \textit{Eccles}, in which the Fourth Circuit decided for federal income tax purposes that the determination of marital status must be made in accordance with the law of the state of the marital domicile.\textsuperscript{29}

B. Estate Tax Consequences

If the revenue ruling is correct that the most efficient and fairest approach is the use of the state

\textsuperscript{20}Baude, \textit{supra} note 12.

\textsuperscript{21}Crandall-Hollick et al., \textit{supra} note 19, at 2.

\textsuperscript{22}Baude, \textit{supra} note 12.

\textsuperscript{23}\textit{Id.} at 1405.

\textsuperscript{24}1958-1 C.B. 60 (the Service held that taxpayers who enter into common-law marriages in a state that recognizes such marriages are married whether or not their state of domicile also recognizes the marriage); and Herzig, “The Tax Implications of \textit{Windsor},” TaxProf Blog, \textit{available at} \texttt{http://taxprof.typepad.com/taxprof_blog/2013/06/herzig-tax.html} (June 27, 2013).

\textsuperscript{25}Rev. Rul. 2013-17.

\textsuperscript{26}For example, a quicky divorce in Jamaica (but not valid in New York) will not stop the IRS from arguing state of domicile applies.


\textsuperscript{28}Rev. Rul. 2013-17.

of ceremony, the only question left is what the consequences are. Let’s revisit the hypothetical posed at the beginning of this article. Jennifer and Katherine, a same-sex couple, were validly married in New York and are now living in Illinois. Under Illinois state law, the marriage is not recognized. The couple had a standard A/B estate plan. Assume further that Jennifer died this year with a total estate of $25 million. Applying the revenue ruling, for federal purposes the credit shelter trust would fund with $5,250,000 and the marital trust with everything else. For federal purposes, there would be no tax due. While in Illinois, no marital deduction would be available and current tax of approximately $3,467,000 would be due.

Which trust pays the Illinois estate tax? The standard tax allocation language would fund the tax, both state and federal, from the marital deduction trust at the second death; the marital deduction trust would owe tax (if it was over the application credit/deduction at the time), while the credit shelter trust would remain estate tax free at both deaths. Therefore, to maximize both spousal credits, the estate tax must be payable from the marital deduction trust.

1. The Chenoweth problem. In the 1980s, estate planners began using standard partnership forms for estate planning. Essentially, individuals would form a newly formed partnership, the so-called family partnership, with family assets. Unlike a traditional partnership structure with unrelated parties, in a family partnership all partners are family members. The primary benefit of applying a traditional corporate structure was the ability to apply various traditional corporate valuation discounts to the minority interests. In other words, although economic value was still there, it disappeared for tax purposes.

The IRS attacked these discounts on various fronts. One of the primary attacks was on the underfunding of the marital deduction trust with discounted partnership units. In Chenoweth, the decedent owned 100 percent of the stock of a closely held business. The decedent left 51 percent of the stock to his wife outright, qualifying for the estate tax marital deduction. The other 49 percent was left to the decedent’s daughter. Section 2056(a) limits the marital deduction in “an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse.”

In Chenoweth, the Tax Court held that valuation for marital deduction purposes differed from valuation for estate inclusion purposes. Because the value of the asset passing to the surviving spouse did not represent the entire interest in the asset in the gross estate, a valuation discount or control premium may apply to the partial interest. Because the decedent left the majority of the shares to his wife, the Tax Court applied a control premium to the value of the stock passing to her. Conversely, because the decedent transferred a minority interest to his daughter, a valuation discount was applied to value that minority interest.

Chenoweth was part of a long line of cases and IRS decisions intended to prevent the “tax” underfunding of the marital deduction. What Chenoweth and its progeny do is offer a glimpse at the IRS’s potential position for our same-sex couple. In each of a series of cases decided during the height of litigation in the late 1990s, the IRS argued that assets at the death of the surviving spouse were undervalued and that additional estate tax should be paid after the death of the surviving spouse. As a result of the Service’s acquiescence in Mellinger and the greater emphasis on Chenoweth, practitioners should expect arguments on audit that estate tax is due after the death of the first spouse, even when there is a seemingly unlimited marital deduction.

2. Failure of marital deduction. The application of the principles of section 2056 and Chenoweth present a significant problem. The marital trust may be calculated on the premise that there is no state
May Regulations That Violate the APA Be Remanded to the IRS?

By Patrick J. Smith

Patrick J. Smith is a partner at Ivins, Phillips & Barker in Washington.

Last year in Dominion Resources Inc. v. United States, the Federal Circuit invalidated a tax regulation in part on the basis that it violated the Administrative Procedure Act’s arbitrary and capricious standard. The IRS failed to provide an explanation for the regulation at the time it was issued. It was the first time a court of appeals invalidated a tax regulation on that basis. Smith discusses a recent case comment in the Harvard Law Review contending that although many tax regulations would be vulnerable to similar challenges, large-scale invalidation would be prevented by remanding defective regulations to the issuing agency for corrective action while leaving them in effect. Smith disputes that contention, arguing that the practice of remanding without vacating would not apply to most tax litigation because of the Anti-Injunction Act.

Introduction

A recent case comment in the Harvard Law Review discusses Dominion Resources Inc. v. United States. In the case, the Court of Appeals for the Federal Circuit held invalid a provision in the interest capitalization regulations. That holding was partly based on the court’s conclusion that the provision violated the arbitrary and capricious standard in the Administrative Procedure Act (APA) as interpreted by the Supreme Court in State Farm. State Farm held that a regulation is valid only if a federal agency provides an explanation of the rationale supporting it at the time the regulation is issued. Dominion held that Treasury failed to provide that explanation in the regulation at issue and invalidated it. It bears noting that Dominion was the

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2 681 F.3d 1513 (Fed. Cir. 2012).