

# How Self-Employment Tax Applies to California RDPs and Same-Sex Couples

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## Introduction

The IRS has taken the position that in the case of California Registered Domestic Partners (RDPs) or same-sex couples, if one of the partners carries on a business, and if the income from the business constitutes community income under California law, self-employment tax must be paid by **both** partners. This represents a departure from IRC §1402(a)(5)(A), which holds that only the spouse that carries on the business is liable for self-employment tax. How did the IRS reach this position? Is it constitutional? Is it likely to change in the future?

## Background

The California Domestic Partner Rights and Responsibilities Act of 2003 ("California Act"), which became effective January 1, 2005, provided that RDPs shall have the same rights, protections and benefits, and shall be subject to the same responsibilities, obligations and duties under the law as are granted to and imposed upon spouses. The California Act, however, provided that "earned income may not be treated as community property for state income tax purposes."

On September 29, 2006, California enacted Senate Bill 1827, which repealed this language by providing that as of January 1, 2007, earned income **would** be treated as community property for state income tax purposes. Accordingly, California currently treats the earned income of RDPs as community property for both property law purposes and state income tax purposes. California also gives RDPs the right to enter into agreements identical to premarital agreements between prospective spouses.

In Chief Counsel Advice 201021050 (5/5/2010), the IRS announced that since federal law respects state law property characterizations, the federal tax treatment of community property should apply to California RDPs. Consequently, for tax years beginning after December 31, 2006, a California RDP must report one-half of the community income of the couple, whether received as compensation for personal services or as income from property, on the RDP's separate federal income tax return. The IRS also issued Letter Ruling 201021048 (5/28/2010) that reached the same conclusion. Neither of these two rulings addressed the issue of self-employment tax.

## IRC §1402(a) and its Applicability to RDPs and Same-Sex Couples

IRC §1402(a) states: "The term 'net earnings from self-employment' means the gross income derived by an individual from any trade or business **carried on by such individual**, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership **of which he is a member** . . . [emphasis added]."

This provision indicates that only the person carrying on the trade or business has net earnings from self-employment from that business, and only the person who is a partner in a partnership has self-employment income from that partnership.

IRC §1402(a)(5)(A) provides that when the income from a business is community income, the income will be treated as net earnings from self-employment "of the spouse carrying on such trade or business" except where the business is jointly operated by both spouses. IRC §1402(a)(5)(B) provides a similar rule for the distributive share of income from a partnership; such income is self-employment income of the partner and not the partner's spouse. As a result, with respect to sole proprietorships, if the net income from a trade or business is community income, self-employment tax is imposed on the spouse carrying on the trade or business. The same holds true regarding partnerships. The entire distributive share of a married partner's income from a partnership trade or business is attributable to that partner for purposes of self-employment tax even if such income is considered community income. If both spouses are partners, then any self-employment tax is allocated based on their distributive shares.

However, since RDPs aren't treated as spouses for federal income tax purposes, the IRS has taken the position that the community income rules of IRC §1402(a)(5)(A) and (B) don't apply, and therefore the community income of one RDP's business must be split with the other RDP for purposes of self-employment tax.

As a result of this position, the IRS revised Publication 555 to provide that RDPs and same sex couples in California are

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required to report community income for self-employment tax purposes the same way they do for income tax purposes, i.e., the partners must split the income 50/50.<sup>1</sup> This requires the non-earning partner to pay self-employment tax, which is contrary to the general rule that applies to married spouses.

## Is the IRS's Position Constitutional?

Before 2004, IRC §1402(a)(5) didn't use the word "spouse," but rather, it said that the net income of a business that was community income was income of the husband for purposes of self-employment tax unless the wife managed and controlled the business. The language was changed by the Social Security Protection Act of 2004 (P.L. 108-203, Act. §425) because the same language that existed in 42 U.S.C. §411(a)(5)(A) (the Social Security Act) was declared unconstitutional since it discriminated on the basis of gender.<sup>2</sup>

The word "spouse" in IRC §1402(a)(5) is defined by the 1996 Defense of Marriage Act or "DOMA" (P.L. 104-199) as "a person of the opposite sex who is a husband or wife." Neither same-sex RDPs nor same-sex couples satisfy this definition. But is this definition constitutional? In *Gill et al. v. Office of Personnel Management*,<sup>3</sup> the District Court for the District of Massachusetts ruled that this definition is unconstitutional because it violates the equal protection principles embodied in the U.S. Constitution. The government has appealed the decision to the First Circuit.

On March 2, 2011, four tax practitioners sent a memo to the IRS Chief Counsel and Commissioner (W&I Division) urging them to revise Pub. 555.<sup>4</sup> In part, they pointed out that the IRS's position in Pub. 555 creates a unique situation where a non-working person (an RDP in a community property state) is treated as having net income from self-employment, which is a position not supported by the legislative history of IRC §1402(a)(5). The IRS has not indicated that it will change its position.

## Conclusion

Given that IRC §1402(a)(5) uses the word "spouse," that DOMA excludes treatment of RDPs or same-sex couples as spouses, and that the federal government has appealed the *Gill* case to the First Circuit, it is unlikely that the IRS will change its position in Pub. 555 that both RDPs and partners in a same-sex marriage are required to treat community income from one partner's business as net earnings from self-employment. Perhaps someone will challenge the IRS's position in Tax Court or another tax-related forum sometime in the future.

## About the Authors:

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<sup>1</sup> See Publication 555, "Community Property" (Rev. Dec. 2010), p.6.

<sup>2</sup> See *Carrasco v. Secretary of Health, Education and Welfare*, 628 F.2d 624 (1st Cir. 1980); *Becker v. Harris*, 493 F.Supp. 991 (E.D. Cal. 1980); and *Hester v. Harris*, 631 F.2d 53 (5th Cir. 1980). In Rev. Rul. 82-39, 1982-1 C.B. 119, the IRS agreed to follow these decisions.

<sup>3</sup> *Gill et al. v. Office of Personnel Management*, 699 F.Supp.2d 374 (D. Mass. 2010), gov't appeal to 1st Cir. pending.

<sup>4</sup> See Memorandum from Donald H. Read, Attorney, Patricia A. Cain, Inez Mable Distinguished Professor of Law, Pan Haskins, CPA, and Karen K. Stogdill, EA (Document No. 2011-5066, Tax Analysts, Inc.).

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