SAN FRANCISCO
Daily Journal
www.dailyjournal.com
MONDAY, APRIL 15, 2013

GUEST COLUMN

DOMA and a bizarre tax bill

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On March 26 and 27, 2013, the U.S. Supreme Court heard arguments in two cases involving same-sex marriage. *Windsor v. United States* challenges the constitutionality the DOMA's definitions of "spouse" as a person of the opposite sex who is an individual's husband or wife, and "marriage" as a legal union between one man and one woman as husband and wife. DOMA effects myriad federal laws, including the Internal Revenue Code (IRC), Employee Retirement Income Security Act (ERISA), Omnibus Budget Reconciliation Act (COBRA), Family and Medical Leave Act (FMLA), Health Insurance Portability and Accountability Act of 1996 (HIPAA). *Hollingsworth v. Perry* addresses the constitutionality of California's Proposition 8 passed in 2008, that restricted "marriage" to the union of one man and one woman.

If DOMA is held unconstitutional, federal law would no longer distinguish between opposite-sex and same-sex spouses and would look to the substantive law of individual states to determine whether they recognize same-sex marriages in order to ascertain an individual's various rights and obligations. If Prop. 8 is struck down, same-sex couples could legally marry and attain all the rights, benefits and obligations of marriage now afforded opposite-sex couples. While decisions in these cases, expected in June, will have far reaching implications beyond the scope of this article, they will assuredly impact the state and federal tax reporting obligations of same-sex couples in California.

The term "spouse" appears in over 170 sections of the IRC on a wide variety of subjects, such as transfers of retirement accounts between spouses, avoidance of income, estate and gift taxes for transfers of property between spouses, allocation of mortgage interest deductions, and taxation of alimony. While the Department of Justice announced it will not enforce DOMA, and the Obama administration filed a brief in the *Windsor* case asserting DOMA's unconstitutionality, the IRS steadfastly applies DOMA's narrow definition of "spouse" by not treating same-sex couples as "spouses" entitled and obligated to the same tax filing positions as opposite-sex couples. In addition to the effects DOMA has on the estate tax question at issue in *Windsor*, one striking example of the discriminatory effects of the IRS's application of DOMA's narrow definition of "spouse" arises in the context of self-employment taxes.

Opposite-Sex Couple		Same-Sex Couple	
Spouse # 1 SE earnings	$100,000	Individual # 1 SE earnings	$100,000
Spouse # 2 wages	$15,000	Individual # 2 wages	$15,000
Amount reportable by each Spouse	$57,500	Amount reportable by each Individual	$57,500
Income taxes due from each Spouse	$16,100 (28% tax)	Income taxes due by each Individual	$16,100 (28% tax)
SE taxes due by Spouse # 1	$7,062	SE taxes due by Individual # 1	$3,531
SE taxes due by Spouse # 2	$0	SE taxes due by Individual # 2	$3,531

In 1930, the Supreme Court ruled that for income tax purposes, community income is taxed to the "owner" of the income. In a community property state like California, each spouse has a vested property right in community property, including income, equal to that of the other spouse. Practically, this means that each spouse owns half of all community property, and community income is split 50/50 for income tax purposes whenever separate returns are filed. *Poe v. Seaborn*, 282 U.S. 101 (1930). While California same-sex spouses and registered domestic partners may file joint state income tax returns, currently they are not permitted to file joint *federal* income tax returns, as they are not considered to be "spouses" under DOMA.

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Same-sex and opposite-sex couples are each obligated to report on their separate returns and pay taxes on one-half of all community income, irrespective of who actually earned the income. To this point, there is no disparity in the IRS's treatment of same and opposite-sex couples. However, a disparity arises when taking the tax computations further, specifically to the allocation of and obligation to pay self-employment taxes.

The self-employment tax is codified at IRC Sections 1401-1402. Under Section 1401, the tax is imposed on the self-employment income of an individual. Under Section 1402(b), "self employment income" is defined as the "net earnings from employment derived by an individual." Section 1402(a) defines "net earnings from employment" as "the gross income derived by an individual from any trade or business carried on by such individual." This language was intended to clarify that "self employment income" is based on income *derived by* (not *owned by*) the taxpayer from "any trade or business *carried on* by such individual." Because a nonearning person is not *carrying on* a trade or business, as to the nonearning person the earnings may be "*owned*" 50 percent by him or her for income tax purposes, but they are not earnings "*derived by*" him or her for self-employment tax purposes.

Despite the clear language of the self-employment tax provisions, the IRS has required same-sex couples not only to report one-half of the income on their separately filed returns, but has required these individuals, as distinguished from opposite-sex couples, to each also report one-half of the self-employment taxes due on their separately filed returns, even though only one member of the same-sex couple earned the income. (See chart for a demonstration of the disparate treatment of similarly situated opposite and same-sex couples who file separate federal income tax returns.)

This disparity exists because Section 1402(a)(5) provides that "gross income ... attributable to [a] trade or business shall be treated as the gross income ... of the *spouse* carrying on that trade or business." For opposite-sex couples, this results in the reporting of 100 percent of the self-employment tax by the person who earned it. A same-sex couple currently cannot rely on this provision since it contains the word "spouse"; they must report and pay one-half of the self-employment taxes on their separate returns. See DOMA, 1 U.S.C. Section 7.

This causes various unjustified results to same-sex couples. First, the nonearning same-sex individual will be required to pay taxes he or she should not otherwise owe. Second, the earning same-sex individual reports only half of the income as his or her own earnings, causing an underreporting of wage earning history for Social Security purposes, and thus possible reduction in the amount of Social Security benefits available upon retirement. Paradoxically, construing the self-employment tax provisions to require a 50/50 splitting of the self-employment tax will cause revenue loss to the government in many cases. The self-employed taxpayer at the $110,000 earnings level will pay half the social security portion of the tax, but if his or her partner is an employee already at the $110,000 salary level, the government will not recoup the tax loss by shifting half of those earnings to the employed partner. That partner will owe no additional tax because he or she is already above the social security maximum.

Striking down DOMA and Prop. 8 will result in an equalization of the reporting obligations of same and opposite-sex couples, and eliminate the absurdly disparate results present in the current state of the law. Pending the court's decisions, tax advisors should advise clients of potential ramifications of the decisions, including that past returns could be audited or should be amended and determine appropriate reporting position for current and future year's with possible explanatory disclosures.

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