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Family and Taxes

The Guide to Slashing Business Taxes with the Help of Relatives

An Exclusive Special Report from
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Tax Reform Increases the Tax Benefits of Employing Your Child

The 2018 tax reform eliminated personal exemptions for taxable years after December 31, 2017, and before January 1, 2026.[1] This makes your child worthless to you on your Form 1040.

But there is a way to get even or, perhaps, much more than even.

Let's set the stage first. For taxable years after December 31, 2017, and before January 1, 2026, the standard deduction for a single taxpayer begins at $12,550 in 2021 and increases every year for inflation.[2]

In comparison, the 2017 standard deduction for a single taxpayer was only $6,350.[3]

The greater standard deduction means that a single taxpayer such as your child can earn up to $12,550 in W-2 wages and pay not a penny in federal taxes.

As the owner of a business, you have the advantage of being able to hire your child to work in your business, and that creates tax-saving opportunities for both you and your child.

Self-Employed Businesses

The big dollar benefits of hiring your child go to the Form 1040, Schedule C taxpayer and the husband-and-wife partnership because such businesses are exempt from FICA when they employ their children who are under age 18.[4]

The parental proprietorship and partnership hiring rules also exempt wages paid to a child under the age of 21 from unemployment taxes.[5]

Keep in mind that the single-member LLC that did not elect corporate tax treatment is taxed as a sole proprietorship for federal tax purposes.

Example. You employ your 9-, 11-, and 13-year-old children to work in your proprietorship. You pay them a fair market wage for the work they perform, and that just happens to equal $12,550 per child and total $37,650 for the year.

Children's federal taxes. Zero! The $12,550 standard deduction zeroed each of the children out of federal income taxes for the year.

Your federal taxes. You claim the $37,650 W-2 wages deduction on your Schedule C, where it reduces both your income taxes and your self-employment taxes. If you are single with Schedule C income and taxable income of $120,000, you save at the 38.13 percent rate, for a total of $14,356.[6]

Of course, your tax rate is likely higher or lower than the example above, but you get the idea of how this works to your benefit. No taxes to the child and tax savings to you. Yes, you are having your cake and eating it, too.

S and C Corporations, Non-Spouse Partnerships, and Self-Employed Taxpayers with Children Age 18 and Over

When you hire the child under age 18, the Form 1040, Schedule C business and the partnership with only the child's parents are exempt from Social Security, Medicare, and federal unemployment taxes.

The S and C corporations and the non-spouse partnerships do not qualify for this benefit. They have to pay the payroll taxes on all employees—period. There is no parental benefit.

(Similarly, the self-employed individual or the spouse-only partnership with a child age 21 or over does not qualify for any employment tax breaks.)

This obviously changes the game. Let's look at the three children above and apply the payroll taxes. Here's how:

- $2,880 employer FICA taxes on the $37,650 in wages paid to the three children
- $2,880 employee FICA taxes extracted from the three children's $37,650 in wages
- $1,200 in state and federal unemployment (this could be a little higher or lower depending on the employer's experience with unemployment and the unemployment condition of the state where the business resides)

The payroll taxes above have left the pockets of either the children or the business entity. But the bottom line is that the money is now with the governments.

All is not lost, and in most cases, this actually works out pretty well.

The business does get a tax deduction for its FICA and unemployment taxes. Let's say this is your business and you operate it as an S corporation, so the net income passes to you. The tax deduction for hiring your three children is the $37,650 of wages paid, plus the $2,880 in FICA and the $1,200 in unemployment taxes, for a total of $40,530.

If you are in the 35 percent tax bracket, you save $14,186 on your $40,530 deduction.

Remember, the children pay no income taxes, although they did suffer the $2,880 in FICA taxes.

Here's the tally for the family:

Cash received from the government	$14,186
Corporate cash paid out for FICA	-$2,880

Corporate cash paid out for unemployment taxes	-$1,200
Children's cash paid out for FICA	-$2,880
Net cash benefit to the family	**$7,226**

You can see that payroll taxes take a toll, but they by no means kill the strategy. You, as the owner of this S corporation that hired the children, just put $7,226 in the pockets of the family. And you are going to do this for a number of years, so this one corporate strategy could be worth a lot of money to you.

Of course, it's unlikely that your savings will equal the calculation above. You might save more or less. Use the example above with your tax rates to calculate your exact savings.

Takeaways

If you can hire your children, the 2018 tax reform did you a big favor with the greater $12,550 standard deduction.

The biggest benefits accrue to the Form 1040, Schedule C business or the spouse-only partnership when such a business can hire the under-age-18 child of the parent (or parents, in the case of the partnership). Why? Because with such a business, both the business and the parents are exempt from FICA taxes.

But every business where the owner can employ his or her children likely produces a nice financial benefit for the family. Make sure to review the tax savings in this article to see how you can come out ahead.

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[1] IRC Section 151(d)(5).

[2] IRC Section 63(c)(7); Rev. Proc. 2020-45.

[3] Rev. Proc. 2016-55.

[4] IRC Section 3121(b)(3)(A); Reg. Section 31.3121(b)(3)-1.

[5] IRC Section 3306(c)(5).

[6] $37,650 x 38.13 percent = $14,356. To find the 38.13 percent, add the 24 percent federal income tax rate and the 14.13 percent self-employment rate. The 14.13 percent self-employment rate comes from multiplying the 15.3 percent self-employment tax rate by 93.25 percent which is the percentage actually taxed on Schedule SE of your tax return.

Five Things to Know About Employing Your Spouse

Hiring your spouse to work as an employee in your business can save you big on taxes. The savings can be particularly great if you are a sole proprietor or have a single-member LLC taxed as a sole proprietorship or as a partnership (as long as your spouse is not a partner).

But this arrangement can backfire if you don't do it the right way. Here are five key things to know about employing your spouse.

1. Pay Your Spouse Tax-Free Employee Benefits, Not Taxable Wages

You'll realize no tax savings if you put your spouse on the payroll and pay him or her cash wages.

Employee wages you pay your spouse are fully taxable. Your spouse-employee must pay federal and state income tax on wages. And you and your spouse must each pay half of the Social Security and Medicare tax on wages. As your spouse's employer, you must withhold these taxes and pay them to the IRS.

In effect, when you pay your spouse wages, you're simply moving the income from one place on your tax return to another.

Instead of wages, you should pay your spouse entirely, or mostly, with tax-free employee fringe benefits. Certain types of employee benefits, such as health insurance, are not taxable income for your spouse-employee, yet they are a deductible expense for you as your spouse's employer. This results in real tax savings.

Also, if you pay a spouse only with tax-free fringe benefits, you need not pay payroll taxes, file employment tax returns, or file a W-2 for your spouse.

Minimum Wage Question

But don't you have to pay your spouse at least the minimum wage, which must consist of cash wages?

No, you don't. In most states, the minimum wage laws don't apply when a sole proprietor business owner hires his or her spouse as an employee.[1] The same holds true for federal and state unemployment taxes.[2]

If your business is a corporation or an LLC, the minimum wage laws do apply when your business entity, not you as an individual business owner, hires your spouse.

Minimum wage laws are not enforced by the IRS.

You need not pay your spouse any cash wages in order to deduct employee fringe benefits you pay him or her. The only requirements are that your spouse is your bona fide employee and that the total compensation you pay is reasonable.[3]

For example, the owner of a day care business was allowed to deduct medical reimbursement benefits she paid her husband-employee even though she paid him no cash wages or other remuneration. She provided the Tax Court with convincing evidence that she was the sole owner of the day care business, that her husband regularly performed simple assigned tasks under her direction, and that he was paid a reasonable amount for the work.[4]

Some tax professionals want their Schedule C business owners to pay their spouse a nominal amount of wages in addition to fringe benefits—for example, $1,000 per year or $100 per month—and file a W-2. They feel having that W-2 creates additional credibility for the spousal employment.

But if your spouse is not your bona fide employee, paying such a small amount of wages won't be much help.

2. Establish a Medical Reimbursement Arrangement

Health benefits are normally the largest tax-free employee fringe benefit you can provide your spouse.

By hiring your spouse and adopting the right type of plan, you convert health insurance premiums and other medical expenses for your spouse, yourself, and your children under age 27 into fully deductible business expenses.

Deducting these health expenses as a business deduction reduces your taxable income not only for income taxes, but for Social Security and Medicare taxes as well.

If your spouse is the only employee of your business, you should establish a spousal health reimbursement arrangement, what we call a "105-HRA." This is the best possible way to pay for health expenses when you own your own business and have your spouse as your sole employee.

With only one employee, your 105-HRA is not subject to Affordable Care Act (ACA) restrictions.

Here's how it works:

- Your spouse purchases his or her own health insurance plan in their name to cover the entire family (including you). You, as the employer, reimburse your spouse for the premiums.

- You also reimburse your spouse for health expenses not covered by insurance, including deductibles, copays, and prescriptions, for your entire family. You can reimburse your spouse for virtually all deductible medical expenses.[5]

The IRS imposes no limit on the amount you can reimburse a spouse-employee with a 105-HRA. But the total amount should be reasonable for the work your spouse performs.

The entire cost of this family plan is a tax-free employee fringe benefit for your spouse.[6] Meanwhile, you (the employer) get to deduct the full amount as an ordinary business expense for an employee benefit program.

Example. Milo Shellito owned a 2,300-acre farm in Kansas and hired his wife, Sharlyn, as his sole employee to assist with all types of farm chores. Mr. Shellito established a 105-HRA and paid Mrs. Shellito $20,897 in medical expense and insurance premium reimbursements one year.

Mr. and Mrs. Shellito deducted the full amount on Schedule F (Profit or Loss from Farming) of their joint Form 1040 tax return as an ordinary business expense for an employee benefit program. This resulted in a tax savings of $6,947. The arrangement was upheld by the Tax Court.[7]

Key point. The 105-HRA creates these tax savings every year.

The spousal medical arrangement works for

- a sole proprietorship reporting on Schedule C of IRS Form 1040;
- a partnership filing IRS Form 1065;
- an LLC taxed as a sole proprietorship or partnership;
- a real estate rental business reporting on Schedule E of Form 1040; or
- a farm business reporting on Schedule F of Form 1040.

You and your spouse should sign a formal plan document, and your spouse should substantiate all reimbursed expenses.

What If I Hire More Employees?

If you have employees other than your spouse, you cannot use a 105-HRA due to restrictions imposed by the ACA. Instead, you may establish an Individual Coverage Health Reimbursement Arrangement (ICHRA) to cover your spouse and other employees.

ICHRAs are new—they began on January 1, 2020. They offer many of the same advantages as 105-HRAs. With an ICHRA, your spouse and other employees obtain their own individual health coverage or Medicare. Your spouse's plan should include you and other family members. Your employees must prove they have coverage each year.[8]

You, as the employer, set a monthly allowance of tax-free money your spouse and other employees can use to pay for their health insurance premiums and other uninsured health care expenses.

The IRS imposes no caps on the allowance—it can be as big or small as you specify. You are even allowed to discriminate among your employees and provide some classes of employees with better benefits than others. For example, you may provide larger reimbursements for full-time employees than for part-timers.[9]

The reimbursements are tax-free to the employees and tax-deductible for you, the employer.

Not for S Corporations

Neither the 105-HRA nor the ICHRA works if your business is an S corporation. When you own more than 2 percent of an S corporation, your spouse is not considered your employee and therefore cannot participate in employee health plans.[10]

3. Take Advantage of Certain Other Fringe Benefits

There are other tax-free employee fringe benefits you can provide your spouse, as follows.[11]

Education. Job-related education for your spouse-employee is deductible by you and not income to your spouse-employee.[12] (But beware of Section 127 education programs, as you'll see below.)

Life insurance. Employers may provide employees up to $50,000 in group term life insurance coverage tax-free.[13]

Working condition fringe benefits. These are expenses for items that help your spouse do his or her job. For example, you can deduct the entire cost of a smartphone your spouse uses for business purposes. Your spouse doesn't have to use the phone solely for business purposes or keep records of the business use of the smartphone.

De minimis fringe benefits. Certain types of relatively low-cost occasional employee benefits are tax-free and deductible by the employer. These include occasional meals and snacks, gifts (such as a small birthday gift), sporting event or theater tickets, and flowers or fruit for special occasions.[14]

4. Beware of Certain Tax-Free Benefits

Section 127 education plan. The law prohibits Section 127 benefits to your spouse and dependents under the 5 percent ownership test.[15]

Transportation benefits. If you and your spouse work in an outside office, you can provide him or her tax-free transportation benefits—just as you can for any rank-and-file employee.[16] For

2023, you may pay up to $300 per month for parking near your business premises or for transit passes.[17] For 2024 and future years, the IRS will adjust this amount for inflation.

But here's the ugly part. As a result of the Tax Cuts and Jobs Act, the tax-free transportation benefits to your employees are not deductible by you, the employer.[18] Because we are talking about your spouse as an employee, the transportation fringe benefit gives no net benefit to you and your spouse (it's a wash).

5. Make Sure Your Spouse Is Your Bona Fide Employee

The IRS usually attacks spouse-employee deductions for health insurance and other expenses by claiming the spouse is not a bona fide employee.

Your spouse won't magically become an employee because he or she signs an employment agreement saying he or she is one. Indeed, a written agreement can backfire if you and your spouse don't live up to its terms. You're usually better off without one.

Instead, you need to be able to prove the following.

Your spouse is not a co-owner of your business. Spouses who co-own a business are engaged in a partnership, not an employer-employee relationship. Your spouse should not share title in any business assets. You should have a separate business bank account under your sole control. And all contracts and government filings should be in your name alone.

Your spouse does real work. Your spouse must perform real work for your business, whether full or part time. The services don't have to be indispensable—only common, accepted, helpful, and appropriate for your business.

Keep track of the work your spouse performs and the related hours by having him or her fill out weekly time sheets. The time sheet should list the date, the services performed, and the time spent performing the services. The time sheet is the key to proving your spouse is a real employee.

Your spouse gets paid. Your spouse should pay all medical and other reimbursable expenses from his or her separate checking account and then submit a claim for reimbursement—ideally, each month. You then pay the reimbursement from your business account, and your spouse deposits those monies in his or her checking account.

Your spouse works under your direction and control. The IRS uses the common-law "right of control" test to determine whether your spouse, or any other worker, is your employee. You should make the management decisions, and your spouse should work under your direction and control.

Your spouse's compensation is reasonable. Your spouse's compensation (which, to achieve tax savings, will be primarily from fringe benefits) must be reasonable to be deductible.[19]

There is a strong temptation to overpay your spouse when he or she is your employee because the payments are deductible. Resist the temptation, and pay no more than similar workers earn for similar work. Furthermore, document what similar workers earn; a simple online search will reveal many sources of salary information.

Key point. Comply with state requirements for employers. Depending on your state, you may need to register as an employer and provide your spouse with workers' compensation coverage even if he or she is your only employee. In a few states, you may also have to withhold and pay premiums for state disability or family and medical leave programs.

Takeaways

Hiring your spouse can result in substantial tax savings, but only if you pay your spouse solely, or mainly, with tax-free employee fringe benefits instead of taxable wages. The IRS doesn't require you to pay your spouse any W-2 wages.

The most valuable fringe benefit you can provide your spouse-employee is reimbursement for health insurance and uninsured medical expenses. You can accomplish this through a 105-HRA plan if your spouse is your sole employee, or through an ICHRA if you have multiple employees and don't operate as an S corporation.

Tax-free employee fringe benefits are not limited to health benefits—for example, you can provide certain education, life insurance, and working condition fringe benefits.

For your spouse-employee deductions to withstand attack by the IRS, you must be able to show that your spouse is a bona fide employee. To do so, your spouse should

- use a time sheet to keep track of the work performed and submit that time sheet to you on a regular basis;
- be regularly paid a reasonable amount;
- work under your direction and control; and
- not be a co-owner of your business.

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[1] See, e.g., California Labor Code Section 3352(a).

[2] IRC Section 3306(c)(5).

[3] IRS Industry Specialization Program (ISP) Settlement Guidelines for Health Insurance Deductibility for Self-Employed Individuals (UIL No. 162.35-02), Factual issue, January 25, 2001.

[4] Peter F. Speltz v Commr., T.C. Summary Opinion 2006-25.

[5] IRC Section 213(d).

[6] IRC Section 105.

[7] Milo L. Shellito v Commr., 437 Fed. Appx. 665 (10th Cir. 2011).

[8] TD 9867, Federal Register Vol. 84, No. 119, ps. 28888–29097; Reg. Section 54.9802-4.

[9] Reg. Section 54.9802-4(d)(2).

[10] IRC Section 1372(a). IRC Section 318.

[11] See IRS Publication 15-B, "Employer's Tax Guide to Fringe Benefits," for a guide to all tax-free fringe benefits.

[12] IRC Section 132(d).

[13] IRC Section 79(a).

[14] Reg. Section 1.132-6(e)(1).

[15] IRC Section 127(b)(3).

[16] IRC Section 132(f).

[17] Rev. Proc. 2022-38.

[18] IRC Section 274(a)(4).

[19] Reg. Section 1.162-7(a).

Husband-Wife Partnerships: The Tax Angles—Part 1

When both members of a married couple participate in an unincorporated business venture, must it be treated as a husband-wife partnership for federal tax purposes? Answer: maybe, or maybe not. Figuring out the answer is important because it can have a huge impact on the couple's self-employment tax situation. Here's why.

For 2021, the first $ 142,800 of an individual's net self-employment income, including any net self-employment income from a husband-wife partnership, gets hit with the maximum 15.3 percent self-employment tax rate.

That 15.3 percent rate comprises 12.4 percent for the Social Security tax component and 2.9 percent for the Medicare tax component. At net self-employment income levels above the Social Security tax ceiling ($142,800 for 2021), the 2.9 percent Medicare tax continues to apply—and increases to 3.8 percent when the 0.9 percent additional Medicare tax kicks in.

Key Point. For a joint-filing couple, the 0.9 percent additional Medicare tax kicks in once joint net self-employment income exceeds $250,000 (assuming no wage income is also potentially subject to the 0.9 percent additional Medicare tax).[1]

So, if both you and your spouse have significant net self-employment income from a husband-wife partnership, you both may have to pay the dreaded maximum 15.3 percent self-employment tax rate on the first $ 142,800 of your respective shares of self-employment income from the partnership. That self-employment tax hit is on top of your income tax bill. Ouch!

Husband-wife partnerships must also file annual federal returns on Form 1065 along with the related Schedules K-1. As you know, partnership returns can be a pain.

For these reasons, you generally want to avoid husband-wife partnership status when possible.

Key Point. You can also have a *husband-wife LLC* that is treated as a partnership for federal tax purposes. For the rest of this article, when we talk about husband-wife partnerships, we also mean husband-wife LLCs that are treated as husband-wife partnerships for tax purposes.

Measuring the Self-Employment Tax Hit on a Husband-Wife Partnership

Say you currently operate a husband-wife business that is classified as a partnership for tax purposes. You must file an annual Form 1065 (U.S. Return of Partnership Income) for the business.

The partnership must issue separate Schedules K-1 to both you and your spouse. The Schedules K-1 allocate the partnership's annual taxable income items, deductions, and credits between the two of you.

You then file your joint Form 1040 by combining the Schedule K-1 amounts for you and your spouse and then mixing in non-business tax items (itemized deductions, personal tax credits, and so forth). No problem so far.

With the joint Form 1040, you must include a Schedule SE to calculate the self-employment tax on your share of the net self-employment income passed through to you by the partnership.

The joint return must also include a separate Schedule SE for your spouse to calculate the self-employment tax on your spouse's share of net self-employment income passed through to him or her by the partnership (LLC).

On each separate Schedule SE, the amount subject to self-employment tax equals the net self-employment income amount multiplied by the factor of 0.9235.

For 2021, each spouse owes the maximum 15.3 percent self-employment tax on the first $ 142,800 of net self-employment income after applying the 0.9235 factor. On any net self-employment income above the $ 142,800 Social Security tax ceiling, the Social Security tax component cuts out, and the self-employment tax rate drops to 2.9 percent, or 3.8 percent if the additional 0.9 percent Medicare tax on higher-income individuals applies.

Here's the rub: both you and your spouse must go through the same drill when filling out your separate Schedules SE. Unfortunately, that can produce a whopping-big self-employment tax liability, as the following example illustrates.

Example: Self-employment Tax Hit on Profitable Husband-Wife Partnership

Your husband-wife partnership will produce $250,000 of net self-employment income in 2021 (after applying the 0.9235 factor).

Assume the $250,000 is properly split 50/50 between you and your spouse ($125,000 for each). You owe $19,125 of self-employment tax (15.3 percent x $125,000), and so does your spouse, for a combined total of $38,250. Oof!

The problem with husband-wife partnership status in your situation is that the maximum 15.3 percent self-employment tax rate hits $125,000 of net self-employment income not once but twice (first on your Schedule SE and again on your spouse's separate Schedule SE).

In contrast, if you could say that your business is a sole proprietorship run only by you, only you would be on the hook for the self-employment tax.

You would pay the maximum 15.3 percent self-employment tax rate on the first $142,800 of your 2021 net self-employment income, but the self-employment tax hit would be "only" $24,957

[(15.3 percent x $ 142,800) + (2.9 percent x $107,200) = $24,957]. That's a lot better than the $38,250 self-employment tax hit if your business is classified as a 50/50 husband-wife partnership.

When Does the Husband-Wife Partnership Actually Exist for Tax Purposes?

Good question. As you can see from the preceding example, the self-employment tax can make the husband-wife partnership an expensive proposition. Of course, the IRS would love it if you have to treat it that way.

Not surprisingly, several IRS publications attempt to create the impression that involvement by both spouses in an unincorporated business activity usually creates a partnership for federal tax purposes.

IRS Publication 334 (*Tax Guide for Small Business*) says the following:[2]

If you and your spouse jointly own and operate an unincorporated business and share in the profits and losses, you are partners in a partnership, whether or not you have a formal partnership agreement.[3]

In other words, you don't have to believe that you have a husband-wife partnership to have a husband-wife partnership for tax purposes.

Similarly, IRS Publication 541 (*Partnerships*) says:[4]

If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss from the business on Form 1065.

But in many (if not most) cases, the IRS will have a tough time prevailing on the husband-wife partnership issue. Consider the following direct quote from IRS Private Letter Ruling 8742007:[5]

Whether parties have formed a joint venture is a question of fact to be determined by reference to the same principles that govern the question of whether persons have formed a partnership which is to be accorded recognition for tax purposes. Therefore, while all circumstances are to be considered, the essential question is whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise.

The following factors, none of which is conclusive, are evidence of this intent:

1. *the agreement of the parties and their conduct in executing its terms;*
2. *the contributions, if any, that each party makes to the venture;*
3. *control over the income and capital of the venture and the right to make withdrawals;*
4. *whether the parties are co-proprietors who share in net profits and who have an obligation to share losses; and*

5. *whether the business was conducted in the joint names of the parties and was represented to be a partnership.*

In many (if not most) real-life situations where both spouses have some involvement in an activity that has been treated as a sole proprietorship, or in an activity that has been operated using a disregarded single-member LLC that has been treated as a sole proprietorship for tax purposes, only some of the five factors listed in Private Letter Ruling 8742007 will be present. Therefore, in many such cases, the IRS may not succeed in making the husband-wife partnership argument.

Regardless of the presence or absence of the other factors listed above, the husband-wife partnership (LLC) argument is especially weak when (1) the spouses have no discernible partnership agreement and (2) the business has not been represented as a partnership to third parties (for example, banks and customers).

Penalty for Failure to File Partnership Returns

The penalty for failing to file a calendar-year 2021 partnership return on Form 1065 or failing to provide required information on the return is $210 per partner per month. The penalty can be assessed for a maximum of 12 months.[6]

For example, the maximum penalty for failing to file a calendar-year 2021 Form 1065 for an unincorporated husband-wife business that legitimately must be treated as a husband-wife partnership would be $5,040 ($210 x 2 x 12 = $5,040). The existence of this penalty obviously dictates in favor of filing husband-wife partnership returns in borderline situations.

Electing Qualified Joint Venture Status

The IRS allows you to make an election to avoid the requirement to file partnership returns for a husband-wife business that meets the definition of a *qualified joint venture*. While electing qualified joint venture status won't avoid the aforementioned self-employment tax issue, it at least simplifies filing your taxes.

A qualified joint venture is a trade or business venture where:

- the only members of the venture are two married individuals who file a joint Form 1040,
- both spouses materially participate in the trade or business, and
- both spouses elect to *not* be treated as a partnership.

According to the IRS, an activity that is operated as a state-law entity, such as an LLC, cannot be a qualified joint venture.

If choosing joint venture status, you make the qualified joint venture election on your joint Form 1040 by dividing all items of taxable income, gain, loss, deduction, and credit between you and your spouse in proportion to your respective percentage interests in the venture. You then file separate Schedules C (one for you and one for your spouse) for the allocated amounts.

File separate Schedules F for a farming or ranching business. File separate Schedules SE to calculate your respective self-employment tax bills, if applicable.

The IRS says that a rental real estate activity can also meet the definition of a "qualified joint venture." To make the qualified joint venture election for a rental real estate activity, file separate Schedules E for you and your spouse. Then check the qualified joint venture box on line 2 of Schedule E for each property that is part of the qualified joint venture.[7] Note that income from a rental real estate activity is not subject to self-employment tax.

Takeaways

If you and your spouse both participate in an unincorporated business activity, you may have a husband-wife partnership on your hands for tax purposes.

The main tax problem with husband-wife partnership status is exposure to much higher self-employment tax bills if the activity is quite profitable.

There are some ways to mitigate the self-employment tax problem, but that's a story for another day (Part 2).

Takeaways

Hiring your spouse can result in substantial tax savings, but only if you pay your spouse solely, or mainly, with tax-free employee fringe benefits instead of taxable wages. The IRS doesn't require you to pay your spouse any W-2 wages.

The most valuable fringe benefit you can provide your spouse-employee is reimbursement for health insurance and uninsured medical expenses. You can accomplish this through a 105-HRA plan if your spouse is your sole employee, or through an ICHRA if you have multiple employees.

Tax-free employee fringe benefits are not limited to health benefits—for example, you can provide certain education, life insurance, and working condition fringe benefits.

For your spouse-employee deductions to withstand attack by the IRS, you must be able to show that your spouse is a bona fide employee. To do so, your spouse should

- use a time sheet to keep track of the work performed and submit that time sheet to you on a regular basis;
- be regularly paid a reasonable amount;
- work under your direction and control; and
- not be a co-owner of your business.

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[1] IRC Sections 1401(b)(2); 3101(b)(2).

[2] IRS Pub. 334, Tax Guide for Small Business (2019), Dated Jan. 30, 2020, p. 3.

[3] IRS Pub. 334, Tax Guide for Small Business (2019), Dated Jan. 30, 2020, p. 3.

[4] IRS Pub. 541, Partnerships (2019), Dated Feb. 25, 2019, p. 3.

[5] Private Letter Ruling 8742007.

[6] IRC Section 6698; Rev. Proc. 2019-44.

[7] Election for Married Couples Unincorporated Businesses.

Husband-Wife Partnerships: The Tax Angles—Part 2

In Husband-Wife Partnerships: The Tax Angles—Part 1, we covered the basic tax angles affecting unincorporated husband-wife businesses that are classified as partnerships for federal tax purposes.

This article is devoted mainly to three tax strategies to reduce the brutal self-employment tax hit on a profitable husband-wife business that is currently operating as a partnership. If that is your situation, keep reading.

First, a look at the basics.

Husband-Wife Partnership Basics

Say you currently operate an unincorporated husband-wife business that is classified as a partnership for federal tax purposes.

You must file an annual Form 1065 (U.S. Return of Partnership Income) for the business.

You and your spouse each must be issued separate Schedules K-1 from the partnership. The Schedules K-1 allocate the partnership's annual taxable income items, deductions, and credits between the two of you.

You then file your joint Form 1040 by combining the Schedule K-1 amounts for you and your spouse and mixing in non-business tax items (itemized deductions, personal tax credits, and so forth). No worries so far!

Note. Your husband-wife partnership may come from your husband-wife LLC that is treated as a partnership for federal tax purposes.

The Self-Employment Tax Problem

The self-employment tax is the government's way of collecting Social Security and Medicare taxes from self-employed individuals, including spousal partners in husband-wife partnerships.

For 2021, the self-employment tax consists of the 12.4 percent Social Security tax on the first $142,800 of net self-employment income plus the 2.9 percent Medicare tax. Once your 2021 net self-employment income surpasses the $142,800 Social Security tax ceiling, the Social Security tax component of the self-employment tax cuts out.

But the 2.9 percent Medicare tax component continues before increasing to 3.8 percent—thanks to the 0.9 percent additional Medicare tax—once the combined net self-employment income of a married couple, filing a joint return, exceeds $250,000. Once the 3.8 percent Medicare tax rate (2.9 + 0.9) kicks in, it continues to hit net self-employment income up to “infinity and beyond,” as Buzz Lightyear would say. Not good!

With your joint Form 1040, you must include a Schedule SE to calculate the self-employment tax on your share of the net self-employment income passed through to you by your husband-wife partnership.

The joint return must also include a separate Schedule SE for your spouse to calculate the self-employment tax on your spouse’s share of net self-employment income passed through to him or her by the partnership.

Here’s the rub: both you and your spouse must go through the same drill when filling out your separate Schedules SE. Unfortunately, that can produce a whopping-big self-employment tax liability, as you will soon see.

To calculate your 2021 net self-employment income from your husband-wife partnership for self-employment tax purposes, multiply net self-employment income from your Schedule K-1 by a factor of 0.9235. Take the resulting number, and tax the first $142,800 at the maximum 15.3 percent self-employment tax rate (12.4 percent for the Social Security tax component plus 2.9 percent for the Medicare tax component).

Above the $142,800 Social Security tax ceiling, continue applying the 2.9 percent Medicare tax rate before increasing the rate to 3.8 percent (thanks to the 0.9 percent additional Medicare tax) once your joint net self-employment income exceeds $250,000.

After calculating your personal self-employment tax hit, go through the preceding drill all over again to calculate your spouse’s self-employment tax hit.

Bottom line. For 2021, you and your spouse each will owe the maximum 15.3 percent self-employment tax on the first $142,800 of your respective shares of net self-employment income (after applying the 0.9235 factor) from the husband-wife partnership.

Example 1. Self-employment tax hit on profitable husband-wife partnership.

For 2021, you and your spouse each have net self-employment income of $142,800 from your profitable 50/50 husband-wife partnership. The self-employment tax bill on your joint Form 1040 is a whopping $43,697 ($142,800 x 15.3 percent x 2). Oof! That hurts!

The Self-Employment Tax Problem Is Only Going to Get Worse

Because the Social Security tax ceiling goes up almost every year based on some arcane inflation-adjusting methodology, your self-employment tax problem is only going to get worse if you have a profitable husband-wife partnership.

The most recent Social Security Administration projections for the ceilings on your 2021-2028 Social Security tax are as follows.[1]

Year	Projected Social Security Tax Ceiling
2022	$149,100
2023	$155,700
2024	$162,300
2025	$168,900
2026	$175,800
2027	$183,300
2028	$191,100

Net self-employment income up to the ever-increasing amounts listed above would be taxed at the maximum 15.3 percent self-employment tax rate.

For instance, say the projection for 2028 turns out to be accurate. In that year, assume that you and your spouse each have net self-employment income of $191,100 from your 50/50 husband-wife partnership. The self-employment tax bill on your 2028 joint Form 1040 would be a mind boggling $58,477 ($191,100 x 15.3 percent x 2). Good grief! What to do? Keep reading.

Strategy No. 1: Use IRS-Approved Drill to Minimize Self-Employment Tax Hit on Husband-Wife Business in Community Property State

IRS Revenue Procedure 2002-69 stipulates that the IRS will respect your treatment of an unincorporated husband-wife business in a *community property state* as either[2]

1. a sole proprietorship operated by one of the spouses, which would include a single-member LLC treated as a sole proprietorship for tax purposes, or
2. a husband-wife partnership, which would include a husband-wife LLC treated as a husband-wife partnership.

Put another way, in a community property state, you and your spouse can choose to treat your unincorporated husband-wife business as a sole proprietorship operated by one spouse for federal tax purposes.

The IRS will never object, even when both you and your spouse are very active in the business. As you will see, this sole proprietorship treatment could save you serious money on your self-employment tax bill.[3]

Qualified Entities

The special rule under Revenue Procedure 2002-69 is limited to *qualified entities* that meet all three of the following requirements:

1. You and your spouse must own the entity as community property under the laws of a state, foreign country, or U.S. possession.
2. No person other than you and your spouse (or both) would be considered an owner of the entity for federal tax purposes.
3. You do not treat the entity as a corporation.[4]

Tax-Saving Strategy

Revenue Procedure 2002-69 also says that a change in the reporting position of a qualified entity is treated for federal tax purposes as a conversion of that entity.

That means the privilege of "converting" a qualified entity that has previously been treated as a husband-wife partnership into sole proprietorship status applies for self-employment tax purposes as well as for "regular" federal income tax purposes.

This opens a nice tax-saving strategy, as the following example illustrates.

Example 2. Self-employment tax savings from converting a husband-wife partnership to a sole proprietorship.

Pursuant to Revenue Procedure 2002-69, you and your spouse (married residents of a community property state) change the federal tax treatment of a qualified entity that you've been treating as a 50/50 husband-wife partnership.

You "convert" the qualified entity into a sole proprietorship operated by you for federal tax purposes (or into a single-member LLC treated as a sole proprietorship for federal tax purposes). You do that by filing an initial Schedule C (or E or F, if appropriate) for the conversion year. Easy!

Naturally, you must consider all the other federal tax consequences of converting.[5] You usually find no negative federal tax consequences from this conversion.

Say your husband-wife business produces 2021 net self-employment income of $250,000 (after applying the 0.9235 factor). You and your spouse have no self-employment income from other sources.

The conversion from 50/50 husband-wife partnership status into sole proprietorship status reduces your 2021 self-employment tax bill by a cool $13,293 [($125,000 × 0.153 × 2) = $38,250 before the conversion, compared with ($142,800 × 0.153) + ($107,200 × 0.029) = $24,957 after the conversion].

This is not a one-time tax-saving benefit. Similar annual self-employment tax savings (or better) can be reaped in future years if your business maintains or exceeds its current profitability.

You accomplish the conversion by liquidating the assets, if any, of your former husband-wife partnership (LLC) into the "new" post-conversion sole proprietorship (single-member LLC) considered to be operated by you.

Key point. Not having to file any more of those complicated Form 1065 partnership returns and related Schedules K-1 is the cherry on top. Just file Schedule C (or E or F, if appropriate) for your "new" proprietorship from now on.

Strategy No. 2: Convert Husband-Wife Partnership into S Corporation, and Pay Modest Salaries to Yourselves

If you and your unincorporated husband-wife business are not in a community property state, consider converting the business into S corporation status to reduce the Social Security and Medicare tax hits. Here is the drill, after first covering the necessary background.

Social Security and Medicare Taxes on S Corporation Salaries

For 2021, the first $142,800 of salary compensation paid to an S corporation employee, including one who also happens to be a shareholder, is subject to the maximum 15.3 percent FICA tax rate: 12.4 percent for the Social Security tax component and 2.9 percent for the Medicare tax component.

Above the $142,800 Social Security tax ceiling, the FICA tax rate drops to 2.9 percent because the Social Security tax component cuts out. Half of the FICA tax hit is withheld from your corporate salary. Your S corporation pays the other half.

For a married, jointly filing couple, the Medicare tax component of the FICA tax increases to 3.8 percent on combined compensation above $250,000, thanks to the 0.9 percent additional Medicare tax.

Now for the good news: S corporation taxable income passed through to shareholder-employees and S corporation distributions paid to them are not subject to the FICA tax.

Similarly, S corporation taxable income passed through to shareholder-employees and S corporation distributions paid to them are not subject to the self-employment tax.[6]

This benign tax regime places S corporations in a more favorable position than equivalent unincorporated businesses (sole proprietorships, single-member LLCs treated as sole proprietorships for federal tax purposes, partnerships, and LLCs treated as partnerships for federal tax purposes).

Tax-Saving Strategy

If you run your husband-wife business as an S corporation, you can follow the tax-smart strategy of paying modest salaries to yourself and your spouse as shareholder-employees while paying out most or all of the remaining corporate cash flow to yourselves as FICA-tax-free cash distributions. Nice!

Example 3. Husband-wife partnership converts to S corporation and pays modest salaries.

Pursuant to the preceding sage advice, you and your spouse convert your 50/50 husband-wife partnership into an S corporation. If you had left your business in husband-wife partnership status, it would have produced 2021 net self-employment income of $250,000 (after applying the 0.9235 factor), and you would have had a self-employment tax bill of $38,250 [($125,000 × 0.153 × 2) = $38,250]. Ouch!

But now you run your husband-wife business as an S corporation and pay yourself and your spouse salaries of $60,000 each. Now the FICA tax bill will be only $18,360 ($60,000 x 15.3 percent x 2 = $18,360). So, you save $19,890 in Social Security and Medicare taxes by operating as an S corporation ($18,360 versus $38,250). Nice!

Again, this is not a one-time tax-saving benefit. Similar annual Social Security and Medicare tax savings (or better) can be reaped in future years if your business maintains or exceeds its current profitability (assuming the FICA tax rules for S corporations stay the same as they are today).

Potential Negative Side Effect on Retirement Plan Contributions

Beware of the potentially unfavorable side effect of paying modest salaries to yourself and your spouse as S corporation shareholder-employees. It can result in reduced allowable deductible contributions to your tax-favored retirement plan.

For example, if your S corporation has a SEP or garden-variety corporate profit-sharing plan, the maximum annual deductible contribution to each shareholder-employee's account is limited to 25 percent of salary. The lower the salary, the lower the allowable contribution.

Thankfully, you can address this concern by setting up a 401(k) plan.

If you do that, paying modest salaries to yourselves as S corporation shareholder-employees will not preclude making relatively generous annual deductible contributions to your retirement accounts.

In Example 3 above, you could make deductible contributions of up to $34,500 to your 401(k) account for the 2021 tax year: $19,500 employee salary reduction contribution plus $15,000 deductible employer contribution (25 percent of your $60,000 salary). Ditto for your spouse.

If you are age 50 or older, you could contribute up to $41,000: $26,000 employee salary reduction contribution (including an extra $6,500 catch-up contribution because you are 50 or older) plus $15,000 deductible employer contribution. Ditto for your spouse if he or she is also age 50 or older.[7] Nice!

IRS and Courts Know About This Strategy, but It Still Works When Properly Executed

The IRS knows all about the strategy of paying modest salaries to S corporation shareholder-employees to mitigate the hits from Social Security and Medicare taxes.

The Social Security and Medicare tax savings are lost if the feds audit you and successfully claim that cash distributions paid to you and your spouse are actually disguised salary payments. Your S corporation can be assessed back FICA taxes, interest, and penalties.

While the IRS has repeatedly made noises about aggressively auditing S corporations to see if too-low salaries are being paid to shareholder-employees with resulting FICA tax understatements, nothing has actually happened so far that should strike fear in your heart.

Even so, you should be prepared to defend shareholder-employee salaries as being reasonable for the work performed (albeit good planning dictates being on the low side of the reasonable curve).

Several court decisions have addressed the subject of paying minimal salaries to S corporation shareholder-employees in order to minimize FICA taxes. While these decisions clarify that the IRS has the power to recharacterize purported cash distributions to shareholder-employees as salaries subject to FICA taxes, they are not very instructive because they involve outrageous compensation understatements.[8]

Bottom line. You are unlikely to lose a fight with the IRS on the modest salary issue if you gather evidence demonstrating that outsiders could be hired to perform the same work for amounts about equal to the stated (modest) salaries paid to you and your spouse as shareholder-employees.

Therefore, until further notice, following a "prudently aggressive" approach to setting S corporation shareholder-employee salaries for you and your spouse continues to be a good tax-saving strategy.

Other Considerations

Setting up an S corporation to reduce Social Security and Medicare taxes is no free lunch, because it triggers other tax complications.

For example, you will have to file a separate federal return for the new S corporation (on Form 1120S), and you may have to file a state return too.

Transactions between S corporations and shareholders must be carefully scrutinized for potential tax consequences. Payroll checks to shareholder-employees will have to be cut, and federal employment tax returns will have to be filed when none were due before. State-law corporation requirements, such as having board of director meetings, also must be respected. Yada, yada, yada.

You need to understand all this before converting your husband-wife partnership into an S corporation.

Strategy No. 3: Disband Husband-Wife Partnership and Hire Spouse as Employee

Consider this strategy for your existing husband-wife partnership if you are not in a community property state and you don't love the S corporation idea.

Step 1. Disband the existing husband-wife partnership or husband-wife LLC treated as a partnership for federal tax purposes, and start running the operation as a sole proprietorship operated by one spouse (or a single-member LLC treated as a sole proprietorship for federal tax purposes).[9]

Step 2. Hire the other spouse as an employee of the new proprietorship. Pay that spouse a modest cash salary out of the business checking account, and withhold 7.65 percent from the salary checks to cover the employee-spouse's share of the FICA tax. As the employer, the proprietorship must pay another 7.65 percent directly to the government to cover the employer's half of the FICA tax. However, since the employee-spouse's salary is modest, the FICA tax hit is also modest.

Step 3. Consider setting up a medical expense reimbursement plan as a fringe benefit for the employee-spouse.[10] Use the plan to cover the family's out-of-pocket medical expenses, including health insurance premiums, by making reimbursement payments to the employee-spouse out of the proprietorship's business checking account.

Deduct the plan reimbursements as a business expense on the sole proprietorship Schedule C filed with your joint Form 1040. On the employee-spouse's side of the deal, the reimbursements are free of federal income, Social Security, and Medicare taxes because the plan is considered a tax-free employee fringe benefit.[11]

Step 4. On the proprietorship's Schedule C (or E or F, if applicable), deduct the medical expense reimbursements made under the plan, the employee-spouse's cash salary, and the employer's share of the FICA tax. These deductions also reduce the proprietor's net self-employment income and thus the self-employment tax bill.

Step 5. Include only one Schedule SE—for the spouse who is treated as the proprietor—with your joint Form 1040. This minimizes the self-employment tax hit, because the maximum 15.3 percent self-employment tax rate applies to no more than $142,800 of net self-employment income (for 2021), versus up to $275,400 if your business is operated as a 50/50 husband-wife partnership.

Warning. The employee-spouse's modest cash salary plus the reimbursements from the medical expense plan must together amount to reasonable compensation for his or her work in the business.

Following this strategy should substantially reduce the total amount you pay for Social Security and Medicare taxes (via self-employment tax for the proprietor-spouse and FICA tax for the employee-spouse). Deducting the medical expense plan reimbursements on the proprietorship's Schedule C (or E or F) will reduce your federal income tax bill too.

Takeaways

Having your profitable unincorporated husband-wife business classified as a partnership for federal tax purposes can lead to alarmingly big bills for Social Security and Medicare taxes.

The good news is that you don't have to sit still for that. Choosing one of the following three strategies, as discussed in this article, will save you some serious self-employment tax money:

1. Stop filing husband-wife partnership returns, and file as a sole proprietor or a single-member LLC if you live in a community property state.
2. Convert your husband-wife partnership to an S corporation.
3. Hire your spouse as an employee.

Takeaways

Hiring your spouse can result in substantial tax savings, but only if you pay your spouse solely, or mainly, with tax-free employee fringe benefits instead of taxable wages. The IRS doesn't require you to pay your spouse any W-2 wages.

The most valuable fringe benefit you can provide your spouse-employee is reimbursement for health insurance and uninsured medical expenses. You can accomplish this through a 105-HRA plan if your spouse is your sole employee, or through an ICHRA if you have multiple employees.

Tax-free employee fringe benefits are not limited to health benefits—for example, you can provide certain education, life insurance, and working condition fringe benefits.

For your spouse-employee deductions to withstand attack by the IRS, you must be able to show that your spouse is a bona fide employee. To do so, your spouse should

- use a time sheet to keep track of the work performed and submit that time sheet to you on a regular basis;
- be regularly paid a reasonable amount;
- work under your direction and control; and
- not be a co-owner of your business.

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[1] 2019 Annual Report of the Board of Trustees of the Federal Old-Age and Survivor Insurance and Federal Disability Insurance Trust Funds, Table V.C1.

[2] Rev. Proc. 2002-69. The nine community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

[3] Alternatively, if you treat your unincorporated business as a husband-wife partnership for federal tax purposes and you file partnership returns, the IRS will not object to that treatment either. However, partnership treatment will not cut your self-employment tax bill.

[4] Under the check-the-box entity classification rules of Reg. Section 301.7701-2.

[5] See IRC Sections 731; 732; 735(b); 1223(1). In most cases, the only federal tax impact of the conversion will be ceasing to file Form 1065 and instead filing Schedule C (or E or F, if appropriate) for the "new" post-conversion sole proprietorship (single-member LLC).

[6] See Rev. Rul. 59-221; *Paul B. Ding*, 84 AFTR 2d 99-7517 (9th Cir. 1999).

[7] Notice 2020-79.

[8] For examples, see *Joseph Radtke, S.C.* (65 AFTR 2d 90-1155, 7th Cir. Wis. 1990); *Veterinary Surgical Consultants, P.C.* (93 AFTR 2d 2004-1273, 3rd Cir. 2004); and *Watson, P.C.,* (105 AFTR 2d 2010-2624, DC Southern Iowa 2010), although the stated salary in *Watson, P.C.* was a not-insubstantial $24,000. For a taxpayer victory, see *Carol Davis, d/b/a Mile High Calcium, Inc.* (74 AFTR 2d 94-5618, DC Colorado 1994), where the government's assessment of federal employment taxes was found to be arbitrary and was thrown out by the court.

[9] Even if the husband-wife partnership (LLC) owns assets and has liabilities, this step is generally a tax-free liquidation under IRC Section 731.

[10] This is a so-called Section 105 medical expense reimbursement plan.

[11] This is the tax-favored treatment for a Section 105 medical expense reimbursement plan.

Reduce Self-Employment Taxes by Renting from Your Spouse

If you are a sole proprietor, you know that the 15.3 percent self-employment tax can eat up your profits in a hurry.

You may be able to use a simple strategy to ease this tax burden.

If you own an office building or other assets, you can set up a rental arrangement with your spouse that could significantly cut your self-employment taxes.

How the Strategy Creates Cash

Suppose you operate a sole proprietorship and you earn $100,000 of net income.

You must report your income on Schedule C of your tax return, which creates a self-employment tax liability of $14,129.55.[1]

Here's how the rental strategy can help. You give the office building to your spouse, who then rents the office space back to you. To do this, you must have a valid non-tax purpose for the transaction, as we explain later.

You pay your spouse $2,000 rent each month (the fair rental value of the building), which moves $24,000 off Schedule C and onto Schedule E.

Schedule E, unlike Schedule C, does not give rise to self-employment taxes.

Thus, this strategy reduces your self-employment income by $24,000, which puts an extra $3,391.09 of cash in your pocket at the end of the year.[2]

The Legal Authority

The tax court approved this arrangement in the *Cox* case. In *Cox*, an attorney rented an office space that he co-owned with his spouse. The court granted the taxpayer his Schedule C deduction even though[3]

- the spouses filed a joint tax return and
- the strategy created a tax benefit.

The IRS directs its auditors to recognize *Cox*. However, the IRS guidance indicates that the IRS will not accept this transaction unless you can show a valid business or non-tax purpose for the transfer and leaseback of your property.[4]

Court cases also require a valid non-tax purpose for giving the property to your spouse.[5]

Why Your Spouse Plays an Important Role

You can deduct rent from Schedule C only for payments relating to property that you *do not own*. In *Cox,* the court ruled that the spouses each owned a 50 percent share of the property. Thus, Mr. Cox could deduct 50 percent of the rent payments.[6]

For you, this means you can use the rent-from-your-spouse strategy if

- you co-own property with your spouse or
- your spouse owns the property outright.

When your spouse owns 100 percent of the property, you deduct 100 percent of the rent payments and therefore increase your tax savings.

Note. There are no gift tax, estate tax, or income tax consequences when you give property to your spouse.[7] However, keep in mind that giving your spouse full ownership of your business property may have consequences outside of tax, such as in a divorce proceeding.

Community Property States

In community property states, you and your spouse each own a 50 percent share of most types of property you acquire during the marriage, regardless of whose name appears on the title.

If you live in one of the community property states, you must take extra steps to give your spouse 100 percent ownership of any asset.

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

The Right Business Purpose

What is a good business purpose for renting your office from a separate entity? Limited liability.

Many business owners put their real estate in a separate LLC for liability protection reasons. The IRS recognizes that liability protection is a common and legitimate reason to create a self-rental arrangement.[8]

Giving full ownership to your spouse requires an additional, non-tax purpose. For example, you might transfer the property to ensure that your spouse has a separate income stream, including the right to take out loans on the property and sell the property as he or she deems fit.

Planning tip. Create a document at the time of the transaction explaining your business and personal reasons for transferring your property to your spouse.

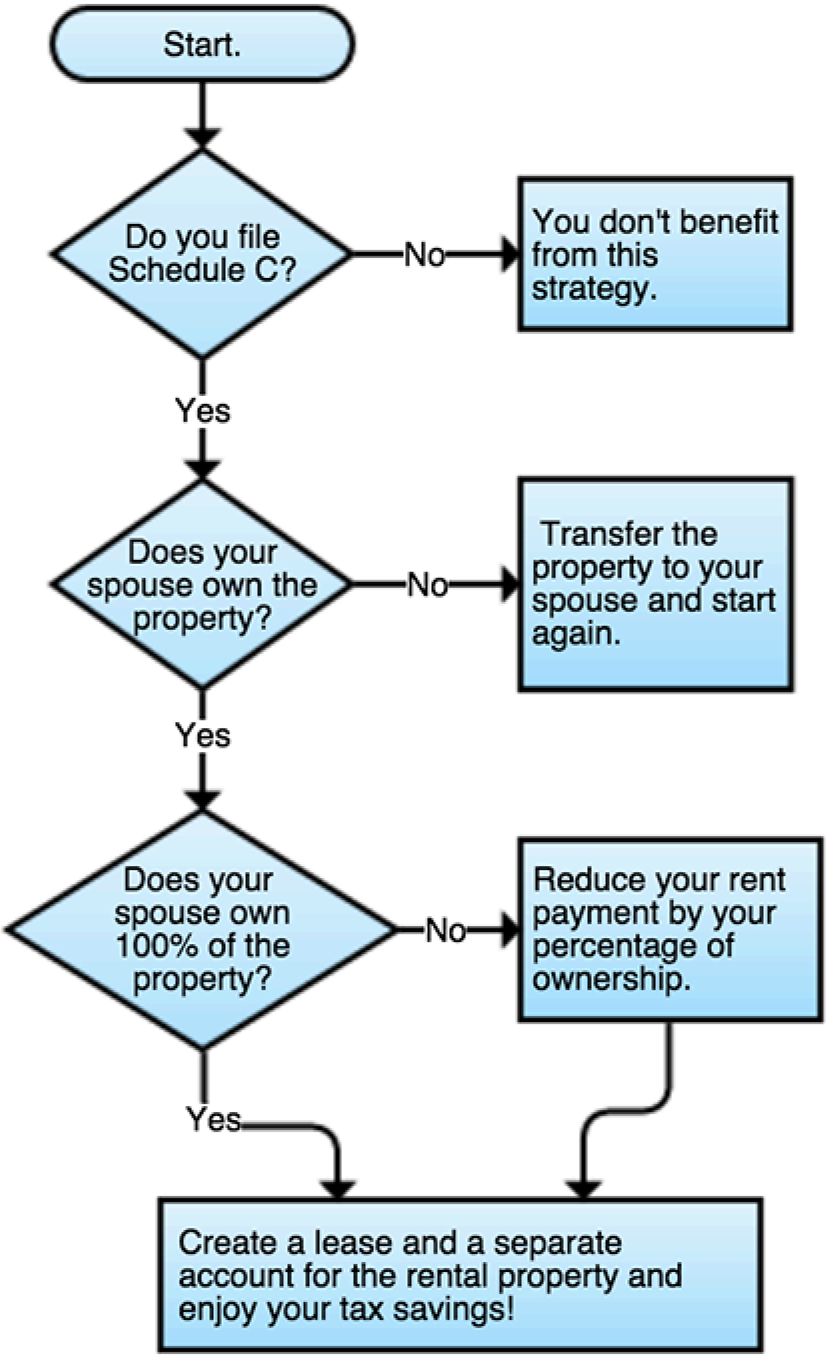
Tips to Make This Strategy Work

You have to respect all the formalities of the lease contract that you enter into with your spouse. You must treat the lease as if you were renting from an unrelated landlord, and your spouse must act as if he or she is the owner of the property.[9]

Here is a list of tips to follow:

1. Find the fair rental value of the property and pay no more or less than this amount, taking into account your ownership in the property. For example, if you own 50 percent of the property, pay your spouse 50 percent of the fair rental value.
2. Create a written lease appropriate for a commercial lease. You can find lease templates online.
3. Make actual payments to your spouse.
4. Your spouse should deposit the funds into a separate checking account for the rental property.
5. Your spouse should pay all expenses and debts relating to the property. (If you have an ownership stake in the property, you pay your share of the expenses and debts.)
6. Give your spouse a Form 1099-MISC for the rent that you paid during the year.

Flowchart



Takeaways

By renting your office space from your spouse, you generate thousands of dollars in self-employment tax savings.

The strategy works by moving income away from your Schedule C, which creates self-employment tax, and onto your joint return Schedule E, which does not.

To do this correctly, you need to remember three main rules:

1. Your spouse needs to have an ownership stake in the property. Ownership of 50 percent is good, and 100 percent is better.
2. If you transfer the property to your spouse, make a note in your records regarding the non-tax purpose of the transfer.
3. You and your spouse must treat the rental arrangement as if you are unrelated businesspeople. That means a contract, a fair rental price, and actual payment of rent.

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[1] $100,000 x 15.3 x .9235 = $14,129.55. The .9235 figure comes from Schedule SE, which gives you a small deduction when computing your self-employment tax.

[2] $24,000 x .153 x .9235 = $3,391.09. Note that the self-employment tax rate drops when you exceed $142,800 of self-employment income as a sole proprietor (in 2021, based on the current wage base). This means you get less tax savings from this strategy when your income exceeds that amount.

[3] *D. Sherman Cox*, T.C. Memo 1993-326.

[4] IRM 4.10.13.9; MSSP Training Guide, Independent Used Car Dealers, Chapter 6, Expense Issues, Rent Expense.

[5] *Finley v Commr.*, 255 F.2d 128 (CA10).

[6] In *Cox*, the two parties each owned 100 percent of the property under state law. However, for tax purposes the court treated each spouse as owning 50 percent.

[7] IRC Sections 1041; 2523.

[8] IRM 4.10.13.9.

[9] See *Finley v Commr.*, 255 F.2d 128 (CA10).

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Blueprint for Employee-Spouse 105-HRA (Health Reimbursement Arrangement)

The 105-HRA is the medical reimbursement plan you likely want to use if (a) you report your business income and expenses on Schedule C of your Form 1040 and (b) you can make your spouse your one and only eligible employee. Also, if you are single and operate your business as a C corporation, and if you are the one and only eligible employee of your C corporation, the 105-HRA is the medical reimbursement plan for you.

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