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Legal Structure to Save Taxes for Husband-and-Wife Business (Part 1 of 2)

Many married couples who start a business simply divide the work and run the business together.

They don't give much thought to how the IRS will characterize their venture for tax purposes. After all, unless they form a C corporation (which is unusual), all the business income ends up on their joint tax return anyway.

Don't make the no-planning mistake. As a married couple running a business, you have options that can lead to significant Social Security tax savings.

The first option—and the one that will likely save you the most in taxes—is to run the business as a sole proprietorship and hire your spouse as your employee.

The Arrangement

If married and you are the only person who manages and controls the business, you can operate as a proprietorship. As such, you can hire any number of employees to work in the business, including your spouse and other family members.

When you hire your spouse in the proprietorship, you deduct as business expenses the salary and benefits you pay to your employee-spouse.

One big tax-free benefit you can provide to your employee-spouse is payment of health insurance and all out-of-pocket medical costs using a Section 105 medical reimbursement plan.[1]

By covering your employee-spouse with a family-coverage Section 105, you can create business tax deductions for all medical costs incurred by

- you,
- your employee-spouse, and
- your children.

- This is a unique benefit to hiring your spouse as an employee of your proprietorship.

Think Noncash Wages

Think of the employee fringe benefits you pay your employee-spouse as noncash wages. And given how much health insurance and other medical expenses cost these days, the noncash wage can be substantial.

Indeed, you might be able to pay your employee-spouse with noncash benefits alone and not have to file a Form W-2 (at least until 2014[2]).

The IRS says that paying an employee with noncash benefits alone is permissible as long as the spouse's total compensation is reasonable.[3]

Example. Joe has a public relations business he runs as a sole proprietor. His wife, Jean, works as his employee, performing administrative tasks. Joe pays Jean no cash wages or salary. Instead, he covers her with a Section 105 medical reimbursement plan.

During the year, Joe reimburses Jean $25,000 for family medical insurance, family dental expenses, family co-pays and deductions, and expenses for over-the-counter drugs and supplies related to sickness and injury. Joe deducts the $25,000 as an employee welfare benefit on his Schedule C. Jean pays no taxes on this tax-free fringe benefit.

The ability of your proprietorship to give your employee-spouse tax-free fringe benefits is the first part of the tax savings available with planning for the husband-and-wife business.

Social Security Tax Savings

Your proprietorship tax plan can save substantial Social Security taxes if your business income exceeds the Social Security tax ceiling.

The 2012 self-employment tax rate is 13.3 percent on the first $110,100 of self-employment income and 2.9 percent on any self-employment income above that figure. The 13.3 percent rate consists of:

- 10.4 percent for Social Security tax, plus
- 2.9 percent for Medicare tax.

Once your self-employment taxable income is above the $110,100 ceiling, the 10.4 percent Social Security tax cuts out and you pay only the 2.9 percent Medicare tax.

Planning note. To find the income that's subject to the self-employment tax, take the Schedule C income and multiply it by 92.35 percent. This means that your true ceiling on the earnings subject to the maximum self-employment tax is $119,220 ($110,100 divided by 92.35 percent).

Let's say your business generates $200,000 of income that's subject to the self-employment tax (92.35 percent of your Schedule C income). If you and your spouse each have a 50 percent interest in the business, you each pay $13,300 in self-employment taxes for a total of $26,600.

On the other hand, say you have a 100 percent interest in the business and your spouse works as your employee for fringe benefits only. Now you have $200,000 in income subject to self-employment taxes of $17,250.[4]

Thus, with you as the owner and your spouse as the employee, the consolidating income strategy saves you and your spouse $9,350 a year ($26,600 minus $17,250).

Add the consolidated income strategy savings to the savings achieved with the employee-spouse Section 105 plan, and you can find a tidy sum.

Bona Fide Employee

The one catch to this arrangement is that the non-owner spouse must be a bona fide employee. This means that the owner-spouse must manage the business while the non-owner spouse works under his or her direction and control.

A spouse cannot be treated as an employee if he or she has an equal say in the affairs of the business, provides substantially equal services to the business, and contributes substantial capital to the business.

Obviously, if both spouses want to have an equal say in how the business is run, the employee classification will fail.

You and your spouse need to carefully document your employer-employee relationship. The owner-spouse should:

- Have the employee-spouse complete weekly time sheets showing hours, dates, and duties performed;
- Comply with all payroll tax, unemployment insurance, and workers' compensation requirements for the spouse-employee;
- Adopt a written medical reimbursement plan; and

- Pay medical reimbursements to the employee-spouse from the business checking account.
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The proprietor-spouse should have all business bank accounts, contracts, and government filings in the proprietor-spouse's name alone.

The employee-spouse should deposit all payments and reimbursements from the employer-spouse into the employee-spouse's separate bank account. That's choice one, and it is the best choice. Choice two is to deposit the proprietorship payments into a non-business joint account.

Reasonable Compensation

Total compensation to your employee-spouse must equal reasonable compensation. Total compensation means the sum of any salary and all the fringe benefits the employer-spouse pays the employee-spouse, including health insurance and medical expense reimbursements, if any.

You determine reasonableness by comparing the amounts paid with the value of the services performed. Either the IRS or the Social Security Administration can conclude that the employee-spouse is not a bona fide employee because the employer-spouse paid unreasonably low compensation. Should this happen, you could face a reallocation giving you half the income and your employee-spouse the other half, resulting in additional Social Security taxes.

In our example above, Joe paid his wife Jean $25,000 in medical reimbursements to work in his public relations business. If she worked 1,500 hours per year, this would come out to $16.67 per hour ($25,000 divided by 1,500 hours).

If $16.67 is much less than the average salary for such work, Joe might need to pay her more. He could provide a small salary in addition to the medical reimbursements.

Sure, the addition of the salary would cause FICA and Medicare taxes, but that would still trigger far less in taxes than if they were partners in the business.

You should document the reasonableness of your employee-spouse's compensation. There is a vast amount of salary information available on the Internet—some for free, some for a fee. Here are some examples of the type of information you can find:

- At the Economic Research Institute, you will find a massive commercial database of salary information.
  At the Society for Human Resource Management, you will find an annual compensation survey. In addition, for a fee, you can obtain compensation reports for specific positions.

- You can find local surveys for a particular city, state, or region—for example, the National Capital Human Resources Association publishes an annual survey of compensation in Washington, D.C.

No Social Security for Spouse? So What?

Paying your employee-spouse little or no cash wages likely means little or no Social Security benefits for your spouse. We say, "So what? No big deal," and here's why:

- Have you and your spouse been married for one year or more? If so, your employee-spouse qualifies for the greater of (a) his or her individual Social Security benefit or (b) an amount equal to one-half your benefit.[5]

- Alternatively, you can be divorced and, if the marriage lasted at least 10 years, receive the benefit based on the divorced spouse's earnings.[6]

When you factor in the amount of money you can earn if you invest your annual Social Security savings by paying the employee-spouse little or no wages, you will find that both you and your spouse come out far ahead by investing.

What About Limited Liability?

Sole proprietorships do have one big drawback: They offer no limited liability protection. When you own your business as a sole proprietor, you have unlimited personal liability for your business debts.

Corporations, limited liability companies (LLCs), and limited liability partnerships (LLPs) provide limited liability, which is the main reason why many business owners use them.

If liability concerns you, you can have your cake and eat it, too, by forming a single-member LLC. The single-member LLC gives you

- corporate-style liability protection, and

- proprietorship (disregarded entity) status for federal income tax purposes.

This means that, as far as federal income taxes go, tax law treats your single-member LLC as if it doesn't exist, and you continue to file your Schedule C as before.

The legal side is different from the disregarded tax side. To maintain your corporate-style limited liability protection, you need to run the business in the name of the LLC.

For payroll tax purposes, the IRS ignores your LLC on the employment of your spouse.[7]

Part 2 Next Month

You may not like the sole-proprietor-to-employee-spouse arrangement, or you and your spouse may want to co-run the business and therefore you will not fit the employee-spouse profile. Next month, we explore those problems and examine solutions.

Also in next month's article, we will share more ways to enhance your husband-and-wife business relationship, including the following:

1. What happens if you do nothing
2. What you could do if you are in a common law state
3. How to make a qualified joint venture election
4. How to make the split in ownership between husband and wife
5. What you should do if you are in a community property state
6. The tax impact of your election

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1 See the article "Roadmap for Producing a Deductible Section 105 Medical Reimbursement Plan," for a detailed discussion of medical reimbursement plans.
2 News Release 2011-31.
3 See IRS Industry Special Program Coordinated Issue, Settlement Guidelines for all industries on health insurance deductible for self-employed individuals, UIL No. 185-35-02, January 25, 2001.
4 ($110,100 x .133) + ($89,900 x .029) = $17,250
5 "Women, Marriage, and Social Security Benefits Revisited"
5 by Christopher R. Tamborini and Kevin Whitman, Social Security Bulletin, Vol. 67, No. 4, 2007.
6 I
7 See the article titled "IRS Now Says No Payroll Taxes on Family Employment in a Single-Member LLC."