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## **Husband-Wife Partnerships: The Tax Angles —Part 1**

Husbands and wives often participate together in business ventures. “What are the tax implications of an unincorporated husband-wife business activity?” you ask. Good question. Read this article for some answers.

### ***Partnership Tax Status Is Unfavorable for a Husband-Wife Business***

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 2020, the first \$137,700 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 (\$137,700 for 2020), 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).<sup>1</sup>

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 \$137,700 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 2020, each spouse owes the maximum 15.3 percent self-employment tax on the first \$137,700 of net self-employment income after applying the 0.9235 factor. On any net self-employment income above the \$137,700 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 2020 (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 \$137,700 of your 2020 net self-employment income, but the self-employment tax hit would be "only" \$24,325 [(15.3 percent x \$137,700) + (2.9 percent x \$112,300) = \$24,325]. 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:<sup>2</sup>

*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.*<sup>3</sup>

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:<sup>4</sup>

*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:<sup>5</sup>

*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 2020 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.<sup>6</sup>

For example, the maximum penalty for failing to file a calendar-year 2020 Form 1065 for an unincorporated husband-wife business that legitimately must be treated as a husband-wife partnership would be \$5,040 ( $\$210 \times 2 \times 12 = \$5,040$ ). 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.<sup>7</sup> 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).

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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.

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