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Husband-Wife Partnerships: Three Tax-Saving Strategies—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 2020, the self-employment tax consists of the 12.4 percent Social Security tax on the first $137,700 of net self-employment income plus the 2.9 percent Medicare tax. Once your 2020 net self-employment income surpasses the $137,700 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 2020 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 $137,700 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 $137,700 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 2020, you and your spouse each will owe the maximum 15.3 percent self-employment tax on the first $137,700 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 2020, you and your spouse each have net self-employment income of \$137,700 from your profitable 50/50 husband-wife partnership. The self-employment tax bill on your joint Form 1040 is a whopping \$42,136 (\$137,700 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
2021	\$142,200
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 2020 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 2020 self-employment tax bill by a cool \$13,925 [(\$125,000 × 0.153 × 2) = \$38,250 before the conversion, compared with (\$137,700 × 0.153) + (\$112,300 × 0.029) = \$24,325 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 2020, the first $137,700 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 $137,700 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 2020 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 2020 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 $137,700 of net self-employment income (for 2020), 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.

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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 2019-59.

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.